The evolution of central banking in post-communist countries

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This article looks at the development to date of central banking in the post-communist countries of central and eastern Europe, and the former Soviet Union. After outlining the state banks' previous role in a centrally planned system, it assesses the progress made in the different countries in three crucial areas: restructuring of the banking sector, reform of monetary and currency arrangements, and modernisation of payment systems. It also describes the help given by international financial institutions and established central banks—including the Bank of England—in the process of change.

Financial sector reform has proved to be one of the greatest challenges facing the former Soviet Union (FSU) and central and eastern European countries (CEECs)(2) in their transition to a market economy. Their central banks have played a vital role in this reform—mainly shaping developments, but also being shaped by them. This article looks at how those central banks have evolved. It describes first the role of the state banks under the central planning system. It then gives an overview of how far the reforms have progressed in the different countries. Finally, it describes how progress has been assisted by established central banks and international financial institutions; a separate box describes the Bank of England's involvement in these historic developments.

Problems of central banking under central planning

Under central planning, resources were allocated by the government according to centralised plans for the whole economy. For the most part, 'finance' consisted of accounting entries resulting from decisions made in pursuit of the plan. So if an enterprise had insufficient finance to allow it to meet its output targets under the plan, it was given more money by the government—either as a subsidy or as a credit. Because of this 'soft budget' environment, enterprises rarely, if ever, went bankrupt (although bankruptcy was technically possible in some countries).

There was no clear separation of the central bank from the commercial banks: instead a monobank structure operated, in which the central bank undertook a wide range of what in capitalist countries are considered commercial banking functions. The central bank did not conduct monetary policy (as it is understood in capitalist economies); rather its main role was to provide the credit necessary to the economy for the central plan to be put into effect. A number of specialist institutions (for example, agricultural banks) also provided banking services to specific sectors of the economy, channelling credit to and from them in line with the central authorities' objectives. In practice, however, these institutions were part of the centralised monobank structure. The central planning system in principle included a cash plan and a credit plan, which determined respectively the currency issue and the level of credit needed to meet output targets.

Within the centralised system, two distinct and separate financial mechanisms operated: one served the household sector, the other the enterprise and government sectors. The main institution for households was the savings bank. Households received their income and did their spending mainly in cash. Any savings could be deposited with the savings bank, and were then channelled back to the state. Households wishing to borrow, and having the necessary permission, could receive credit from the savings bank at a fixed—and typically low—rate of interest. The second mechanism served enterprise and government. The central bank and other specialist banks provided credit to enterprises and to the government in accordance with the central plan. The separation of these two mechanisms was absolute: individuals were allowed to deal only with the savings bank and enterprises only with their respective institutions. The savings banks could not lend to or take deposits from enterprises.

Interest and exchange rates played no role in credit allocation, which was determined by the central plan. Credit was provided to enterprises at fixed, low rates of interest and little consideration was given to default risk or loan maturity. The surpluses earned by enterprises were usually returned to the state as a result of very high marginal tax rates. And any surplus financial assets that enterprises held earned little interest and were in effect channelled back to the government by the banking system. The exchange rate was used mainly as an accounting device to link the domestic to the international economy. Foreign exchange purchases, imports and exports, and levels of foreign borrowing were all determined as part of the central plan, and domestic

(1) The article was written while the authors were working, respectively, in the Bank's Centre for Central Banking Studies, and Supervision and Surveillance areas.
(2) For the purposes of this article, 'central Europe' refers to Hungary, Poland, the Czech Republic and Slovenia, 'eastern Europe' to Slovakia, Albania, Romania and Bulgaria.

prices—even of internationally traded goods—bore little relation to world prices.

So the state budget, mediated by the banking system, served as the main source of both investment funds and enterprise subsidies. And credits offered by the banking sector to enterprises were in effect financial transfers between different government departments. This close relationship between the suppliers and users of capital resulted in inefficiencies in its allocation.

Progress with reforms

Creating an efficient, market-based financial sector has been an essential part of removing the state from the process of credit allocation. It has had three main elements: restructuring the banking sector, including the central bank; introducing market-orientated monetary management, including liberalising interest and exchange rates; and modernising payment systems. The changes involved have been implemented very rapidly.

Restructuring the financial sector

Reform of the financial system began with the dismantling of the monobank system, and the separation of central and commercial banks. The former central banks were restructured and their commercial banking functions removed into separate institutions. And new small private banks were encouraged to develop in order to boost competition. In most cases, the central bank was made responsible for the implementation of monetary policy, exchange rate policy and banking supervision—though not in Hungary, where a separate supervisory authority has been established—and for the creation of an efficient payment system.

The changes to central bank functions were in many cases linked with a radical transformation in structure. Generally, the aim was to reduce their size, by centralising their activities and reducing their branch networks. The central banks have also sought to attract market-orientated staff; this has meant establishing new recruitment, appraisal and promotion procedures. Training has also been given a high priority, and in a number of cases new training departments and institutes have been established, in some instances in conjunction with commercial banks.

In the CEECs, the restructuring process began in the late 1980s, initially in Hungary (in 1987) and Poland (in 1988). In many countries in the region, new legal and accounting frameworks were put in place. In Poland, some 800 branches of the central bank were converted into nine separate commercial banks. Elsewhere, central bank branches were maintained as regional ‘agencies’—primarily to collate local economic data, conduct banking supervision and operate local payment systems.

Despite the speed with which the restructuring of the financial sector was initially tackled, the sector continues to face problems—both financial and institutional. These vary from country to country. In many of the FSU countries, the former savings banks continue to dominate transactions involving the household sector, and the commercial banks remain specialised by either region or economic sector. And credit allocation remains concentrated in a few banks partly owned by the state; these continue to struggle with non-performing assets inherited from the communist regime (although in some cases the assets have been taken over by the state). In central and eastern Europe, the reforms have progressed further: in Hungary and Poland, for example, there are active and sophisticated money markets and functioning capital markets.

Table A
Extent of progress with banking sector reform in CEECs and FSU countries

Little progress (a)	Some progress (b)	Substantial progress (c)
Armenia	Albania	Croatia
Azerbaijan	Bulgaria	Czech Republic
Belarus	FYR Macedonia	Estonia
Georgia	Kyrgyzstan	Hungary
Kazakhstan	Lithuania	Latvia
Tajikistan	Moldova	Poland
Turkmenistan	Romania	Slovakia
Ukraine	Russian Federation	Slovenia
Uzbekistan		

Source: *EBRD Transition Report*, October 1994.

Notes:
(a) Little progress beyond the division of the previous monobank into central and commercial banks.
(b) Interest rates significantly influencing the allocation of credit.
(c) Substantial progress on bank recapitalisation, bank auditing and establishment of a functioning prudential supervisory system; significant presence of private banks; full interest rate liberalisation with little preferential access to cheap refinancing.

Reforming monetary management

As the financial reforms have progressed, the new central banks have often encouraged major changes in the instruments used by the authorities to conduct macroeconomic policy. First, interest and exchange rates have become major components of market reforms and key instruments in stabilisation policies. In central Europe and some of the Baltic countries, post-communist monetary policy was often very restrictive initially, as a way both of dampening inflation expectations following the liberalisation of the goods market and of establishing public confidence in the domestic currency. In eastern Europe and elsewhere in the FSU countries, the initial stance was generally more lax. Second, there have been a number of moves to reduce the extent of centrally directed credit. In Poland, for example, two laws passed in 1991 (the National Bank of Poland Act and the Banking Act) limited the provision of central bank credit to the government.

An important element in the increasing importance of monetary policy has been the movement towards using indirect tools of monetary control—primarily market-determined interest rates, refinance auctions and open-market operations (see Table B for details). Generally, the central European economies have made the most headway in this area, although progress across the whole region has been hampered to varying degrees by the initially rudimentary nature of financial markets. Indirect instruments were used first by the National Bank of Hungary in 1987, when they replaced credit ceilings. In the same

Table B
Examples of direct and indirect monetary policy instruments used by economies in transition

Type of instrument	Definition
Direct	
Credit ceilings and controls	Central bank imposes quantitative limits on, or influences the direction of, lending by commercial banks, either generally or selectively.
Administered interest rates	Interest rates fixed directly by the authorities, not by market forces.
Indirect	
Reserve requirements	Every bank required to hold obligatory reserves at central bank, calculated as percentage of the bank's loans or deposits.
Refinance auctions	Auctions at which domestic commercial banks bid for credit from the central bank. When introduced, credit frequently unsecured, but collateralisation often subsequently introduced.
Secured lending	Short-term central bank credit facilities, offered against collateral, often at a penal interest rate.
Open-market operations	
(a) Outright purchases or sales	Sales or purchases of securities by the central bank, as a means of influencing the liquidity of the banking system and short-term interest rates.
(b) Repos (sale and repurchase agreements)	Sales of securities by the market to the central bank, with agreement to repurchase them on an agreed date at an agreed price; thus similar to a short-term secured loan with the central bank providing temporary liquidity to the market.
(c) Reverse repos	Sales of securities by the central bank to the market, with an agreement to repurchase them on an agreed date at an agreed price, so temporarily withdrawing liquidity from market.
(d) Foreign exchange transactions	Spot or swap transactions by central bank with intention of influencing liquidity of money market (may also have direct influence on exchange rate).

year, reserve requirements became available to the Hungarian central bank as an instrument of monetary control, although it made little initial use of them for this purpose.

Hungary was also the first of the countries to issue Treasury bills—which it did in 1989—and to use them in open-market operations for monetary policy purposes. It was followed in 1990 by Poland—where the central bank issued bills—and by the former Czechoslovakia in 1992. Initially, because of high inflation expectations, the bills had very short maturities, sometimes of only a few weeks; but maturities have tended to lengthen as inflation has fallen. The success of the Czech reform programme has led to large capital inflows, which the authorities are trying to sterilise both by selling Czech National Bank bills and Treasury bills, and by increasing reserve requirements.

As these arrangements have developed, there have inevitably been tensions between central banks and ministries of finance. It is often in the interests of monetary policy, normally the responsibility of central banks, to keep interest rates high in order to bear down on inflation in the long term; fiscal policy considerations, on the other hand—normally the responsibility of ministries of finance—may favour keeping interest rates low to reduce the government's debt-servicing burden, and to avoid short-run costs in terms of output and unemployment.

While market operations have gradually been used more widely in central Europe—and maturity dates have lengthened—in other countries the development of effective monetary policies has been complicated by an increase in foreign currency deposits and a continuing high demand for loans despite rising interest rates. In those countries, the demand for credit has remained insensitive to its price for a variety of reasons, including the continuing monopoly power of many enterprises, incomplete price liberalisation and slow progress with the pursuit of bankruptcy proceedings. In some countries, the interest rate increases have sometimes been too small to influence the demand for credit; in others, such as Ukraine, real interest rates remained negative for some time despite official increases. As a result, the increases had little influence on borrowing.

In addition, the evolution of indirect monetary instruments has been slower in these countries. In Romania, for example, the authorities continued throughout 1991 to rely on credit controls as a tool of monetary management. They allowed bank credit to the enterprise sector to expand substantially at the end of 1991, in order to bring within the banking system the inter-enterprise arrears that had grown substantially during the year. But this expansion led to a need to tighten monetary policy sharply in early 1992 in order to combat inflation. In mid-1992, more indirect methods of monetary management were established, with the National Bank placing increasing reliance on credit auctions to influence liquidity in the banking system.

A key element in the redesign of monetary policy has been the deregulation of interest rates. Interest rate policy has been designed to address two problems: large price rises following price liberalisation, and the large monetary and debt overhang inherited from central planning. Positive real interest rates have had to be established, which has often meant sharp nominal rises; in Poland, real rates have been positive since February 1990, in Bulgaria since 1991 and in Romania since late 1993.

But it has been difficult to determine the correct level of interest rates: although positive real rates have been judged necessary to stimulate domestic currency savings and to contain inflation, too high a rate has sometimes been seen as risking higher inflation in the short term. At the same time, rates have needed to be high enough to protect balance of payments' positions, prevent large capital outflows and, in some cases, maintain the adopted exchange rate regime. And the weakness of banks' balance sheets has introduced a further consideration: higher lending rates would cause bad debts to increase.

Immediately after interest rate deregulation, the norm has been wide spreads between bank lending and deposit rates; in many countries, these persist. But spreads in central Europe are now generally smaller than those in eastern

Europe and the FSU countries, in part perhaps because of greater competition in the banking sector.

In the former Czechoslovakia, for example, in 1991 average spreads were large. Although the banks were allowed some freedom to decide rates, the central bank maintained effective control via the discount rate, a maximum lending rate and moral suasion. In 1992, however, the ceiling on interest rates was abolished; as a result, the average spread rose a little further. For a time, the size of spreads allowed the banks to strengthen their capital positions and create reserve funds to cover potential risks. But it was not sustainable indefinitely (disintermediation through alternative financial channels might eventually have occurred); and spreads subsequently started to narrow.

Independent currencies

A development among many of the reforming countries—especially the FSU countries—has been the introduction of independent currencies. They have been introduced both as symbols of newly gained sovereignty and as a way of breaking away from the high inflation endemic in the rouble zone.

The policy has been most successful in the Baltic republics, where independent currencies have been successfully introduced and inflation contained. Independent currencies alone, of course, are not sufficient for macroeconomic stabilisation; supportive monetary and fiscal policies are equally important. And in the Ukraine, for example, where the rouble was replaced by the karbovanets in 1992, inflation has been even higher than in Russia, as monetary policy has served only to support the very loose fiscal position. The experience of the transcaucasian republics—which have struggled with hyperinflation—has at times been still more difficult.

As important as the introduction of new currencies have been reforms to introduce new exchange rate regimes and to unify the various administered exchange rates. Progress with unification has varied considerably across the region. In central Europe it was achieved at the start of the reform process, whereas in Russia dual exchange rates were unified in early 1992 and in Romania in mid-1994.

In choosing the exchange rate regime, a key consideration has been whether foreign exchange reserves were sufficient to allow the official intervention that might be required if the exchange rate were either fixed or managed. IMF standby facilities—and their associated policy conditions—as well as stabilisation funds provided by industrial countries have given credibility to the exchange rate pegs introduced by a number of countries as part of their reform programmes.

Another consideration has been whether rapid inflation has become embedded. When it has, and has been accompanied by a continuous depreciation against hard currencies, it has been extremely difficult to judge what adjustment to domestic monetary policy was needed to support a particular exchange rate policy. In such circumstances, the authorities have in practice often been obliged to accept a free float with some expectation that a more actively managed rate might be possible once domestic monetary conditions were under control. Occasionally, they have retained multiple rates or strict foreign exchange controls.

The exchange rate regimes adopted in the CEECs range from a fixed rate in the former Czechoslovakia—where the crown was fixed against a basket of currencies and inflation is among the lowest in the region—to more flexible regimes in Poland and Hungary, where a crawling peg and a fixed but adjustable peg, respectively, have allowed cumulatively large, but controlled, depreciations in the exchange rate. Romania and Bulgaria have adopted essentially freely-floating rates.

Within the FSU countries, the experience of the Baltic republics has been distinct. Estonia successfully introduced a currency board in 1992, before inflation had become too seriously endemic after marshalling enough reserves to support it; Lithuania has recently followed suit. A currency board guarantees to exchange domestic currency for a specified foreign currency at fixed rate, and should always be able to do so, since it is required to hold realisable financial assets in the reserve currency at least equal to the value of the domestic monetary base. This 100% cover for the domestic currency gives great credibility to its exchange rate. Partly because of the domestic monetary stance, Latvia's currency has been stable: it is pegged to the IMF's special drawing rights (SDRs)—a basket of currencies created by the International Monetary Fund. But elsewhere in the FSU countries, exchange rates are floating, and generally depreciating continuously, as a result of the relative indiscipline of macroeconomic policy. Table C summarises

Table C
Currency arrangements in selected CEECs and FSU countries

Currency	Percentage change against US dollar in the year to:		Exchange regime at end-1994
	End-1993	End-1994	
Czech crown	-3.2%	1.0%	Fixed peg. Two-currency basket: $:DM 35%:65%.
Hungarian forint	-16.5%	-13.0%	Adjustable peg. Two-currency basket: $:DM 50%:50%.
Polish zloty	-33.1%	-23.9%	Crawling peg. Five-currency basket: $:DM:£:SwFr:FFr 45%:35%:10%:5%:5%.
Romanian leu	-146.8%	-114.6%	Free float.
Slovenian tolar	-39.2%	-14.2%	Free float.
Estonian kroon	-9.1%	. .	DM-backed currency board.
Latvian lats	29.4%	9.8% (a)	*De facto* peg to SDR.
Russian rouble	-318.9%	-113.3%	Free float.
Ukrainian karbovanets	-1,254.5%	-240.1% (a)	Free float.

. . not available.

Sources: BIS, IMF.

(a) Estimate of change to end-October. In the Ukraine, the National Bank abolished the previous official rate on 24 October 1994.

the currency arrangements in selected countries in the region.

Modernising payment systems

The modernisation of payment systems has been a difficult challenge. The systems inherited from central planning were slow and cumbersome, despite elements of automation, and have failed to cope with the increasing numbers of transactions and the demands for more rapid payment in a market economy. A slow payments mechanism can leave banks with large volumes of uncleared transactions, and makes assessments of risk and creditworthiness—which were not necessary in the pre-reform period—complex and uncertain. It is also a concern for banking supervisors. For businesses, it can create severe cash-flow problems. And more generally, it weakens the application of the hard budget constraint, which is essential if a market economy is to allocate resources efficiently.

As with other areas of reform, headway in the modernisation of payment systems varies considerably across the region. In Russia, for example, some progress has been made: it is reported that by mid-1993 the credit float—the credit trapped in a payment system as a result of the delay between posting payment entries to the accounts of payer and payee—had halved from its 1992 peak. In part, this reflects the central bank's efforts to modernise the operating procedures of its cash settlement centres. Progress has also been made in developing clearing houses, where the central bank has set up a licensing system. Much remains to be done there, however, for example to introduce technical standards, payment instruments for the retail sector and a legal framework for payment systems. Progress with reform in this area has perhaps been greatest in Poland; and the Polish experience of developing clearing arrangements is being studied by other countries in the region.

Assistance from established central banks and international financial institutions

Since the fall of communism, the reforming central banks of the CEECs and the FSU countries have made a number of requests to established central banks and international financial institutions for advice on central banking in a market economy.

A number of these institutions have responded by offering support, mainly in the form of training and technical assistance. Help is needed particularly in the core areas of central banking—assuring monetary and financial stability—but also in areas such as organisational structure and staff issues. The effectiveness of such assistance depends not only on the donor institution addressing the practical issues facing the recipient, but also on the advice and training being put to use effectively.

Multilateral assistance

The main multilateral donors have been the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development and the European Union. All have provided training and technical assistance, drawing on their own staff and the staff of established central banks, as well as other bodies. The multilateral agencies have also set up a joint training institute in Vienna—the Joint Vienna Institute.

As part of the IMF's activities, its Monetary and Exchange Affairs Department has provided technical assistance itself and has co-ordinated that given by 'co-operating' central banks. Activities for each country have usually been divided among the donor central banks. The IMF has then co-ordinated missions to agree with the recipient authorities a detailed reform programme in each area of the central bank. Once that has been done, assistance has often switched towards smaller, more focused missions, short-term visits by experts and technical assistance workshops to assist with implementation of the programmes. The IMF has also appointed resident advisers to the central banks in most of the post-communist countries.

The short-term visits by experts allow continuing advice as reforms progress. The technical assistance workshops enable problems common to a number of countries to be discussed by those responsible for tackling them. And resident advisers provide local assistance by liaising with co-operating central banks, as well as monitoring and assisting the implementation of reforms.

In addition to technical assistance, the IMF Institute in Washington has continued to provide specialised training in economic analysis and policy-making for officials, including central bankers from its new member states.

The IMF's twin institution, the World Bank, traditionally provides longer-term finance for structural and sectoral reform as well as for projects. In the post-communist countries, it has also provided technical assistance, and its Economic Development Institute (EDI) has offered training. As far as training is concerned, the IMF covers central banking and the World Bank the broader financial sector—including commercial banking.

The European Bank for Reconstruction and Development (EBRD) was set up in 1991 to foster the transition to open-market economies, and to promote private and entrepreneurial initiative in the CEECs and the FSU countries applying the principles of democracy, pluralism and market economics. As well as making loans and investments in both public and private sector bodies, the EBRD also provides technical assistance and training. In 1993, the EBRD's technical co-operation funds (which also cover training) committed ECU 85 million (roughly £64 million). The EBRD has supported the establishment of bank training institutes in Romania, Albania and Russia, and a regional bank training centre in Uzbekistan. Although the centres focus on commercial banking, there has been some central bank involvement.

The European Union has two programmes under which assistance can be provided to former communist central

Assistance from the Bank of England

For several decades, the Bank of England has been providing technical assistance and training to central banks around the world, particularly those in the Commonwealth states. It set up its Centre for Central Banking Studies (CCBS) in 1990 to give a more specific focus to this work, in response to the additional demand for assistance from central banks in eastern and central Europe and the FSU countries. Roughly 70% of its training is now focused on these countries.

In its first four years, the CCBS has trained well over 2,000 participants from over 105 countries and co-ordinated technical assistance from the Bank of England to more than 30 central banks. In its training, the Centre explains and explores the main principles and functions of central banking, drawing on international comparisons. It offers a variety of short courses and seminars designed to meet participants' requirements, and course members are able to compare the experiences of their countries. In addition to using its permanent staff, the CCBS draws on speakers from elsewhere in the Bank, from government, the UK financial sector and universities.

As well as offering courses at its London premises, the Centre runs courses and seminars abroad for central bankers from a single country or a region. In 1994, it ran courses in Bulgaria, the Czech Republic, Hungary, Macedonia, Romania, Russia, Slovenia and Ukraine among others, and also provided teachers or lecturers for courses organised in a number of other countries. Where necessary, the courses are interpreted into the participants' language.

The CCBS is largely financed by the Bank, but some of its activities are supported by the British Government's Know How Fund and the European Commission's PHARE and TACIS programmes. The Centre also co-operates in providing technical assistance and training with other organisations, including the IMF, British Invisibles and the Chartered Institute of Bankers.

As central banking in the post-communist countries has developed, the CCBS's training methods have been adapted, so that increasingly the basic instruction in central banking has been supplemented by seminars and workshops where common policy issues are discussed.

The Centre also co-ordinates the Bank's technical assistance to central banks around the world, aiming to provide experts to advise on particular subjects or projects, and to arrange assignments in the Bank.

banks. The first is PHARE, which was set up in 1989 to help the countries of central and eastern Europe rejoin the mainstream of European development and build closer political and economic ties with the European Union. In the five years of operation to 1994, PHARE made available a total of ECU 4,283 million (approximately £3,330 million) in grants to 11 partner countries. Within this, it has, for example, funded the drawing-up of a training programme for the staff of the National Bank of Poland.

The second programme—set up in 1990—is TACIS. It aims to assist the FSU states to deal with the economic and social problems of becoming democratic market economies. TACIS has provided grant finance for technical assistance, the transfer of know-how and training; a total of ECU 850 million (roughly £682 million) was committed under the programme in 1991 and 1992. Several of the new central banks receive assistance from TACIS. Together with the IMF, for example, it provides a comprehensive training programme to the Central Bank of the Russian Federation, which includes courses offered by many established central banks.

The Bank for International Settlements has also been providing training and technical assistance to the new central banks; it has staged occasional seminars and courses, and it maintains a database on the training and technical assistance being provided, in order to facilitate co-ordination.

The Joint Vienna Institute (JVI) is a co-operative venture between the BIS, EBRD, World Bank, IMF and OECD. The European Commission also played a important role in its start-up and early development, and it is supported by the government of Austria, the Austrian National Bank and several other donor countries. It provides training to help the former centrally planned economies in eastern and central Europe, the FSU countries and Asia in their transition to market-based systems. It offers a variety of courses, run by the sponsoring institutions, in economic and financial management and public administration to policy advisers, training officers and private sector executives.

Bilateral assistance

In addition to their participation in these multilateral initiatives, many established central banks provide training or technical assistance directly (while keeping others informed of their activities). They are often supported in this by their own government aid agencies or similar bodies. The Austrian National Bank and the Bank of England appear to be among the most heavily involved. Several central banks, including those two and the Swiss National Bank, have set up special training institutions or departments for international central bankers. The Swiss and Austrian institutions train both commercial and central bankers, and the Austrian Bankers College also provides language tuition. The Bank of England concentrates on training central bankers, both in London and abroad (see the box above).