



THE EASTWARD ENLARGEMENT OF THE EUROZONE

THE SHAPING OF CAPITAL MARKETS

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The Eastward Enlargement of the Eurozone

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THE EASTWARD ENLARGEMENT OF THE EUROZONE THE SHAPING OF CAPITAL MARKETS

Executive Summary

- Capital markets have undergone massive changes in the past decade; in Western Europe but of course more fundamentally in the Central and Eastern European Countries (CEEC).
- The euro has fostered the transformation of financial systems toward a more market based approach. Its impact in Eastern Europe will be even stronger.
- To ensure the success of EMU an active and open-market stance is required. The euro increases the cost of failure and thus provides a strong incentive to comply.
- Repercussion to current members will be stronger, hence, they will not allow any substantial deviation from the consensus economic policy.
- A common currency fosters capital market integration—ie, liberalisation, deregulation, and consolidation of financial services throughout the currency area. Competition increases and will lead to higher efficiency.
- More efficient financial markets improve the allocation of capital and hence contribute to long-term growth and prosperity. The main vehicle is more and better investments.
- In the short run it will be important to avoid imbalances which might destabilise the CEE applicant states
- Capital inflows to the CEEC might overshoot a sustainable level and be channelled into unprofitable investments. Eventually this money may be withdrawn all of a sudden undershooting the long-term level and depriving the applicant states of financial resources and leading to crisis.
- A prudent treatment of these flows requires a developed capital market, something the CEEC are only about to acquire. Hence, special attention should be given to the evolution of financial institutions and a sufficient regulatory framework. Applicant states should use foreign capital flows to promote capital market development—eg, in the form of foreign entry of banks.
- The adoption of the *acquis communautaire* and the Stability Pact provides a tested institutional framework and macroeconomic stability. Both support financial development.

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The shaping of capital markets

Report of Ezoneplus working package no 1

Thomas Meyer

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1 Introduction

Ten countries are about to join the European Union (EU), perhaps as early as 2004, including Malta (if public support can be restored), Cyprus (if the political/geographical problem can be tackled) and some eight central and eastern European countries (CEEC) which are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, Slovak Republic but not Romania and Bulgaria—in general both are considered not to be ripe for accession.

Shortly after, and perhaps just two years after joining the EU, these countries will adopt the euro as legal tender and will become part of the European System of Central Bank—which includes voting rights with the monetary policy of the European Central Bank. European Monetary Unification (EMU) as of 1999 has provoked a lot of academic (and not so academic) discussion on the pros and cons of a joint currency, usually starting with Mundell's optimum currency area arguments (Mundell 1961)—which eventually awarded him the Nobel prize in the very same year. The trade-off is seen between the advantages of economic integration—ie, enhanced cross-border allocation of resources which should lead to more efficiency—and the loss of flexibility in economic policy in terms of monetary autonomy and exchange-rate variations. When the benefits of integration are low; a high probability of asymmetric shocks renders the need for economic discretion very valuable, and other means of flexibility, mainly in the form of fast price adjustments, migration, or fiscal transfers, are missing, the verdict is returned against a common currency.

Apart from that rather static point of view, the notion has been pronounced that EMU itself might change some of those issues. Given that economic policy is constrained, and that flexibility might be needed, which markets are not yet providing, than that latter fact might change. Economic actors might realise, for instance, that a currency devaluation, an expansive monetary policy, or a substantial fiscal stimulus will not become available and react by creating more flexibility themselves. Markets reshape when confronted with changing constraints. Market forces might coerce public authorities to accommodate this process (cf Bolle and Neugart 2000).

Capital markets are a prominent part of the economic system and obviously strongly affected by monetary integration. Costs of cross-border transactions dwarf as currency risk (vis-à-vis the euro) vanishes and other *de jure* and *de facto* barriers to international mobility of financial flows will be eliminated. Previously segmented markets become more integrated, exposing less efficient usages of funds and starting a reallocation. The resulting process of restructuring includes a considerable amount of *creative* destruction and will leave winners and losers in both, the applicant states as well as in the current eurozone. Prospective losers might lobby against restructuring, and part of the success of enlargement will depend on how will be dealt with potential losers—ie, whether they will be ignored, compensated, or allowed to block a process that otherwise might

yield economic advantages for a majority. In that sense eastward enlargement is not Pareto-efficient, however, given that prosperity will grow, resources will be created that might suffice to compensate legitimate claims of potentially disadvantaged.

Capital markets comprise more than financial systems and foreign direct investments. They include all productive resources that are not labour, but are priced and traded in an organised way. The financial system is a key element in that respect because here pricing and trading takes place in market institutions which are explicitly set up—such as stock exchanges—or at least follow an institutionalised pattern, for instance bank financing. Evidently, the institutional framework plays an important role, in particular with regard to ensuring property rights and enforcing the rules of the game. Financial development and economic growth are increasingly perceived to be complementary (Levine, 1997). Financial institutions provide a number of important services such as trading, hedging, allocation of capital, screening, and monitoring. Financial development may even enhance the domestic savings rate (Pagano, 1993). Indeed, a strong correlation of financial and economic development has been found in influential studies such as King and Levine (1993).

This paper aims to analyse most likely effects of an eastward enlargement of the eurozone on capital markets in the CEE applicants, and to a lesser degree in the current eurozone. It is part of an international research project, ezoneplus, which is supported by the European Commission in the 5th framework programme. Other reports focus on trade and foreign direct investments, labour markets, and exchange-rate regimes, so that corresponding issues are omitted here. The division is of course delicate and overlaps might be inevitable. Moreover, previous work has explored theoretical arguments (Meyer 2001) and provided an empirical background (Meyer 2002, Vieira and Vieira 2002, Lavrac 2002, Kiander 2002, Marzo 2002). Hence, this paper sums up both strands and draws some preliminary conclusions.*

* I am indebted to Jochen Blessing, Algara Stenzel, and Felix Kaup for research assistance. Moreover I thank participants of the 50th Anniversary Conference at Tsenov Academy, Svishtov, Bulgaria; and the First Conference Amadeus at Université de Marne-La-Vallée, where previous versions of this paper were presented, for useful comments and discussions. All remaining flaws are with the responsibility of the author alone. The usual disclaimer applies.

2 Agenda ahead

2.1 EU and EMU

In Gothenburg the current members of the European Union envisaged to include the CEE applicants by 2004—albeit no binding commitment has been made. However, the most likely scenario seems to be an accession of ten applicants, including Malta and Cyprus but without Bulgaria and Romania, somewhat around 2004 or shortly after. Though it might be favourable to include only a smaller number of the most advanced countries in a first round (cf. Eichengreen and Ghironi 2001), the political cost of disappointing those who remain outside seem to be too high.

In contrast to the current EU members there will be no opt-out clause for EMU granted to future participants—ie, those who join the EU are expected to join EMU as well, as soon as the Maastricht criteria are fulfilled. One condition laid down in the Maastricht treaty requires participation in the successor of the European Exchange-Rate Mechanism (ERM), now dubbed ERM2, for a minimum period of two years without realignment. Consequently, most prospective members plan the adoption of the euro within two years after joining the EU (European Commission 2001). By then, future EMU members will not only have adopted the *acquis communautaire* and have fulfilled the Amsterdam conditions, both necessary to join the EU, but will also have complied to the Maastricht criteria and will be subject to the regulation of the Stability Pact.

The Maastricht criteria require convergence of a number of nominal variables to EU levels, such as, inflation, exchange rates, and long-term interest rates, as well as the two notorious fiscal criteria which set an upper limit for budget deficits of 3 percent of GDP and a maximum of 60 percent of GDP to total indebtedness. The Stability Pact extends the 3 percent constraint into the future and includes levies in case of non-compliance, subject to the approval of the council of EU-ministers. The *acquis communautaire* represents the sum of EU legislation and includes such juicy pieces as the common agricultural policy. With regard to financial markets and banking it includes a wealth of regulation ranging from capital account liberalisation (Capital Liberalisation Directive) to deposit insurance of at least €20k per customer (deposit protection). In many respects, these joint standards create a level playing field for financial transactions in a then enlarged eurozone which will improve market efficiency. However, the transition may prove to be painful for some CEE financial institutions, in particular the many banking directives which increase European competition and may put a strain on very small banks (cf Wagner and Iakova 2001).

Accessions to the EU and to the eurozone share a lot of commonalities. But joining the euro will add a new quality to the process of European integration for the CEE applicants, just as it did for the current members. The reason lies with the growing dependencies in the economic development of participants. Sharing a currency means sharing an inflation rate—at least to some extent. The European Central Bank (ECB) determines a common interest rate which might be too high for some countries and too low for others, given differences in the financial systems and business cycles. CEE applicants are economically small and should have only a minor impact on European inflation—in normal circumstances. A financial crisis in CEE might lead to the expectation of an ECB bail-out, moreover the national branches of the ECB may act independently as a lender of last resort and increase money supply. The accession countries will also get their say in the ECB board of directors and participate in the decision-making process and probably opt for a more convenient—ie, expansionary—monetary policy. Whether or not they will get away with it seems rather unclear. Anyhow, the worse economic conditions become in CEE the more explicit and implicit pressure will current members and the ECB feel to assist—for instance because standard tools such as exchange rate realignments or sovereign monetary policy ceased to exist. The cost of economic distress in the CEEC can be partly exported to the present eurozone which increases the incentive on both sides to prevent it in the first place.

The current euro-members have a vested interest in the stability and prosperity of the joining countries in CEE. The cost of economic failure would be magnified by the euro and part of it would be transferred to the present eurozone. In order to rule out failure, the eurozone will insist on a sound macroeconomic policy and the enforcement of the *acquis*. The detection of non-compliance, however, is a tricky task burdened with political considerations. But given the linkage created by the euro, the rigor with which *acquis* and macroeconomic austerity will be enforced (coerced) should be much stronger. For instance, chances should become slim that deviations from the *acquis*—in particular in the day-to-day application—would be tolerated for political reasons.

The commitment of the EU towards its prospective members becomes more credible with the euro and hence shapes market sentiment toward an expectation of stable and growing CEE applicants. This credibility lowers the real cost of stabilisation. A caveat might be that the current EU values stability in the CEEC higher than prosperity, relative to the applicant's preferences—ie, the EU is more risk-averse, because it might share the cost of failure rather than the fruits of strong growth. However, given the high cost of buying macroeconomic credibility without a strong anchor and the tremendous advantages of a sound institutional framework the price of staying too prudent seems rather modest.

2.2 Financial development and EMU

Since 1999, the time when the first countries joined the EMU, capital markets in the eurozone have undergone massive changes. Though it is to acknowledge that capital markets are changing anyway—due to advances in research and technology, transforming investment patterns, corporate restructuring, just to mention a few—it can be argued that the euro is strengthening and precipitating this process.

Economies of scale render integrated capital markets more efficient by two respects. First, price volatility will sink because more supply meets more demand, regional imbalances are mitigated on the European level. Reduced price volatility means less liquidity risk and thus lower cost of capital. Moreover, an integrated financial market sets a level playing field with regard to regulation and institutions, for instance in the form of the *acquis communautaire*, which lowers transaction costs. The potentially biggest advantage stems from increased competition for funds on a European level. Capital market integration, by definition, means the removal of market segmentation. The latter sometimes provides a cosy resort for less profitable investments only because outside options were missing. In a bigger market lenders may eventually find a more lucrative asset; borrowers a cheaper source of financing. Less lucrative investments and expensive financing will be driven out of the market.

Studies, such as Danthine et al. (2000), and Galati and Tsatsaronis (2001), have shown that EMU spurs the trends toward a unified capital market with the beneficiary effects described above: While market size increases, the euro-market is bigger than the sum of the previously separated national capital markets, liquidity and fundamental risk is reduced. Hardouvelis et al. (1999) estimate a reduction of 2% in the cost of capital due to the process of European integration 1992 - 1998. Moreover, the standardised expression of prices in euro and the creation of a euro-wide yield curve as a benchmark improves market efficiency (Danthine et al. 2000). Thanks to the bigger European market, the average size of bond issues has increased. With the euro's introduction average corporate bonds issue value \$400m, up from just \$200m the year before. Government issues now seem to exceed a minimum of €5bn-€20bn if they aim for a benchmark issue (cf Santillán et al. 2000).

The removal of segmentation can be exemplified with European equity markets where movements in price indices have become more and more in line. For instance the correlation of the main German index, the DAX, and the main French one, the CAC 40, has increased from .63 (1993-1996) to .83 (1997-2000). Table 2.2.1 shows the correlations for the two periods for most European stock exchanges.

Table 2.2.1**Correlation coefficients between weekly variations of stock exchange indices, 1993-1996**

	<i>PSI20</i>	<i>MADX</i>	<i>FTSE100</i>	<i>CAC40</i>	<i>DAX</i>	<i>MIB30</i>	<i>Stoxx50</i>
PSI20, Portugal	1.00						
MADX, Spain	0.34	1.00					
FTSE100, UK	0.20	0.51	1.00				
CAC40, France	0.25	0.59	0.62	1.00			
DAX, Germany	0.26	0.52	0.59	0.63	1.00		
MIB30, Italy	0.11	0.43	0.39	0.49	0.45	1.00	
DJ Euro Stoxx 50, EU	0.30	0.70	0.74	0.86	0.85	0.63	1.00

Correlation coefficients between weekly variations of stock exchange indices, 1997-2000

	<i>PSI20</i>	<i>MADX</i>	<i>FTSE100</i>	<i>CAC40</i>	<i>DAX</i>	<i>MIB30</i>	<i>Stoxx50</i>
PSI20, Portugal	1.00						
MADX, Spain	0.71	1.00					
FTSE100, UK	0.55	0.68	1.00				
CAC40, France	0.65	0.76	0.74	1.00			
DAX, Germany	0.64	0.75	0.71	0.83	1.00		
MIB30, Italy	0.62	0.76	0.62	0.75	0.72	1.00	
DJ Euro Stoxx 50, EU	0.68	0.84	0.79	0.93	0.92	0.81	1.00

Source: Banco de Portugal, Relatório do Conselho de Administração 2001

Table 2.2.1 shows increased correlations for the movements of all major European stock exchanges. The removal of market segmentation gave capital markets throughout the eurozone more clout. Financing slowly turns from a traditional bank-based system at least to some extent toward a more open-market approach. Banks still increased their business (see table 2.2.2) but changes are visible. Germany's banking system has experienced much pressure which initialised some restructuring, in particular the disentangling of banks and firms. Though convenient for many business-leaders, this structure has proved to be an obstacle in international competition and an integrating capital market makes such disadvantages more apparent. Creation of

shareholder value has become more prominent since more people own stocks and exit options—within and outside Europe—have become cheaper (cf Meyer 2002).

Table 2.2.2

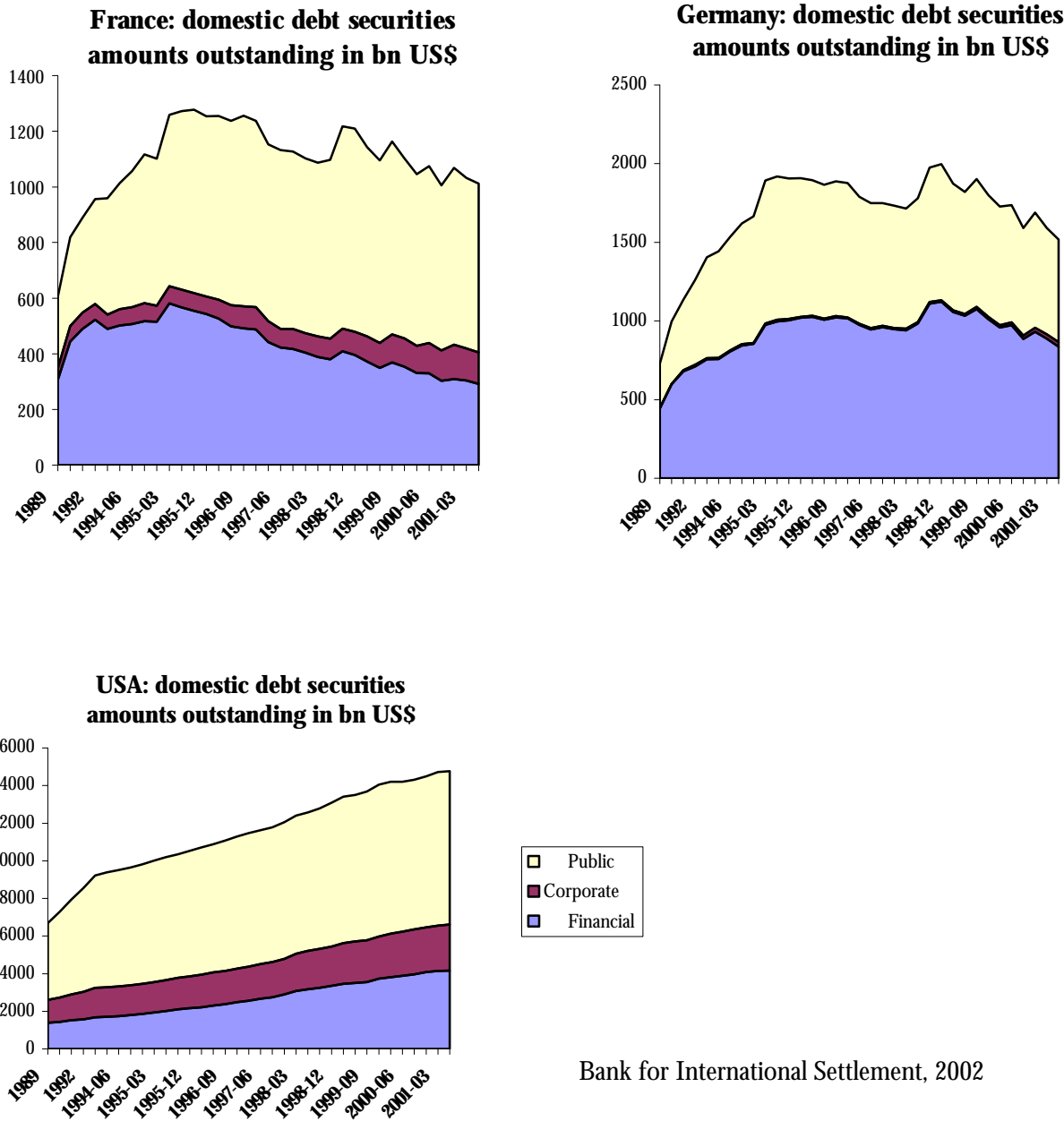
		<i>Belgium</i>	<i>France</i>	<i>Germany</i>	<i>Netherlands</i>	<i>USA</i>
Domestic credit provided by banking sector (%GDP)	1990	70,3	104,4	105,4	103,0	110,9
	1999	147,3	102,2	145,2	126,8	164,2

World Development Indicators 2001

Fixed incomes have been the biggest success in the still young euro-history. Bonds emissions have soared with the introduction of the joint currency (figure 2.2.1), though some technical considerations played a role. The subsequent decline in US\$-terms has to take into account the considerable depreciation of the euro vis-à-vis the greenback. More interesting than the amounts is the composition of the bonds markets: Corporate bonds are on the rise; in Germany their share multiplied by nearly twenty, albeit from a very small level. Corporate bonds are of particular importance because they (i) are an alternative to bank lending, and (ii) indicate the functioning of the financial system, because bonds-holders can enforce their property rights only in a stable and reliable institutional setting (cf Meyer 2002).

The euro increases international mobility of capital by (i) lowering the cost of international transactions, (ii) reducing *de facto* barriers to international operations, and (iii) helping to enforce the *de jure* liberalisation of the capital account—ie, mainly the enforcement of the *acquis communautaire*. An integrated European financial market increases the efficiency of capital allocation, which strengthens an ongoing process of restructuring in corporate and public Europe. International mergers and acquisitions are eased as financing them has become more and more possible at lower cost. Tremendous amounts of money—such as for the expensive G3 telecom-licenses—could be raised on European capital markets. Institutions and legislation is following market pressure: European stock-exchanges, though still very much a matter of national pride, are increasingly collaborating in order to realise the economies of scale so much needed in financial markets. And there is still much to make up in comparison to the biggest and most liquid trading floors in the US (see table 2.2.3). The latest sign of increased competition is the intrusion of Nasdaq into the European market with the foundation of Nasdaq Germany jointly with the stock-exchanges of Berlin and Bremen—both very small regional exchanges struggling for survival.

Figure 2.2.1



Bank for International Settlement, 2002

Differences in regulation are an often quoted impediment to capital market integration in Europe. Standards, practises, and law deviate from each other within the eurozone—and with regard to other financial centres, mainly London and the US. Particularities in domestic regulation can become a problem because they increase information costs of investors, which have to know and assess the differences, and may be rewarded by a discount on domestic asset. Hence, the current trend toward a unified regulation, respectively the attempts to explain the benefits of some particularities (“comply or explain”). The quality of institutions are an important

determinant of investment decisions. Members of the eurozone have felt the increasing pressure to modernise their financial regulation. In Germany, a new code on corporate governance has just (February 2002) been published, which is a good example. Though not a formal law, and thus no formal sanction in case of non-compliance, German firms may face a discount on the capital market if they deviate from this standard without an appropriate explanation. Hence, enforcement is given to the capital market, which may be more efficient than a public authority. Note, however, that it needed some public impulse to create the code in the first place.

Table 2.2.3: Stock markets – Key indicators 1999, 1998

Country	Market capitalisation (% GDP)	Turnover ratio (value % capitalisation)	Number of listed domestic Companies	Trading costs (basis points)		
				1998		
				Explicit	Market impact	Total
France	103,0	62,4	968	22,76	7,10	29,85
Germany	67,8	107,5	933	24,45	14,59	39,04
USA*	181,8	123,5	7651	13,36	17,53	30,89

*Trading costs refer to NYSE

World Development Indicators, 2001; Domowitz et al. 1999

3 The bright and dark side of the euro

Transition includes acquiring living standards of the Western models. The arrival of market forces in the formerly planned economies revealed the low value of the then existing capital stock. Thus the accumulation of capital in productive investments is a necessary condition to increase productivity, incomes, and prosperity. Hence, quantity and quality do matter. Capital is supplied by domestic savings—ie, waiving of consumption—and by net imports of foreign resources. Given the low capital endowment in most CEEC, investment opportunities should be aplenty—ie, the demand for capital or the real interest rates investors are willing to pay should be quite high. However, the interest rate may be not a sufficient tool to allocate funds to the most profitable investment, because very risky projects, even with a negative net present value, might be able to pay higher interest rates, but only pay in favourable conditions—if not they go bust with little or no payment to lenders. Less risky projects are more likely to have a positive net present value, but might even in good states of nature not be able to afford rocketing interest rates. Thus a prudent and sophisticated financial system is needed to distinguish between risky and less risky projects. Without such a system lenders ration credit and tightening financial condition might stall economic growth.

Financial markets in CEE share some disadvantages: They are very small, indeed; even the biggest markets in Poland, Hungary, and the Czech Republic come only close to half of the German size in terms of stock market capitalisation and provided credit. And that is in relation to GDP (see table 3.1). In absolute terms—which are arguably more important—these markets are minuscule which points to some severe difficulties in acquiring and channelling funds efficiently as—again—economies of scale play a crucial role. Moreover, the institutional framework has not yet levelled with mature economies, in particular with regard to the enforcement of legal and business norms. The ability of the financial system to tell good from bad investments is less developed which increases the chances of imbalances and asset-price bubbles. Foreign financial institutions consequently take over a majority of the CEE market but have to experience some resistance in terms of political and public opposition.

Countries in CEE want to gain prosperity and maintain economic and social stability at the same time. Transition may create a trade-off between these goals. A consequent open-market approach would improve long-term economic growth, however, short-term destabilisation and a strain on social cohesion might be a side-effect. With regard to capital market this dilemma can be exemplified with the rigor of capital account liberalisation. The removal of barriers to capital mobility increases in general quantity (see table 3.1.1) and quality of investments, as net capital inflows are combined with a transfer of know-how, technology and management skills. The

restructuring process from a planned economy toward markets will be fostered. However, restructuring may be painful, because production factors might not be easily transferable to new usages. This affects sunk costs in old industries—ie, now redundant machines and property—but in particular employees in these sectors, who have to burden the cost of adapting to new jobs and might lobby in favour of policies to reduce this burden. Moreover, the restructuring might reduce economic activity and increase volatility in the short-term.

The success of the eastward enlargement of the eurozone depends on the developments on several levels of the capital market. Capital account liberalisation and the prospect of monetary stability lure considerable amounts of money into the applicant states. The sustainability of these flows depends on the quality of investments chosen, which in turns depends on the allocation abilities of the financial system. Apart from the intrusion of foreign intermediaries, institutions play a crucial role, especially the guarantee of long-term property rights, including a sufficient corporate governance. Deficits on one of these levels might cause instability which eventually might lead to a sudden reversal of foreign money out of CEE. Hence, the following three sections cover the development on these levels.

Table 3.1: Overview—financial markets in CEE

<i>2000</i>	<i>Bulgaria</i>	<i>Czech Republic</i>	<i>Estonia</i>	<i>Hungary</i>	<i>Latvia</i>	<i>Lithuania</i>	<i>Poland</i>
Domestic credit provided by banking sector (% of GDP)	18,29	57,28	40,01	53,95	24,22	14,44	37,83
Financing from abroad (% of GDP)	-1,69	0,04	-0,06	1,53	-0,26	1,93	0,04
Foreign direct investment, net inflows (% of gross capital formation)	50,44	30,42	30,21	12,12	21,02	16,17	22,35
Inflation, consumer prices (annual %)	10,32	3,9	4,03	9,79	2,65	1,01	10,13
Interest rate spread (lending rate minus deposit rate)	8,42	3,74	3,86	2,97	7,49	8,29	5,83
Market capitalization of listed companies (% of GDP)	5,15	21,67	37,15	26,34	7,88	14,03	19,83
Short-term debt (% of total external debt)	4,21	42,34	28,78	14,12	37,58	22,95	11,18
Stocks traded, total value (% of GDP)	0,48	12,96	6,57	26,63	3,19	1,79	9,28

<i>2000</i>	<i>Romania</i>	<i>Slovak Republic</i>	<i>Slovenia</i>	<i>Germany</i>	<i>United States</i>
Domestic credit provided by banking sector (% of GDP)	14,13	59,85	47,12	147,54	161,72
Financing from abroad (% of GDP)	-----	3,17	1,73	-----	0,52
Foreign direct investment, net inflows (% of gross capital formation)	14,36	35,67	3,48	44,55	-----
Inflation, consumer prices (annual %)	45,67	12,04	10,85	1,95	3,38
Interest rate spread (lending rate minus deposit rate)	-----	6,44	5,72	6,23	-----
Market capitalization of listed companies (% of GDP)	2,91	3,88	14,05	67,82	153,54
Short-term debt (% of total external debt)	3,53	12,24	-----	-----	-----
Stocks traded, total value (% of GDP)	0,64	4,68	2,56	57,08	323,89

World Development Indicators 2002

3.1 Capital flows vs destabilisation

All transition countries, except Bulgaria, in central and eastern Europe, which have applied for EU membership run investment quotas higher than in most mature economies. And all of them import considerable amounts of foreign capital:

Table 3.1.1: Key figures 1998/1999

	<i>Investment rate</i>	<i>Current account deficit</i>
	<i>In percent GDP</i>	
Bulgaria	16,4	5,5
Czech Republic	32,6	3,5
Estonia	25,4	6,9
Hungary	23,2	3,4
Latvia	20,1	9,9
Lithuania	22,5	6
Poland	25,3	7,1
Romania	20,2	4,9
Slovenia	26,9	2,6
Slovak Republic	40,8	3,3

EBRD (2000)

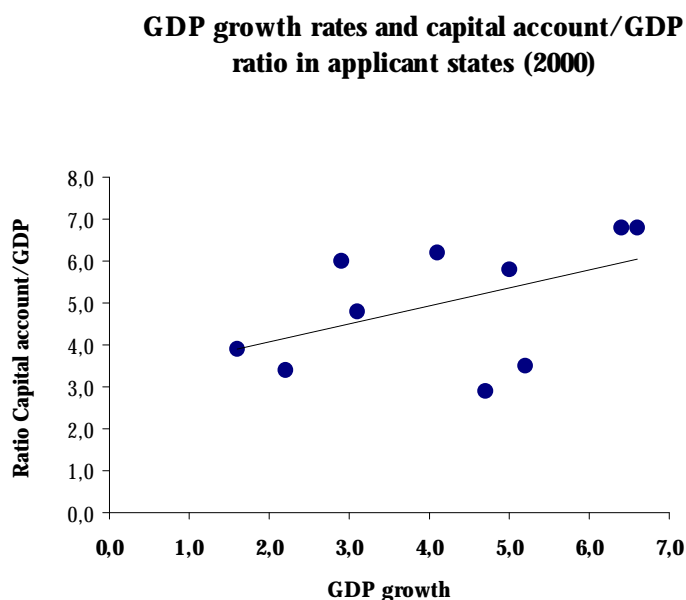
In principle this is a benign situation: Considerable investments quotas, most of them higher than the usual 20 percent prevalent in Western Europe, can be financed without sacrificing private consumption. However, what happens if for whatever reason these flows do not sustain? A sudden reversal of capital flows may trigger financial and currency crises as seen in Mexico 1994, East Asia 1997, or Argentine 2002 for that matter.

A wealth of literature has described the detrimental effects of a sudden outflow of capital. The financial system, and in particular the banking industry, is the vulnerable part. A common argument goes like this: The loss of foreign capital deprives local banks of financial resources and exposes their currency and maturity mismatch. Banks react by reducing credit, thereby worsening the financial conditions of the private sector. A credit crunch translates into shrinking profits and rising numbers of company failures, which in turn worsen banks' assets again. Either by depreciating loan values (non performing loans) or collapsing values of private sector investments such as shareholdings. The mechanism reinforces itself and may lead to a vicious cycle and to financial crisis (cf Mishkin 1998).

The magnitude of this threat is determined by the probability of a turnaround of flows as well as by the associated costs. A reversal of capital flows shares some commonalities with a bank run; in both cases a lack of collective action may magnify an in the first place minor cause of concern. For instance a temporary liquidity problem of a bank can lead to a bank run that deprives remaining resources and threatens the solvency (the seminal model is Diamond and Dybvig 1984, cf. Radelet and Sachs 1998). However, whole economies cannot be directly compared with banks. But international investors may be as capricious as banks' depositors, in particular when the costs of repatriating their money are low and the overall economic conditions becomes at least unclear. A typical problem is the build-up of bubbles—ie, overinvestments in certain assets that are mainly reasoned by the expectation of strong investment into this specific asset in the future. The asset itself is rather arbitrary, be it Dutch tulips or Malaysian real estate. When the bubble bursts, asset prices may not only return to the whatever fair value, but undershoot this level considerably, because investors flee the market. Without sustained funding even profitable project in the first place will eventually go bust. Hence, overreactions in both directions harm the economy. The better a financial market is developed the less likely will be an asset price bubble—though the dotcom-bubble shows that even the presumably highest developed markets are not immune. Now, overinvestment must not necessarily lead to an asset-price bubble, but anyhow it distorts the allocation abilities of the capital market and increases the probability of a sudden removal of funds.

Growth attracts foreign money—ie, those CEEC with higher growth rates experienced higher capital imports—or is it the other way round? Growth creates investment opportunities which can be met by funds from abroad. Increased investments may translate into higher growth.

Figure 3.1.1: Growth and capital account



Source: EBRD (2001)

Figure 3.1.1 illustrates the point: growth is associated with higher rates of capital import. That may create an argument for pro-cyclical capital flows—ie, growth is complemented and pushed further by foreign investment (and vice versa), whereas the other way round, a loss of either growth or foreign capital might be aggravated by an additional loss of the other.

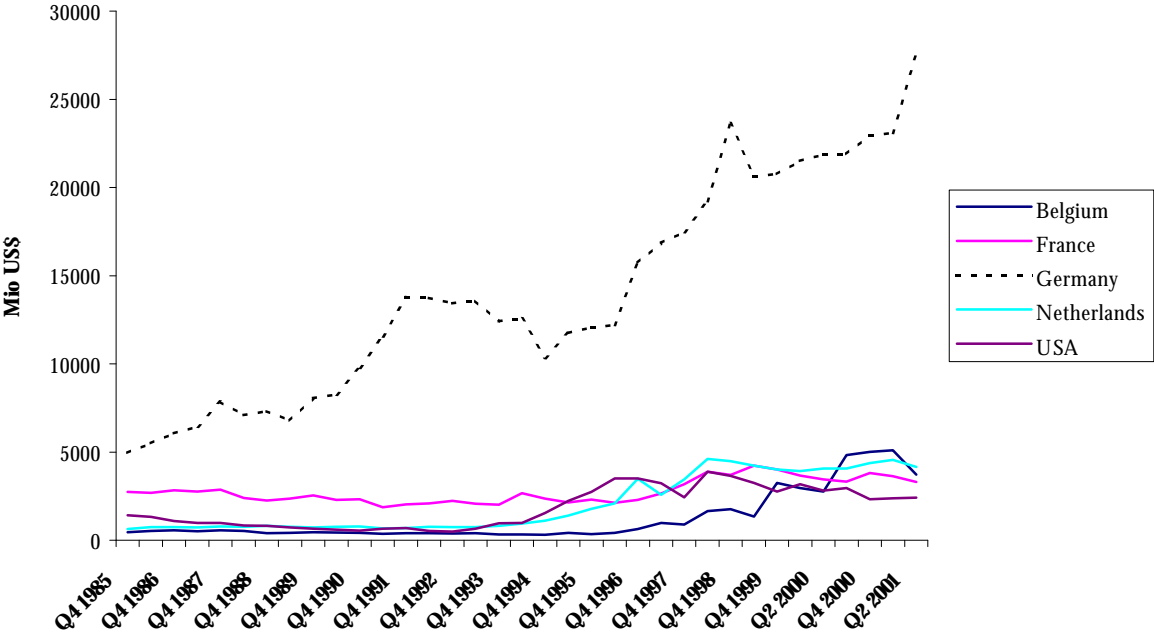
The literature on capital account comes up with a positive outlook as long as the institutional setting is sufficiently developed and macroeconomic stability is sustained (for a survey cf IMF 2001). There is a good chance that this will be the case in CEE, because liberalisation is embedded in a process of European integration, which provides the institutional framework to attach—the *acquis*—as well as macroeconomic austerity—for instance, in the form of the Stability Pact.

However, the problem must not necessarily be with the CEE applicants. Figure 3.1.2 shows that the amounts of foreign loans provided by the banking system is rather unevenly distributed—for instance German banks lend more than \$27bn, much more than French or US banks. A German

credit crunch could thus easily translate into tightening financing conditions for the CEEC initiating the process described above.

Figure 3.1.2

Consolidated International Claims of Reporting Banks to CEEC (by nationality of reporting banks)



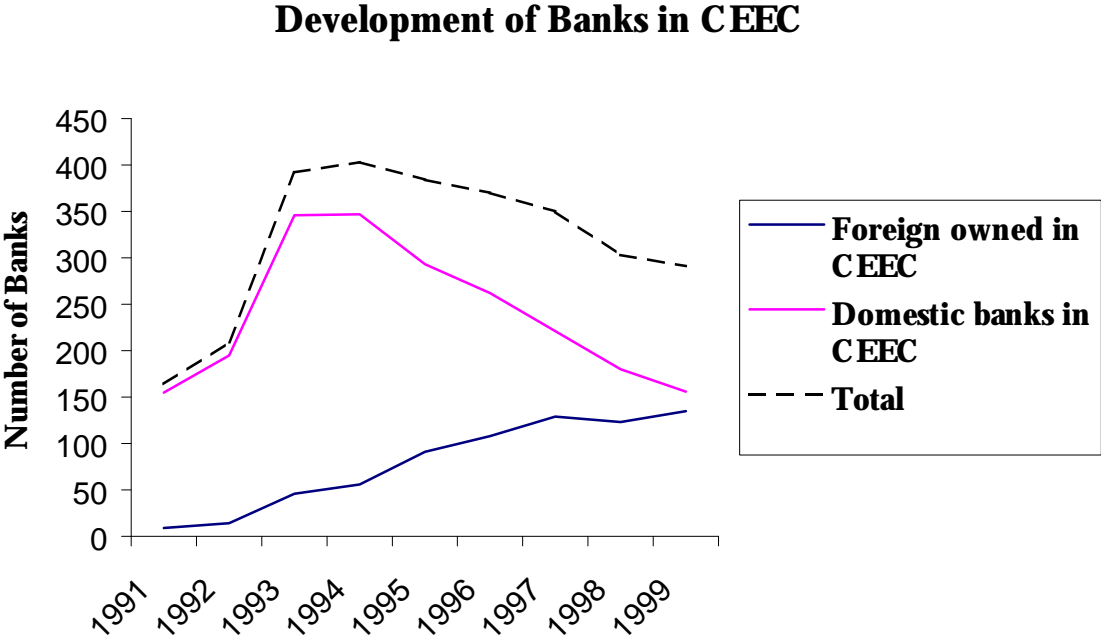
Source: BIS 2002

Capital inflows are an inevitable source for domestic investment—barring any substantial capital controls more than already in place to discourage a too strong short-term bias. To make the best out of them, the CEEC should seek to improve the allocation abilities of their financial markets. The less money is channelled into unsustainable investments the less likely (or necessary) will be financial distress or crisis. CEE applicants should welcome foreign expertise in telling apart those from profitable ones—ie, allow foreign entry (see next section). And they should be particularly careful not to create room for bubbles themselves—for instance in the form of public guarantees which might induce moral hazard.

3.2 Foreign entry vs lending discrimination

The previous part suggested that the success of the eastward enlargement of the eurozone depends strongly on the financial system’s ability to cope with increasing but volatile capital imports. The financial system itself is shaped by the stream of foreign money if only because part of it is used to acquire stakes in CEE financial institutions—ie, mainly banks.

Figure 3.2.1



EBRD (2001)

In the early 90s the total number of banks exploded in most CEEC. Planned economies have been traditionally under-banked, hence this surge may be a sign of catching-up with mature economies’ levels of financial services. However, the number of new banks might have overshoot and exceeded demand which may explain the shrinking numbers starting in 1995. On the other hand, financial sectors in most countries have consolidated as international competition grew and the realisation of economies of scale has become more and more important to guarantee survival, hence declining numbers of banks may indicate an increasing integration into an international capital market.

Foreign ownership is on the rise. Soon, every second bank in CEE will be foreign owned. However, national differences persist: Some of the CEEC showed more enthusiasm toward foreign owners, whereas others have been rather reluctant—for instance in Slovenia, one of the

advanced applicant states, only 5 out of 31 banks have foreign owners (numbers for 1999, EBRD 2000).

Foreign banks that enter emerging markets generally have lower interest rate margins and overhead expenses but higher profits than domestic banks, indicating their superior competitiveness. This improves the functioning of capital market and is supposed to have positive welfare effects, at least in the long run (Claessens et al., 2001b). Foreign banks (i) improve quality and availability of financial services by increasing bank competition and enabling greater application of modern banking skills and technology, (ii) serve to stimulate the development of bank supervisory and legal framework, and (iii) enhance a country's access to international capital (Levine, 1996). These beneficiary effects are supported by a number of studies, such as Levine (1996), Walter and Gray (1983), Goldberg and Saunders (1981), and Gelb and Sagari (1990).

If it is true that foreign financial institutions improve market efficiency then there are nevertheless a couple of associated risks to consider. First, foreigners may lack public acceptance which might prevent governments to sell financial institutions abroad. This feeling is not limited to Eastern Europe but can be found throughout the world—for instance, French authorities did not allow to let ailing *Crédit Lyonnais* fall into hands of *Deutsche*, Germany's biggest bank (The Economist 1999). Banks and financial institutions are an important feature of the economic cycle, losing control over it is seen as losing national sovereignty in that respect. Moreover, having such an integral part of the economy being taken-over by foreigners may seem as disqualifying domestic talents and capabilities which might be hard and unpleasant to accept. A similar fear can be observed with regard to the tradability of land. Real estate is a non-negligible asset as investment and arguably even more important as collateral for credit. Limiting the purchase of land is a strong impediment for investors, and all CEEC, except Estonia and Lithuania, have restriction on tradability of land for foreigners in place, either *de jure* or *de facto* (EBRD 2000). Land is burdened with emotion like banks are: Slovenians cherish their small *Adria* coastline (Lavrac 2002), and do not want to forgo it into foreign hands. Poles are more precise and especially dislike the vision of Germans buying considerable parts of the countryside. However, there are some reasons behind these arguments than just sentiment, and many flaws. The EMU of 1999 has created a European capital market, enhanced competition, and improved efficiency. Now, financial institutions play on a European level which led to considerable changes and consolidation (for a more detailed description see the background paper on Benelux, France, and Germany). The Western European financial industry has in many points advantages over their CEE counterparts, mainly their superior financial technologies and access to capital. Their disadvantage is that they are less informed about regional particularities, with regard to

governments, institutions, firms, and customers. If a very big part of the financial system is replaced by foreign players, then this specific knowledge might get lost. Small and medium sized firms (SME) seem to be mostly affected. Bank loans are usually the only access to external capital, except for private investors, but most other means such as shares and bonds are not cost efficient. Moreover, SME financing is traditionally risky, has small margins, and hence, promises only little profit. Assessing the economic and financial condition of SME requires detailed knowledge about the business environment and the firm itself; something that is often acquired only in a long-term relation between bank and customer: A relation often dubbed as arm's length lending. SME may suffer in two ways: Either domestically owned banks disappear, or competition with foreign competitors forces them out of any low profit business, which SME lending often is (cf Agénor 2001, or Stiglitz 1993). But this must not necessarily be so. International competition might render SME lending the only remaining resort for domestic banks; new banking skills and technologies might improve the profitability of SME lending and let foreign banks enter this business; by the same token, improved access to capital might turn SME lending more attractive, and so forth. Hence, some recent evidence suggests that lending conditions for SME even improve under foreign entry (cf Clarke et al. 2001a,b).

Financial markets in CEE are rather small compared to EU standards. European consolidation will create fewer but bigger financial institutions, and most of them will come from mature economies, given their superior market (and marketing) power. However, even a medium-sized player on a European level will be big enough to dominate a national market in an applicant state. If integration into a European capital market falls short of the creation of a dominant financial actor, than the result may be de facto a monopoly with the usual adverse concomitants (cf Agénor 2001). Moreover, in times of distress, foreign banks might “cut and run”—ie, retreat from the problematic market, leaving the country with an incomplete financial industry (again cf Agénor 2001). Hence, the reluctance of many CEE politicians to allow foreign banks to acquire controlling stakes in domestic financial institutions. But banks and financial markets are also often used as policy-instruments; again a phenomenon not limited to CEEC. Politicians try to keep as much control as possible—for instance in order to pursue development objectives. A domestic bank may be asked to lend to ailing firms, albeit economic sense tells otherwise, in order to save jobs or to guarantee support for the next election campaign. International firms seem less dependent, and thus, less subject to a comparable holdup. The distrust of foreign banks extends consequently to a distrust of private ownership of banks at all: In many CEEC state-owned banks still have an asset share of more than 20 to 40 percent (EBRD 2000), albeit these shares are not too scary, given that for instance half the German banking sector is public-owned.

However, the track-record of governmental intervention is rather mixed, to say the least. For instance, La Porta et al. (2002) show that countries with higher government ownership in banks usually suffer from lower growth rates. With regard to the CEEC this relation is not self-evident. Slovenia, one of the most successful applicants has an asset share of state-owned banks of more than 40 percent, but so have rather less fortunate Romania and Bulgaria (EBRD 2000).

Since the mid-90s foreign banks have gained more and more importance in the applicant states. Whatever the associated resentments, financial markets have improved during that period. Domestic credit to enterprises (in percent GDP) has increased or has been stable with figures from 10 to more than 40 percent. Only the Czech Republic observed a considerable decline from 48 to 44 percent after the 1997 currency crisis, albeit it still has the highest level (EBRD 2000). But the Czech Republic also has a high share of non-performing loans in relation to total loans with more than 30 percent, again raising after 1997, only surpassed by Romania (37 percent) and the Slovak Republic (40 percent). But the general picture is rather positive. The same holds for other indicators such as the EBRD index of banking sector reform and the EBRD index of reform of non-banking financial institutions. Foreign entry has improved market efficiency and further progress can be expected.

The question whether or not foreign ownership is welcome will not be posed, because the *acquis communautaire* does not allow any restrictions that violate the internal market, in particular the freedom of capital. Hence, it will be important to manage the financial integration and consolidation. The most important lesson might be to ensure diversity—ie, to prevent being dominated by few major players. The most viable way to do so, seems to pursue the integration into the European capital market, where huge domestic financial institution (foreign owned or not) shrink to one of many fish in a bowl.

3.3 Institutional development

Institutions do matter. Markets develop their full potential only when appropriate rules are in place which hinder or limit detrimental behaviour of market participants. Transaction costs rise when rules and framing institutions are missing, making especially those transaction unprofitable that require high institutional standards. Ordinary spot transactions, such as buying a standardised good, can be easily monitored and enforced and thus require only few institutional prerequisites. The more monitoring and enforcement become problematic, for instance because the transaction comprises deals now and in the future, the higher standards are needed or the higher transaction costs rise respectively.

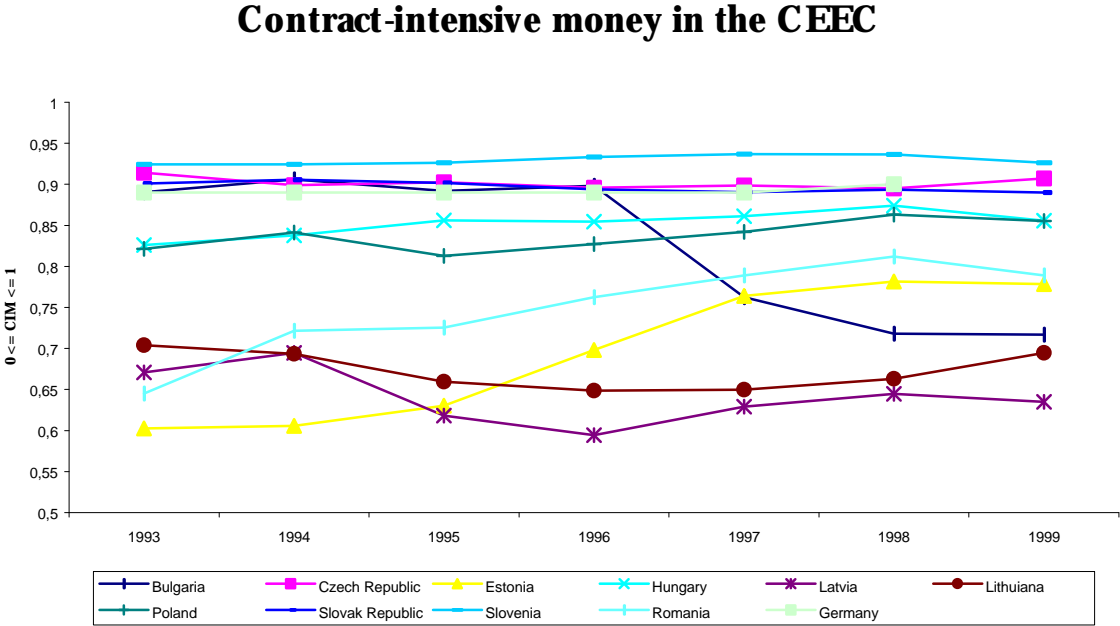
Financial transactions are among the most demanding contracts. Even common credit and loan relations have several distinct points of execution, such as the initial transfer to the debtor and the following interest and repayments. More advanced contracts do not specify the due amount but have some residual claims like stocks, where dividends are paid as a share of profit less interest. Any investment now relies on the expectation that the counter-party is willing and able to fulfil its commitment in the future. Trust is needed, and trust grows the stronger and reliable institutions are.

Capital markets basically suffer from three variants of contract problems: (i) *Ex ante*, the price might not reflect the fair value of the asset—for instance, the interest rate charged might not sufficiently reflect default risk. Moreover, a raising interest rate may drive good risks out of the market and hence worsen the pool of remaining risks with a loss in total return (cf Akerlof 1970, Stiglitz and Weiss 1981). (ii) *Ex post*, contract-parties may change their behaviour—eg, the manager of a firm which has firstly issued stocks, might turn away from value-maximisation in favour of perquisite consumption and asset-stripping. The loss in firm value is often dubbed as agency cost (cf. Berle and Means 1932, Fama 1980). (iii) Again *ex post*, contract-parties may renegotiate the terms of the deal and may get away with it, given that the other party has little outside options—ie, the deal has a high degree of specificity (cf Williamson 1985, Blanchard and Kremer 1997). Institutions have evolved to reduce the potential of (i)-(iii). There are laws and regulation that require to report truthfully and to comply with contract terms; norms and values structure behaviour that is not subject to legal action, and contract-parties may find it to be in their own interest to behave honest and trustworthy, if only to gain reputation and other favourable signals for future business (cf Williamson 2000).

Most CEEC have by now adopted commercial law and regulation quite similar to that of mature economies. In fact, some just transferred the respective codes to new grounds. But there is still a significant discrepancy between law on the books and its effectiveness. A glance at the EBRD's transition indicators may be illuminating. It may be true that financial transition indicators may be high in general, though, with regard to securities markets and non-bank financial institutions—ie, the more advanced parts of a financial system—these indicators are lower, on average two notches (EBRD, 2000). Moreover, with regard to the legal framework—ie, commercial law and financial regulation—it is important to note that there is still a difference between extensiveness and effectiveness according to the respective indicators, extensiveness being ranked usually 0 to 3 notches higher than effectiveness (EBRD, 2000). Enforcement of rules seem to be the crucial ingredient of capital market development.

A glance on the institutional development is allowed by the calculation of the CIM indicator (contract-intensive money) as proposed by Clague et al (1999). Figure 3.3.1 displays the CIM for the 10 CEEC plus Germany as a reference.

Figure 3.3.1



International Monetary Fund 2001, own calculations

The CIM calculates the ratio between contract-intensive forms of money—ie, non currency money—and total money supply. Non-currency money is estimated with a broad M2 definition and total money as currency held outside banks. The CIM is used as a proxy for institutional quality, because longer-term commitment, such as savings deposits, are only accepted when people feel that their property rights are respected. Without trust, they would hold only very short-term assets or cash, including foreign currency. Hence, the higher the CIM the more contract-intensive forms of money are used in relation to total money supply, and hence, the more confidence in the financial system and its institutions can be seen. The average CIM for the CEEC (not weighted) amounts to 0.8 as opposed to 0.9 in Germany. However, the regional dispersion is quite interesting, albeit data comparability and quality is certainly a caveat. The Baltic states score lowest; only Estonia shows a remarkable increase starting in 1995. Bulgaria exhibits the sharpest fall, whereas Romania managed a considerable increase, though from a low level. Slovenia and the Czech Republic have similar and above values than Germany (see figure 3.3.1).

Joining EMU affects the institutional framework in multiple ways: The *acquis* includes a wealth of laws and regulation that has to be adopted by the prospective members. The European Commission will monitor if these are only adopted on the book or put effectively into practise. By the same token, financial markets will monitor these efforts and will reward success by lower real interest rates. Failure to improve the institutional framework would mean constant perhaps even higher real interest rates which might lead to a violation of the Maastricht convergence condition on long term interest rates. Thus, the incentive to enforce an appropriate institutional framework is strengthened.

Whenever institutions are discussed the role of the state in providing these is often emphasised. With regard to features such as laws, regulation, supervision, and legal system this pronounced position is evident. Why then is the enforcement of certain institutions still a problem? The usual responses include arguments that highlight the legal tradition, respectively that it takes time for new institutions to evolve, or argue that it might not be in the interest of politicians to change the status quo because private benefits more than compensate for the loss in welfare. True as they are, these answers seem not entirely convincing. The involvement of the private sector may be the missing link.

The state is not the only one to put institutions into practise. An appropriate law might be in place as well as trained judges and lawyers; however, it still requires a plaintiff. If trails are cumbersome and time and money consuming, private parties might abstain from suing even if chances to win are high. Moreover, they might abstain from business that might require the enforcement of claims via the courts. But in particular with respect to rather vague institutions such as norms, values, and ethical behaviour, private enforcement is crucial. Cheating during a deal might not be legally traceable—or the costs of doing so are prohibitively high—but impairs future business.

With the promise of the euro in the applicant states, foreign investors are attracted by monetary stability and profitable investment opportunities. They may also change the way institutions are enforced. Foreign investors have presumably less possibilities for private benefits—ie, they require fair and honest transactions more than domestic investors do. Note, we all are only in it for the money, but the average foreign investor, given the lack of a domestic network, might maximise its profit under developed financial and legal institutions. Moreover, big international and institutional investors might take legal actions even if they do not pay off as a stand alone project. But their size and time horizon allows them to internalise the positive external effect in the form of an improved legal (enforcement) system.

EMU will integrate the applicants in CEE into a European capital market where a certain set of formal and informal rules apply. The *acquis* requires the fulfilment of the formal side, whereas market participants enforce formal and informal rules. Of course, international investors will try to exploit institutional deficiencies in the same way as locals, but they might have less scope to do so compared to domestic incumbents, with their established connections and networks. It will be important to keep pace with this development in order to ensure that internationals work to support the institutional setting instead of exploiting it.

4 Conclusions – don't fight it

Capital markets in Europe are changing toward a more open-market approach, and so are the capital markets in the CEE applicant states, albeit they are still in process of transition. An open-market solution is generally regarded as the more efficient solution in terms of allocation and corporate governance, but might also increase financial volatility. Institutional quality, such as the guarantee of property rights, sufficient competition, and so forth, plus macroeconomic stability are necessary to mitigate volatility.

Eastward enlargement of the European Union includes the CEE applicants to this development. The adoption of the euro promises monetary stability, the accompanying mandatory conditions require fiscal austerity and an institutional upgrade to western European levels. In that sense will the arrival of the euro strengthen the process toward markets and accommodate it by providing institutional quality and macroeconomic stability.

The downside might be that any deviations from this train would become more costly. A very early reliance on markets and deregulated banking might not suit the transition economies which, due to their volatile economic development, might prefer a more interventionist stance. Exuberances and downward spirals are sometimes part of financial markets. Apparently small causes might trigger destabilising capital flows which increase economic volatility. CEE applicants are in particular exposed to foreign funds, and it will be important that potential triggers from the financial system or corporate sector will be suppressed.

A financial crises would hurt the CEEC anyway, but the euro somehow increases the bets: The euro raises expectations in the form of macroeconomic, monetary, and institutional stability, which fuel optimism and capital inflows. This enthusiasm might easily overshoot. However, if the high hopes would be disappointed or adjusted to reality, enthusiasm might turn sour and capital flows might even undershoot a long-term level and cutting the CEE applicants of financial resources. The euro improves access to international capital at lower cost and facilitates integration into the European financial market, however, failure to keep pace with this development might also incur much higher cost, which is the very logic of this process.

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