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# FINANCIAL TRANSITION IN EUROPE AND CENTRAL ASIA

## Challenges of the New Decade

A W O R L D F R E E O F P O V E R T Y



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# Financial Transition in Europe and Central Asia

Challenges of the New Decade

*Edited by*  
Lajos Bokros  
Alexander Fleming  
Cari Votava

The World Bank  
Washington, D.C.



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To Ilham Zurayk  
1941–2001  
Sector Manager, World Bank

*“Dedicated to assisting in the historic  
process of economic and financial transition”*



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# Foreword

**T**he financial sectors of the post-communist economies of Europe and Central Asia are perhaps where the most intractable problems existed and where the most difficult reforms were forced to begin. This element of the transition experience has been extremely educational not only for financial practitioners, regulators, and policymakers, but equally so for those of us in international institutions who consider ourselves “experts” in the field. We at the World Bank are still trying to comprehend fully what the concept of transition really means. This book seeks to take that learning process one step farther.

This publication, as well as the seminars in Prague and Benešov on which it was based, brings together the views of a wide range of financial sector experts, and shares some of the lessons learned from the past decade. With the benefit of hindsight, it also looks toward the second decade of financial transition. I believe this is a very valuable exercise, as some countries have quite successfully completed the toughest part of their financial transition, while others still have this hurdle to overcome.

The chapters contributed to the book came predominantly from those who have lived through, and played active roles in, the economic and financial transformations. This is appropriate. Every effort was made to include a wide range of country experience, as well as the experience of partners such as the International Monetary Fund and the European Bank for Reconstruction and Development. I want to personally thank all who participated in this important effort for their invaluable contributions.

*Johannes F. Linn*  
Vice President  
Europe and Central Asia Region  
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# Preface

**T**he transition countries of the Europe and Central Asia (ECA) region experienced a remarkable transformation over the past decade, not least in their financial sectors.<sup>1</sup> In fact, while many sectors of the economy had difficult adjustments to make, the financial sector was unique in having to be reestablished virtually from scratch. In the former Soviet Union—with the exception of the Baltics—the business of finance, at least as it is known in the West, had not existed for more than 80 years. In Central Europe and the Baltics, experience with market-based financial systems is more recent, but significant restructuring of the infrastructure and structure of financial markets had to take place even there. This presented serious challenges to financial sector policymakers in the ECA countries.

The breadth and depth of this challenge can be gleaned from this collection of papers, which were presented at two seminars and a conference on transition finance that took place, respectively, in Prague and the historic town of Benešov, Czech Republic, at the time of the World Bank–International Monetary Fund Annual Meetings (September 2000). Even in countries where the starting points appeared similar following the breakup of the Soviet Union, experience with the implementation of reforms was markedly different.

Important to financial transition was the global economic and financial environment in which the ECA countries evolved. Had world financial markets—and in particular those in neighboring Western Europe—stood still this past decade, the path of financial transition for ECA countries might have been smoother. But they did not, and global financial markets are likely to continue to grow apace and to evolve in ways unimaginable even a few years ago. The financial systems of ECA have had to adapt quickly.

This book examines the factors that influenced, and will influence, this process of adaptation, starting from an examination of how the global financial system—

especially the Western European component—has evolved, and how these developments have both influenced and challenged different types of transition economies.

The book also provides an opportunity to take stock of progress in the financial systems of ECA countries over the past 10 years and to identify the main challenges confronting financial policymakers during this period.

As would have been expected, the banking systems in the transition economies have spearheaded financial development, but it has not been a linear process by any means. The need to develop the legal, regulatory, and supervisory framework for banks from scratch has been a challenging one, especially as the personnel needed to operate and supervise the banks had to be trained from the outset. The institutional context from which each financial sector has evolved in each transition economy has differed greatly. But in most cases, early lapses in regulation led to the emergence of a superfluity of banks. Therefore, much of the history of banking development in ECA has surrounded the question of how the banking system could consolidate into a more manageable number of players. Sometimes the consolidation took place through mergers

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1. The ECA region, for the purposes of this book, is defined to include Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, the former Yugoslav Republic of Macedonia, Georgia, Hungary, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, the Russian Federation (Russia), the Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

or an orderly process of liquidation. In other cases, it took place in the context of serious banking crises.

Considerable effort has gone into the establishment of capital markets, particularly stock markets, in ECA countries, but this has not been an easy process. Much of the stimulus to the growth of these markets has come from the privatization of state enterprises and the specific financial mechanisms used to bring this about. Controversy has surrounded the role and impact of the use of vouchers, for instance. As with the banking sector, the legal, regulatory, and supervisory framework for the capital markets has evolved to different degrees of sophistication in different transition economies. But these markets have not become a significant source of new financing for private enterprises. Moreover, the movement to integrate stock markets across national boundaries is calling into question even the need for local stock market capacity.

A sufficiently long set of data pertaining to the transition economies is now available, allowing us to draw out some of the lessons of experience by applying appropriate analytic techniques. In particular, there is a question as to

how successful policy reform has been in stimulating a deepening of the financial sector and improving private sector access to finance. The book seeks to address this question.

Looking ahead and through to the end of the new decade, it is clear that a fresh set of challenges will confront ECA's financial systems. It may prove difficult for the ECA accession economies to catch up with, and fit into, an integrated European financial system that has been subject to the twin stimuli of the euro and rapid technological change. The latter, in particular, may create a new set of challenges for financial markets and their regulators. But for many of the nonaccession transition countries of Eastern Europe and Central Asia, the challenge will remain simply one of restructuring the financial sector so that it has a core of sound and efficient market institutions.

Finally, the book seeks to examine the changing role of the World Bank and the International Monetary Fund in the financial sectors of the ECA countries.

*Lajos Bokros, Alexander Fleming, and Cari Votava*

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# Acknowledgments

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# Overview

**T**his book brings together 21 papers—organized into six parts—that address a wide range of issues pertaining to financial sector transition in the countries of Europe and Central Asia (ECA). The initial chapters (Part I) place the transition economies in the context of recent and prospective developments in global financial markets. Part II then looks back at the experience of the past 10 years and takes stock of progress in the move from a command financial system to a market-based one, identifying some of the key characteristics of the financial transition. Parts III and IV examine in more detail—and with reference to specific countries—financial transition in the banking sector and the capital markets respectively. Part V takes a cross-country, analytic approach to addressing a number of key policy questions pertaining to the course of financial transition. It also looks forward, drawing out some of the lessons culled from the experience of the past 10 years that have relevance for the future, but also speculating on those factors that are likely to shape the next 10 years. The book concludes with Part VI, which describes the roles that the World Bank and International Monetary Fund (IMF) have played in supporting financial transition and how they are likely to evolve in the future.

## **Part I. Global Financial Markets and the Transition Economies**

One of the key themes that run through the book is developed in the context of the chapters by De Larosière and Padoa-Schioppa. De Larosière's chapter makes the point that ECA countries can no longer be considered a homogeneous group. A two-speed ECA clearly has emerged. The faster reformers—mainly the countries of Central Europe and the Baltics—are those countries that aspire to accede to the European Union (EU), an aspiration that is providing a major impetus to the reform effort. The other group—predominantly the countries of Eastern Europe and Central Asia—are those countries that still have, even 10 years into the transition, fundamental reforms to undertake in the financial sector. Padoa-Schioppa develops this theme further, stressing that even in the case of the fast reformers the catch-up process with the EU is not a simple one. The financial systems of current members of the European Union, for instance, also are changing rapidly in the face of the twin forces of introduc-

tion of the euro and financial innovation. This makes the catch-up process all the more difficult. Padoa-Schioppa explains why accession countries would be advised to look closely at the evolving financial systems of the EU countries, for they are integrating quickly and in ways that are not obvious to the casual observer. Policymakers in accession countries will have to track these developments closely.

## **Part II. Financial Sector Development in Perspective**

The chapters by Bokros and by Kawalec and Kluza step back from the 10 years of financial transition and seek to draw general conclusions about the process. Bokros—who focuses on 10 Central and Eastern European countries—develops a typology of financial sector development. He emphasizes that financial sector development has been an uphill struggle and much less successful than reforms in some other areas. It has had to overcome a dire legacy of crime, corruption, and collusion. Therefore, financial transition will take a long time to complete. Bokros stresses—as did the authors in Part I—the large and

growing differences between countries in their financial sector development and points to the fundamental factors that determine the scope, nature, and quality of emerging financial institutions: specifically, internal and external governance structures, domestic and international competition, and prudential regulation and supervision.

The chapter by Kawalec and Kluza highlights the need for the banking sector and capital markets to develop in a balanced way in transition economies. They make 21 insightful observations about the nature of the financial sector transition. Looking to the future, they emphasize that, except for small and open economies, countries without a sound domestic stock market may be handicapped in their economic and social development.

### **Part III. Banking Sector Restructuring**

Part III examines the widely divergent experience of ECA countries in relation to banking sector reform. The chapters examine experience ranging from Estonia, where restructuring of the banking sector is virtually complete, to Central Asia, where the process of restructuring has a significant way to go. The chapter by Meigas highlights the rapid change that has taken place in the banking sector over recent years. Increased competition has resulted in several major mergers, and many weaker and inefficient institutions have left the market. The banking market is now almost totally foreign owned and heavily concentrated. This is a unique outcome within the set of ECA transition economies and probably not one that is broadly replicable.

The chapter by Skreb and Sonje takes up a very specific issue on banking sector policy: the relationship between the central bank and the ministry of finance in their pursuit of financial sector restructuring. This analysis is undertaken in the context of Croatia, but the question of coordination between the central bank and the ministry of finance is pertinent to other ECA countries as well. Skreb and Sonje call for much closer coordination between the two institutions. In the absence of proper coordination, financial restructuring will be slower, less efficient, and more expensive.

As Jotev vividly explains in reference to the Bulgarian experience, transforming the banking sector can be a costly business. The state-owned banks funded inefficient and loss-making enterprises, contributing to the almost total collapse of the Bulgarian economy in late 1996. Recapitalizing the Bulgarian state-owned banks—prior to their privatization—cost about 25 percent of gross domestic product. Jotev concludes that there is strong evidence that the most efficient and stable economic systems are those that combine little or no state ownership in the bank-

ing sector with strong prudential regulation and supervision. Bulgaria has learned this lesson the hard way.

Szalkai provides a succinct overview of the development of financial markets in Hungary, which highlights some of the structural vulnerabilities remaining in the banking sector. These include a need to cleanse portfolios of remaining losses on the books of privatized banks. But the main challenges for the future will be associated with readying the financial sector to join the European Union. This will require removing the remaining structural impediments in the financial system. Further banking consolidation is expected. The nonbank financial institutions also are expected to develop quickly, driven in part by the growth of the fully funded pillars of the pension system. The introduction of a unified agency for financial supervision reflects the integration that is under way across financial institutions in Hungary.

The chapter by Chekurova examines the restructuring of the Russian banking system, focusing especially on the role of the Agency for Restructuring Credit Organizations (ARCO). The analysis is centered on the period since the Russian financial crisis in the summer of 1998. The critical stage of the banking crisis is now over, and the Russian banking system is gradually adapting itself to new economic conditions. Chekurova cautions that the banking system remains vulnerable, however. Moreover, she believes that banking development will require recapitalization of private sector banks, improvements in legislation and supervision, and the introduction of private deposit insurance. These are needed to rekindle public confidence in the banking system.

The evolution of the banking sector in Central Asia is addressed in the chapter by Uyanik and Segni. Compared with other parts of the ECA region, banks in Central Asia typically have remained relatively small, undercapitalized, and poorly governed, with underdeveloped technical and operational capacities. This situation changed somewhat in the second half of the 1990s, with an improved economic environment and enhanced legal and supervisory infrastructure for banks. There has been only a modest move toward banking consolidation in this part of the ECA region, with consolidation being most marked in Kazakhstan. More needs to be done to improve the overall soundness of banks in Central Asia and to restore confidence in the banking system at large.

### **Part IV. Capital Markets: Ready to Take off or Stalled in Flight?**

In the first decade of financial transition, governments—supported by the international financial institu-

tions and bilateral aid programs—put considerable effort into the establishment of capital markets, particularly the stock market component. Such markets were viewed as being the cornerstone of market-based financial systems. Although the infrastructure for most ECA stock markets has been put in place, the volume of stock trading and the number of new stock issues have been modest, for the most part. At issue, therefore, is whether these markets are now poised to play an important role in the next decade of transition, or whether they are more likely to go into decline or be absorbed into larger international stock exchanges.

Claessens, Djankov, and Klingebiel conclude that stock markets in transition countries are small and dormant and that most of these markets will not achieve minimum economies of scale in the foreseeable future. They note that in the era of globalization, stock market services will be readily available abroad, both for companies wanting to raise capital and for investors wanting to invest in stocks. Thus, they recommend that transition economies avoid developing costly stock markets and concentrate instead on building basic legal infrastructure to protect creditor and shareholder rights and on supporting development of the banking sector.

Kawalec and Kluza—as intimated above—disagree with the thrust of the Claessens, Djankov, and Klingebiel analysis and instead stress the likely impetus that will be provided to domestic stock markets when the reformed pension schemes mature. Such schemes hold out the prospect, in the longer term, of generating large volumes of investible funds that will be channeled through the capital markets. Furthermore, Rozlucki, in the context of a chapter analyzing the factors that have shaped capital market development in Central Europe, believes that international capital markets can perform few of the functions of a domestic stock exchange in a transition economy. The failure of local capital markets would deprive ECA countries of important national assets.

Veselinovič examines ECA's evolving capital markets from a Slovenian perspective. He highlights factors that would lead to the development of a successful stock market and indicates political constraints on the process. Veselinovič believes that in the future, Central and Eastern European stock markets will be either regional or local and that they all eventually will have to integrate into the globalized (European) markets.

Rudlovčák undertakes a detailed review of the political economy of capital market development in the Czech Republic, which was initially spurred by a voucher priva-

tization scheme under a mass privatization program. Despite the problems encountered in its early development, the structure of the stock market has improved, and about 150 core companies are now listed. The establishment of the Securities Commission in 1998 was an important step in the creation of a standard regulatory environment for the market, and a strong infrastructure for the capital market now exists. However, in Rudlovčák's view, the market has not yet played a visible and effective role in the economy nor fostered the efficient allocation of funds, but there are signs that the capital market might be maturing.

Vasiliev tracks the development of the Russian capital markets, which was initially ignited—like that of the Czech Republic markets—by the trading of privatization vouchers. Vasiliev describes three stages of capital market development up to the onset of the financial crisis in 1998, which saw the collapse of the Russian securities market. The crisis brought to the surface structural weaknesses in the Russian market, but the period since 1999 has given grounds for optimism. The relatively stable macroeconomic and political situation has served to rekindle the markets. Vasiliev takes heart from the fact that, while the development of the fledgling securities market has encountered difficulties, these are not unique to the Russian Federation (Russia). It already has contracted some of the diseases typical of a young market and has developed some immunity against them. But addressing all of the issues in the Russian capital market must await the resolution of some of the deep-seated structural problems confronting the Russian economy.

## Part V Lessons Learned and Future Challenges

In Part V, the analysis of 10 years' worth of key cross-country data for the financial sector yields important findings, with implications for the conduct of financial sector policy and the determinants of financial sector deepening.

The chapter by Fries and Taci considers whether the policies espoused by the World Bank and IMF in support of financial sector reform in transition countries have been sufficient to encourage the development of sound, market-oriented banking systems. Their analysis assesses the development of banks in transition economies at both the aggregate level and the level of individual banks. The analysis finds that at the aggregate level the expansion of banking activity, particularly lending to the private sector, has been associated with progress in structural and institutional reforms and growth of output. The analysis at the individual bank level broadly supports this finding. In particular, banking

regulation and supervision—especially capital adequacy requirements—are helping to establish a firm foundation for the expansion of bank lending. Banking development nonetheless remains stunted, as the real expansion of lending to the private sector has failed, on average, to keep pace with output growth. Analysis contained in the chapter also points to the need to strengthen the supply response of banks. The measures proposed include the more effective regulation of the entry and exit of banks, improvements in the corporate governance of banks, removal of obstacles to the expansion of foreign banks, strengthening of the judiciary, and protection of investor rights.

The chapter by Peachey and Roe analyzes the factors that influence the path of financial deepening and the role that financial crises play in the process. The authors put down differences in progress toward financial deepening to the nature of the macroeconomic disruptions associated with the early transition years and to the quality of the recovery from those disruptions. They point to the fact that several countries, including Russia and Ukraine, have sidestepped the macroeconomic pressures coming from tight monetary and fiscal policies by allowing high levels of barter and nonpayment in their economies. As a result, significant damage has been done to the prospects for the early recovery and deepening of their financial systems. The propensity of some countries to protect high-cost and inefficient banks also contributes to the slow pace of financial deepening. Peachey and Roe propose a menu of policy proposals that would reduce bank costs and lead to deeper banking systems. These include the reform or elimination of most government policies that contribute to the high cost of banking (such as directed lending), the radical reform of systems of nonpayment or barter in all countries in which these practices are widespread, and the adoption of an increasingly low supervisory tolerance of the high operating costs and low ratio of earnings to total assets that are characteristic of many large state and former state banks. The authors also call for the adoption of explicit supervisory policies to accelerate bank consolidation so as to concentrate a bigger percentage of banking business on the lower-cost banks. They take the view that banking crises can reinforce strong regulation, provided the end result is intermediation increasingly focused on a smaller group of more efficient banks. Accordingly, politicians in transition countries should not fear crises as much as they typically do.

One of the critical policy areas that impinges significantly on the evolving structure of ECA financial systems relates to banking regulation and supervision. Durand and Fonteyne examine the role of banking supervision and the challenges it will face as ECA banks adapt to the fast

changing economic, financial, and technological environment around them. The thorny question of whether foreign banks should be welcomed into ECA financial systems is broached, and recent evidence on foreign bank penetration is presented. A number of countries around the world are moving to one or another variant of a unified supervisory body that could incorporate banking, securities, insurance, and pension fund supervision. Durand and Fonteyne examine the case for ECA countries moving in this direction (as is already the case in Estonia, Hungary, and Latvia). They also address the difficult question of the supervisory response to banking failure that has been a common feature of the past decade and is likely to persist in the foreseeable future. The authors set out specific principles that should govern the sequencing of prudential supervision and bank restructuring policies. They conclude that ECA countries should establish effective banking supervision, fulfill the prerequisites for its proper functioning, and ensure that its design is consistent with the stage of development of the economic and financial system it oversees.

Looking to the future, Claessens, Glaessner, and Klingebiel examine the broader global financial sector environment in which ECA financial systems are going to have to operate in the years ahead. They discover that some transition economies are starting to participate in the e-finance revolution and that this is having a significant, positive impact in some markets. E-finance can assist some transition economies to leapfrog the formal stages of financial sector development through which many developed countries have progressed. The form in which this e-finance revolution will come about will be shaped by the forces of supply and demand as well as by regulatory and other barriers. To reap the fruits of the e-finance revolution, ECA countries will need to give priority to improving the framework for financial and other information, modernizing and strengthening their legal systems, and improving technology-related infrastructure (such as telecommunications).

## **Part VI. The Role of the World Bank and IMF**

The concluding chapters by Siegelbaum and Fleming of the World Bank, and Ingves of the International Monetary Fund examine the changing role of their respective institutions in fostering financial sector development in ECA countries. Siegelbaum and Fleming explain how the nature of the Bank's involvement has changed over time, reflecting both the changing needs of its ECA clients and changing perceptions in the Bank as to what constitutes good practice in analysis and operational design. All ECA countries—with the exception of the Czech Republic—have availed themselves of Bank support for financial sector

reform. This support has focused mostly on restructuring banks and building a sound legal, regulatory, supervisory, and institutional framework for financial activity. An analysis of Bank involvement is undertaken with reference to five categories of ECA countries. The various categories of countries have drawn on different mixes of Bank lending instruments and different types of policy intervention. In the future, the Bank is likely to concentrate its support less on the EU accession countries and more on the remaining ECA countries.

Ingves explains how IMF support for ECA countries was initiated, focusing on developing the central banking function, while promoting the independence of central banks. This has involved assistance in developing instru-

ments for monetary policy implementation. Support also has been furnished in the area of banking supervision, accounting reform for banks, development of payment systems, and, most recently, the application of standards and codes to different fields of financial sector activity. The basic challenge over the next decade, from the standpoint of the IMF, is to have countries complete fundamental tasks, while responding to and assisting them in an appropriate and timely manner when specific problems arise, even where the fundamental institutions, instruments, practices, and procedures are in place. Inevitably, the IMF will be guided by certain international standards and best practices in its assessment of the basic work that remains to be done in a particular context.



Part I

# Global Financial Markets and the Transition Economies



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## Chapter 1

# Transition Economies in the Evolving Global Financial Markets

*Jacques de Larosière*

**T**he role of the financial sector in all countries is of paramount importance. Banks are the intermediation agents between savings and investment, and only solid institutions are able to attract deposits and to channel them in a professional way toward productive opportunities. The efficiency of the banking sector and of financial markets is a well-recognized factor of lasting growth.

Freedom of capital flows is now present in almost all countries. Combined with deregulation and a more and more integrated international financial system, this freedom is creating many opportunities for emerging economies. Net financial flows to emerging countries have increased enormously over the past years, boosting economic growth. But this freedom is also creating more vulnerability. Indeed, short-term capital is volatile, and, as the experience of Southeast Asia has shown, the lack of a robust, well-capitalized, and properly managed and monitored banking system can be a major source of weakness when investor sentiment changes and capital movements start to shift.

This chapter examines how these trends are affecting transition economies and what progress has been made in developing their financial institutions. It also addresses the future and outlines the possible avenues offered to transition countries regarding banking systems and capital markets. This discussion also addresses the European Union (EU) accession process.

### **Financial Sector Development in a World of Free Capital Movements**

To understand the developments of the financial sector in transition countries, it is useful to look back at the starting point. Under central planning, the financial system was

little more than “a bookkeeping mechanism for tabulating the authorities’ decisions about the resources to be allocated to different enterprises and sectors” (European Bank for Reconstruction and Development 1998, Transition Report, pg. 92). Securities markets were absent, since no marketable securities were available, and there was no need for prudential and supervisory regulations. The challenge for the transition economies after 1989 was huge: to create from scratch a functioning financial system.

The progress made in the banking system has been quite significant, albeit uneven and incomplete. The problem was all the more difficult to resolve in that state banks had portfolios dominated by nonperforming loans and personnel with few technical skills in the field of banking.

Transition countries acted to create a true banking system in two ways:

- Privatization of state banks
- Development of new banks (private).

Methods of privatization varied from country to country. For instance, in the Czech Republic the rapid move toward privatization based on a voucher scheme had the political advantage of speed but led to a number of problems related to the absence of new equity and know-how inherent in that method. Other countries, like Hungary and Poland, took more time to privatize their banks but did so

by allowing strategic partners (most often foreign) to participate in the process, which eventually brought significant benefits (equity, corporate governance, and worldwide presence). The European Bank for Reconstruction and Development played a useful role in the process.

In the Russian Federation (Russia) and many other transition economies, the weakness of the regulatory authorities allowed the creation of numerous small private banks, which generally were not prepared to perform the banking functions in a professional way.

The banking sector in transition countries has been subjected over the years to a number of crises. Those crises occurred in countries where the financial environment had been liberalized, but where the regulatory framework had not been developed sufficiently to contain the risks stemming from capital liberalization. Crises also have emerged in countries where macroeconomic stabilization has failed. A banking crisis was experienced in Estonia in 1992 and in Latvia and Lithuania in 1995. The Czech Republic saw the failure of several medium-size and large local banks in 1996. Bulgaria faced a full-fledged banking crisis in the same year, and in 1998 Russia faced a financial crisis that led to the collapse of much of its banking system.

The causes of those crises differed from country to country, but in all cases a combination of two factors was at work:

- Accumulation of bad loans (either inherited from the communist period or developed under the new conditions, in particular because governments insisted on protecting loss-making companies)
- Insufficient regulation and supervision of the banking system.

Repairing the banking sectors in transition countries has been a major task that has developed over the years and is still ongoing in some countries. It has implied massive injections of capital by the state. In order to make privatization possible, governments either have to provide equity directly to the ailing privatizing banks or have to carve out impaired assets from their balance sheets.

These actions to repair the banking systems have typically cost on the order of 10 percent of gross domestic product (GDP) per country. This is by no means unique to transition economies. Banking sectors in other countries, be they industrialized (such as the Scandinavian countries and Japan) or emerging (Latin America and Southeast Asia) also have experienced crises that have led, in some cases, to more heavy injections of equity than in transition countries.

Moreover, these banking crises in transition countries did not always produce the severe economic disruptions typical to many other countries. This is probably because

transition economies have a relatively underdeveloped system of financial intermediation.

An examination of the ratio of bank credit to the private sector relative to GDP by the countries' level of income per capita reveals that transition economies, except for the Czech Republic, are well below the corresponding market economies. But this gap is gradually eroding, as progress is made in strengthening the banking systems in transition countries.

Indeed, enormous progress has been made in a number of transition countries in terms of banking supervision, privatization, and consolidation. Hungary, for instance, has a widely privatized banking system, which is now controlled largely by foreign strategic partners and is well supervised. Poland also has advanced far in that direction, and the Czech Republic is catching up rapidly, with the privatization of its banking system. In Russia, the systemic crisis of the banking sector persists, and the process of restructuring needs more clarity.

In a number of less-advanced transition countries, the consolidation and privatization of banks are among the major tasks ahead and are most often the centerpiece of International Monetary Fund (IMF) programs.

### **Progress in Building Local Capital Markets**

Capital markets in transition economies have less depth and breadth than those in market economies at comparable levels of development (where development is measured by gross national product per capita).

Comparing the market capitalization of local corporations with that of other emerging-market economies reveals that the stock market capitalization in transition economies remains relatively low, although it has developed over recent years in countries like the Czech Republic, Hungary, Poland, and Slovenia. Stock markets in the region also have seen considerable volatility in recent years.

In this regard, it is interesting to look at the balance between risk and return offered by the stock markets in transition economies. The industrial market economies and developing countries have tended to offer a more favorable balance between risk and return over the past four years than have the transition economies as a group. Except for Hungary, the price to book value ratios are lower in the transition countries than in developing countries. Firms that are successful in investing their capital as well as their borrowings clearly tend to have strong prospects for earnings growth and to have low discount rates applied to their future earnings. Price to book value ratios can be viewed as a reflection of the business climate in the interested countries.

## Looking to the Future

Long-lasting growth in transition economies requires the conjunction of two major elements:

- Stronger local savings
- Higher investment in the productive sector.

In order for this to happen, macroeconomic stability needs to be pursued. This is indispensable for reassuring savers that their deposits and investments will not be wiped out by inflation. (In this respect, there has been a trend, in some countries, toward a somewhat excessive recourse to foreign debt and higher current account deficits). A favorable business climate is also needed, with clear rules of the game and a competitive business environment. Eliminating subsidies to loss-making companies, enforcing bankruptcy laws, and eradicating state intervention in the conduct of enterprises are some of the prerequisites for improving the business climate.

All countries, and in particular the European ones, are exposed to the powerful changing trends that have characterized the international financial system during the past decade. These trends are forcing banks to consolidate and adapt to new information technology. They are leading to the emergence of financial conglomerates and are shifting financial resources from commercial banks to markets. These trends are particularly evident in the United States, but they are affecting Europe and the rest of the world as well. They are posing new challenges to regulators and supervisors. Under such conditions, how should the Eastern and Central European economies react?

It might be imagined that, starting from scratch, their financial systems would have adapted to the new trends, thus circumventing the process of rebuilding a classical network of commercial banks. But that was not possible given the existence of banking systems (albeit inefficient) in those countries. Therefore, the transition countries will have to strengthen their financial systems and allow them both to adapt to the changing trends and to adopt new technologies and best industry practices.

Banks must be adequately capitalized, and they must make their decisions on the basis of a professional risk assessment analysis. They must be independent in the way that they act, and they must be seen as independent. Supervisory authorities have, of course, a major role to play in monitoring the capital adequacy ratios and the risk assessment methods of the financial institutions under their control.

As far as the development of capital markets is concerned, the following factors are especially important:

- Clear regulation
- Strong supervision

- Protection of minorities' rights
- Progress of privatization
- Improvement of the business climate and openness toward foreign investors
- Development of pension systems
- Strong macroeconomic fundamentals.

These are some of the conditions that eventually will reinforce the already encouraging, but still limited, progress that has been made in this field in a number of transition countries.

Transition countries need a modern capital market and a good banking system to help their corporations and their many small and medium enterprises raise funds more easily.

In 1993 the European Council in Copenhagen adopted the principle of the European Union (EU) enlargement. Ten countries—the Czech Republic, Estonia, Hungary, Poland, Slovenia, followed by Bulgaria, Latvia, Lithuania, Romania, and the Slovak Republic—are now in the process of negotiation. The process started in December 1998 with the first wave of five candidates, followed later by the second wave.

The preaccessions' strategy consists of combining reforms by the candidate countries with some financial assistance by the EU. The idea is to help the candidates before accession to conform with the *acquis communautaire*. The procedure is based on the negotiation with each country of an accession partnership. These partnerships outline the list of priorities—short- and medium-term—that have to be met before accession. The partnerships also lay out the amount of resources that will be allocated to each candidate (total of 3 billion euros a year starting in 2000). This financial assistance is conditional on the achievement of reforms: it can be suspended in the event of unsatisfactory performance.

Each country is assessed continuously according to its performance and becomes a member of the EU when it has met the obligations that apply to all member states. Negotiations are conducted on a bilateral basis between the EU and each candidate. Each country is assessed toward the month of November of each year in terms of its progress toward accession. The commission's November 1999 paper stresses, for example, that "Apart from Hungary and Poland, all of the candidate countries need to make major efforts to ensure financial control. The development of internal control system requires particular attention" (European Commission, November 1999, Report on Progress Towards Accession).

More recently, the European Commission has proposed strengthening the process regarding financial insti-

tutions. The commission notes that "From the moment at which their countries join the EU, financial institutions from Central and Eastern Europe countries should receive a 'European passport' allowing them to operate under home country supervision in the entire EU." In view of this, the accession countries will have to fully adopt all EU financial services legislation. The commission will continue its current efforts to monitor the transposition of the *acquis communautaire*. However, formal transposition of the *acquis* into national law is not all that is required. Supervisory bodies also are needed with sufficient administrative capacity to implement the national law in practice. Therefore, it will be necessary to:

- Provide technical assistance to candidate countries and help them to build this capacity, and
- Assess the resources, experience, and prudential techniques of supervisory bodies in these countries, possibly by way of peer review procedures.

Since the commission by itself cannot provide the necessary assistance to the financial services supervisors in those countries, nor check their efficiency, it is looking to the prudential authorities of member states for assistance and advice.

Evaluation in this context should be based on reviews carried out by supervisors from EU countries or on assessments made under the Financial Sector Assessment Program of the International Monetary Fund in cooperation with the World Bank. The results either should determine further needs for institution building or should help to judge the effective transposition of the *acquis* by a given country. In view of this, the results, after being seen by the appropriate supervisors at the EU level, should be transmitted to the Enlargement Group of the Council.

Contrary to the wish of certain candidates, the European Council has fixed neither a timetable for the enlargement nor an objective date for the first accession. What the 15 countries have agreed on is that the European Union will be ready by the end of 2002 to accept new members if three conditions are met:

- Sufficient financial resources
- Completion of the institutional reform of the EU
- Satisfactory bilateral negotiations on accession.

Ideally, if all conditions are met, first accessions could be ready by the end of 2002. Given the usual delays in ratification, the first accessions could become effective in 2004. This is a purely theoretical notion, and the process may well take more time.

An economic and monetary union is an integral part of the accession process. Accession implies that the new members commit themselves to participate in the monetary union (as long as they meet the convergence criteria fixed in the Maastricht Treaty). But the observance of those criteria is not a necessary condition for acceding to the European Union. Candidates very probably will enter the union first and the monetary union later on. Each country will have to negotiate thoroughly, and, at least in some fields, some may have to go through a transition period.

In summary, considerable progress has been made in strengthening the banking and financial institutions in transition countries. This is all the more remarkable in that it has been accomplished in less than 10 years, starting from a very low point. But there is still much to be done.

The accession process is proving a powerful engine for pushing strategic reforms and for consolidating and expanding what has already been achieved.

One of the difficulties of the exercise is that the *acquis communautaire* has become, in a world of integration and increasing competition, a moving target. Present members of the European Union themselves have much to do in improving the functioning of their financial and banking markets. The creation of the euro should be a catalyst in this respect. Candidate countries have to think of their financial future in terms of the changing requirements of an integrated global world. A constant collaboration with the monetary, regulatory, and supervisory authorities, but also with the private financial institutions and practitioners, will be of the essence if those candidates want to reap the benefits of more efficient integrated financial markets.

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## Chapter 2

# Financial Integration in Western Europe: Can the East Catch Up?

*Tommaso Padoa-Schioppa*

**T**his chapter examines the development of financial systems in transition economies—specifically in those countries in the process of accession to the European Union (EU)—against the backdrop of recent developments in the Western European financial sector. It then addresses the changes in the EU financial landscape following introduction of the euro, focusing on the issue of how to strengthen the public policy side of the process in step with private market developments. Finally, the chapter examines more specifically the relations between the EU and its neighbors, 12 of which are now accession candidates.

Nowadays, postcommunist countries of Central and Eastern Europe and the former Soviet Union are not the only countries undergoing a transition: the EU financial sector is also experiencing a profound change. The EU member states, and perhaps even more so those that have adopted the euro, have become the standard of reference for many of the transition economies in the region. But, as many Western European countries are experiencing significant changes of their own, they, in fact, represent a rapidly moving target. First, forces as intense as deregulation, disintermediation, and technological change are, in general, shaping the financial systems. Second, the introduction of the euro has provided a further impetus for change in the countries participating in the single currency. Hence, while the transition economies are in the process of building political and economic systems based on those in Western Europe, the financial systems in these “model economies” are evolving rapidly into new models. The financial landscape in Western European countries may well have undergone a major transformation by the time the transition economies reach their current goals or the objectives set for them as a condition of membership in the EU.

A good illustration of the catching-up problem is the process of building payment systems. A process has been under way in Western European countries to build real-time payment and settlement systems, which reduce systemic risk because they do not entail counterparty risks but are quite costly to build and run, particularly if volumes are small. Central bankers of the transition economies have tended to boast that they are in the process of launching or contracting for the development of such systems. Meanwhile, EU development suggests that, when financial markets integrate within a larger area, tendencies toward cross-border consolidation emerge. Payment and settlement systems have begun to consolidate across Western European countries. Therefore, separate national payment and settlement systems may not be the reality of tomorrow. Given the small scale of the markets in at least some accession countries and the high cost of establishing market infrastructures, these countries perhaps could anticipate this development and consider the opportunities it may offer.

The same argument applies to securities markets. Securities markets tend to be strongly country-specific when they are currency-specific, with the markets for gov-

ernment securities or foreign exchange providing good examples. But when the national currency is replaced by a regional currency and the national currency ceases to exist—as has occurred in the euro area—the securities markets redirect their operations beyond national borders. Today, this evolution is taking place very rapidly in the euro area. The money markets in euro practically integrated within a few days of the launch of the euro on January 1, 1999. As far as the bond and equity markets are concerned, the pricing conditions have been equalized, and market liquidity has radically increased, providing an impetus for private issuers in particular to increase the use of capital market financing. The remaining regulatory frictions blocking the achievement of integrated securities markets are under lively debate at the moment. Despite this fundamental transformation of markets, the development of securities markets is viewed in many transition economies in isolation from the evolution of markets in Europe at large, or the full potential of securities markets is not recognized, the focus being mainly on financial institutions.

### **The EU Financial Landscape after the Euro**

A decade ago, the EU had barely liberalized capital movements. The basic directives concerning banking and financial services that have opened up the European markets, permitting access to financial institutions and customers beyond national borders and harmonizing the basic regulations governing prudential supervision, had not yet taken effect. Naturally, 10 years ago, the world was totally different for the transition economies, which had just emerged from the Soviet bloc.

The two most significant developments that have changed the European financial landscape over the past 10 years have been, first, the creation of a single market and, second, the move to a single currency. The second step represents a very consequential step toward integration, since as long as different national currencies exist, finance is fundamentally linked to currency, even if the markets have been unified by common regulations and the opening up of borders for external competition. Indeed, the multiplicity of currencies in the single market was the fundamental factor behind the preservation of segmentation of the banking industry. Interesting questions that have been raised in this context—also by myself on other occasions—are, first, whether signs of a single financial banking and securities system already are emerging in the euro area and, second, to what extent the euro area resembles or is approaching what has historically been a single-country model with a unified banking system, stock exchange, and

securities markets, all of which are based predominantly on the national currency.

The signs that the banking industry is becoming a single euro-area banking industry are much more noticeable if one looks beyond the façade. Ordinary people view a banking system from the consumer or retail banking perspective. Retail banking is very much anchored to the territory and local elements, which are often even subnational or regional. For example, in a country such as Germany, only a few banks are operating nationwide, and the five largest banks account for less than 20 percent of the total banking market in the country. Other evidence of the local nature of retail banking activities is apparent from the still significant price differences across German Länder. Exactly the same phenomenon of market localization can be seen in the United States, as well as in many other countries. There is a single banking system because there is a single currency, but the system is not crucially formed by retail banking, although this is on many people's minds. Proximity is an intrinsic characteristic of the retail market, at least for the time being, with or without the emergence of a currency embracing a wider area.

Another common yardstick for measuring the degree of banking market integration has been the extent to which cross-border mergers have taken place. This yardstick is also erroneous because it overemphasizes the ownership structure, which should not be used as a key criterion for assessing an industry's level of integration. Until recently, very few cross-border bank mergers had taken place in Europe, as most of the many mergers had been conducted within national borders. This also has been the case in the United States, where cross-state mergers were quite rare after the restrictions on interstate banking were lifted. Because both Europe and the United States have seen relatively few important cross-border bank mergers, consolidation of ownership in the United States and Europe has been rather similar.

Going beyond the façade, it can be seen that the banking and financial system in Europe is emerging in many respects as a single banking system, as in the United States. First, corporate banking and asset management are increasingly important activities for banks, although they are not immediately visible to the public. Exploiting economies of scale in these activities has led to a rapid move toward concentration and consolidation, which has effectively unified the market for both corporate finance services and asset management activities.

Second, the other large segment of the financial system, which involves securities transactions, is probably moving even faster. There are daily news stories about the attempts

to merge large stock exchanges. The bond market is unifying rapidly as well, involving the technical infrastructure of the market and the clearing and settlement systems, which do not, however, always make headlines in the media. The greatest cost savings are possible in the unification and standardization of these aspects of trading. So, in many respects, the euro area is becoming almost one country with its own financial system.

Finally, one could, of course, say that a banking system is, by definition, a single banking system from the very moment it has a single currency and a single central bank, a single lender of last resort, a single payment clearing system, a single money market, and a single interest rate at the short-term end of the market. In the case of banks, we talk about a *system* precisely because of the common currency and the central bank. The existence of a common framework for accessing central bank liquidity is tying together euro-area banks to a much larger extent than is usually acknowledged, thus creating an integrated euro-area banking system.

### **Policy Aspects of Integration**

Much of the unification of the markets to date has been driven by private business motives. Even the consolidation of stock exchanges has become possible only as a result of a recent development, in which stock exchanges have become a business in themselves, a service-providing industry that can be run as a profitable enterprise. Stock exchanges have been privatized and have become limited companies. Some, in fact, are even listed on a stock exchange themselves. This process has been driven by profit motives rather than policy motives. Ultimately, however, every financial system needs to be ruled both by market considerations, reflected in private arrangements, and by policy considerations, reflected in regulations. Therefore, one must ask whether these two elements have moved sufficiently in parallel to ensure that public interests are protected. In my view, what is needed at this point is to strengthen the policy side of the integration process.

Of course, this issue exists in all countries, because the public policy side always tends to move more slowly than the private side. This is the case at the national, the European, and the global level. On the whole, the EU has been quite effective in developing regulations in parallel with the process of European integration. At the global level, by contrast, there is no formally recognized rule-making capacity, although much has been achieved on a de facto basis. In the EU, this capacity exists: the EU is a legislator that produces binding and enforceable laws supported and implemented by the judiciary.

An important aspect of public policy in Europe is the idea that banks can provide services over the whole spectrum of financial activity, while the legal framework is very strict in requiring a license. To provide financial services, an institution needs an appropriate license, and, hence, it becomes subject to the regulations in force for the particular type of financial activity it conducts. Compared with the American approach, Europeans prefer more rigidity on the issuance of licenses and more flexibility with regard to the principles of universal banking. There also have been movements on this front in the United States, but Europe has basically never abandoned the universal banking principle as the United States did in the 1930s.

On the whole, the EU is evolving from national segmentation toward integration of the financial industry. Throughout this evolution, it has been relatively successful in combining the rapid changes driven by market forces with developments on the regulatory, public policy side.

The debate in Europe over the past two years has concentrated on the implications of the euro for financial supervision, both of banks and of securities markets. The first wave of discussions addressed the issue of whether banking supervision should remain a national responsibility in spite of the fact that monetary policy and other central banking activities were being integrated at the euro-area level. The ECOFIN Council has launched a debate on similar problems related to the securities field. A committee has been convened to analyze these issues and is due to report its conclusions in a few months.

A system in which major components of the financial industry are integrated on a euro areawide basis, while the public and supervisory functions are not, would result in a dichotomy. Regarding supervision, much discretion is left to the power of secondary legislation and to the method of implementation by the supervisory agencies. This dichotomy raises the question of whether or not the current supervisory functions are adequate. The European Central Bank (ECB) has taken the position that this arrangement is adequate as long as cooperation among national supervisors and the exchange of information among them and between supervisors and the central banks develop in parallel with consolidation of the banking system. At the same time, the authorities need to work toward an effective area-wide perspective.

### **The EU and the Transition Economies**

Of the some 200 sovereign countries in the world, 100 or so lie between Finland and South Africa. This part of the world could be referred to as the European and African sphere, to distinguish it from the Western sphere,

which refers to about 40 countries, and the Asian and Far Eastern sphere, including Australia, which amounts to some 60 countries. Looking at the world in this way, the European and African sphere has the largest number of independent states.

Virtually all countries in the European and African sphere have a close relationship with the EU, which is their primary trading and financial partner. For each of them, there is a treaty of association and cooperation on trade-related issues, as well as activities to foster economic development. In addition, one of the most striking changes during the latter half of the 1990s was the growing presence of foreign banks in the local banking and financial system, often through the acquisition of previously state-owned banks or through the establishment of subsidiaries.

The fact that the EU provides a natural and actively used model for other countries—and the fact that this model itself is constantly changing—imposes an obligation on the EU to be very open and transparent as regards the changes it is undergoing. The ECB maintains a close relationship with accession countries, as well as with a wider group of countries, to ensure that the systems that exist in EU countries are sufficiently open and transparent.

The ECB plays a specific role in the accession process. It is not in charge of banking supervision, and it has no specific functions in guiding the transformation of the financial system. Nevertheless, it has a strong interest in the stability of the banking system and has the expertise that every central bank has, even though it is not entrusted with the task of supervising the banks.

One reason for the ECB to maintain and develop close ties with the accession countries is to ensure that monetary policy is both sound and stable. Since the Eurosystem (the European Central Bank and the participating national central banks) follows the principle of equal treatment in selecting its counterparts for monetary policy operations, it also can deal with the branches or subsidiaries of the banks from the accession countries, which may also participate, in a broader sense, in the single interbank market in euro. For

these reasons, the Eurosystem also has a specific interest in sound financial structures in the accession countries.

More broadly, in the monetary field, the accession process has a degree of flexibility and allows diversification in the formulas, the paths, and even the timetables that is not possible in other areas. Accession itself does not automatically imply adopting the euro, nor does adopting the euro as an official currency automatically follow participation in the exchange rate mechanism, ERM II. So there are actually four steps: first, preaccession developments; second, attainment of the status of membership; third, participation in the ERM II arrangement; and fourth, adoption of the euro itself.

This multistep process basically reflects the path that the original members have followed over the years. At the beginning, there was only membership of the European Economic Community, which did not have a monetary system of its own. Later, ERM was set up. Finally, the euro was created. Even the present members of the single currency have approached this final stage at different speeds, and some EU member states are still outside the euro area or even outside ERM II. So the considerable flexibility in the aspects of the accession process that concern the monetary field may not exist in other areas of the accession process.

## Conclusions

A broad and long-term perspective is needed when dealing with issues related to the financial system. The euro-area financial system provides a model for the transition countries, but the model itself is evolving at a rapid pace. The euro area is quickly developing into a more integrated financial system, particularly in wholesale banking operations and, increasingly, in capital market structure. In the long term, separate national financial systems may not continue to coexist. A lively policy debate in the EU has started to address the consequences of the integration process, which the accession countries would be advised to follow.

Part II

# Financial Sector Development in Perspective



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## Chapter 3

# A Perspective on Financial Sector Development in Central and Eastern Europe

*Lajos Bokros*

**F**inancial sector development in Central and Eastern Europe has proved to be a dramatic process characterized by some well-trumpeted successes, but even more so by many unexpected collapses of seemingly decent institutions and some systemic meltdown as well. The overall record of transition in the area of financial sector development is much less impressive than the achievements in macroeconomic stabilization, economic liberalization, and privatization of formerly state-owned enterprises. There are several reasons for this. Chief among them are the complexities of the financial sector and the intense political as well as emotional sensitivity attached to any major move in this area. Influential stakeholders such as politicians, government officials, business, and media people tend to overestimate the real value of particular institutions and to overemphasize their importance to the national economy. In the absence of strong external and internal governance structures, managers and owners of banks, brokerages, and insurance companies abuse this situation at times to increase their own influence and perceived importance. Therefore, financial sector development in most countries of Central and Eastern Europe in the first decade of transition has been an uphill struggle to restore reliable channels and prudent practices of financial intermediation—to create a new culture of trust and confidence against all odds given a dire legacy of crime, corruption, cronyism, and collusion.

### **Trust Based on Culture and Tradition**

It is, of course, crucially important that financial intermediation be reestablished in a credible way since there is no economic growth unless the financial savings of the enterprise and household sectors are channeled effectively and efficiently into investment. This is precisely what was lacking in the transition world after the devastating experience of communism, where funds were reallocated by orders rather than business decisions based on calculated risk taking. This clearly created a culture and tradition that did not require trust. To change this culture and tra-

dition back into a market-oriented one will take a long time, even if the political class understands what it takes to recreate this trust and behaves accordingly. But the first decade of transition has shown that the elements constituting this trust are neither fully understood nor promoted in practice. In most countries there has been some abuse of the incipient public trust, and in some countries—notably the Russian Federation (Russia)—abusive degradation of the financial system has systematically destroyed the public trust altogether. Many Russians who put their money into licensed banks lost it twice: when hyperinflation in the

first half of the 1990s wiped out most savings and when the banking sector collapsed in August 1998. Those who kept their savings in foreign currency, either under the mattress or abroad, still have it. Capital flight is not only a phenomenon reflecting illegal and massive exportation of funds by wealthy businessmen and a few criminals but also a well-established, everyday practice of the common man that has been reinforced by hard experience.

### Initial Conditions

Some countries started to reform their financial system—first and foremost banking—even before the political changes. Hungary and Poland had established a two-tier banking structure as early as 1987 and 1988, respectively. Yugoslavia, having had a formal, two-tier arrangement throughout the socialist period, started to liberalize banking regulation gradually in the second half of the 1980s. Bulgaria, Czechoslovakia, Romania, and member states of the former Soviet Union were much less fortunate; financial sector reform could start only after the rather tumultuous political events and under the auspices of the first democratic governments. However, in all countries regulations for the establishment and operation of banks and other intermediaries were quite liberal—sometimes even too liberal—and this unleashed substantial initiatives leading to rapid growth in the number and size of these institutions. The good news was that—apart from initially restricting banks' ability to collect household deposits or engage in foreign exchange-related transactions—there were no significant administrative restrictions on attracting clients and setting fees and interest rates. Competition was not restricted by administrative limitations on the range of clients, lines of business, and product pricing. The bad news was that prudential regulation did not exist either, and minimum capital standards, liquidity ratios, the concept of solvency and capital adequacy, requirements for asset classification and provisioning, and adequate tax rules were all missing at the beginning of transition. This created a “wild east” type of environment for liberal capitalism, where clients and managers of state-owned financial institutions as well as owners and managers of newly established private ones could use and sometimes abuse many of the legal and regulatory loopholes for their own personal advantage and at the expense of depositors, creditors, and ultimately taxpayers as well.

### Common Features in 2000

After 10 years of transition, the financial sector in Central and Eastern Europe is characterized by:

- A low level of financial intermediation in the range of 5–40 percent of gross domestic product (GDP)
- Relatively poor asset quality and serious undercapitalization
- A narrow range of services, especially in nonbanking
- Largely immature external and internal governance structures
- An increasingly sophisticated legal and regulatory framework
- Shallow implementation and enforcement capacity.

Compared to either the developed industrial countries or even some of the fast-growing Asian or Latin American ones, financial intermediation in Central and Eastern Europe is still very shallow. The level of savings channeled through the banking and insurance systems lags behind that of mature economies, and the amount of funds injected directly into the real sector in the form of loans, corporate bonds, and secondary share issues seems to be well below comparative standards and genuine demand. Even the most advanced Central European economies—the Czech Republic, Hungary, and Poland—show a large deficit in corporate lending: the outstanding amount of loans to the real economy does not exceed 40 percent of GDP. This marked shortfall is the direct result of several factors. All countries experienced excessive and generous lending for some years, followed by a credit crunch and extreme risk aversion after the collapse of some banks and brokerages and the tightening of both monetary policy and prudential rules applicable to asset classification, valuation of collateral, and provisioning. While the expansion in the first period clearly was assisted by directed and insider lending promoted by influential members of parliament, government officials, and well-connected businessmen, this lavish and sometimes imprudent behavior eventually starved even the most creditworthy and viable ventures. Many banks in the transition world continue to act like brokerages in money and capital markets by trying to link their business partners directly and offering them fee-generating services rather than properly intermediating the available funds.

Consecutive government attempts to clean up the mess and improve the quality of assets also proved to be a double-edged sword. Although rehabilitation of the largest state-owned banks clearly was inevitable given the sizable amount of inherited bad loans, state-orchestrated programs of bank recapitalization and restructuring were too generous, too broad, too many, and too costly. Managers of state-owned banks were inclined to understate the true size of their losses before it was too late and then rushed to overstate it once a program of rehabilitation had been announced. It was very difficult to distinguish

between bad assets truly inherited from the past and those generated after the political changes, and it was almost impossible to establish who was responsible for the sharp deterioration of the loan portfolio in light of the collapse of a good number of corporate clients. Governments had no choice but to admit defeat and pump fiscal funds into ailing flagships of the banking sector. This was not a good excuse, however, for the lack of serious efforts to define and enforce an adequate set of time-bound, quantifiable, and monitorable performance criteria against which to evaluate the achievements of old and new management. For this reason and also for the rather loose design of other aspects of the rehabilitation plans, coupled with serious flaws in understanding and realizing the magnitude of implicit losses in the case of individual banks, quite a few governments were forced to repeat bank and insurance consolidation, thus spending a disproportionately large amount of fiscal resources on an economically unavoidable but politically very painful process. Even Hungary, which has achieved the best results in financial sector development so far, spent more than 10 percent of its GDP in more than three rounds of banking sector rehabilitation. In Romania, the flagship bank Bancorex, the former foreign trade bank, was recapitalized five times before the government finally liquidated it. In other countries—most notably Croatia—governments felt obliged to rehabilitate large private banks as well in order to avoid a systemic collapse. But in countries where private commercial banks did not play any significant role in collecting household deposits and channeling them to the real sector, even a systemic collapse did not necessarily trigger any meaningful government action for banking sector rehabilitation. Russia is the best-known example of this rational inaction.

### **“Banks Have Much Money, but It Belongs to Other People”**

There is terrible confusion about the nature and role of banking in the transition world. People tend to have distorted views about the essence of banking, especially if they make judgments while having only a superficial understanding of financial intermediation. In the early period of the evolution of banking, it was quite common and publicly acceptable to demand that banks pay high interest on deposits, charge low interest on loans, and still remain profitable in order to maximize dividends after corporatization. Managing risks and liquidity in a prudent manner, keeping growth in check, and optimizing the costs of gain-

ing maximum productivity were concepts largely unheard of or clearly misunderstood. Private businessmen, local governments, and even some churches wanted to establish their own banks in order to attract other people’s money to finance their own particular businesses and related activities. In the name of promoting the establishment, expansion, and proliferation of new firms, banks—private and public alike—were expected to accumulate a largely illiquid investment portfolio of corporate equity. Government officials openly criticized state-owned banks for not bailing out important enterprises and for placing too much money into risk-free government debentures. And the tax police raided those few managers who attempted to set aside more reserves to cover eventual losses of their banks. Government did not establish a consistent set of behavioral guidelines for the managers of state-owned banks.

Representatives of various state institutions sitting on boards and supervisory boards of state-owned banks were following either the narrow interest of their government department, at best, or their own personal interests, at worst. These representatives were replaced frequently and in many cases were sent to promote specific political interests of their own constituencies. There were no prudential rules guiding their activity either. Modern banking legislation was introduced late and changed frequently. Regulatory and supervisory agencies remained weak and overly politicized, even in the most advanced economies. In sum, the structure of both internal and external governance remained largely inadequate, except for those financial institutions that were finally privatized and sold to strong and prudent investors, in most cases to first-rate and reputable foreign strategic partners.

### **Increasing Differences among Countries in Financial Sector Development**

Behind this generally opaque picture, there are huge and growing differences in financial sector development among countries, and these can be explained mainly by variations in the degree of government policies and the reforms implemented for modernization. Since these divergences are gaining increasing importance by the day and contribute to the ever-growing differences in mid-term development potential as well, it is indispensable to highlight them in more detail.

This chapter compares the experience of 10 Central and Eastern European countries, which can be categorized in five groups:<sup>1</sup>

1. There are other important subgroups in the transition world: the Baltic republics, the reconstruction economies of the Balkans, and the countries of the Caucasus and Central Asia.

- Advanced reformers: Poland and Hungary
- Reluctant modernizers: the Czech Republic and Slovenia
- Countries struggling with a double legacy: the Slovak Republic and Croatia
- Desperate reformers: Bulgaria and Romania
- Prolonged crisis cases: Russia and Ukraine.

This classification reflects the level of progress achieved in financial sector modernization only, and the countries in question may not have reached a similar degree of development in other areas of structural reform. In contrast to macroreforms, where shock therapy and comprehensive packages of adjustment can be devised and implemented successfully all at once, in the case of structural and institutional reforms at the microlevel, only gradual progress has been made in an evolutionary path that shows a cyclical pattern over time. Nevertheless, after the first 10 years of transition, one lesson is clear: the maturity and consistency of reforms aimed at financial sector modernization have proved to be the most important factor behind the sustainable and healthy growth of financial intermediation. This, in turn, has contributed to the rejuvenation and emergence of a competitive and rapidly expanding real economy producing sustainable growth.

One more caveat: other factors, such as initial conditions (for example, the degree of freedom tolerated and achieved under the communist system, the relatively free flow of people and ideas, the openness of higher education, the level of private property, and the experience in entrepreneurship at large), geographic location (proximity to western markets), political factors (democratic stability and maturity and cultural attitudes like popular sentiments toward foreign investment), and widespread and genuine desire to access the North Atlantic Treaty Organization (NATO) and European Union (EU) also played an important role in determining overall progress in economic adjustment and modernization in the 10 countries in question. There is no doubt that all of these factors have shaped policies and reforms targeted toward financial sector restructuring and that the results and failures of these policies and reforms have modified the impact of all other factors as well.

### *Advanced Reformers*

Advanced reformers such as Hungary and Poland share the following characteristics:

- Foreign strategic investors control most large banks.
- Foreign capital has a dominant role in overall banking.
- Most banks have good portfolios, adequate reserves, and adequate capital.

- Internal corporate governance is close to Western practices.
- The quality of services is improving rapidly in corporate business.
- Retail banking is developing rapidly, and there is a wide selection of services.
- Capital markets (government bond and equity markets) are fairly large and liquid.
- Regulation is advanced, and enforcement is improving.
- The environment is competitive, and entry and exit are well regulated.
- Cross-border financial services are almost completely liberalized.
- There are pockets of resistance in privatization and regulation.
- Pension reform and fund management are at an advanced stage.

Poland and Hungary both adopted a liberal approach to attracting foreign direct investment in their move to modernize the financial sector. Newly established foreign subsidiaries and joint ventures with state-owned banks and insurance companies appeared in the market even before the political changes. Interestingly enough, Hungary had sold off the controlling stake in its two large state-owned insurance companies by 1993 just to avoid bankruptcy and eventual liquidation. Moreover, foreign strategic investors acquired all other newly established smaller ventures in the insurance business in the first half of the 1990s. Poland, in turn, was much more cautious and somewhat timid in this area: its single state insurance firm has been restructured only partially and still awaits privatization.

Banking was much more exposed to fast-track modernization in Poland than in Hungary. Large state-owned banks, originally established to serve certain well-defined regions and partially modernized through twinning arrangements with experienced Western financial institutions, have all been absorbed by foreign investors and are competing at the level of the national market. The only exception is by far the largest bank—part of the former specialized savings bank, PKO BP, which is still owned completely by the state treasury and keeps being overburdened with the unresolved stock of nonperforming housing loans. This is a primary example of the more sensitive and complex nature of savings bank restructuring; the political class tends to nurture the illusion that it is a very special type of business, a crown jewel not to be sold to foreign investors.

Hungary also fell into the same trap to a certain extent when Postabank—a newly established and formally privately owned large spin-off emerging from the postal sav-

ings business—went bankrupt in 1998 as a consequence of brutal mismanagement and eventual fraud. The government felt obliged to rehabilitate this bank with a huge dose of taxpayers' money, and there was extensive debate whether to keep it in state ownership or to privatize it again and, if the answer was to privatize, whether to sell control to a strong and prudent strategic investor or to aim at an initial public offering only. The former savings bank, OTP, was privatized in this manner. (Postabank was intended to be sold to OTP without any tender, but the Hungarian government would not accept the price offered by OTP, which was considered ridiculously low. As of April 2000, the government was talking about selling or transferring Postabank to the state-owned post office.)

In Poland, Bank Handlowy was proud of having no controlling stakeholder for a long time, just to be swallowed almost completely by Citibank at the beginning of 2000, after the treasury opposed a thinly disguised takeover bid from the German Commerzbank. This example clearly shows that, despite political resentment and fierce debate, privatization by selling control to a reputable foreign strategic partner is by far the most successful way of stabilizing and modernizing ailing state-owned banks. Keeping control effectively either by the government or by self-serving management, even in the case of majority private ownership, can easily lead to a sharp downturn in the fortunes of the bank. In turn, if and when management is prudent and supported by quality investors, the bank may fall prey to large strategic bidders in a rapidly consolidating market.

Foreign strategic investment in most leading banks has proved to be an unqualified success in both Poland and Hungary, after several consecutive efforts of government-orchestrated and government-financed consolidation of insolvent state-owned banks. Foreign strategic partners have been able and willing to provide not only much-needed additional capital and management skills but also product development and innovation, modernization of risk management and treasury operations, internal audit and control, and information technology.

It is no coincidence that Poland and Hungary provide the best example of capital market development as well. Both countries have a fairly large, well-capitalized, and rather liquid equity market by regional standards. This leading position is a significant achievement in light of either the absence (Hungary) or the subordinated importance (Poland) of a mass scheme of privatization. Instead, governments and market participants relied on two important factors: a gradual and, by the mid-1990s, complete liberalization of foreign portfolio investment (coupled with early capital account convertibility for this type of invest-

ment) and a high level of transparency, which was made possible by adopting and enforcing the latest Western standards of information dissemination, listing rules, price formation, and clearing and settlement. A high level of self-regulation has characterized both institutions all along, which has helped to recreate the culture and trust needed for a steady growth of turnover in capital market transactions. Apart from trading in equity, the Warsaw Stock Exchange has developed a sizable corporate bond market, while the Budapest Stock Exchange has become very active in trading government securities. Derivative instruments, such as options and futures, also are traded, albeit this market is still in an incipient stage in both countries.

Poland and Hungary already have initiated a comprehensive overhaul of their pension system by establishing a three-pillar structure with fully funded and privately managed mandatory and voluntary schemes. These pension funds—together with the private insurance companies—are now providing the backbone of domestic institutional investment by channeling a growing amount of contractual savings through the recognized capital markets.

The deepness of financial sector reform in these two countries is reflected by the high and sustainable level of economic growth achieved in the past four to five years. A wide choice of financial services is readily available for real sector firms on a competitive basis. Due to the broad liberalization of cross-border financial transactions, at least in the longer end of the market, the largest ventures—including the foreign ones—can easily finance themselves even from abroad. Mid-size companies have dozens of banks wooing them and also have access to the less heavily regulated segments of the private capital market. Small firms, however, still face difficulties, as only a few banks have decided to serve this market segment. At the same time, the difficulty for banks of keeping a track record of these small ventures, assessing their risk-return profile, and foreclosing collateral in case of default has to be acknowledged as well.

### *Reluctant Modernizers*

Reluctant modernizers such as the Czech Republic and Slovenia share the following characteristics:

- The largest banks are still under government control or were just recently privatized.
- Moves to invite foreign strategic investors have been postponed or are half-hearted.
- Rehabilitation of leading banks is under way or recently completed.
- The portfolio of other, mostly mid-size, banks is relatively healthy.

- Corporate governance needs to be strengthened considerably.
- Both the quality of services and retail banking are developing rapidly.
- Capital markets are smaller, quite fragmented, and rather illiquid.
- Regulation is improving, with few loopholes, but uneven enforcement.
- Competition is increasing in domestic financial services.
- Nonbank financial intermediation is in need of further reforms.
- There is some resentment and resistance against further liberalization.
- Pension reform and fund management are still at an incipient stage.

The Czech Republic and Slovenia are prime examples of countries where certain favorable initial conditions have become a mixed blessing. These include, most notably, a high level of income per capita based on a rich industrial tradition, a sophisticated economic structure well developed by regional standards, and freedom from the obligation to support less-developed parts of the country as a consequence of the breakup of both Czechoslovakia and Yugoslavia. Both countries enjoyed unprecedented political stability and an extended honeymoon period, with the same government or a grand coalition for a long time. The tremendous success of early macrostabilization, coupled with a successful shift of export orientation to western markets, has produced a sense of complacency and great reluctance to undertake more substantive and painful structural reforms such as financial sector modernization. Both countries undertook an early recapitalization of their largest financial firms and then decided to stop there. Governments were clearly and publicly against selling control of the flagship banks and insurance companies to any foreign investor. Either they claimed that banks were already in private hands (in the Czech Republic, large banks were formally half privatized as a consequence of mass privatization) or they decided that, in the absence of strong domestic investors, it was better to keep banks under close state control (Slovenia).

Mass privatization does not seem to have helped financial sector modernization. In the Czech Republic at least two of the largest banks—Komerční Banka and Investiční a Poštovní Banka (IPB)—felt obliged to continue financing many of their traditional and still unstructured clients, a good number of whom also became owned by them through the investment management companies they established. The bank practice of increasing equity holdings in

their clients' capital was seen as copying the seemingly positive German practice of establishing an intimate relationship between banks and industrial enterprises without having the burden of German regulation or German investors themselves. Slovenia used to have a similar aversion toward foreign investors. Even large banks, brokerages, and insurance companies have not always welcomed foreign financial investors. The Yugoslav way of mass privatization created even more conflicts of interests because banks often were owned by their less than fully creditworthy clients rather than the other way around. This is clearly the most dangerous way of interlocking ownership, representing a vicious cycle.

The cost of reluctance and complacency has proved to be especially high for the Czech Republic. This is perfectly reflected in the forced renationalization and immediate sale of the failing IPB to Československá Obchodní Banka in June 2000, which was an unprecedented move in the history of bank consolidation and privatization. Several lessons can be drawn from this case.

First, there is no point in selling even a relative majority stake to any foreign entity without transferring real management control and responsibility. Second, not all good-sounding foreign names represent trademarks of truly prudent strategic partners. Third, and most important, governments should prepare very carefully the legal documentation for all transactions, making sure that, after due diligence, the value of the assets is assessed reasonably and realistically, any remaining uncertainties regarding asset value and contingent liabilities are perfectly identified, and the assets involved are clearly ring-fenced. Unfortunately, none of these fundamental conditions seems to have been met when the formal transaction of selling IPB to Nomura took place in 1997. As a consequence, a textbook case of moral hazard emerged where the private partners were able and allowed to privatize all of the gains and the (new) Czech government finally was obliged to socialize all of the losses. The cost of rehabilitation for the three large Czech banks eventually will exceed 10 percent of GDP. It could have been much lower had these banks been sold to reputable and prudent foreign strategic investors right after the initial cleanup, which happened well before the breakup of Czechoslovakia, eliminating all nonperforming assets inherited from the communist period. Even though the Czech Republic can easily afford the resulting increase in its public domestic debt, this is a serious loss of opportunity in terms of slower growth and delay in catching up with the EU.

Slovenia has been less complacent in making policy and issuing declarations, but equally reluctant in inviting

foreign stakeholders in financial sector institutions. The two largest banks—Nova Ljubljanska Banka and Nova Kreditna Banka Maribor—are still controlled by the treasury, and no specific plans for their final privatization are in sight. Although some foreign banks established wholly owned subsidiaries and started to compete with the two large banks as well as the smaller regional financial institutions, the small Slovene market has become so overcrowded that the two large public banks may lose market share quickly, especially when free branching will be the rule of the game by the time of EU accession. In addition, in an apparent move to defend the domestic currency, Slovenia imposed quite a few brakes on the flow of short-term and equity capital and kept them in place until very recently. The country even discouraged direct investment in nonfinancial firms, perpetuating the inefficiencies of enterprises caused by the flawed mass privatization program. These inefficiencies, in turn, have effectively blocked any major restructuring by making it impossible to reduce excessive labor and keeping salaries much higher than is affordable, sustainable, and reasonable.

Government policies did not facilitate quick adjustment and deep restructuring either. Payroll taxes are intolerably high just to support a generous and hardly reformed pay-as-you-go pension system and an overextended health care system. Private initiative in managing pension funds as well as insurance premiums and other contractual savings is in an incipient stage, only partially accessible to foreign players. In sum, the Slovene financial sector is clearly underperforming its potential because—apart from successful bank rehabilitation—it has not yet been exposed to any major fundamental reform.

It is an irony of history that both the Czech and Slovene equity markets are much smaller and less liquid than the Polish and Hungarian ones, not so much despite but largely because of the unfavorable initial conditions created by the mass privatization schemes. Again, the Czech equity markets constitute a perfect example of what went wrong. At first sight, mass privatization programs seem to have provided a magnificent one-time boost for the formal capitalization of open markets, especially in the absence of any meaningful criteria for listing stocks and disseminating information on them. Ideological extremists have even praised the lack of requirements for entry in the name of unlimited liberalism to create markets first rather than kill them with burdensome regulation and heavy supervisory structures. But the lack of transparency and enforceable rules has proved to be an open invitation to abuse and created a backlash of widespread disillusionment with and even hatred against stock markets.

Negative sentiments, especially among foreign portfolio investors, and the heroic efforts of some enlightened officials of the otherwise weak and politically targeted supervisory agency have resulted in tighter regulations just to recreate trust and confidence, which either have been lost or never were created. The Prague Stock Exchange delisted hundreds of firms in the last couple of years, but despite introducing and enforcing tough rules for listing and continuous disclosure, its overall turnover was still less than one-third that of the Budapest Stock Exchange in 1999. (Hungary constitutes by far the best comparator for the Czech Republic: its economy and population are roughly the same size, with GDP of \$50 billion and a population of 10 million people, which is shrinking and aging quite rapidly.)

### *Countries Struggling with a Double Legacy*

Countries struggling with a double legacy, such as Croatia and the Slovak Republic, share the following characteristics:

- The largest banks are, or are about to be, sold to foreign strategic investors.
- There is a strong drive to privatize all banks after costly systemic rehabilitation.
- A number of insolvent banks still have to be rehabilitated or finally liquidated.
- The quality of the portfolio is largely poor except for some mid-size banks.
- Prudential behavior is still marginal in corporate governance.
- Both the quality of services and retail banking are slowly improving.
- Capital markets are small and illiquid, and foreign participation is low.
- Regulation is improving, but still timid, and enforcement is uneven.
- Competition is weak, with regional and sectoral segmentation.
- Nonbank financial intermediation is in an incipient stage.
- The intention and efforts to liberalize cross-border transactions are serious.
- Fiscal and structural problems are deep, and pension reform has been postponed.

The political and economic development of the Slovak Republic and Croatia during the first decade of transition is strikingly similar and in marked contrast to that of the Czech Republic and Slovenia, with which they shared a common fate and history for almost 70 years. Both countries had nationalist and autocratic governments for a prolonged period after regaining independence in the early

1990s. Since Croatia was involved in an armed struggle to restore its own territorial integrity, and also was involved indirectly in Bosnia, nationalist tendencies have become more deeply rooted and caused more distortions in the weak economy and fragile social fabric than in the Slovak Republic. Charismatic and populist political leaders attempted to create a domestic oligarchy in both countries, and this oligarchy gained prominence quickly as a result of insider transactions following the mass privatization programs that had been started in Czechoslovakia and Yugoslavia.

Initial conditions were much less favorable for the development of financial institutions in many respects. Both countries have inherited a more inward- and eastward-oriented and less competitive real economy, with disproportionately high emphasis on less than state-of-the-art heavy industries (for example, shipbuilding in Croatia and armaments in the Slovak Republic). Markets for these products have collapsed very quickly, and neither of these countries has been able to regain sustainable export-led growth since. Overall, real sector modernization has proved to be painstakingly slow, as weak insiders—in most cases, former managers and newly emerging political clients—effectively blocked external participation, including much-needed foreign investment. Relatively high growth in the mid-1990s was short-lived because it was based on an artificial boost in demand fueled by corporate borrowing in both countries and by a reconstruction boom in Croatia. Because both countries inherited minimal foreign debt, fiscal overspending made it possible to hide structural weaknesses and postpone serious reforms addressing them.

Major financial institutions became formally private almost by definition as a consequence of the mass privatization schemes. Croatia—like any other former Yugoslav member state—experienced the least advantageous form of privatization. When workers' self-management was transformed into share ownership for insiders, banks immediately and almost automatically fell into the hands of their still unstructured clients. In addition, the strong regionalization of Croatia—reflected also in the name of its banks—created local monopolies with little or no competition. Autocratic governments in both countries actively promoted a sense of national unity by assisting the establishment of interlocking ownership between local firms and financial institutions blessed and sanctioned by local governments. An intimate web of mutual services and a lack of transparency created extremely fertile ground for political abuse and corruption, which finally resulted in the collapse of many banks in 1997–98. Rehabilitation proved to be an unusually broad and expensive exercise in both

countries and covered almost the whole sector, public and private financial institutions alike.

The legacy of this futile experiment with oligarchic development is as damaging as that of the communist system. Broad coalitions of democratic parties are now trying to overcome the dire consequences of these distortions by implementing bold reforms aimed at catching up with the most advanced transition economies.

In the Slovak Republic, the government has cleaned up the portfolio of the three largest state-owned banks—Vseobecna Uverova Banka, Investicna a Rozvoja Banka, and Slovenska Sporitelna—and announced its determination to sell controlling stakes in all of them to first-class foreign strategic partners as quickly as possible. (The sale of Slovenska Sporitelna to Erste Bank has already been completed.) Legal and regulatory modernization, as well as corrections of insider privatization deals, is occurring rapidly, together with a strong drive to attract foreign direct investment in large nonfinancial firms. Sweeping financial liberalization and other bold structural reforms resulted in Slovakia's becoming the 30th member of the Organization for Economic Cooperation and Development in 2000.

Croatia, for its part, has successfully completed the privatization of its flagship bank, Privredna Banka Zagreb, while continuing serious efforts to attract strategic partners for a number of mid-size banks. The sale of control to strong foreign professional investors in Rijecka Banka and Splitska Banka also has been finalized. However, the liquidation of a number of deeply insolvent mid-size banks—including one of the largest and most important, Dubrovacka Banka—needs to be completed before good governance can take hold in managing financial institutions. Insurance remains largely unstructured in both countries, while foreign players are gaining ground very quickly at the expense of the state-owned former monopoly.

Again, the irony of history is that the Slovak and most likely the new Croat authorities probably will show a more genuine desire to introduce the most advanced best practices of corporate restructuring, insolvency, liquidation, and restructuring and, at the same time, will woo much-needed foreign direct investment just to compensate for the poor image their countries have acquired among international investors compared with the Czech Republic and Slovenia. Given their double legacy and their less-developed economic structure, the Slovak Republic and Croatia are encountering more difficulties in attracting a sizable amount of foreign direct investment carried out by truly reputable foreign firms. This is especially true in the case of financial institutions, where foreign strategic investors are motivated not so much by the present net asset value of existing ventures but rather

by the future growth potential of the whole economy and the chances that the country will access quickly to the EU. The Slovak Republic tends to be much more fortunate in this regard. It may even be able to catch up with the first-tier accession candidates and join the EU at the same time as they do, while Croatia has yet to enter serious negotiations at all.

As far as capital market development is concerned, mass privatization coupled with the lack of adequate regulation and enforcement proved to be detrimental to substantive takeoff. Within the equally bleak picture, the Slovak equity market seems to have more stocks and perhaps more liquidity, while the Croat market has some larger firms with better quality (Pliva, Podravka, and Zagrebacka Banka are well-known names even in the international arena). Legislation and regulation have improved recently, but enforcement still leaves much to be desired. Latecomers are struggling not only with the legacy of oligarchic development but also with the lack of enthusiasm for going and remaining public. The small size of the domestic market and the lack of institutional funds to be invested constitute additional impediments in the short run. Fiscal constraints and strong vested interests in maintaining generous pension privileges, especially in Croatia, will make any effort to boost contractual savings highly unlikely in the foreseeable future. Conversely, government bond markets have a better chance of expanding quickly due to sizable fiscal deficits and debt in both countries.

It is an interesting feature of the institutional arrangement in both countries that the central bank plays a crucial role not only in overall banking regulation but also in supervision and oversight. Since both institutions assumed the role of a proper central bank and started issuing money and regulating money supply only 10 years ago, it is no surprise that there is a relatively weak institutional capacity to carry out all these new functions. Both central banks have implemented strict monetary policies, and this contributed significantly to the maintenance of macroeconomic stability throughout the 1990s. Prudential regulation and supervision, in turn, proved to be politically sensitive and controversial because strong vested interests worked against prudent practices more often than not. It is not so much the weak intellectual capacity but the lack of political support that has prevented the implementation of tough rules of prudential regulation and supervision.

### *Desperate Reformers*

Desperate reformers such as Bulgaria and Romania share the following characteristics:

- Few large insolvent banks are still in government hands.

- Desperate attempts have been made to sell systemic banks to foreign strategic investors.
- A number of insolvent banks still have to be rehabilitated or liquidated.
- Good portfolios are expanding slowly, because creditworthy clients are few.
- Prudential behavior is still marginal in corporate governance.
- The quality of services is improving slowly, but retail banking is expanding faster.
- Capital markets are very small and illiquid, with low foreign participation.
- Regulation is improving, with uneven and unpredictable enforcement.
- Competition is weak, and foreign subsidiaries play a marginal role in Romania.
- Nonbank financial intermediation is in an incipient stage.
- Liberalization of cross-border transactions is yet to be achieved.
- Institutional investors are lacking, and no pension reform is in sight.

Except for Albania and the former members of the now defunct Soviet Union, Romania and Bulgaria have inherited nothing but the worst from the communist system in Eastern Europe. Both countries used to have extremely rigid, neo-Stalinist systems of economic management, with more tolerance toward small-scale auxiliary ventures in Bulgarian agriculture and especially devastating autarchic tendencies in Romania. Although preserving national statehood after World War II may have been an asset, public institutions have proved to be very weak, with a quite shallow implementation capacity ever since.

Political fragmentation, especially in Romania, has further weakened the reform drive, and no critical mass of consistent measures has been introduced in any important area of the transition agenda. Romania lost not only the first six years of transition by postponing structural reforms but also the next four, when a center-right multiparty coalition government remained largely paralyzed by constant factional fighting. Bulgaria, in turn, has been more fortunate. Since the deep crisis of 1996 and 1997, an unusually strong and unified government has tried to make up for lost time not only by restoring macrofinancial stability but also by initiating corporate restructuring, privatization, and financial sector modernization. Despite the negative impact of external factors, such as the Russian crisis, the war in Kosovo, and the disruption of trade and transportation links, Bulgaria has managed to distinguish itself as having an economy with the best mid-term perspectives in the whole

Balkans. Nevertheless, both countries have a long way to go before they can truly satisfy membership criteria for EU and close the income gap with other candidates for accession.

Banking sector development was started with the establishment of three or four large state-owned banks (each typically oriented toward foreign trade, industry, and agriculture) without transforming the old savings bank into a universal financial institution. The left-leaning socialist governments in the first half of the 1990s did not consider bank privatization seriously. All they did was allow the proliferation of new and small private commercial banks as a consequence of a liberal policy on entry, which also could be interpreted as a lack of adequate regulation on minimum capital standards and prudential requirements of ownership. These small banks constituted a mixed blessing because most of them turned out to be almost like pyramid schemes and quickly went bankrupt, providing a good excuse for those who opposed privatization of banks altogether. However, the large state-owned banks did not perform better either, and virtually all of them in both countries proved to be technically insolvent by the mid-1990s as well.

Reactions to this disappointing development were somewhat different in the two countries, mostly because of divergent political solutions to the emerging crisis. In Bulgaria, the whole unreformed economy collapsed at the end of 1996, and the new authorities made a complete U-turn in policy. They decided to rehabilitate all state-owned banks by cleaning up their loan portfolio and announced an uncompromising and ambitious privatization program involving foreign strategic investors. The Bank Consolidation Company (BCC), established in 1992 to manage the rehabilitation of state-owned banks, was empowered to direct individual transactions selling control to reputable foreign investors. Given the dire situation of the Bulgarian economy in 1996–97 and the negative image of the country among global investors, it has been extremely difficult to attract prudent foreign partners. But the government's steadfastness and perseverance have paid off.

The Bulgarian government has made wise and careful decisions on timing and sequencing and has been able to build up momentum and gradually change the perception of the outside world of the prospects of the Bulgarian economy. The easiest target, Postbank—a newly established and hence relatively unspoiled, small, state-owned bank plus a spin-off of the large foreign trade monopoly, the United Bulgarian Bank—went off the hook first, followed by two somewhat larger, regionally important, and more easily restructured state-owned banks (Expressbank and Hebrosbank). The privatization of the largest and by far the most important bank—the former foreign trade monopoly,

Bulbank, which covers almost 40 percent of the economy—was successfully completed in 2000, despite fierce and open resistance of the incumbent management to the sale of control to foreign strategic interests. Only two large state-owned banks remain to be sold—Biochim and Savings Bank—and this process may not be too difficult given the momentum generated by recent transactions.

Romania has been able to make much less progress in both bank rehabilitation and privatization. Although BancPost, a newly established and healthy state-owned bank, was easily sold together with the relatively clean and small Development Bank, little or no real progress has been made on privatizing the large, truly systemic banks. On the contrary, the flagship bank Bancorex—the former foreign trade monopoly—was recapitalized five times, costing more than \$1 billion to the Romanian taxpayer, only to be liquidated in 1999. Banca Agricola also was rehabilitated several times and was cut drastically in size without any hope of a quick sale, apparently due to the lack of political agreement on a coherent privatization strategy and, lately, very little outside interest. Banca Comerciala Romana (BCR), which was perceived as the healthiest of the three largest banks, remains in government hands as well. Given the volatile political environment and the excessive bargaining power of the managers of the state-owned banks—who were appointed on the basis of their political affiliation according to coalition agreements—there seems to be no quick fix either for these two large state-owned banks or for the recently corporatized Savings Bank.

Given these circumstances, it is almost inconceivable to expect substantive improvements either in corporate governance and prudent behavior or in the quality of services, assets, internal audit, risk management, or credit allocation. Although legislation improved considerably in the second half of the 1990s in both countries, enforcement remained uneven, unpredictable, and sometimes politically conditioned, especially in Romania. Shallow implementation capacity constitutes a real bottleneck in both jurisdictions. None of the two central banks has ever been up to the requirements of crisis prevention and management.

The lack of confidence and the confusion about rules and values to be upheld are highlighted clearly by the series of small banking crises hitting Romania in 2000. As a side effect of the collapse of a sizable investment fund, there was a run on BCR, and three other mid-size banks were brought under receivership. (One of them was the proudly named International Bank of Religion.) In the meantime, courts rejected the request of the National Bank of Romania (NBR) for declaring a powerful regional bank,

Dacia Felix, bankrupt—precisely two years after the request was submitted. And when the bank finally was declared insolvent, the new leftist government forced NBR and the Savings Bank to accept a partial settlement in order to pull Dacia Felix out of liquidation in early 2001. This reflects the lack of clear interpretation and enforcement of banking regulations as well as the continuation of arbitrary political interference in managing the financial sector.

Capital markets are very small and illiquid in Romania and Bulgaria despite or because of the flawed and botched mass privatization programs that flooded the initially underregulated equity markets with hundreds—in the case of Romania, thousands—of poor-quality stocks. Despite heroic efforts in both countries to introduce serious confidence-building measures by creating all the necessary infrastructure for trading, clearing, and settlement as well as listing and information dissemination, so far neither domestic nor foreign participants have invested any meaningful amount of money in those two markets.

The underdeveloped nature of banking, insurance, and capital markets in Romania and Bulgaria is strongly correlated with the incipient results of efforts to restructure the real economy. Severe distortions caused by inept and irresponsible communist megalomania clearly render the legacy extremely difficult to deal with, again, especially in Romania. A large number of sizable industrial firms are not candidates for privatization, even after financial liquidation and dismemberment. In quite a few important cases, only the physical closure of enterprises makes sense because markets are completely lost, the technology involved is outdated and harmful to health, the ecological degradation is immense, and there are financial liabilities rather than assets.

In light of these extremely disadvantageous initial conditions, the predominance of mass privatization schemes was even more harmful in these two countries than in more mature industrial economies, like the Czech Republic and Slovenia. Mass privatization not only created an illusion of real positive value but also erected a formidable obstacle to painful restructuring and an aversion to losses. It is no surprise that prudent banks find it extremely difficult to lend to the real sector because creditworthy clients with manageable risk are few and far between. This is especially true in Bulgaria, where most of the systemic banks are now in the hands of reputable and strong foreign strategic investors.

The establishment of a market economy depends largely on new ventures, both domestic and foreign. Since foreign direct and portfolio investment have been almost negligible in nonfinancial sectors, both economies have depended mostly on the expansion and organic develop-

ment of domestically owned small and medium-size enterprises. Due to the rapid contraction of the state sector, the incipient and vibrant private sector simply has not been able to compensate for all the losses in overall output. In addition, small and medium-size enterprises are much less “bankable” and have little access to open capital markets as well. Thus the state of affairs in the financial sector is a mirror image of the hardships in the real economy.

Apart from the growing arrears in certain enterprises, especially in large public utilities, and the ballooning intercorporate debt, which reflects soft budget constraints and lack of strong market discipline involving credible threats of bankruptcy and liquidation, both countries largely maintained fiscal prudence in the second half of the 1990s. Bulgaria clearly was helped by the currency board arrangement introduced in the summer of 1997, but even Romania, which reportedly was on the verge of a financial collapse from time to time, maintained fiscal discipline and outperformed even Hungary in terms of general government balance. The sad irony is that fiscal prudence alone is not a recipe for restarting economic growth, especially if there is no supply-side adjustment in the economy due to the lack of flexible micro structures able to respond to market signals. Postponing structural reforms time and again might render prudent macroeconomic policies largely useless or even harmful. Romania has proved to be an almost textbook case for this lesson.

### *Prolonged Crisis Cases*

Bulgaria and Ukraine are experiencing a prolonged crisis with the following characteristics:

- Most banks are in private hands and are insolvent.
- Rehabilitation is selective, and there is a reluctance to invite foreign strategic partners.
- A large number of banks need to be delicensed and liquidated.
- Portfolio quality is very poor and hardly improving.
- Corruption, crime, and cronyism are rampant.
- The quality of service is low, and retail banking is rudimentary.
- Capital markets are small, discredited, and abused.
- Regulation is weak, and enforcement is openly politicized.
- Domestic markets are fragmented and monopolized.
- Nonbanking financial intermediation is almost nonexistent.
- The attitude toward financial liberalization is largely hostile.
- The country is experiencing a permanent fiscal crisis, in which pension reform is not on the agenda.

Russia and Ukraine represent such peculiar cases that they hardly find their place in international comparison. Russia is very special for its sheer size and strategic importance, while Ukraine is unique for its truly permanent crisis and apparent lack of opportunities. Russia could well afford not to implement any serious structural reform because its vast exportable natural resources and ability to extract large amounts of financial assistance from the Western countries have helped it to survive the worst crises. Ukraine has given up its nuclear arsenal and does not possess any meaningful amount of natural wealth. Moreover, regaining full sovereignty after 300 years of Russian dominance is not an easy task. The Ukrainian state is particularly weak and fragmented and has easily fallen prey to the emerging local oligarchy. Russia's ruling elite (the political class and the oligarchy) is largely unwilling, while in Ukraine it is unable, to introduce substantive market-oriented reforms.

Financial sector development in the two countries was very similar until the mid-1990s. Like in Romania and Bulgaria, three to four large state-owned banks originally were carved out of the mainframe of the former central bank of the Soviet Union. Saving banks that were operating throughout the communist period maintained their narrow focus for many years. And hyperinflation eliminated the value not only of banking assets but also of liabilities, creating a very special "bank rehabilitation scheme" financed exclusively and involuntarily by the depositors. This devastating crisis, however, created a magnificent window of opportunity for strengthening the hard core of the banking sector by privatizing the state-owned banks of systemic importance in a prudent and efficient way. Unfortunately, this moment was lost because the political class in both countries remained suspicious, if not openly hostile, to the idea of selling their perceived crown jewels to foreign investors. Instead, they decided to create a domestically rooted echelon of large entrepreneurs by allowing some well-connected people to acquire immense chunks of former state property for a symbolic price. This artificially and deliberately accelerated "original accumulation of capital" was assisted first by selective licensing of foreign trade transactions in a largely closed economy, then by the mass privatization schemes that concentrated a large amount of wealth in the hands of insiders, and finally—mostly in Russia—by the loan-for-share schemes in which a handful of privileged individuals were allowed to take over the controlling stakes in large chunks of extractive industries. In Russia the emerging oligarchy acquired control over the large state-owned banks as well, while in Ukraine most are still in government hands but have lost

considerable market share to new and private financial institutions.

Another common feature of banking sector development in Russia and Ukraine was the rapid proliferation of small private financial houses in the first half of the 1990s. Like in Romania and Bulgaria, this tendency was the result not so much of a genuine drive for liberal market reforms but rather of the lack of meaningful and consistently applied legislation and regulation. Although banking laws and rules have been improved considerably in the last three years in both countries, central banks are still struggling with the immense backlog of small, frequently nonoperating, bank-like creatures that await delicensing.

From a systemic point of view, it is more important to analyze the situation and health of the large banks operating nationwide. In both countries even the large banks play only a marginal role in financial intermediation in general and in financing the real sector in particular. That is one of the most important reasons why the collapse of the whole Russian financial system in August 1998 did not trigger a serious downturn in the real economy. Nevertheless, the insignificant role of banks in financing real sector activity did not prevent the same banks from accumulating huge losses in their loan and investment portfolios. Although the August 1998 meltdown was triggered basically by the collapse of the government debt market and was exacerbated further by the devaluation of the Russian currency, the crisis was only making already insolvent banks illiquid. At present, the reverse is also true; the refloating of the Russian economy as a consequence of the exceptionally high export prices for oil and some other natural resources coupled with the newfound fiscal discipline and real sector growth largely due to opportunities of import substitution have restored liquidity for quite a few banks, without addressing the more fundamental problem of deep insolvency.

There are at least two more reasons why financial intermediation has not developed in a more satisfactory manner. First, real sector decline was dramatic in both countries. Russia lost roughly half of its former output, while Ukraine lost more than 60 percent in the 1990s. Contrary to what happened in Romania and Bulgaria, even small and medium-size enterprises could not develop fast enough in these rapidly declining economies due to self-serving bureaucratic bottlenecks, devastating criminalization of economic and social life, and rampant corruption. Rent-seeking behavior and public acceptance of corruption are predominant, crippling almost all economic activity, but, first and foremost, productive investment. As a consequence, except for firms in the export sector, creditworthy clients are few and far between, while opportunities to

make money in corporate lending are scarce, and profitability is much higher in other areas.

Retail banking was even less lucrative, and banks did not put high priority on developing these services. Banks were, and have largely remained, much more interested in acting as brokerage firms in the incipient but—at least in Russia at one stage—fast-expanding capital markets.

Capital market developments are very different in the two countries. Russia was a magnet for foreign portfolio investors at least before the crisis, even though legislation and regulation concerning property rights, transfer of title, minority protection, clearing and settlement, and foreign exchange controls were far from perfect (as they are even today). This exceptional appeal of investments in Russia was explained by the sheer size of the potential rather than the actual market, the overall attractiveness of the export-oriented extractive industries, the marked liberalization of foreign portfolio investment, and the significant amount of public borrowing, which created a speculative market for state debentures. None of these factors was present in Ukraine, except for the last one, which proved to be insufficient in light of political instability and lack of strategic importance.

Things changed considerably after the onset of the Russian crisis. Since influential people, including reputable foreign firms, lost a fortune when capital and foreign exchange markets collapsed, it is unlikely that the same enthusiastic rush for Russian equity and government paper will materialize in the foreseeable future. Russia is not keen to step into the same river either. Recent efforts to keep tight budget controls and at the same time implement fundamental reforms in taxation suggest that the authorities do not intend to restart massive foreign borrowing even after the oil bonanza. There is more hope of seeing a gradual revitalization of equity markets in the long run, if and when much needed changes in basic legislation and corporate behavior take place.

Although there clearly is opportunity, if not certainty, for the Russian real economy to take off, Ukraine is likely to prolong its permanent crisis. The political class is more fragmented than ever, and the government—which is led by the former central bank governor as a last resort to technocratic leadership—does not seem to have either the impetus or the political support to undertake any of the desperately needed basic reforms. Unfortunately, in terms of implementing efficient public policies and micro reforms, there is no one single bright spot on the horizon of Ukraine in the short and medium run.

The vast majority of the population in Russia and Ukraine have lost their trust in public institutions and domes-

tic financial firms. This is also true in most other countries of the Commonwealth of Independent States. To reverse this trend will require heroic efforts and a sea change in behavior on the part of governments and ruling oligarchies.

### Three Pillars of Financial Sector Development

As is obvious from even a sketchy analysis of the political economy of financial sector development in the transition world, the formation and evolution of reliable channels of financial intermediation throughout the 1990s were very different from one country to the next, and there is no reason to believe that this trend will soon be replaced by strong convergence toward well-developed and mature structures. Some countries will join the dreamland of the European common market within a very short historic period of time. Others perhaps will wait another generation before getting in. There might be a tendency toward equalization in income-generating capacity among the transition economies after another decade of differentiation. But there will be no easy reversal of the culture and tradition that are so detrimental to the expansion of healthy financial intermediation fostered by efficiently managed and prudent institutions. The emergence and dominance of local oligarchies, sometimes stronger than the state itself and characterized by rent-seeking behavior, asset stripping, state capture, crime, and corruption could well become so embedded in the social fabric that it is no longer possible to get rid of them without a devastating, full-blown crisis of the economic and societal system.

The Slovak Republic and Bulgaria have been fortunate to have changed course relatively early on; Croatia has every hope of following suit. Romania, however, is fast approaching a historic crossroad: the results of parliamentary elections in 2000 clearly strengthened nationalist and populist elements. Some other countries, most notably Russia and Ukraine, do not seem to have a historic chance of breaking the overarching influence of their oligarchies in the short run. But the strongly appealing perspectives of EU accession and the genuine desire of the local electorate to achieve Western economic standards by embracing not only the values of an open and competitive market economy but also its consequences can be crucial in a mid-term horizon and may bring about substantive change. It clearly is in the interests of people involved in the development business to facilitate the accumulation and strengthening of all creative elements that promote prudent civic culture and to establish a tradition of individual integrity and honesty in business and civic life. It also is their moral obligation.

In the area of financial sector development, there are three fundamental pillars determining the scope, nature,

and quality of emerging institutions and influencing the basic course of development on which these institutions embark:

- Internal and external governance structures
- Domestic and international competition
- Prudential regulation and supervision.

These three pillars are mutually complementary and overlapping: improvements in one area clearly help to modernize and strengthen the other two. Nevertheless, a critical mass in all three areas must be achieved in order to develop a mature financial system, put it on a secure path of sustainable expansion and development, and maintain a high level of trust and confidence. Unfortunately, none of the transition countries has reached this stage of development yet; the regulatory and supervisory structures need to show considerable progress, even in Poland and Hungary.

### *Corporate Governance*

The following recommendations are offered to improve internal and external governance structures:

- Once and for all, rehabilitate viable state-owned banks of systemic importance.
- Recapitalize private commercial banks only in exceptional cases.
- Privatize state-owned banks immediately after restoring minimum solvency by selling a controlling stake to reputable foreign strategic investors.
- Depoliticize and professionalize financial intermediation.
- Discontinue all directed and insider lending and investment practices.
- Draw up management contracts with time-bound and monitorable performance criteria.
- Ensure adequate representation of the interests of all stakeholders in supervisory boards.
- Institute proper checks and balances in internal management and credit allocation.
- Implement management information systems and internal audit.

In light of the growing tide of antiforeign sentiment and fierce debate about the “desirable and acceptable” level of foreign participation in the financial sector, it seems impractical and unwise to advise governments to sell their largest and systemically most important financial institutions to foreign strategic investors. Even enlightened and pragmatic governments are reluctant to offer management control to foreign professionals, at least in the large saving banks and insurance firms, no matter how prudent and reputable the prospective foreign buyers

might be. PKO BP in Poland and OTP in Hungary are good cases in point.

People might find it strange that a kind of universal panacea is being offered to remedy most, if not all, fundamental illnesses of the financial sector. The experience of continental Europe does not seem to justify this peculiar type of sweeping privatization either; there are quite a few countries, like Germany, France, and Italy, where state—or at least local government—control as well as dispersed ownership of domestic nonfinancial institutions and individuals have characterized important segments of banking, insurance, and capital markets without substantially deteriorating the quality of governance. Why is it not possible for Central and Eastern Europe to follow their example?

There are several reasons for this, some of them decisive. First, communism lasted too long and was too successful in destroying trust in domestic private institutions and a tradition of prudent behavior in economic and social life. Second, when the futile communist experience in economic management finally ended, world markets were characterized by massive cross-border transactions, and international competition was producing new and improved services at a scale never seen before. Third, the demonstrational impact of liberal capitalism—very much magnified by modern telecommunication—coupled with the strong desire to catch up with the developed world produced an almost insatiable thirst of clients in Central and Eastern Europe for getting access to the latest and best services without delay. The interplay of these and many other factors make it impossible for people to wait another 50 years before enjoying the same quality of services as their Western counterparts. But people demanding the best as customers are unfortunately unable to create them as producers. Consumers demand reliable and proven foreign products and services while they may refuse to accept the structures, including those of foreign governance, that create and maintain the high level of quality for those products and services. Communist deputies of the Russian parliament have indicated privately that, although they cannot accept foreign control in flagship domestic banks, they would place their own money mostly in foreign banks domiciled in Russia or abroad. Nationalism and populism just perpetuate the rule of the oligarchy.

Selling control in financial institutions to foreign strategic partners is the best way to bridge the huge gap between the very demanding and fully Westernized consumer mentality and the ignorance of what it takes to be a prudent provider of the same quality of products and services. Since there is no point in resisting or slowing down the influence of consumer capitalism, the only path is to accelerate the

(re)creation of the culture of confidence and the tradition of prudence inherent in an efficient, well-functioning market economy.

### Competition

The following recommendations are intended to improve domestic and international competition:

- Provide equal opportunities for entry and exit with maximum transparency.
- Mount a decisive drive against all sectoral and regional market fragmentation.
- Eliminate administrative limits on credits, interest rates, and fees.
- Gradually liberalize cross-border transactions and capital flows.
- Introduce simple, reasonable, transparent, and equitably enforced rules for taxation.
- Create a strong culture and regulation of creditor protection in corporate life.
- Enforce insolvency strictly across the whole spectrum of clients.
- Create a level playing field in all areas of financial intermediation.
- Use fiscal preferences only temporarily to increase the creditworthiness of clients.
- Involve the state directly in building physical and human infrastructure.

Managing transition is an art rather than a science, and timing and sequencing are key. While fostering unlimited domestic competition is indispensable from day one, international competition could be increased gradually, according to a well-established, publicly announced set of operational criteria. Countries preparing themselves deliberately for adopting the single market of the EU will be able to catch up more quickly in terms not only of income and productivity but also of culture and tradition. Enhancing the creditworthiness of corporate and individual clients by introducing proper incentives for stimulating financial savings and investment could multiply the growth and profit opportunities for financial intermediaries, thus creating a virtuous cycle of trust and prudence.

Competition, while being a strong incentive and disciplinary force to enhance quality and increase efficiency, also should be properly managed. Governments should focus on creating their own single market by eliminating all remaining administrative barriers, on the one hand, and helping disadvantaged clients, like small and medium-size enterprises, on the other. Transparent, easily accessible guaran-

tee schemes, one-time grants to cover initial costs, training and marketing subsidies, and infrastructure support make a lot of sense, as do the strict and even enforcement of regulations on bankruptcy, liquidation, secured lending, foreclosure of collateral, title transfer, share and company registration, minority protection, and taxation.

### Prudential Regulation and Supervision

The following recommendations are aimed at strengthening prudential regulation and supervision:

- Implement Basle core principles on banking.
- Set even higher capital adequacy and solvency standards.
- Strictly apply the rules on portfolio classification.
- Gradually increase provisioning requirements.
- Extend deposit insurance only to reputable institutions.
- Use independent rating of leading financial intermediary firms.
- Foster close cooperation or consolidation of supervisory agencies.
- Maintain the political and financial independence of supervisory agencies.
- Foster strong cooperation between host- and home-country regulators.
- Fight relentlessly against crime and corruption, cronyism, and collusion.

Finally, the weakest point: after 10 years of transition, there is no one single country in Central and Eastern Europe where the financial regulatory and supervisory agencies are free from—sometimes very open and brutal—political interference and where the highest professional standards could be applied without compromise. This is less of a problem in those jurisdictions where governance in and competition among individual financial institutions are strong enough to support prudent behavior. Nevertheless, this is still a very dangerous situation because the churning out of new financial products and services is accelerating, and this requires constant attention to market developments, frequent licensing, deep analysis of complex problems, and increasing reliance on discretionary judgments. If the underlying values and mandates governing the behavior of management and staff of these agencies are shaky or inconsistent, there is little hope that public confidence will prevail in these financial markets. The first task for the next decade is to strengthen considerably the institutions of prudential regulation and supervision.



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## Chapter 4

# Challenges of Financial System Development in Transition Economies

*Stefan Kawalec and Krzysztof Kluza*

**T**ransition economies are the economies of the former socialist countries and states of the former Soviet Union, which in the early 1990s started to transform their economies from a socialist to a market system. Building a market-type financial sector constituted a key element in these efforts. However, after a decade of change, the results and the experience are mixed. Most transition economies still have a long way to go to build a robust and efficient financial system.

This chapter assesses the present situation of the financial sector in transition economies and discusses what are, and how to face, the challenges that lie ahead. Three segments of the financial sector—banks, corporate debt market, and equity market—are examined. Based on the experience of developed countries, some observations are made about the role of these segments in the financial sector and the economy as a whole. Then the actual role of these segments in transition economies and future challenges are discussed. Findings are formulated in the form of twenty-one concise observations, some of which are supported by statistical analysis presented as figures.<sup>1</sup>

### **Bank-Dominated Versus Capital Market-Oriented Financial Systems in Market Economies**

A healthy financial system should generate an adequate level of population's savings, allocate these savings to efficient uses, and provide efficient tools of corporate control. To support attainment of this goal, two models of financial sector structure can be distinguished:

- *Bank-dominated model.* In this model, individuals keep their savings predominately in banks, which are the main source of external financing for the corporate sector. Banks also are the dominant investors in equity and corporate debt markets since stocks, bonds, and commercial paper function as bank products, alongside traditional loans.
- *Capital market-oriented model.* In this model, bank deposits are not the dominant savings and investment instruments for individuals. Individuals invest directly in the capital market, buying stocks and corporate debt instruments and, to a growing extent, investing through nonbank intermediaries like pension funds or investment funds. Accordingly, banks play a smaller role in financing the corporate sector than capital and corporate debt markets, which are dominated by nonbank investors (Mellyn and Saal 1998).

For years many observers praised the advantages of the bank-dominated model exemplified by financial sectors in

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1. These observations mostly describe the prevailing features of the financial sectors in the whole group of 28 transition countries in Europe and Central Asia. Some of these observations may not apply to a few Central European countries that have the most robust financial sectors.

Germany and Japan. Advocates of this opinion underlined that banks, having insight into companies' financial situation, may effectively control their managements, while assuring the stability that is necessary for developing and implementing long-term strategy. They also stressed that in the capital market-oriented model—exemplified by financial sectors in the United States and United Kingdom—dependence on the capital market may force managers to concentrate on current profits at the cost of neglecting long-term development.

However, in the 1990s, as a result of problems in the Japanese economy, flaws of the bank-dominated financial sector were widely acknowledged. At the same time, in conjunction with the successes of the U.S. economy, more attention was devoted to the significance of the stock market. In the United States, in the second half of the 1990s, the stock market boom and high valuation of information technology stocks—which raised concerns about, on the one hand, a bubble economy, and on the other hand, a possible crisis—meant easy access to capital for new technology companies. This enabled the reallocation of capital from traditional industries to information technology sectors, with a speed and scale that would be unthinkable in countries without a developed stock market and where banks constitute the main source of external financing for companies. Thus, there is growing evidence that the underdevelopment of the stock market may hamper an economy's ability to restructure in response to technological changes (Hale 2000).

*Observation 1.* The banking sector, corporate debt market, and equity market all play an important role in the financial sector. It is important for all of these to develop in a balanced way.

*Observation 2.* It is advisable that banks not dominate the equity and corporate debt markets. To achieve this goal, nonbank financial intermediaries are necessary, as is a broad group of individual investors.

### Goals in Financial Sector Reforms at the Start of Transformation

Bank deposits were the only officially available savings and investment instruments for individuals in socialist economies. The exclusive source of financing for the enterprise sector was bank credit, provided on the basis of investment and production decisions by central planning bodies. Banks themselves did not make credit allocation decisions and did not need to evaluate credit risk. Thus there were no equity or corporate markets. Although institutions called banks existed, they functioned as government agencies having little to do with modern commercial banking institutions.

*Observation 3.* At the start of the transformation, the main goals of financial sector reform were to (1) replace the monobank system with a genuine banking system and (2) create basic equity and corporate debt markets.

Over the past 10 years financial systems in transition countries have undergone significant changes as a result of the successes and failures of macroeconomic and microeconomic reforms and changes in the institutional framework. Today, the shape of financial sectors in transition economies varies significantly in regard to their relative size, structure, health, and efficiency.

### The Present Status of Financial Systems in Transition Economies

Three segments of the financial sector are examined here: banks, the corporate debt market, and the equity market. The following aggregates are used to indicate the size of these segments: value of bank deposits, value of outstanding corporate debt instruments (corporate bonds and commercial paper), and stock market capitalization. The aggregate sum of these three components can be regarded as a proxy for the size of the financial system. This section uses this aggregate (in relation to gross domestic product) to compare the structure of the financial sector in transition economies and selected developed economies and then discusses the health and efficiency of the financial sector in transition economies.

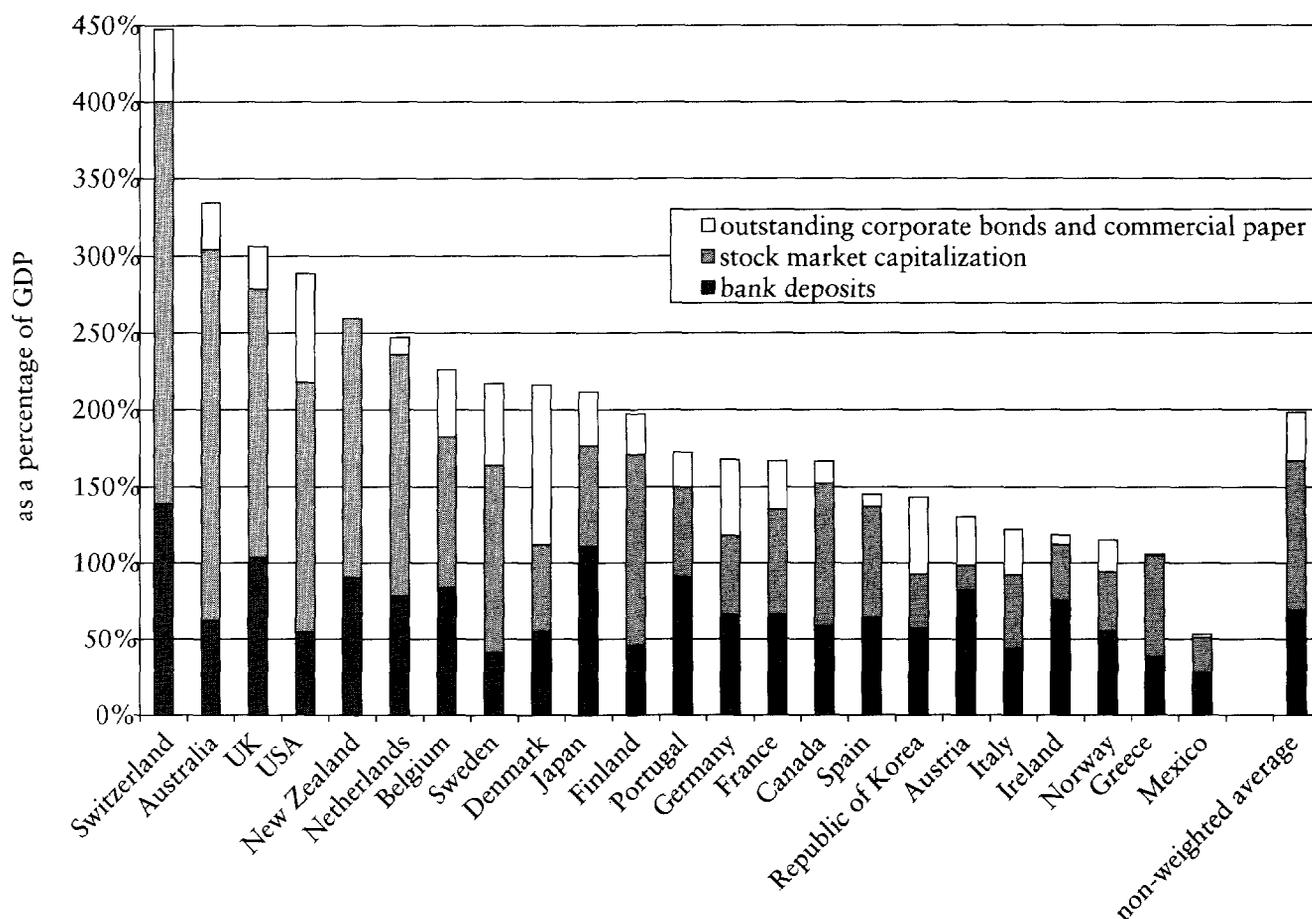
#### Relative Size of the Financial Sector

The size of the financial sector as a percentage of gross domestic product (GDP) in Organisation for Economic Co-operation and Development (OECD) countries and in transition economies is shown in figures 4.1 and 4.2. The unweighted average for financial sector size is 198 percent of GDP in OECD economies and 34 percent in transition economies. The size of the financial sector in OECD economies ranges from 100 to 450 percent (the only exception being Mexico, with 53 percent). The range for transition economies is 2 to 90 percent.

*Observation 4.* The relative size of the financial sector is, on average, much smaller in transition than in developed economies.

*Observation 5.* There are significant differences in the relative size of financial sectors among transition countries.

Figure 4.3 illustrates the relation between the relative size of the financial sector in transition economies in 1998 and cumulative inflation in 1989–98. The trend line shows that higher cumulative inflation coincides with the smaller

**FIGURE 4.1 SIZE OF THE FINANCIAL SECTOR IN OECD COUNTRIES, 1998**

Note: "OECD countries without Iceland, Luxembourg, Turkey and Czech Republic, Hungary, Poland."  
 Source: BIX, FIBV, IMF, Morgan Stanley Dean Witter, OECD, World Bank.

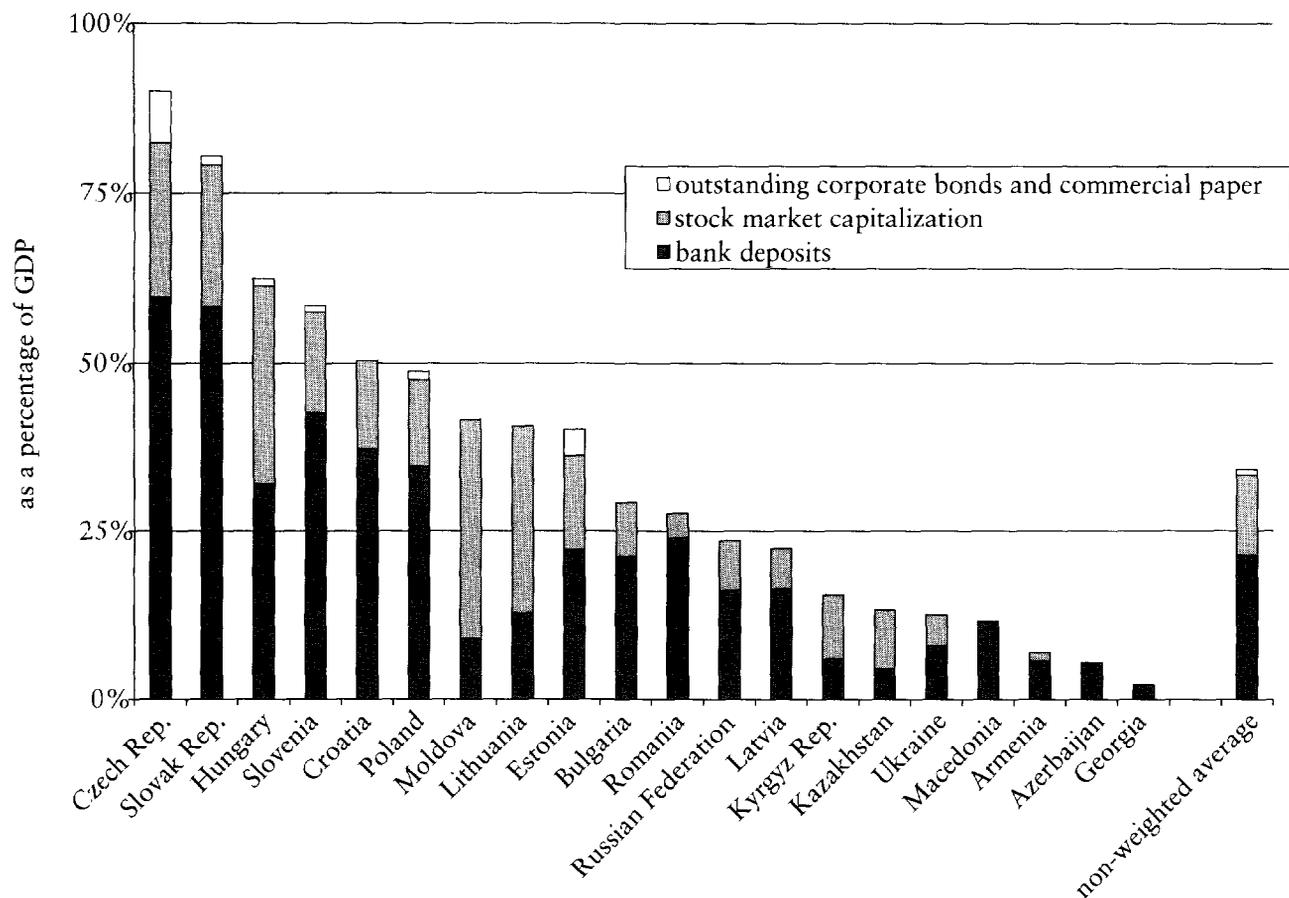
relative size of the financial sector. The coefficient of 0.77 indicates a strong statistical relation.

Figure 4.4 illustrates the relation between the size of the financial sector in 1998 and the change in cumulative GDP in 1989–98. The trend line shows that the higher is the contraction in cumulative GDP, the smaller is the financial sector's relative size. The coefficient of 0.57 indicates a modest statistical relation. This figure also illustrates the significance of the primary mode of enterprise privatization (as depicted by the European Bank for Reconstruction and Development [EBRD] 1999). Out of nine countries with a dominant system of voucher privatization, all but one have larger financial sectors than it is implied by the trend (located on the right side of the trend line). However, most of the countries with a predominance of other methods of privatization (direct sale or management or employee buyouts)

have smaller financial sectors than implied by the trend. All things being equal, voucher privatization seems to contribute to a larger size of financial sector.

The statistical relation with a change in cumulative GDP is stronger when focus is placed on the banking sector (shown in figure 4.5). The trend line shows that the higher is the contraction in cumulative GDP, the smaller is the banking sector's relative size. The coefficient of 0.71 indicates a strong statistical relation.

Figure 4.6 illustrates the relation, in 1998, between the relative size of the financial sector and the average EBRD grade of progress of reforms in the financial sector (EBRD 1999). The trend line shows that the smaller is the progress in financial sector reforms, the smaller is the financial sector's relative size. The coefficient of 0.58 indicates a modest statistical relation.

**FIGURE 4.2 SIZE OF THE FINANCIAL SECTOR IN TRANSITION ECONOMIES, 1998**

Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

Figure 4.7 illustrates the relation between the relative size of the financial sector in 1998 and the level of economic development in the same year, measured by GDP per capita. The trend line shows that the lower is the level of economic development, the smaller is the financial sector's relative size. The coefficient of 0.48 indicates a modest statistical relation. The relation becomes stronger when the banking sector is highlighted (shown in figure 4.8). The trend line shows that the lower is the level of economic development, the smaller is the banking sector's relative size. The coefficient of 0.66 indicates a reasonably strong statistical relation.

*Observation 6.* The very small relative size of the financial sector in transition economies in 1998 usually coincides with (a) very high cumulative inflation over the preceding 10-year period, (b) a highly negative change in cumulative GDP over the preceding 10-year period, (c) weak legal and institutional infra-

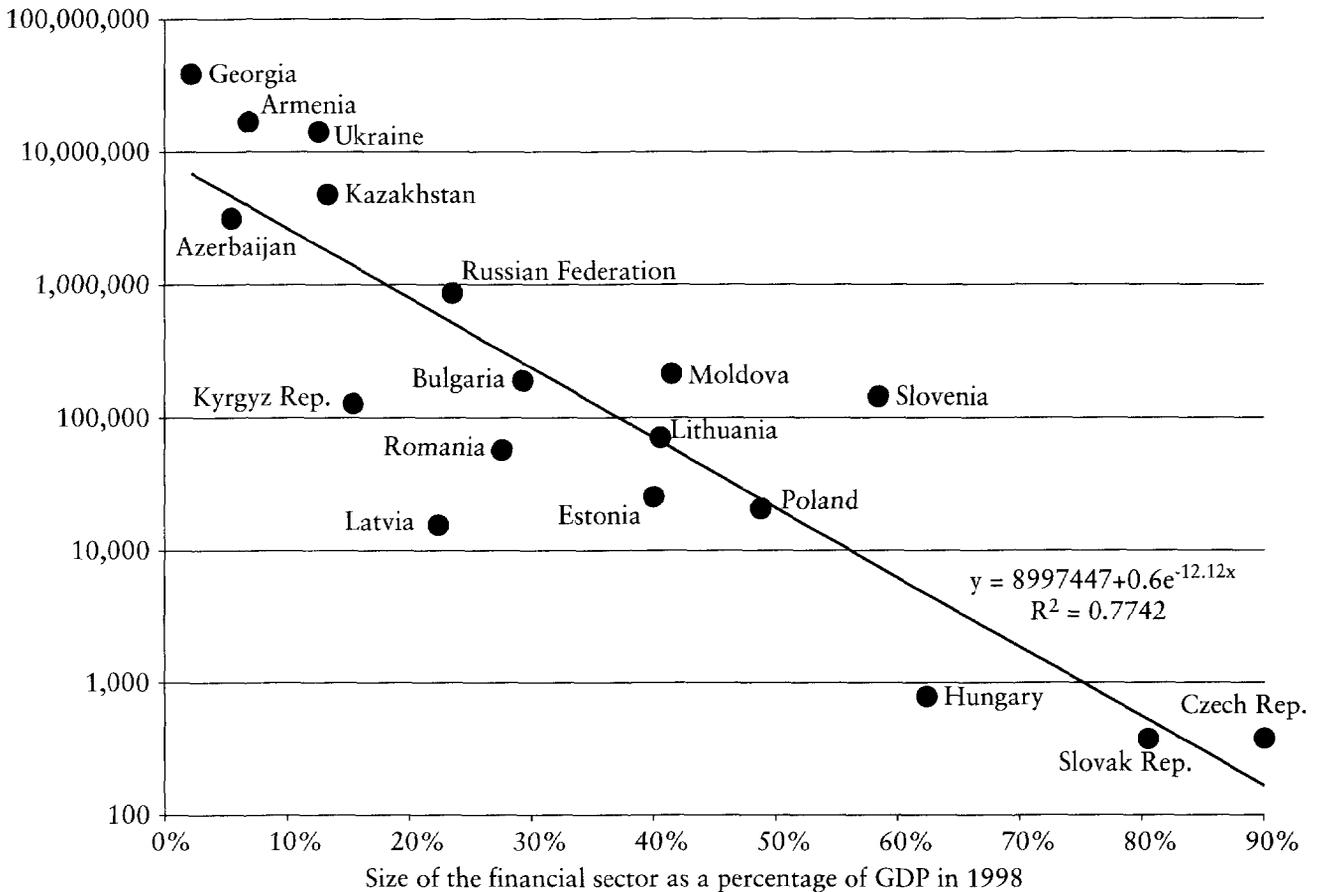
structure of the financial sector, and (d) low GDP per capita.

Observation 6 describes statistical relations that, in themselves, do not explain the relation between cause and effect. In general, it can be assumed that the small size of the financial sector is an effect rather than a cause of inflation, a decline in GDP, a weak institutional framework, and low GDP per capita. It is clear that the circumstances (such as adverse economic policies, external shocks, and civil wars) that triggered high inflation, currency depreciation, and prolonged economic decline did not create a climate for the development of equity and debt capital markets.

Very often, a deep decline in GDP reflects a significant shift from the official to the unofficial ("gray") economy, where funds are neither kept in nor transferred through banks within the reach of the government or the tax authorities. An example of such a situation is

**FIGURE 4.3 RELATION BETWEEN THE SIZE OF THE FINANCIAL SECTOR AND INFLATION**

Cumulated inflation (consumer price index)  
in 1989–1998 (1988=100) [log scale]



Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

Ukraine, where in 1998 official GDP in real terms was just 37 percent of its 1989 level. The relative size of the gray economy is reportedly very high, and bank deposits constitute barely 8 percent of GDP (see Sultan and Mishev 1999).

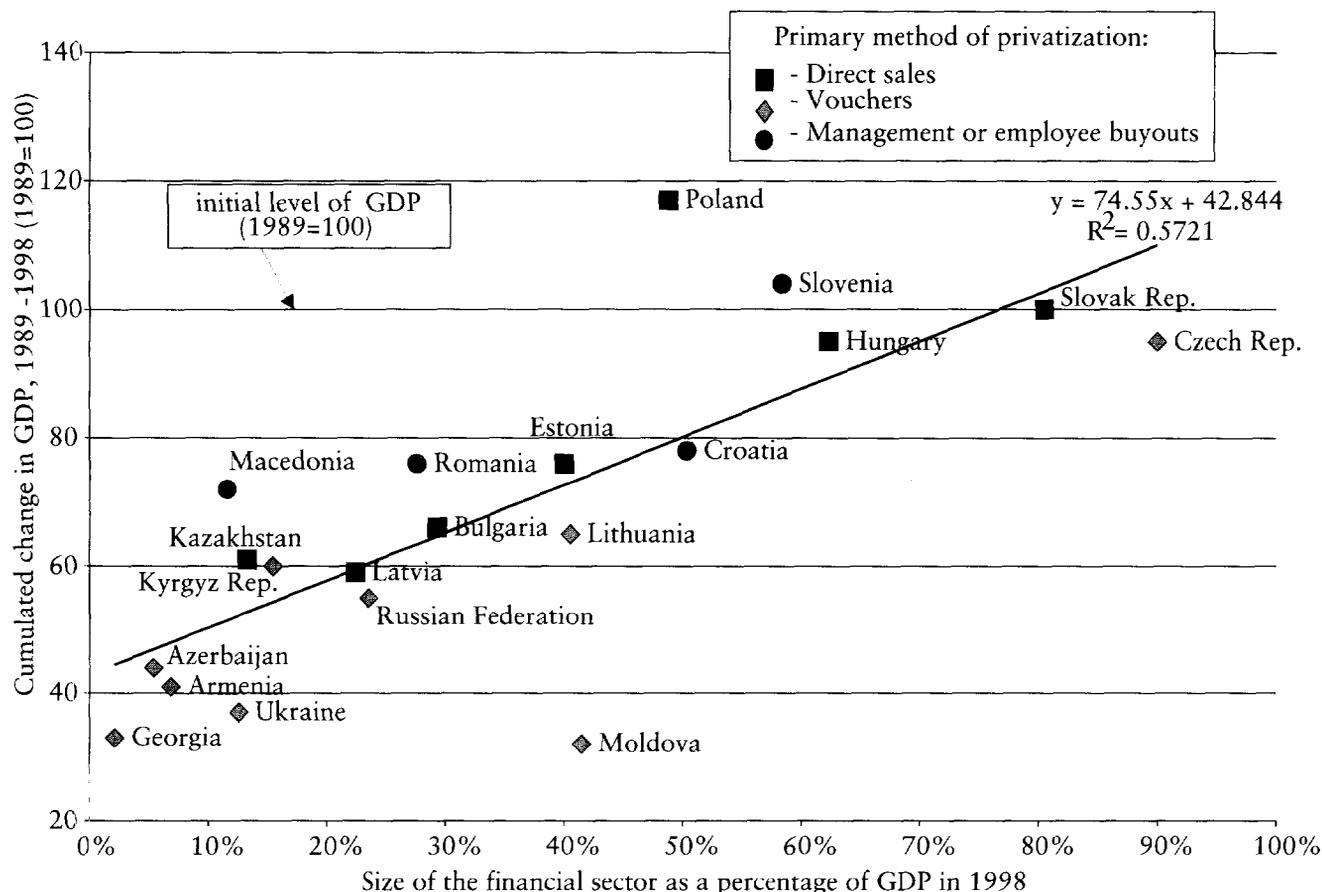
In some cases, however, a sudden contraction of the financial sector causes a surge of inflation and a severe decline in GDP. In Bulgaria, in 1996, a mounting situation of bad debts undermined confidence in the banking system and led to a run on banks and a depreciation of the domestic currency. Inflation rose sharply, and the value of the domestic currency declined in real terms to less than one-sixth of the level before the crisis. Real GDP dropped cumulatively 18 percent over 1996 and 1997.

### *Financial Sector Structure*

In developed economies, all three segments of the financial sector play significant roles (see figure 4.9). Bank deposits account, on average, for 35 percent of financial sector size, stock market capitalization for 49 percent, and corporate debt for 16 percent.

In most transition economies, the financial sector is dominated by bank deposits, which account, on average, for 63 percent of financial sector size (see figure 4.10). Stock market capitalization accounts, on average, for 35 percent. However, in several countries (Moldova, Lithuania, Kazakhstan, and the Kyrgyz Republic) stock market capitalization represents 60–80 percent of the financial sector size. Corporate debt markets are noticeable in only a few countries and, on average, have a

**FIGURE 4.4 RELATION BETWEEN THE SIZE OF THE FINANCIAL SECTOR AND CHANGE IN GDP**



Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sportitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

rather marginal share (2 percent) of the total financial sector size.

*Observation 7.* Compared to developed economies, transition economies usually have smaller banking sectors in relation to GDP. However, these small banking sectors usually dominate the financial sector, as other financial sector segments are even less developed. (a) Compared to developed economies, stock market capitalization in transition economies is lower in relation to GDP and, in most cases, also in relation to the aggregate size of the financial sector. However, market capitalization is quite significant in some countries. (b) Corporate debt markets in transition economies are hugely underdeveloped, and in most countries they hardly exist.

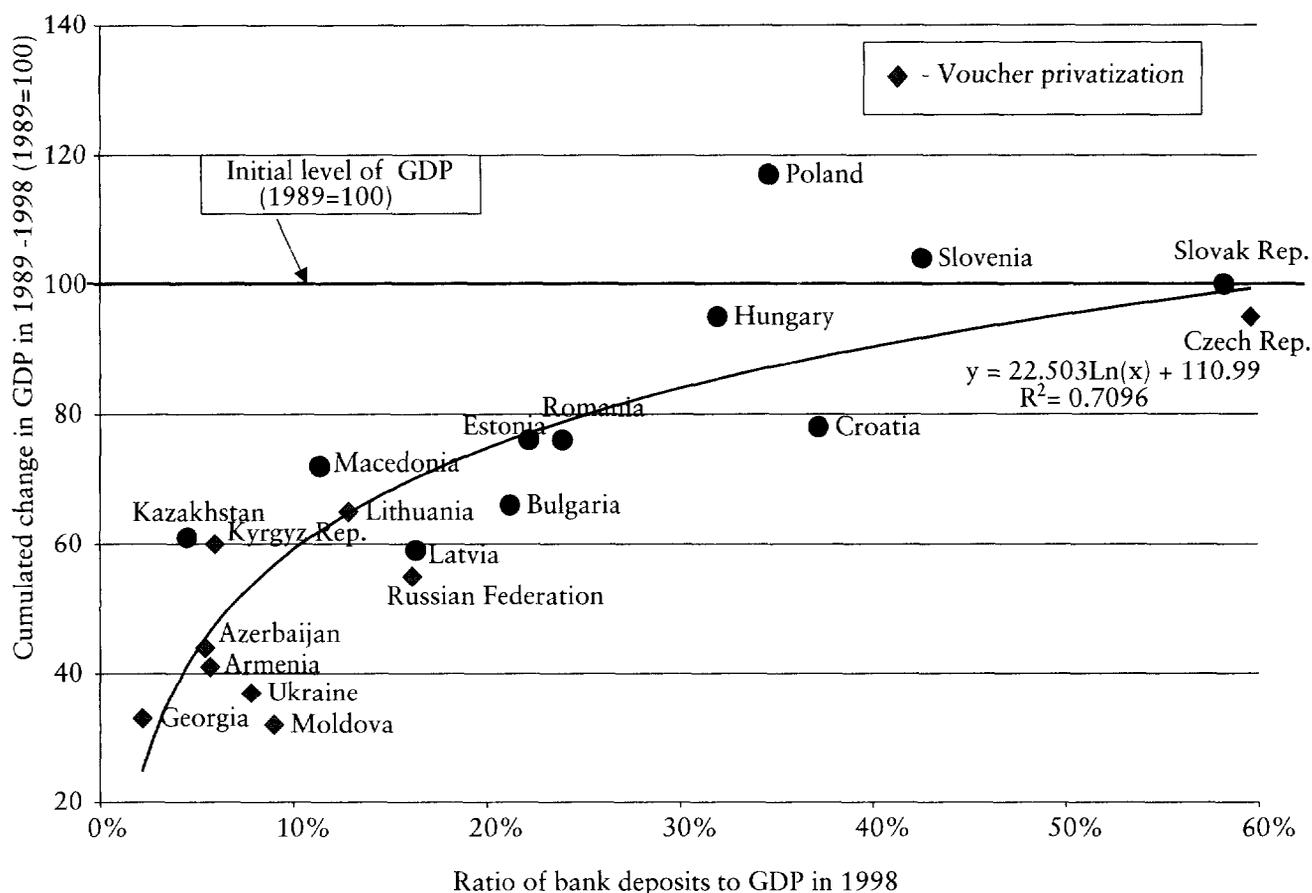
### Financial Sector Health and Efficiency

The size of the financial sector and its components is not always a good indicator of their contribution to economic growth. In looking at the financial system's health and efficiency, it is important to analyze separately the banking sector and the equity market.

*Observation 8.* The shapes of banking sectors differ dramatically among transition countries, and three typical groups can be distinguished. (a) The first group, composed mostly of Commonwealth of Independent States (CIS) countries exemplified by Russia and Ukraine, has extremely small banking sectors as a result of the deep deterioration of bank balance sheets.<sup>2</sup> There is a lack of confidence in banks, which have a limited role in financial inter-

2. The CIS includes former republics of the Soviet Union except the Baltic states (Estonia, Latvia, and Lithuania).

FIGURE 4.5 RELATION BETWEEN THE SIZE OF THE BANKING SECTOR AND CHANGE IN GDP



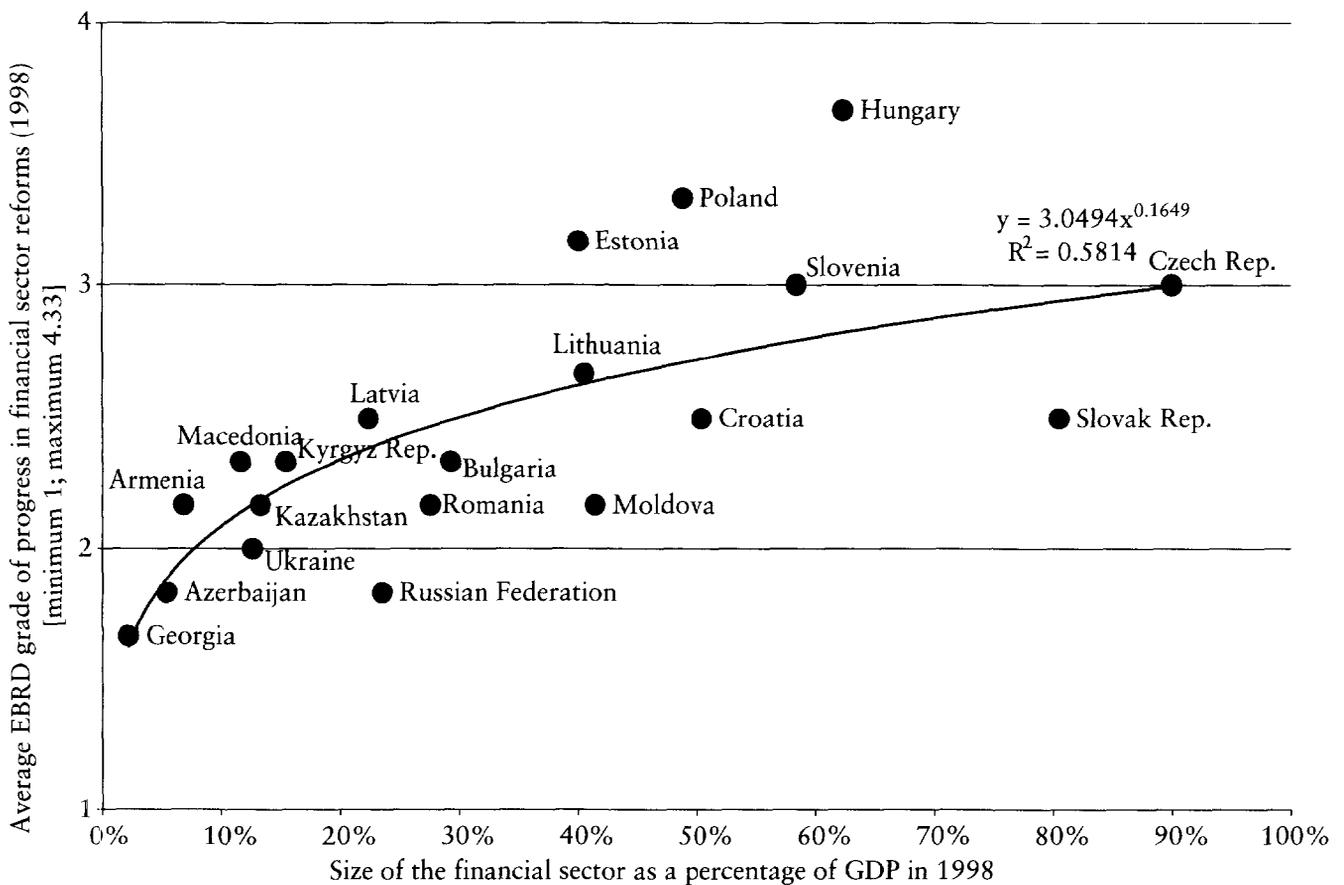
Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

mediation. The fundamentals for an efficient banking sector have yet to be created in these countries. (b) The second group, exemplified by the Czech and Slovak Republics, consists of countries with a sizable, but unhealthy, banking sector, where banks are overburdened with a stubbornly high share of bad debts. However, stable macroeconomic policies and firm government support for the banking sector in these countries have made it possible to maintain confidence in banks and avoid destabilization of the system. The intermediary role of banks in these countries is very significant, although their efficiency is poor: banks allocate savings to inefficient uses and provide inefficient tools of corporate control. (c) The third group, exemplified by Hungary, Poland, and Estonia, consists of countries with banking systems that are relatively small but are healthy and growing. These countries overcame banking crises in

the first half of the 1990s, without undermining the general confidence in banks. They created healthy fundamentals for their banking systems and privatized the bulk of bank assets with the participation of foreign strategic investors.

*Observation 9.* In some transition economies stock market capitalization is quite significant. However, this indicator may be misleading, as it is related to the ability of companies to raise funds on the stock exchange. In some countries, stock market capitalization is inflated as a result of voucher privatization. In some countries, strategic holdings, mostly by foreign investors or the state treasury, represent the bulk of market capitalization. The role of the stock market as a source of capital for domestic companies is very limited.

There are no data on the amount of capital (as a percentage of GDP) raised by companies through new share

**FIGURE 4.6 RELATION BETWEEN THE SIZE OF THE FINANCIAL SECTOR AND PROGRESS OF FINANCIAL SECTOR REFORMS**

Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

issues—which would be an important indicator for judging the stock market’s contribution to economic growth. Fragmented evidence indicates that the ability to raise capital through primary share offerings for companies in transition economies is very limited—much lower than data on market capitalization would suggest.

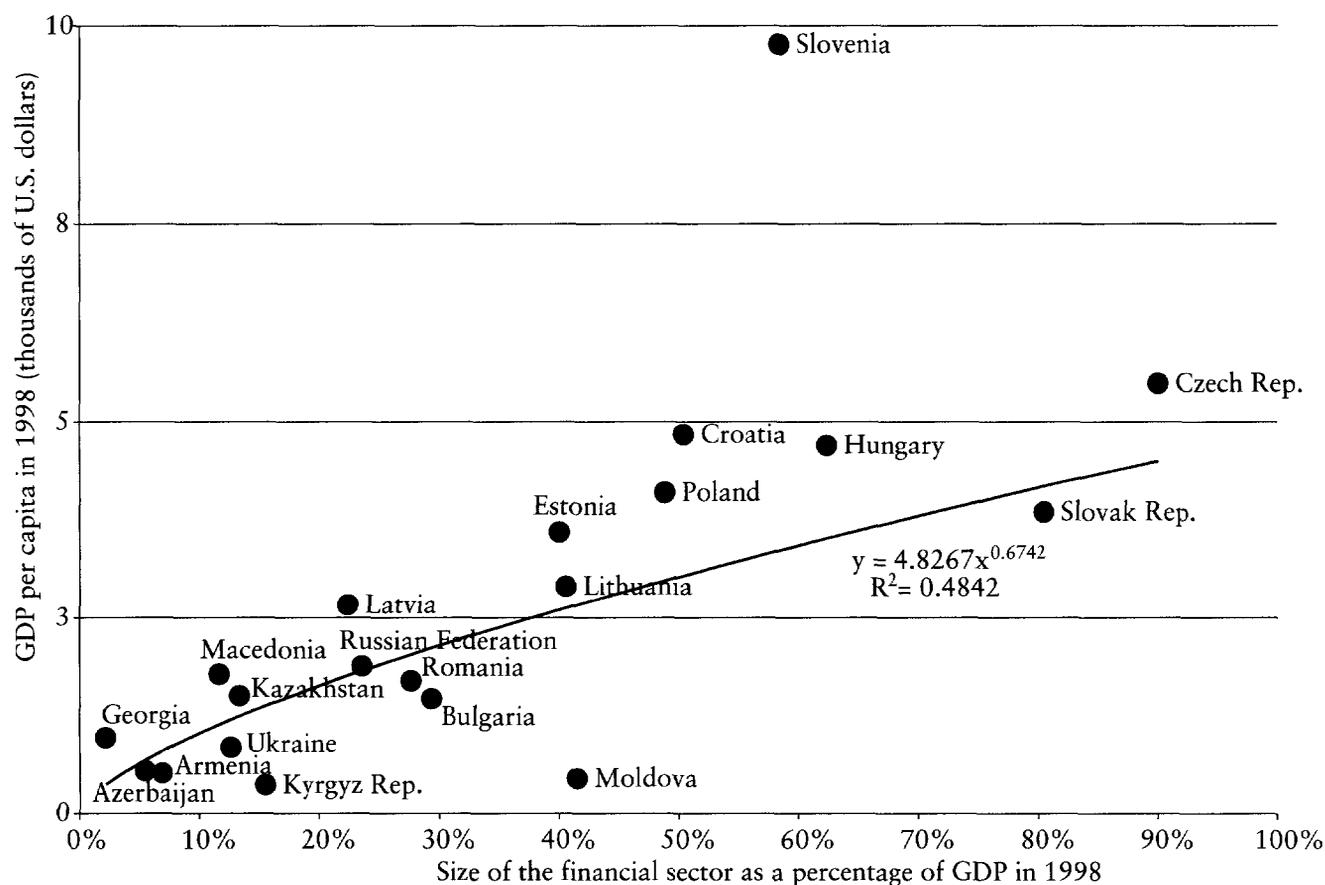
*Observation 10.* Except for a few countries in transition, there is a lack of trusted and appropriate savings or investment instruments for individuals. This absence hinders the growth of financial systems, hampers economic development, and constitutes a source of instability for transition economies.

Except for a few countries in the Central European and the Baltic region, there is a lack of public confidence in banks and capital markets in transition economies. People feel that the official financial sector does not offer them any

trusted and appropriate savings and investment instruments. Given the shortage of such instruments, individuals may follow several strategies:

- Increase spending, which on a macroeconomic level translates into higher consumption and a lower savings rate.
- Invest abroad, which translates into capital flight and fewer domestic savings available to finance investments in the country.
- Invest in the gray economy, which translates into fewer savings available to finance investment in the official economy.
- Keep money under the mattress, which translates into fewer savings available to invest in the country.

All in all, the lack of an appropriate savings or investment instrument hinders the growth of the financial system and results in fewer savings being available for financing

**FIGURE 4.7 RELATION BETWEEN THE SIZE OF THE FINANCIAL SECTOR AND LEVEL OF ECONOMIC DEVELOPMENT**

Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sportelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

investments in the official economy, which has a negative impact on official GDP growth.

In cases where foreign capital inflows substantially compensate for low domestic savings as a source of financing for the corporate and government sector, the small size of the domestic financial system in relation to foreign flows makes economies vulnerable to financial and currency crises.

### Challenges for Future Development

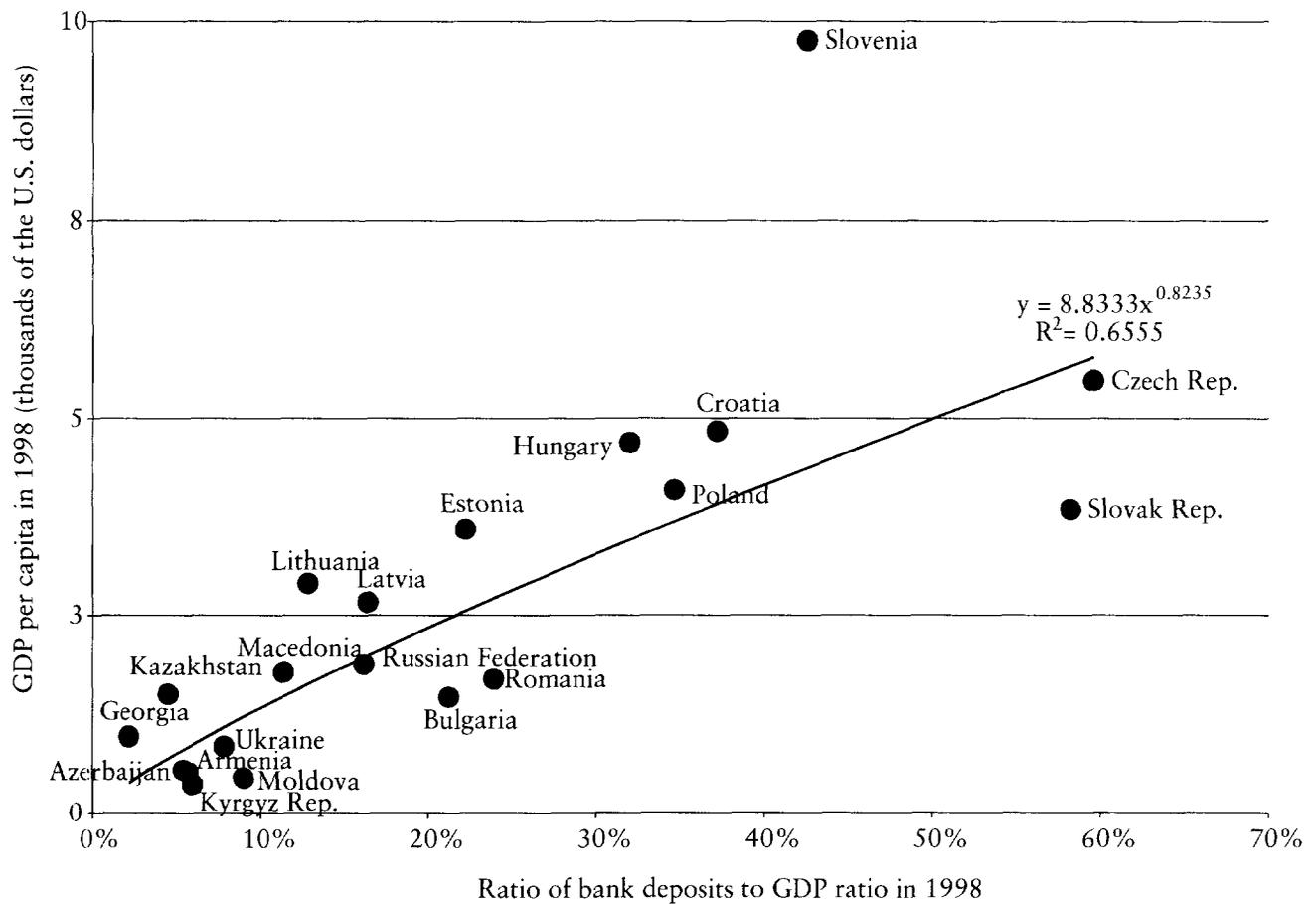
After 10 years of transformation, most transition economies still have a long way to go to create a robust and efficient financial system. Actions in several fields are needed to build long-term confidence in the domestic financial system.

### Accounting and Auditing Standards

A number of transition economies have made progress in bringing their national accounting and auditing standards broadly in line with international accounting standards (IAS) and international standards on auditing (ISA). There are, however, still material differences between national and international standards in many instances.

*Consolidated basis.* A very important weakness of prudential regulations and reporting and auditing standards in transition countries is the lack, or insufficient level, of consolidation requirements. This makes it difficult to supervise banks on a fully consolidated basis, and banks may sweep some problems away into their affiliates.<sup>3</sup> Without full

3. "The implementation of these regulations on a solo rather than a consolidated basis enables banks to bypass the spirit whilst operating within the 'letter of the law' should they so choose" (FITCH IBCA 1998: 2).

**FIGURE 4.8 RELATION BETWEEN THE SIZE OF THE BANKING SECTOR AND LEVEL OF ECONOMIC DEVELOPMENT**

Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

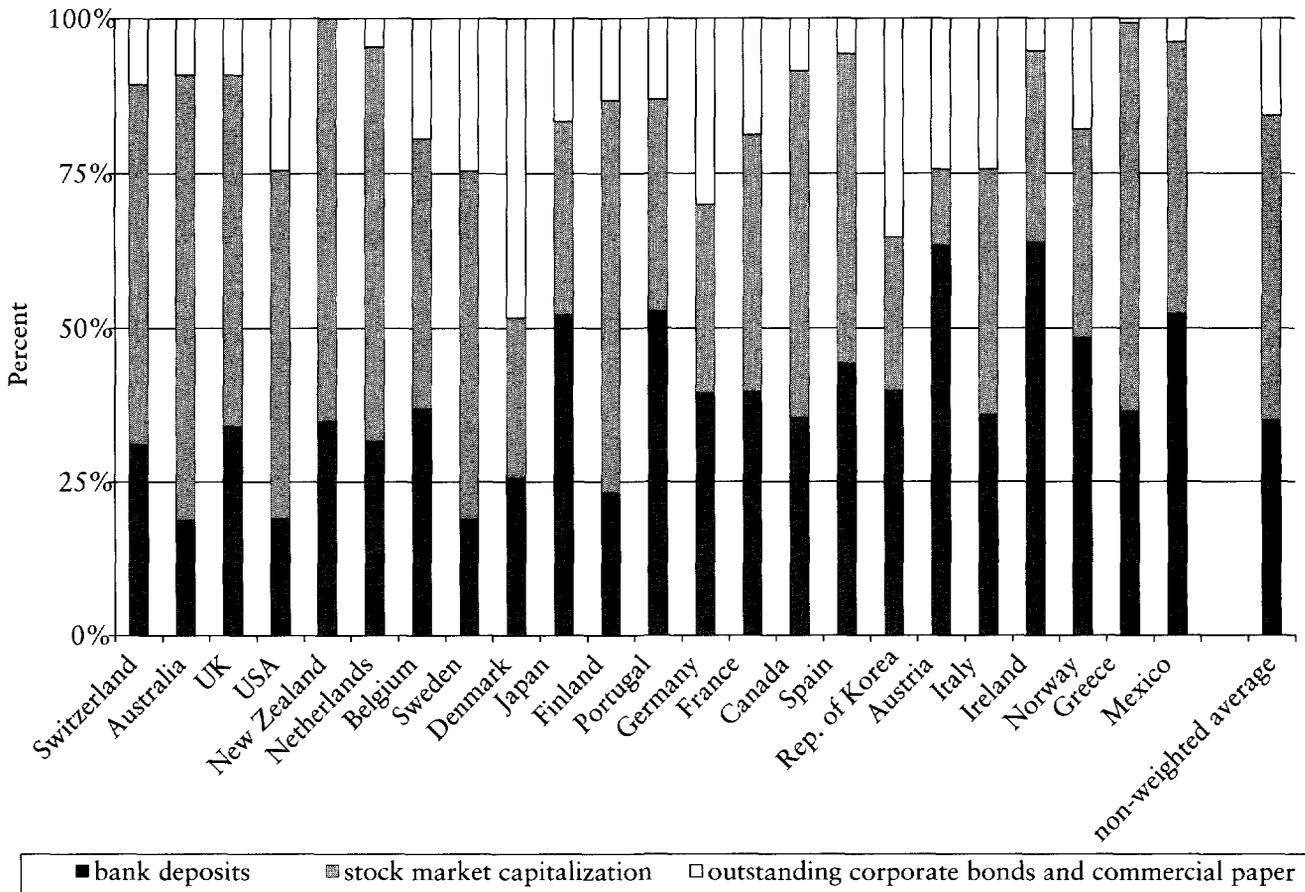
consolidation, not only the public and supervisors may be misled, but also bank management may not properly understand the risks borne by their institutions.

*Application of the substance-over-form rule.* One of the most important shortcomings of the accounting regulations in transition countries is the precedence of the legal form of a transaction over its commercial substance (Cunningham 1998). Application of the substance-over-form rule is one of the most important tools against unfair reporting practices. This tool is not available to auditors in most transition countries.<sup>4</sup>

The introduction of the substance-over-form rule is getting more urgent, as transactions become more complicated and their economic substance is being changed by derivative instruments. Presentation of accounts based on the legal form of transactions often is misleading. In these circumstances, banking supervisors, who may have difficulty catching up with innovations in the commercial sector, would find it difficult to assure adequate enforcement of *the substance* of prudential regulations.

*Application of the truth-and-fairness principle.* Auditing regulations in transition economies emphasize compliance

4. The concept of substance over form that is absent from accounting legislation usually is recognized in tax legislation; see Cunningham (1998).

**FIGURE 4.9 STRUCTURE OF THE FINANCIAL SECTOR IN OECD\* COUNTRIES, 1998**

Note: "OECD countries without Iceland, Luxembourg, Turkey and Czech Republic, Hungary, Poland."

Source: BIS, FIBV, IMF, Morgan Stanley Dean Witter, OECD, World Bank.

with regulations and do not provide the auditor with an overriding principle of truth and fairness, which is key in IAS and constitutes an important tool for countering practices that formally comply with, but are against the spirit of, the regulations.

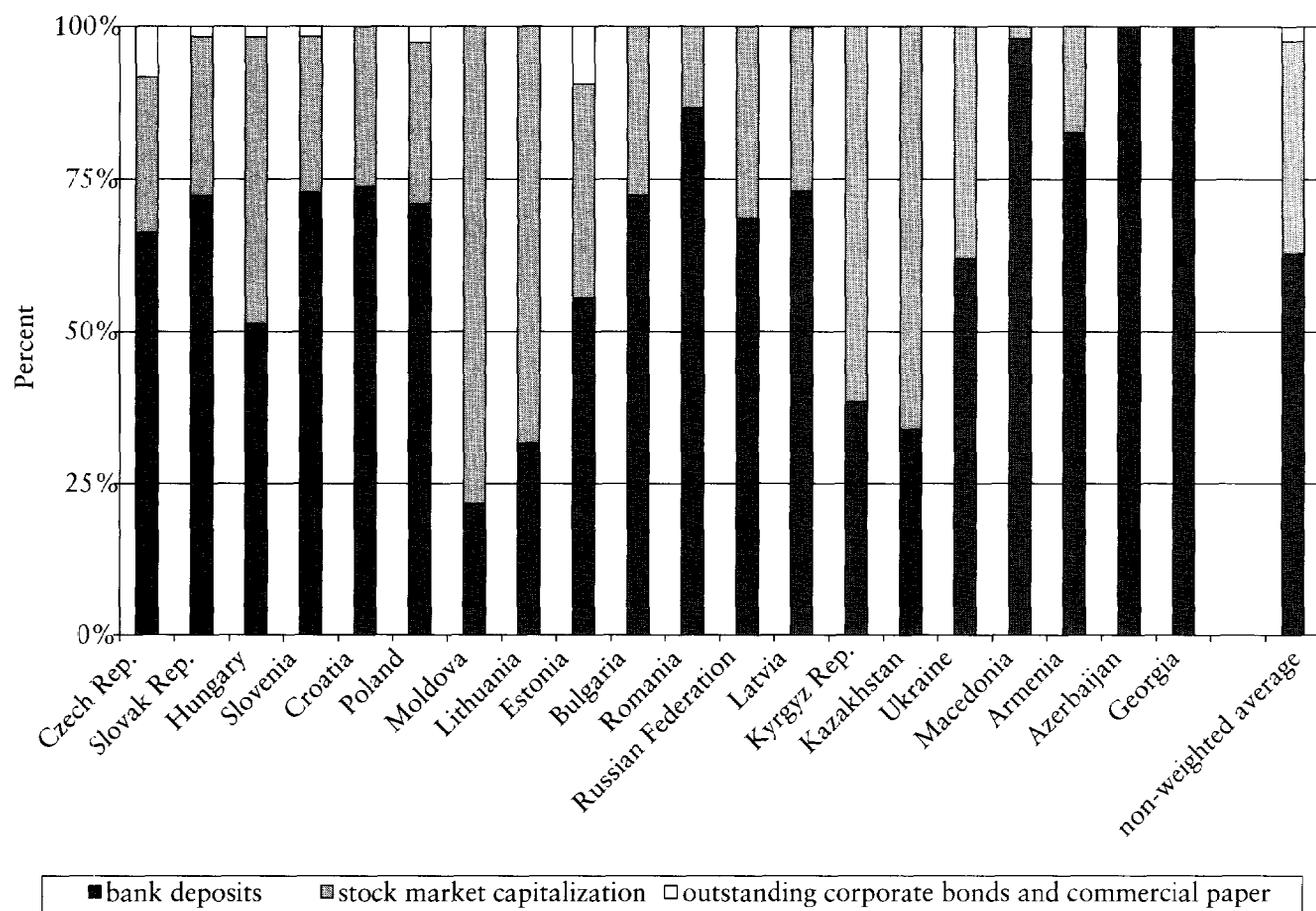
*Observation 11.* Accounting and auditing standards should be brought fully in line with international standards: companies should be obliged to present fully consolidated accounts; the substance-over-form rule as well as an overriding truth-and-fairness principle should be applied.

### Legal Framework

Key tasks of a modern legal framework are to protect the rights of creditors and shareholders and to protect individuals and firms from excessive and arbitrary taxation.

*Protection of creditor rights.* In order to carry out their business, banks need to have the ability to secure their loans with various types of collateral and be able to quickly seize the collateral in case of loan default. Bankruptcy procedures should allow creditors to effectively recover loans through liquidation. In addition to the proper legal framework, there is a need for efficient courts and other institutions to assure that creditor rights are effectively exercised.

*Protection of shareholder rights.* Shareholders need adequate information about the company's standing, and they should have the ability to put up their representatives as supervisory board members and to change management. Any privileged transactions that transfer value to insiders (dominant shareholders, management, or employees) at

**FIGURE 4.10 STRUCTURE OF THE FINANCIAL SECTOR IN TRANSITION ECONOMIES, 1998**

Source: Alfa Capital (Ukraine), BIS, EBRD, FIBV, IFC, IMF, JPMorgan Securities, OECD, Reifeissenbank Romania, Slovenska Sporitelna, Troika Dialog, World Bank, national stock exchanges, trading systems, central banks and depository authorities.

the expense of the company's shareholder value should be properly disclosed and preapproved by shareholders. Minority shareholder rights should be protected from abuse by dominant shareholders.

The EBRD survey on corporate governance in transition economies supports the view that, while many laws in the region theoretically provide a sound basis for protecting shareholder rights, the implementation and enforcement of these laws are lagging (Ramasastry, Slavova, and Bernstein 1999).

*Protection from excessive privileges of tax authorities.* Effective tax collection is a prerequisite of macroeconomic stability and a level playing field in business activity. However, granting excessive privileges to tax authorities should not be treated as an easy substitute for an efficient

tax system and an effective tax administration. When banks act as tax collectors and tax authorities have the ability to garner transfers coming into bank accounts to cover tax or wage arrears, then firms tend to avoid transacting through banks (Sultan and Mishev 1999). Giving tax authorities priority over secured creditors undermines the value of secured loans. Long-term investors' confidence can hardly be built if companies' financial situations may be unexpectedly affected by the discretionary actions of tax authorities.

*Observation 12.* Laws and law enforcement institutions should adequately protect creditor and investor rights.

*Observation 13.* Tax rules should be clear-cut, with no room for discretion in tax administration. Tax authorities should not have excessive privileges over

other creditors. In case of a dispute with tax authorities, taxpayers should have an effective possibility to appeal to court.

### ***Financial Sector Supervision***

Independent, strong, and decisive supervision is a necessary condition for building confidence in the financial sector. The growth of the relative size of the financial sector further increases the macroeconomic risk of a financial sector crisis and thus increases the requirements for proper regulation and effective supervision.

*Observation 14.* Independent, strong, and decisive supervision is a necessary condition for building confidence in the financial sector. (a) In order to become more effective, supervision of the financial sector should be highly focused, putting as much responsibility as possible on the private sector and market discipline; public disclosure requirements should be strengthened; and the responsibilities of auditors should be expanded (see Kawalec 1999: 33–34). (b) Interdependency among various segments of the financial sector calls for organizational integration under one regulatory roof in order to make regulation more consistent and effective as well as diminish industry's cost of dealing with regulators. (c) Supervision of the financial sector needs very good professional staff who are adequately remunerated. To enable this, the financial industry could pay special fees to finance supervision.

### ***Macroeconomic Stability***

In case of high inflation, financial assets are likely to lose part of their real value. When unsound macroeconomic policies result in a currency crisis or default of government domestic debt (as happened in Russia in 1998), capital market investors as well as bank depositors may experience severe losses. Once confidence is lost, it requires many years to rebuild.

*Observation 15.* Long-term growth of the financial sector requires sound and stable macroeconomic policies.

### ***Dealing with Unresolved Banking Crises***

For most transition countries, the priority is to lay down institutional fundamentals to allow the development of a sound banking sector and stimulate its growth from an exceptionally small relative size.

For some countries, a pressing need is to deal with crisis situations where the large share of nonperforming assets threatens the liquidity or solvency of a significant part of the banking sector. A banking crisis constitutes an acute problem if it happens in a country with a relatively sizable banking sector, like the Czech Republic, Slovakia, Croatia, or Romania (Kawalec 1999; *Banka* 2000).

A banking crisis affects the economy in various ways. It undermines overall confidence in the economy and causes misallocation of resources. It may result in a major banking destabilization, in which major banks lose liquidity or a bank panic resulting in downsizing of the banking sector's balance sheet. Such destabilization is likely to be connected with a drop in GDP (as occurred in Bulgaria in 1996 and 1997). Even if a one-off destabilization is avoided, an unresolved banking crisis undermines the confidence in banks and threatens their liquidity, contributing to the systematic erosion of bank balance sheets (as happened in Romania). A prolonged banking crisis, even if it neither destabilizes nor erodes the banking sector, is likely to have a deep negative impact on economic growth (as happened in the Czech Republic and Japan). Dealing with a banking crisis both decisively and in a way that inspires confidence may minimize the disruptive impact on economic growth. The recapitalization of banks, however, usually requires significant budgetary resources.<sup>5</sup>

*Observation 16.* For a group of countries facing banking crises, the pressing need is to deal with these crises both decisively and in a way that supports rather than undermines confidence.

### ***Bank Privatization***

Political influence in the selection of management and in credit and investment decisions adversely affects bank efficiency, asset quality, and confidence in banks. Governments should withdraw themselves as owners and not influence bank business decisions. If there is a shortage of sound domestic investors who understand banking business, the involvement of reputable foreign banks as shareholder in local banks is warranted.

*Observation 17.* Banks should be privatized and separated from politics and government influence. The key objective of bank privatization should be to create the best conditions for long-term development, soundness, and efficiency of the privatized institution.

5. Opinions on various ways to recapitalize and restructure banks are presented in Kawalec (1999: 30–31) and Simoneti and Kawalec (1995).

*Observation 18.* A specific task, still not carried out in a number of transition economies, is the restructuring and privatization of former specialized savings banks.

### ***Pension System Reform: Opportunities and Risks for the Capital Markets***

All transition countries face the challenge of developing capital markets capable of playing a significant role in providing funds to the corporate sector and constituting an effective instrument of corporate control. Pension system reform—of the type introduced in Chile in the 1980s or in Poland in 1999—creates a stream of mandatory savings that is channeled into specially created, privately managed pension funds. This might constitute a substantial cure for a weak base of domestic investors and a lack of long-term portfolio investors.<sup>6</sup> Pension funds soon may become significant investors, sharply increasing the capacity of domestic capital markets to absorb new issues. Pension reform creates tremendous opportunities for capital market development. There are, however, associated risks:

- One concerns the introduction of pension reform when the legal and institutional framework for capital markets is too weak. If investor rights are not protected and there is a lack of transparency, as well as a lack of effective supervision, then widespread fraud might undermine the realizable value of pension fund investments. This could destroy confidence on the part of pension fund members, leading to dangerous frustration.
- High inflation or a financial crisis as a consequence of unsound macroeconomic policies may cause a negative return from pension fund investments.
- Another risk concerns the possibility of a stock market price bubble if growing investments of pension funds constitute too big a part of stock market free float. Stock prices might increase sharply, exceeding any conceivable estimates of the fundamental value connected with future earnings. Sooner or later a price bubble has to end with a market crash, leading to a severe loss of the value of the investments.

In order to diminish the risk of a price bubble, there is a need to increase the amount of assets in which pension funds could invest. Technically, the easiest way would be to increase the percentage of pension fund assets that may be invested abroad and limit the percentage that may be

invested in the domestic market. However, in the case of transition countries that have a domestic savings deficiency and substantial domestic investment needs, it does not seem rational to create a forced saving scheme in order to export capital. Another solution would be to force pension funds to invest the bulk of their assets in government debt. However, this likely would dilute and diminish the benefits of pension fund reform. Thus other solutions should be preferred.

Privatization policy may contribute to the growth of stock market free float, through more privatization transactions and preferences to initial public offerings as opposed to direct sales or employee buyouts.

It also is critical to increase the availability of attractive debt instruments. Adequate regulations are needed concerning commercial paper, corporate bonds, and municipal bonds, as well as mortgage securities and other asset-based securities. An adequate regulatory policy is needed that allows pension funds to invest a substantial portion of their assets in various nongovernmental debt instruments.

*Observation 19.* Reform of the pension system through the creation of privately managed pension funds may have a substantial impact on capital market development and thus contribute to the improvement of financial sector structure. However, the introduction of pension reform when the legal and institutional framework for capital markets is too weak or macroeconomic policies are unsound may result in failure.

*Observation 20.* Pension reform, creating a growing stream of forced savings channeled into the capital market, may contribute to a stock market price bubble. To diminish this risk, there is a need to increase the availability of assets in which pension funds can invest. To this end, privatization policies should aim to increase stock market free float. It also is critical to increase the availability of eligible, attractive corporate debt instruments.

### ***Is There a Role for Domestic Capital Markets in Transition Economies in the Future?***

In this paragraph we react to suppositions presented in Claessens, Djankov, and Klingebiel (2000) that domestic stock markets will have no significant role in transition economies in the future. Claessens, Djankov, and Klingebiel analyze the present situation and best-case sce-

6. The introduction of funded pension schemes has been presented as “the single most important decision Baltic governments can make to support equity culture” (Hansabank Markets 2000: 9).

narios for market capitalization and market turnover in transition economies until 2005. They conclude that stock markets in transition economies are small and dormant and that most of these markets will not achieve minimum economies of scale in the foreseeable future. They notice that, in the era of global stock markets, services will be easily available abroad, both for companies wanting to raise capital and for investors wanting to invest in stocks. Thus, they recommend that transition economies should avoid developing costly stock markets and instead should concentrate on building basic legal infrastructure to protect creditor and shareholder rights and support development of the banking sector.

As far as the present situation of stock markets in transition economies is concerned, the findings by Claessens and his co-authors are compatible with observations presented here. We also subscribe to their insistence on building basic legal infrastructure and developing the banking sector. However, their conclusions and recommendations concerning the future role of stock markets in transition economies are less convincing.

Claessens and his co-authors' conclusions—that most of the stock markets in transition economies have no chance of achieving minimum economies of scale—could be different if they took a long-term perspective of 10 to 20 years instead of 5 years only. With a longer perspective, the effects of pension reform on the capital market would be dramatically bigger than in their five-year scenarios.

In our view, there is interdependence between development of a domestic stock market and pension reform based on the introduction of mandatory funded pension schemes. From one side, introduction of mandatory funded pension schemes may dramatically speed up development of the stock market. From the other side, without the existence of a domestic capital market including a stock segment, a macroeconomic rationale for mandatory funded pension schemes is questionable, as it would mean mandatory export of capital from countries that have a domestic savings deficiency and huge domestic investment needs.

We do not agree that foreign listing may adequately substitute for a domestic stock market. For a substantial group of smaller companies, which could consider listing on the lower tier of the domestic market, foreign listing may not be practical because of additional costs resulting from dealing with different legal systems, the necessity to present documentation in a foreign language, and distance to investors. We also think that a domestic stock market hardly can be substituted in its important educational role for the elite, media, and broader public. Lack of a domes-

tic stock market may contribute to creation of the Third World type of structural division of the economy, in which a separate group of international companies predominately bypasses the local legal system, using foreign jurisdiction and foreign listing, and in which little pressure is brought to bear on improving the domestic legal and institutional framework.

With the exception of very small and open economies (with very high ratios of foreign trade to GDP) efforts to develop domestic stock markets make sense, as countries without them will be handicapped in their economic and social development. Of course, the existence of a domestic stock market does not exclude the possibility of cooperation links (including co-listing agreements) with other stock markets.

*Observation 21.* Except small and open economies, countries without a sound domestic stock market may be handicapped in their economic and social development. (a) For potential issuers, a domestic stock market cannot be fully substituted by foreign listings, as direct access to foreign stock markets may be practical only to a relatively small group of companies. (b) Lack of a domestic stock market will slow down economic education of the elite and broader public and will slow down development of equity culture. (c) Without a domestic stock market, investors interested in stocks will be forced to invest abroad, which would diminish the level of domestic investment. (d) Lack of a domestic stock market may contribute to creation of a Third World type of structural division of the economy characterized by the existence of a separate group of international companies that predominately bypasses the local legal system, using foreign jurisdiction and foreign listing, and an absence of pressure on improving the domestic legal and institutional framework. (e) Without the existence of a domestic capital market including a stock segment, the macroeconomic rationale for mandatory funded pension schemes is questionable, as it would mean mandatory export of capital from countries that have a deficiency of domestic savings and a huge need for domestic investment.

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Part III

# Banking Sector Restructuring



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## Chapter 5

# Estonia: The Financial System in Retrospect and Prospect

*Helo Meigas*

**T**his chapter investigates how prospective changes in the business environment are likely to affect the banking sector in Estonia and, by examining whether global pressures are likely to dominate country-specific factors, assesses the extent to which the changes expected to take place in the global banking sector will be replicated in Estonia. Two main areas are considered:

- Changes in the structure of the banking industry
- The future of banking.

Among many trends that are having an important effect on banking, this chapter emphasizes the significance of competition (both internal and global) and new technology. But these trends first must be examined against the background of Estonia's emerging financial market structure.

### **Evolution of Estonian Banking and Securities Market**

Estonian banking has changed dramatically since the new economic and legal framework was introduced in the early 1990s. The number of credit institutions dropped sharply from 42 banks in 1992 to 11 by the end of 1997 (see table 5.1). A second wave of restructuring occurred in 1998. Increased competition resulted in several major mergers, and many weaker and inefficient institutions left the market. Consolidation was followed by an inflow of foreign capital from Scandinavia. Swedish banks acquired majority stakes in Estonia's two biggest banks, increasing the market share of foreign-owned banks to more than 90 percent. In autumn of 1999, the Bank of Estonia issued a license to a new bank for the first time since 1993, increasing the total number of banks to seven.

Partly due to the implementation of policy and regional integration, financial markets in Estonia generally have adopted the model of "universal banking," in which the separation of banking and securities is not mandatory, and different segments of the financial market are integrated, giving banking groups the leading position in financial intermediation. The two largest banks account for 85 percent of the banking sector, 90 percent of leasing and investment funds, 60 percent of life insurance, and 70 percent of transactions on the Tallinn Stock Exchange (TSE).

The securities market started to develop in 1994 when the Estonian Central Depository for Securities (ECDS) was founded. The ECDS maintains the central register for securities and is the clearinghouse for securities transactions. The securities market is comprised mainly of equities, while the share of debt securities is modest. The fixed exchange rate supported by the currency board system has reduced the possibility of introducing monetary policy instruments based on the Estonian kroon. The budget of the central government has been balanced on the whole, and the securities market has developed without short-term central

**TABLE 5.1 STRUCTURE OF THE ESTONIAN BANKING SECTOR, 1992–99**

<i>Indicator</i>	1992	1993	1994	1995	1996	1997	1998	1999
Number of commercial banks	42	19	22	18	13	11	6	7
Number of private banks	38	17	21	17	12	11	5	6
Number of state-owned banks	2	2	1	1	1	0	1	1
Concentration index 2 <sup>1</sup> (percent)	—	31	37	41	45	49	85	84
Concentration index 4 <sup>2</sup> (percent)	—	57	62	68	72	81	94	98
Total assets of banks (millions of EEK <sup>3</sup> )	4,788	6,391	10,067	14,857	21,902	40,582	40,995	47,071
Growth of domestic credit	1.34	1.56	1.60	1.54	1.74	1.82	1.12	1.12
Ratio of bad to total loans	—	—	1.5	1.1	2.4	1.2	1.4	1.7
Capital adequacy (percent)	—	18.1	13.4	13.7	12.1	13.5	17.0	16.2
Share of foreign ownership (percent)	—	—	14.7	29.0	33.4	44.2	60.	61.6

— Not available.

<sup>1</sup> The percentage of two largest banks' assets from total banking sector assets

<sup>2</sup> The percentage of four largest banks' assets from total banking sector assets

<sup>3</sup> 1 EUR = 15.65 EEK (Estonian Kroon)

Source: Bank of Estonia

government securities. The private sector has taken over benchmarking to a large extent.

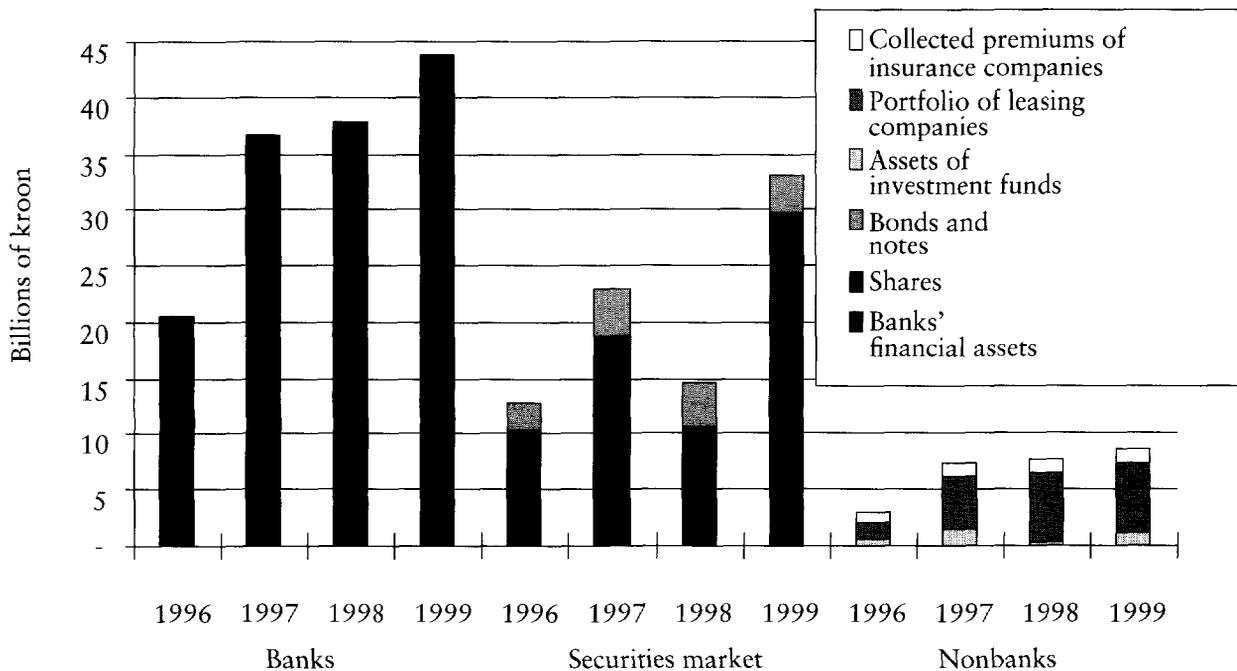
Since 1996, the TSE has operated an electronic on-line interactive trading system offering continuous quotation within an order-driven system, and all securities are dematerialized. Clearing and settlement are processed on a delivery versus payment basis.

From November 1996 to September 1997, the number of traded companies grew from 5 to 26. As a result of the excessive optimism of local investors, the abuse of leverage, and changes in the external environment, Estonia's stock exchange index, TALSE, more than tripled. Market size grew sevenfold in 1997, reaching 38 percent of gross domestic product (GDP). The volatility in global markets has had a ripple effect in Estonia. The first crisis hit in October 1997, when the TALSE index fell 60 percent from its peak in August of

that year. In 1998, the TALSE fell another 68 percent, and market turnover fell 50 percent; it has yet to recover fully. The relatively low level of stock prices encouraged foreign investors to acquire a majority stake in several Estonian companies. The share of foreign investors in the equity market increased to more than two-thirds and is dominated by Swedish and Finnish capital. The more than twofold growth in the capitalization of the stock market in 1999 was mainly due to the listing of Estonian Telecom shares.<sup>1</sup>

Despite the rapid development of the securities market, the banking sector remains dominant (see figure 5.1). Strong relations between banks and other financial intermediaries allow banks to exert a significant influence on the development of the financial sector at large. At issue is whether global trends are going to alter Estonia's pattern of financial development.

1. The shares of Estonian Telecom constituted approximately half of the EEK 40 billion capitalization of the stock market at the end of the first quarter of 2000 (Estonia's currency is the kroon).

**FIGURE 5.1 ASSETS OF BANKS AND OTHER FINANCIAL INTERMEDIARIES IN ESTONIA, 1996–99**

Source: Bank of Estonia.

### Changes in the Structure of the Financial Service Industry: Concentration and New Competitors

Internationally, the main driving force behind consolidation has been the need to enhance competitiveness by expanding activities geographically and offering a wider variety of services. The obvious implication of consolidation has been the reduction in the number of banks.<sup>2</sup>

In Estonia, the number of banks has decreased from 42 in 1992 to 7 today. The profit margins of banks have been relatively high, and mergers have been triggered mostly by the need to strengthen the balance sheet of weaker banks. There is almost no room for further consolidation through mergers, and each institution must find the means to increase efficiency within itself.

Recent mergers show that consolidation helps to increase efficiency. Until 1998, banks did not target costs

because the market was expanding and margins were wide. Since 1998, when consolidations took place, banks have been trying to lower their costs by reducing their staffing and closing branches. As a result of these efforts, banks likely will again enjoy upward-sloping returns.

When internal resources for streamlining costs have been used up, the only way for banks to remain competitive is to expand their activities to neighboring markets using cross-border and cross-business acquisitions. Both of these have occurred on a wide scale in Scandinavian countries and on a smaller scale in the Baltic states during the past two to three years.<sup>3</sup> By 1996–97, several Estonian banks had established leasing subsidiaries and were about to open subsidiary banks in other Baltic countries. Instead, the Russian crisis forced them to lower their own cost base and to concentrate mainly on domestic organi-

2. In the United States the number of banks decreased from 9,881 to 7,152, or 28 percent, during 1988–98 (Mishkin and Strahan 1999); in Europe the drop was from 12,256 to 9,285, or 24 percent, during a slightly earlier period (ECB 1999).

3. For example, in the case of MeritaNordbanken or Skandinaviska Enskilda Banken (SEB), the initial building blocks came from one country. During the 1990s they were transformed into pan-Scandinavian financial conglomerates offering a wide range of financial products. After establishing a presence in Scandinavia, Skandinaviska Enskilda Banken, MeritaNordbanken, and Swedbank enlarged their scope to the Baltic region by entering all three countries during 1998 to early 2000. MeritaNordbanken made the last acquisitions, buying banking subsidiaries from Société Générale in Latvia and Lithuania. The deal went into effect on March 31, 2000.

zational structures. As a result, financial organizations consolidated in 1998–99, revising and postponing pan-Baltic strategies.

Geographic expansion has been accompanied by diversification into other financial services. Leasing offers good possibilities for diversification and is growing rapidly.<sup>4</sup> Life insurance is included in organizational structures, but the market is immature and volumes remain low.

The structure of the Estonian banking sector is expected to follow international trends. Based on recent developments, the number of banks in Estonia probably will be roughly the same in 10 years as it is today. Consolidation is not likely to proceed further. Three (at most four) banks will offer a wide range of financial services, and a few smaller, niche banks will compete mostly with nonbank institutions, largely because they are oriented toward asset management. All banks are either predominantly or fully owned by foreign capital. They maintain efficiency by expanding to neighboring countries and by looking for sources of revenue outside traditional banking services.

### *The Asset Side of the Banking Sector*

It is an international trend for borrowers to bypass banks. Offering access to bond markets has become a profitable business for nonbank financial institutions. Through the elimination of one middleman, borrowed funds have become less costly, and that, in turn, has opened up the market to nonbanks and led to a boom in the commercial paper market. This has caused banks to shift their assets from lending to securities.<sup>5</sup>

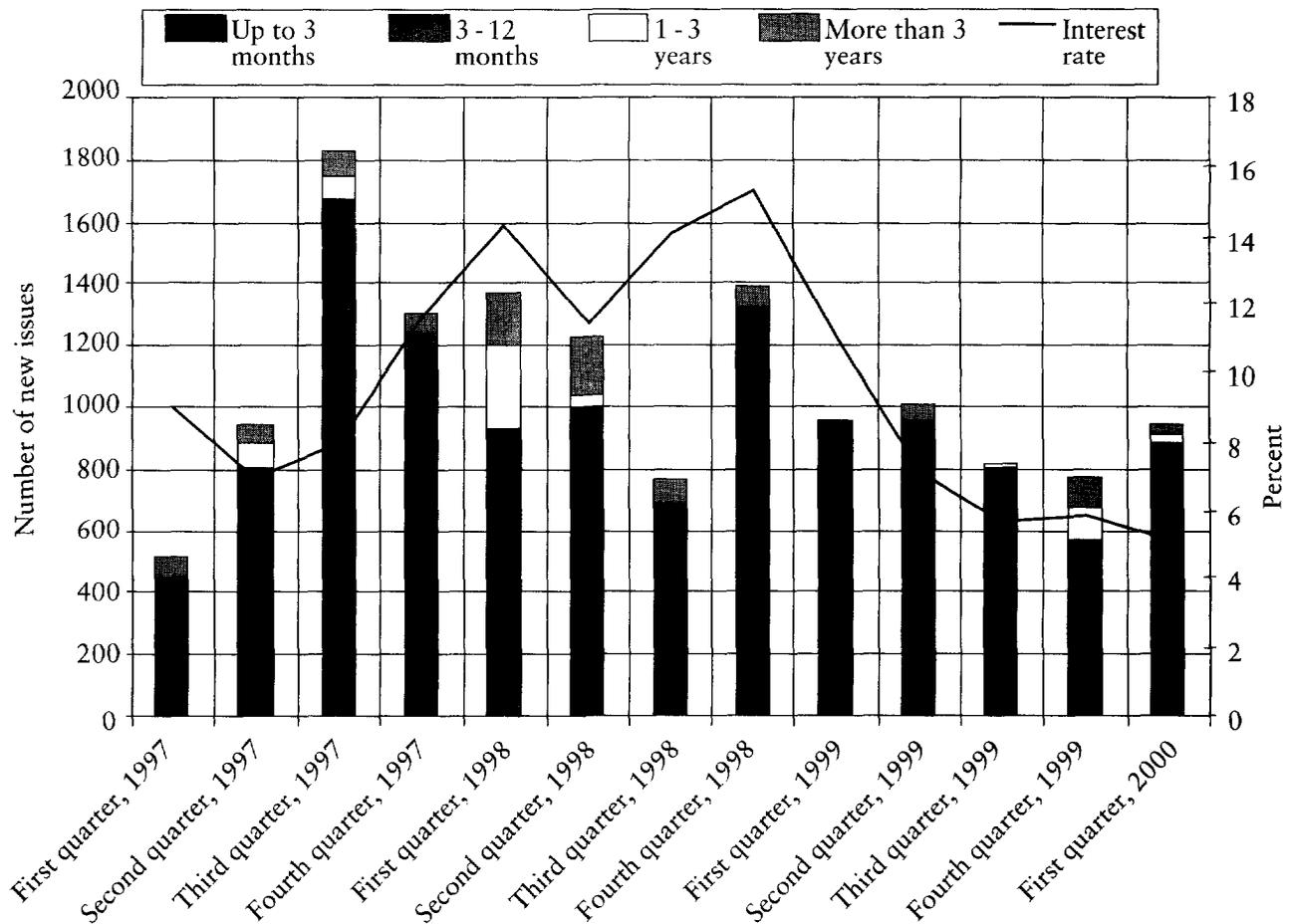
In Estonia, the volume of the bond market historically has been low, with no significant increase in recent years.<sup>6</sup> Compared with the banking sector's loan portfolio, capital markets have not established themselves as an alternative for financing the economy. Commercial paper has been dominating the market, and only very recently has turnover increased in the maturities of 3–12 months; longer maturities are still almost nonexistent (see figure 5.2).<sup>7</sup>

Banks are the main intermediaries and dominate the business side of the bond market. Several analysts in Estonia have argued that there is no good reason why other institutions could not offer similar services at better prices. Nonbanks have been able to compete successfully with banks primarily in public offerings. The development of pension funds should increase the demand for fixed-income products, which are traded on the secondary market. As a consequence, big, high-quality borrowers (such as municipalities, telecommunications firms, and utility companies) will shift away from banks. The small and medium-size enterprises, which are difficult to analyze and in which lending risks are higher, likely will become the main clients for banks.

Two factors are offsetting this trend in Estonia. First, banks have established themselves firmly in the commercial paper and bond market and have good client relationships with larger corporations. Their main advantage is their ability to offer combined services, because nonbank financial institutions do not have sufficient balance sheets to offer underwriting. Looking at the liabilities' side of Estonian enterprises shows that banks are very dominant (see figure 5.3).

Banks' superior ability to assess the credit risk of a borrower historically has been a major comparative advantage of banks. Banks also have been able to access funds at better rates. Today, credit rating agencies in developed markets are taking business away from banks, and the market is now able to estimate the credit risk of borrowers. Investors feel comfortable lending directly to companies without the intermediation of banks, making it possible for companies to obtain competitive rates. Estonia, in contrast, does not have local rating agencies. International rating agencies are not likely to establish themselves in the market, because local companies are too small to afford the costs of rating. Banks are the only other companies that possess ratings from international rating agencies, and that is not likely to change significantly in the near future.

4. The income earned from the leasing activities of the total consolidated banking groups in Estonia reached as high as 44 percent of total interest income and 16 percent of total revenues as of the first quarter of 2000. In recent years, when the economic slowdown brought a decline in lending, growth was restored first in lending to financial institutions, mostly leasing companies. In the first half of 2000, total banking sector lending to financial institutions was double lending to corporations.
5. According to Saapar and Soussa 2000, the share of loans in big banks in the Organisation for Economic Co-operation and Development (OECD) countries decreased and investments into securities increased over the period of 1991–98. The sample included 74 OECD banks with total assets of £100 billion or more as of December 31, 1998.
6. The total volume of new bond issues registered in ECDS at the end of 1999 was less than EEK 800 million. Total bond market capitalization at the end of the first quarter of 2000 was EEK 3.6 billion (less than 5 percent of GDP), whereas the loan portfolio of the total banking sector in the first quarter of 2000 was EEK 27.5 billion (36 percent of GDP).
7. In absolute terms, it amounted to EEK 750 million.

**FIGURE 5.2 NEW ISSUES OF DEBT SECURITIES IN ESTONIA, 1997-99**

Source: Bank of Estonia.

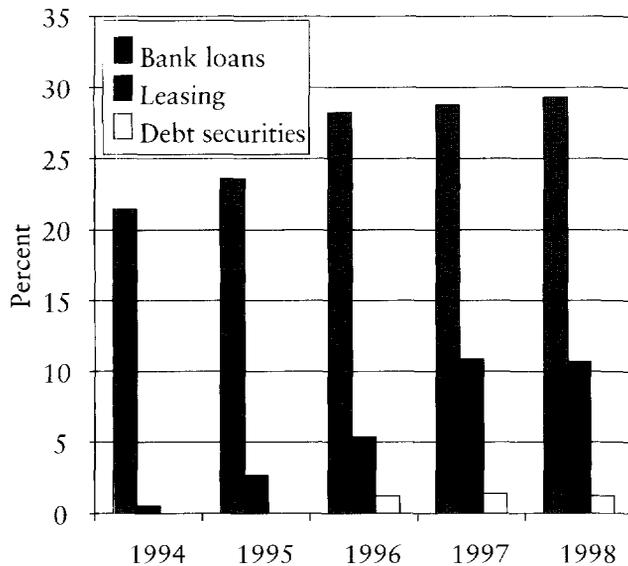
Infrastructure companies and banks are the only companies likely to be able to tap directly into (international) bond markets. Banks, with their strong ownership structure, are in a relatively good position to access capital markets.<sup>8</sup> Consequently, the cost of funds to nonbank and industrial borrowers tends to be higher than the cost of funds to banks. If smaller enterprises were to issue a public bond, they still would need a bank either to underwrite the issue or to provide a guarantee.

Second, the size of the market in absolute terms will work against the development of a local bond market. The capitalization of the debt securities market is EEK 3.6 billion or 8 percent of bank assets (as of March 2000). Additional supply to the market can come either from the

government issuing debt or from foreign investors hedging their local currency positions. In connection with the forthcoming pension reform, various foreign experts have recommended issuing central government securities in the local market. But from the point of view of long-term financial safety, it may not be advisable to generate government deficit just to create domestic investment opportunities for the second pillar of pension reform. The government's financial discipline in avoiding significant amounts of external or internal debt has contributed to macrostability and enhanced credibility in the currency board arrangement. After Estonia joins the European Monetary Union, foreign investors will no longer have to issue kroon-denominated securities to cover foreign

8. Recent improvement of Hansabank credit rating to BBB by Standard and Poor's has brought its rating to the level comparable to that of the Republic of Estonia, and the recent 150 million euro bond issue was priced significantly lower than even the sovereign debt of the neighboring countries (that is, Eurobor + 109 basis points, including costs).

**FIGURE 5.3 SHARE OF BANK LOANS IN TOTAL CORPORATE LIABILITIES IN ESTONIA, 1994–98**



Source: Bank of Estonia.

exchange risk. Today, the main players in the debt securities market are Nordic financial institutions, whose bond issues cover two-thirds of the primary market and approximately half of the secondary market. This trend is changing as Estonia is increasingly perceived as a home market, and therefore, neither financial institutions nor real sector enterprises hedge their investment positions in local currency. As the supply to the bond market is fairly limited, the demand for fixed-income investments (coming from pension funds and from other institutional investors) is likely to go to foreign issuers, which are rated by independent agencies and have a longer track record.

Securitization of the loan portfolios of banks will remain relatively limited because the secondary market for fixed-income products is not active enough, and little local expertise is available to assess the securitized credit risk. Also, the cost of setting up the legal and institutional framework for starting an efficient securitization is relatively high compared with the limited volume of the market. Until their capitalization remains high and they need their earning assets, banks will not be interested in selling loans.<sup>9</sup>

In Estonia, local factors (the smallness of the market, the dominant market position of banks, and the small size of local companies) suggest that disintermediation will take much longer than in other countries. In the coming years, banks will lose some of their largest clients, but as the fixed-income market for medium-size companies is not likely to pick up rapidly, most of the financing will come either from banks or directly from parent companies.

In Estonia, capital markets do not seem to be significantly threatening the position of banks in the lending market. This may not be beneficial from the point of view of competition and efficiency of the financial markets. To take a more active approach to developing the infrastructure, authorities will need to analyze which segment of the fixed-income market is most likely to succeed and develop that particular market segment. Within the context of the globalization of financial markets, a full-fledged local bond market may turn into an inefficient undertaking, suffering from low liquidity and high volatility.

#### *The Liabilities Side of the Banking Sector*

Internationally, pension funds and mutual funds have been fighting for access to household savings. By purchasing a diversified portfolio of assets, they have been able to offer investors the possibility of holding a well-diversified and liquid portfolio with a much higher yield than that provided by a bank deposit. Adequate regulation has helped such intermediaries to offer their clients the same level of confidence as that offered by banks.

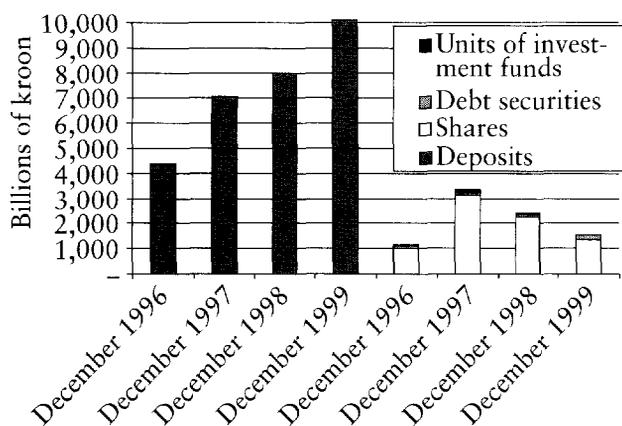
The structure of personal savings (bank deposits versus securities market versus insurance premiums held by private individuals) shows the dominant position of bank deposits in Estonia (see figure 5.4). Neither the equities market nor investment funds have been able to advertise themselves as safe alternatives for personal long-term savings.<sup>10</sup> Most of the money in the securities market has been speculative, as proved by the market's relative liquidity despite its smallness in absolute terms.<sup>11</sup> In order to gain a reputation and growth rate similar to those of banks, securities markets and fund managers must demonstrate a good track record in order to attract savings instead of speculative money.<sup>12</sup> Another illustration of the lack of

9. Average capital adequacy of the Estonian banking sector in the first quarter of 2000 was above 17.3 percent.

10. The total investment of private residents at the end of 1999 was EEK 1.4 billion in shares and EEK 37 million in investment fund units. Total private resident deposits in the commercial banks had risen to more than EEK 10 billion.

11. The liquidity ratio of the Estonian equity market has been relatively high throughout its history. In 1997–98 the liquidity ratio (turnover to market capitalization) for equities was more than 100 percent. It dropped to 15 percent, though, in 1999, both because of a decrease in turnover as well as an increase in market capitalization due to the listing of Estonian Telecom.

12. The average annual growth rate of bank time deposits for the period 1993–99 was 54 percent.

**FIGURE 5.4 STRUCTURE OF PRIVATE SAVINGS BANKS AND OTHER INTERMEDIARIES IN ESTONIA, 1996–99**

Source: Bank of Estonia.

confidence is the very small volume of pension funds, which, despite generous tax benefits, have not been able to get off the ground.<sup>13</sup> Population trends also will be influencing the structure of savings—demographically the population is aging fast, but retirees have smaller savings and less knowledge of securities markets than the general population. Their conservatism is very high, and consequently they choose bank deposits with smaller returns.

There is, nevertheless, little doubt that the international trend of investments flowing from bank deposits into higher-yield products will be replicated in Estonia. Even if the local market is unable to offer alternative products with a suitable degree of risk, accession to the European Union will make it easier for European institutions to offer standard products in Estonia.<sup>14</sup> This would expand the choice of investment products, making investments in funds more attractive. Also local banks are developing products that serve as alternatives to bank deposits. Most banks have established mutual funds, have acquired, or are in the process of acquiring, licenses for pension funds, and offer life insurance products. By cross-selling products offered by different companies in the group, they are able to sustain the loyalty of their clients.

It is likely that Estonian households will continue to use bank deposits as an important instrument of savings,

but the overall trend is likely to be similar to the international one. International investments will be favored over products specific to local markets. With products based on local securities, banks, which have a better distribution network, will have an advantage over nonbanks, which will have difficulty achieving adequate volume. Nonbanks in Estonia will attract local savings that are largely speculative. Clients looking for higher returns (and willing to take higher risks) will go to asset managers offering venture capital funds. Decisions concerning pension reform may influence the competitive position of nonbanks. If the pay-as-you-go system becomes dominant, the banking sector will not be challenged. But if the government decides to place more emphasis on funded pension schemes, the development of the securities markets will be encouraged at the expense of banks.

#### *Developments in Banking Business: Reorientation of Business, New Channels of Distribution*

Internationally, it has been argued that a need to improve return on equity and assets and to compensate for a decrease in net interest margins will be the driving forces leading to restructuring in the banking system. Banks need to change the way they do business, both by restructuring their operations as well as by increasing their risk taking in order to achieve higher margins and larger volumes. If this trend leads to a decline in their credit rating below that of their customers, this may lead to a further decrease in their traditional business and to an acceleration in their search for nontraditional services that offer higher returns.

In Estonia, the ownership structure of banks will have a significant effect on how banks operate. In order to improve profitability, Swedish (and Finnish) banks, presently operating in Estonia under the slogan “offering local banking,” will most likely turn banks into branches. As a result, many services will be outsourced to the parent bank, and branches will be run under strong central supervision. For this reason, banks in Estonia are unlikely to decompose their services in order to subcontract specialist services to other companies. Such processes will be increasingly conducted through parent banks. An Estonia-specific feature may be that some development of information technology will take place in Tallinn; for example, Internet banking

13. Up to 15 percent of annual income invested in pension funds is tax deductible.

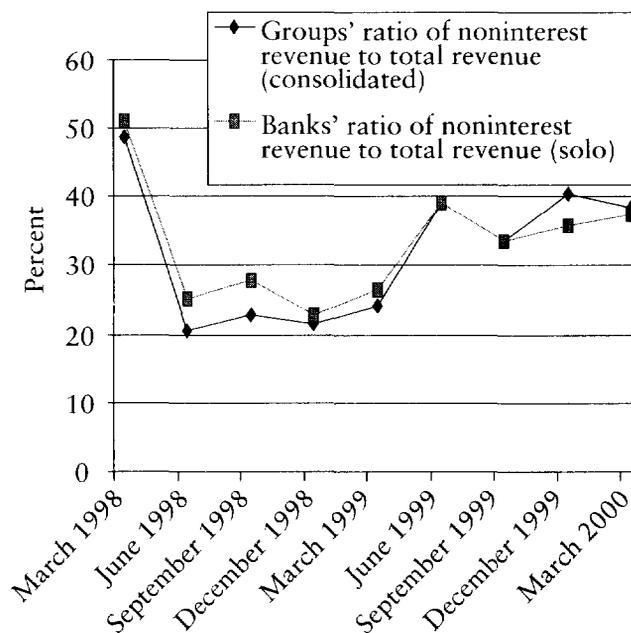
14. As of June 2000, four Estonian banks offered retail investment products of Europe-oriented funds, managed mainly by their Nordic owners. MeritaNordbanken branch in Tallinn offered three funds (a fixed-income, a mixed, and an equity fund) managed by Merita Rahastoyhtiö. Minimum investment was \$300. Ühispank offered two funds managed by SEB with no limitations on minimum investment. For investments into foreign funds, Hansapank has set a minimum limit of \$5,000.

will be conducted in Estonia for the whole banking group.<sup>15</sup>

Developing new lines of business would mean putting more emphasis on investment banking and asset management. The limited supply of local investment products will force banks to look increasingly toward other markets. This will put them into direct competition with banks already well established in the business (banks and fund managers operating in that particular market). Consequently, instead of developing tailor-made products based on securities from other markets, banks are likely to act as agents for global fund management companies or parent banks and to offer their products for an intermediation or agency fee (recent campaigns where banks offer funds managed by their parent banks are first examples of such a trend). As the value added by such services is very limited, they will not become a major source of revenue for local banks. Therefore, the ratio of noninterest income to total income, which for Estonian banks has been between 20 and 40 percent in recent years, is not likely to change significantly (see figure 5.5). It is unlikely that on-balance-sheet items will shift to off-balance-sheet items in the income structure to the extent that this is happening in banking internationally. Instead, offering alternative investment vehicles is necessary for banks to keep customers within the bank and to avoid losing them to non-bank financial institutions, which are intensively competing with them in this market. The central role of traditional banking services is well reflected in the income statement of banks. The share of noninterest income increased sharply—by roughly 20 percentage points—until 1997 due to the booming stock market. After the crash and subsequent crises, however, this proportion is again returning to “normal.”<sup>16</sup>

Profitability will not be a great problem for banks in Estonia because competition is fairly relaxed. The entrance of strong newcomers from abroad offering traditional banking services is not likely, as the market is too small and the cost of establishing a business is too high relative to the potential increase in business volume. This will allow larger banks to charge fairly high rates for their services and consequently to sustain high earnings. As a result, in coming years capital likely will remain in Estonia rather than be employed more profitably elsewhere. Assets in Estonia have a potential to offer good returns.

**FIGURE 5.5 NONINTEREST REVENUE OF BANKS IN ESTONIA, 1998–2000**



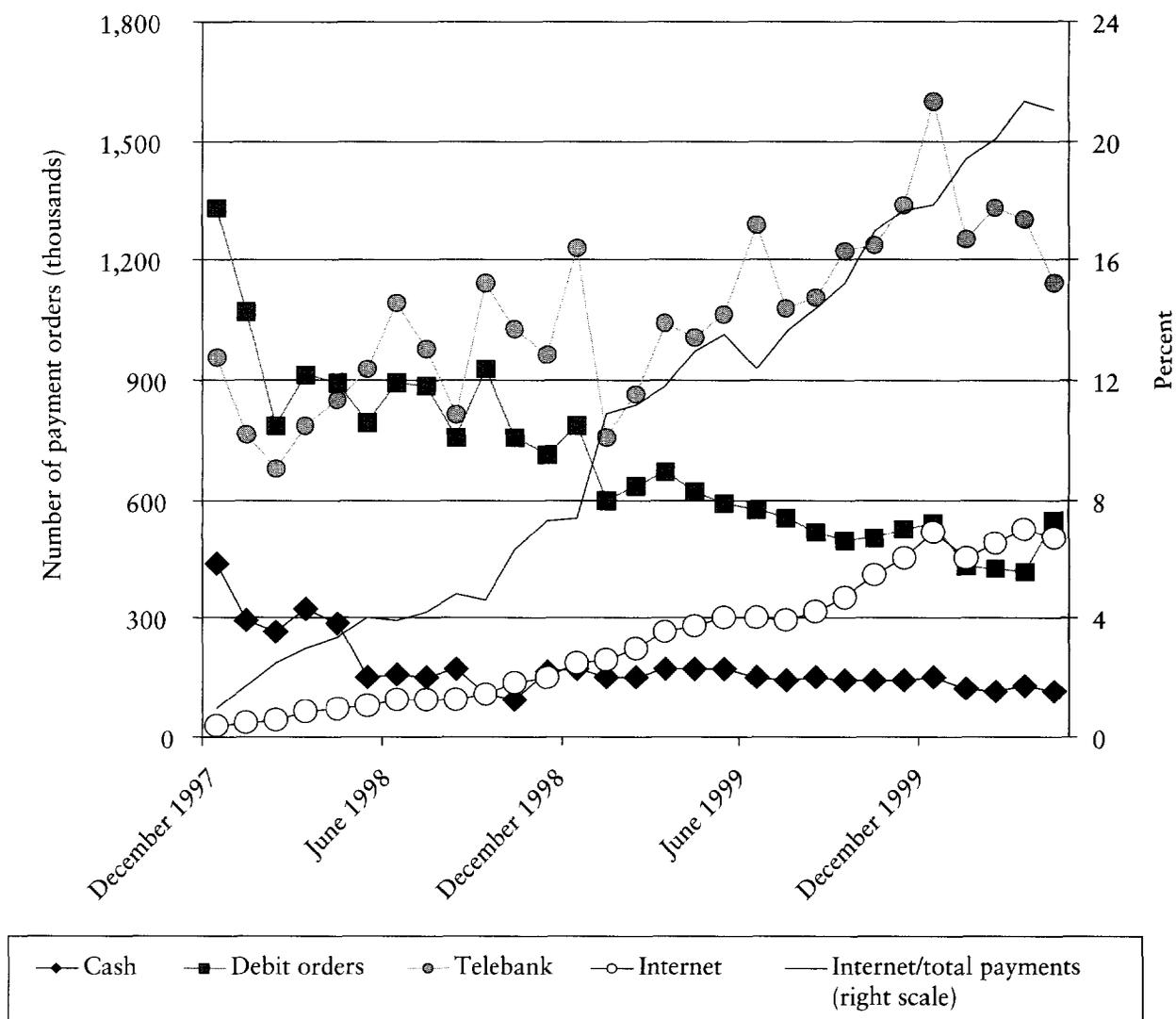
Source: Bank of Estonia.

In an environment in which banking is largely foreign-owned, local factors probably will be subordinated to the needs of the group, because of the high costs of maintaining separate structures and operations in each country. It remains to be seen whether this will lead to inefficiencies in the local market and open up business opportunities to local nonbank financial institutions, thus strengthening their position in the market. The ownership structure of banks will limit their activity in asset management. Acting as an agent to global managers and offering the standard products of parent banks will keep the margins from such activities low. Moreover, competition in this market segment will be fierce, because a limited amount of investments will be required to start operations. As a result, in the next 10 years the share of revenues earned from traditional banking services (loans) in the Estonian banking sector will remain relatively high, in contrast to the international trend.

Internet banking has been available in Estonia for many years (see figure 5.6). Because commercial banking as an industry is only 10 years old, there have been fewer

15. As an example of this, the Union Bank of Estonia and SEB formed an information technology consortium on May 15, 2000, to be located in Tallinn, Estonia. That institution will develop new electronic solutions for the whole group.

16. Noninterest income for banks on a solo basis was 38 percent in the first quarter of 2000.

**FIGURE 5.6 USE OF DIFFERENT PAYMENT CHANNELS AND INTERNET PENETRATION IN ESTONIA, 1997–99**

Source: Bank of Estonia.

opportunities to develop costly branch networks. The number of branches per 1,000 inhabitants has never reached levels common in Europe.<sup>17</sup> Instead, in the past two years, this number has been decreasing, as branches closed and banks opened Internet service points in relatively remote areas. The percentage of clients making payments through electronic means shows a steep upward

trend.<sup>18</sup> Customers seem ready to accept electronic banking. Consequently, the spread of Internet banking will not constitute a cultural change for people in Estonia, where Internet has been offered continuously in parallel with developing new services.

The development of Internet banking may even occur much faster in Estonia than in many countries in Europe.

17. The number of branches in Estonia was 0.17 per 1,000 people in 1999. Compared with a European average of 0.48 in 1997, this is a modest number.

18. The slight drop in the number of Internet payments and a consecutive increase in debit orders are due to the introduction of a fee for Internet payments by the major bank in April 2000.

Developments in the telecommunications sector strongly support this. Last year, the number of people using the Internet in their everyday banking increased significantly, and by early 2000 more than 15 percent of all accounts opened at banks used the Internet. The number of Internet users in Estonia is one of the highest in Eastern Europe.<sup>19</sup> Even the state administration is making full use of the technology.<sup>20</sup> In addition, Estonia is well positioned regarding mobile devices, which, in turn, will allow fast introduction of mobile financial services. This favorable technological background will allow the fast implementation of electronic means of conducting business. Also labor laws, which are an impediment to change in many countries in continental Europe, provide Estonian workers no protection against redundancies. As a result, banks can streamline their business as technological advances allow them to close branches and switch increasingly to electronic banking.

Electronic banking will substantially improve the efficiency of banking in Estonia. Although the amount of investment required to make full use of modern technology is very high, electronic banking enables banks to decrease the costs of offering banking services in the long run (the cost of a transaction conducted over the Internet is only a fraction of the cost of a transaction conducted in a branch). As a result, banks have a strong incentive to offer a wide range of products to support such investments. Consequently, banks put high priority on product development. Today, only one brokerage company is capable of selling shares through the Internet, whereas most banks have offered this service for several years.<sup>21</sup> Because of the small customer base and relatively high fees, this company is not yet popular among day traders.

Banks have detected a source of value (both for themselves and for their customers) by intermediating customer transactions in so-called “bank malls.” Information systems will allow banks to create a secure environment in which customers can pick up the merchant from the bank’s website, choose the goods, and pay for them. The next step will be adding such possibilities to mobile devices, which will help banks to retain old and gain new customers

more easily. Although, historically, having a branch network has been seen to support the strong position of banks, the relative balance between banks and nonbanks probably will not shift considerably with the wide adoption of new technologies. Using the Internet to offer financial services is still an investment-intensive strategy, which, although it increases efficiency in the sector in general, will not change the relative position of banks versus nonbank financial institutions.

The only likely competitors in the local market will be international banks with strong brand names (from neighboring countries). An increase in the use of electronic transactions will open the door for international banks to compete in the retail market. As their level increases, deposit insurance and sophisticated Internet portals, which have been developed to be used globally and benefit from high volumes, will have a fair chance of attracting customers away from local banks.

Estonia is not likely to suffer from the “conservatism” of European households, which has limited the spread of Internet-based banking services. As far as technological advances are concerned, and the impact that they have on the way business is done, Estonia is in the forefront in Europe. Innovative attitudes to offering services to clients, and a lack of preconceived ideas about what banking should look like, will make it easier to develop banking in a more up-to-date manner. Obviously, such fast development will be a major challenge for supervisors who have to keep themselves up to speed. Although improving efficiency, this is not likely to substantially increase competition in the financial services market. High investment costs, which are sustainable only with high volumes, make it very likely that the position of banks versus nonbank financial institutions will remain strong.

## Conclusions

The Estonian banking sector probably is not applicable to the Europe and Central Asia region in general. Consolidation has already taken place in Estonia, and the market is almost totally foreign-owned. In the near future banking in Estonia is likely to develop in the same direction

19. The degree of Internet usage among Estonians between the ages of 15 and 74 almost tripled during past 2.5 years, from 10 percent in the third quarter of 1997 to 26 percent in the first quarter of 2000.

20. An example of such innovations is the initiative of banks and tax authorities this year to offer individuals the possibility of filing their personal income taxes using Internet banking facilities. The number of people who filed their personal income taxes over the Internet was 11,760 (approximately 0.75 percent of the banks’ base of private clients). Only two banks offered this service in 2000, but a higher rate of activity is expected over the coming years.

21. Historically, more than 75 percent of domestic securities trading is performed through or by banks.

as banking in Europe. At the same time, there are several areas in which global trends will not be fully replicated.

The main factor shaping the banking market internationally is competition. A limited volume and client base in Estonia will not encourage sufficient competition from outside. The market is so dominated by banks that it is increasingly difficult for nonbanks to gain sufficient market share in order to offer services at competitive prices. As a result, banks in Estonia are well equipped to preserve their competitive edge against nonbanks. The ability to adjust the cost base and a strong market position will help them to keep their customers. Even a very fast spread of electronic banking services may not be sufficient to allow non-bank financial institutions to improve their position because very high investments are needed to develop competitive Internet-based solutions.

Concentration likely will remain high unless regulators intervene. The market is small and well divided among the largest players, with concentration much higher than is considered normal in European countries. As a result, smaller institutions find it difficult to establish themselves in the market. Special attention needs to be paid to possible malpractices, which may further decrease the ability of new institutions to enter the market. Banks have the advantage of using cross-subsidies for new products developed by

somebody else. As a result, the market is practically closed to newcomers. If competition comes neither from non-banks nor from the outside, the efficiency of the financial markets in general will deteriorate and may begin to depress economic growth. The demand for banking (and other financial) services likely will continue to rise, along with the income of the population. This will pose a serious challenge for regulators if the developments described here take place. In order to use the securities market as a complement to bank services, more attention should be paid to providing a favorable environment for the development of nonbank financial institutions.

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## Chapter 6

# Financial Sector Restructuring: The Croatian Experience

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**F**inancial sector restructuring is a very demanding task in countries in transition, both in theory and in practice.<sup>1</sup> There are at least two reasons for this. First, before the transition began, the financial sector was one of the least-developed sectors in the socialist economy. Second, even in developed economies, there is no consensus on many of the issues surrounding financial sector regulation, restructuring, and institution building.

This chapter seeks to analyze the relationship between the central bank and the ministry of finance in their pursuit of financial sector restructuring. This approach is taken for three reasons. First, those two institutions are usually responsible for regulating, supervising, and restructuring the financial sector. Even if some specialized agencies are formed, they are usually under the auspices of the ministry of finance or the central bank. Second, their joint effort is needed to produce an efficient, stable financial system, a necessary condition for sustained growth. Nevertheless, their coordination is rarely analyzed. Third, a healthy financial sector relies on the following ingredients: "...the reform of the banking sector, the restructuring of the enterprise sector, and the attainment and preservation of macroeconomic stability." (Blejer 1999: 385). This chapter therefore addresses the question of banking and macroeconomic

stability. The central bank and the ministry of finance are the main institutions behind financial sector reform, and their relationship is crucial for the soundness of the financial sector.

The analysis is framed in terms of the coordination between monetary and fiscal authorities in the process of transition.<sup>2</sup> These authorities need to coordinate their activities, while remaining independent in pursuing their specific objectives at the same time. Because the subject of overall coordination is very broad, the analysis narrows the focus to two topics: (a) macroeconomic issues of fiscal and monetary policy coordination and (b) the coordination between monetary and fiscal authorities in the banking sector and, in particular, in the resolution of banking crises.

Both features are essential for successful financial sector restructuring. First, without macroeconomic stability

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1. For more details, see, for example, Blejer and Skreb (1999); European Bank for Reconstruction and Development (1999).
2. In this chapter, the terms fiscal authority—authorities responsible for implementing fiscal policy—and monetary authority—authorities responsible for making decisions on monetary policy, banking regulation, and supervision—are used extensively. Thus the monetary authority is assumed to be the supervisory authority; that is, it performs the function of supervising banks. Monetary authority has a broader meaning than just institution(s) responsible for monetary policy. The terms central bank and monetary authority are used as synonyms.

(including low inflation), no meaningful financial sector restructuring can take place. Second, as all transition economies had a banking crisis and as banks are the most important financial intermediaries, resolving crises in the banking sector is essential for financial sector restructuring. With time, the need for state intervention will diminish.

Transition economies did not inherit well-developed institutions from the past, and institution building is one of the main priorities of reforms. Genuine coordination between monetary authorities and fiscal authorities is scarce. There is the risk that one side will dominate the other (usually the fiscal authority tries to dominate the monetary authority). Neither side shares the same perception of the same problem nor necessarily has the same objectives. The legal framework within which monetary authorities and fiscal authorities operate is sometimes poorly defined and changes frequently. This can exacerbate the problem of coordination, which affects the speed and quality of financial sector reform. Besides, not everything can be written down in laws. The quality of coordination and reform depends in large part on day-to-day business, habits, relative political power, and (sometimes) the strength of personalities that head the monetary and the fiscal authorities.

The analysis is based on the case of Croatia, but the conclusions have broader applications.

### **Macroeconomic Issues**

The literature on central banking usually distinguishes among the three basic types of central bank independence: goal independence, instrument independence, and legal independence. Numerous authors assume independence to be a value in and of itself. It is generally believed that central bank independence brings about low inflation, which is good for economic growth (Cukierman 1992; Cukierman, Miller, and Neyapti 1998).

The Croatian experience indicates that this view oversimplifies the independence-growth agenda. Although high inflation slows economic growth, there are other important mechanisms for linking central bank independence and growth. Two of them proved to be very important in the case of Croatia. The first is the operational coordination between fiscal and monetary policy. The second is the clear division of responsibilities between fiscal and monetary policy during the resolution of a financial crisis.

### ***Central Bank Independence and Fiscal-Monetary Coordination***

Four conditions are related to the positive impact of independent monetary policy on growth. The legal independence of the central bank is not the only necessary con-

dition. Long-term sustainable economic growth can be supported by an independent central bank only if at least three political and economic mechanisms, which link central bank independence and growth, function properly:

- Reasonably low inflation
- The successful operational coordination between fiscal and monetary policy
- The clear division of responsibilities between fiscal and monetary policy in the process of resolving a financial crisis.

These three conditions are equally important. The simultaneous proper functioning of all of them makes central bank independence good for economic growth. On the one hand, it is still an open question as to whether or not central bank independence, when it leads to a central bank “going it alone” in its commitment to low inflation, is good for the economy (Wagner 1998). For example, if commitment to low inflation is followed in times when money issues are used to finance the resolution of a large-scale financial crisis, this probably will lead to a classical clash between fiscal and monetary policy. A clash can show up either as a clash between the domestic and external (exchange rate) goals of economic policy (Bordo and Schwartz 1996) or as an “unpleasant monetarist arithmetic.” This kind of “arithmetic” can show, *ex post*, that low inflation is not an optimal solution if fiscal policy dominates monetary policy (Sargent and Wallace 1981).

On the other hand, a society can extract great benefits from low inflation even when the legal independence of the central bank is incomplete. This probably will occur if the benefits of low inflation are broadly understood among the population, if there is successful operational coordination of independent monetary and fiscal policy, and if there is a clear division of responsibilities between the central bank and the government in the resolution of financial crises (that is, if there is no confusion concerning who is responsible and who bears the costs of the insolvency of financial intermediaries). In these circumstances, reputation or habitual independence will substitute for imperfect legal independence.

### ***The Legal Environment and Inflation***

The Croatian Central Bank Law was enacted in 1992, when many transition countries were passing Bundesbank-type legislation. At the same time, many technical assistance missions from the International Monetary Fund and other institutions were shaping local legislation (Coats and Škreb 1999). Since imitation is never perfect, departures from legal independence occurred. In the case of Croatia, there were two main departures.

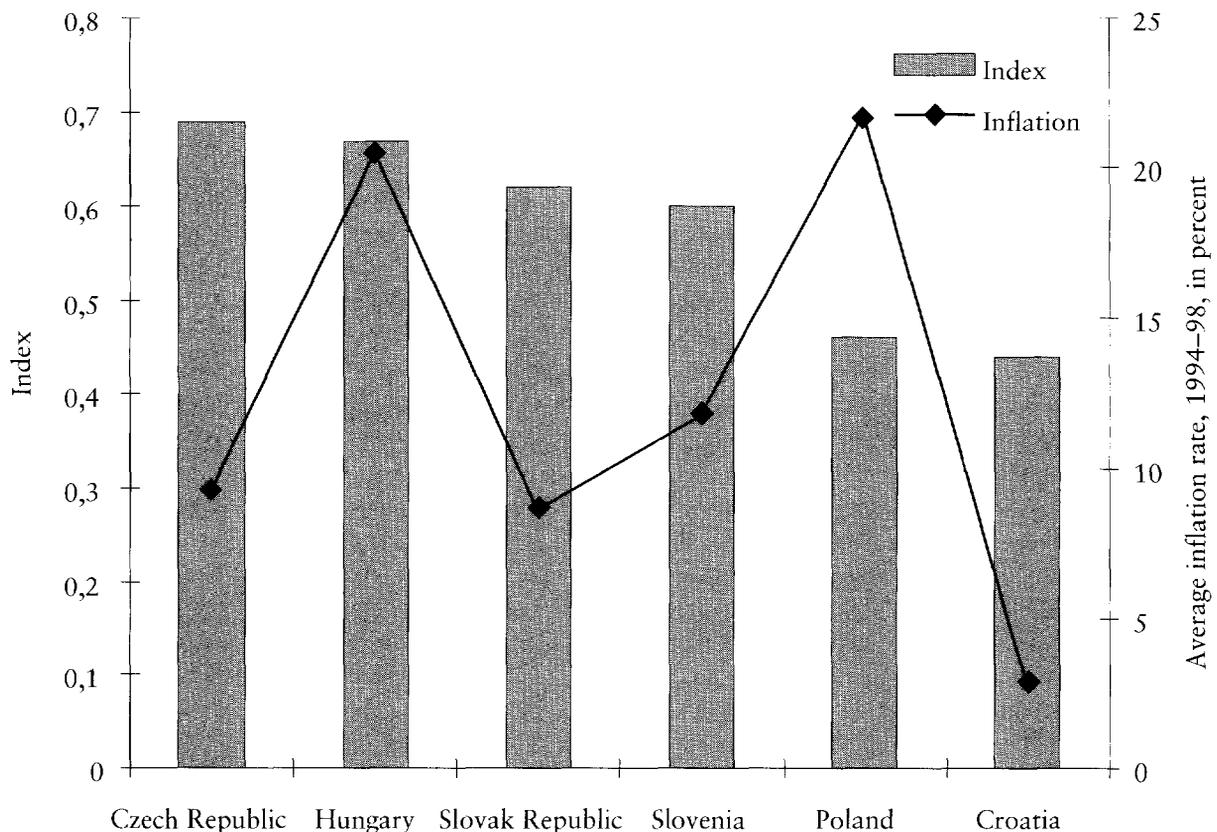
First, the central bank was allowed to lend directly to government. Lending to the government was constrained by the obligatory repayment of loans by the end of the year. This legal provision put a strong limit on the financing of budget deficits. An additional limit was provided by the provision that lending to the government within a fiscal year could not exceed 5 percent of the annual budget plan. However, the mere fact that the government could ask for a short-term loan, coupled with the fact that the loan could be payable at an interest rate below money market levels, seriously undermined central bank independence.<sup>3</sup>

The second departure from best practice was related to the relationship between the central bank and the parliament. The mere fact that the central bank is accountable to parliament, and not to the government, is a necessary but insufficient condition for independence, since the same

political party or coalition controls both the government and the parliament. The main danger to the independence of the Croatian National Bank (CNB) comes from the parliamentary ability to dismiss the governor and members of the Central Bank Council by a simple majority vote. Also the law does not address the dismissal of the governor, and the government can take a long-term loan from the central bank if the parliament enacts such a law.

Figure 6.1 shows that Croatia is ranked below advanced transition countries according to the value of the Cukierman-Miller-Neyapti (1998) index of central bank independence (the higher is the value of the index, the more independent is the central bank). Despite this, Croatian central bank independence is at a medium level. Although the possibility of removing the governor and members of the governing council by a simple majority vote

**FIGURE 6.1 INDEX OF CENTRAL BANK INDEPENDENCE AND AVERAGE INFLATION RATE IN SIX TRANSITION COUNTRIES, 1994–98**



Source: Cukierman, Miller, and Neyapti (1998).

3. Loans to the government are charged at a discount rate, while the main interest rate in lending to banks is the Lombard rate. Despite the fact that there are no legal limits on the discount rate, historically it has been lower than the Lombard rate.

is a sign of weakness, the clear expression of goals proved to be a source of the central bank's strength.<sup>4</sup> The same goals are written in the constitution and the law on the Croatian National Bank: currency stability and general liquidity in domestic and international payments.<sup>5</sup>

Both in relative (given the level of independence) and in absolute terms, inflation in Croatia was the lowest during 1994–98 among the countries presented in figure 6.1. This suggests one conclusion and raises two questions. The conclusion is that low inflation is possible with a low degree of legal central bank independence. (Actually, this is just a case study confirmation of an old finding.) The following questions arise: What is the main mechanism that ensured low inflation with a very imperfectly independent central bank? Was low inflation achieved at the expense of some other valuable economic goal?

### *Coordination and Independence: Is There a Short-Term Tradeoff?*

Legal independence and inflation are measurable and can be used to classify different countries. The other two criteria (the operational coordination of fiscal and monetary policy and the clear division of responsibilities between them in times of financial crises) are not so well established or measurable.

Assume that in most countries in the world (and in transition economies and emerging markets in particular), central bank independence is highly imperfect.<sup>6</sup> There is a permanent strain between fiscal and monetary policy. This strain may lead to a short-term tradeoff between the coordination of fiscal and monetary policy and actual independence. This tradeoff is realized in the following way: imperfectly independent central bankers may fear that operational coordination would lead to additional pressures to extend loans to the government. However, fiscal policymakers work under the daily pressures of public finance, which can lead to unproductive fiscal-monetary meetings where discussions, instead of focusing on coordination on equal grounds, instead elaborate government requests for loans from the central bank (or ask for a particular type of open-market operations if direct lending to

the government is legally forbidden). In conclusion, fighting for actual independence on the basis of weak legal independence may lead to less coordination than is optimal in the short run.

This is clearly not socially optimal. Maxwell J. Fry (1997) shows that monetization of the fiscal deficit has a negative impact on economic growth in developing countries. Inflation can be minimized for a given fiscal deficit by relying on a transparent market for domestic public debt. Hence, the government and the central bank have a clear long-term interest in cooperating to develop a stable and transparent market for public debt (it is impossible to build this market without proper coordination). An underdeveloped market for public debt in a low-inflation environment is a sign of a suboptimal solution (lack of coordination because of weak legal independence).

Additionally, in a financial crisis it sometimes is impossible to distinguish between the operational coordination of fiscal and monetary authorities and the clear division of responsibilities between them. Central bank lending to banks in distress can become lending to the government if ex ante information on the banks' solvency is highly imperfect (which is often the case). Since fiscal policymakers sometimes partly or entirely refuse to bear responsibility for expenditures related to the banking system, this conflict can grow. In the extreme, the central bank can absorb fiscal losses without intending to do so (due to lending to banks that appeared to be illiquid but solvent, but later proved to be insolvent).

In summary, the following three characteristics were present in Croatia in the 1990s, indicating a short-term tradeoff between coordination and independence:

First, the lack of operational coordination between fiscal and monetary policy was reflected in three main deficiencies:

- The lack of a clear institutional setup for coordination (no public debt committee or similar institution was established, so that coordination emerged on an ad hoc basis).
- The absence of a single treasury account and lack of coordinated liquidity planning, which led to sudden loan requests from the ministry of finance, while

4. This came to be true in April 2000, when the newly elected parliament (after the January 2000 elections) refused to confirm the central bank's financial reports after strong political and media pressure was exerted on the governor and council to resign.

5. Politicians still find some ambiguity in this definition and emphasize that the three goals might be in conflict (that is, domestic liquidity versus currency stability). In public discussions, people tend to interpret these goals as they like. However, currency stability being listed in the first place shows a public choice and makes a case for monetary policymakers to defend their policies.

6. Indeed, indexes for individual countries cluster around 0.5, which we assume not to be a consequence of rules of measurement, but more a reflection of the true imperfection of central bank independence around the world.

some other governmental spending units had large volumes of funds in their accounts.

- The lack of a deep and transparent market for tradable government debt.<sup>7</sup>

Second, the lack of strategic coordination between fiscal and monetary policy was reflected in three main deficiencies:

- The government planned annual central bank seigniorage on its own, without formal consultation with the central bank.
- The government refused to coordinate main macroeconomic expectations (real gross domestic product growth and inflation) with the central bank, which led to widely divergent estimates of growth that confused the public.
- The government refused to recognize the expected costs of resolving the banking crisis in the budget despite the fact that the expected cost calculations were presented to it by the central bank on the basis of legally binding obligations (mainly related to the expected costs of insured deposit payouts in banks that failed or were expected to fail).

Third, the lack of a common understanding of basic macroeconomic principles was reflected in two main deficiencies:

- While the central bank was preaching financial discipline, the government was generating financial delinquency, accumulating 6.2 percent of gross domestic product (GDP) in arrears on payments for goods and services until early 2000 (according to anecdotal information, the accumulation of arrears largely began in 1995).
- While the central bank was preaching price stability, its critics were emphasizing the central bank's responsibility for "liquidity in domestic payments"; these were actually calls for monetization of government arrears.

If all of these weaknesses in the coordination mechanism were clear expressions of a short-term tradeoff between coordination and independence, then the tradeoff (a socially suboptimal outcome) could have been avoided in either of two ways:

- Increasing central bank legal independence up to the point where the central bank could promote a

transparent market for public debt without fearing that the fiscal authority would abuse its role.

- Decreasing central bank independence to the point where the monetary authorities would be clearly subordinated to the fiscal authority.

Developing the central bank's institutional independence halfway to where it should have been was a dubious attempt. If, throughout the 1990s, Croatia was under a fiscally dominated regime, then the central bank's attempts were futile and created social costs. If the country was under a monetarily dominated regime, then these attempts represented good efforts, both in terms of the current impact of monetary policy as well as in terms of investment into building up a culture of price stability. This issue is explored further in the next section, because answering this question is crucial for determining where the transition process will go in the next decade or so. Clearly it could go both ways.

### **Some Unpleasant Monetarist Arithmetic: Measuring Fiscal and Monetary Dominance**

This section does not give a definitive answer to the crucial question concerning whether Croatia is under a regime dominated by a fiscal authority or a monetary authority. In other, more precise, words, the key questions are as follows: If the regime is dominated by the fiscal authority, is the accumulation of government arrears worse than the central bank's lending to the government? Or should the central bank's commitment to achieving low inflation be viewed as an investment in a more stable and fiscally viable future?

The time series are too short to come to an answer with a critical degree of analytical precision. Therefore, we limit ourselves to a conceptual discussion of a few basic numbers. A discussion follows presentation of the basic theoretical facts.

Following the seminal paper by Sargent and Wallace (1981), economists' interest has centered on the issue of fiscal solvency or, more precisely, on the following question: Who sets the anchor for the economy: fiscal or monetary policy? Money does not necessarily determine prices. Moreover, some authors think this to be a rather special case (Woodford 1995). In the real world, it is more likely that we live in a fiscally dominated regime, according to

7. The only notable exceptions are short-term T-bills. However, the central bank issued its own short-term paper for sterilization purposes (CNB bills) because it could not rely on the government's ability to recognize the need for sterilization. The CNB was always afraid that it would not be able to reach agreement with the ministry of finance about the amount of money collected by government paper issues, which should be kept in the sterilized account with the central bank, but not spent for fiscal purposes.

Woodford. In this case, if there is a currency peg, monetary policy alone cannot ensure its sustainability. Fiscal policy needs to ensure solvency if a peg is to be viable (Canzoneri, Cumby, and Diba 1997).

How can we distinguish between regimes dominated by the fiscal authority and regimes dominated by the monetary authority? If primary fiscal surpluses respond to the level of government debt in a way that assures fiscal solvency, then money and prices can be determined by the supply and demand for money. In other words, in a regime dominated by the monetary authority, a fiscal surplus should pay off part of previously accumulated public debt. So, for example, if the debt to GDP ratio falls after an innovation in the surplus to GDP ratio (like in the United States), we are in a monetarily dominated regime (Canzoneri, Cumby, and Diba 1997).<sup>8</sup>

This calculation is impossible for Croatia for at least three reasons. First, comparable data are available only for a period of six to seven years, which is too short a period for drawing conclusions. Second, the debt to GDP ratio has been changing mainly due to one-off expenditures related to:

- The consolidation of the transitional banking system (such as payouts of insured savings and bonds issued for bank recapitalization)
- Postwar reconstruction
- The regularization of external debt inherited from the former Yugoslavia.

Third, the primary surplus may not be a good measure for a country that has a low initial level of indebtedness and is engaged both in the large privatization of public enterprises as well as in large investment programs (recovery and return of displaced persons to their homes, financed entirely by the state). Fiscal solvency is particularly hard to measure when the desire of market participants to hold government debt instruments is expected to increase and jump to the new sustainable (higher) level in the long run. Issues on how to account for privatization receipts and investment can be resolved by looking at current surpluses instead of primary surpluses and by looking at them in comparison to the debt to GDP ratio, keeping in mind one-off shocks to this ratio.<sup>9</sup> Finally, looking at basic ratios during a six-year period gives just a preliminary impression about the nature of the system.

The data in table 6.1 reveal how problematic, in fiscal terms, was the year 1999. Contrary to government expectations of 5 percent real growth rate, GDP fell 0.3 percent in real terms, and government consumption continued to run high, due to the political cycle (1999 was a *de facto* election year, since the elections were held on January 3, 2000).<sup>10</sup> Consequent sharp drops in the current surplus and in the overall balance underestimate the true fiscal shock, which was much stronger on an accrual, than on a cash, basis (numbers are on a cash basis). As of early in 2000, the new government had inherited 6.2 percent of GDP in fiscal arrears from the former government. Arrears

**TABLE 6.1 MAIN FISCAL INDICATORS OF THE CONSOLIDATED CENTRAL GOVERNMENT AS A PERCENTAGE OF GDP, 1994–99 (cash basis; that is, without arrears estimated at 6 percent of GDP as of early 2000)**

<i>Indicator</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
Overall balance	1.6	-0.9	-0.4	-1.3	0.7	-2.0
Current balance	2.8	1.8	4.0	3.1	5.2	1.1
Public debt to GDP	22.0	19.3	28.5 <sup>a</sup>	27.3	31.4 <sup>b</sup>	39.2
of which: Domestic	21.0	18.0	16.0	12.5	16.3 <sup>b</sup>	18.2
Foreign	1.0	1.3	12.5 <sup>a</sup>	14.8	15.0	21.0

a. Effect of regularization of foreign debt inherited from former Yugoslavia.

b. Effect of recognition of HRK (Croatian Kuna) 7.5 billion as a domestic debt to pensioners.

Source: Authors' calculations on the basis of *CNB Bulletin*.

8. With one additional condition: the surplus to GDP ratio cannot be negatively correlated with the surplus to GDP ratio in the future.

9. The implicit assumption is that public investment can be cut as soon as capital revenues from privatization stop flowing in.

10. As of late 1998, the central bank publicly announced its expectation of a growth rate around 0 percent.

were accumulated at an unknown pace, probably beginning in 1995.

This was a clear break from previous years. The country had begun with practically no external debt, which meant a fairly relaxed fiscal constraint after the regularization of inherited external debt and, particularly, after winning a sovereign investment grade as of early 1997. If two “debt recognition shocks” are disregarded and it is kept in mind that, in 1996, 1998, and 1999, there had been a debt buildup due to bank rehabilitation programs, fiscal solvency seems to have been obeyed until 1999, when a major shock emerged. Besides the cash-accrual problem, an additional problem stemmed from guarantees, which were issued largely in the period from 1997 to 1999 and are not included in table 6.1.

In conclusion, it is not at all clear whether Croatia has a fiscally or a monetarily dominated regime. Until 1999, it seemed to be closer to a monetarily dominated regime since fiscal surpluses were used largely to repay debts, while cash deficits were very small. When a country stops to recognize transition-related one-off debts, fiscal solvency will be achieved. The year of 1999 marked an obvious break with a sound fiscal history.

Croatia is now at a crossroads. The government elected in early 2000 is trying to implement new fiscal stringency but is having difficulty doing so following the major fiscal failure in 1999. It is not at all clear whether the recognition of one-off debt increases is over, because there is pressure to recognize more debts to pensioners, which the new government promised to do. Three years ago it seemed that Croatia was heading firmly toward a monetarily dominated regime despite weak legal fundamentals; three years later Croatia has reached the crossroads.

The Croatian experience points to the fact that having a legally weak but very ambitious central bank in terms of achieving low inflation creates pressure for the expansionary fiscal policy to adjust. Fiscal inertia leads to the accumulation of arrears and strain between monetary and fiscal authorities, implying lack of operational coordination between monetary and fiscal policy. This strain becomes obvious when a country experiences banking sector problems.

### **Banking Sector Issues**

The banking system is usually the core and the largest part of the financial system, especially at relatively early stages of transition, when other financial markets (like the capital market or insurance market) are both shallow and narrow. Therefore, questions of regulation, supervision, and systemic stability of the banking system are of

utmost importance for the efficient functioning of the financial system and the overall economy as well. Coordination between monetary authorities and fiscal authorities on those issues is extremely important. Banking crises are (unfortunately) a common feature of transition (but are in no way limited to transition), and coordination is needed to resolve them. One could argue that if the monetary authorities and fiscal authorities coordinate successfully in times of crises, they will do so in “peaceful” times when discussing regulation, deposit insurance, and stability safeguarding. The coordination between monetary and fiscal authorities on the resolution of the banking crisis in Croatia and its implications for the financial system are analyzed next.

### ***The Role of Banks in Transition***

Substantial transformation is needed if the banking industry is to play a vital role in the economy. Commercial banks have played, do play, and will continue to play an important role in transition economies. But, to fulfill the demanding task of an efficient financial intermediary, the banking sector had to undergo significant changes. It had (and in some cases still has) to be de-politicized, restructured, and privatized; in short, it had to be completely different from what it was before the transition.

The starting point for the development of the banking industry in transition was very problematic. In centrally planned economies, money was an accounting unit that served to accommodate planning goals in the real sector, goals usually expressed in physical quantities (see Sheng 1996; Coats and Škreb 1999). The financial sector was not an intermediary, nor did prices reflect the relative scarcity of goods. Risk and its pricing were virtually unknown in such an environment. Enterprises could not fail, and workers could not be jobless. The financial system was stable because no one was allowed to go bankrupt (especially not the banks). Banks paid no attention to credit risk (the allocation of funds was based on plans), foreign exchange risk, or any other type of risk (with the notable exception of the noncompliance risk, meaning the risk of not complying with the plan and instructions of party officials). It makes sense to think of socialism as a big insurance company, where implicit insurance premiums were collected regardless of the risks. Moral hazard behavior was very common in such an environment. At that time, there was no difference between the central bank and commercial banks (it was a monobanking system). Overall credit allocation was based on the plan.

Croatia was not a typical centrally planned economy. It started to transform its monobanking system in the mid-

1960s (when it was part of the former Yugoslavia). But many behavioral patterns and consequences of the socialist system remained.

All the economies in transition inherited socialist, inefficient banking systems, which operated in a centrally planned environment. The change to a market environment resulted in bad loans and insolvencies of existing banks. Besides the problems inherited from the past, new banks were created with financing from nouveau rich individuals, whose aim was to finance their own conglomerates. Accordingly, most transition economies experienced severe banking crises not only due to their socialist past but also due to the failure of new banks. In many cases, the two types of crises followed (and overlapped) each other.

### *The Costs of Banking Crises*

The costs of a banking crisis differ widely from country to country. Generalizations and conclusions are relatively difficult to make (Frydl 1999; Caprio and Klingebiel 1996). Therefore, this section illustrates the costs of the banking crisis in the case of Croatia alone.

Before doing so, a word on the methodological problems of defining the costs of banking crises is warranted. First, there is no well-defined analytical framework for defining a banking crisis. Even worse, there is no clear framework on how to account for all of the costs of banking (financial) distress. This is very surprising, especially because some banking crises can cost in the range of 40 to 50 percent of GDP. Very often they exceed 10 percent. One would expect such big numbers to initiate much more research.

One might distinguish between the concept of fiscal (resolution) costs and the concept of the economic costs of banking crises. For simplicity, it is assumed that fiscal and resolution costs are the same. Both economic and fiscal costs could be viewed on a gross (only costs and expenditures) and net (costs minus revenues and benefits) basis.

Fiscal costs can be defined as all those costs that the budget had to pay out to resolve the banking crises. They may include the costs of bank recapitalization, the carving out of bad loans (and the issuance of bonds instead), the payout of insured deposits, and so forth. They can be defined on a gross or a net basis. The net basis should deduct from total costs budgetary revenues from the privatization of rehabilitated banks (if they are nationalized in the process of rehabilitation) or proceeds from bank bankruptcy.

The economic costs of banking crises are a broader concept. They could encompass (on top of fiscal costs) a fall in deposits in the overall system, indirect costs to companies

and households of a bankrupted bank, and, ultimately, lost economic growth. On a net basis, the revenues side should include benefits from “possibly” avoiding a widespread systemic crisis and taxes paid by the bank, which remained operational. In the Croatian example, only the concept of gross fiscal costs is used.

Despite the absence of a well-defined analytical framework (which cries out for much more research on the subject), it is clear that Croatia has, over the past 10 years (since independence), undergone two banking crises:

- The first was the crisis of the old banks with their inheritance (of bad assets) from the previous economic system and the legacy of war and disintegration of the former Yugoslavia. It could be called a structural or inherited crisis.
- The second crisis occurred in banks founded during the transition, because of weak management, including fraud, connected and insider lending, increased competition in the market as the transition period progressed, and inadequate regulation and supervision of the banking industry.

The first banking crisis—the crisis of the old banks—started with the beginning of the transition process (and even before it) and is even now ending with the sale of rehabilitated state banks to foreign strategic investors. The costs of this crisis include the following (for more details, see Jankov 2000; Škreb 2000a):

- The issuing of the so-called big bonds in 1991, in the amount of about \$990 million
- The 1992 conversion of foreign currency savings into a public debt, in the amount of \$3.1 billion
- The rehabilitation of the four major banks during the period from 1995 to 1996, at a cost of \$473 million (for more details, see Lovegrove 1998). At that time, those banks represented about 40 percent of total banking assets. The total costs of these crises may be seriously underestimated because the resolution with the Paris and the London club creditors (and their effect on banks) was neglected.

All told, the first banking crisis cost an estimated \$4.6 billion. These high costs are typical of countries caught up in war, like Kuwait and Israel at certain points in their history (Frydl 1999).

At the beginning of 1998, another—the second—banking crisis started in Croatia. In 1998, the government decided to rescue two banks that represented about 7 percent of total banking assets. The costs were estimated at \$347 million. The second feature of the crisis was the costs of paying insured savings deposits in banks where bankruptcy proceedings had been started (on request from the cen-

tral bank). These costs were a charge on the budget, because not enough premiums had been collected by the State Agency for Deposit Insurance and Bank Rehabilitation. During the period from 1997 to 2000, the Croatian National Bank initiated bankruptcies or revoked licenses for 22 deposit-taking institutions.

The costs of paying out insured savings in the case of banks and savings banks where bankruptcy proceedings had already started were in the region of \$450 million. Accordingly, the total costs of the second banking crisis can be estimated at about \$800 million.

If the costs of the first and the second crises (with the renewed qualification that this is a matter of gross costs) are added together, the total costs are about \$5.45 billion. Of this, about 85 percent are accounted for by the first crisis and 15 percent by the second. This amount represents about 27 percent of 1999 GDP (at \$20.1 billion).<sup>11</sup>

### ***Coordination between Monetary and Fiscal Authorities in the Resolution of Banking Crises***

Banking crises are not specific to transition economies. What is essential is that banking crises are swiftly and completely resolved, meaning that the full costs should be adequately expressed and dealt with.<sup>12</sup> An adequate legal and regulatory framework must be put in place, and new supervision enforced. The relationship between monetary authorities and fiscal authorities on the issue of building up a sound and robust banking system is very delicate. Usually the central bank is the supervisor, but the costs of resolving a banking crisis to a large degree are fiscal. In Croatia this is the case regardless of whether market discipline was enforced by liquidation or bankruptcy, as a too generous deposit insurance scheme had to be financed from the budget, or whether recapitalization (or rehabilitation) by the state was used as a means of dealing with the problem banks.

The resolution of the banking crises can be viewed as a complex exercise in cost allocation. Resolution has serious distribution impact on different socioeconomic groups. Because of the different objective functions of monetary authorities and fiscal authorities, there might be a dispute on how to allocate costs. Therefore, it is somewhat surprising that articles on banking crises and their resolution rarely distinguish between monetary authorities and fiscal

authorities. They speak only about “authorities” as if they were one homogeneous decisionmaking body (Frydl 1999; Sheng 1996). We argue that this is not the appropriate approach, as in reality they are heterogeneous institutions with different objective functions. Based on the Croatian experience, in particular, the problem of postponing the resolution of a banking crisis lies partly in the lack of adequate coordination between monetary authorities and fiscal authorities.

Speed is important in resolving banking crises, which raises the question: Why are the (unavoidable) decisions to resolve banking crises delayed? Frydl (1999) distinguishes between a perception lag (a lag between the time when a problem occurs in the banks and when the authorities become aware of it) and an action lag (measures that are taken to resolve a problem).

This is a useful concept, but it should be amended because of the differences between monetary and fiscal authorities. Consider the resolution process (which is a lengthy process, not a one-time event) in the following way.

Before a banking crisis is resolved, time passes because of several lags:

1. *Perception lag.* This is the time period between the occurrence of problems within a bank (or banks) and when monetary authorities (assuming that the monetary authority is the bank supervisor) learn about them. This period can be lengthy because of inadequate accounting standards in banks, lags in reporting data from banks to the monetary authority, deliberate fraud that hides the real numbers in banks, lax commercial audits, ill-defined or unenforced reporting requirements to the monetary authority, or inadequate data analysis within the monetary authority. The last issue is particularly disturbing because all relevant information on banks may be in the monetary authority, but no one analyzes it properly or no one is aware of the problem.
2. *Action lag 1.* This is the time period between the moment when the monetary authorities learn (become aware) of the problem in banks and decide on what action to take alone (or propose an action plan to fiscal authorities). Due to the lack of human capital (inadequate people in banking supervision

11. Jankov (2000) estimates total costs at 31 percent, but the methodology is somewhat different. It just proves the lack of coherent methodology for examining the costs of banking crises.

12. It would be very interesting to develop a formal model based on the game theory framework (war of attrition) used in Alesina and Drazen (1991) to analyze this problem. We do not do it here.

and problems in their communication with top management of the monetary authority), this process may take time. It is not an easy task to find an adequate solution for the resolution of bank problems, especially if several distressed banks are involved at the same time. Even when the monetary authority is aware of the problem in a bank, the decisionmaking may be delayed. Concerns about systemic stability may urge the monetary authority to be softer than warranted. There are two arguments. The first one is the usual argument: too big to fail. What should the monetary authority do when it has information that a big bank is insolvent? The second one is a question: Why should the monetary authority reveal bad results in a bank, as it will be blamed, as a supervisor, for not acting sooner? On top of this, one should expect very strong lobbying in an attempt to convince the monetary authority not to resolve the problem. Predatory behavior of overpaid management or bank owners can affect inexperienced and sometimes unmotivated (and badly paid) staff at the monetary authority. All these (and other) factors, combined with lack of prioritizing or failure to realize the importance of the problem from top management of the monetary authority, can seriously delay swift action.

3. *Persuasion lag*. This is the time period between the moment when the monetary authorities learn about the problem and decide what to do and the moment when they persuade the fiscal authorities to get involved in the resolution. This lag does not exist if the monetary authorities propose bankruptcy as a solution for a distressed bank (in which case, one can immediately go to lag 5—legal lag). But if the resolution requires public funds, the persuasion lag may be important.
4. *Action lag* 2. This is the time period between the moment when monetary authorities and fiscal authorities agree that there is a banking crisis (or at least a big problem) and the moment when sufficient measures are taken to end the banking crisis. This is the second coordination problem between monetary authorities and fiscal authorities.
5. *Legal lag*. This is the time lag between when the monetary authority initiates bankruptcy proceedings against a bank and the legal system takes it up. Lag 5 does not apply if bank rehabilitation is a solution. The bankruptcy proceeding is usually within the decisionmaking power of the courts and not the central bank. The Croatian experience shows that it

may take from one to six months to initiate bankruptcy proceedings. Courts may accept the bankruptcy petition, which may cause greater delays in the overall process. Another question is relevant: How long may it take to complete the bankruptcy proceedings? It is a relevant question for creditors, who do not know how long they will have to wait to get (at least part of) their claims back.

Lags 1 and 2 are problems of the data collection and reaction curve within the monetary authority alone (a micro-micro issue) and could be very important, especially if the legal and regulatory framework is inadequate and banking supervision is inexperienced. Lag 5 is completely outside the control of monetary and fiscal authorities (but nevertheless is very important). Lags 3 and 4 are a coordination problem between monetary authorities and fiscal authorities.

What problems are evident in lags 3 and 4? Based on the Croatian experience, the fiscal authorities have to realize that there is a banking crisis or banking distress in the country. There is an information asymmetry between monetary authorities (which are usually responsible for collecting data on banks) and fiscal authorities (which bear at least part of the costs). This is the first coordination problem. There also may be an asymmetry of understanding the problem. If there are large differences in the speed of accumulation of human capital between the central bank (monetary authority) and the government (fiscal authority), they may have a completely different perception of basic notions and events, such as insolvency and the reasons leading to it. In this case, for example, the fiscal authority can accuse the monetary authority of being “too rigid” in the classification of quality of assets. “If just the classification would be softer, banks would become solvent” is an argument heard all too often. A similar argument applies to loosening monetary policy as a “tool” for resolving banking problems. It is true that additional liquidity may hide the insolvency and delay (only delay, not remedy) the inevitable, but at the expense of rising inflation. In the case of Croatia, the “kill the messenger” syndrome has been experienced. This perception asymmetry can seriously impair coordination in the resolution of banking crises.

The fiscal authorities rarely are fully informed about the situation in banks. However, bad news takes time to digest. The fiscal authorities may suffer from the denial syndrome (unwilling to accept either the existence of the problem or its size). Even when the monetary authorities are fully convinced that there is serious distress in the banking industry and that a systemic crisis is possible, it will take time for the fiscal authorities to agree on this.

Governments, including the fiscal authorities, rarely act quickly and decisively.

Even when the problems of coordination between the monetary and fiscal authorities are resolved, other agents (interest groups) will place political pressure on the fiscal authorities to alter the outcome in their favor. First, the management of the banks will try to influence the decision to their advantage. They have clear vested interests (high wages, influence, a motive to hide the incorrect decisions made in the past). Second, the bank owners will try to put political pressure on the government to bail them out. Third, bank personnel know that either all or part of them will be unemployed. Fourth, politicians (other than the fiscal authorities) will try to minimize the problem in the hope that this will not hurt their “image” or make them less popular. In short, there will be resistance to admitting the problems in the banking industry, not only from the fiscal authorities but also from other agents in this political game. Every decision on bank resolution is a redistribution problem; there are always welfare losses for some interest groups, so everyone should be aware of very strong lobbying, corruption, ruthless behavior, or vested interests seeking to alter the decision. Needless to say, lobbying implies the use of scarce resources to influence the outcome. Predatory behavior has a lot of incentives in transition and particularly in the banking industry.

When lag 3 is resolved and the monetary and fiscal authorities agree that there is a banking crisis or distress and that it has to be dealt with in a coordinated fashion, there is much room for disagreement on what is the best course of action (lag 4). The main problems are deciding what measures to take for resolving the bank crisis, including cost and timing for action.

The problem with deciding what measures to take is more than a source of possible professional disagreement. It can arise due to the different objective functions of the monetary and fiscal authorities. The objective of the monetary authorities is to have a stable banking industry as soon as possible. Therefore, the monetary authorities should normally want full disclosure of banking problems and rapid action (which need not always be the case). The objective function for the fiscal authorities in resolving banking distress is to take the least-cost approach for the budget. Therefore, resolving a banking crisis is an exercise in intersectoral and intertemporal redistribution. The rest of this section deals with intersectoral redistribution; the following section deals with intertemporal distribution.

Intersectoral distribution means deciding whether the costs should be born by (a) society as a whole (inflation), (b) taxpayers (the socialization of costs through the bud-

get), (c) the owners of a bank, meaning shareholders (loss of capital), (d) the private sector (deposits) and households (savings), (e) or by any combination of these. Obviously, all parties involved try to bear as few costs as possible.

The Croatian experience indicates that the fiscal authorities may even change some outcomes necessary for the resolution, proposed by the central bank, in an effort to minimize expenditures for the budget without prior consultation with the monetary authorities. This may undermine the efficiency of the final result.

What is the best timing? Conventional wisdom usually assumes that the action should be speedy. It is well known that if a bank is insolvent or has a very low net worth, it has an incentive to gamble even more. The problem of moral hazard behavior is obvious, and asset stripping can occur. All of this increases the costs of bank resolution.

Even if the monetary authority opts for a quick resolution of banking problems, the fiscal authority incentives need not be the same. Not only do they often try to minimize the problem (and minimize the costs for the budget), but also they try to postpone the payments in two ways—by postponing the unpopular decisions as much as is politically bearable, preferably beyond the political cycle (after the elections), and by issuing bonds and not cash, for example, by redistributing those costs to future generations (intertemporal distribution).

The fiscal authorities are part of the government, which is subject to political elections. If elections are approaching, the government, including the fiscal authorities, has a strong incentive to pass the fiscal burden on to the next government (even if the same government remains in power) and to spend the money on more popular and voter-sensitive issues.

The process of coordination between the fiscal and monetary authorities in Croatia was very difficult and lengthy. Lessons for the future can be learned from the experience. Croatia did not “avoid” the banking crisis by “printing” more money; that is, by trying to postpone the resolution of the problems by passing the burden to the future and the economy at large (by creating inflation). The pressures to act in such a way were very strong, but successfully avoided. Better coordination is warranted especially in two areas: overcoming the information and human capital constraints and improving the definition and mutual understanding of the roles of the fiscal and monetary authorities in the banking industry.

### **The Future of the Financial Sector Restructuring**

It is reasonable to expect that the need for state intervention in financial restructuring in transition economies

will diminish in the future. Financial market development will bring to the market more agents capable of recognizing a future problem institution as well as capable of raising the capital required for mergers and acquisitions. Experience, transfer of knowledge, and competition will improve the ability to recognize a problem institution long before it produces negative externalities on a large scale. Coordination among public institutions will increase as well. It also is clear that institutional solutions in a small country in the neighborhood of the largest monetary union (the European Monetary Union) cannot diverge substantially from the rules in the union itself. Institutional convergence will quicken with the entry of international banks to local markets. In some of these countries, such as Hungary and Croatia, international banks already play much more important roles than domestically owned banks. This puts international cooperation of bank supervisors high on the agenda for the future of financial sector supervision.

Despite the generally positive outlook, many wrong roads can be taken and many mistakes made. Even in the most developed countries with developed market infrastructures, policymakers can make mistakes. How can these be avoided or their effects minimized?

Three factors of key importance, and under the direct operational control of policymakers, are transparency, education (public relations), and institutional specialization (efficient judicial processes).<sup>13</sup> All three factors should act to minimize the five coordination lags.

Transparency, education, and institutional specialization should act in this way regardless of the shape of institutions and processes that manage financial sector restructuring. After all, the shape of institutions is subject to political decisions. Basic principles, however, should not be subject (only) to political decisions; they should be the focus of policymakers. This should be the task of policymakers regardless of their political orientation, background, reputation, and targets.

By *transparency* is meant transparency of financial data (their regularity, accessibility, and conformity to international accounting standards), transparency of institutions (their openness in expressing goals, means, and results), and transparency of processes (who acts, when, and how). Both sides of the market for transparency should be active: the government and central bank should be

responsible for supplying transparency, and the private sector should demand transparency (as well as be transparent itself). Optimum transparency constitutes an equilibrium between the two sides of the market—that is, between the two sectors.

However, transparency without *education* and *public relations* is worth nothing. This second factor is crucial in times of financial crisis, which should be resolved by some degree of state intervention. Education and promotion should be the permanent tasks of public bodies in order to encourage private sector responsiveness in a transparent environment. Active public relations are crucial in times of crisis, when media can be problematic, especially if some are controlled by interest groups linked to the banking industry (which is often the case, not only in transition countries). Policymakers, including their advisors from international financial institutions, do not pay enough attention to these facts.<sup>14</sup> Most of the time they assume that the general public knows or believes the same sound principles that they share at the basis of sophisticated theoretical and empirical experience. That many will perceive the world differently than they do comes as an unpleasant surprise, sometimes leading to confusion and a reluctance to act. The general public in a transitional environment still fails to understand the basic principles of capitalism, such as knowing the difference between money and capital or understanding the tradeoff between risk and return.

The third key factor for the future of financial sector restructuring is institutional specialization. Since many professionals who manage different institutions lack knowledge, experience, and expertise to deal with banking problems, bankruptcies, and antitrust or complex commercial cases, the principle of specialization is the only one that can help the system to function. This is relevant not only for all institutions in the financial system but also for other social systems, especially for commercial courts. In a small country (and transition countries are very small, with the notable exceptions of Russia and, to a certain extent, Poland), it is impossible to expect that every regional commercial court will be able to conduct complex cases in an equal way. Specialization means concentration of experience and expertise, which leads to efficiency, speed, and equality of treatment. Of course, the optimum level of specialization will depend on circumstances.

13. We emphasize operational control here. Many strategic issues are not under policymakers' direct operational control because of interference from political processes.

14. For more details on the lack of public relations in times of financial crisis in the case of Croatia, see Škreb (2000b).

## Conclusions

Some light has been shed on the consequences of inadequate coordination between monetary authorities and fiscal authorities for financial sector restructuring. The analysis in this chapter has focused on the coordination problem between monetary and fiscal authorities. There is a genuine need for coordination, because monetary authorities acting alone cannot reach their goals, whether price stability, financial sector stability, including an efficient banking system, or the resolution of banking crises. Coordination is needed.

The central banker's point of view based on the Croatian experience has been illustrated in this chapter. Some recommended courses of action for small and open emerging-market economies arise from the Croatian experience:

- Invest resources in sharing the same (professional) perception between the monetary and fiscal authorities (avoid large differences in the speed of human capital accumulation in the two institutions).
- Increase the central bank's legal independence to a maximum, with a transparent legal framework, but make it responsible for developing the transparent market for public debt as well.
- Invest as much as possible in banking supervision, especially in early warning systems, and use the reports of the early warning system as triggers for supervisory action.
- Impose some kind of fiscal rule or establish a fiscal stabilization fund, which will accumulate resources that can be used to resolve banking problems without triggering a conflict between the monetary and fiscal authorities. Make the rules as transparent as possible and use the fund as long as the fund of deposit insurance premiums is thin.
- If a fiscal rule or stabilization fund cannot be implemented (for various reasons), establish a fund at the monetary authority to act independently of the fiscal authority to resolve banking problems; such a fund may not be sufficient to cope with a larger crisis, but it may provide the basis for a more rapid response in the initial phases of a crisis.
- For the need for state intervention to decrease in the future, ensure that both the monetary and fiscal authorities work on transparency, education (including better public relations), and the formation of specialized institutions (like specialized courts for financial issues), as the financial world is becoming more and more complex.

The central bank's independence is very important, but isolation in conducting sound economic policy may not

result in optimal solutions for a country. Of course, as long as it is not completely clear that the country is in a fiscally dominated regime, it pays to insist on, and build, central bank independence and conduct in-depth banking sector reform. However, putting too much of a burden on the monetary authority alone is not a sustainable option in the medium run. Either the fiscal authority will have to implement sound policies, or the transition will take longer than warranted. In other words, it takes two to tango. The tango is a difficult dance, which requires patience to learn. Even before that, monetary and fiscal authorities should agree whether they want to dance a tango or a waltz. If they cannot agree on this, the crucial issue is the willingness of the monetary authority to act—if necessary alone. Acting alone is suboptimal, but better than no action at all. Therefore, the monetary authority has to stand ready for a Pareto inferior solution (inferior as compared to successful coordination). It is clear that in such an environment, financial sector restructuring will be slower and more expensive (less efficient). In other words, there is a price to be paid when the monetary authority and fiscal authority do not act together.

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## Chapter 7

# Financial Sector Restructuring in Bulgaria, 1997–2001

*Petar Jotev*

**T**he transition from a centrally planned to a market-oriented economy has been a dramatic, sometimes painful, process for Bulgaria in the past 10 years. Unfortunately, the country made many mistakes along the way. For almost seven years, from 1990 to mid-1997, Bulgarian governments were hesitant to give up ownership and administrative control over the banking sector as well as many key industrial and commercial enterprises. The state-owned banks continued to fund inefficient and loss-making enterprises, contributing to the almost total collapse of the Bulgarian economy in late 1996. Hyperinflation resulting from the huge fiscal deficit translated into a dramatic loss of purchasing power for both enterprises and consumers. There was a chronic and severe shortage of even basic food supplies, as imports necessary for production became unaffordable as a result of an inflated domestic currency. In January 1997, the government was facing a forceful outcry from Bulgarian citizens demanding a fundamental change in policy.

In April 1997, new elections resulted in an unusually strong mandate for the Union of Democratic Forces, which, in turn, created favorable conditions for sweeping economic reforms. Macroeconomic stabilization started with the adoption of a currency board arrangement in July 1997, and the Bulgarian currency, the lev, was pegged to the deutsche mark. Bulgaria immediately experienced currency stability, which has characterized its economy ever since. The currency board arrangement also forced fiscal discipline, producing positive monetary and budgetary results. Gross inflation was reduced sharply from annualized monthly increases of approximately 522 percent in January 1997 and 2,916 percent in February 1997 to only 6 percent in 1999. Although the annual inflation rate rose to 11 percent in 2000, this was mostly due to the substantial increase in the price of imported oil and gas rather than to Bulgaria's fiscal or monetary policies. Despite difficulties in develop-

ing an effective mechanism for collecting taxes, Bulgaria achieved general government equilibrium by 1998.

Starting in 1997, Bulgaria also adopted an aggressive privatization strategy, and the private sector now contributes approximately 70 percent of gross domestic product (GDP). This policy was especially radical in the area of commercial banking. The new Bulgarian government successfully privatized five of the six large state-owned banks existing in 1997, and the last one—Biochim Bank—is expected to be sold fairly soon. All five state-owned banks were sold to strong and reputable foreign strategic investors with the capability of infusing significant capital and management expertise into Bulgarian banking. This is in marked contrast with how Bulgaria privatized a substantial part of the nonfinancial sector, which was accomplished mainly through various mass privatization schemes as well as management buyouts, with no increase in much-needed

investment or infusion of management expertise. In hindsight, the benefits of a large number of these deals were questionable, despite the fact that the general objective of increasing the role of private ownership was at least formally achieved.

### **Early Efforts of Bank Restructuring**

In 1992, the Bulgarian government established the Bank Consolidation Company (BCC) for the purpose of restructuring and privatizing the state-owned banks. At that time, there were more than 70 banks in the country, most of them very small, regional ones with insufficient assets to achieve any reasonable level of operational efficiency. The BCC accomplished its primary goal of restructuring the banking sector rather effectively by consolidating small banks into larger entities with branch networks covering the whole country. However, these banks continued to operate under state ownership, with little or no movement toward privatization for the next several years. Although some minor efficiency gains in operation were achieved, most banks remained quite inefficient by maintaining unprofitable branch networks and even more so by offering irrecoverable loans, mainly to state-owned nonfinancial enterprises but also to *other insiders*, affiliated persons, and entities.

In order to clean up the balance sheets of the state-owned banks, the government issued bonds to replace the nonperforming loans. The total cost of recapitalizing the banking system has not been quantified precisely, but it is estimated to have been more than \$3 billion, roughly 25 percent of the GDP of Bulgaria today. (This amount includes the cost of covering deposits and public debt resulting from the issue of state bonds and the reduction of sales proceeds received by the government on privatization as a consequence of ring fencing the remaining nonperforming loans in the balance sheet of the banks.)

By mid-1997, all state-owned banks had been recapitalized to the extent necessary for them to meet the minimum capital adequacy standards established by the Bulgarian National Bank. This factor was critical in starting the privatization in an effective manner, particularly in light of the intention of the newly elected government to target reputable international strategic investors.

### **The Objectives of Bank Privatization**

When selling state-owned banks, the Bulgarian government clearly sought to receive the highest possible return from strong, financially sound, and reputable strategic investors rather than to maximize the price regardless of the buyer. The government wanted to have confidence that

the new owner would manage the acquired banks in a safe and sound way. Obviously, it would not make sense to get a few extra millions of dollars when selling a bank and then have to pay out many times more in deposit insurance and rehabilitation when the bank fails some years later. Consequently, only large and well-managed foreign banks and nonbank financial institutions were allowed to participate in the privatization tenders for Bulgarian state-owned banks. Although it might be considered controversial to allow only foreign banks to compete for domestic financial institutions, from the viewpoint of maximizing post-sale efficiency of the banking sector, there was hardly any better choice for the authorities.

Due to the determination of the Bulgarian government, especially the concentrated efforts of the BCC, five large state-owned banks out of the six controlled by the BCC in mid-1997 have been successfully privatized. All of these banks have been sold to first-class foreign investors, such as Societe Generale, UniCredito Italiano, and AIG Group. Much of this period was characterized by relatively poor market conditions due, first and foremost, to the weak international reputation and perceived low-growth potential of the Bulgarian economy, later to the Asian and Russian financial crises, and, last but not least, to the military conflict in Kosovo. Given this background, selling five large state-owned banks—basically the whole sector—in four years is a good record by any reasonable standard.

One of the most important factors that clearly contributed to this successful privatization drive was the structure of the entity responsible for the process. The BCC was created as a corporation and capitalized through an initial infusion of capital by the Ministry of Finance and the Bulgarian National Bank. It required the shares of the state-owned banks to be restructured and privatized as well, so that it became the nominal titleholder for the state-owned banks. It functioned much like any other corporation, with the same structure of governance, despite having government entities as majority shareholders. Furthermore, the general privatization law did not apply to banks under BCC control. This provided a great deal of flexibility in establishing policy and making specific decisions as market conditions permitted and dictated.

These results are especially impressive in light of the far less successful privatization of enterprises in the real economy.

### **Policy Considerations in Privatizing State-Owned Banks**

The bank privatization program was successful because the government applied a few simple rules, which

are sometimes forgotten or overlooked: seller due diligence, marketing, valuation, investor due diligence, and contract terms and conditions.

“Seller due diligence” refers to the need for BCC to know exactly what it was going to dispose of. It involved a comprehensive and detailed assessment of the financial condition of the banks to be sold as well as management and operational audits. Once the level of attractiveness of the banks was determined, further restructuring was carried out before privatization in order to enhance their franchise value. This exercise proved that it was more beneficial either to transfer all remaining bad loans and investments to a separate entity specializing in asset workout or to sell them to a professional resolution agency than to keep them in the banks, because the potential buyers would severely discount their value in any case.

Once banks were in salable conditions, the second phase of the seller due diligence involved putting together an information memorandum so that potential buyers could have detailed knowledge before investing a lot of time in gathering information at their own expense. This was to help not only buyers but also the BCC in identifying issues that needed to be addressed either in marketing or in the sales contract.

The BCC typically spent three to six months preparing a complete information package detailing all legal issues (such as litigation cases, title problems with buildings, and problem loans) as well as the banks’ financial and operating conditions; a list of major loans and deposits and terms and conditions thereof; and information technology systems. This perfectionist approach to putting together privatization memoranda greatly enhanced the powers of the BCC to attract wide interest from foreign investors because the authorities already had performed part of the required due diligence.

Perhaps one of the biggest problems for Bulgaria in the whole process of bank privatization was the lack of adequate time for marketing. One way to get around this problem was not to set any final deadline until the initial marketing efforts had indicated what level of interest could reasonably be generated. By having the flexibility to set the parameters for the sale during the marketing period itself, the BCC could better avoid noncompetitive offers and maintain a higher level of interest throughout the period.

Unfortunately, most privatization transactions in Bulgaria’s real sector implied a very short time frame for offers (usually 30 days), which made it very difficult, if not impossible, for many bidders to decide to participate, perform due diligence, prepare a bid, and obtain internal

approval for the offer. One lesson here is that pushing for deadlines in completing transactions, especially publicly announced ones, could be counterproductive by weakening considerably the position of the seller.

Perhaps one of the biggest hurdles in privatization is gaining a level of comfort with fair valuation. From a political point of view, this constitutes the most sensitive and controversial issue. There can be a negative reaction if opponents of privatization claim that a particular asset of national importance was sold at a very low price. Nevertheless, setting a minimum acceptable price could be counterproductive both to obtaining a fair price and to generating competition. Setting the minimum price too low clearly will discourage higher offers. Setting it too high might produce only a few offers or no offers at all, forcing the seller to lower the threshold. And changing conditions *ex post* never produces better results.

Of the six banks offered by the BCC, there were only two cases where valuations were obtained, and, even in those cases, the valuation was never used to set a minimum price. In practice, only the market itself can determine the real value of an asset. That is another reason why it is so important to expose assets to the assessment of markets for a reasonable period of time.

Prospective investors also need a considerable amount of time to perform their own due diligence. They usually need to hire local legal and financial experts capable of analyzing the records of the banks to be acquired. In addition, serious investors inevitably make an on-site inspection of their own and need adequate time to prepare their internal valuations after completing the due diligence, to alter the terms and conditions in the draft share purchase agreement, and to obtain necessary management or board approvals for the final offer.

When the BCC wanted to sell the state-owned banks, it did not establish a deadline for bids at the outset of the marketing period because the time required for investor due diligence depended very much on the number of potential interests, which, in turn, were not known in advance. Nevertheless, as time passed, it was important to set a final deadline for bids to arrive in order to avoid a situation where offers based on outdated information no longer could be considered valid.

Contract terms and conditions were essential for the successful closure of privatization transactions as well. The BCC always attempted to provide a standardized contract to all potential bidders in an effort to facilitate the selection of the best offer. The contracts were drafted in view of what the potential acquirers might demand. The BCC offered relatively extensive representations and war-

ranties regarding the financial condition of the banks. Although it was made clear that all bidders should perform their own due diligence and determine the net asset value of the bank concerned, the BCC provided wide assurances and guarantees with respect to the legal validity of claims and obligations of the banks. Since the risks involved were considered minimal from the government side, this was an excellent tool for eliminating many elements of discounts that investors might have asked for otherwise.

One major difference between the contracts offered by the BCC and those established by the Bulgarian Privatization Agency and various ministries responsible for the privatization of nonbanking assets was the post-privatization commitments placed on buyers. The BCC, in fact, placed very few, if any, restrictions or requirements on investors after the sale. Typically, there was a clear commitment to holding the acquired shares for a period of at least two to three years. But no requirement was placed on the number of employees to be retained, additional capital to be infused (except in the case of banks marginally above the minimum adequacy), or business lines to be developed in the future.

This relaxed attitude toward future requirements proved to be a wise policy. First, in the nonbanking sectors these commitments resulted in a costly administrative burden for the government in monitoring compliance with legal and administrative obligations embedded in thousands of privatization contracts. Second, it was extremely difficult to enforce such provisions in light of the fast-changing business environment. Sometimes enforcement did not make much sense from a business point of view. Modifying these conditions was a tricky issue as well. Therefore, an important lesson of a sweeping privatization drive is to try to minimize “social obligations,” as enforcing them is next to impossible even if there seems to be good rationale for them, which is rarely the case.

## Concluding Remarks

Bulgaria has come a long way since the deep economic and social crisis of 1996–97. Despite the many years it takes for reforms to produce meaningful improvements in the living standard of the majority of the population, there are already some impressive results. GDP per capita—which was declining more than 4 percent a year in 1995 and 1996—increased more than 4 percent a year in the past three years, including a 5 percent increase in 2000, based on preliminary numbers. Budget revenues, which stood at 5.6 billion leva in 1997, reached 9.7 billion leva in 1999 and 11.1 billion in 2000, an increase of almost 100 percent in three years. Foreign currency reserves grew from \$400 million in January 1997 to almost \$3 billion at the end of 1999 and \$3.5 billion at the end of 2000. Average monthly salaries increased from the equivalent of only \$12.10 in January 1997 to \$120.00 in January 2001.

Confidence in the banking system has been largely restored. While total bank assets were only \$1.8 billion in January 1997, they reached \$4.2 billion by the end of 1999 and \$4.7 billion at the end of 2000, an increase of more than 160 percent in less than four years.

There is strong evidence that the most efficient and stable economic systems around the world are those that combine little or no state ownership in the banking sector with strong prudential regulation and supervision. Bulgaria has learned this lesson the hard way. By privatizing large banks of systemic importance, the financial sector has been liberated from political and administrative intervention, while at the same time prudent governance and behavior are enforced by adequate regulation and supervision. The task for the future is to modernize the nonfinancial sectors rather quickly in order to provide a good opportunity for banks to live up to their full growth potential. Banks need creditworthy clients and new lending opportunities. There is high hope that further reforms will deliver them quickly, thus contributing to the modernization and sustained fast-paced growth of the whole Bulgarian economy.

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## Chapter 8

# Financial Markets in Hungary: Achievements and Prospective Challenges

*István Szalkai*

**I**n Hungary, the need to reform financial markets and institutions was recognized as early as the middle of the 1980s, and this recognition produced several institutional and policy reforms before the beginning of the political transition. These included the introduction of the two-tier banking system, the establishment of the basic pillars of a money market, and the liberalization of interest rates. The decade of the 1990s brought new challenges: earlier policy reforms had to be revitalized and enhanced as the country became more open and the external economic environment became less favorable. This required coordinated efforts to strengthen the institutional framework in which the central bank, credit institutions, securities firms, and other financial undertakings operate.

Several legislative steps proved to be instrumental in achieving these objectives. The 1990–92 reforms in financial legislation resulted in the introduction of safe and sound prudential regulation in banking. They took into consideration several recommendations of the Basle Commission and directives of the European Union (EU), including comprehensive and up-to-date rules on securities business, stock, and commodity exchanges. They also were supported by the enactment and strict implementation of market-oriented accounting and bankruptcy rules in 1992. Beginning in 1996, new foreign exchange legislation permitted the current account convertibility of the Hungarian forint and liberalized international financial transactions. The 1996 Law on Credit Institutions established the basic framework for banking supervision on a consolidated basis and, in accordance with this, merged the formerly separate Banking Supervision and the Securities and Stock Exchange Supervision into a new supervisory institution called the Hungarian Banking and Capital Market Supervision. The 1998 amendment of the

Law on Credit Institutions allowed banks to provide banking and investment services under one roof and opened the possibility for universal banking. The Law on Single Supervision, which entered into effect on April 1, 2000, merged the formerly separate Hungarian Banking and Capital Market Supervision, Insurance Supervision, and Pension Supervision in an effort to improve the supervision of financial groups that emerged in the second half of the 1990s in Hungary.

As a result of legislative changes in the 1990s, Hungary achieved a significant level of harmonization in its banking and capital market legislation in relation to that of the EU. Several further steps need to be taken, however, in order to reach full compliance by the time Hungary's accession to the EU is realized (see box 8.1). The amendment to the Law on Credit Institutions and related modifications in the financial legislation introduced enhanced consolidated supervision requirements as well as market risk capital requirements (including rules for keeping trading books) in accordance with the

### BOX 8.1. AMENDMENTS OF LEGISLATION

Additional amendments to existing legislation stem from regulatory experience based on recent market developments. The need for additional amendments draws on the suggestion of a government committee headed by Mr. Ferenc Pacsi.

*Harmonization of different fields of financial legislation.* Different fields of financial legislation were drafted and enacted at different times and later were interpreted and developed on their own. The introduction of the “single supervisor”—with the aim of ensuring efficient consolidated supervision of financial groups—reveals that supervisory procedures are very different for banks, securities firms, insurance companies, and pension funds. Consolidated supervision requires harmonization of these to a considerable extent. Prudential requirements remain highly influenced by sector specifics, but some harmonization is possible in this area, too. Reconciliation is needed among the separate pieces of legislation for collective investment products like mutual or pension funds and certain life insurance products. Moreover, reconciliation is required between the provisions of the corporate and securities laws referring to the same or related issues of regulation.

*Revision of the law on securities.* The reason for this comes partly from the introduction of universal banking. Originally, provisions of this law were applied to investment service providers, meaning brokers, dealers, and underwriters. Following the

introduction of universal banking, provisions were applied equally to banks that offered investment services. Another reason is the need to strengthen investment service providers, in the light of failures following the Russian crisis as well as the introduction of stricter regulatory requirements that promote investor protection, including better disclosure and reporting rules. Regulations on cross-border activities also need to be enhanced.

*Revision of the law on bond issues and related regulations.* Stipulations of this law need to be revised in an effort to facilitate the development of rudimentary corporate and municipal bond markets. This requires removing the restriction that limits bond issues for companies (except credit institutions) in the amount of their shareholders' equity. The regulation on continuous issues, bond programs, and so forth, which have become more frequent and important, also needs to be improved.

*Modernization and unification of rules on exchanges.* There is professional support for replacing the segmented sui generis regulations on exchanges with unified rules based on profit-oriented corporate form.

*Improvement of regulation on collateral and taking possession of collateral.* This can be a catalyst in real estate and small and medium enterprise finance and would make the payment and settlement systems more safe.

directives of consolidated supervision and capital adequacy.<sup>1</sup>

The insured amount in the deposit insurance scheme and the minimum capital for savings cooperatives also need to be increased. In Hungary, anonymous deposits still exist (and are not covered by deposit insurance). These deposits have to be discontinued according to the requirements of the European Union. Although regulations can be changed overnight, the practical implementation will be gradual and can probably be completed by the time of accession. The legislation allows foreign banks to have branches in Hungary. Existing rules, however, are more restrictive than the regulations required in the countries of the European Union. Present regulations maintain the capital requirements of subsidiaries, supplemented with a special asset maintenance ratio for branches. Liberalization of branching would significantly influence the structure and

competitive position of the Hungarian banking system and cannot be expected prior to accession. The amendment of the Law on Credit Institutions included all of these stipulations up-front and indicated when the specific changes would enter into force.

Hungary has achieved good compliance with the Basle core principles. Specific areas where compliance with Basle core principles continues to be insufficient mirror those where compliance falls short of the directives of the European Union, that is, the need to enhance supervision and the enforcement of prudential rules on a consolidated basis, to measure and capture market risk (and the risk management process), and to use specific capital charges against this. Measures to be taken include the following:

- The supervisory right to exercise regulatory powers needs to be reestablished in order to ensure quick regulatory responses to market developments and

1. The amendment became effective on January 1, 2001, and supportive regulation on the use of trading books went into force on April 1, 2001.

violations of the rules. There is no understanding among the institutions interested in regulation and enforcement on how to implement this requirement in practice.

- The evaluation of banks' policies, practices, and procedures for granting loans needs to be improved. Other investments and the management of loan and investment portfolios have to be strengthened, especially the evaluation of management responsibilities. Regulations and enforcement of connected lending should be stricter. These requirements can be treated partly through the forthcoming amendments of the Law on Credit Institutions and the tightening of supervisory practice.
- The possibilities for correcting regulatory violations and enforcing corporate governance in financial institutions need to be enhanced. Several proposals to amend the Law on Credit Institutions have been made to increase the flexibility of supervision. Tightening of supervisory practice, however, also is required.
- The consolidated supervision of internationally active banks needs better cooperation, and memoranda of understanding (MOUs) among supervisory authorities of partner countries are required. MOUs have been signed with several securities supervision agencies. The legal framework is in place, but no MOU has been concluded with foreign bank supervision agencies. An important task for the Hungarian authorities in the next couple of years will be to more actively cooperate with bank supervisory authorities of the EU members and other important partners in international financial transactions.

### **Remaining Structural Vulnerabilities of the Banking System**

In the beginning of the 1990s, when Hungary lost a considerable part of its traditional markets due to the collapse of the Council for Mutual Economic Assistance, a simultaneous enforcement of stricter accounting, bankruptcy, and prudential banking rules—loan classification and provisioning—accelerated the necessary structural changes in the economy and inevitably led to an abrupt increase in the stock of nonperforming loans in the banking system. Part of these already accrued in earlier years as a consequence of inexperience in credit evaluation and collateral management. Another—probably smaller—part was related to the ongoing difficult market conditions. The stock of nonperforming bank loans became very large

by the end of 1992 in comparison with the banking sector's total equity capital, and several large banks were forced to seek capital replenishment to an extent that appeared out of their reach. In an effort to avoid the spread of a systemic banking crisis, the government launched a bank rehabilitation program. The rehabilitation program of 1993–95 covered the troubled banks as well as their large debtors. These banks were rescued partly through the restoration of their loan book and partly through direct capital infusion following the submission of restructured recovery plans to the government institutions responsible for bank rehabilitation. As a consequence of this, capital adequacy returned to the statutory minimum corresponding to the Basle minimum requirements. The total cost of this program amounted to about 10 percent of Hungary's 1993 gross domestic product (GDP; see table 8.1).

The legislative steps taken, coupled with the government's bank rehabilitation program and the restructuring activities carried out by bank management, opened up the Hungarian banking system to foreign strategic participation and integration in the European and global financial markets. Following restructuring and recapitalization, banks were mostly privatized, typically through sales to foreign strategic investors. By the end of 1999, banks under foreign control represented a 65 percent share from the total registered capital of the Hungarian banking system. The share of the public sector in the registered capital of credit institutions was reduced to 19 percent.

These changes have contributed to a more transparent ownership structure. The professionalism of management typically has improved in banks with foreign strategic investors, reflecting the deeper experience of foreigners in banking, coupled with local familiarity with market circumstances. Management's motivation also has changed; their lending practices have been revised, and internal and external audit systems have improved in general. At the outset, restructured banks remain risk averse and concentrate their traditional lending activities mainly on blue-chip customers.

Bank losses may remain hidden for years when owners' control of bank activities continues to be weak, corporate governance and external audit are insufficient, and the supervisory authority lacks efficiency in conducting supervision on a consolidated basis. The case of Postabank in 1998 illustrates that a mismanaged private bank without appropriate control can accumulate hidden losses and increase the threat of systemic consequences by forcing the government to undertake a costly rescue action.

In spite of the widespread portfolio cleansing, losses may remain in the loan, securities, and real estate portfolios

**TABLE 8.1 COST OF RESOLVING BANKING SECTOR PROBLEMS: INTERNATIONAL COMPARISONS**

<i>Country and time period of problems</i>	<i>Estimate of total costs as a percentage of annual GDP during restructuring period</i>
<i>Latin America</i>	
Argentina (1980–82)	13–55
Chile (1981–85)	19–41
Mexico (1995)	15–17
Venezuela (1994–95)	17
<i>Transition countries</i>	
Bulgaria (1990s)	14
Hungary (1992–95)	10
<i>Industrial countries</i>	
Finland (1991–93)	8–10
Japan (1990s)	3
Spain (1977–85)	15–17
Sweden (1991–93)	4–5
United States (1984–91)	5–7

Source: Crockett (1997); IMF (1998: 78).

of privatized banks. When revealed, these need to be covered by provisions or written off. Owners have to accept these consequences in the form of additional capital. Deferring the infusion of capital in very competitive market circumstances, like the present one in Hungary, might compound the difficulties, partly through the delay in restoring confidence.

Another challenge for Hungary's future is the sharply increasing operational risk due to an outdated and segmented information technology, and unreliable management information systems, especially in the case of some medium-size and large banks. These banks are forced to absorb very high costs in order to accelerate investments and catch up with their competitors.

Any remaining structural problems of banks might prove to be a serious competitive disadvantage and may even be disastrous when integration with the EU financial system accelerates.

### **Financial Sector Depth and Concentration**

By the end of 1999, there were 260 credit institutions in Hungary, of which 43 operated as joint-stock entities and 217 operated as cooperative institutions (savings and cred-

it cooperatives). In recent years there has been a tendency for increasing concentration, and the numbers of both joint-stock banks and cooperative institutions have declined. Ten major banks represent 73 percent of total banking activities at present. The concentration is more striking in the retail sector, where the National Savings Bank (OTP) has a dominant position, and 10 major banks control about 90 percent of the market.

The process of concentration is expected to continue. In the cooperative sector, bank regulation promotes further concentration, with a gradual increase in capital requirements to the level of the European Union. As regards joint-stock banks, the privatization of the remaining two commercial banks, which are under direct state control at present, could create considerable demand from banks already operating in Hungary. Hungary's entry into the European Union probably will set in motion a further wave of consolidation, the direction of which will be influenced by bank mergers in the European market. The reasons for these mergers will be the commercial banks' efforts to improve cost savings under competitive pressures, and the geographic and functional diversification of their activities. It also will reflect efforts to achieve appropriate size in

order to increase profitable activities and sustain a competitive edge in a larger and unified market.

The degree of financial intermediation carried out by the banking system can be measured by the ratio of bank deposits to GDP. This ratio was 44 percent at the end of 1999, having demonstrated only a modest average annual growth from the 40 percent level registered in 1995. The ratio is low in Hungary compared with member countries of the European Union (see figure 8.1). The reason for this is the level of income per capita, like the regional distribution of economic activities (inequalities) and the urbanized character of society, which influences the density of bank branches and the use of bank services. In Hungary, the number of bank branches per million inhabitants, for instance, falls well below that of Western European countries. The depth of the banking sector appears to be low, relative to Hungary's economic development.

Hungary has a higher level of banking sector intermediation than most of Eastern Europe and countries of the former Soviet Union. This divergence in banking sector depth was considerably influenced by the level of inflation experienced during the 1990s.

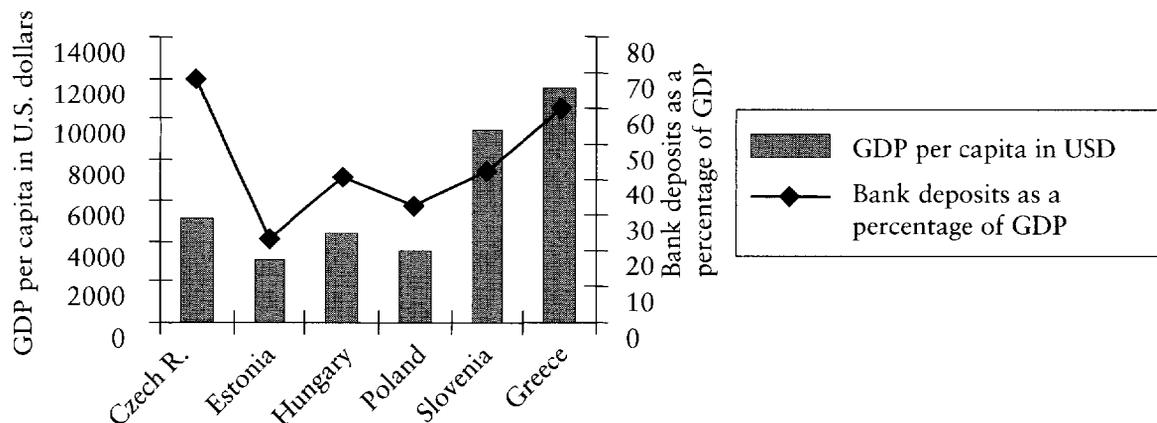
Following the 1995 stabilization program, economic growth revived and accelerated, while inflation declined steadily in Hungary. Against this background, a strong increase in the degree of financial intermediation carried out by the banking sector would be expected. This was also the period when mutual funds' and contractual savings (especially in pension schemes and life insurance products) began to grow markedly in Hungary. This, in turn, brought about a considerable increase in demand for corporate

shares and longer-term government bonds. The growth of institutional investors (mutual funds, pension funds, and insurance companies) could explain why the degree of banking sector depth—measured by the ratio of bank deposits to GDP—grew less than expected in circumstances prevailing between 1995 and 1999. The share of claims of the household sector in the form of mutual fund units and contractual savings increased from 2.2 percent in 1995 to 7.9 percent of GDP in 1999 (see figure 8.2). Throughout the period, this also contributed to an increase in market capitalization, volume traded, and depth and liquidity of the capital market.

It is probable that deposits will grow faster than GDP and that banking sector depth will increase gradually from the present low level. The share of mutual fund investments and contractual savings, compared with both total financial assets and GDP, will continue to grow. The speed will be significantly influenced by the availability and extent of tax incentives as well as the regulation of the level of contributions to the compulsory, fully funded pillar of the pension system. This means that due to the availability and development of securities markets, companies can rely on relatively more financing from equity and bond issues than they will receive from the banking system. The capitalization, depth, and liquidity of capital markets are expected to grow significantly. When companies can raise financing by issuing equity and bonds at lower cost than the cost of bank financing, banks have to respond with services that increase their off-balance-sheet noninterest income.

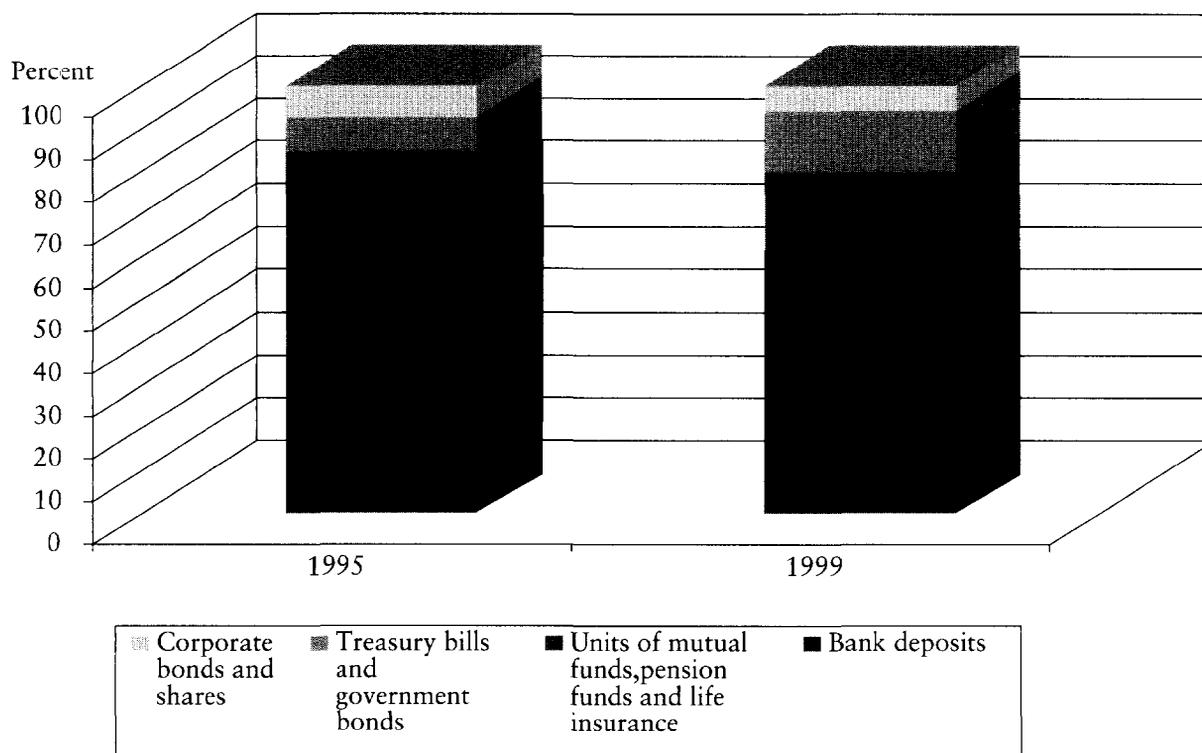
Until 1999, Hungarian banks could not apply for a license for full-scale investment services, but they could offer these services—and also insurance—through sepa-

**FIGURE 8.1 DEPTH OF BANKING INTERMEDIATION IN PROSPECTIVE EU MEMBERS AND GREECE, 1997**



Source: OECD (1999); IMF (1997).

**FIGURE 8.2 COMPOSITION OF FINANCIAL ASSETS OF HOUSEHOLDS (WITHOUT CASH HOLDINGS) IN HUNGARY, 2000**



Source: National Bank of Hungary (2000).

rate subsidiaries. Banks established subsidiaries for other financial or supplementary financial services like financial leasing and factoring. In this regulatory environment, banking and financial groups engage in a wide range of financial services. Pension funds are organized as mutual societies and do not belong to the financial group. All services related to pension funds, however, are provided by subsidiaries in the group. The largest banks typically have subsidiaries for nearly all of these services in their groups (with insurance being the least frequent). In the case of medium-size and smaller banks, the provision of investment services through separate subsidiaries is common (most banks, except specialized ones, have their own securities firms). Since the beginning of 1999, several banks have obtained approval to provide investment services directly. Some of them already have merged the separate subsidiary for investment services with the bank.

Bank assurance activities are carried out in different forms. At present eight joint-stock banks and the majority of savings cooperatives have received approval to sell insurance products as agents of insurance companies. Insurance companies are mostly members of the same financial

groups that banks belong to, and the bank typically is the main operating company of the group. At the same time, five banks use insurance companies as agents for selling their banking or joint products.

Banking and financial groups usually have originated from banks' efforts to offer a broader range of financial services and their response to changes in the structure of savings of their clients. It is expected that the successful large banks and some of the medium-size banks (six to eight banks) will continue to move in this direction and offer, in addition to bank deposits, a wide range of investment fund products at different levels of risk as well as contractual savings opportunities. They also provide different forms of financing, in addition to bank lending, including leasing and factoring. Groups of institutional investors can invest in different securities and contribute to a more balanced corporate and household financing structure, especially through the availability of long-term funds. Commercial banking, investment banking, fund management, and insurance already are concentrated to a significant extent within the existing groups around these banks, and this concentration will increase further in the future.

Other small and medium-size banks, including specialized institutions such as mortgage and home saving banks, will be partly taken over by the dominant groups and partly transformed into branches of foreign banks when legal provisions on branching are eased. Given the increasing familiarity with and access to electronic banking from major international banks, the viability of savings cooperatives over the next 10-year period is questionable, even with improved capital strength and a better institutional framework.

Banks already have made substantial investments in the development of Internet banking in Hungary. Banks typically own these facilities themselves. Internet banking can supplement the branch network and even replace it. It will also typically be a way to offer financial and investment services abroad, possibly as an alternative to cross-border mergers. Besides households, there appears to be a remarkable increase in demand for on-line services from small and medium-size businesses, where savings of cost and time are important. The challenge for supervisors in this field is that several elements of this progress are out of supervisory oversight. Supervisors have to study and understand the process, estimate the speed and scope of expansion, and respond with appropriate explanations for customers as well as regulations to mitigate emerging risks.

### **Soundness of the Banking System**

The 1993–95 bank rehabilitation and the subsequent 1995 economic stabilization program—through more stringent lending practices, high real interest rates, and initially declining domestic demand—had a negative impact on the ratio of outstanding bank loans to GDP. The ratio declined from 28 to 25 percent in 1996, then recovered slightly in 1997 and 1998. The share of loans accounted for 40 percent of total assets of credit institutions in 1997 and 1998, securities holdings for the purpose of trading or investment constituted about 20 percent of assets, while claims on the central bank and other banks constituted about 29 percent of assets during these years. Relying on exchange and interest rate policies of the central bank, banks could count on low-risk, profit-making possibilities for converting their foreign currency funds to government securities and central bank instruments denominated in national currency. Conditions in the money and exchange markets became less predictable after the Russian crises. Several banks suffered losses through subsidiaries involved in the securities business. By the end of 1998, the resulting profit squeeze forced banks to revitalize their lending activities toward the corporate and household sectors. In 1999 the ratio of loans to GDP increased to 30 percent, reflect-

ing a 16 percent increase in loans outstanding in real terms. In the structure of bank assets, the share of loans increased to 44 percent, while the share of securities showed a corresponding decline to 16 percent. In the years ahead, the ratio of loans to GDP and the share of loans in total assets are expected to grow further. Their present level is fairly low by international standards. Since the share of households in the total stock of credit is very low and there are better prospects for their income growth, a large increase is expected in the demand for household credit, which basically will be satisfied by credit institutions.

As a result of the portfolio cleansing that occurred during the bank rehabilitation program, a number of individual rescue actions, and cautious lending activity, the loan portfolio of banks operating in Hungary is very sound. In 1999 and early 2000, the share of bad components in total assets remained below 2 percent. At the end of 1999, the share of sound components was 92 percent of total assets. Of the remaining components, the share that needed special attention was 4.5 percent of total assets, the share of substandard and dubious components was 2.3 percent, while the share of bad components was only 1.1 percent. Although management expertise and methods of credit evaluation have improved, the move toward small and medium-size business and household lending as well as the general acceleration in lending activities most probably will result in an increase in problem items as a share of total assets as well as in an increase in bad components as a share of total qualified items in the years ahead.

In 1997, credit institutions in Hungary had a return on assets (ROA) of 1.3 percent and a return on equity (ROE) of 14.6 percent (see table 8.2). Profitability turned negative in 1998 due to revealed losses at Postabank and Realbank as well as losses suffered at several other banks through their subsidiaries in the securities business. In 1999, both ROA and ROE improved compared with 1998, but they still were lower than they were in 1997, when ROA and ROE were 0.7 and 8.0 percent, respectively (see figure 8.3). The major reasons behind the decline in profitability have been disinflation, the concomitant decline in nominal interest rates, and a parallel decline in interest margins due to a sharp increase in banking competition. At the same time, there is no apparent improvement in cost efficiency either, which in 1999 can be explained by the efforts of banks to expand their retail network as well as by expenditures on system development connected with the Y2K problem. In the future, interest margins likely will remain under pressure, since competition continues to be fierce and additional pressures will come as Hungary's financial system becomes more integrated with that of the European Union.

**TABLE 8.2 THE BANKING SYSTEM IN HUNGARY, 1998–99**

<i>Type of institution</i>	<i>Concentration</i>				<i>Profitability</i>				<i>Number of loss makers</i>
	<i>Number</i>		<i>Market share (percent)</i>		<i>ROA (percent)</i>		<i>ROE (percent)</i>		
	1988	1999	1988	1999	1998	1999	1998	1999	
Large banks	10	10	72.8	72.8	-1.9	0.8	-24.6	11.1	2
Large banks excluding Postabank					1.4	0.9	15.9	11.4	
Medium-size banks	9	9	16.4	17.4	0.4	0.5	4.6	6.1	2
Small banks	12	10	5.1	4.3	-4.0	-0.7	-3.4	-5.1	6
Small banks excluding Realbank					-0.5	-0.7	-3.4	-5.1	
Specialized institutions	13	14	5.7	5.5	-12.8	0.5	-5.9	-1.2	7
Specialized institutions excluding Hungarian Development Bank					-3.0	-0.5	-15.3	-3.3	
Bank system	44	43	100.0	100.0	-2.2	0.7	-24.7	8.0	17
Bank system excluding removed banks					1.0	0.7	10.6	8.3	

Note: The government recapitalized Postabank in 1998. The bailout was partly undertaken by the Hungarian Development Bank. Realbank failed in 1998. The figures do not cover saving and credit cooperatives.

Source: Annual reports of the Hungarian Banking and Capital Market Supervision, 1997–99.

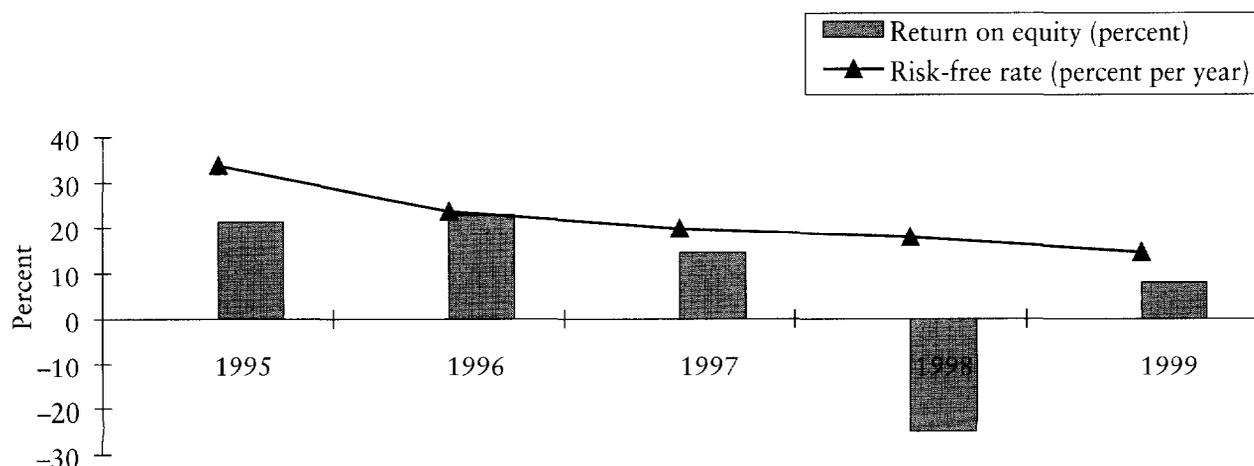
Banks that can improve their cost efficiency and expand fee-based business (partly through increased securitization) will be able to maintain or increase their profitability.

The capital adequacy ratio (consistent with Basle guidelines) showed a declining trend, reflecting both the acceleration of higher-risk lending and the decline of profitability of credit institutions. This ratio was 17.5 percent in 1997 and 14.2 percent in 1999. The present level of capital adequacy provides room for further risk taking in the general banking system in the medium term. Foreign strategic partners have declared their readiness to contribute infusions of capital in case of need. Despite this, the expansion of the activity of certain banks may be constrained temporarily by an insufficient capital base.

### **New Financial Markets**

A number of new financial markets or market segments have begun to evolve in Hungary. These include real estate finance and home construction by households, small and medium-size enterprises, agricultural producers, and municipalities.

In recent years credit to households accounted for about 10 percent of total credit stock, and half of total credits to households financed home construction. Following the termination of the system of subsidized housing loans of the former economic regime, the stock of housing loans declined steadily due to high financing costs. The overwhelming majority of housing credit stock has remained with the National Savings Bank, which, until

**FIGURE 8.3 HUNGARY: BANKING SYSTEM, RETURN ON EQUITY, AND RISK-FREE RATES IN HUNGARY, 1995–99**

Source: Annual reports of the Hungarian Banking and Capital Market Supervision 1997–99 and monthly reports of the National Bank of Hungary.

recently, was practically the only player in the market. Financial sector legislation also has been introduced, which has addressed these issues. Two years ago, parliament enacted laws on home savings banks (in line with the German Bauspar model) and mortgage banks (also in line with the German mortgage bank model). Four home savings banks and two mortgage banks have started operations. Mortgage banks are the only institutions that can issue mortgage bonds. At the beginning of their operation, they concentrated mainly on finance to commercial and industrial real estate. Products of home savings institutions include preannounced government subsidies for home construction. In order to accelerate home construction, in 2000 the government selected—as a government-supported institution—one of the mortgage banks as a channel for the provision of new subsidies for homebuilders and also as a basic institution of the secondary market for mortgages. This mortgage bank has contracted with commercial banks, insurance companies, and savings cooperatives in an effort to expand the provision of housing loans under the new subsidy scheme. Besides channeling subsidies, the government-supported mortgage bank provides liquidity to primary market lenders and improves market efficiency by moving toward standardized mortgage lending. Having this special government-supported status, the selected mortgage bank enjoys a better market standing. Purchased loans are kept in the portfolio of this bank and are financed by issuing mortgage bonds. The new arrangement has provided an incentive for borrowing and—with the establishment of the secondary mortgage market—also for primary lending.

With the enforcement of this new arrangement, however, the long-term viability of home savings banks may become questionable. It also means a deviation from the original model of mortgage banks and creates competitive distortions in this sector. These anomalies need to be redressed, and a sound way for system development needs to be established.

Although some years ago there was a general shortage of credits to small and medium enterprises in Hungary, medium-size enterprises now have better access to credits. The increased competition and the profit squeeze have driven banks toward small and medium enterprises, and this has been supported by new institutions that moderated the lending risks of banks (credit guarantee funds, credit information systems) and also by new instruments like public warehouse warrants that were used mainly by agricultural producers as collateral for their short-term credit requests. Lending to small enterprises, however, continued to be insufficient compared with the economic importance of this sector. Credit to small enterprises accounted for only 3–4 percent of total credit stock, although this sector accounted for more than 10 percent of GDP. The access of small and medium enterprises to financing in the years ahead can be improved further by revising the regulations on venture capital funds, which may be prepared to invest in anticipation of improved exit opportunities. These funds can provide valuable support to firms with their expertise in strategic planning, marketing, and ability to access complementary financing. Regulations on taking possession of collateral need to be made more flexible, and the regis-

tration of liens, as well as the system of credit information, has to be improved in Hungary.

During recent years, credits to municipalities accounted for about 1.5 percent of total credit of the banking system. The amount of municipal deposits exceeded significantly the amount of their credits. Very few banks lend to municipalities. Municipalities with idle funds also avail themselves of the portfolio management services of securities firms. At present, public sector borrowings are centralized. Municipal bond markets—which existed earlier in Hungary—need to be revitalized if significant longer-term financing is needed for local development projects. The revitalization of the municipal bond market requires the revision of the present Law on Bond Issues. Since local rating agencies already provide services in Hungary, the introduction of mandatory ratings for municipal bond issues is possible. A municipal bond rating would help investors to estimate the risk they undertake with new issues, and continuous monitoring by rating agencies would provide additional information on the financial position of municipalities.

### Major Challenges for the Next Decade

Hungary's membership in the European Union and further integration with the international financial systems require full harmonization of Hungarian financial regulations with those of the European Union, as well as full compliance with the Basle core principles during the next three to five years. There are five major issues to be treated in this field: (a) capturing and measuring market risk, (b) enhancing consolidated supervision, (c) strengthening the regulatory powers of financial supervision, (d) improving the possibilities for timely corrective supervisory measures, and (e) achieving better international supervisory cooperation in order to implement consolidated supervision, including cross-border transactions.

Integrating Hungary's financial system with the European and global financial system will require removing the remaining structural problems of financial institutions. With a further increase in competition in the financial markets, these structural problems could provide serious competitive disadvantages. One of the major challenges in this field is to minimize the high operational risk in institutions where the development of information technology was not well devised and management information systems are weak.

The concentration of market players, especially in banking, is expected to increase further. By the middle of the next decade, six to eight financial institutions providing universal banking services will control the majority of the Hungarian financial markets. These groups will be the

market leaders in offering specialized banking services (real estate, home, and car finance) as well as nonbanking financial services (leasing and factoring). Some of the smaller banks will be transformed into branches of foreign banks if the regulation is eased. Foreign nondeposit-taking institutions in consumer finance will increasingly penetrate the market, but they may fund themselves basically from abroad. Only a few small banks can survive as niche players. With increasing familiarity and access to electronic banking from major international institutions, the viability of savings cooperatives over the next 10-year period is questionable even with improved capital strength and a better institutional framework. In the second half of the next decade, the concentration process will continue, but due to the overwhelming foreign ownership, mergers and acquisitions in a wider European framework will determine the outcome. Among the reasons for mergers will be the efforts of commercial banks to improve cost savings under competitive pressures.

Banks already have made substantial investments in the development of Internet banking in Hungary, which they typically own. Internet banking is suitable to supplement a branch network and even to replace it. It also is a typical way to offer financial and investment services abroad, and therefore it can be an alternative for cross-border mergers. Besides households, there is a significant increase in demand for on-line services in small and medium-size businesses. The challenge for supervisors in this field is that several elements of this progress are out of supervisory oversight. Supervisors have to study and understand the process, estimate the speed and scope of expansion, and respond with appropriate explanations for customers as well as regulations to mitigate emerging risks.

Outsourcing of banking activities will gain momentum during the next decade. Supervisors will have to ensure that this process remains under their control. With specific legal stipulations as well as licensing requirements, all activities covered by the outsourcing will have to remain—in principle—under supervisory jurisdiction, which is then exercised in accordance with the concentration of risks.

The low average level and high variance in profitability, together with the large number of loss makers, pose a challenge in the next three to four years for the Hungarian banking system. It is expected that, where capital replenishment is required, owners will provide for this in the near future without major difficulty. In light of further pressures on profit margins due to increased competition, it may take longer for several banks to achieve a break-even status. Although problems with systemic consequences are unlikely to emerge, the owners' behavior in such cases is

less predictable and might raise supervisory concerns at a later stage.

As a result of liberalizing the entry of the products of foreign investment funds in the Hungarian market, the strengthening of the fully funded pillars of the pension system, and the growing share of bank assurance activities in financial groups, intermediation through institutional investors is likely to grow rapidly. Institutional investors will contribute further to the development of capital markets both in terms of depth and liquidity, while reducing risks by increasing the demand for improved disclosure and risk rating as well as corporate governance. Changes in the structure of intermediation may cause problems for certain credit institutions. The majority of the market, however, will be controlled by financial groups, which, through their diversified activities, can manage these changes without difficulties.

One of the major challenges for the next 5 to 10 years is the development of a secondary mortgage market. This would potentially provide liquidity to primary market lenders and improve market efficiency by moving toward standardization in mortgage lending. It is already apparent that during this process there will be a movement from the German to the American model of mortgage finance (the core of the secondary market will be one, or more, government-supported institution). Another challenge in this process is the long-term viability of home savings banks, which need to be maintained, while home savings (Bauspar) and mortgage finance have to stay complementary. The improvement of financing for small and medium enterprises is critical in Hungary in order to stabilize high economic growth rates. The access of small and medium enterprises to financing in the years ahead can be improved further by revising the regulations on venture capital funds, which may be prepared to invest in anticipation of improved exit opportunities. In a 10-year period, venture capital funds could grow to play an important role in Hungarian capital markets.

Corporate and municipal bonds have to be developed. Not only multinationals but also large companies will divert their financing from Hungary if they do not find appropriate maturities at reasonable costs. Progress in the corporate and municipal bond markets can contribute to a more balanced financing system, which can benefit productive investments and bolster savings and stability when adverse shocks come. In an effort to achieve this, supportive changes are required in legal regulations as well as market infrastructure.

With a higher level of integration to European and global financial systems, small Central European exchanges

cannot maintain their competitiveness. It is expected that during the next five years, they will develop into a regional association of national exchanges.

Analysis, rating, and evaluation by shareholders, auditors, and supervisors can work only with appropriate disclosure requirements. In Hungary, availability or periodicity of consolidated accounts needs to be improved for credit institutions, and disclosure rules for investment service providers have to be revised. In light of recent developments, there is a need to improve accounting and auditing procedures and practices.

In Hungarian circumstances, foreign owners who are represented in the boards of directors and other supervisory boards typically provide the strategic guidance to financial institutions. This kind of corporate governance can be regarded as quite developed in comparison with other countries in the region. Laws in force, especially corporate and banking law, establish the accountability of boards, but their stipulations and transparency of requirements need to be improved. Laws regulate the composition of boards of banks in detail. This requirement, however, has to be eased in the future, giving the owners of institutions more room for discretion.

Following the integration of banking, securities, insurance, and pension fund supervisory institutions, one of the basic supervisory challenges for the future is to establish a credibility on the level of the most efficient agencies of the former institutional setup, while harmonizing the different supervisory cultures and preserving supervisory values of specialized agencies. An efficient "change management" process should be put in place. Consolidated supervision based on integrated supervisory structures needs to be enhanced and requires amendments in the legal framework as well as improvements in supervisory practice. More international supervisory cooperation has to be established in order to monitor cross-border business more efficiently. The most important challenge for supervisors in the next decade is to recognize that the traditional "compliance" approach does not work anymore. In a rapidly changing business environment, characterized by increasing financial innovations and possibilities for regulatory arbitrage, supervision needs to be proactive and the supervisor must be sure that risks undertaken by different institutions are coupled with an adequate level of risk management and capital backup. Besides a better regulatory framework, this requires more cooperation in the control carried out by owners, internal and external auditors, and supervisors. During the next decade, the role of self-regulatory organizations will increase and will become an important component in the overall regulation of market developments and behavior.

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## Chapter 9

# Restructuring the Russian Banking System

*Marina Chekurova*

Since the beginning of 1998, the Central Bank of Russia (CBR) has been restructuring the banking system in an attempt to improve the overall quality of commercial banks and to increase their liquidity. An important part of this program was the creation of the Agency for Restructuring Credit Organizations (ARCO), which was intended to address some of the problems resulting from the country's systemic banking crisis. This chapter examines the role of ARCO in restructuring the Russian banking sector.

### **Recent Developments**

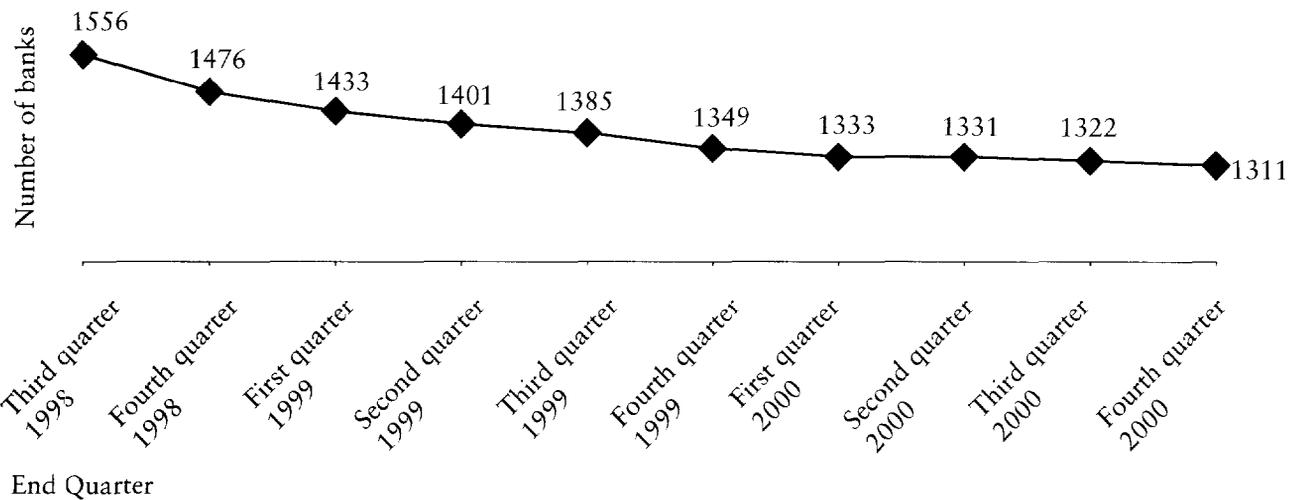
In the summer of 1998, a financial crisis occurred in the Russian Federation (Russia), leading to a sharp decline in the ruble exchange rate and, consequently, a crisis in the banking system. The crisis was sparked by complex international economic circumstances and fueled by domestic economic factors. The fragile banking system was unable to protect the financial system at large against external shocks. Those banks suffered most of all that held large blocks of government securities, had long positions in national currency, or had finalized many forward contracts to sell foreign currency. A significant number of banks suffered heavy losses of capital and liquidity, and a number of banks failed (see figure 9.1). Further, a substantial reduction in the number of bank branches also occurred after the CBR suspended the banking licenses of major Moscow banks. Between January 1999 and December 2000, a total of 648 bank branches were closed, 295 of which belonged to Sberbank (the Savings Bank).

In 1999 and 2000, the banking system rebounded from the crisis. Aggregate assets of banks increased 2.2 times over this period (figure 9.2). Aggregate capital in banks also increased between March 1999 and July 2000 (figure 9.3). Since the beginning of 1999, household

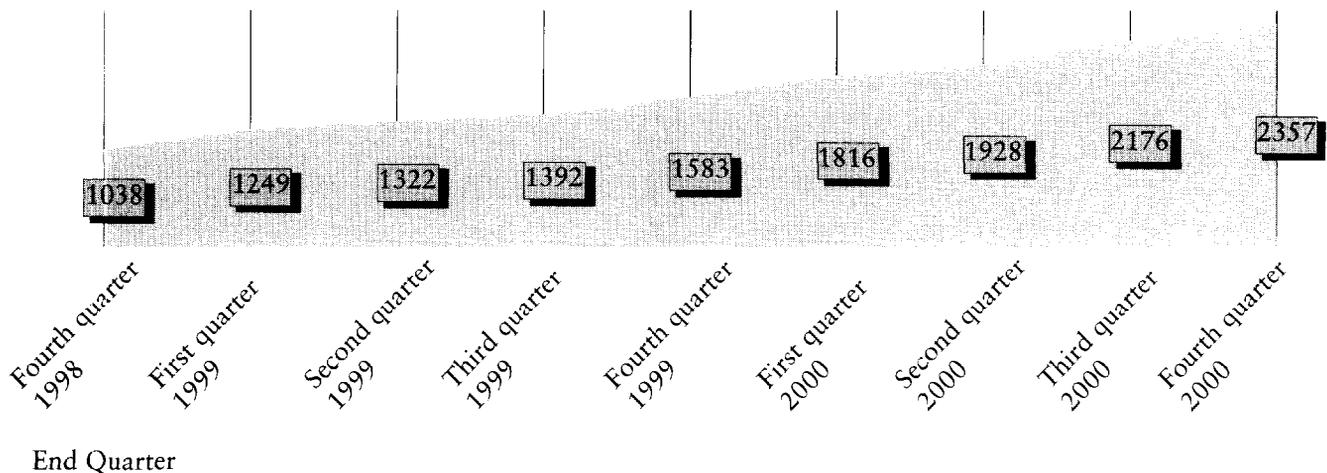
deposits and savings in the banking system have grown markedly. From January 1999 to December 2000, ruble household deposits, foreign currency household deposits, and corporate deposits grew significantly. However, deposits with maturities exceeding one year remained low.

Over the same period, the volume of consumer lending increased, as did the volume of foreign currency and ruble loans, but at a slower rate than deposits. The volume of lending to Russian enterprises increased quite sharply (figure 9.4).

The critical stage of the banking crisis is now over, and the Russian banking system is gradually adapting itself to new economic conditions. The banking system still remains vulnerable, risks associated with banking activity are still considerable, and banks are hesitant to increase their lending activity because accurate risk assessment in the current economic climate is still very complicated. Moreover, bank managers are still inexperienced in commercial lending activities. A large increase in the volume of lending to the real sector at this time would inevitably increase systemic risks to the banking system. Nevertheless, banks are once again ready to pursue intermediation functions by offering the traditional range of bank products and services, including lending and pay-

**FIGURE 9.1 NUMBER OF BANKS IN THE RUSSIAN BANKING SYSTEM, 1998–2000**

Source: Bulletin for Banking Statistics, CBR.

**FIGURE 9.2 AGGREGATE ASSETS OF OPERATIONAL BANKS IN THE RUSSIAN BANKING SYSTEM. 1998–2000**  
Billions of Russian rubles

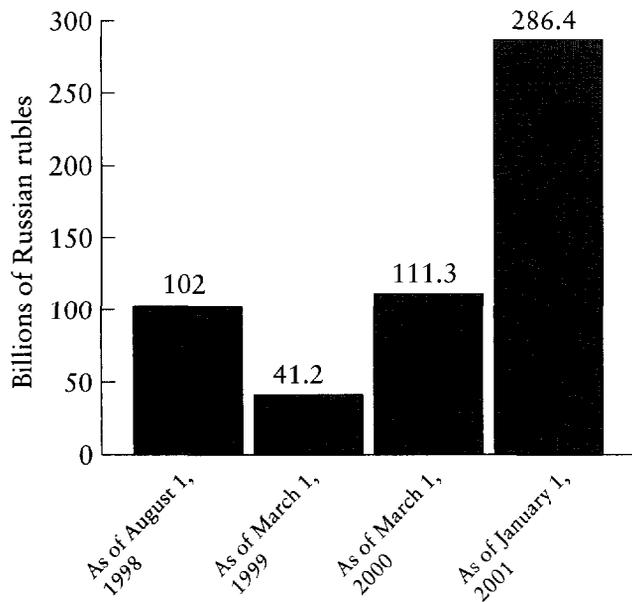
Source: Bulletin for Banking Statistics, CBR.

ment transfer services. In order to diversify the risks of lending to Russian manufacturing enterprises, a system of syndicated lending should be developed and supported under close supervision.

The main problems facing the Russian banking system are the low level of available aggregate capital and the lack of public confidence in the system. These two factors are inextricably linked because restoring confidence in the banking sector would promote the inflow of foreign capital and encourage the establishment of foreign-owned banks in Russia.

Although the aggregate capital of banks is currently on an upward trend, it has not yet reached precrisis levels. Banks are still searching for suitable means with which to raise capital, including attracting foreign investments, offering new banking products and services, reducing costs, and expanding activities. The government also could contribute to the process by reforming tax policy and equalizing taxes on profits for banks and enterprises in line with generally accepted international practice. The capital base also would improve if banks were allowed to provision for loan losses before taxation.

**FIGURE 9.3 AGGREGATE CAPITAL OF BANKS, EXCLUDING SBERBANK, IN THE RUSSIAN BANKING SYSTEM, 1999–2000**



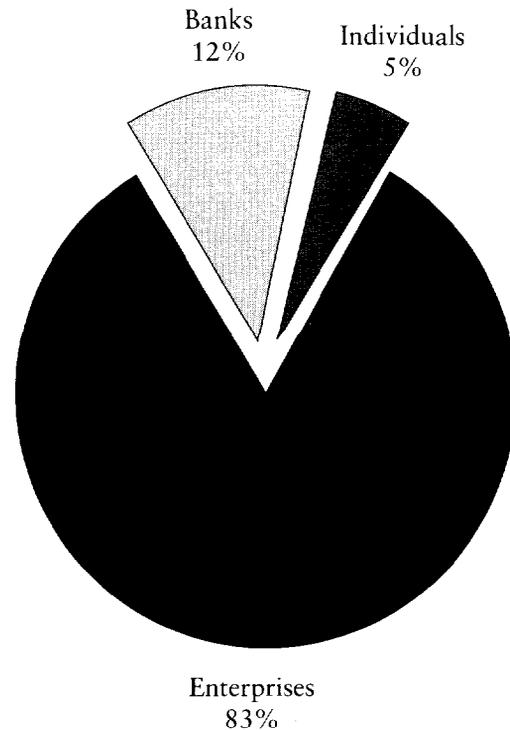
Source: CBR Vestnik.

To restore confidence in the banking system, the government and the CBR should promptly complete the process of liquidating banks whose licenses have been revoked. This would further consolidate the banking industry, eliminate banks that represent significant risks to the system, and stimulate bank mergers and acquisitions. To accomplish these objectives, appropriate amendments should immediately be made to legislation on banks and banking activities and on bankruptcy of credit institutions.

The existing regulations on bank liquidation and bankruptcy are overburdened by unnecessary procedures, do not protect the interests of creditors, and artificially expand the timeframe for reaching settlements with creditors. According to statistical data, 40 percent of liquidation procedures do not begin until one year after a license is revoked. This lengthy delay almost always results in the disappearance of bank assets. The revocation of a bank license should automatically trigger immediate liquidation procedures analogous to bankruptcy, and court actions should be initiated with a view toward simplifying procedures.

Russian banking officials should continue their efforts to improve the transparency of banking activities in accordance with international principles of bank supervision and should complete the transition to international accounting standards (IAS). The implementation of IAS requires certain measures to be undertaken, including the

**FIGURE 9.4 STRUCTURE OF THE CREDIT PORTFOLIO IN THE RUSSIAN BANKING SYSTEM AS PER JANUARY 1, 2001**



Source: Bulletin for Banking Statistics, CBR.

introduction of amendments to current legislation in the field of accounting and financial reporting.

Public confidence in the banking system will improve if bank supervision is strengthened in a credible manner. The CBR has recently introduced a new system to analyze the financial condition of banks with a goal of detecting potential problems at an early stage. These results will be used to determine remedial and supervisory measures and will give bank examiners a clearer picture of the current financial position of a bank, as well as trends over the past year, taking into consideration possible changes in external parameters. However, in order to improve the quality of CBR supervision, the financial data on which its analysis is based need to be more reliable and accurate.

In the field of bank technology, Russia is substantially behind international standards. One key element of bank reform should be the implementation of new technology, including further development of payment card systems and extensive implementation of payment transfer and settlement systems through the Internet. In this regard, laws on electronic transfers of funds are necessary.

To sum up, since the crisis of 1998, the Russian banking system has shown some improvement. Much remains to be done, but the system appears to be moving in a pos-

itive direction. For example, the level of household deposits in banks is rising steadily. This may indicate an improvement in public confidence. However, to attract further household deposits, a system of deposit insurance still is needed, as are relevant laws and regulations.

Banks in Russia can be divided into three groups: financially stable banks, banks whose licenses have been revoked due to negative capital, and banks placed under management of ARCO.

### **The Objectives and Techniques of ARCO**

In November 1998, the government and CBR issued declarations on measures for restructuring the Russian banking system and credit organizations. These legal acts laid the framework for establishment of the Agency for Restructuring Credit Organizations and set general principles for restructuring the banking system. They also classified banks and financial institutions based on state participation, clarified obligations with respect to implementing remedial rehabilitation measures, and designated regional banks as responsible for regional banking development.

ARCO was established by the Russian Federal Property Fund, an agency specializing in asset management for government property. It was created initially as a nonbanking financial institution with 10 billion Russian rubles of charter capital (\$400 million).

ARCO began its operations on March 22, 1999. At first, ARCO was only permitted to restructure banks requesting assistance on a volunteer basis and pursuant to written agreement with the bank and its owners. A federal law on restructuring of credit institutions, which took effect on July 13, 1999, only recently gave ARCO the legal authority to impose restructuring measures on banks. This law also reconstituted ARCO as a state corporation instead of a public corporation.

ARCO seeks to overcome the consequences of the Russian banking system crisis and to restore the ability of banks to make settlements, make loans, and ensure the safety of bank deposits. ARCO has the following goals:

- Minimize state budget expenditures by implementing effective procedures for restructuring banks and reinvesting revenues into further restructuring programs.
- Restructure banks by implementing objective, clear, consistent, and transparent procedures.
- Implement consistent policies for bank restructuring in accordance with clear and thorough criteria, regulations, and procedures.
- Ensure restructuring plans to take into account the interests of creditors as well as depositors and improve the safety of deposits.

- Apply market infrastructure capacities to achieve restructuring targets.
- Upgrade the level of professional skills among bankers.

### **Summary of Restructuring Projects (on a Voluntary Basis)**

The board of directors approved ARCO's program of activities for voluntary bank restructuring on March 2, 1999. This program laid out the basic approaches for bank rehabilitation. It stipulated that decisions concerning the continued operation of banks under ARCO's management should be made on the basis of detailed analysis of financial performance. ARCO set forth criteria for selecting banks for restructuring assistance on a regional basis. This approach allowed ARCO to concentrate on eliminating bottlenecks in the banking system.

In the three months prior to adoption of the federal law on restructuring of credit institutions, ARCO conducted negotiations and examined the documents of 46 banks that had applied for restructuring assistance. The board of directors agreed to provide restructuring assistance to 14 banks, subject to agreement of the owners. These banks were from eight regions of the Russian Federation, and restructuring is currently under way in accordance with contracts signed between ARCO and the banks' owners and shareholders. Bank rehabilitation measures include the following:

- Reorganization of branch network and reduction of unprofitable divisions
- Management of substandard assets aimed at improving the structure of the balance sheet and quality of the loan portfolio
- Development of asset operations and rehabilitation of profitability
- Diversification of the client and customer base.

Because ARCO regards financial restructuring of banks as important as operational and organizational restructuring, an important goal of bank restructuring is to help banks to change the manner in which they conduct business.

In 1999, ARCO undertook to improve the liquidity and enhance business development in two large multiple-branch Russian banks. These projects were not referred to ARCO by the CBR and are not under management of ARCO.

An ARCO examination of Vozrozhdeniye Bank indicated that the bank suffered from insufficient short-term liquidity. In collaboration with the bank's staff, ARCO developed 14 scenarios to assist the bank, and it was agreed that ARCO would purchase one of the bank's larger loans

under the condition that the bank repurchase the loan after a three-year period. This repurchase agreement has significantly improved the bank's liquidity and economic status. ARCO representatives were nominated as members of the bank's board to assist in supervising implementation of the plan.

The financial crisis of 1998 weakened the branch networks of major Russian banks, creating a lack of good-quality banking services in many regions, weakening the interregional payment system, and preventing real economic integration in the regions. To begin solving this problem, ARCO started a project of regional financial infrastructure rehabilitation. Due to the likely costs required to support development of regional banking, ARCO chose a less costly alternative of branch networking to provide support.

ARCO extended a loan to Alpha Bank to enable it to establish branches in regions lacking access to good-quality banking services. The project provided target financing for up to 1 billion Russian rubles for a fixed two-year term, secured by collateral of securities and other bank property and at a commercial rate of interest. To supervise use of the loan resources and monitor financial performance of the bank, 25 percent plus one share have been entrusted to ARCO, and ARCO has two seats on the board of the bank for the duration of this project. General principles of cooperation have been agreed by contractual arrangement among ARCO, the bank, and its shareholders.

### **Mandatory Restructuring in Accordance with Federal Laws**

Currently, ARCO only restructures banks referred to it by the CBR that meet at least one of the following criteria:

1. The share of household deposits is more than 1 percent of total aggregate household deposits in all Russian banks.
2. The share of corporate loans (excluding loans to banking institutions) is more than 1 percent of total aggregate assets of all Russian banks.
3. The share of household deposits is more than 20 percent of the total aggregate amount of household deposits of regional banks (including bank branches).
4. The share of corporate loans (excluding loans to banking institutions) is more than 20 percent of total aggregate assets of regional banks.

A bank also can be taken over by ARCO if (a) the capital adequacy ratio of a credit organization does not exceed 2 percent or (b) a credit organization does not meet the claims of creditors or fails to make customers' payments for

the period of time exceeding seven days due to lack of liquidity.

Once the CBR refers a bank for restructuring, ARCO institutes bank examination procedures that may not exceed 90 days. Once this process has begun, shareholder rights are suspended, and the CBR appoints a temporary administrator to manage the bank. On the basis of the results of the examination, ARCO decides whether taking over management of the bank is feasible or not. ARCO has the right to reject a bank for restructuring on the basis of the following:

- There are no valid reasons for the referral.
- Rehabilitation would be inefficient.
- Restructuring measures are needed beyond ARCO's institutional or financial capabilities.

When ARCO rejects a proposal to restructure a bank, the CBR must decide whether to suspend the bank's license within 15 days. Furthermore, ARCO has the right to liquidate the bank if there is sufficient reason to believe that rehabilitation is impossible. If ARCO accepts the bank for restructuring, it can write down the charter capital of the bank. If the value of the capital of the bank is negative, the charter capital shall be stated as one ruble. ARCO may then decide to increase the charter capital by issuing additional shares or a capital contribution.

ARCO may restructure banks pursuant to a restructuring plan, the duration of which may not exceed three years. Restructuring has three main goals:

- Restructure liabilities
- Reestablish reserves in accordance with federal laws and CBR regulations
- Reestablish norms of financial performance pursuant to federal laws and CBR regulations.

In accordance with the law, a bank and its creditors have the right to enter into voluntary restructuring agreements. The purpose of a voluntary agreement is to restructure the bank's obligations on one hand, and to maximize payments to creditors as compared to the bank's bankruptcy on the other hand. ARCO also has the right to represent the interests of the Russian Federation regarding overdue payments and interest owed the Russian Federation.

The voluntary settlement procedures have been completed in five banks to date, including four regional banks (Amurpromstroybank, Bashprombank, bank Voronezh, Dalrybbank) and a large Moscow bank—Rossiyskiy Kredit Bank. In all five banks the agreements have been approved by the creditors (minimum legal requirement of 50 percent supporting creditor votes passed) and ratified (as required by law) by arbitration courts. All banks began

settlements with creditors in accordance with the terms of the agreements.

ARCO also has drafted the voluntary settlement agreement for creditors of SBS-AGRO, which the creditors supported at their meeting on February 2, 2001. The documents for ratification of the agreement were submitted to the Arbitration court of Moscow.

To sum up, as of January 1, 2001, ARCO had 15 restructuring projects under implementation, with 20 par-

ticipating banks located in 12 regions of the Russian Federation (see table 9.1).

The overall limit for financing of projects approved in 1999 was 7.46 billion Russian rubles (approximately \$260 million).

### Conclusions

The future development of the banking sector in Russia will depend on three factors:

**TABLE 9.1 RESTRUCTURING PROJECTS OF ARCO, AS OF JANUARY 1, 2001**

<i>Bank</i>	<i>Region</i>	<i>Date of referral under management</i>	<i>Agency's actual shareholding (percent)</i>	<i>Restructuring period, years</i>
AvtoVAZbank	Samara	August 31, 1999	88.1	3
Investbank	Kaliningrad	November 10, 1999	85.2	3
Rossiyskiy Kredit	Moscow	October 18, 1999	25 percent + 1 share (+50 percent in trust)	3
Regional project in Kemerovo	Kemerovo			
a) Kuzbassugolbank (core bank)		September 21, 1999	90.9	3
b) Kuzbassprombank, c) Kuzbassocbank, and d) Kemerovo		January 31, 2000	99	1.5
Eurasia	Izhevsk, Udmurtskaya Republic	November 23, 1999	75	3
RNKB	Moscow	November 16, 1999	46.1	2.5
Vyatka	Kirov	December 10, 1999	61	3
Peter the First	Voronezh	August 10, 1999	96.6	3
ChelyabComZemBank	Chelyabinsk	September 16, 1999	76.3	3
Bank Voronezh	Voronezh	January 27, 2000	99	1.5
Dalrybbank	Vladivostok	December 20, 1999	99	3
SBS-AGRO	Moscow	November 16, 1999	99.9	3
Amurpromstroybank	Blagoveshensk	March 29, 2000	99	3
Bashprombank	Ufa	July 21, 2000	99	3

Source: ARCO.

- Availability of free funds for recapitalization of banks in the private sector
- Further development of the legislative environment for bank operations, including tax laws
- Improvement in the risks of corporate and household customers of the banks, including further development of bank supervision and introduction of a private deposit insurance system.

The process of bank consolidation is taking place quickly, as a number of smaller regional banks are becoming integrated in multiple-branch banks.

If a new system of deposit insurance is introduced, new competitors may appear in the consumer banking market that truly are capable of competing with the Savings Bank of Russia. Nevertheless, it is likely that in the next five to seven years Russian banking will be dominated by four types of banks:

- Banks with state participation (possibly partly privatized, but still with a significant share of state capital)
- Multiple-branch private banks (7 to 10 banks with actively developing banking services and major customers coming from export-oriented industries)
- Regional banks working primarily with small and middle-size regional customers (depending on the development of regional economies, there can be 50–60 such banks)
- Special-purpose banks and nonbanking credit institutions with limited licenses (mortgage agencies, mutual funds, banking cooperative societies).

The first three groups are already in the market. The fourth group may emerge as institutions capable of mobilizing household savings.

The process of consolidation in the banking sphere will be driven primarily by the necessity to reduce costs and to increase the efficiency of banking operations.

Although no specific legal constraints impede the entry of foreign banks to the Russian banking system, the lack of transparency with respect to corporate clients of banks continues to subdue foreign investment. Foreign banks are entering the Russian banking market more often by establishing subsidiary banks than by acquiring existing banks. The main reasons for this are the high risks associated with nontransparency of Russian banking institutions (hidden losses, for example) and the poor quality of corporate governance.



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## Chapter 10

# Evolution of the Banking Sector in Central Asia

*Tunç Uyanik and Carlo Segni*

Soon after independence, the governments of Central Asia recognized that the transition to a market economy would require the supportive development of their banking and financial system, involving considerable capacity building in a sector that needed to be reestablished virtually from scratch. As a result, reform programs were designed and implemented throughout the 1990s, aimed at restructuring and modernizing the components of a financial system so as to create conditions for sustainable economic growth.

Essentially, the reform programs took place in two phases. In the first phase, between 1993 and 1997, monetary stabilization—except for Tajikistan—became a priority. During this phase, governments also tried to implement ambitious privatization programs in the small scale area and to develop a legal framework supporting a market economy. In the second phase, governments focused on strengthening the banking system, developing financial and legal infrastructure, and fiscal stabilization.

### **The First Phase**

During the first phase, the introduction of sovereign currencies was accompanied by restrictive monetary policies, to contain inflation. As a result, high interest rate policies and formal and informal restrictions on convertibility were introduced and implemented. High interest rates, low level of reserves, lack of liquidity, economic and political instability, and devaluation continued throughout 1995–96, together with consistent dollarization of the financial system and an outflow of funds.

The banking sector, which was based on a two-tier system, struggled during these years in all of the Central Asian economies. Specialized banks, mostly state-owned, dominated the assets and liabilities side, and banks were fragile

and badly managed. Governments at this stage of the transition did not demonstrate or possess the capacity, experience, and political will to restructure the system. Specialized state-owned banks were considered “too big to fail,” and their liquidation was perceived to be too expensive given tight domestic budgets. Between 1993 and 1996, most of the governments were forced to subsidize these banks with budget resources, and the underlying problems in the financial sector were not addressed. Fundamental financial sector reform, including the privatization of state banks and capacity building in financial institutions, came more as sporadic initiatives than as part of a comprehensive approach.

Compared with other Commonwealth of Independent States (CIS) and former Soviet Union countries, banks in Central Asia remained relatively small, undercapitalized, and poorly governed, with underdeveloped technical and operational capacities. Most important, losses continued to mount in their balance sheets. Enterprises struggled to service their debts, and banks, with large amounts of direct lending to loss-making state enterprises, simply rolled over the losses.

Moreover, financial misinformation became a major problem. Inadequate accounting, poor supervision, and

insufficient information disclosure within the enterprise and banking sectors, all contributed to the lack of transparency of the participants in banking markets. Only in late 1995-1996, when some improvement in transparency had taken place did the extent of the deterioration of the banking systems become more apparent.

Governments, as part of this first phase, began the process of developing legal frameworks and modernizing financial infrastructure, especially in the area of accounting, auditing, and supervision. However, the process lacked coordination and enforcement. Many laws and regulations directly contradicted each other, and large loopholes existed on crucial issues, such as the responsibilities of managers and shareholders in cases of insolvency or liquidation. Similarly, clarity in defining banking activities was rare, and there were few clearly stated obligations with respect to property rights, capital requirements, insolvency, liquidation, reporting requirements, and accounting standards.

In parallel, governments tried to address the lack of information flows throughout the system and the inadequate supervision and monitoring capacity of the central banks. Accounting reforms were initiated to get national accounting closer to international standards. The accounting reforms moved slowly in this first phase, especially in the area of implementation and enforcement. The supervision and accounting departments of central banks were developed and strengthened relatively faster. The availability of a legal framework supporting central banks' institutional role and activities, and their new role within the framework of market mechanisms, set the pace and challenged governments to expedite their development. New accounting systems required new technical and analytical skills, together with the modernization and automation of data collection and statistics. Central banks largely met this challenge, improving their supervision, monitoring, resolution, and regulation capacities. Improved confidence in the central banks' capacity to manage financial flows and monetary bases allowed governments to initiate reforms of the payment system. Even with major delays due to inexperience and lack of financial resources, governments started to reform the payment system during the early stages of the 1990s.

## The Second Phase

The combination of improved monetary policies, structural and institutional reforms, and improved fiscal discipline eventually brought economic stability to the Central Asia region by the mid-1990s. Inflation was contained and dropped from hyperinflationary levels in 1993 to around 15–20 percent in 1997–98, slowing the devaluation of

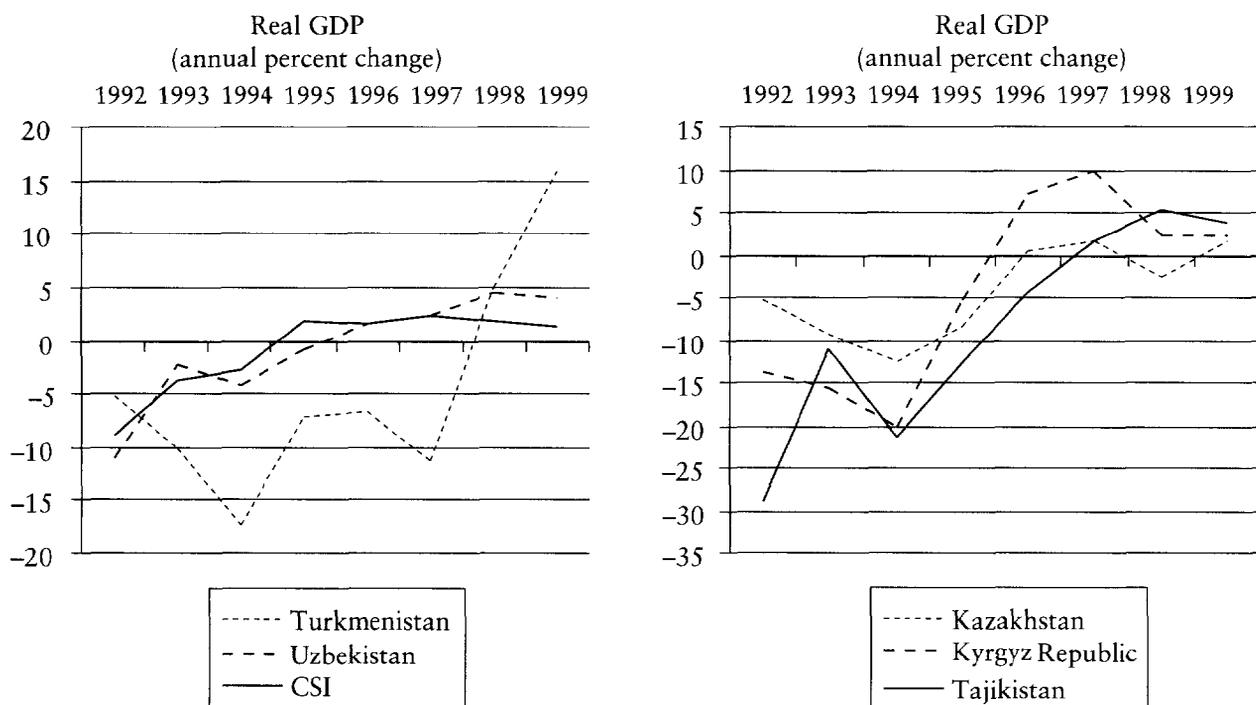
local currencies, which remained relatively stable until the Russian financial crisis of 1998. In addition, at the end of 1997 real gross domestic product (GDP) began to grow in the region (see figure 10.1)

The improved economic environment and legal and technical infrastructure (including the enhanced capacities of central banks, the existence of laws and regulations on bankruptcy and banking activities, and an improved financial information framework) enabled the governments to address problem banks. Throughout the region, governments contemplated consolidation and rationalization of the banking system, primarily through (1) higher minimum capital requirements, to force weaker banks either to exit the system or to merge with a sounder institution; (2) a more comprehensive reconciliation of accounts, liquidation of bad assets, and institution of mechanisms for recovering assets, collecting bad loans, and facilitating mergers and forced bankruptcies; and (3) introduction of prudential regulations in line with international standards, including capital adequacy, loan classifications, and provisioning and liquidity requirements.

Enforced and supported by improved supervision and tighter prudential regulations, banking consolidation achieved some notable results, especially in ensuring and improving the overall soundness of the commercial banking system. The specialized—still dominant in Central Asian banking systems—were partially restructured or liquidated, but their consolidation was limited.

Moreover, the lack of strategy and delays in implementation, as well as corruption and lack of political will of governments, limited the outcomes of the consolidation and rationalization efforts. To sum up, consolidation and rationalization could have been significantly improved if some of the following conditions had been met:

- Bank consolidation and rationalization should have involved a comprehensive restructuring of the sector leading to the privatization of healthy and systemic banks and liquidation of all others.
- Foreign strategic investors should have been invited to take part in the privatization of large state-owned banks.
- The consolidation and restructuring of the banking systems should have been addressed in parallel with enterprise sector restructuring.
- Governments only dealt with portions of the bad debts and with banks in crisis or severe distress, without adequately addressing issues such as poor management and governance.
- In a few cases, central banks intervened directly in bank restructuring, taking direct financial exposure

**FIGURE 10.1 REAL GDP IN CENTRAL AMERICAN COUNTRIES, 1992–99**

Countries	1992	1993	1994	1995	1996	1997	1998	1999
Kazakhstan	-5.3%	-9.2%	-12.6%	-8.2%	0.5%	1.7%	-2.5%	1.7%
Krygyz Rep.	-13.9%	-15.5%	-20.1%	-5.4%	7.1%	9.9%	2.3%	2.2%
Tajikistan	-28.9%	-11.1%	-21.4%	-12.5%	-4.4%	1.7%	5.3%	3.7%
Turkmenistan	-5.3%	-10.0%	-17.3%	-7.2%	-6.7%	-11.3%	5.0%	16.0%
Uzbekistan	-11.1%	-2.3%	-4.2%	-0.9%	1.6%	2.4%	4.4%	4.1%
CSI	-8.8%	-3.8%	-2.9%	1.7%	1.6%	2.3%	1.8%	1.4%

Source: World Economic Outlook WEO, April 2000.

to these banks, in the expectation that the cost of restructuring would be paid by the budget. In this way, the deterioration of central banks' financial situation increased the risk of systemic liquidity crisis and hyperinflation.

The consolidation efforts succeeded in reducing the number of both public and private banks in some of the countries (see table 10.1). In 1994, for example, Kazakhstan had 184 banks, six of which were state-owned. In 2000, only 48 Kazakh banks remained. In Tajikistan, the number of banks decreased between 1997 to 2000, as 11 banks exited the system. In contrast, the number of banks in the Kyrgyz Republic increased, despite the liquidation of three state-owned banks between 1995 and 1996. In Uzbekistan and Turkmenistan, the number of banks

remained relatively stable throughout the period under analysis.

Further consolidation and rationalization still are needed to address overall soundness and to restore confidence in the remaining banks. Much more needs to be done to strengthen the infrastructure of the financial system. The pace of reforms in this area slowed during this second phase. Although central banks took the lead and fostered further reform of the accounting and payment system, delays were experienced in strengthening the legal environment and the judicial system and creating suitable debt-recovery mechanisms. Moreover, the devaluation of local currencies and the increase in inflationary pressures following the Russian financial crisis of 1998 led to a further deterioration in the quality of bank portfolios.

**TABLE 10.1. NUMBER OF LICENSED BANKS**

Country	1993	1994	1995	1996	1997	1998	1999	2000
Kazakhstan	204	184	130	101	81	71	55	48
Kyrgyz Republic	20	18	18	18	20	23	23	22
Tajikistan	15	17	18	23	28	20	20	17
Turkmenistán*	—	—	67	68	67	13	13	13
Uzbekistán	21	29	31	29	30	33	35	35

— Not available.

\* In 1995, 56 agriculture cooperative banks were established as spin-off of Agroprom Bank. These institutions were eventually remerged into Agroprom Bank in 1998.

Source: EBRD Transition Report 2000.

### Country Experiences

Financial sector developments in the five countries that comprise Central Asia are influenced by a number of general factors: (a) macroeconomic imbalance and uncertainty; (b) weaknesses related to the legal and judicial system, especially the enforcement of laws and regulations; (c) inadequate banking supervision and regulation; (d) limited competition and credit market distortions due to government subsidies and guarantees, as well as the dominance of specialized banks, mostly state-owned and politically affiliated private interest groups in the banking sector; and (e) the absence of uniform accounting, reporting, and auditing standards and the existence of inefficient payment systems. Before turning to the country-specific factors that influence financial sector development, the general causes of banking fragility in these five countries are discussed.

Macroeconomic instability is reflected in high inflation, balance of payment difficulties, price and foreign exchange controls, real exchange rate appreciation, and growing subsidies and external borrowing. These create an inefficient price structure for goods, services, and factors of production, which distorts economic decisionmaking. Credit decisions made on the basis of prices that later are realigned substantially have a negative effect on the solvency of financial institutions. In addition, in environments where the exchange rate is significantly overvalued or there is significant flight from domestic currency assets, the realization of foreign exchange risks increases the share of nonperforming loans in bank portfolios.

Legal uncertainties, loopholes, and lack of regulatory harmonization undermine enforcement in Central Asia, severely limiting the capacity of governments to address

the development of the business environment and the rationalization and restructuring of the banking sector. Banking sector development relies heavily on the confidence of depositors and banks in the enforcement of the terms of the contract. A transparent and effective legal and judicial framework that assures speedy, efficient, and impartial settlement of claims is necessary to achieve this objective. Courts and judges in the region are sometimes influenced by political or personal interests, and judges lack adequate resources, training, and technical skills. This situation impedes the development of a healthy business environment.

In some Central Asian countries, the banking and central bank laws and regulations do not create sufficient incentives for bank owners and managers to abide by the rules. Prudential banking legislation does not define clear eligibility criteria for owners and top managers of banks; and adequate supervision and enforcement of strong fines and criminal penalties for violations are lacking. Governments have a role to play in creating the necessary institutions, mechanisms, and incentives for ensuring implementation of prudent banking practices and proper regulation and monitoring of the banking system. However, in most of these countries, this is a politically very sensitive issue.

State-owned banks create incentives for fiscal and quasi-fiscal subsidization and undermine confidence in the system. Widespread state ownership and intervention in the banking sector limit financial development and lead to unfair competition and higher spreads. State banks often are used to channel funds to favored groups and sectors. Political will is lacking to recognize losses in these banks,

and governments eventually cover them with capital from the state budget. As a result, almost 70 percent of loan portfolios of state-owned banks in the region are nonperforming or at least doubtful. This situation has led to capital erosion in state banks. Governance problems, corruption, and insider lending usually lead to the transfer of large funds to a few companies or families, and in the event of a crisis, governments typically have to assume the related losses and fiscal costs.

Although uniform charts of accounts have been developed in some of the countries under discussion, they are not fully compatible with the international accounting standards (IAS), and related accounting standards for financial reporting have not been developed. This situation does not guarantee provision of timely, accurate, and transparent information. As a result, the valuation and quality of assets, recognition of income, calculation of capital adequacy, exposure violations, assessment of risks, and management of asset liabilities often are subject to serious misstatements and misrepresentation. Thus, financial problems can be hidden from supervisors and stakeholders. If properly complied with, standards based on IAS provide a basis for accountability and transparency as well as understandability and comparability. Currently, the services of credit information bureaus or rating agencies are either very limited or nonexistent in Central Asian countries. As a result, neither the banks nor other lenders or investors can readily access information such as credit histories, including the total indebtedness of potential borrowers. Thus, the banks become more vulnerable to credit risk.

The following is an examination of how these general factors work with country-specific factors in each of the five countries of Central Asia.

### *Kazakhstan*

After independence in 1992, Kazakhstan went through a difficult period of macroeconomic instability. From 1992 to 1995, inflation reached as much as 3,000 percent and GDP declined 35 percent cumulatively. Authorities reacted to this difficult situation by adopting a comprehensive market-based reform program and restructuring the financial sector. One of the goals of the restructuring program was to strengthen and rationalize the banking sector. In 1992 the banking system comprised the National Bank of Kazakhstan (NBK), five state-owned specialized banks, and 72 commercial banks. By the end of 1994, there were 179 privately owned banks. This rapid expansion was related mainly to the nature of intermediation, which vertically stratified banks along lines of specific production sectors and industrial conglomerates.

In the first years after independence, banking sector assets were highly concentrated and extremely sensitive to external shocks, including the worldwide demand for oil and mineral products as well as currency fluctuations. The economic downturn that followed—together with the drop in worldwide demand for oil products and severe devaluation of the new Kazakh currency—exposed the fragility of the Kazakh banking sector. Banks shouldered the burden of this economic contraction, and losses from the real sector accumulated in bank balance sheets. By the end of 1995, 50 percent of total commercial loans—or 11 percent of GDP—were classified as either doubtful or nonperforming, leading to the apparent insolvency of the banking system. At this point, the authorities began to address this problem.

Although accounting and financial disclosure standards were deficient, the NBK began identifying nonviable banks and initiated liquidation procedures, starting the process of consolidation and rationalization of the banking sector. NBK first began withdrawing licenses from banks, most of which exited the system or merged (although banks were given five years to comply with the new prudential regulations). NBK applied a case-by-case approach to four of the largest banks, wherein nonperforming assets were evaluated and carved out from the balance sheets and then transferred to special debt-recovery agencies. This rationalization and consolidation program reduced the number of banks to 55 by the end of 1999 and then further to 48 by the end of 2000. Nonperforming assets remained above 40 percent of total assets, or 11 percent of GDP, by the end of 1996.

Despite this, the banking system remains highly concentrated, and the quality and level of intermediation have not improved significantly. The five largest banks account for 63 percent of total assets and 73 percent of total deposits. Total deposits decreased as a percentage of GDP from 72 percent in 1996 to almost 9 percent in 1999. Lending decreased from 64 percent of GDP in 1996 to 4 percent in 1999. At the same time, the monetary unit (Tenge) was devalued further. This had an adverse effect on bank soundness, harmed operating margins, and accumulated losses throughout the system. Gains from devaluation against hard currencies were recognized in the balance sheets of banks, since almost 50 percent of banking assets in 1999 were denominated in hard currency. However, doubts remain on the overall quality of these assets and the capacity of the real sector to service these debts.

The next few years will be critical for banks in Kazakhstan. The banking sector has grown substantially, and it appears that a supportive legal framework is in

place, together with the basic technical infrastructure (for example, payments system), and a modernized accounting system is taking hold, albeit slowly. Moreover, the banking sector has demonstrated its resilience in recovering from the Russian financial crisis. Savings grew 54 percent in fiscal 2000, with real interest rates at between 5 to 6 percent, while inflation remained stable at around 10 percent. However, banks still struggle to diversify their investments. Portfolios remain concentrated in a few core industrial sectors, and the dollarization of investments is still increasing, which puts the banking system at risk of external shocks. In addition, banks still need to build necessary capacity in corporate governance, risk assessment, and liquidity management. Operating expenses are high, earnings from basic intermediation are low, foreign exchange risk is poorly managed, and the quality of loan portfolios continues to deteriorate.

To deal with the current situation, the NBK needs to pursue policies that will result in further consolidation through liquidation and mergers. Fewer more financially stable banks would increase competition, efficiency, and product innovation, and as a result, confidence in the system likely would rise. This would cause domestic and foreign investors to channel more resources through the banking system. The NBK also should continue to improve monitoring and supervision as well as improve the disclosure of financial information by adopting better accounting standards. In this regard, the NBK does not yet have access to consolidated financial data that include the activities of bank affiliates.

Finally, the government and the NBK should focus on the development of alternative forms of investment for banks and other financial institutions. Kazakhstan has an operating stock exchange, which attracts funds for foreign exchange transactions (60 percent), treasury securities and euronotes (37 percent), and corporate securities (3 percent). The basic legal framework is in place, as is a modern supporting technical infrastructure. However, banks and pension funds—the main operators on the market—struggle to find alternative longer-term investments.

### ***Kyrgyz Republic***

With total assets estimated around \$60 million, or 4.9 percent of GDP at the end of 2000, the formal banking sector in the Kyrgyz Republic is still small, weak, and struggling to develop both a commercial and a public institutional infrastructure. The main problems are the quality of bank assets, the lack of liquidity and capacity, and a weak legal and institutional infrastructure supporting banking activity.

Historically, the banking system in the Kyrgyz Republic developed relatively early compared with the other Central Asian countries. After independence, the banking sector adopted the two-tier system, where specialized banks were organized as affiliates to industry, running limited banking services and providing funding to favored industrial sectors. At the same time, the absence of a banking culture, credit discipline, and a healthy business climate—as well as the economic difficulties due to the transition from a socialist to a market economy—encouraged the stripping of assets, which caused substantial losses to bank portfolios.

But the Kyrgyz authorities sought to move fast on reforms. Between 1993 and 1996, a two-stage restructuring plan was implemented. In the first stage, bank supervision and licensing requirements were strengthened, while minimum capital requirements were increased. As a result, a few small banks had to exit the system or merge, and the number of new, nonqualified entrants was substantially reduced. In the second stage, the authorities introduced IAS-based accounting and addressed insolvency of the largest banks on a case-by-case basis. The Savings Bank and the Promstroi Bank were closed and liquidated. Other problem banks were quickly restructured or merged. The reform was quite successful: by the end of 1997, the banking system was essentially in compliance with new capital requirements, and aggregate nonperforming assets decreased from 75 percent (in 1994) to 7 percent.

To further improve the financial condition of the system, the authorities also decided to create a special bank, Kairat Bank, fully owned by the National Bank of Kyrgyz Republic (NBKR), which acquired the assets and liabilities of the two state-owned banks that had been liquidated. At the same time, in 1996, the authorities established an asset resolution agency, DEBRA. This institution performs the debt collection function for insolvent banks and receives their assets. Its creation coincided with the development and initial implementation of the government's comprehensive consolidation and rationalization program. This strategy involved building the capacity of the NBKR and continuing to consolidate the banking sector.

In the meantime, the NBKR and the minister of finance used government securities and central bank notes to sustain troubled banks. Despite the effort, the financial condition of the system further deteriorated in the wake of the Russian financial crisis of 1998. The local currency (sum) was devalued significantly, losing almost 55 percent of its value within one year. The largest industrial conglomerate

in the country—Kyrgyz Gas Munaizat—was declared bankrupt, and the insolvency of its affiliated banks revealed the gaps in institutional capacity, corporate governance, banking supervision, auditing, and the legal environment. Between 1998 and 1999, three of the largest banks in the country collapsed, and the banking sector lost the confidence of investors and depositors. Following devaluation, bank capital declined 54 percent between 1998 and 2000 in U.S. dollars. Depositors also withdrew funds from banks, reducing total deposits approximately 35 percent in nominal terms. In the aggregate, the level of deposits decreased from 70 percent of GDP before the Russian crisis to almost 10 percent in 1999.

Despite these stark losses of funding resources, banks managed to improve profitability. Because assets were denominated largely in hard currency, the devaluation of the sum (together with the sharp decrease in deposits) drastically raised interest margins. Yet extensive dollarization of the system increased the debt-servicing obligations of the economy. Banks continued reflecting gains from devaluation in their balance sheets, although the overall quality of their investment portfolios deteriorated further. Losses continued to mount, since the real sector did not have the necessary liquidity for debt repayment. This situation continued throughout the end of 1999, when the currency finally stabilized, and inflation decreased from 37 to 10 percent in fiscal 2000.

Problem loans place a heavy burden on the financial system in the Kyrgyz Republic. Bank assets are invested in state-owned entities. In addition, mismanagement, inefficiency, and economic instability contribute to the erosion of the financial condition of the banking sector. As a result, most of the existing 22 banks are having liquidity or solvency problems. The liquidity crises in the Kyrgyz Republic appeared even more critical after the latest increase in capital requirements by the NBKR, in August 2000. As of July 2001, only two banks fully complied with the new requirements.

Judicial reform is needed as well as improvement of the legal framework for the financial sector. Legally, enforcement capacity is very weak, and creditor rights clearly are not enforceable. Furthermore, prosecution is heavily influenced by personal and political interests, making corruption rampant. In this environment, the supervision and regulatory authority of the NBKR is weakened. There are cases in which the NBKR has revoked banking licenses, and banks have continued to operate by the consent of the courts.

Thus, a strong commitment to a comprehensive reform strategy is necessary, with the highest priority being:

- Reform of the judiciary system and development of the existing legal framework
- Tightening and enforcement of banking regulations, closure of insolvent banks and recognition of fiscal costs through the DEBRA
- Strengthening of the technical capacity of the NBKR so it can improve supervisory and monitoring functions
- Development of responsible corporate governance and technical capacity within banks
- Upgrading of banking infrastructure, including the payment system
- Further movement toward an IAS-based system.

### *Tajikistan*

Tajikistan has an embryonic financial system. The banking sector, which is the main component of the financial system, does not yet perform basic intermediation functions. Household deposits account for only 2 percent of GDP compared with an estimated household savings ratio of 7 percent of GDP. On the other side of the balance sheet, banks have been performing very limited lending activities, as total loans accounted for only 10 percent of GDP at the end of 1999.

The reason for the low level of intermediation is the extremely low public confidence in the banking system and political turmoil, which have fueled the informal sector and depressed the demand for financial services from the private sector. Despite the low level of intermediation, however, progress has been made since independence. Prior to 1992, the National Bank of Tajikistan (NBT) was responsible for allocating resources to the economy through five specialized banks, directed toward the main economic sectors of the country.

Banking regulations were first introduced in 1991, then revised in 1995 and 1998. At the beginning of 1998, the number of banks operating in the country grew to 28, most of them “pocket banks.” The five largest banks survived the transition and took the lead in the banking sector, with 76 percent of loans and 97 percent of deposits. In the meantime, four of the five state-owned banks were privatized in 1998, following a restructuring plan stipulated between the government and the NBT. The plan prohibited the NBT from further financing banks with direct lending.

The agreement also focused on reorganization of the NBT’s Banking Supervision Department, modernization of the legal framework supporting banking activities, and consolidation and rationalization of the banking sector through increases in minimum capital requirements.

Thus, the banking system has remained relatively weak and concentrated. Progress has been made in consolidation, with the number of banks falling from 28 to 17 at the beginning of 2000. Minimum capital requirements had been increased early in year 2000, but the most serious problems remain the general lack of compliance and the poor quality of the loan portfolios, which have continued to worsen in the past two years. During the year 2000, the NBT again began to finance the banking sector. As a result, government guarantees and NBT direct lending facility provide for some 50 percent of the funding mix of banks.

Moreover, the banking sector remains highly concentrated, with the four largest banks accounting for 84 percent of total assets, 80 percent of total loans, and 95 percent of total deposits. In addition, the economy is becoming increasingly dollarized. Deposits in hard currencies are 2.2 times deposits in local currency, exposing the financial sector to serious foreign exchange risks.

From the banking infrastructure point of view, Tajikistan has progressed in developing the legal framework, even though much more needs to be done to fully implement and harmonize it (most of the laws governing banking activities contradict other laws and regulations). The payment system is still based on cash, although it is relatively efficient due to the extensive branch network of banks. The accounting reform, which began in 1998, is progressing slowly. The conversion to IAS-based accounting was initiated in early 1999, and is almost complete, but banks lack the necessary technical skills to make the switch complete. Finally, the NBT needs to further strengthen and update its own technical capacity and enforce full compliance with minimum capital requirements.

### *Uzbekistan*

With a sizable banking sector, compared with the other countries of the region (total assets equaling \$4.3 billion, or 25 percent of GDP, at the end of 1999), Uzbekistan began implementing modern financial sector reforms later than the other countries of Central Asia. The main reason for this delay was the monetary policy pursued by the authorities throughout the 1990s.

In 1994, the monetary authorities introduced the soum, the new national currency, and in 1995 and 1996, the government adopted the law on foreign investments and the first banking law. The expansive monetary policies that followed the introduction of the new currency—aimed at stimulating economic growth—had the side effect of increasing inflation. The monetary authorities then decided to give priority to the stabilization of monetary aggregates, and immediately sterilized capital inflows. As a

result, tight exchange controls were adopted, together with import/export restrictions, making the soum practically nonconvertible by the end of 1995. Inflation stabilized at about 30–40 percent on an annual basis, but in 1996 the monetary aggregates expanded once again. Bank financing from the budget, broad money, and credit to industry increased substantially. At this point, in conjunction with a collapse in worldwide prices, the authorities were forced to tighten monetary policy again in an attempt to stabilize the economy.

Tight monetary policy continued until mid-2000. The government, in an attempt to control inflation and financial flows, monopolized intermediation. It provided subsidies through the commercial banking system by issuing state guarantees to back the credit exposure of banks. At the end of 2000, the state guaranteed the majority of all banking loans.

These policies had detrimental effects, as some banks failed to develop the necessary operational skills because of the noncompetitive business environment created by the government's policy of continuing to guarantee risks. As a result, the financial condition and institutional capacity of the banking system have not improved.

Six state-owned banks account for approximately 96 percent of all bank credit. Total loans represent approximately 66 percent of total banking assets, or 20 percent of GDP. Total deposits of the banking system stand at only 10 percent of GDP. Out of these six banks, one in particular—the National Bank of Uzbekistan—dominates, with over 60 percent of total assets.

The government is currently moving ahead in restructuring and rationalizing the banking sector and in trying to liberalize financial flows throughout the system. During spring 2000, the Cabinet of Ministers issued a number of resolutions addressing the need to initiate a comprehensive privatization program. The program will include the creation of a centralized collection mechanism, which will permit the restructuring of the nonperforming loan portfolios of these banks and the resolution of the issues related to the outstanding government guarantees attached to these loans. The authorities also will address the full convertibility of the soum. In May 2000, the official rate was fixed to incorporate a depreciation of 57 percent, and a few commercial banks were authorized to open exchange bureaus and apply a floating rate based on market rates.

In the near future and to restructure the banking sector further, the authorities will have to revisit their financial sector reform strategy and address some urgent and important issues:

- Further strengthening banking supervision and monitoring
- Initiating comprehensive classification and assessment of loans and evaluation of the financial position of banks
- Establishing executive loan recovery mechanisms
- Building capacity within the banking system and stratifying and fragmenting the commercial banks
- Accelerating the reform of national accounting standards, initiated in 1997, to meet full compliance with IAS.

### **Turkmenistan**

Turkmenistan has been slow to modernize and develop its financial system, mainly due to the difficult economic situation following independence in 1991. The disruption in oil and gas exports, poor harvests, and weak economic management led to a fall in GDP between 1992 and 1997 of about 50 percent in comparison with other CIS countries. The discontinuation of gas exports to Ukraine in 1997 had an adverse effect on the economy at the beginning of 1999, but the economy has started to grow again, fueled by an increase in agricultural output and energy exports.

In 1993 a two-tier banking system was created, together with the introduction of the new currency, the Manat, and the foreign exchange law. Against this background and improving economic conditions more generally, the government initiated a comprehensive process of bank restructuring and consolidation. The number of banks decreased from 22 to 15 in 1998 and to 13 in 1999. The government still controls most of the banking system, with seven state-owned banks controlling almost 95 percent of all commercial bank loans in local currencies and almost all of the loans extended in hard currencies.

Consolidation was achieved by paying off shareholders (other than government or public entities), by netting shares with outstanding loans or tax obligations, and by engineering mergers, liquidations, and closures.

The bulk of bank lending takes the form of channeling directed credits and foreign loans to designated and affiliated state enterprises, mostly in the cotton and oil sectors. The previous banking structure has survived, and the state still uses banks as channels through which to subsidize the economy from the Central Bank of Turkmenistan (CBT). Moreover, most credits to industry currently are collateralized with sovereign debt or guarantees.

The CBT initiated the development of its bank supervision capacity early in the 1990s, but only quite recently has modern bank accounting been introduced. Accounting

standards, in accordance with IAS, are now implemented for most of the major banks in the country, and further implementation will take place in 2001. New regulations on loan classification and provisioning were introduced in 1999. At the same time, minimum capital requirements were increased, together with new limits on maximum exposure to single borrowers and shareholders. These were the first steps toward a comprehensive bank rationalization process. In addition, on-site supervision capacity was improved, and the collection of information within the central bank was automated and centralized. Despite these efforts, the quality of loan portfolios is doubtful and difficult to evaluate.

Progress has been achieved in the development of legal infrastructure, including the strengthening of banking laws and regulations. The first banking law was adopted in 1993, and bank supervision regulations were brought more in line with international standards in 1995. Bank for International Settlements capital adequacy was enacted in 1997, but compliance has remained poor. There are signs of excessive restrictions on trade, such as registrations, licensing, and continuous government interference in the private sector through a proliferation of government agencies. As a result, the banking sector remains small, and access to financing by the real sector is limited.

The central bank is currently developing a system of automated and computerized payments, although there continues to be significant use of non-cash transactions between enterprises. The foreign exchange regime is highly distorted. In 1998, the interbank currency market was closed, and, currently, participation in foreign exchange auctions is carefully screened and restricted. Moreover, new restrictions banning citizens from holding foreign bank accounts were introduced in 2000.

Financial information disclosure is still deficient and inaccurate, and international auditors have yet to audit the banks, largely because accounting reform is still under way.

### **Conclusions**

It is important that governments in Central Asia make the development of comprehensive financial sector reform strategies a high priority in order to foster further economic and private sector development. Specific emphasis should be given to:

- Improving information disclosure
- Implementing accounting reforms
- Enhancing and developing the capacity of lower courts
- Strengthening the capacity of supervisory and regulatory agencies (central banks, ministries of justice, higher courts, and specialized commissions).

Additionally, priorities should include liberalizing and stabilizing economies, clarifying the role of state banks within the economy, and limiting public intervention in the economy, while at the same time strengthening banking supervision. As a first step in this direction, the authorities should assess on an individual basis the strengths and weaknesses of their banking systems, develop medium-term strategies, and set intermediate objectives and targets to achieve effective long-term and sustainable growth and development. Efficient banking sectors need to respond effectively and quickly to the needs of the real sectors, which are in a constant state of evolution. As a result, reform strategies should reflect the need for flexible intermediate objectives.

Governments are responsible for creating an environment that can foster sustainable financial sector development. While improved government policies can reduce shocks to the economy and banking system, banks also can protect themselves by improving the management of risk to limit exposure and by strengthening their capital base. The legal and judicial environment must encourage proper behavior of bank managers and owners, market participants, and supervisors by providing proper incentives and penalties. Strengthening the legal and judicial framework for debt collection and contract enforcement is essential to increasing the number of creditworthy clients for banks.

Governments also should create the necessary institutions, mechanisms, and incentives for ensuring implementation of prudent banking practices and proper regulation and monitoring of the banking system. Government interference in the banking system should not go beyond these objectives. It also is important to ensure independence and autonomy of central banks and courts from political and private interests. These authorities need enhanced capacity and credibility within the banking sector in order to deal with liquidation and privatization of weak financial institutions. Bailouts or recapitalization of ailing banks by state subsidies reinforces wrong behavior and moral hazard of owners and managers. Major bank creditors also should participate in enforcing effective market discipline. More

attention and controls should be dedicated to interbank lending, blanket guarantees, and provisioning.

Proper assessment of the overall soundness of the banking and financial system is critical. Banking assets are generally of doubtful quality, liquidity is scarce, and the risk of capital flight and runs by depositors is increasing. Authorities should focus their efforts on improving the overall creditworthiness of the system. Bankruptcy laws need to be tailored, taking into consideration the scarcity of financial resources and financial information, the quality of accounting and financial reporting, and the relative lack of experience in financial analysis. Many of these issues need to be addressed simultaneously by legislators and supervisory authorities, considering that transparency and soundness carry social implications.

Another issue to be addressed is the role of savings banks, which have large branch networks and protected monopolistic positions in providing banking and quasi-fiscal services. If not properly carried out, the privatization of these banks could have very negative social and fiscal implications due to conflicting interests, which arise in acting as transfer agent of government funds for pension and other budgetary payments, performing fiscal collections as agent for the government, and usually being the main holder of household deposits. Sufficient assurance for the uninterrupted delivery of these services should be put in place through alternative methods prior to privatization. A detailed strategy should identify options (such as the creation of postal banks), which could supplement or substitute delivery of these services or functions prior to completion of the privatization process. If privatization is concluded before ensuring the continued delivery of basic banking and quasi-fiscal services, the conservation of existing capacity (branch network) should be guaranteed prior to transferring ownership. In parallel with these banking sector issues, governments also should promote greater diversification in the financial markets, through deepening the government and corporate bond markets. In this context, reforming and strengthening the insurance and pension systems have an important role to play in increasing the availability of long-term funds.

## Part IV

# Capital Markets: Ready to Take Off or Stalled in Flight?



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## Chapter 11

# Stock Markets in Transition Economies

*Stijn Claessens, Simeon Djankov, and Daniela Klingebiel*

**W**ell-developed stock markets provide many benefits (see Levine 1997 for a survey). They enhance economic performance by enabling growing companies to raise capital at lower costs. Because these companies do not have to rely as much on internal financing, they are able to grow faster. Stock markets also have advantages over other sources of financing. Companies in countries with developed equity markets are less dependent on bank financing, which can reduce the risk of a credit crunch. Equity markets also allow companies to rely more on equity and less on debt, creating a less risky financial structure in the event of an economic downturn.

Finally, stock markets can increase the efficiency of corporations' investment and management by enhancing their governance. Overall, a mix of bank-intermediated funds and stock markets can enhance growth (Demirgüç-Kunt and Maksimovic 1998).

Stock markets are not new in transition economies—the Warsaw Stock Exchange was opened in 1817, and the Prague Stock Exchange was established in 1871—although all stock markets were closed under socialism. During the transition from plan to market, stock exchanges reemerged or were created in 20 of 26 transition economies. These exchanges are used mainly for the mandatory listing of shares of mass-privatized companies and for voluntary initial public offerings (IPOs).

The first stock market in transition economies emerged in the Czech and Slovak Republics in 1992; Bulgaria, Lithuania, FYR Macedonia, Moldova, and Romania followed soon after (table 11.1). The basic feature of this first group of markets was the transfer among investors of ownership rights to mass-privatized companies. At first these markets listed a large number of stocks, many of which were illiquid. But once the markets became more established, through transactions at stock exchanges, the number of stockholders fell, and ownership became more concentrated.<sup>1</sup> A second type of market—developed in Croatia, Estonia, Hungary, Latvia, Poland, and Slovenia—started with a small number of stocks, all of which were offered in traditional ways using IPOs. Many stocks had fairly liquid trading.

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1. Claessens and Djankov (1999) find that this was the case in the Czech Republic, and similar patterns occurred in most countries that adopted mass privatization. However, Earle and Telegdy (1998) find little evidence of ownership concentration on the Rasdaq in Romania. Recent studies argue that foreign investors misunderstood the mass privatization of markets and poured in money only to discover that disclosure requirements were weak and that they did not have much legal recourse because the regulatory framework was not developed (Black, Kraakman, and Tarassova forthcoming). In some countries these foreign portfolio flows seem to have slowed the concentration of ownership.

**TABLE 11.1 ORIGINS OF STOCK MARKETS IN TRANSITION ECONOMIES**

<i>Mandatory listing after mass privatization</i>	<i>Voluntary initial public offerings</i>	<i>Mandatory listing of minority packages during privatization</i>
Bulgaria	Croatia	Armenia
Czech Republic	Estonia	Azerbaijan
FYR Macedonia	Hungary	Kazakhstan
Lithuania	Latvia	Kyrgyz Republic
Moldova	Poland <sup>a</sup>	Poland <sup>a</sup>
Romania	Slovenia	Russia
Slovak Republic		Ukraine
		Uzbekistan

a. Poland also had mandatory listings of mass-privatized companies and National Investment Funds after 1996. See Hashi (2000) for a detailed description of the program.

Source: Compiled by the authors.

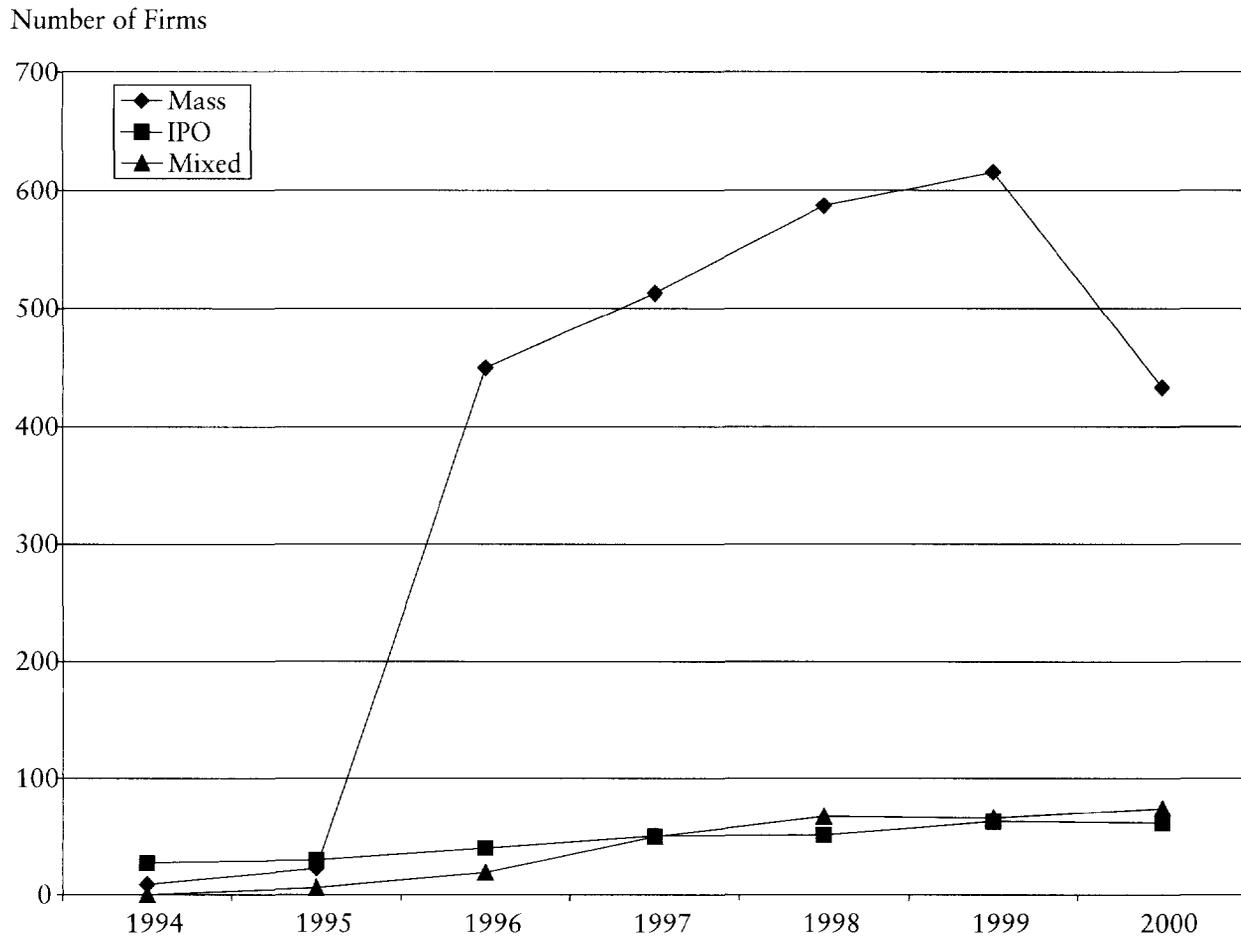
A third group of stock markets set up in seven transition economies—Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, the Russian Federation (Russia), Ukraine, and Uzbekistan—straddled these two types. All these countries had mass privatization programs, but the initial exchange of voucher shares took place off the stock exchanges. Although some of the companies in the privatization programs were publicly listed, such listings were not mandatory for all companies. In several countries (Kazakhstan, the Kyrgyz Republic), the plan was to develop the privatization program and the stock market in parallel. To that end, during privatization the stock market was built around public offerings of companies whose majority ownership was sold to strategic investors. The government then floated a small percentage of the listed shares on the market, creating broader ownership. Finally, six transition economies—Albania, Belarus, Bosnia and Herzegovina, Georgia, Tajikistan, and Turkmenistan—have not established stock markets.

### Features of Stock Markets in Transition Economies

Because markets in the first group were designed to facilitate a rapid transformation of ownership, the regulatory framework was intentionally left light. And because regulators in mass-privatized markets had to oversee many companies, enforcement was limited. Sometimes a formal

regulator or supervisory body was not even established, as in the Czech Republic. Most companies in these markets were not natural candidates for raising capital through stock markets and did not see much purpose in being listed. For example, in 1999 the median company on the Sofia (Bulgaria) Stock Exchange in terms of market capitalization, a textile company, had annual revenues of \$4 million, and the largest owner controlled 64 percent of the shares. Given its small size and concentrated ownership structure, it seems unlikely that the company would have been willing to list in the first place, float more equity, or raise new capital from equity offerings.

As a result, starting with the Czech Republic in 1996, Bulgaria, Lithuania, and the Slovak Republic in 1999, and Bulgaria in 1998, the number of listed companies fell in the first group as illiquid stocks were delisted (figure 11.1; table 11.A1). Several other factors also explain the decision of corporations not to trade publicly and to delist. First, by listing on stock markets, corporations were less likely to be able to avoid paying taxes. Second, the cost of external capital was quite high relative to the cost of bank credit. This was especially the case in countries where large firms could lobby politicians for directed credit. Finally, the extensive disclosure requirements of listed companies made it harder for corporations to conduct nonmarket-based transactions.

**FIGURE 11.1 NUMBER OF LISTED FIRMS IN TRANSITION ECONOMIES BY MARKET ORIGIN, 1994–2000**

Note: The mass privatization line represents the median number of publicly traded firms in Bulgaria, the Czech Republic, Lithuania, FYR Macedonia, Moldova, Romania, and the Slovak Republic. The IPO line tracks the median number of publicly traded firms in Croatia, Estonia, Hungary, Latvia, Poland, and Slovenia. The hybrid group includes Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Uzbekistan.

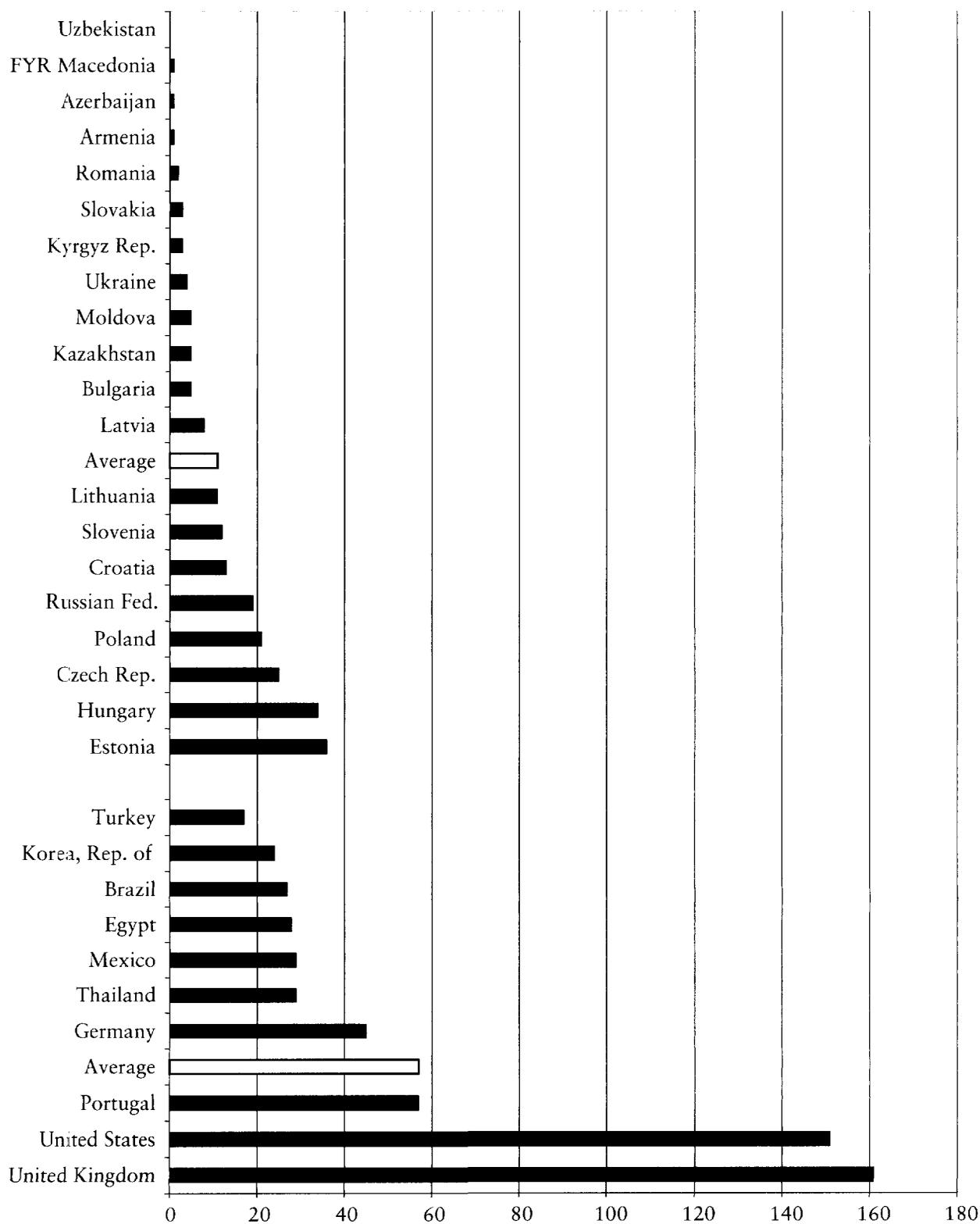
Source: Stock exchange websites and information departments.

In contrast, the IPO markets in the second group of countries (such as Hungary and Poland) saw increases in the number of listed companies, starting from a low base. In the third group of countries—as in the IPO markets—the number of companies listed was significantly below that of mass privatization markets but rose in the second half of the 1990s. Here some corporations were sold directly to international investors, with the residual free float offered domestically. Of the 45 percent free float offered to investors of the Polish oil refinery *Polski Koncern Naftowi*, for example, 30 percent was sold to international mutual funds and foreign-managed domestic investment funds, while 15 percent was available on the market in tradable employee shares.

### Market Capitalization

Countries with better fundamentals (a more stable macroeconomy, better laws and accounting rules, and stronger disclosure requirements) generally have larger stock markets as measured in market capitalization as a share of gross domestic product (GDP). Of the 20 stock markets in transition economies, only three—the Czech Republic, Estonia, and Hungary—have ratios of capitalization to GDP comparable to those of other emerging markets (figure 11.2). Market capitalization is very low in countries in the Commonwealth of Independent States (CIS), with the exception of Russia (see table 11.A2). At an average of 11 percent of GDP, market capitalization in

**FIGURE 11.2 MARKET CAPITALIZATION IN TRANSITION AND COMPARATOR ECONOMIES AS A PERCENTAGE OF GDP**



Note: Data are for March 2000 for transition economies and December 1998 for comparator countries.

Source: Stock exchange websites and information departments and author's calculations.

transition economies is significantly lower than in comparable emerging market economies.

### Market Turnover

“Market turnover,” defined as the value of trading over market capitalization, is an important indicator for measuring the effect of stock markets on growth (Levine and Zervos 1998). Among transition economies, market turnover is highest in Hungary (93 percent), the Czech Republic (81 percent), and Poland (69 percent; see figure 11.3; table 11.A3). Most other transition markets are illiquid, particularly in Central Asia—market turnover is less than 5 percent in Kazakhstan, the Kyrgyz Republic, and Uzbekistan.

Overall, markets in transition economies are less liquid than their comparators in both developed and other emerging markets. Only the most liquid markets in Central Europe compare favorably to Latin American markets, where market turnover is about 50 percent. But these markets significantly trail those of developed countries. Market turnover is 167 percent in Germany, for example, and 127 percent in Portugal. On average, stock markets in transition economies have a turnover of 30 percent, compared with 121 percent in 10 comparator countries. This lower market turnover can be attributed mostly to ownership concentration, a relatively limited free float, and the international migration of trading among large firms.

Stock markets in transition economies are dominated by a small number of firms. As a result, the concentration of market turnover—defined as turnover of the top 5 percent of listed firms as a percentage of total turnover—is high in most transition economies. Yet at an average of 75 percent, it is similar to that of other stock markets. At about 40 percent, Poland is the least concentrated market in terms of turnover (figure 11.4). Armenia, Azerbaijan, Bulgaria, Kazakhstan, Latvia, FYR Macedonia, Moldova, Romania, Ukraine, and Uzbekistan all have turnover concentrations above 80 percent.

Although similar concentration levels are found in Germany and the United Kingdom, a larger number of firms account for the concentration. For example, on the London Stock Exchange 112 listed equities (5 percent of 2,274) account for 85 percent of market turnover. In contrast, five or fewer companies account for all of the market turnover in Azerbaijan, FYR Macedonia, and Uzbekistan and for more than 95 percent of the market turnover in Armenia, Bulgaria, Kazakhstan, the Kyrgyz Republic, Lithuania, Moldova, Romania, Slovenia, and Ukraine.

### Foreign Financing

Many large, publicly listed companies in transition economies have sought equity financing abroad. At the end of 1999, 72 corporations from transition economies had American depository receipts (ADRs) listed on the New York Stock Exchange or the Nasdaq, and 61 corporations from transition economies were listed in London. Corporations listed abroad (in New York, London, and Frankfurt) account for an average of 18 percent of domestic stock market capitalization in transition economies and for almost two-thirds in Kazakhstan (figure 11.5). In Estonia, Hungary, Latvia, and the Slovak Republic companies listed abroad account for about one-third of domestic market capitalization.

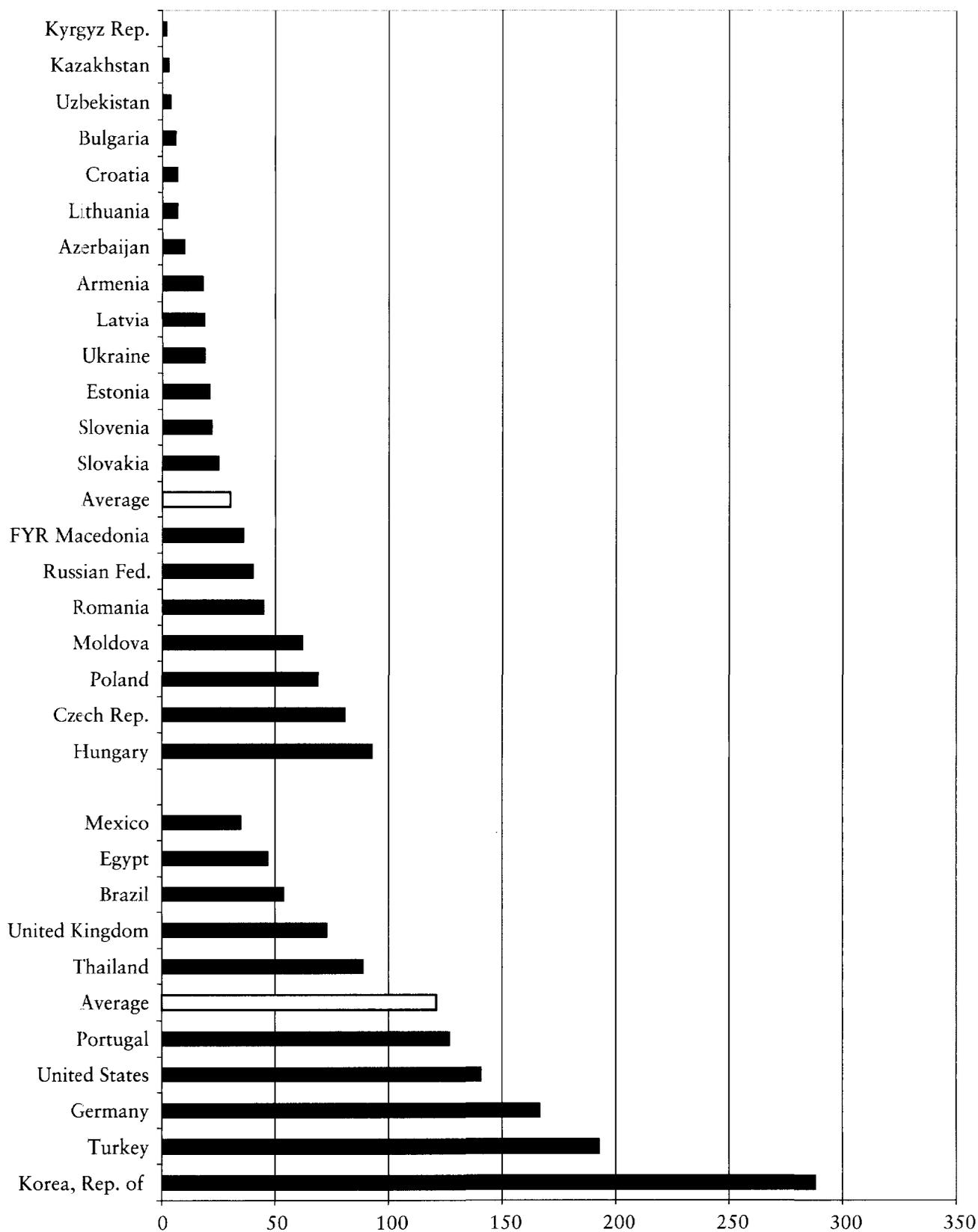
On average, the value of the shares traded abroad is almost half of the value traded on local markets, and the number of shares traded abroad is twice as high as the number of shares traded locally. The turnover of Russian depository receipts in Frankfurt, for example, was more than twice as high in the first three quarters of 1999 as the turnover of the same instrument in Moscow (Creditanstalt 1999). Incentives to list abroad are particularly strong in transition economies that have had trouble establishing credible frameworks for corporate governance (Black and Gilson 1998). But the tendency to list and trade abroad has not been limited to markets with weak minority rights: of the 14 countries with good investor protection, 9 have more than 20 percent of their stocks traded abroad.

This offshore migration has been especially strong among big companies—for example, 7 of Russia’s 10 largest listed stocks have depository receipt programs. Many of the firms listed abroad are involved in resource extraction or telecommunications. But new, Internet-related firms also are listing and raising capital abroad, especially firms from the Czech Republic and Hungary. The disappearance of big companies that trade only domestically—the average size of companies that are cross-listed or that have depository receipts is 12 times that of companies listed only domestically—deprives local exchanges of liquidity, discouraging foreign investors from considering the remaining stocks. Even large stock markets in transition economies are hurt by this development, because foreign portfolio managers may avoid them in the belief that trading in these markets is not worth their research time and money.

### Determinants of Stock Market Development in Transition Economies

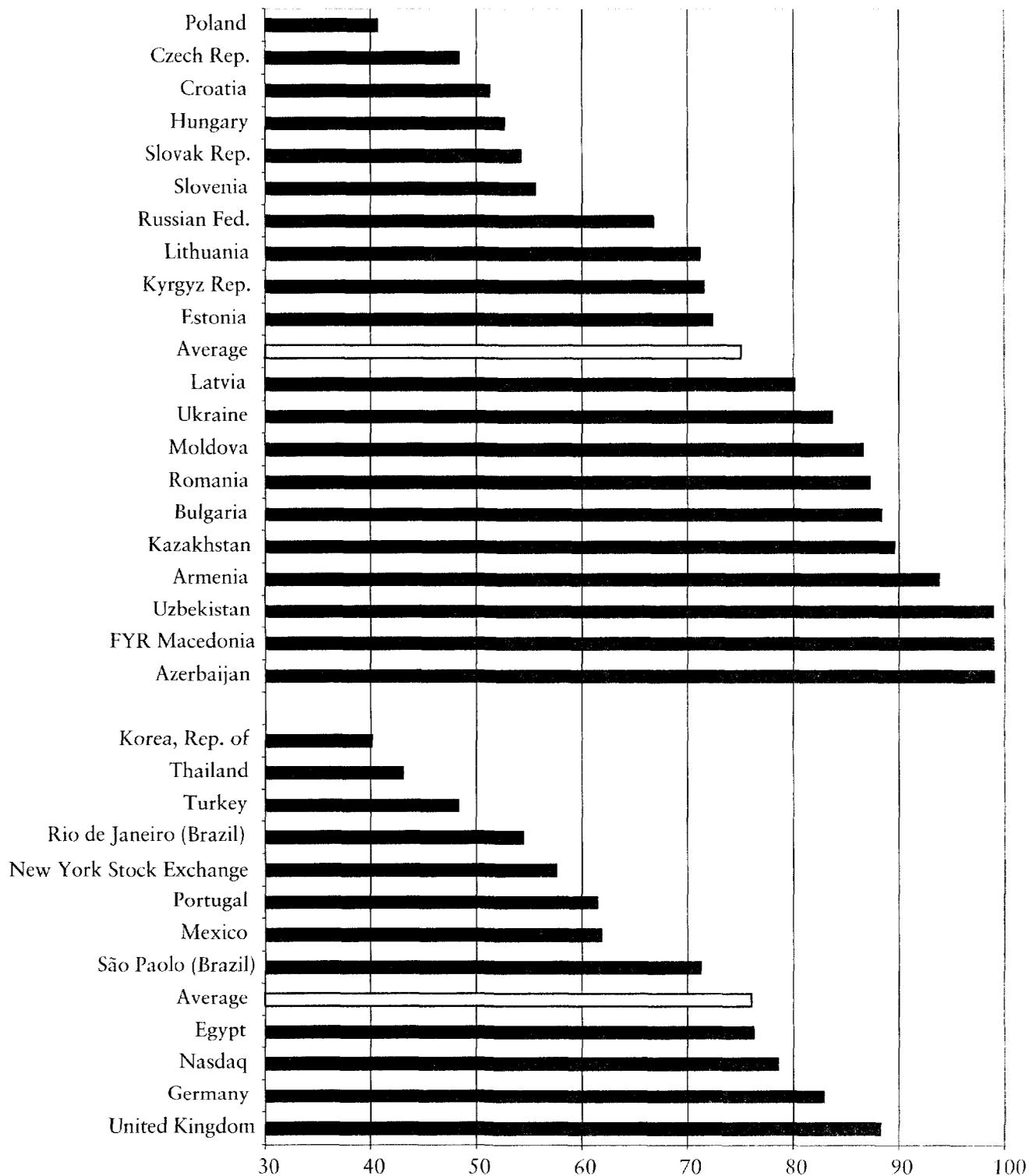
There is some empirical literature on what determines successful stock market development (see Levine and

**FIGURE 11.3 MARKET TURNOVER IN TRANSITION AND COMPARATOR ECONOMIES, MARCH 2000**



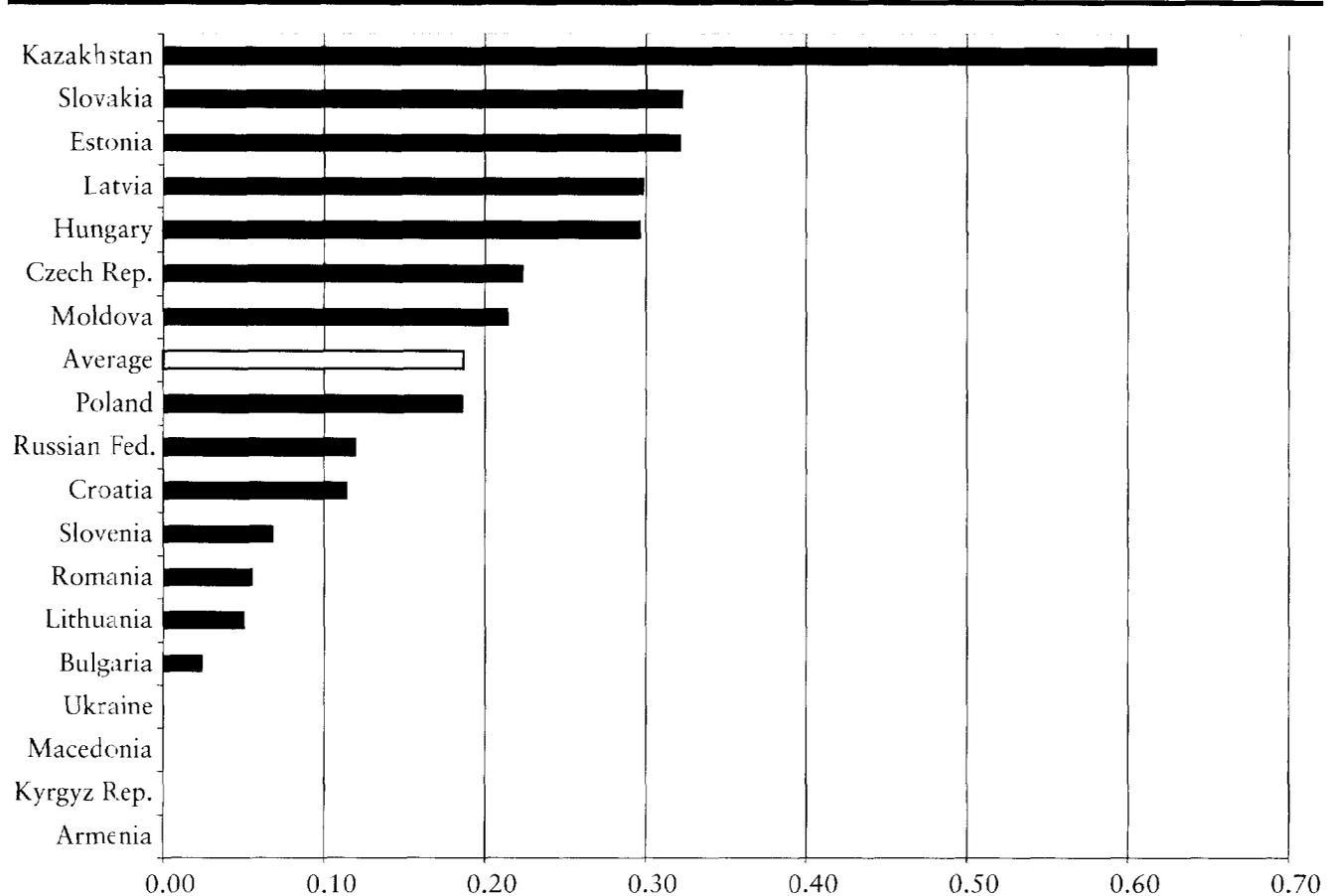
Source: Stock exchange websites and information departments and authors' calculations.

**FIGURE 11.4 CONCENTRATION OF MARKET TURNOVER IN TRANSITION AND COMPARATOR ECONOMIES, MARCH 2000**  
 (percentage of market turnover accounted for by the top 5 percent of listed companies)



Source: Stock exchange websites and information departments and authors' calculations.

**FIGURE 11.5 MARKET CAPITALIZATION OF TRANSITION ECONOMY COMPANIES LISTED ABROAD, 1999**  
(percentage of domestic market capitalization)



Source: Stock exchange websites and information departments and authors' calculations.

Zervos 1998). The basics are clear: for any market to exist, there needs to be a demand and a supply for the product. In the context of stock markets, the product is the external equity financing of firms. Companies that do not have a sufficient flow of retained earnings want to tap stock markets. The supply of funds typically comes from institutional investors like pension funds, investment funds, life insurance companies, and mutual funds.

But the professed demand and supply are not enough. Countries that experience high inflation are unlikely to see equity markets develop, because investors will not invest or will keep their money in foreign assets (Boyd, Levine, and Smith forthcoming). Or, if the return on government securities for bank deposits is higher than that on corporate stocks and bonds, a stock market will not develop because the supply goes elsewhere. In addition to favorable macroeconomic conditions, adequate regulations for listed corporations and proper governance of institutional investors are needed to ensure proper intermediation (Levine,

Loayza, and Beck 2000). These rules include protection of minority rights, disclosure of the activities of corporations, and proper accounting rules and practices.

The size of a market also will play a large role in determining its long-term viability. A small country will have a hard time supporting a stock market because there will be a small number of firms suited for public listing, the costs of running a stock market will be relatively high, and firms may find it cheaper to raise money abroad. The desire of market participants for larger, more liquid markets and lower transaction costs—including trading, clearing, and settlement systems—is illustrated by the recent cross-border mergers of large stock exchanges (as with the integration of the London Stock Exchange, the Deutsche Boerse, and the Nasdaq). This trend toward market consolidation is aided by Internet technology, which makes it easier to link stock markets. In that respect, the minimum size of a stock market has increased substantially.

To assess the potential for stock markets in transition economies, it is important to understand what determines their current development. Their recent establishment plays a large role, but the development of stock markets in transition economies also depends on the degree of macroeconomic stability, the evolution of securities and corporate laws, and the assets accumulated by institutional investors in each country.

### *Macroeconomic Stability*

Only four of 26 transition economies—Croatia, the Czech Republic, the Slovak Republic, and Slovenia—averaged single-digit inflation during 1994–99, in contrast to most comparator emerging markets (except Brazil, Mexico, and Turkey). Several transition economies—Armenia, Azerbaijan, Bulgaria, Ukraine, and Uzbekistan—had triple-digit inflation over the period (see table 11.A4). Stock market development is difficult in a high-inflation environment.

High inflation meant that during 1994–99 the real return on stock market investments in transition economies was often negative before adjusting for risk and was largely negative on a risk-adjusted basis. Stock market returns also compared unfavorably with those on bank deposits: before adjusting for risk, only stock markets in Hungary, Russia, and Slovenia offered investors higher returns than bank deposits during 1994–99. On a risk-adjusted basis, only two of 20 markets—Hungary (16 percent returns) and Russia (42 percent)—likely outperformed bank deposits (this calculation does not take into account losses on bank deposits due to bank failures). In Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, Romania, and the Slovak Republic, bank deposits yielded a positive, but low, annual return of about 2 percent in real terms. In contrast, stock market investments in these countries yielded a negative average annual return on a risk-unadjusted basis in 1994–99. Especially in CIS countries, holding foreign currency would have yielded the highest returns. For example, in Kazakhstan and Ukraine holders of U.S. dollars saw the worth of their holdings appreciate 5 and 10 percent, respectively, in real terms over 1994–99.

### *Legal Framework*

Another key determinant of stock market development is the level of shareholder protection in publicly traded

companies, as stipulated in securities or company laws (Shleifer and Vishny 1997 and Glaeser, Johnson and Shleifer 2001). Stock market development is more likely in countries with strong shareholder protection because investors do not fear expropriation as much. Moreover, ownership in such markets can be relatively dispersed, which provides liquidity to the market. La Porta and others (1998) provide formal support for the importance of minority rights' protection by using indicators of the quality of shareholder protection as written in laws. They show that the quality of shareholder protection is correlated with the capitalization and liquidity of stock markets in 49 countries around the world. Pistor (2000) extends the analysis by constructing identical indexes for transition economies. The results of both studies are presented in table 11.2.

The indicators of minority rights' protection show that, starting from no legal basis whatsoever, many transition economies have made significant strides in improving—at least on the books—the legal environment for investors. All but six transition economies (Azerbaijan, Croatia, the Kyrgyz Republic, FYR Macedonia, the Slovak Republic, and Ukraine) have better investor protection laws than Egypt, Germany, Mexico, and Turkey. The relatively high scores for Eastern European countries are perhaps not surprising because these countries have started harmonizing their stock market laws with those of the European Union. But the scores are surprising for the countries of the former Soviet Union.<sup>2</sup>

These indicators of formal shareholder rights do not indicate how well these laws and regulations are enforced in transition economies. Slavova (2000) expands on the formal laws by creating an index of effective shareholder protection. Among transition economies, Hungary has the highest score of effective protection—71 percent of that in the United States—followed by Poland, Estonia, and Bulgaria. The other transition economies fall far short in their enforcement. Armenia, Azerbaijan, and FYR Macedonia have effective enforcement that is just over 20 percent of that in the United States. Ineffective enforcement of shareholder protection can be attributed largely to corruption, a weak judicial system, and limited disclosure of information (Pistor, Raiser, and Gelfer 2000). For example, Armenia has formal levels of shareholder protection similar to those in the United States. Yet its ability to enforce

2. Pistor (2000) points out that 10 transition economies, including Armenia, Kazakhstan, the Kyrgyz Republic, Latvia, Moldova, Russia, Ukraine, and Uzbekistan, have received technical assistance from the U.S. Agency for International Development in drafting capital market legislation. This assistance has resulted in well-designed shareholder protection laws that borrow extensively from U.S. laws.

**TABLE 11.2 SHAREHOLDER PROTECTION IN TRANSITION AND COMPARATOR ECONOMIES, 1998**

<i>Country</i>	<i>Shareholder protection rating</i>	<i>Effectiveness of shareholder protection (U.S. = 100)</i>
Armenia	5	21.2
Azerbaijan	2	25.2
Bulgaria	4	62.3
Croatia	2	44.7
Czech Rep.	3	51.4
Estonia	3	62.1
FYR Macedonia	2	23.7
Hungary	3	71.0
Kazakhstan	4	56.2
Kyrgyz Rep.	2	28.6
Latvia	3	49.7
Lithuania	3	52.9
Moldova	3	45.5
Poland	3	68.6
Romania	3	43.7
Russian Fed.	5	49.1
Slovak Rep.	2	56.5
Slovenia	3	39.8
Ukraine	2	53.9
Uzbekistan	3	27.6
Brazil	3	
Egypt	2	
Germany	2	

TABLE 11.2 (CONTINUED)

<i>Country</i>	<i>Shareholder protection rating</i>	<i>Effectiveness of shareholder protection (U.S. = 100)</i>
Korea, Rep. of	4	
Mexico	1	
Portugal	3	
Thailand	3	
Turkey	2	
United Kingdom	5	
United States	5	

Note: The shareholder protection rating is a sum of the following indexes: proxy by mail is allowed (true = 1; false = 0); shares are not blocked before a shareholder meeting (true = 0.5; false = 0); there is no registration cutoff date before the meeting (true = 0.5; false = 0); cumulative voting for election of supervisory board is allowed (true = 0.5; false = 0); other rules to ensure proportional representation are in place (true = 0.5; false = 0); shareholders can take judicial recourse against decisions by executives (true = 0.5; false = 0); shareholders can take judicial recourse against decisions made at shareholder meetings (true = 0.5; false = 0); preemptive rights are allowed in the issuance of new shares (true = 1; false = 0); and shareholders representing 10 percent or less of the vote can demand the convocation of an extraordinary shareholder meeting (true = 1; false = 0). The shareholder protection rating can have a maximum value of 6. Effectiveness of shareholder protection is estimated based on structured interviews with securities and exchange commission officials in transition economies. EBRD consultants conducted the interviews in June 1998.

Source: La Porta and others; Pistor (2000); Slavova (2000).

compliance with these rules is only a fifth of that in the United States—even though there are only four actively traded companies in Armenia.

Even these indexes of effective enforcement may paint an overly rosy picture of investor protection in transition economies. While Russia scores as high as the United States on legal protection of shareholders, and is only twice as bad as the United States in securities law enforcement, basic property rights stemming from company laws are often neglected. Troika Dialog (1999) and Fox and Heller (1999), in reports on corporate governance in Russia, document many cases of minority as well as majority shareholder expropriation by incumbent managers or by local governments. While the disregard of investor rights is beyond the narrow scope of stock market enforcement, it is of primary importance in the provision of public and private funds to equity issuers.

### ***Institutional Investors***

The development and particularly the liquidity of a stock market depend on the development of a class of well-governed institutional investors. Institutional investors are small in transition economies, with assets accounting

for an average of just 7 percent of GDP—much less than in other emerging market economies. In only 3 of 20 countries (the Czech Republic, Hungary, and Poland) do institutional investors have assets averaging 18 percent of GDP, and even that is lower than in other countries with similar per capita incomes (table 11.3).

There are three types of institutional investors. Investment and mutual funds form the largest group in transition economies. Investment funds largely emerged out of the mass privatization funds used to transfer ownership during privatization. The funds collected vouchers from citizens and invested them in corporate securities. The mutual fund industry is still in its infancy in transition economies. Hungary is the region's leader: by early 2000 mutual fund holdings accounted for 8.5 percent of GDP.

Pension funds are another class of institutional investors. Because funded pension schemes have yet to be established or were set up only recently in transition economies, pension funds are insignificant in terms of the size of assets under management. In only 4 of 20 countries do these funds amount to a few percentage points of GDP. In most transition economies assets in pension funds do not even amount to 1 percent of GDP. Hungary was the first

**TABLE 11.3 ASSETS HELD BY INSTITUTIONAL INVESTORS IN TRANSITION AND COMPARATOR ECONOMIES, 2000 (percentage of GDP)**

<i>Country</i>	<i>Investment and mutual funds</i>	<i>Pension funds</i>	<i>Insurance</i>	<i>Total</i>
Armenia	4	0	0	4
Azerbaijan	0	0	0	0
Bulgaria	5	0	1	6
Croatia	2	0	2	4
Czech Rep.	8	2	9	19
Estonia	5	0	3	8
FYR Macedonia	4	0	0	4
Hungary	12	4	3	19
Kazakhstan	2	3	1	6
Kyrgyz Rep.	2	0	0	2
Latvia	5	0	1	6
Lithuania	6	0	0	6
Moldova	4	0	2	6
Poland	8	2	5	15
Romania	8	0	0	8
Russian Fed.	2	1	1	4
Slovak Rep.	6	0	4	10
Slovenia	5	0	4	9
Ukraine	0	1	0	1
Uzbekistan	0	0	0	0
Brazil	16	10	1	27
Chile	5	40	13	58
Germany	28	13	32	73

TABLE 11.3 (CONTINUED)

<i>Country</i>	<i>Investment and mutual funds</i>	<i>Pension funds</i>	<i>Insurance</i>	<i>Total</i>
Korea, Rep. of	20	2	16	38
Mexico	4	3	2	9
Portugal	21	11	10	42
Turkey	3	1	1	5
United Kingdom	60	101	89	250
United States	129	90	43	262

Note: Data are for June 2000 or most recent available period.

Source: Authors' calculations based on OECD (1999); Mercer (2000); World Bank data.

transition economy to introduce a funded occupational pension scheme (in 1993) and a defined contribution scheme (in 1998). By March 2000 the assets of the defined contribution scheme amounted to 3 percent of GDP, and the assets of the occupational pension scheme accounted for 1 percent of GDP. A number of countries followed Hungary in establishing defined contribution plans and funded occupational pension schemes. By June 2000 Croatia, the Czech Republic, Kazakhstan, Poland, Russia, Slovenia, and Ukraine had created defined contribution schemes, and Bulgaria, Estonia, Latvia, and FYR Macedonia will have established such a pillar by the end of 2001.

The insurance industry in transition economies started developing only after 1996. Thus the assets of the third type of institutional investors—insurance companies—are no more than a few percentage points of GDP in most transition economies.<sup>3</sup> One exception is the Czech Republic, where the insurance market is relatively well developed and is dominated by foreign players. Foreign players also dominate the insurance sector in Hungary, where they account for more than 90 percent of assets.

### *The Importance of Each Factor*

To show the relative importance of different factors in stock market development, we analyzed the determinants

of stock market development and turnover in transition economies. We constructed time series for 1994–99 for market capitalization, market turnover, inflation, institutional assets, and minority shareholder protection. The simple correlation coefficients among these variables suggest that market capitalization is positively correlated with single-digit inflation, the size of institutional investor assets, and high shareholder protection, and it is negatively correlated with triple-digit inflation and low shareholder protection. Market turnover is positively related to the size of institutional investor assets and is negatively related to triple-digit inflation and low shareholder protection. These correlation coefficients are all statistically significant at the 5 percent level.

These simple correlations do not control for other explanatory variables, such as initial income and integration with more developed countries, proxied by geographic location. To establish more formally the importance of various factors in stock market development, we used regression analysis while controlling for income (proxied by the log of GDP per capita) and distance from Europe (proxied by the log distance from Vienna). The ordinary least-squares regressions are shown in table 11.4.<sup>4</sup>

The analysis shows that low inflation, good shareholder protection, and the size of institutional investor

3. It is not always possible to distinguish between life and nonlife insurance, so these numbers overestimate the potential liquidity that insurance assets can inject into capital markets.

4. Between regressions (ordinary least-squares regressions on means) and random regressions show that the results for market capitalization are robust to alternative specifications, while the association between market turnover and high shareholder protection turns insignificant. As a robustness check, we repeated the regression analysis described in table 11.4, this time using data

**TABLE 11.4 DETERMINANTS OF MARKET CAPITALIZATION AND MARKET TURNOVER IN TRANSITION ECONOMIES, 1994–99**

<i>Dependent variable</i>	<i>Market capitalization</i>			<i>Market turnover</i>		
	(1)	(2)	(3)	(1)	(2)	(3)
Inflation < 10 percent a year	3.54* (3.09)	3.15* (2.58)	2.84* (2.61)	9.24* (2.07)	4.56 (1.02)	5.65 (1.20)
Inflation 10–50 percent a year	0.33 (0.42)	0.29 (0.35)	0.05 (0.12)	10.47* (2.93)	9.90* (2.67)	8.92* (2.38)
Inflation 50–100 percent a year	-0.41 (0.52)	-0.34 (0.42)	-0.63 (0.76)	5.53 (0.91)	6.28 (1.04)	4.35 (0.73)
Medium shareholder protection	0.61 (0.92)	0.44 (0.64)	0.75 (1.17)	10.94* (3.58)	12.84* (3.94)	10.15* (3.32)
High shareholder protection	6.28* (3.69)	6.73* (3.85)	5.93* (3.49)	10.37* (2.51)	15.85* (2.21)	8.61 (1.22)
Institutional assets	0.64* (6.80)	0.57* (5.31)	0.56* (4.88)	3.07* (5.07)	2.19* (3.18)	2.68* (4.01)
Log distance from Vienna		-0.62 (1.38)			-7.48* (2.72)	
Log GDP per capita			0.82 (1.61)			4.21 (1.61)
Number of observations	156	156	156	156	156	156
Adjusted $R^2$	0.61	0.61	0.61	0.41	0.44	0.42

\* Statistically significant at the 5 percent level.

Note: Standard errors are heteroskedastic-consistent. A constant term is included in every regression. Medium investor protection is defined as a Pistor (2000) score of 2 or 3. High investor protection is defined as a Pistor (2000) score of 4 or 5. The t-statistics are in parentheses.

Source: Authors' calculations.

for the 26 transition economies as well as the 10 comparator countries. The six transition economies that do not have functioning stock markets get a score of 0 for market capitalization and market turnover. Table 11A.5 shows that the importance of low inflation in explaining market capitalization doubles in comparison to the sample of transition economies only, shareholder protection is no longer statistically significant, and the role of institutional investor assets declines slightly. In contrast, the importance of shareholder protection increases in the market turnover regressions, and the role of institutional investor assets decreases significantly (table 11A.5, col. 4). In both cases a country's per capita income is the most robust explanatory variable for both market capitalization and market turnover.

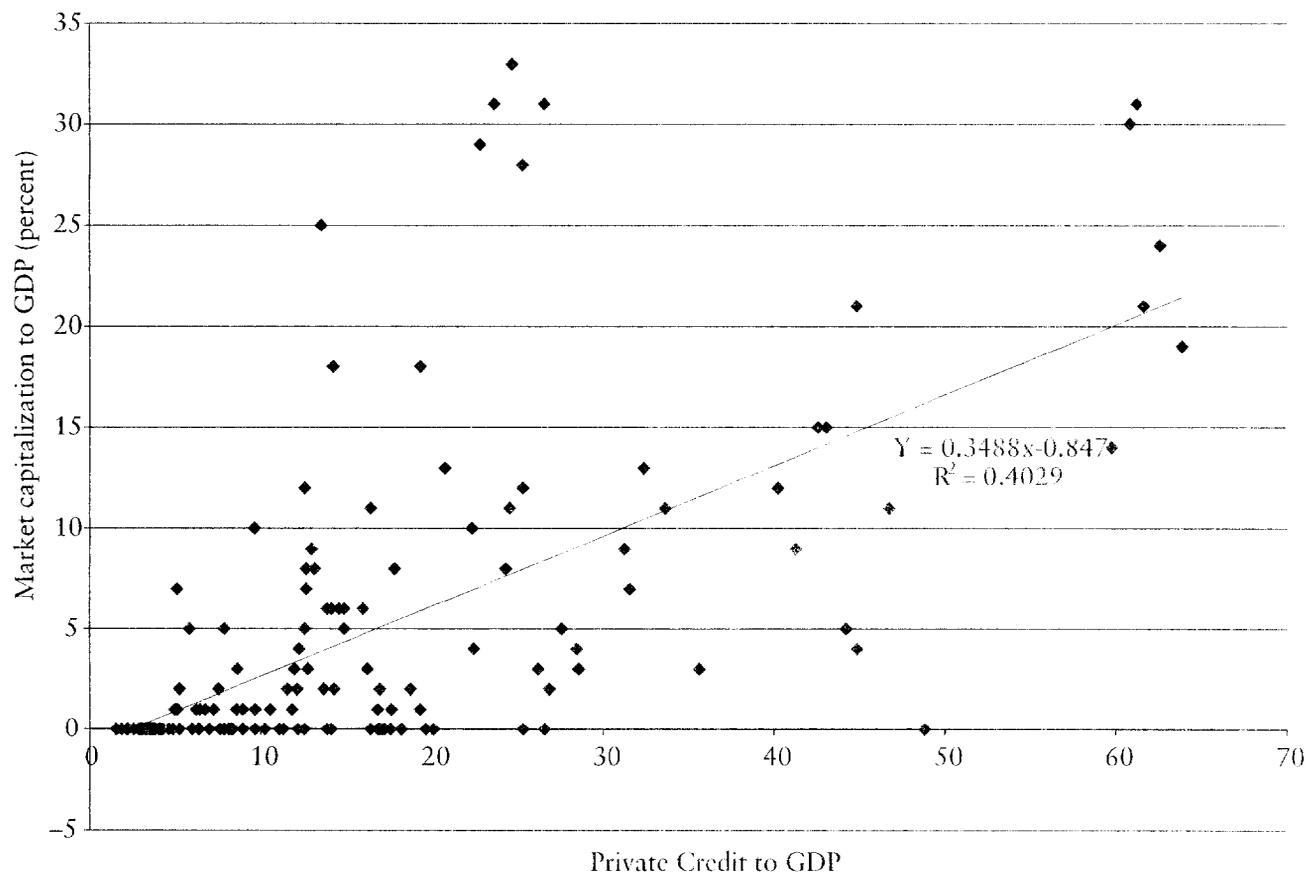
assets are important in explaining market capitalization, even after controlling for income or distance. The pattern is less clear for market turnover. The size of institutional investor assets is positively associated with high turnover, and this association is statistically significant. But the association between market turnover and inflation or shareholder protection is not monotonic. As long as inflation is not above 50 percent and shareholder rights are average or high, market turnover increases. This is consistent with the findings of Boyd, Levine, and Smith (2000) for other equity markets. These regressions highlight the importance of mild inflation and institutional investor assets in enhancing the development of stock markets in transition economies.

The results in table 11.4 suggest that the underdevelopment of stock markets in transition economies can be traced to these countries' unstable macroeconomic environment, weak minority shareholder rights, and limited asset base of institutional investors. Many of these factors

should improve over time. Today few countries have double-digit inflation, and legal frameworks have improved considerably, although much remains to be done in improving enforcement in most transition economies. Experiences in other emerging markets show that it takes considerable time and effort to protect minority rights. Relatively well-developed stock markets in East Asia, for example, still experienced large expropriation of minority shareholders in the late 1990s (Claessens and others 1999).

Market capitalization is positively correlated with ratios of private credit to GDP in transition economies (figure 11.6). Low ratios of private credit to GDP indicate that basic financial sector infrastructure is lacking in transition economies. Many transition economies have very shallow banking systems, with credit amounting to less than 10 percent of GDP. Because banking systems typically develop before stock markets, countries should focus on developing the basic infrastructure—investor protection, contract enforcement, sound accounting standards—for

**FIGURE 11.6 PRIVATE CREDIT AND MARKET CAPITALIZATION IN TRANSITION ECONOMIES, 1994–99 (percent)**



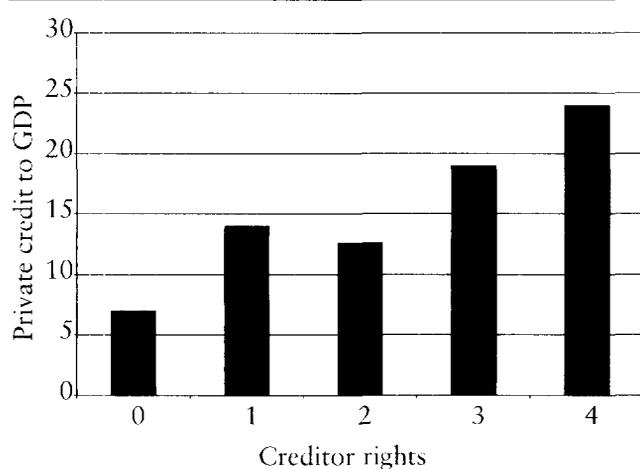
Note: The sample is based on a panel set, 1994–99, for 26 transition economies.

Source: Authors' calculations.

both credit and equity markets. The benefits of focusing on the institutional framework are confirmed by a growing literature stressing the importance of creditor rights in developing banking systems (La Porta and others 1998; Levine, Loayza, and Beck 2000; Rajan and Zingales, 1998). In addition to macroeconomic instability and low per capita income, weak creditor rights are an important reason that banking systems are underdeveloped in transition economies. The better is the quality of creditor rights, the more developed is the banking system (figure 11.7). Thus, before considering equity markets, transition economies should focus on improving and enforcing creditor rights to foster development of their banking system. This also is the most effective way to foster the development of small and medium-size enterprises, a key source of economic growth. Several transition economies could foster funded pension schemes to boost the demand for shares of listed securities. Yet under current policies, the projected assets of funded occupational pension funds will remain fairly small in most transition economies. By 2005 assets are expected to be 10 percent of GDP in Kazakhstan, 8 percent in Hungary and Poland, 7 percent in the Czech Republic, 6 percent in Croatia, and 4 percent in Estonia, Latvia, and the Slovak Republic. But not all of the increase in funds will flow to stock markets, because regulations often limit the share of assets that can be invested in stock markets. In Kazakhstan, for example, this share is just 10 percent.

Over time these restrictions will be phased out in countries vying for European Union (EU) membership, and

**FIGURE 11.7 CREDITOR RIGHTS AND RATIO OF PRIVATE CREDIT TO GDP IN TRANSITION ECONOMIES, 1999**



Note: The higher is the index of creditor rights, the better creditors are protected. For details, see Pistor (2000).

Source: Authors' calculations.

equity investment could rise. Fewer restrictions also will allow institutional investors to diversify their portfolios by investing abroad. But this beneficial development will reduce the resources available for domestic investment. Phasing out restrictions on foreign investment will be important; otherwise, countries will create a captive investor base that may impede institutional development and result in inefficient resource allocation.

### Prospects for Stock Markets in Transition Economies

To investigate the potential for and economic viability of stock markets in transition economies, we used the regression analysis to simulate the future development of stock markets under different policy assumptions (for similar policy experiments, see Beck 2000 for Brazil and Levine 2000 for capital markets in Latin America). In particular, we simulated the market capitalization and market turnover that could materialize if policymakers achieve macroeconomic stability (as indicated by single-digit inflation), the highest score on shareholder rights, and the projected accumulation of new pension fund assets (table 11.5). These represent best-case scenarios in which countries achieve and maintain the highest scores on all three variables.

Such scenarios may not be realistic, however, and projecting that all three best-case policies will materialize may be overly optimistic for some transition economies. Indeed, a number of countries have backtracked rather than progressed. In Bulgaria, inflation increased in 1996 after an initial stabilization. The Slovak Republic saw a deterioration in shareholder rights after 1996. And Croatia's parliament recently retracted a draft pension fund law after more than a year of deliberations. The simulation results also assume that shareholder rights will remain well protected, at least on the books.

In the results presented in table 11.5, a country sees an increase in market capitalization only if it has not already achieved the highest scores for each variable. For example, Bulgaria already has single-digit inflation and a shareholder protection score of 4. Thus, it would not see an increase in market capitalization due to either factor, but only due to further accumulation of pension fund assets.

At the other end of the spectrum, 11 of 26 transition economies—Belarus, Bosnia and Herzegovina, Kazakhstan, the Kyrgyz Republic, FYR Macedonia, Moldova, Romania, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan—stand to gain from macroeconomic stability and improved shareholder rights. Under the best possible policy outcomes, six stock markets (in Croatia, the Czech Republic, Estonia, Hungary, Poland, and Russia) could

**TABLE 11.5 BEST-CASE SCENARIOS FOR MARKET CAPITALIZATION AND MARKET TURNOVER IN 2005**  
(percentage of GDP)

Country	Market capitalization		Change in market capitalization from			Market capitalization		Market turnover			
	In 1999	In 2000	Macro stability	Investor rights	Institutional assets	Increase from 2000	In 2005	In 1999	In 2000	Increase from 2000	In 2005
Albania	0	0	0	5	0	5	5	0	0	16	16
Armenia	1	1	0	5	5	10	11	15	18	25	43
Azerbaijan	1	1	0	5	0	5	6	13	10	16	26
Belarus	0	0	3	5	0	8	8	0	0	16	16
Bosnia and Herzegovina	0	0	3	5	0	8	8	0	0	16	16
Bulgaria	6	5	0	0	3	3	8	98	6	20	26
Croatia	11	13	0	5	7	12	25	5	7	40	47
Czech Rep.	19	25	0	0	14	14	39	61	81	15	96
Estonia	31	36	0	0	5	5	41	44	21	28	49
FYR Macedonia	1	1	3	5	5	13	14	45	36	31	67
Georgia	0	0	0	5	0	5	5	0	0	16	16
Hungary	31	34	0	0	12	12	46	103	93	9	102
Kazakhstan	2	5	3	5	3	11	16	68	45	28	73
Kyrgyz Rep.	5	3	3	5	2	10	13	2	2	20	22
Latvia	6	8	0	0	4	4	12	21	19	22	41
Lithuania	12	11	0	0	2	2	13	13	7	13	20
Moldova	5	5	3	6	2	11	16	81	62	29	91

(Table continues on the following page.)

TABLE 11.5 (CONTINUED)

Country	Market capitalization		Change in market capitalization from			Market capitalization		Market turnover			
	In 1999	In 2000	Macro stability	Investor rights	Institutional assets	Increase from 2000	In 2005	In 1999	In 2000	Increase from 2000	In 2005
Poland	18	21	0	0	17	17	38	62	69	10	79
Romania	2	2	3	6	4	13	15	58	45	33	78
Russian Fed.	25	19	3	0	5	8	27	27	40	7	47
Slovak Rep.	4	3	0	6	8	14	17	48	25	46	71
Slovenia	11	12	0	6	6	12	24	28	22	42	64
Tajikistan	0	0	3	5	0	8	8	0	0	16	16
Turkmenistan	0	0	3	5	0	8	8	0	0	16	16
Ukraine	3	4	3	5	1	9	13	12	19	18	37
Uzbekistan	0	0	3	5	0	8	8	2	4	18	22
Average	7	8	1.5	3.5	4	9	17	31	24.3	21.8	46

Source: Authors' calculations.

see market capitalization of 25 percent of GDP or more by 2005, which would put them at about the average of middle-income emerging markets.<sup>5</sup>

The elasticity from policy changes is higher for market turnover, so even countries that do not have stock markets with any liquidity (such as Turkmenistan) could reach 16 percent market turnover by 2005. Under the best-case scenario, market turnover of more than 50 percent may be reached in nine countries, namely the Czech Republic, Hungary, Kazakhstan, FYR Macedonia, Moldova, Poland, Romania, the Slovak Republic, and Slovenia. But even under the best scenario, turnover remains far below that of other markets in Europe (such as London or Frankfurt) and in many other emerging markets. Low liquidity not only implies that these markets will not be providing corporations with the opportunity to raise new capital at relatively low cost, but also that investors will be more reluctant to trade given the high implicit costs of price movements. Perhaps most important, low liquidity means that it will be harder to support a local market with its own trading system, market analysis, brokers, and the like, because the volume of business simply would be too low.

### The Influence of International Developments

Stock market developments in transition economies cannot be analyzed without reference to global developments. While some transition economies may be able to develop reasonably liquid stock markets in the next few years, such progress could be stalled by global events. Around the world, stock markets are changing rapidly. They are becoming increasingly global, with large increases in cross-border capital flows. Listing, trading, and new issuance are concentrating in fewer markets. And alternative electronic trading networks are gaining market share. These trends are starting to affect stock markets in transition economies.

Globalization is proceeding in all forms of financial services, through capital flows, cross-border provision, and

entry of foreign financial institutions. International equity issues have grown substantially, from \$120 billion in 1997 to \$214 billion in 1999 (Bank for International Settlements 2000). Within these international equity flows, depository receipts—global depository receipts (GDRs), American depository receipts (ADRs), and the like—have been the most popular instrument for raising capital. In 1999 a record \$22 billion in new capital was raised in U.S. markets through depository receipts, bringing the total equity capital raised through ADRs to \$133 billion since 1990. Other financial centers have seen similar trends.

Depository receipts are used not just to raise capital but also to effectively cross-list a stock in more markets. In 1999, 1,800 depository receipt programs from 78 countries were in existence in the United States, compared with 352 from 24 countries in 1990. The combined market capitalization of these companies exceeded \$6 trillion at the end of 1999 (Bank of New York 2000). In London the use of depository receipts is more limited, and cross-listing is mostly direct. At the end of 1999, 512 of 2,274 companies listed on the London Stock Exchange were foreign.

Trading is also moving offshore. During the 1990s the trading value of ADRs grew 22 percent a year, reaching \$758 billion in 1999 (Bank of New York 2000). As a result of these trends, listing and trading are concentrating, with the combined capitalization of the top five markets (New York Stock Exchange, Nasdaq, Tokyo Stock Exchange, London Stock Exchange, and Deutsche Boerse) accounting for about three-quarters of global capitalization and trading. Thus activity outside these centers is only one-quarter of global capitalization and trading (table 11.6; see also Clayton, Jorgensen, and Kavajecz 1999).

Increased cross-listing and use of depository receipts and other means of raising international capital reflect the recognition among large corporations worldwide that larger stock markets offer more financing, lower capital costs, greater liquidity, and better name recognition than smaller ones. Empirical evidence provides strong support for this

5. The increase in market capitalization reported in table 11.5 will be enhanced in countries that have not achieved low inflation if the estimated coefficients in table 11A.5 are used instead of the coefficients in table 11.4. But this will be counterbalanced by a reduction in the positive effects from increases in the value of institutional investor assets and improvements in investor protection. On net, this leads to a reduction in the projected market capitalization across all transition economies, especially in countries that have poor shareholder protection—such as Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Croatia, and Georgia. Projected market turnover also decreases across transition economies, but not uniformly. Countries that have made significant strides in accumulating institutional investor assets stand to gain less. But countries that can still improve investor protection record a higher increase in market turnover. These robustness checks show that the results reported in table 11.5 should be seen broadly as the most optimistic scenario, the upper bound of growth potential of stock markets in Central and Eastern Europe and the former Soviet Union.

**TABLE 11.6 FEATURES OF THE WORLD'S LARGEST STOCK EXCHANGES, 2000**

<i>Market or exchange</i>	<i>Average daily trading volume (billions of U.S. dollars)</i>	<i>Market capitalization (billions of U.S. dollars)</i>	<i>Links with other exchanges or electronic communication networks</i>
New York Stock Exchange	35	12,000	Preliminary talks with Toronto Stock Exchange, Euronext, and Mexico's Bolsa; cooperative links with Tokyo Stock Exchange
Nasdaq Stock Market	41.5	5,020	All electronic communication networks trade Nasdaq stocks; deals with Osaka Stock Exchange, Deutsche Boerse, London Stock Exchange, Quebec government, Hong Kong Stock Exchange, and Australian Stock Exchange
Tokyo Stock Exchange	6.8	4,100	Cooperative links with exchanges in the Republic of Korea, Philippines, Singapore, and Thailand, as well as with the New York Stock Exchange
Deutsche Boerse	4.53	1,500	Merger with London Stock Exchange, Nasdaq joint venture, MarketXT joint venture
London Stock Exchange	13.5	2,800	Deutsche Boerse merger, Nasdaq joint venture
Hong Kong Stock Exchange	1.5	568	Co-listing agreement with Nasdaq and New York Stock Exchange
Paris Bourse	4.18	1,500	Euronext alliance
São Paulo Bovespa	0.4	208	London Stock Exchange, Lisboa Stock Exchange, Argentina's Caja de Valores; New York Stock Exchange
Australian Stock Exchange	0.8	370	Nasdaq; Singapore; New York Stock Exchange
Toronto Stock Exchange	2.85	1,700	New York Stock Exchange, Euronext, Hong Kong Stock Exchange, Mexican Bolsa, São Paulo Bovespa
Globally total	148.8	35,005.4	

Source: *Wall Street Journal*; Fédération Internationale de Bourses de Valeurs.

assessment. When firms from emerging markets use ADRs or GDRs or list on U.S. equity markets, their financing constraints are relaxed—that is, their new investment becomes less sensitive to internal cash flow (Lins, Strickland, and Zenner 1999). In addition, domestic firms that enter international markets obtain better financing opportunities and extend their debt maturities (Chaplinksy and Ramchand

2000). Trading in foreign markets is typically much more liquid than in local markets. For example, Mexican stocks with ADRs see more trading in New York than in the domestic market, with mixed benefits for investors (Domowitz, Glen, and Madhavan 1998).

Because corporate governance rules are more stringent for international listings, corporations have used them

to signal that they are willing to protect the rights of minority shareholders. Corporations from countries with weak corporate governance laws are more likely to list (cross-list) abroad if they are allowed to do so (Reese and Weisbach 2000). And by raising bonds abroad (in the United States), corporations certify to act in the interests of investors and so lower their borrowing costs and increase shareholder wealth (Miller and Puthenpurackal 2000).

New Internet-related startups in Latin America and Israel, for example, are establishing their legal domicile in the United States to facilitate the raising of new capital. Cross-listing will be further facilitated by the recent announcement that the International Organization of Securities Commissions, the club of stock market regulators, will develop more complete international accounting standards. Incoming multinational corporations could use these standards in cross-border offerings and listings.

### *Trading Systems Are Consolidating and Going Global*

These trends are being influenced by advances in information technology that make it easier for market participants to trade from remote locations. Trading is moving toward electronic forms that are not tied to any particular location. Nasdaq's computers are based in Turnbull, Connecticut, for example, but traders are located around the globe.

A number of electronic communication networks have emerged in recent years. These networks started as pools of liquidity feeding into existing markets, but they increasingly serve as alternative trading outlets. Electronic communication networks now account for a large share of trading in some developed stock markets—for example, they account for one-quarter of the dollar volume of Nasdaq trading.

Alternative trading systems are also being set up around the world, often with links to existing trading systems. For example, Instinet started out as a brokerage service but now has automatic routings to a number of stock exchanges.<sup>6</sup> There is speculation that a few trading systems will emerge globally that allow investors to trade 24 hours a day. Existing exchanges are recognizing that their services—trading systems—are becoming a commoditized product offered through other means.<sup>7</sup> Many observers predict that traditional stock markets (such as the New

York Stock Exchange) will cease to exist in their current form, reflecting changes in corporate structure, physical trading location, and institutional organization (such as the distinction between specialists and retail brokers).

Reflecting these competitive pressures and the general desire for increased liquidity through larger markets, many stock exchanges in developed countries have established links or even merged. Recent examples include the proposed mergers of the Amsterdam, Brussels, and Paris exchanges and of the London and Frankfurt exchanges; the joint ventures and alliances between Nasdaq and stock exchanges in Australia, Canada, Japan, and Hong Kong (China); and a joint venture between Nasdaq and the proposed London-Frankfurt exchange focusing on growth stocks (table 11.6). The Singapore and Australian stock exchanges recently agreed to cross-list all traded shares. The New York Stock Exchange has formed alliances with the Tokyo Stock Exchange, Australian Stock Exchange, Toronto Stock Exchange, Mexican Bolsa, São Paulo Bovespa, and Euronext to trade through linked exchanges 24 hours a day. The consolidation of these markets, which account for more than 60 percent of global market turnover, is leading to a small number of very large markets.

### *Most Transition Economies Have Missed Out on These Developments*

With few exceptions, transition economies have not participated in these consolidation trends. The only merger has been among the three Baltic exchanges (Estonia, Latvia, Lithuania), which also have established links with Helsinki (Finland). Other countries are still pursuing a “made at home” strategy. Global trends suggest that many of these import substitution approaches are doomed to fail. Even under a best-case scenario, most transition markets will remain small even relative to most emerging markets—let alone compared to developed markets. This raises the question of whether transition-economy stock markets will achieve the economies of scale needed to compete internationally alone, or whether they need to join global alliances.

To reach the point where increasing market activity is associated with decreasing costs in the processing of trades, a market needs to have capitalization of more than \$15 billion (Malkamaki 1999). Using the best-case scenario for

6. For purposes of executing cross-border transactions involving foreign securities, retail investors are, in effect, connected to foreign markets through an electronic “pass through.” A U.S.-based investor may, for example, be linked electronically to a U.S. broker-dealer, who in turn is linked electronically to foreign markets, either directly or through a local broker-dealer.
7. To the extent that they have not done so already, many exchanges are considering demutualizing—that is, becoming for-profit organizations—to survive in an increasingly competitive environment.

market turnover from table 11.5, only four of 26 transition economies will reach this point by 2005—the Czech Republic (with an estimated \$19 billion in market capitalization in 2005), Hungary (\$16 billion), Poland (\$46 billion), and Russia (\$53 billion). The next largest markets, Romania and the Slovak Republic, will each have market capitalization of less than \$5 billion. This suggests that, given their scale, most stock markets in transition economies will not be able to compete with other markets in providing trading services. Moreover, these estimates are based on existing economies of scale. The globalization of stock markets is continuously increasing the scale needed for trading systems to operate competitively and provide the desired liquidity, making an independent stock market an increasingly difficult proposition even for those transition economies that today appear to have sufficient size.

Low economies of scale are corroborated by the cost structure of stock markets in transition economies. Domowitz, Glen, and Madhavan (2000) use data from 42 developed and emerging markets to calculate the explicit and implicit costs of equity trading, where explicit costs include commissions and fees and implicit costs represent indirect trading costs (the main one being the price impact of trades). Even though most transition economies do not have explicit taxes that raise trading costs and lower liquidity, total costs in the leading transition markets (Budapest and Prague) are twice the sample average, about three times the costs in Germany and the United States, and about 60 percent higher than in leading Latin American and East Asian markets. This analysis suggests that even the largest transition-economy stock markets will have a hard time competing internationally.

## Appendix

TABLE 11A.1 NUMBER OF LISTED EQUITIES IN TRANSITION AND COMPARATOR ECONOMIES, 1994–2000

<i>Country</i>	1994	1995	1996	1997	1998	1999	<i>March 2000</i>
Armenia	1	1	10	59	82	86	95
Azerbaijan	0	0	0	1	2	2	2
Bulgaria	16	26	15	15	998	828	842
Croatia	29	61	66	77	50	59	59
Czech Rep.	1,024	1,635	1,588	276	261	164	154
Estonia	0	0	0	22	26	25	23
FYR Macedonia	0	0	2	2	2	2	2
Hungary	40	42	45	49	52	66	65
Kazakhstan	0	0	0	13	36	24	20
Kyrgyz Rep.	0	10	27	40	51	63	66
Latvia	0	17	34	51	69	70	64
Lithuania	13	351	460	607	60	54	54
Moldova	0	11	16	48	61	58	28
Poland	44	65	83	143	198	221	221
Romania	4	7	17	76	5,753	5,825	5,578
Russian Fed.	72	170	73	208	237	207	218
Slovak Rep.	18	18	816	872	837	845	843
Slovenia	25	17	21	26	28	28	34
Ukraine	0	96	99	102	113	117	120
Uzbekistan	0	0	0	4	4	4	3
Brazil <sup>a</sup>							472
Egypt							1,051
Germany							851
Korea, Rep. of							723
Mexico							185
Portugal							125
Thailand							390
Turkey							298
United Kingdom							2,274
United States <sup>b</sup>							3,025

Note: Excludes over-the-counter (OTC) traded issues. For example, in March 2000, 51 companies were registered with the Almaty (Kazakhstan) Stock Exchange and traded OTC, but only 20 companies were traded on the exchange. More than 100 companies are prelisted on the Macedonian Stock Exchange, more than 500 are prelisted in Moldova, and more than 2,000 are prelisted in Ukraine.

a. São Paulo Bovespa only.

b. New York Stock Exchange only.

Source: Stock exchange websites and information departments; Beck, Demirgüç-Kunt, and Levine (1999).

**TABLE 11A.2 MARKET CAPITALIZATION IN TRANSITION AND COMPARATOR ECONOMIES, 1994–2000**

<i>Country</i>	1994	1995	1996	1997	1998	1999	<i>March 2000</i>
Armenia	0	1	1	1	1	1	1
Azerbaijan	0	0	0	0	0	1	1
Bulgaria	0	1	0	1	8	6	5
Croatia	3	3	15	21	15	11	13
Czech Rep.	14	30	31	24	21	19	25
Estonia	0	2	10	11	28	31	36
FYR Macedonia	0	0	0	0	0	1	1
Hungary	3	5	12	33	29	31	34
Kazakhstan	0	0	0	1	1	2	5
Kyrgyz Rep.	0	0	1	5	7	3	3
Latvia	0	1	3	6	6	6	8
Lithuania	1	2	11	18	10	12	11
Moldova	0	0	0	2	6	22	19
Poland	3	4	6	8	13	18	21
Romania	0	0	0	2	3	2	2
Russian Fed.	2	5	9	8	7	25	19
Slovak Rep.	8	7	12	9	5	4	3
Slovenia	4	2	4	9	13	11	12
Ukraine	0	0	0	0	2	3	4
Uzbekistan	0	0	0	0	1	6	6
Brazil	27	24	24	30	27		
Egypt	8	10	16	23	28		
Germany	23	22	27	36	45		
Korea, Rep. of	44	42	34	22	24		
Mexico	45	39	31	33	29		
Portugal	15	17	24	34	57		
Thailand	92	82	66	44	29		
Turkey	19	14	15	25	17		
United Kingdom	116	119	137	146	161		
United States	74	82	101	122	151		

Note: Excludes over-the-counter (OTC) traded issues.

Source: Stock exchange websites and information departments; Beck, Demirgüç-Kunt, and Levine (1999).

**TABLE 11A.3 MARKET TURNOVER IN TRANSITION AND COMPARATOR ECONOMIES, 1994–2000**  
(percentage of market capitalization, mid-period)

<i>Country</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>March 2000</i>
Armenia	0	2	2	7	5	15	18
Azerbaijan	0	0	4	12	12	13	10
Bulgaria	0	8	1	1	2	4	6
Croatia	8	8	13	10	5	5	7
Czech Rep.	26	33	50	47	37	61	81
Estonia	0	0	59	78	108	44	21
FYR Macedonia	0	0	3	24	41	45	36
Hungary	22	17	42	76	112	103	93
Kazakhstan	0	0	0	2	2	2	3
Kyrgyz Rep.	0	2	8	2	6	2	2
Latvia	8	12	15	35	24	21	19
Lithuania	0	37.3	9	18	16	13	7
Moldova	0	0	12	81	173	81	62
Poland	177	72	85	78	54	62	69
Romania	2	7	72	73	66	58	45
Russian Fed.	367	7	11	20	11	27	40
Slovak Rep.	96	69	134	109	74	48	25
Slovenia	68	71	82	31	35	28	22
Ukraine	0	5	11	6	4	12	19
Uzbekistan	0	3	19	12	3	2	4
Brazil	76	47	61	85	70	64	54
Egypt	19	11	22	33	22	38	47
Germany	98	109	123	137	145	152	167
Korea, Rep. of	172	97	109	171	183	223	288
Mexico	44	31	42	40	28	32	35
Portugal	36	48	59	67	96	114	127
Thailand	60	41	36	39	70	86	89
Turkey	87	221	139	128	141	167	193
United Kingdom	78	78	37	44	53	62	73
United States	70	85	92	104	106	117	141

Source: Stock exchange websites and information departments; Beck, Demirgüç-Kunt, and Levine (1999).

**TABLE 11A.4 INFLATION IN TRANSITION ECONOMIES, 1992–2000**

<i>Country</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000<sup>a</sup></i>	<i>Average 1994–99</i>
Armenia	1,341.0	10,896	1,885.3	31.9	5.8	21.8	-1.3	8.2	—	325.2
Azerbaijan	1,395.0	1,294.2	1,788.4	84.5	6.5	0.3	-7.6	1.7	—	312.2
Bulgaria	79.0	63.8	121.9	32.9	310.8	578.6	1.3	1.8	7.2	174.5
Croatia	938.2	1149	-3.1	3.8	3.4	3.8	5.4	4.0	5.5	2.9
Czech Rep.	12.7	18.2	9.7	7.9	8.6	9.8	6.8	3.5	4.3	7.7
Estonia	953.5	35.6	42.1	28.9	15.1	12.4	4.4	3.1	4.7	17.7
FYR Macedonia	1,935.0	241.8	55.1	9.0	-0.6	2.6	-3.1	2.2	—	10.8
Hungary	21.6	21.1	21.2	28.3	19.8	18.4	10.3	8.1	9.2	17.7
Kazakhstan	2,984.1	2,169.3	116.1	60.4	28.6	11.3	1.9	19.6	14.2	39.7
Kyrgyz Rep.	1,259.0	1,363.2	95.7	31.9	35.4	14.7	18.3	40.1	—	39.3
Latvia	959.0	35.3	26.2	23.1	13.1	7.1	2.8	2.1	2.9	12.4
Lithuania	1,161.1	188.8	45.2	35.5	13.1	8.5	2.4	2.5	3.5	17.9
Moldova	2,198.0	837.2	115.8	23.8	15.1	11.2	18.2	29.7	n.a.	35.6
Poland	44.3	37.6	29.4	21.4	18.5	13.2	8.6	6.5	n.a.	16.3
Romania	199.2	295.5	61.7	27.8	56.9	151.4	40.6	38.9	40.5	62.9
Russian Fed.	2,506.1	840.1	204.4	128.6	21.8	10.9	84.5	45.3	18.2	82.5
Slovak Rep.	9.1	25.1	11.7	7.2	5.4	6.4	5.6	14.5	14.3	8.5
Slovenia	92.9	22.8	19.5	9.1	9.2	8.8	6.5	6.4	n.a.	9.9
Ukraine	2,730.0	10,155	401.2	181.3	39.7	10.1	20.1	17.2	25.2	111.5
Uzbekistan	910.1	885.2	1,281.2	117.4	64.1	49.8	26.2	42.3	n.a.	263.4

— Not available.

a. Projected.

Source: International Monetary Fund (2000).

**TABLE 11A.5 DETERMINANTS OF MARKET CAPITALIZATION AND MARKET TURNOVER IN TRANSITION AND COMPARATOR ECONOMIES, 1994–99**

<i>Dependent variable</i>	<i>Market capitalization</i>		<i>Market turnover</i>	
	<i>Transition economies</i>	<i>Comparator economies</i>	<i>Transition economies</i>	<i>Comparator economies</i>
Inflation <10 percent a year	9.13* (3.79)	5.04* (2.28)	21.09* (2.34)	11.38 (1.31)
Inflation 10–50 percent a year	2.76 (1.47)	0.76 (0.49)	9.29 (1.17)	6.58 (0.86)
Inflation 50–100 percent a year	2.08 (1.02)	0.46 (0.25)	7.41 (1.70)	15.42 (1.11)
Medium shareholder protection (index of 2 or 3)	-1.24 (0.59)	-2.75 (1.38)	31.21* (5.29)	19.10* (3.83)
High shareholder protection (index of 4 or 5)	2.13 (0.83)	0.35 (0.13)	40.59* (4.71)	20.87* (2.77)
Institutional assets	0.46* (11.66)	0.43* (10.06)	1.60* (3.18)	0.90* (1.97)
Log GDP per capita		3.19* (3.42)		25.34* (9.11)
Number of observations	216	216	216	216
Adjusted $R^2$	0.81	0.82	0.23	0.46

\* Statistically significant at the 5 percent level.

Note: The table reports findings for a panel of 26 transition economies and 10 comparator countries (Brazil, Egypt, Germany, Republic of Korea, Mexico, Portugal, Thailand, Turkey, United Kingdom, and United States). Transition economies that do not have stock markets have a score of 0 on market capitalization and market turnover. The shareholder protection indexes are constructed from La Porta and others (1999), and Pistor (2000). Data on institutional investor assets are reported in table 11.3. Standard errors are heteroskedastic-consistent. A constant term is included in every regression. The t-statistics are in parentheses.

Source: Authors' calculations.

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## Chapter 12

# Emerging Stock Markets in Central Europe: Where Do We Stand?

*Wiesław Rożłucki*

**T**he past 10 years have brought an unprecedented scale of change in the structure and organization of European stock exchanges. Different forces have shaped their development in both the western and eastern parts of Europe. In the west, changes were driven by three main factors:

- Technological progress toward electronic trading
- Harmonization of the regulatory framework exemplified by the Investment Services Directive
- Introduction of the euro.

These changes resulted in the consolidation of stock market infrastructure as four consecutive developments occurred, beginning in the 1990s:

- The gradual disappearance of regional (subnational) exchanges
- Mergers of stock and derivatives exchanges
- The consolidation of exchanges, clearing, and depository organizations
- Alliances and mergers of national exchanges.

During the same period, the transition economies of Central and Eastern Europe witnessed the emergence of new securities markets and exchanges. Many of them resumed operation after 50 years of suspension. In 1990, the Ljubljana and Budapest exchanges started trading, followed by Warsaw in 1991 and Prague and Bratislava in 1993.

The development of capital markets in Central and Eastern Europe has been a complex and often controversial process, both in its initial conceptual phase in each country and in its subsequent evolution. There is, however, one common element: capital markets emerged in the process of economic transition from a planned to a market economy. In all the remaining aspects, wide differences can be

observed in the concept, extent, performance, and speed of development of capital markets in Central and Eastern Europe. It is surprising, taking into account initial conditions in the early 1990s, how differently capital markets in Central and Eastern Europe evolved over the past decade.

### **The Establishment of Markets**

In almost all the countries in the region, privatization was the primary impetus for the formation of capital markets. In contrast to typical emerging markets on other continents, thousands of enterprises, comprising the bulk of national economies, were privatized in a relatively short time. There was no precedent for privatization of this scale and speed, and little wisdom and advice based on past experience were directly applicable. Therefore, those who designed the strategies for privatization and the formation of capital markets in Central and Eastern Europe were breaking new ground.

Despite this, there was a universal sense that speed was essential. In other words, in contrast to other countries, many hundreds of state-owned enterprises had to be privatized as quickly as possible. In most countries of the region, the privatization process was expected to benefit ordinary citizens who had neither the financial resources to own shares nor the basic knowledge of what owning shares meant.

Capital markets were expected to provide the necessary infrastructure for privatization and secondary trading in securities. Taking into account privatization contingencies, the basic structures of capital markets had to be established rapidly. This was possible because of a relatively developed industrial structure, a high level of education, and general acceptance of the principles of a market economy and private ownership. The urgency of mass privatization and its impact on the structure of capital markets were not uniform in the region. In Hungary and Slovenia, for example, the development of capital markets was not shaped by mass privatization. In other countries, however, privatization to a large extent influenced the development of domestic capital markets.

### **Mass Privatization and Capital Markets: A Difficult Marriage**

Interrelationships between mass privatization and capital markets can be discussed drawing on the experiences of two neighboring countries: Poland and the Czech Republic. Although the idea of mass privatization originated in Poland (the concept of J. Szomburg and J. Lewandowski in the late 1980s), it was implemented first as voucher privatization in Czechoslovakia. As early as 1990, Poland and then Czechoslovakia had different concepts of capital markets. At a World Bank conference in Washington, D.C., in 1990, two different strategies of privatization and development of capital markets were presented for the Czech Republic and Poland, respectively.

The Polish approach was more conventional, if not orthodox. The desire was to follow, as much as possible, the patterns of regulation, organization, and practices of mature, developed securities markets. In building capital markets, Poland clearly preferred a tested solution and compliance with international standards. It was thought that regulation should precede trading practices. Trading was to be centralized to concentrate the initial low liquidity. In technical terms, electronic trading with dematerialized settlement and a depository was to be introduced. The licensing of brokers became obligatory, along with strict prospectus requirements for issuers of securities. The market was open to small investors, who were to be protected from the very beginning.

As a result, early in 1991 basic infrastructure for the capital market was established in Poland, consisting of a stock exchange, a central securities depository, licensed brokerage houses, and a securities commission. The regulatory and functional structure was based on practices of modern securities markets, notably France and the United States.

The idea of voucher privatization has always been popular in Poland. It took rather long, however, to design and implement the mass privatization program, covering 500 enterprises and managed by 15 national investment funds. By the time the program was launched in 1995, the structure and organization of capital markets were completed. The mass privatization program was shaped to fit in the existing structures of capital markets, as opposed to the other way around.

Clearly, developments in the Czech Republic followed a different philosophy and strategy. Absolute priority was given to voucher privatization. Transfer of ownership was the main goal, and capital markets were seen merely as a means to achieve this goal.

The authors of voucher privatization in the Czech Republic treated capital markets instrumentally and not as a public good in their own right. The infrastructure of voucher privatization (the RMS) was to be used later as a network leading to concentration of equity ownership. The speed of this process was considered essential for market reform. Common features of modern securities markets such as the high level of regulation and transparency or minority protection were seen as premature and potentially conflicting with the concentration of ownership.

This approach was not uniform in the Czech Republic. Those responsible for establishing the Prague and Bratislava stock exchanges had different views on the subject. The conflict between stock exchanges and the RMS drained scarce resources from those institutions.

During the past 10 years, a radical *laissez-faire* approach was modified in the Czech Republic and, for different reasons, in the Slovak Republic. Foreign investors played an important role because they were only comfortable with standards similar to their own. In hindsight, it is still surprising how deeply initial concepts influenced the subsequent development of capital markets. Despite recent improvements in regulation and transparency of the Czech market, certain habits were difficult to overcome, as evidenced by the problems of the Securities Commission early in 2000.

In Poland, in contrast, the Securities Commission and regulation in general have always been very strong. To many observers, Poland has an overly regulated market. Both the Czech and Polish markets must evolve toward a European model, which is being formed within the European Union (EU). The structure of the capital markets in Poland in 2000 is probably closer to the EU model. More time is needed to judge how mass privatization programs contributed to the development of capital markets as well as to economic transformation and growth in general.

### East and West: Bridging the Gap?

Given the differing approaches to economic transition and capital market development in Central and Eastern Europe over the past 10 years, which countries have been more successful in building their capital markets? As any qualitative judgment is difficult and subjective, it is safer to use standard quantitative measures of stock markets. To allow comparison, smaller securities markets in Western Europe can be used as a benchmark.

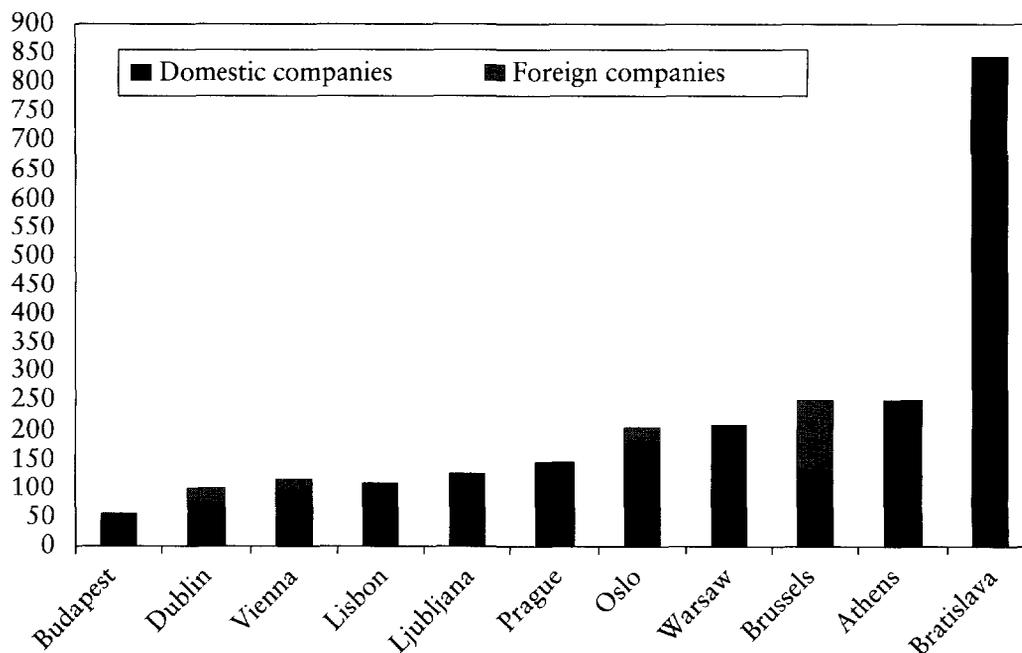
The question to be answered is whether the stock markets in Central and Eastern Europe still belong to different categories, or whether some convergence has occurred. In comparing five Central European markets to six smaller western markets, figure 12.1 indicates that, in terms of the number of listed companies, there is a continuum and not a sharp divide between eastern and western parts of Europe. Some figures should be examined with caution, as exemplified by Bratislava, where only 9 companies out of 846 are "listed" in a proper sense of the word. In Poland, however, all 221 companies, no matter the segment of the market in which they are traded, fulfill strict admission and reporting requirements to be classified as "listed."

In terms of market capitalization and trading volumes (figures 12.2 and 12.3), the situation in Central Europe is

much less favorable. The figures for eastern and western markets are quite divergent. In general, the smallest markets in Western Europe are several times larger than the biggest markets in Central Europe. The only exception to this rule is Vienna, where market capitalization is smaller than that of Warsaw and trading volume is smaller than that of Warsaw and Budapest.

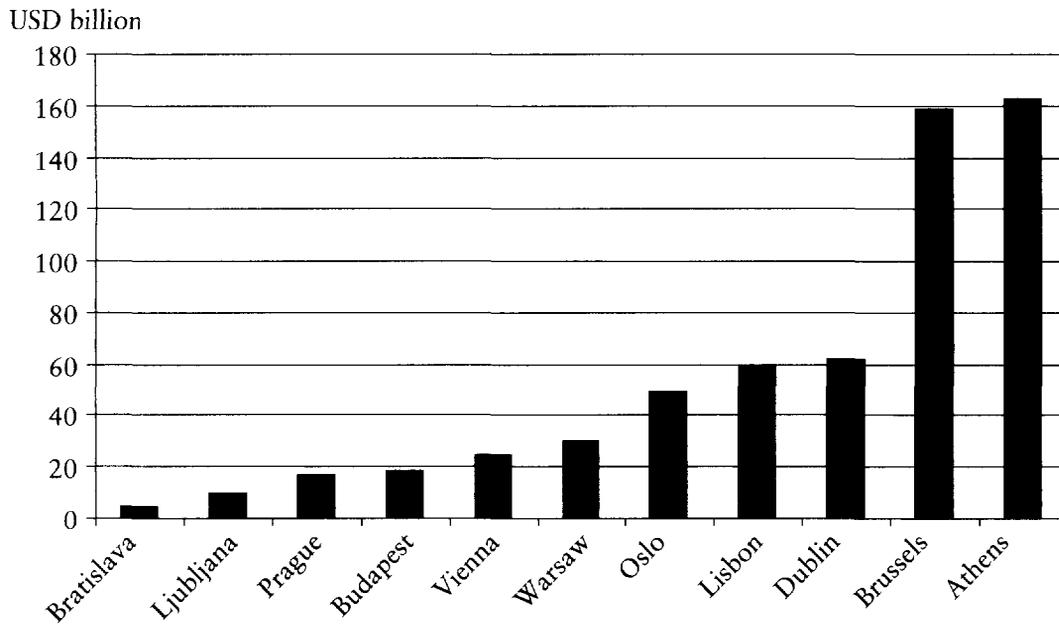
In the terms of size, European stock markets are very different, not only between east and west but also within each part of the continent. Market capitalization of Warsaw is 50 times bigger than that of Bucharest or Sofia. Those markets, in turn, are much bigger in comparison to the very small, embryonic markets at the end of spectrum (for example, FYR Macedonia). After 10 years of accelerated development, the most advanced stock exchanges from Central Europe managed to bridge the gap, dividing them from their smaller western counterparts. Some exchanges have achieved more than just catching up with small western exchanges. Both Budapest and Warsaw, which recently developed their derivatives markets, managed to overtake Vienna, Oslo, and Copenhagen in trading index futures. In sum, the process of convergence between stock exchanges of Western and Central Europe is clearly under way, producing a continuum of ranking rather than two different classes of markets.

**FIGURE 12.1 NUMBER OF LISTED COMPANIES IN CENTRAL AND WESTERN EUROPEAN MARKETS, MARCH 2000**



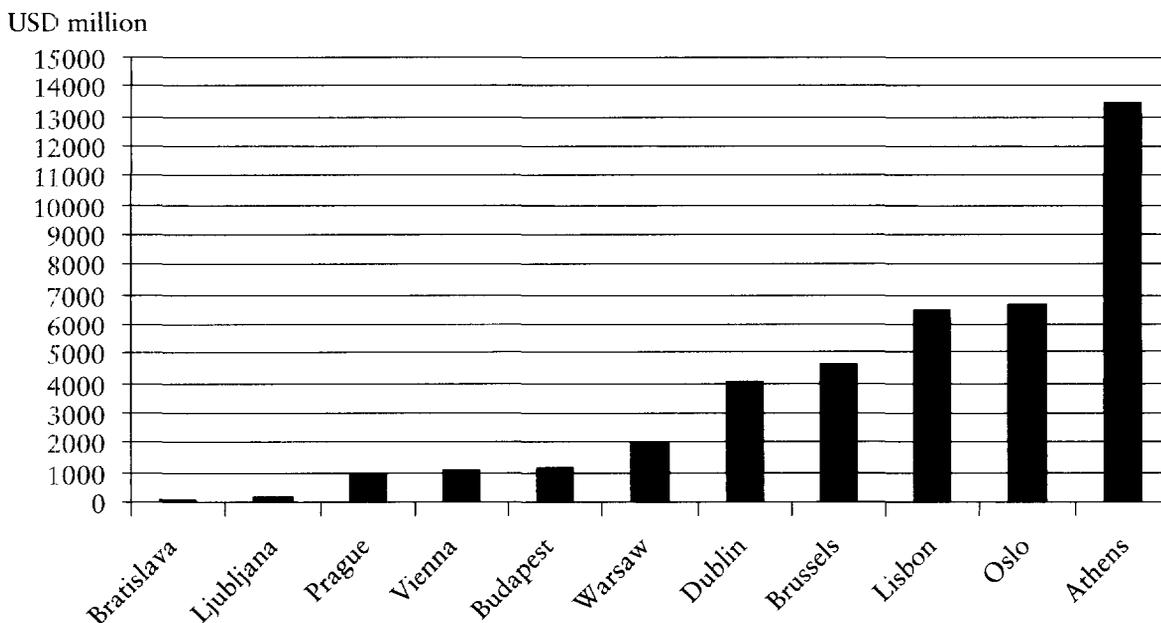
Source: FIBV and Standard & Poors.

**FIGURE 12.2 MARKET CAPITALIZATION OF DOMESTIC COMPANIES IN CENTRAL AND WESTERN EUROPEAN MARKETS, MARCH 2000**



Source: FIBV and Standard&Poors.

**FIGURE 12.3 AVERAGE MONTHLY TRADING VALUES IN CENTRAL AND WESTERN EUROPEAN MARKETS, JANUARY-MARCH 2000**



Source: FIBV and Standard&Poors.

### Consolidation in Central Europe?

As some exchanges from Central Europe have reached a level of maturity and sophistication similar to western exchanges, the question arises whether they also will be affected by the consolidation trend of Western Europe. At the national level, this has already taken place. For example, the Warsaw and Budapest exchanges run both cash and derivatives markets. They also own important stakes in their clearing, settlement, and depository institutions.

Even within the existing structures, much can be done to increase market capitalization, the number of listed companies, and the involvement of local investors, both individual and institutional. No stock market in Central, not to mention Eastern, Europe has reached a level adequate to the size of its population and economy. At the end of 1999, market capitalization reached 5 percent of GDP in Slovakia, 11 percent in Slovenia, 20 percent in Poland, 21 percent in the Czech Republic, and 33 percent in Hungary. Those figures are several times smaller than corresponding indicators in Western Europe and show an untapped potential of domestic markets in Central Europe. The recent development of pension funds in Poland, as well as continued activity of retail investors, shows that the shortage of domestic capital should not be viewed as a factor limiting the development of a domestic stock market. This argument assumes a continued policy of free and easy access of foreign investors to those markets.

Cross-border investment raises a question of supranational consolidation of trading and other functions of national stock exchanges. If new attractive solutions are not found, the process of consolidation can be as long, complex, and political in Central and Eastern Europe as in the West.

### Foreign Listings and the Risk of Fragmentation

At present, foreign investors can trade securities from Central and Eastern Europe both directly in domestic markets and outside the region, the main place traditionally being London. To a smaller extent, such trading has been going on also in Vienna and several German exchanges. A joint project of Vienna and Frankfurt called Ost Boerse, and recently renamed Newex, has been in progress for some time. Its designers hope to concentrate trading of blue-chip companies from Central and Eastern Europe. Its target group comes from institutional investors of Western Europe.

From the very beginning, the Ost Boerse/Newex project has not been discussed with Central European exchanges. It is no surprise, therefore, that their reaction was not positive. At a meeting in Prague in 1999, representatives of stock exchanges from Warsaw, Prague,

Bratislava, Budapest, and Ljubljana expressed their "surprise" with the Vienna/Frankfurt initiative. At the same meeting, the participants decided to coordinate their activities toward meeting the standards of the stock exchange in the European Union.

From the Polish perspective, the Ost Boerse/Newex project has not been favorably received. One concern is the risk of market fragmentation. Even in the United States, current discussion concentrates on excessive fragmentation of trading.

The markets of Central Europe are not big by international standards, and the risk of splitting liquidity is greater, leading to inefficient price formation and increased costs of trading. Several studies have shown that the major element in trading costs clearly is not the direct fees charged by intermediaries, but the so-called market impact, which is inversely proportional to the liquidity of each stock. Fragmentation reduces liquidity, thus raising the real costs of trading.

Trading equities requires complicated price-discovery mechanisms based on complex information. This information is usually centered on domestic factors, including economic policies, the political environment, company laws, and tax regimes. Moreover, economies of scale present in trading and settlement do not extend to listing, surveillance, and regulation. It is doubtful, therefore, that the concentration of trading that took place in foreign exchange, money markets, and interest rate products can be easily replicated in equity trading.

Fragmentation of trading would have a negative impact on the development of national markets. Transferring the main center of price formation outside national borders would discourage the natural growth of listings and the number of investors. It would be negative, not only for the Polish market but also for the European securities market in general. It is the mission of the Warsaw Stock Exchange to develop equity culture in Poland, increasing the number of investors in the country. No other exchange intends to do anything about it. Yet very shortly, Polish investors will start buying stocks in other markets. Therefore, the number of investors and their level of education will have a positive impact on many European markets. Anything that hampers this process cannot be seen in a favorable light.

### Joining the Network or Building Domestic Markets

In order to minimize the threat of fragmentation, national exchanges must provide open access (and exit) and high-quality, low-cost services according to European standards. They must watch carefully the integration

process in the West, preparing themselves to become nodes (hubs) in the inevitable electronic network of European exchanges.

To achieve this, they must act on two fronts: technological and regulatory. Technological platforms must be compatible with those standards that are now being established in Western Europe. Regulation must be harmonized with EU directives, as well as the market model developed by the leading European exchanges. In terms of corporate structure and ownership, domestic exchanges do not have to be owned by domestic institutions. Stock exchanges in Central Europe should be transferred gradually into demutualized, for-profit organizations open to foreign participants and shareholders. The natural partners in such development are foreign stock exchanges, investment banks, providers of information technology, and telecommunication services.

The emerging electronic network of European exchanges will set high standards in all aspects of technology, organization, and regulation. It seems that few established exchanges in Central and Eastern Europe will be able to achieve those standards in the near future. For them, the challenge will be to secure appropriate positions in the European network. For the remaining exchanges, the main task will be to build domestic or local markets serving their national economies and local businesses, while at the same time being open to foreign investors. The new Internet-based technology makes this strategy feasible.

When it comes to building domestic capital markets, the question of competition of bigger, foreign stock

exchanges is almost irrelevant. First and foremost, international stock exchanges are interested only in listing or trading a limited number of blue-chip companies originating from the Europe and Central Asia region. Most potentially listed companies are beyond their scope of interest. In a scenario where domestic stock exchanges do not play their proper role, most companies will be deprived of alternative sources of capital and valuation. The same argument holds for local individual investors, who will never grow in numbers and size if the only place to trade their local stocks is outside national borders.

Building a domestic investing community requires much more than efficient trading and settlement mechanisms, which probably can be supplied at the lowest cost by big international exchanges. Educating investors, attracting new companies, and monitoring reporting obligations are best done by domestic market operators and regulators. Even when it comes to the costs of trading, it is important to remember that the fees charged by stock exchanges and central depositories are only a small fraction of the total cost of trading paid by an investor.

Few of the functions of a domestic stock exchange in a transition economy can be performed by international capital markets. The failure of local capital markets would deprive countries in Europe and Central Asia of important national assets. The new Internet-based technology facilitates low-cost, efficient trading and settlement platforms. Other elements of regulated markets can be learned and constructed relatively quickly if there is adequate determination among decisionmakers in individual countries.

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## Chapter 13

# Emerging Capital Markets: A Slovenian Perspective

*Draško Veselinovič*

**I**t is still quite unbelievable that territories the size of Slovenia could break away from the former Yugoslavia and achieve international recognition as independent states. The same goes for the former Czechoslovakia and the other countries that were part of the former Soviet Union. The reasons for the breakups were political, and there was relatively little rational economic strategy behind them. Although a major factor was the inefficiency of the socialist nonmarket economies, most of these break-away states soon will find economic advantages in establishing economic ties with one another in areas like banking and capital markets. These ties will develop all the more strongly in the context of accession to the European Union (EU).

This chapter analyzes capital market development in emerging countries with special emphasis on Slovenia. It defines what constitutes a transitional or emerging economy and financial market and addresses some of the developmental challenges of emerging stock markets, including the question of whether a stock market is necessary for the economic development of transitional economies. Finally, the chapter examines the path of capital markets development in Slovenia and assesses its future prospects. The thesis explored is that, if the financial sector mirrors the real sector, a developed financial sector is not possible with an underdeveloped real sector, although the converse is possible. Slovenia represents a small and relatively successful transitional economy.

The generic phrases “transitional” or “emerging” often are used in reference to post-communist countries of the former Soviet Union (FSU) or those economies “transitioning” from low- or middle-income status to a higher-income

range, measured in gross domestic product (GDP) per capita per year. The World Bank, for example, defines countries in transition as those with more than \$10,000 GDP per capita per year.<sup>1</sup> According to the World Bank’s criteria, Slovenia falls into the world’s high-income bracket, yet it still is classified as a transitional or emerging economy.

### **Creating a Stock Market**

In setting forth a strategy for national economic development, small or emerging economies must decide whether developing a stock market should be a part of that strategy. Determining whether to go forward with the development of a stock market and stock exchange requires serious consideration of many important issues, because establishing a properly functioning and credible system requires a rather heavy front-end investment of money and political will.

The question of whether small or emerging countries need an organized stock market at all is one that has

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1. Approximately 70 percent of the European Union average.

attracted much debate. Stiglitz (1995) claims that stock markets are, by definition, irrational and inefficient in emerging economies and that resources flowing through them are irrationally allocated and, consequently, contribute negatively to GDP growth. This idea was adopted in part by early reformers in the Czech Republic, who advocated an extreme model of political and economic liberalization (Klaus 1994; Triska and Simoneti 1994). The early Czech economic reformers decided that there was no need for a stock exchange at all. Despite their view, a stock exchange was created with a very minimal regulatory infrastructure.

It soon became clear that the Czech stock market was too unregulated and needed to improve its regulatory structures and enforcement mechanisms. However, this extended period of relatively disorganized trading, together with the lack of adequate enforcement mechanisms and a substantially unregulated over-the-counter market system (the so called RM system), perpetuated many destructive (that is, nontransparent and unethical) trading practices, which resulted in a near collapse of the stock market when many foreign and domestic investors pulled investments out in the middle-to-late 1990s. The Czech stock market has not yet fully recovered from this costly period, although the regulation progress has been made in improving securities, corporate governance, and bankruptcy laws, as well as enforcement mechanisms.

Other economists take the position that stock markets are necessary for economic development in emerging economies (see, for example, McKinnon 1976). According to Bishop (1989), there are many important factors to be considered when deciding which model of a stock market or stock exchange to adopt. One of the most important issues is whether to implement a mass privatization scheme (vouchers or other forms of mass privatization; see Pirie 1991). The next policy question then becomes whether such markets are necessary after privatization is completed to spur ownership restructuring and dilute concentration.

Newly created stock markets tend to be over-regulated at the beginning, and this can damage the market at an early stage. However, if the market is not adequately regulated, as demonstrated by the early Czech model, irregularities can cause mistrust to flourish in the market and even in the financial system, which can be equally costly. It is impossible to establish a formula for the optimum level of regulation. Each market must have an appropriate governmental or quasi-governmental body with legal and regulatory authority to enforce relevant laws, regulations, and sanctions and to intervene in the market when necessary to ensure fair trading and transparency and to deter

unethical and fraudulent practices of market participants. The self-regulating role of the market (stock exchange, central depository or registry, associations of brokers, dealers, investment societies, and similar) will grow as the market develops, just as the capacity of the regulatory system must grow.

A well-functioning securities registry is a prerequisite for a successful stock market. The stock market has to win the confidence of the public by providing a reliable system of registration and transfer of securities. Dematerialization of all issued securities is desirable because it tends to be cheaper and more efficient, affords fewer opportunities for forgery and fraud, and makes the market more attractive to foreign investors. If this is not possible, securities should at least be immobilized, as the traditional (materialized) securities environment is much less desirable, although it is still used in many large financial centers. A virtual central marketplace for listed securities also provides better liquidity and transparency, which is of particular importance in emerging markets. Discussion of the value of electronic communications networks or alternative trading systems is of lesser importance here, as new emerging markets should focus more on providing the basic instruments and centralized liquidity. However, Rice (1999) points out that new technology also brings new financial instruments.

Ideally a centralized marketplace with proper infrastructure should be the main goal, although with as little market segmentation as necessary. Where market segmentation is necessary, adequate safeguards should be in place to prevent monopolistic pricing by market providers. Listing and disclosure requirements may vary among segments, but these requirements should be clear and strictly (but fairly) enforced within segments. Market segmentation can be quite costly and may not always increase efficiency or decrease transaction costs. A study by Malkamaki (2000) illustrates that increasing the size of individual stock exchanges does not always increase their relative efficiency. The Irish Stock Exchange is very efficient, although relatively small, as is the New Zealand Stock Exchange, while Amex, one of the largest, is the most inefficient.

Serious consideration should be given to selecting the methods by which trading will take place. The two obvious methods are price-driven (sometimes called quote-driven) or order-driven. Whether to choose direct (order) or indirect (quote or price) trading also depends on circumstances such as sophistication, risk awareness of financial intermediaries, financial soundness of intermediaries, and actual size of investors. Overall, the direct trading system seems to offer more advantages for emerging markets. Price-

driven trading loses some ground given the revolutionary technological changes that are taking place, including Internet trading. A direct-order system is simpler, easier to handle, and probably more transparent. Smaller or emerging markets should consider continuous trading systems for liquid stocks, one auction (fixing) per day for illiquid stocks, and a few auctions per day for stocks that are traded irregularly during the day, but in waves.

After the fundamental decisions about infrastructure, organization, and methods of trading are made, the choice of technology is the final decision to be made. Such decisions about technology are complicated by the fast pace of the technological revolution. Most important is to determine the technical conditions in a particular country (especially the level of telecommunications development and availability of programmers), and these should be analyzed against the requirements of the available technologies. Electronic trading is probably always the right course, but consideration must be given to whether to trade electronically on the “floor” or to employ remote methods. Other factors to consider are the quality of telecommunications infrastructure in the country as well as logistical and other customs of the financial community.

### Constraints on Stock Market Development

In their development process, the emerging stock markets have many hurdles to overcome. The primary one is creating a stock market from the ground up in an environment still lacking strong supporting sectors (banking, public, regulatory, and private). This is complicated by the fact that these stock markets typically are developing much faster than stock markets in developed countries.

Large local companies and international firms often seek original listings, parallel listings, or the so-called global depository receipts (GDR) programs abroad, because the local markets are too small (too volatile and illiquid). Some studies have tried to establish that foreign listings and GDR programs are endowing local markets with additional liquidity (Bank of New York 1998; Bankers’ Trust Company 1998). But many are of the opinion that GDR programs actually deplete local markets of needed liquidity.

Unstable macroeconomic conditions prevent a faster and more efficient development of the local stock markets. Adequate and credible accounting standards and

auditing practices (in line with international standards) are an absolute prerequisite for the development of a stock market. In many emerging countries, this has proven to be problematic, as is adequate development of the legal system, which goes hand-in-hand with low ethical standards (Steinmann 1999; Veselinovič 1999). Corruption is a particularly serious problem (Meško and others 2000).

Integration with international markets is, in the long run, probably most crucial for all small or emerging countries. In 2000, the developed European markets put much effort into cooperation and even mergers. London and Frankfurt have concluded deals with Vienna and Dublin, while Paris, Amsterdam, and Brussels have concluded deals with Luxembourg. There are a number of other initiatives as well. The end result eventually may be one large “super-bourse” or “pan-European” network.

Emerging countries will have to focus much attention on narrowing the technological and development gaps with respect to western European countries. Emerging stock markets should intensify cooperation among themselves, while competing among themselves to spur advancement. Such relations already exist, for instance, among the Visegrad group of countries.<sup>2</sup> The Visegrad countries (except Slovakia) are first-round candidates for full EU membership.

There also exist a number of regional political initiatives, including the South Eastern Cooperation Initiative (SECI) as well as the Southeastern Europe (SEE) initiative, or Stability Pact countries (based on Škoda 2000, which sets forth the new Marshall Plan for southeastern Europe).<sup>3</sup> There is also a Federation of European and Asian Stock Exchanges initiative (FEAS).<sup>4</sup> Turkey is increasing its involvement in some of these, and Slovenia is playing a very important role in SEE (the Stability Pact) and in SECI. Austria is taking steps to emerge as the regional center for the most important public companies from the southeastern European region—a role so far quite successfully cast by London and partly also by Frankfurt.

Stock exchanges can be divided into three categories: global, regional, and local. Global exchanges are large international exchanges in international financial centers that attract the majority of local, regional, and global capital and companies. Regional exchanges are those that are too small to be global and too large to be local and that can attract regional capital and companies. Local exchanges are

2. Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.

3. Albania, Bulgaria, Romania, and the former Yugoslavian countries (with the exception of Slovenia).

4. East Balkans, the southwestern territories of the former Soviet Union, western Asia, and even some parts of the Middle East.

usually the national exchanges in small countries; they may act in a regional capacity with respect to larger countries, but their focus remains local.

### Future Issues

In the future, Central and Eastern European (CEE) stock markets will be either regional or local, and all eventually will have to integrate into the globalized (European) markets. The position they achieve will depend on whether they lose some global companies and remain regional or local financial centers or networks. However, Malkamaki and Topi (1999) have predicted the likely trends in stock market development:

- Increasing cross-border investment activities and enhanced competition between marketplaces and providers of financial services
- Growing involvement of the largest institutional investors in direct trading, leading to efficient and cost-effective trading infrastructures
- Continuing integration of trading and settlement infrastructure via mergers, alliances, links, agreements, or other forms of cooperation
- Increasing emergence of new electronic exchanges and alternative trading systems operated by members of stock exchanges or off-exchange companies
- Growing numbers of Internet brokers.

If these trends prove correct, efforts to expand cooperation among ECA stock markets, in order to improve their position for integration with developed stock markets, is crucial. But parallel cooperation between the developed and ECA markets is imperative as well. Today, the developed markets influence the development of technologies and the need for electronic trading, clearing, settlement, and registry systems. However, to a certain extent, they also drain local exchanges of listings.

The most developed of the CEE stock markets are Hungary, Poland, and, to a certain extent, Slovenia, the Czech Republic and Estonia (see table 13.1).

Some of the stock markets noted in the table are already developing rapidly and are gaining in national prominence and credibility. They do not yet play a major international role, although they are gaining global acceptance and recognition. Many of these countries will have to focus on further organizational and developmental improvements to gain greater credibility locally.

### *Slovenian Financial Sector Development*

Slovenia is a small transitional country with an emerging financial market. It is one of the most developed of the CEE countries (see table 13.2). The development of the

Slovenian financial market, however, lags behind the development of the Slovenian economy (compare table 13.1 with table 13.2). Slovenia could improve its relatively high and stable growth rates if the financial market were more developed. The financial sector in Slovenia has undergone a successful process of banking rehabilitation. It is traditionally banking oriented, but with the insurance subsector playing a major role. Investment banking, brokerage houses, different types of investment funds (closed- and open-end), and other institutional investors are still developing niches within the Slovenian financial sector.

The Ljubljana Stock Exchange (LJSE) is a relatively well-organized secondary market. The primary market is underdeveloped, and it is still hard for private companies to raise money on the market, although this is not a problem for the government, central bank, and the financial sector itself. The level of Slovenian savings is relatively high, by European standards, although rather short term in nature. The result of the privatization process chosen by Slovenia is that company insiders and employees hold a majority of shares in 90 percent of privatized companies. The remaining 10 percent of privatized Slovenian companies are listed on the organized markets, and shares are held by the general public and investment funds. If a company issues publicly transferable securities of any kind, they are traded automatically on the free market segment of the stock exchange. To be listed on the stock exchange, there are many requirements—both quantitative and qualitative—of which the most important are disclosure requirements.

Slovenia combined two methods of privatization: the buyout (with 50 percent discounts) and voucher schemes. The mass privatization process caused an oversupply of equity securities on the market. Closed-end investment funds were used in company privatizations. Under the Slovenian privatization scheme, 10 percent of the companies were transferred to the National Pension Fund, 10 percent were transferred to the Restitution Fund, 20 percent were transferred to the Development Fund (which auctioned this portion to closed-end privatization funds), 20 percent were transferred or sold to insiders or employees (subject to certain conditions pursuant to law), and the remaining 40 percent were made available for public sale and/or to insiders (employees). Foreigners were not allowed to participate directly in the privatization process in Slovenia.

The ownership structure of Slovenian companies is not advantageous to the development of the capital market. The financial behavior of Slovenian companies is still inefficient, which is considered to be a remnant of the nearly 50

**TABLE 13.1 MARKET PERFORMANCE OF CAPITAL MARKETS IN SELECT COUNTRIES OF EUROPE AND CENTRAL ASIA**

<i>Country</i>	<i>Market capitalization in 1999 (millions of U.S. dollars)<sup>a</sup></i>	<i>Turnover (millions of U.S. dollars)<sup>b</sup></i>	<i>Turnover velocity<sup>c</sup></i>	<i>GDP (millions of U.S. dollars)<sup>d</sup></i>	<i>Market capitalization as a percentage of GDP</i>	<i>Number of listed companies</i>	<i>Country risk ranking</i>
Bulgaria	706.3	53.2	0.08	11,737	6.02	828	84
Croatia	2,584.5	70.0	0.03	21,249	12.16	59	70
Czech Republic	11,796.0	4,705.3	0.40	53,800	21.23	195	44
Estonia	1,789.3	229.0	0.13	7,856	22.78	25	55
Hungary	16,317.0	14,847.9	0.91	48,400	33.71	66	42
Latvia	390.9	35.0	0.09	6,221	6.28	70	59
Lithuania	1,138.4	284.0	0.25	10,760	10.58	54	61
Poland	29,576.7	10,820.0	0.37	135,915	21.76	206	43
Slovak Republic	1,100.0	488.5	0.44	20,347	5.41	830	66
Slovenia	2,854.0	1,203.1	0.42	20,011	14.26	134	32
Romania	873.1	300.2	0.34	34,700	2.52	5,825	107
Russian Federation	72,205.0	3,352.0	0.05	276,120	26.15	207	133

a. Capitalization excluding investment funds and including domestic companies only.

b. Turnover of main and parallel markets, including investment funds.

c. Ratio of total annual turnover of shares to market capitalization of shares.

d. GDP data for Russian Federation, Croatia, Poland, Hungary, Estonia, Latvia, Lithuania, Ireland, and Malta are for 1998; GDP data for Cyprus and Romania are for 1997.

Source: Standard & Poor's (2000a, 2000b); Bank of Slovenia (2000a, 2000b); Iceland Stock Exchange (2000); Focus. Monthly Statistics. FIBV, Paris (2000); unpublished IMF country statistics and EBRD reports; Country Risk, Commodity prices boost emerging markets, *Euromoney* 371 (March 2000): 106-10.

**TABLE 13.2 SELECT MACROECONOMIC INDICATORS FOR SLOVENIA, 1995–99  
(percent)**

Year	Real GDP growth	Budget deficit as a percentage of GDP	Public debt as percentage of GDP	Inflation	Unemployment <sup>a</sup>	Current account (millions of U.S. dollars)	External debt (billions of U.S. dollars)
1995	4.1	- 0.0	—	8.6	7.4	- 36	2.970
1996	3.1	+ 0.3	22.8	8.8	7.3	+ 39	4.010
1997	2.9	- 1.1	23.2	9.4	7.1	+ 37	4.760
1998	3.8	- 0.6	23.6	6.5	7.9	- 3.8	4.959
1999	4.9	- 0.7	23.8	8.0	7.4	- 581.0	5.491

— Not available.

a. From the International Labour Organisation.

Source: Bank of Slovenia (1996, 1998, 2000); Institute of Macroeconomic Analysis and Development (2000); unpublished data from the Ministry for Economic Relations and Development.

years of socialism. The LJSE plays an effective and active role in post-privatization restructuring with respect to ownership concentration. However, there is no effective demand for equity. Institutional investors (funds, insurance, pension funds) are not yet generating a significant demand for long-term assets. Mutual funds are growing rapidly, but closed-end privatization funds are not yet in a position to make any substantial demands on the market because of their lack of cash, and private pension fund schemes have only recently been established (in 2000).

The government and central bank both offer relatively attractive and safe financial instruments on the capital market. Fiscal policy provides good incentives for bank savings. Although minor restrictions on foreign portfolio investors have been retained in the market, foreign investors represent 1.5 percent of total volume of LJSE and less than 5 percent of total market capitalization of the LJSE or the Slovenia capital market.

Slovenia's market capitalization, volume of trading, and turnover velocity are average for an economy of its size. Concentration in the market is relatively high. Liquidity is focused on a few of the most active stocks. All privatization closed-end funds are listed in the free market section on the LJSE and are relatively liquid. All in all, there

is still some potential for developing the Slovenian capital market, although some Slovenian macroeconomists claim that this window will close quickly (Ribnikar 1999). Prašnikar and others (2000), for instance, believe that all larger companies will be listed abroad and that company managers will be not be willing to accept their rewards in equities or options if local (emerging) stock markets remain illiquid. The largest listed Slovenian company is Krka pharmaceutical company.<sup>5</sup> Two Slovenian companies are listed through the GDR program in London. Nevertheless, it is expected that, since privatization has been completed, the primary market will begin to function. The LJSE also is considering the establishment of a "new market" for fast-growing companies. As Slovenia is in the first round of EU accession countries, the continued integration of all sectors, including the financial sector, will help the capital market to play a stronger and more effective role.

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5. Worth just \$0.5 billion (market value as of May 2000, according to LJSE 2000).

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## Chapter 14

# Czech Capital Markets: Illusions and Disillusions

*Vladimír Rudlovčák*

**I**n the middle to late 1990s, debates concerning the development of the Czech capital markets became quite animated until eclipsed by topics of a more global consequence, namely the financial crises in Asia (1997) and Russia (1998). This chapter attempts to revive a number of those debates and looks back on some of the issues raised, admittedly with the benefit of hindsight and with more data and information.

### **Privatization and Stock Market Development: Synergies and Conflicts**

The Czech stock market arose out of the voucher auction, a specific component of the large-scale privatization that began in the former Czechoslovakia in 1992. In the five rounds of the auction, citizens purchased vouchers for a symbolic fee, and these vouchers were traded for stocks of about 1,600 privatized companies, which became publicly held companies. The second wave of the large-scale privatization was launched in 1994 in the Czech Republic, which, in the meantime, had separated from the Slovak Republic. This auction lasted nine months and consisted of six rounds in which shares of more than 800 privatized companies were traded. The uncertificated, dematerialized shares were registered in the Securities Center (SCP), which, supported by a large branch network, maintains records of share transfers, stockholders, publicly traded companies, and investment funds. After the second wave of large-scale privatization, the SCP registered more than 2,000 issues of shares and had approximately 6.5 million accounts of individuals, more than half of the entire population of the Czech Republic.

The voucher auctions proceeded smoothly, affording all participants equal treatment, and the results proved satisfactory. In each round, bids for the outstanding shares of simultaneously auctioned companies were collected via

local post offices. The relative prices of various stocks (expressed in vouchers) fluctuated in accordance with demand, and generally, the final sale prices were considered fair and adequate. This sent a positive signal to eager traders ready to begin trading stocks for real money. Most important was that the auctions provided the chance for the economy to begin to develop out from under the command of state bureaucrats. State enterprises which devolved into the hands of private shareholders were given a new lease on life.

### ***Large-Scale Privatization Goals***

The large-scale privatization process, and particularly its voucher component generated extensive debate and discussion. Approaches differed somewhat as to the methods to be applied, the institutional mechanisms, and ultimate goals. The transformation of the entire economy was a major process with many components, including privatization. Privatization was an important step, which served a number of purposes:

- Suppressing the role of the state in the economy and weakening the links between the state and the enterprises
- Starting a long-term and supposedly complicated process aimed at creating efficient structures of own-

ership, partly through gradual concentration of the massively, more or less evenly, distributed ownership rights

- Supporting development of a core private sector, based on small and medium enterprises from which a market economy would develop most rapidly
- Enabling a technologically backward and artificially expanded heavy industry sector previously dependent on Comecon to function without state subsidies and guidance, gradually separating, through natural selection, enterprises capable of efficient restructuring from those without prospects to survive
- Enabling all interested citizens to profit directly from liquidation of the centrally planned economic system
- Creating external pressures and incentives for fast development of institutions and rules of a functioning market economy.

To a large extent, the voucher auctions and other components of the large-scale privatization sent the appropriate impulses through the economy. There was little dispute that an important by-product of the privatization process and, more generally, a goal of the transformation as such, was to introduce capital markets. Nevertheless, debates flourished over the steps necessary to achieve this. Those who expected the instant creation of a Western-style capital market system did not fully comprehend the limitations involved in the large-scale privatization of a non-market economy, which still lacked the appropriate institutional and legal infrastructure, and, primarily, appropriately functioning enterprises. Functioning capital markets require an environment that includes stable, prosperous, and transparent enterprises. But privatization alone does not make companies instantly transparent and prosperous. In a post-communist environment, companies need time to re-structure and adapt to new structure to operate in a free market environment.

Originally, there were two views concerning suitable conditions for the further restructuring of the privatized enterprises. Some anticipated that the rapid sale of shares by early voucher investors would encumber the process of company restructuring. In an effort to mitigate this risk and spur restructuring, it was proposed that the quick sale of shares by early investors be somewhat restricted, and that internal structures of corporate governance be simplified on the grounds that the standard corporate governance models were not the most appropriate for shareholders, officers and directors with a little experience in managing non-standard restructuring tasks. Others warned that share ownership that was too thinly spread might also impede efficient company restructuring. It was decided to allow trading to

proceed in accordance with supply and demand to enable investors seeking to acquire larger blocks of shares to do so, and allow those interested in divesting ownership in favor of short-term profits to do so, in the hope this would expedite company restructuring. Naturally, this approach ushered in organized trading of newly acquired shares as well as introduction of the model of corporate governance used in mature economies. What still remains unclear is whether this model of corporate governance was the best for an adolescent market and whether the use of this model hindered fulfillment of the original goals of privatization and development of the Czech capital market.

### *Stock Trading as an Instrument to Accelerate Privatization*

Once the decision was made to promote trading in ownership rights as the primary incentive to improve the initial ownership structures, it became evident that an efficient system supporting mass securities trading was vitally necessary. A number of mass privatization models failed to a considerable extent due to the introduction of an insecure system of registration of ownership rights. Primarily, the system required the support of a robust and secure process for registering securities capable of preventing “evaporation” of the fragile new ownership rights in the massive transfer of those rights.

The centralized, electronically supported share registry system, with its backbone, the Securities Center, paved the way for an electronic system of trading. Technology was important as the system had to be user-friendly and easily accessible, and most trading was conducted directly and not through intermediaries. Additionally, it had to be efficient, secure, able to deal with direct trades as well as special auctions, and capable of accommodating a volume of trading that was expected to decline over time.

### *Legal and Technical Facilitation of the Privatization Securities Market*

The RM-System was equipped with a large branch and communications network, which covered the whole country and was originally designed to serve the needs of the privatization securities market and was not to support a sophisticated stock market or a full-fledged capital market. Having acquired the position of a securities market organizer, the RM-System extended its functions supporting the initial voucher auction. It served the Securities Center, supported the execution of direct trades outside of the organized markets, and introduced periodic auctions in 1993 when the securities market began. In the course of a period of several weeks, buy-sell orders were collected and

processed simultaneously, resulting in confirmed trades for some orders and denials for others. These periodic auctions were, in many respects, similar to the procedures of the voucher auctions. Improvements were made until orders were processed in a continuous auction. The system was equipped with clearance and settlement functions and later was able to accommodate on-line orders from individual customers or brokers.

From the beginning, the RM-System functioned as a division of a privatized company, with little participation from the state. Consistent with the general goals of transformation and privatization, the RM-System accommodated trading of all securities generated by large-scale privatization. Legally, the RM-System was introduced by the Law on Securities, which set forth a legal definition of "security" and the principles for uncertificated securities, established the Securities Center, enumerated rules for securities registration, authorized the Ministry of Finance to perform some essential regulatory functions in the area of securities, and defined legal obligations and activities of market organizers and broker-dealers. The original legislation contained weak disclosure and other requirements that are standard for capital markets. Initially, there were few legal requirements for the issuance and trading of securities, and enforcement capacity was rather weak. The law required basic information to be contained in a prospectus, but there were limited means for the regulator to require companies to update this information as necessary. It was expected that the privatization securities market would help companies consolidate and stabilize their structure of ownership, and, most probably, leave the area of public companies in order to undergo deep restructuring.

### ***Capital Market Development: Initial Problems***

Little was known at the outset about the proper sequencing of phases in the process of creating a full-fledged capital market, yet it was generally agreed that this was an important task for the economy. Many questions still had no answers, including whether certain types of companies should be the initial impetus for establishing a new capital market or what was the minimum level of institutional infrastructure necessary in view of the maturity of potential market players.

The most appropriate way to initiate a market is to promote a domestic bond segment with debt securities issued both by the state and by prosperous companies. In a transition economy, it is only worth considering launching a stock market after the economy has entered a path of steady growth, the banking and insurance sectors have attained a certain level of maturity, and some profitable and

well-performing enterprises have emerged. Profitable, stabilized enterprises should be the first to float their shares publicly, and market participation should be limited initially to sophisticated investors trading on their own account. Exposing the savings of small investors to the risks of an underdeveloped capital market operating in an unstable and risky environment, where even deposits in banks are not considered absolutely safe, is the best way to endanger successful development and completion of a modern financial system in the country.

Experiments in the financial sphere can prove risky. In the Czech Republic, individual savings that accumulated during the former system were to a large extent insulated from turmoil of the transition process. In the early 1990s, it was a high priority of the government to take all reasonable precautions to safeguard the savings of the population, despite the enormous transitional burden carried by the banking system in the adjustment to the market economy. This is why a parallel system for trading in securities, as opposed to the privatization securities market supported by the RM-System, was introduced. Stock exchanges were originally established in the two capitals (Prague and Bratislava) of the former Czechoslovak Federation.

In 1993, the Prague Stock Exchange (PSE) was established by a special law that contained all the necessary provisions for the gradual development of standard capital market mechanisms with the attributes of a mature market. The PSE was based on the principle of membership of many respectable institutions that were capable of full compliance with the rules and procedures necessary for proper regulation of the stock market.

One scenario for capital markets development could have been based on the parallel, but separate development of the two securities market organizers, the PSE and RM-System. The RM system could have focused fully on activities related to the specific privatization market, aimed primarily at optimizing ownership structures in privatized enterprises, with the prospect of covering some special segment of the future capital market; and the PSE could have served as the securities market with more rigorous rules, making full use of the powers given to it by the Law on Stock Exchanges. Had more attention been paid to separating the functions and operations of the PSE and the RM-System, the PSE might have implemented strict disclosure requirements, and a process for categorization of listed companies into different tiers according to size, efficiency, and frequency of trades.

Unfortunately, this did not happen. In an effort to remain faithful to the initial principles of the transition strategy which favored allowing market forces to promote

competition over centralized control mechanisms, private interests emerged as dominant where a better balancing of the public and private sector interests might have been beneficial.

As the legislation setting forth the roles of professional market participants was rather vague, these players proactively pursued carving out their longer-term niches and functions in the developing capital markets system. Both the PSE and the RM-System felt that their expensive equipment and prestige would be wasted if they cooperated, and as a result they began competing for the same clients. This was likely one source of many of the institutional problems, shortcomings, and misunderstandings that complicated the development of the Czech securities markets hindering the effective conclusion of privatization.

The initial trading volumes, artificially calculated market capitalization, and other quantitative parameters looked very promising and caused an unrealistic optimism on which future prosperity and evolution were thought to be well grounded. As a result, thousands of people actively participated in the market as brokers, dealers, and investment advisors, not to speak of those who joined in the business of collective investments. For instance, after quite a short period of time, there were more than 500 licensed broker-dealers. This created tensions in the securities markets that were becoming more visible as the potential of the privatization market to generate the expected initial profits was gradually being exhausted.

The unjustified, and to some extent misleading, “advertising” campaigns inviting investors, enchanted foreign investors greatly. Smaller domestic investors had rather bearish tendencies. The main trading base consisted of a set of publicly traded joint-stock companies with very uncertain chances for success and unclear corporate values. The result was a substantial oversupply of securities on the market, while the interest of active investors was concentrated on a limited number of enterprises that effected share prices. Shortly after the PSE trading floor opened in 1993, the PX-50, which is the official index of the Prague Stock Exchange, exceeded 1,200 points, and remained around the 1,000 level through the beginning of 1994. Shortly thereafter, a long-term decline began which ended in 1995 at 400 points. The index then oscillated between 400 and 500 points, and saw little growth until the year 2000. Early investors in Czech securities had reason to be disappointed, and hence began the wave of criticism of the Czech capital markets.

Critics concluded that the stock market was not well regulated, and not transparent enough, especially for the

period of 1993–95. From the beginning, the most frequently discussed shortcoming was a lack of transparency. Initially, many shortcomings were attributed to the absence of an advanced clearance and settlement system and other imperfections of a technical nature. When these technical problems were resolved, it became obvious that many problems still remained, including the insufficiency of the price-discovery function and consequent lack of uniformity of stock pricing and block trading in large blocks of stocks and, in this respect, predominance of direct trades. Special attention was given to the lack of shareholder protection (a very complicated and controversial issue under specific conditions and goals of large-scale privatization) and to problems related to the investment funds and unit trusts. As a consequence, a limited number of initial public offerings were quoted.

Many problems of the market originated from the fact that the privatized enterprises fell short of public expectations regarding profitability, and certain aspects of a corporate culture could not be enforced by market regulation. A rather serious problem resulted from the fact that the same stocks were simultaneously treated as belonging to the privatization securities market, and traded in the framework of the standard stock market. The privatization market was a temporary phenomenon intended to create ownership structures of privatized enterprises to support privatization. Typical for this market in its more advanced phase was dealing with high-volume direct trades, implying a non-uniformity of the prices and, consequently, unique regulatory circumstances that were supporting specific privatization goals. Yet the more standard component of the securities market—covering a very limited number of sufficiently large, well-performing companies—needed a more traditional kind of regulation. Regrettably, these and other questions have not been thoroughly analyzed, and the relevant discussions have been limited to simplified arguments on deviations from standard legislation and regulatory structures, leaving many questions unanswered.

### *Transparency in the Framework of the Privatization Market*

Lack of transparency in the market was the most frequent criticism. However, it must be admitted that the concept of transparency becomes rather elusive in the context of a post-communist transitional economy. The size and coverage of the privatization market and the millions of citizens participating in the voucher privatization and other forms of privatization (restitutions, small-scale privatization) meant that the Czech population had rather good access to the relevant information. But there are

many barriers to the distribution of information in a transition economy. Transparency has two basic aspects: (1) transparency of the *processes* related to operations on the securities markets and (2) transparency of the *material base* of the market, the current state, and performance of the publicly traded companies.

These separate concepts often get mixed together and it becomes unclear what kind of information is missing and how the alleged lack of transparency can be improved. The availability of information on market operations relates primarily to appropriate technical support and development of the trading systems. The situation has been improving, however, and the development here is not solely dependent on the improving and enforcing of disclosure requirements, improving technology, or the proliferation of firms which provide information and analyze data related to the securities markets. Also important is the reduction in the number of small trades associated with sales of stocks by those who acquired them in the voucher auctions. These trades tended to avoid organized markets and were executed primarily by registration through the Securities Center. As substantial volumes of these trades were exhausted, closing an initial phase of the privatization market, direct trades were transferred to the PSE and RM-System, and the criticism softened. Thus it was not entirely clear whether the complaints concerning transparency were related to the lack of information on prices and volumes related to direct trades from the privatization market, or whether they were simply coming from market organizers who felt excluded from profits in the direct trade market when there was no role for them to play.

The issue of access to company information in the context of the privatization market is even more problematic. First, it is important to consider the state of a recently privatized company. To disclose publicly the information describing the current situation and its unclear future prospects can cause misunderstanding and serious financial harm. Privatizing a company under a large-scale scheme is a somewhat artificial operation. Before undergoing restructuring and stabilization, the company has a rather cloudy future, and standard financial information, even if properly disclosed, would be of very limited use to investors.

Finally, there is an issue of enforcement. It is not easy to enforce disclosure requirements, let alone assess the quality and timeliness of the information disclosed. To punish a company by prohibiting trade in its stocks contradicts the goals of privatization and the very purpose of the privatization securities market but serves the interests of managers of the company and some stockholders. To punish the stockholders did not seem productive under the

circumstances. Punishing the managers seemed the better alternative but did not wholly solve the problem. Even more difficult was finding appropriate sanctions when disclosure requirements were not sufficiently met. Standard information and accounting data may often prove insufficient for investment decisions in a transition economy and may even be misleading. Under the circumstances, it is not surprising that for years the disclosure obligations of some 2,000 publicly traded companies were met by only 30–40 percent of the companies. In sum, newly privatized enterprises need time before they are capable of producing reliable financial information that might serve to encourage investors.

Standard transparency requirements and criteria as understood in countries with developed capital markets clearly are not so easy to apply in the early stages of a stock market created from a recent, large-scale privatization. A special aspect of transparency, relating to the actual structure of ownership, was not recognized in the early stages of market development. Initially, legislators consistently assumed that shareholders were anonymous. In the context of privatization and, especially, the privatization market, this approach was deficient. From the point of view of the privatization market, the ability to obtain updated information on the ownership structure is vital to potential investors interested in attaining an influential position among shareholders. This problem was rectified by the 1996 requirement for obligatory disclosure of shareholders with 10 percent or more of a company's stock.

### *Initial Public Offerings*

Many of those promoting rapid development of the capital markets based on large-scale privatization presumed that access to capital would be readily available to privatized companies after their transformation into public companies. This expectation was probably somewhat naive. As the banking sector develops and the banks become more experienced and understand better the enormous riskiness of the enterprise sector, a transformation economy experiences a heavy credit crunch. Even obtaining a simple bank loan for reasonable interest rates becomes quite difficult for any company. However, it was argued that functioning capital markets offer financial services cheaper than banks, because, for example the amount and payment of dividends can be made on a discretionary basis, yet interest payments must be paid at agreed rates and intervals.

In reality, the Czech capital market saw only a small number of initial public offerings (IPOs). This was primarily evident due to the lack of sufficient protection of shareholder rights (especially minority rights) and the

alleged unwillingness of controlling shareholders to dilute their interests by allowing entry of new shareholders. On closer analysis, the matter was not quite so simple or straightforward. Usually, a newly privatized company needs structural changes such as layoffs, reorganization, reorientation and upgrading of production, and modern managerial expertise. Such restructuring typically requires a strategic partner. If the IPO is the mechanism through which small investors are to acquire ownership rights in a company, they must first be convinced of the likelihood that the purchase of shares will generate revenue. In the case of funds targeted for fundamental restructuring, the question is whether this process will ensure sufficient returns for the current shareholders (most having purchased shares with vouchers) as well as for the new shareholders who invested cash.

Inevitably, other difficulties in privatization include the uncertainty of risk assessment in a non-mature market (so investors have some idea as to what risks they are assuming when they invest) and identifying a fair sale price for shares. In resolving some of these issues, perhaps the case-by-case method of privatization can more aptly provide solutions rather than relying on the questionable abilities of the nonstandard market. But the case-by-case approach is costly and not necessarily acceptable for all shareholders. Therefore, the privatization securities market fulfills a very specific and limited function of concentrating ownership to enable a limited group of shareholders who have an ownership stake in an entity to take decisions toward productive corporate restructuring.

Initially, in the Czech Republic, few investors purchased shares for cash, and a large majority of those who acquired shares through vouchers shortly disposed of them. Thus, in spite of all the criticism, imperfections, unethical or fraudulent practices of investment fund managers, and failure of some privatized companies, the purchase of shares for vouchers through auctions and their sale in the privatization market proved to be, on average, quite profitable, which was an intended goal of the voucher privatization. On the other hand, the privatization market was not meant as an instrument of teaching ordinary people to become investors and, consequently, actively participate in buying shares offered through IPOs.

There were also more tangible reasons to reduce the attractiveness of IPOs in the Czech Republic. In the very early stages of the capital markets, many companies, including banks, increased their capital through IPOs. Extensive advertising campaigns were launched to attract investors. Such investment risks were perhaps not wholly understood by small investors, who thought that buying

shares issued by a bank involved no risks, or were the relative equivalent of purchasing bonds or depositing money in a bank account. Shortly after new shares were issued, share prices fell sharply (fell to about 25–30 percent of the original value), and some companies and banks went bankrupt. This left many investors, both domestic and foreign disillusioned and disappointed. These problems were not limited to the performance of particular companies, but were closely related to the performance of the economy as a whole. Thus, the duration of declining share prices has been a serious obstacle to the launch of IPOs. This situation will likely resolve itself as progress is made in the development of the corporate sector, the overall maturity of the financial institutions, and general growth of the economy.

### *Investment Funds: A Principal Problem*

The manner in which investment funds were introduced was also a constraint to the successful development of the capital market, as well as to a more efficient privatization. In the beginning, the initial concepts of privatization, and its voucher component in particular, did not involve detailed considerations of investment funds or other institutions of collective investment. The pragmatically conceived, rather simple, model was based on the idea that such investment mechanisms would allow the small groups of investors to accumulate a joint package of vouchers and use the voucher auction to gain a significant interest in a company. It was envisioned that this process would help resolve the problem of thinly dispersed ownership and foster more direct interaction between shareholders and the companies they owned. There was little consideration of the sophisticated rules as to organizational structures of investor associations or funds.

The legislation finally adopted introduced funds in a manner similar to that present in standard capital markets. Under the law on investment funds, an investment fund was not permitted to acquire more than a 20 percent interest in the joint-stock company's total registered capital. In practice, fund managers had very limited powers to influence the companies whose shares they held. Trading in the stocks of privatized companies began at relatively high prices. Subsequently, though, a long-term fall in stock prices prevailed in an environment where the prices of most of the stocks were uncertain. Under these conditions, it was not possible to assess which steps taken by a fund manager were appropriate and which were not. For example, total passivity could prove to be much more effective than attempts to modify a portfolio with the aim of improving it. In the situation characterized by the overall

price decline, only a few funds decided to retain their original portfolio.

The first wave of the large-scale privatization saw the establishment of 264 investment funds, whose advertising campaigns generated an unexpectedly high number of voucher investors. The funds gained around two-thirds of all vouchers and, consequently, a corresponding share of assets. The second wave introduced unit trusts (mutual funds), which resulted in the participation of 195 investment funds, 37 open-end unit trusts, and 121 closed-end unit trusts, which acquired roughly two-thirds of available assets. One positive aspect was that about 50 percent of assets managed by funds were in the hands of approximately 10 large funds or groups of funds, with some of them being founded by large financial institutions. This guaranteed a certain level of professionalism and trustworthiness. These investment funds introduced certain distortions into the trading process resulting from the fact that most trading of these funds was done in larger blocks and primarily outside the scope of the central market. It is also not clear that the aims of participants in the funds and the fund managers were consistent. Authorities were fully aware of these problem but were reluctant to take any strong measures, as there were concerns about undermining new ownership structures at the outset. Moreover, the funds wielded too much economic power to trifle with. It was clear at the outset that future developments would bring problems and disputes. In the beginning, it was not clear how long the negative influence of such funds would prevail. It was obvious that many small funds would not last, but this also could have been the case of a large fund if the shareholders themselves had made a joint decision to liquidate the fund.

Imperfections related to the inadequate role of funds gradually became more visible, and a number of events in 1995 publicly exposed many of these problems. Some asserted that the largest funds founded by large banks created a special structure in the economy that controlled a significant part of the enterprise sector. It became clear that funds were becoming an obstacle to successful fulfillment of the privatization goals, not to speak of the capital market development. These problems were resolved by opening closed funds and placing new requirements on fund performance. The process of opening funds has been started, and its completion is scheduled for 2002.

## Conclusions

Despite the problems encountered in the early development of the capital markets, the steps taken in recent years by the Prague Stock Exchange have substantially

improved the structure of the market. About 150 core companies are listed with the stock exchange. The yearly volume of trades in securities supported by the systems of the PSE amounts to more than 90 percent of all trades. Privatized companies have not yet finished leaving the public markets, but, in general, the original number of about 2,000 public companies has been substantially reduced. Presently, the RM-System registers about 1,200 companies with access to its trading systems. After the latest amendment to the Law on Securities, more than 700 publicly held companies are expected to leave the organized markets, giving new impulse to standardization of the stock markets.

Despite all the shortcomings of the costly process of capital market implementation, the legal and institutional support of the market is, as of today, functioning and up-to-date. The same is true of the technological support for the relevant systems. The privatization market has enabled many people to become highly qualified specialists, such as securities dealers, investment consultants, and analysts. The most advanced informational technologies—including Internet and e-mail trading—are proliferating rapidly in the Czech Republic, giving stock market participants direct access to information systems of the PSE, RM-System, Securities Center, and other agencies. There are many opportunities for trading in securities, including foreign securities, with the assistance of a licensed broker.

The establishment of the Securities Commission in 1998 was an important step in the creation of a standard regulatory environment for the market. The commission has raised the quality of the disclosure procedures to the extent that the updated information concerning public enterprises is going to be available on the Internet. Of more than 500 brokerages (including licensed physical persons), less than 30 percent have received new licenses. New legislative initiatives are aimed at making the Czech securities legislation fully compatible with that of the European Union and, more generally, with the relevant international standards. The relevant regulations of the PSE and RM-System are being modified. The PSE also is preparing a special trading system for derivatives trading, and another new system (the New Market) is being created to support IPOs of middle-size companies.

Nevertheless, the market has not yet played a visible and effective role in the economy nor fostered the efficient allocation of funds. The latest situation in the area of open-end unit trusts, which have developed more rapidly than other financial institutions, seems quite promising. However, there are signs that the capital market finally might be maturing. The corporate sector seems to be coming to an important point in its restructuring and develop-

ment. The substantial group of enterprises constituting the core of the industrial system of the former centrally planned economy and fully dependent on the former Soviet Union and other Comecon markets, after having supported for a time the new developing market economy, is now at a final

crossroads. Many of these entities will not survive, while the others will have to streamline their activities and modify their products in accordance with demand. New investments will be necessary for the final restructuring and development, opening new opportunities for the capital market.

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## Chapter 15

# Capital Market Development in the Russian Federation

*Dmitri Vasiliev*

**T**he securities market plays a significant role in a modern economy, and the transitional nature of the Russian economy has had a strong impact on the functions and operation of its securities market. This chapter tracks the development of the Russian securities market over the period 1991–2000 and makes predictions as to its future evolution.

### **Economic Reform and the Securities Market (1991–99)**

As a result of reforms initiated at the end of 1991, the Russian Federation (Russia) is moving toward a market economy. Several major events have determined the development of the Russian securities market: the large-scale massive voucher privatization program, the financing of federal and local government deficits, the appearance of pyramid schemes, the nonpayment crisis, loan-for-share auctions, and the August 1998 banking crisis.

From 1992 to 1994, the large-scale massive voucher privatization and related events had a significant effect on market development. About 147 million privatization checks (vouchers) were issued as freely transferable bearer securities, accepted by the state as payment for shares of privatized enterprises. State-owned enterprises were transformed into joint-stock companies, and shares of the privatized enterprises were issued. Voucher privatization resulted, among other things, in the emergence of more than 40 million retail shareholders (individuals) and the establishment of the first Russian institutional investors (voucher investment funds).

From 1993 to 1998, the deficits of the federal and local budgets were financed by issuing securities, and this resulted in the collapse of the government securities market in 1998. Government short-term debt securities—govern-

ment short-term bonds (GKO) and federal loan bonds (OFZ)—were issued in book-entry (paperless) form. In 1992, the Ministry of Finance issued internal hard currency loan bonds (OVVZ) denominated in U.S. dollars and state savings loan bonds denominated in rubles in coupon-bearer form.

Domestic commercial banks were major investors in government securities, and some smaller banks had more than half of their assets in them. These banks suffered most from the collapse of this market. Fast growth of government debt, excessively high yields (50 percent and more annually in dollar terms), and the perceived reliability and liquidity of federal government debt resulted in the flow of a major portion of domestic savings into this market. This crowding-out effect inhibited the development of the equity market and depressed growth in the real sector of the economy.

From 1993 to 1994, new commercial institutions, including unlicensed financial companies, issued a massive amount of securities and substitute securities, and financial pyramids were widespread. In 1993–94, more than 1,000 financial pyramids attracted funds from some 30 million retail investors. The collapse of these companies in 1994–95 undermined individuals' confidence in securities venture capital companies. At present, fewer than 5 percent of individuals are willing to invest in such financial

instruments, and in 1994-97 the main task of the state in this area was to assist citizens in recovering the funds they had invested in venture capital companies. After these pyramids collapsed in the summer of 1994, as well as in light of the development of the government securities market and strengthening of the regulatory regime for the market, the absorption of funds by venture capital companies almost stopped in early 1995.

From 1992 to 1998, a nonpayment crisis occurred, accompanied by soft budgetary policy and the issue of specific instruments—treasury notes, tax waivers, and promissory notes. The crisis of nonpayment in the national economy—explained, in particular, by the challenges for enterprises of adapting to market discipline and the weak application of bankruptcy—resulted in a significant issuance of specific “securities,” which were used for settlements among economic entities. After this, in 1994-95 the Ministry of Finance issued a massive amount of treasury notes to be used for settlements with enterprises that had liabilities toward the federal budget. These notes were exchanged for tax waivers, which were acceptable for payment of federal taxes. In some cases, regional authorities also issued promissory notes, which allowed them to avoid complicated procedures for registering the prospectuses of municipal bond issues at the Ministry of Finance. A large issuance of promissory notes has inflationary implications and, in Russia, resulted in a great number of scandals related to the bearer form of these securities.

In 1995-96, loan-for-share auctions accelerated the development of the power of oligarchs and increased the instability of ownership rights, weakening confidence in reforms.

On the one hand, the August 1998 crisis seriously undermined the development of the securities market in general. On the other hand, it put an end to the pyramid of GKO, the overvalued ruble, and the strong power of banks, creating the conditions for economic growth in 1999-2000.

### **Establishment and Growth Stages (1991-97)**

The securities market in Russia began to develop in the first half of 1991, after the adoption of a resolution by the Council of Ministers in December 1990 (RSFSR 601 about approval of the provision on joint-stock companies). This first stage was characterized by the appearance of the first open joint-stock companies, the beginning of the trading of state bonds on exchanges, the creation of hundreds of exchanges, and the start of operation of the first investment companies.

By spring of 1992, various types of securities had appeared, with a wide range of maturities, issued mainly by the state and corporations. The regulatory framework for the securities market was formed in this stage. In December 1991, the Council of Ministers issued a resolution (RSFSR 78 about approval of the provision on issuance and circulation of securities and stock exchanges) that was to govern the securities markets for the next five years (except for privatized enterprises).

The main milestones of the second stage were the system of privatization legislation in 1992-94 and the creation and development of an organized government securities market (from 1993 onward). The starting point was a presidential decree issued in July 1992 (president decree 721 about organizational measures for the reorganization of state-owned enterprises and voluntary merger of state-owned enterprises into joint-stock companies), which had a significant impact on the development of the market in 1992-94. Voucher privatization technology became, in turn, a decisive factor in the development of securities market infrastructure.

In 1994, the Russian securities market exerted a strong influence over both economic and political developments in the country (both positive and negative). Thus, the sudden expansion of government short-term discount (noncoupon) bonds (GKO) in 1994 permitted a decrease in the amount of free monetary resources, which temporarily reduced the pace of inflation. At the same time, the government securities market inhibited investment activity on the corporate segment of the market and became one of the reasons behind the 1998 financial crisis.

The sharp increase in the population's savings encouraged the appearance of a large number of issuers (often financial pyramids) oriented to retail citizens. At the same time, the government failed to address the problem of financial pyramids, either through alternative and reliable financial instruments or through an efficient system for controlling and preventing fraud.

In 1994, securities first started being used as a means of resolving the nonpayment crisis (treasury notes). In that year also, Russia saw the first large investments by foreign investors in equities of privatized enterprises. The absence of an adequate regulatory system and mechanisms for stimulating domestic investment in corporate equities (through taxes and an appropriate macroeconomic and legal environment) up until the crisis of 1997-98 made the Russian equity market highly dependent on the cyclical flows of mostly speculative portfolio investments from abroad.

Therefore, two quantitative shifts coincided in 1994. On the one hand, the supply of securities increased sharply

because of heavy issuance activity (securities issues by privatized enterprises, the government, and financial pyramids). On the other hand, the demand for securities grew dramatically as a result of the involvement of foreign investors, the formation of a stable layer of the population with longer-term savings available to invest in securities, as well as the involvement of banks and other financial institutions in this market, a result of the drop in returns on hard currency and credit market operations.

By the time the mass privatization program had been completed (1992–94), the initial stage of institutional change in Russia was over. Its most important result was the formation of the corporate sector of the economy, the emergence of exchange and over-the-counter markets (including the trading infrastructure and secondary market for shares of privatized enterprises), and the appearance of institutional investors.

These factors determined market dynamics. Because the market grew so rapidly, the needs of issuers and investors exceeded the capacity of the market infrastructure. In 1992–93 the development of infrastructure was ahead of market development; by 1995–96 the situation had inverted. Fast market development also highlighted the need to develop new legislation and market infrastructure.

The third stage of securities market development (1996–97) was characterized by development of the legislative framework (introduction of the Joint-Stock Company Law and Securities Market Law), infrastructure development (growth of the number of professional market participants, appearance of licensed registrars and depositories, creation and development of the Russian trading system, and shaping of the self-regulatory system of professional market participants). These developments were accompanied by generally positive macroeconomic trends, a significant potential for growth of market liquidity and capitalization, and increased market stability. At the same time, poor corporate governance made Russian securities rather risky investments.

During this stage of market development, international recognition was growing, as was the access of various types of Russian issuers to world financial markets. Key events in this area were Russia's entry into the International Organization of Securities Commissions (IOSCO), assignment of international credit ratings, a successful eurobond issue, publication of the International Finance Corporation (IFC) Global Russia Index, and the structuring of programs for American depositary receipts (ADRs) and global depositary receipts (GDRs) by a number of companies. At the same time, the pyramid of GKO was growing at an exorbitant speed. The resulting finan-

cial crisis of 1998 dramatically altered the situation in the securities market.

### **Causes and Lessons of the 1998 Financial Crisis**

The world financial crisis started in 1997 and hit emerging markets most of all. Russia was no exception. Russia, like other emerging markets, felt the global reorientation of investment institutions' strategies in 1998. At the same time, the crisis on world financial markets led to relatively volatile national stock indexes throughout 1998.

Both the Asian crisis and the drop in world prices for primary goods were just the external causes of the financial crisis in Russia, which had its own specific origins. The catastrophic downfall of the Russian stock market in 1998 cannot be explained solely by unfavorable world financial conditions. These only aggravated the negative trends present in the Russian economy. Internal factors such as the GKO market, overvalued ruble, and poor regulation and supervision of the banking sector exacerbated the general situation in 1998.

The situation on the domestic state debt market was the mirror image of what was happening in the Russian equity market. The unique feature of the domestic state debt market was its short-term nature and significant share of foreign investors. Domestic debt was largely in short-term (mainly less than one year) securities. As a result, the monthly amount required to redeem previously issued bonds (without taking into account coupon payments on two- to three-year OFZs) reached the level of 10–15 percent of monthly gross domestic product (GDP). The sizable participation of foreign investors in the financing of the federal budget deficit heightened the dependence of the Russian economy on world financial markets. At the same time, the corporate equity market from 1995 to 1998 was totally dependent on the government securities market in both volume and dynamics.

The collapse of the GKO pyramid led to the collapse of the Russian equity market, and global investors stopped viewing Russia as a profitable investment after the country defaulted on domestic debt. Indirectly, the market also was affected by the indecision of the Russian government and the central bank regarding devaluation of the ruble: investors "incorporated" devaluation risks into the price of government securities, which, through growth of yields, resulted in the further fall of equity quotations.

Of course, the significant decline in stock quotations and market liquidity during the year beginning in the autumn of 1997 was connected to a range of factors:

- The danger of overall economic recession increased sharply, followed by a corresponding decrease in

profitability of Russian enterprises and a deterioration of their financial condition.

- Default on government debt securities, which domestic and foreign investors justly regarded as judicial nihilism, seriously undermined the confidence of investors in the securities of Russian issuers and led to a freezing of large amounts of investors' assets.
- A sharp decrease in the liquidity of shares of first-tier issuers and the complete illiquidity of second- and third-tier shares on the Russian equity market also resulted in a freezing of investors' assets, which led to a sudden decrease in market demand.
- Banking crisis, related not solely to losses on financial markets but also to the abolition of the primary source of revenues (the GKO and OFZ market), aggravated nonpayments, which had a direct impact on securities market participants.
- The difficult financial situation of almost all Russian brokers and the crisis of commercial banks paralyzed the securities settlement system and increased systemic risks.

As a result, the drop in quotations and liquidity of Russian shares directly affected investment perspectives. Russian companies were no longer able to attract funds by issuing securities on domestic and foreign markets. The state was unable to borrow or sell blocks of shares of Russian firms to financial investors. Market evaluations of Russian companies decreased significantly, which made it impossible to sell strategic blocks of shares to foreign investors. Direct investment funds, which had been planning in August 1998 to invest about \$1 billion in shares of Russian issuers, temporarily lost interest in Russian projects.

The financial crisis of 1998 posed a serious challenge for professional market participants. Market participants, holding assets in government securities, incurred significant losses, which affected the business of market intermediaries as a whole. Before July 1998, the number of professional market participants (brokerage, dealing, and fiduciary securities management) and their capital were increasing; after August the situation had changed completely. The strongest decrease took place in pure brokerage services as a result of the termination of the so-called "vacuum cleaner" era of the market's functioning (when smaller regional brokers were buying shares for Moscow brokers, who were selling them to foreigners). At the same time, in 1998 the dealer market for foreign investors also experienced a crisis, whereas traditional exchanges turned out to be the most viable in crisis conditions.

The subsequent period from September 1998 through the first half of 1999 can be characterized as post-crisis stagnation. Although some segments of the Russian financial market were reignited by autumn of 1998, many key issues remained unresolved until mid-1999 (uncertainty regarding debt principal and interest, the GKO restructuring scheme, a clear program of regulation and sanitation of the banking sector in crisis conditions, and overall uncertainty with respect to the prospects for Russian economic development). All of this deprived active economic entities of any clear short-term markers and led to stagnation in the market.

The financial crisis revealed serious impediments in the domestic securities market:

- The strong orientation of market participants toward speculative revenues and the lack of interest in long-term investments
- The very low level of participation of domestic investors in the market (both retail and institutional)
- Minimal interest of investors in transparency of the market (in part as a result of the continued struggle for control within enterprises)
- Weak protection of investor rights and a poor culture of corporate governance
- Poor coordination of efforts of the state regulatory authorities on the securities market and persistent conflicts of interests within the respective regulatory authorities, for instance, inside the central bank
- Preservation of significant gaps and contradictions in the regulatory framework for the securities market.

### **Post-Crisis Growth (1999–2000)**

The period from 1999 to early 2000 gives grounds for optimism regarding the prospects for development of the Russian securities market. Some positive assessments are based largely on the revitalization of Russian industry after devaluation of the ruble and the rise of world oil and gas prices, which increased the tax revenues of the budget and the revenues of exporters. Such positive dynamics were witnessed in the majority of industries, including the chronically depressed ones (such as electrical manufacturing industry, consumer goods, and agricultural products processing). The year 2000 was perhaps the most favorable for economic development in Eastern Europe over the past 10 years.

Several trends had a positive impact on the Russian securities markets during this period: the post-crisis economic growth in 1998–99 (with GDP growing 3.2 percent and industrial production growing 8.1 percent), a relative-

ly stable macroeconomic situation, and positive political developments in 1999–2000. In 1999, the Russian securities market was among the three most rapidly growing markets in the world. The price of Russian debt grew to 60–70 percent of its face value in 1999. The market capitalization of the blue chips grew 185 percent in one year. The RTS-Interfax Index became the second fastest-growing index in the world (after Turkey). In January 2000, investors became interested in second-tier companies, which is a sign of reorientation from purely speculative short-term investments to a longer-term strategy.

In 1999, for the first time since the financial crisis, a number of Russia's largest companies issued depositary receipts. Meanwhile, most Russian corporate borrowers on the eurobond market tried to fulfill their current obligations in a timely manner. Interest in Russian corporate bonds also renewed in 1999, and some of the largest companies issued debt that year.

Against this background, Russia's international credit rating is likely to improve gradually, which will have a direct influence on the ability of the government and corporations to attract capital in international financial markets. Agreements reached in February 2000 between the Russian government and the London Club of Creditors support these optimistic views in the medium term. However, problems still remain. The Economic Freedom Index, for instance, historically published by the American Legacy Foundation, estimates the investment climate in 161 countries. Russia occupies 121st place, being classified as "a mostly dependent country." Almost all countries of Eastern Europe and the Commonwealth of Independent States (CIS) are classified under the same category, although with better scores.

The following trends for the securities market are expected in the near term:

- Reduction in the number of professional market participants and an increase in competition
- Post-crisis redistribution of ownership in financial groups and corporations (which could result in many violations of shareholder rights)
- Appearance of financial instruments new to the Russian market, caused by the attempts of corporations to find alternative sources of capital (corporate bonds, warehouse certificates, and mortgage securities)
- Gradual development of new collective investment mechanisms (closed real estate unit investment funds)
- Efforts to improve the quality of corporate governance.

## Privatization and Corporate Governance

The Russian model of privatization practiced from 1992 to 1994 (called the biggest sell-off of state property in the twentieth century) determined the basic structure of corporate ownership and governance in Russia (loan-for-share auctions in 1995–96 did not change the overall direction of development, although they somewhat strengthened the position of oligarchs). Three-fifths of Russian open joint-stock companies in operation today arose as a result of privatization, and they account for four-fifths of all industrial production. This, in turn, predetermined to a great extent the nature and specific characteristics of the development of the Russian corporate securities market.

The principal features of the Russian model of privatization can be summarized as follows:

- Mass corporatization in the course of privatization (more than 30,000 open joint-stock companies were created in Russia, and there are more of these companies in Russia than in the rest of the countries of Eastern and Central Europe and the CIS combined).
- Significant special advantages for insider employees and managers and their widespread participation in privatization (at the very onset of the privatization process, 50–60 percent of shares were transferred to insiders for vouchers or were sold for cash).
- A large-scale (or free) distribution of shares in privatized enterprises for vouchers, which were issued to all citizens for a symbolic charge.
- The freely transferable nature of the vouchers and their free circulation on the market, which made it possible for processes involving the concentration of ownership to begin considerably sooner than the actual sale of shares (approximately 25–30 percent of citizens sold the vouchers they received, and one-third of the vouchers sold went into the hands of foreigners).
- The sale of shares under certificate-based privatization both directly and through intermediaries (some 25 million citizens became shareholders in 450 certificate investment funds, which were the first collective investment institution in post-communist Russia).
- The open nature of joint-stock companies created in the course of privatization, which allowed the processes of redistribution of ownership through the free sale of shares.

The initial structure of corporate ownership that emerged was the result of the implementation of this type of privatization model.

On average in 1994 insiders accounted for 60–65 percent of shares held in privatized enterprises, while outsiders accounted for 18–22 percent. The state's ownership was as high as 17 percent.

In connection with the state's hold on large blocks of shares in so-called strategic enterprises and by virtue of the size of these enterprises (which are typical of countries such as Hungary, the Czech Republic, and Poland as well), the structure of corporate ownership and the subsequent trajectory of the development of corporate governance differed sharply. This was the case across enterprises in the petroleum and gas industry, the electric power industry, and telecommunications, where the state's stake was usually around 38–51 percent. The insiders' stake was 20–30 percent. This compared with the majority of enterprises in light industry, the food industry, and the production of building materials, in which the state's stake was nonexistent or in the 10–15 percent range, and insiders played a dominant role.

Continuing participation by the state in the capital of many Russian enterprises is one of the main reasons for the inefficiency of their economic operations and the source of a number of Russian political and corporate scandals. Therefore, the privatization of these blocks is important, not just for eliminating the budget deficit but also for improving the efficiency of the Russian economy. The government has announced privatization plans involving the quick sale of minority (up to 25 percent) blocks of state-held shares in thousands of privatized enterprises but has not carried them out.

Generally speaking, the substantial dominance of insiders at the initial stage of development after privatization is the most important feature of corporate ownership and governance in Russia. This dominance by insiders and the inevitable problems and conflicts arising from it, which are related to the violation of shareholder rights, also characterize other post-communist countries. For example, they are occurring in Armenia, Croatia, Georgia, Lithuania, FYR Macedonia, Mongolia, and Slovenia.

Certificate-based privatization resulted in a major dispersion of owners in Russia, as in other countries (in July 1994 there were 40 million small shareholders in Russia, but this number is smaller now). In the Czech Republic, for example, the struggle for control began as soon as mass privatization was complete. As in many other countries in Eastern and Central Europe, the managers of the enterprises played, and are continuing to play, a major role in this process.

For a number of objective reasons, such as excessive advantages offered to insider employees and the use of investment intermediaries, investment funds did not under-

go the same vigorous development in Russia as they did in the Czech Republic. For example, investment funds hold 60 percent of the shares in Czech enterprises and are the real owners of Czech industry. Investment funds in Russia hold approximately 10 percent of the shares in Russian enterprises, and they usually are minority outside shareholders. They could potentially play a positive role as a champion of minority rights.

At the same time, managers of Russian investment funds are infringing on the rights of small shareholders, as are the managers of Czech funds. The problem of "dormant shareholders" of investment funds is even more pressing for Russia, and up until 1998 the regulation of these funds was too lax.

During the course of large-scale privatization in Russia—and the majority of other countries with transition economies—there were no market quotations or reference points for the purchase of shares (as was the case with privatization in the 1980s in Western countries, such as the United Kingdom under Margaret Thatcher). Shares of enterprises being privatized appeared on the market for the first time in 1992–94. As the market developed further, quotations of many stocks appeared, providing an opportunity for firms to obtain a market valuation of their assets. This is likely to reinvigorate the market for privatization fund stocks, which will create new stimuli and incentives for funds to act as shareholders of enterprises and as players in the stock market.

The structure of stock ownership that took shape after the completion of mass privatization is changing fairly rapidly. Specifically, the following changes have occurred since 1994:

- A substantial reduction in the proportion of employee-shareholders (who play a minor role in management because most of them delegate their votes to the administration)
- An increase in the role of the administration (management)
- An increase in the role of large outsider shareholders
- A decrease in the role of the state.

The struggle for control at Russian joint-stock companies is becoming more intense as a 50/50 balance of forces between insiders and outsiders has developed at many enterprises. This struggle for control has resulted in numerous violations of shareholder rights (especially on the part of managers) and created disincentives for the disclosure of information about enterprises. For example, managers who want to buy shares at a lower price have no interest in disseminating information about their joint-stock company. This struggle for control can lead to the

domination of Russia's over-the-counter market, since it is not profitable for brokers to disclose prices and the volume of transactions to their clients. It creates a situation in which enterprises do not have sufficient interest in new stock issues out of fear of losing control of the enterprise (although there clearly are other obstacles to new stock issues, such as competition with monetary privatization and placement of government securities). Finally, this struggle is hindering the effort to transfer the management of registers to independent registrars.

The creation of a system for transforming savings into investments will require a major effort to restore the public's trust in investment intermediaries (banks and collective investments) after the widespread scandals involving pyramid schemes from 1994 to 1995 and the losses of individuals stemming from the banking crisis of August 1998. Restoring the public trust is a complex and long-term task that can be achieved only with a serious tightening of government control over the securities market and a targeted public information and promotional campaign.

Currently, banks, investment funds, and foreign investors are not significant sources of financing for the enterprise sector. As economic growth accelerates, however, the situation is changing. The acceleration of this process is primarily attributed to:

- A decline in the profitability and scale of government borrowing on the securities market (which for a long period of time crowded out investments in the real sector)
- Development of the legal framework, for example, the creation of an institution for securing credits provided to the real sector on the basis of the privatization of land and real property, the development of a mortgage lending system, and the strengthening of the legal position of creditors
- Introduction of legislative and enforceable liability for violation of shareholder (creditor) rights, which will increase the level of interest in investing in enterprises
- The success of efforts to increase the openness of enterprises to investors (disclosure of information and accounting reform).

### **The System of Legal and Corporate Governance**

The delay of legal reform during 1991–98 not only had a material impact on the development of the securities market during those years but also permitted the creation of financial pyramid schemes. Market participants were forced to use outdated, Soviet-style civil and penal codes and other laws.

Similarly, no united regulatory authority was in charge of the securities market. Until the beginning of 1995, market participants were regulated and licensed by the central bank (all securities operations of banks), the Ministry of Finance (all nonbanking institutions, except for voucher investment funds and registrars), and the State Property Committee (voucher funds and registrars). The Commission for Securities and Exchanges, established in 1992 by the then president of Russia, existed from 1992 to 1994 only as an interministerial consultative agency.

By the beginning of 1996, the joint efforts of the president, the government, and the federal assembly changed the situation. Parts 1 and 2 of the civil code were adopted and enforced, as were the Joint-Stock Company Law and the Securities Market Law. In November 1994, a presidential decree created the Federal Commission for Securities as a united authority responsible for regulating all types of professional activities on the securities market. Its powers were set out in the Securities Market Law (April 1996) and the Joint-Stock Company Law (December 1995), as well as a number of presidential decrees.

Over the period 1996–99, the Federal Commission for Securities adopted more than 100 regulations for all aspects of market functioning, reissued licenses to professional market participants, prepared materials for initiating criminal proceedings against more than 800 financial pyramid builders, introduced more rigorous requirements for the registration of securities issues and disclosure of information by issuers, and strengthened enforcement.

The legislative framework improved rather slowly from 1996 to 2000, except for the adoption of the Law about Protection of Rights and Legitimate Interests of Investors in spring of 1999. Many important issues, connected with the adoption of amendments to the criminal procedural code and civil procedural code, joint-stock company law, and law on investment funds, remained unresolved. In particular, two programs connected with the protection of investor rights, which were adopted by the government in 1996 and 1998, were not implemented.

Russia is characterized by very weak enforcement of existing legislation on the protection of shareholder rights. Concentration of ownership has become widespread, but this may change as the quality of accounting improves and the legislation is enforced.

The legislation in force in Russia now incorporates a number of important measures to protect shareholder rights (for all practical purposes, the only elements missing are mandatory dividends and the right of a minority of shareholders to overturn management decisions). The main reason for Russia's problems, however, is poor enforcement

of the legislation. Russia is lagging far behind other transition economies in this regard, including a number of CIS countries.

The most typical violations of shareholder rights include violation of a shareholder's right to participate in a general shareholders meeting, dilution of capital, violation of shareholder rights in the course of reorganizing and consolidating companies (especially in the process of converting to a single stock), and the violation of information disclosure requirements. It also includes asset stripping and the transfer of assets to friendly companies, transfer pricing, conclusion of sweetheart deals in violation of established procedure, and fraudulent bankruptcies with the subsequent purchase of assets being sold.

### ***Shareholders' Rights***

In spite of the crisis conditions in 1998–99, there was no significant decline in stock-issuing activity by joint-stock companies. This can be explained by the fact that the mechanism involving the placement of securities was employed not as a means of attracting needed investments, but as an instrument in the struggle for control of a company through the “dilution” of shares held by undesirable shareholders (primarily small and mid-size shareholders who hold a so-called “blocking” parcel of shares).

The boards of directors, taking advantage of the opportunity afforded by law to adopt decisions that increase authorized capital, often placed shares through a closed subscription to affiliated persons at what were clearly below-market prices, frequently without notifying shareholders. The conditions of the placement were based on the “bottleneck” principle—the idea was to make it impossible or extremely difficult for shareholders to acquire stocks. For example, the stocks of a large issuer were placed on a single day, and a shareholder had to appear in person to conclude the transaction.

Violations of shareholder rights involving the reorganization of joint-stock companies also were widespread. The purpose of reorganization was to allow a “controlling” shareholder to convert a profitable business into new companies. The remaining shareholders inherited the financial problems of the “old” company. In other words, some shareholders were forced out of the company and given shares in new companies with an unfavorable financial status.

To prevent such violations, the Russian Federal Securities Commission included a number of provisions in its regulatory acts aimed at protecting shareholder rights in the process of issuing securities. These provisions required that a decision to place stocks through a closed subscription

be adopted only by a general shareholders meeting of the given joint-stock company. This provision was subsequently written into the federal Law on Protection of the Rights and Legal Interests of Investors in the Securities Market.

### ***Information Disclosure***

Progress has been made on information disclosure. In 1997–99, the Russian Federal Securities Commission, pursuant to the requirements of the Law on the Securities Market, adopted several regulations identifying the nature of the information to be included in the quarterly reports of issuers and establishing the procedure for its disclosure. In addition, requirements were established for the disclosure of information provided by issuers in the course of a securities issue.

Progress also has been made through publication of the Law on Protection of the Rights and Legal Interests of Investors in the Securities Market. Under this, the Russian Federal Securities Commission obtained the authority to impose penalties for violations in the area of information disclosure. This same law established a ban on public trading of securities of issuers that do not disclose the amount of information required or do not follow the procedure established by the legislation.

### **The Post-Presidential Elections Period**

When the 2000 presidential race was over, Russia entered a new stage of its development. The main basis for political stability is now in place, and this is critical for the securities market.

Still, the president of the Russian Federation and the government face a number of political problems. The solution is important for reform in general and for the securities market in particular. These include the danger of deprivatization (reprivatization and nationalization). A positive solution would be to shorten the period of limitation for reviewing privatization transactions and to apply other measures aimed at protecting the rights of investors—good-faith purchasers in the case of nationalization. The main challenge, which is critical to development of the securities market, is to reform the state.

The main mid-term challenges facing the president in the sphere of capital market development are as follows:

1. Macroeconomic and structural reforms, primarily tax reform, reduction of macroeconomic risks and improved efficiency of sovereign debt management, introduction of international accounting standards, banking system reform, development and circulation of a system for registering real estate titles of

ownership, development of an insurance industry, and pension reform and development of private pension funds.

2. Improvement in the quality of corporate governance, through more rigid regulation of issuers' behavior, increased activity of investors themselves on behalf of their own rights, and stronger information disclosure requirements.
3. Acceleration of legal reform, especially enforcement and improvement of the court system.
4. Strengthening of the securities market through an increase in the efficiency of market infrastructure, including the establishment of a central depository; creation of preconditions for the development of collective investment vehicles, including closed-end funds that are investing in real estate; introduction of new financial instruments to the market (warehouse certificates and mortgage securities) and cre-

ation of conditions for the development of existing instruments (corporate bonds); development of the system of insurance (guarantee) of investors' risks; and improvement in compliance with the rules on the securities market.

### **Conclusions**

The development of the fledgling securities market has encountered difficulties, but these are not unique to Russia. The securities market was born less than 10 years ago and has grown rapidly. It already has contracted some of the diseases typical of a young market (such as building pyramids and pumping up the governmental securities market) and has developed some immunity against them. It is as volatile as any other emerging market, and it is as risky. Solving all of these difficulties must await the resolution of some of the deep-seated structural problems confronting the Russian economy.



Part V

# Lessons Learned and Future Challenges



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## Chapter 16

# Banking Transition: A Comparative Analysis

*Stephen Fries and Anita Taci*

**T**he development of sound, market-oriented banking is fundamental to the postcommunist transition. Banks in a market economy must provide monetary payments, without which markets can function only at high cost. Although this is taken for granted in industrial market economies, there has been an unprecedented proliferation of nonmonetary forms of payment in some transition economies (Seabright 2000). Banks also must mobilize and allocate capital efficiently and prudently to facilitate the process of saving and investment and to promote long-term growth. But bank intermediation remains stunted even after a decade or more of reform (EBRD 1998: ch. 5). These persistent symptoms raise concern that the banking reforms implemented so far have failed to spur adequately the development of banking in transition economies.

The transformation of socialist banking systems was bound to be difficult. While cement factories still could produce cement, the services of socialist banks were of little use in a market economy. These institutions were primarily bookkeepers for the planned allocation of resources, providing “monetary” accounts for resource flows. However, these accounts differed fundamentally from bank deposits in a market economy. There were tight restrictions on the use of the monetary balances of enterprises and households, and interest rates on these balances were set administratively. Credits were allocated to enterprises on the basis of planned investment priorities, and the repayment of credits was subject to bargaining. Bankruptcy and legal enforcement of creditor rights were nonexistent. Moreover, to facilitate their role in the planning process, socialist banking systems were highly concentrated, with little separation of central banking and commercial banking activities. Some banks specialized by activity, particularly in industry, agriculture, foreign trade, and household savings.

Most transition economies have followed the same broad paradigm for transformation of the banking sector—a paradigm associated with, but not confined to, the policy advice of the International Monetary Fund (IMF) and the World Bank (see, among others, Calvo and Frenkel 1991; Fisher and Gelb 1991; Caprio and Levine 1994; Fries and Lane 1994). The so-called Washington consensus on banking transition called for separation of commercial banks from the central bank, abolition of restrictions on internal convertibility of money, liberalization of interest rates, restructuring and privatization of state banks, and entry of new private banks regulated by minimum capital and licensing requirements. At the same time, the state had to take on important new roles to provide effective prudential regulation and supervision of banks. This involved development of significant new state capacity in terms of the enactment of new banking laws and regulations and their effective enforcement by the supervisory authorities and the courts. Although most countries have followed this

broad paradigm, the pace and sequencing of reforms have differed significantly.

The advocated reforms clearly were required to overcome some of the legacies of socialist banking, but have they been sufficient to spur the development of sound, market-oriented banking systems? A basic measure of the development of banks is the scale of their activity. The level and growth of deposit taking and lending are useful indicators of banking development because deposits and loans embody the payment and intermediation services provided by banks.

This chapter assesses the development of banks in transition economies at both the aggregate level and that of individual banks. The aggregate analysis covers all countries of Central and Eastern Europe, the Baltic region, and the Commonwealth of Independent States (CIS) except Bosnia and Herzegovina, Georgia, Tajikistan, Turkmenistan, Uzbekistan, and the former Republic of Yugoslavia for the years 1994–99. At the bank level, the chapter focuses on 14 countries in Central and Eastern Europe and the Baltic region (all except Albania, Bosnia and Herzegovina, and the former Republic of Yugoslavia) and four CIS countries—Belarus, Kazakhstan, the Russian Federation (Russia), and Ukraine (16 in all)—for the period 1994–98. This sample of banks is selective across and within countries, because it excludes those banks that do not disclose publicly their financial accounts—typically small banks or those that are chronically loss making. The banks included in the sample tend to be the larger commercial and savings banks in each country, and they account for the vast majority of the banking operations in their respective countries.

The chapter finds at the aggregate level that expansion of banking activity, particularly lending to businesses and households, was associated with progress in structural and institutional reforms and growth in output. Where there was little progress in structural and institutional reform (including banking reforms) and growth in output, there was little development of banks. Only a few countries in Central and Eastern Europe and the Baltic region saw over the period 1994–99 an increase in bank loans outstanding to the private sector relative to gross domestic product (GDP) in 1999—Bulgaria, Croatia, Poland, the Slovak Republic, and Slovenia. Moreover, the ratio of private sector credit to GDP in all transition economies remained well below the estimated benchmark for a sample of 127 developing and industrial market economies in 1995, and evidence points to the crowding out of credit to the private sector by government borrowing.

The analysis of lending to businesses and households at the level of individual banks allows for the influence of

both country-level and bank-specific factors in a reduced-form model that includes variables expected to be associated with the demand for and supply of bank loans to customers. This analysis finds that progress in banking reform has been the *sine qua non* of banking development. Where there has been little progress in banking reform, there is no significant association between the real growth in customer loans and the potential supply and demand factors.

Where banking reform has advanced, however, the real growth in bank lending displays a number of distinctive features. Output growth is significantly associated with an expansion of bank lending, although growth in lending has failed on average to keep pace with that of output. This is consistent with the lack of evidence at the aggregate level of increasing depth of transition banking systems. There is a significant, positive association among bank capitalization, the ratio of shareholder equity to total assets, and loan growth. This suggests that financially stronger banks are attracting resources with which to expand, an indication that loan growth is based on a sound foundation where banking reforms have advanced. At the same time, the larger banks—primarily those that emerged from the old regime—are expanding relatively slowly or are contracting their customer lending. This reflects a declining role of old institutions, even after their restructuring and privatization, and the relatively stronger growth of smaller, less dominant banks. A surprising finding is that bank ownership—newly established private, privatized, or state-owned—is not associated systematically with loan growth, while foreign ownership is associated strongly with loan growth only in one country.

The empirical findings suggest that, while progress in banking reform is shaping the development of banks in transition economies, the supply response of banks remains weak, particularly given the weak association between bank ownership and growth of customer loans. Policies that could complement the consensus banking reforms and spur a strong supply response are discussed in the conclusion to the chapter.

### **Implementation of Banking Reforms**

One measure of progress in reform of the banking sector is the transition indicator of the European Bank for Reconstruction and Development (EBRD) for banking reform. This indicator provides a ranking of progress in liberalization and institutional reform of the banking sector, on a scale of 1 to 4\* (4.3). A score of 1 represents little change from a socialist banking system apart from the separation of the central bank and commercial banks, while a score of 2 means that a country has established internal currency convertibility and has liberalized significantly both

interest rates and credit allocation. A score of 3 means that a country has achieved substantial progress in developing the capacity for effective prudential regulation and supervision, including procedures for the resolution of bank insolvencies, and in establishing hardened budget constraints on banks by eliminating preferential access to concessionary refinancing from the central bank. A score of 4.3 represents a level of reform that approximates the institutional standards and norms of an industrial market economy, as represented, for example, by the Basle Committee's Core Principles on Effective Banking Supervision and Regulation. The scoring assessments are by EBRD country economists (see EBRD 1998, 2000).

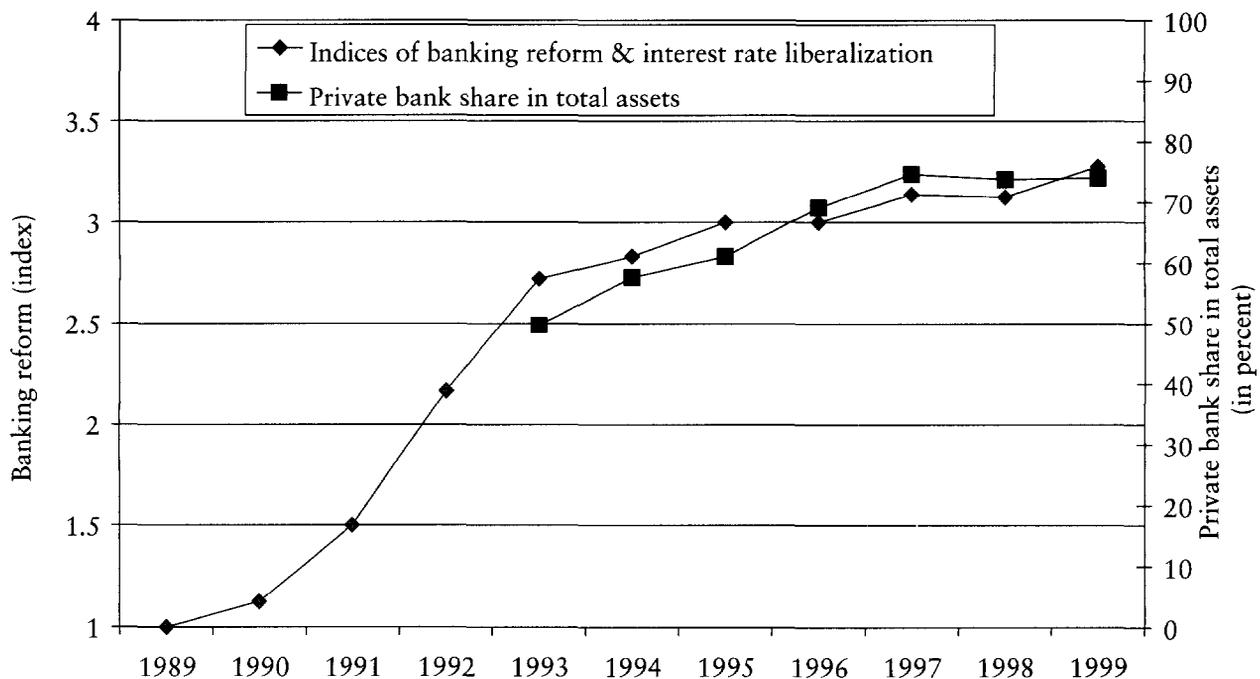
A second, complementary measure of the transformation of the role of state in the banking sector is the share of private banks in the total assets of the banking system. This indicates the extent to which the state has withdrawn from direct provision of banking services through the privatization of state banks and entry of new private banks into the system. The measure also captures the potentially differential rates of growth of private versus state banks.

With these two measures of the transformation of the role of the state in the banking sector, it is possible to show how the broad paradigm for banking reform has been

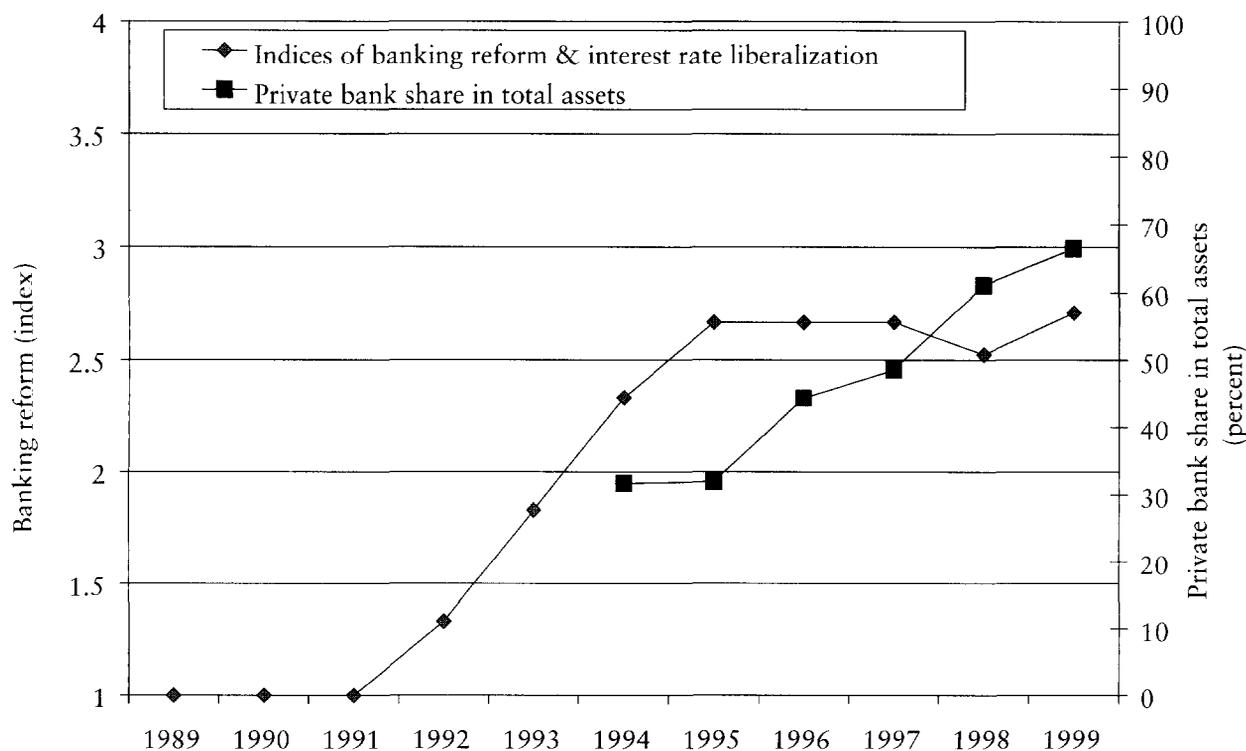
implemented. Figure 16.1 shows that, in Central Eastern Europe and the Baltic states (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia), liberalization and institutional reform in the banking sector have advanced in parallel with the state's withdrawal from the direct provision of banking services. This approach is balanced in the sense that the state has liberalized the market for banking services and developed the capacity for effective prudential supervision and regulation in step with the growing role of private banks in the system.

The countries of Southeastern Europe (Albania, Bulgaria, Croatia, FYR Macedonia, and Romania) have followed a similar approach, albeit at a much slower pace (see figure 16.2). This reflects at least in part the more difficult economic and political conditions at the start of transition in these countries, particularly the misallocation of resources, macroeconomic imbalances, trade flows, geographic location, and turnover of old political elites (see de Melo and others 1997; EBRD 2000: ch. 2). The banking systems in these countries remained a source of indirect subsidy for troubled enterprises well into the transition, which constrained the pace of banking reforms, such as the implementation of prudential regulations and bank priva-

**FIGURE 16.1 PROGRESS IN BANKING REFORM AND PRIVITIZATION IN CENTRAL AND EASTERN EUROPE AND THE BALTICS, 1989 TO 1999**



Source: EBRD (2000).

**FIGURE 16.2 PROGRESS IN BANKING REFORM AND PRIVITIZATION IN SOUTHEASTERN EUROPE, 1989 TO 1999**

Source: EBRD (2000).

tization. These practices ultimately culminated in banking crises (Bulgaria in 1997 and Romania in 1999) that eventually helped to spur a stronger pace of reform.

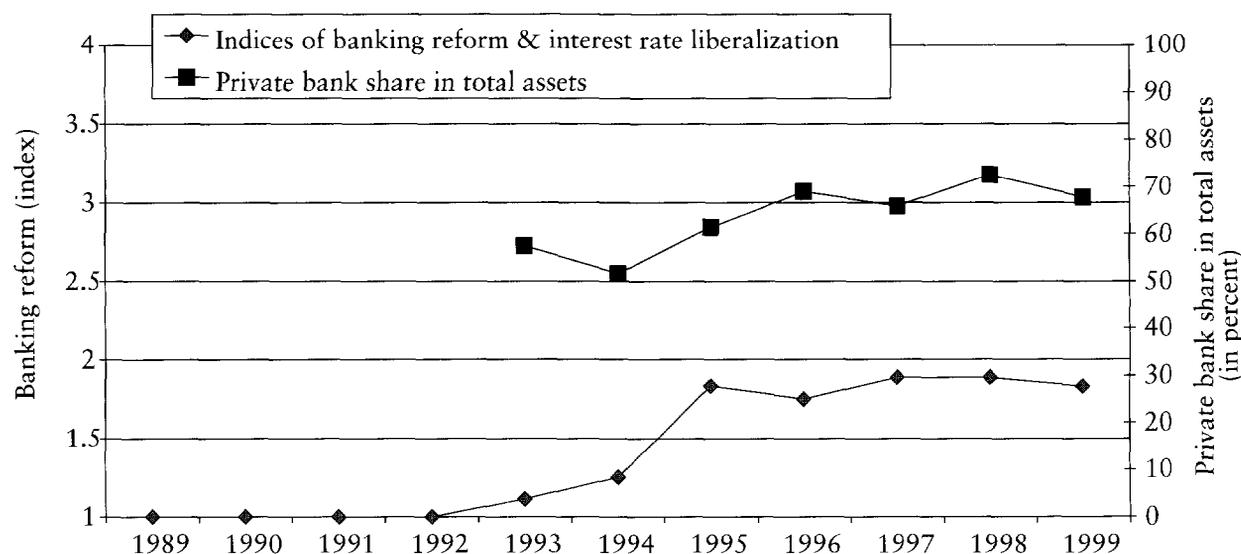
The transformation of banking in CIS countries, in contrast, has followed a markedly different sequence and pace. Figure 16.3 shows that the state withdrew more rapidly from its role in the direct provision of banking services in the CIS (except Georgia, Tajikistan, Turkmenistan, and Uzbekistan, where data are missing) than in Central Eastern Europe and the Baltic states. This reflects, in part, the political strategy of those seeking to break up the former Soviet Union by promoting the devolution of economic power away from the Soviet federal government largely through the spontaneous privatization of state assets. Central to this strategy were the transfer of most state banks into private hands and the laissez-faire formation of new banks. However, the implications of this approach for other dimensions of banking reform have been problematic. The proliferation of nonviable banks created significant interests that were opposed to sound prudential regulation and mechanisms for the exit of nonviable banks. The slow pace of banking reform in these countries reflects, in part, this resistance to further reforms.

### Development of Banking Systems

After a decade of extensive reform of the banking sectors of the region, it is time to take stock and to assess whether the Washington consensus on banking transition has succeeded. The measure of success, however, is not simply whether the policy prescription has been followed but also the extent to which the tonic has proved to be the antidote to socialist banking and the spur to the provision of banking services to the private sector. At the most basic level, this includes the provision of deposit-taking and lending services. Measures of this activity can be used both at an aggregate level for banking systems as a whole and at the disaggregated level of individual banks. An advantage of disaggregation is that it reveals the process of adjustment by individual banks and the potential influence of some factors associated with the supply of banking services. At the same time, an aggregate analysis can help to identify factors at the country level that influence the development of banking, such as output growth and progress in structural and institutional reform.

One aggregate measure of banking development is the ratio of domestic credit or broad money to GDP. Following EBRD (1998: ch. 2), figure 16.4 shows the ratio of domestic credit provided by banks to GDP for

**FIGURE 16.3 PROGRESS IN BANKING REFORM AND PRIVITIZATION IN THE COMMONWEALTH OF INDEPENDENT STATES, 1989 TO 1999**



Source: EBRD (2000).

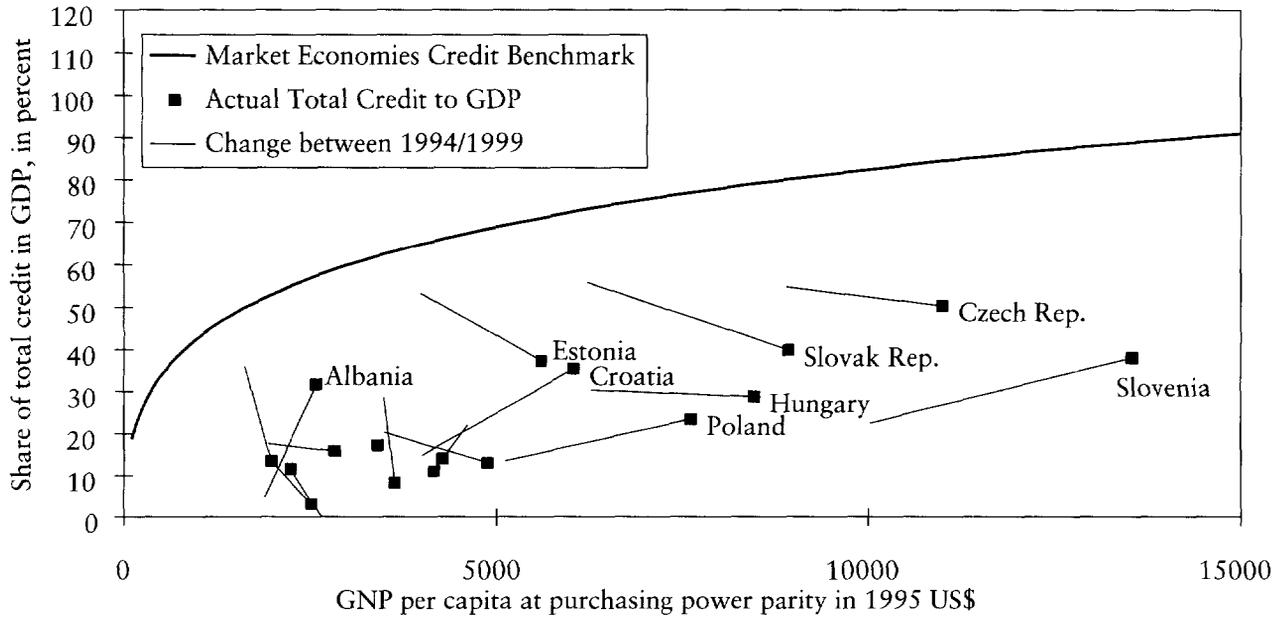
countries at different levels of development. The solid line shows the fitted regression relationship for a sample of 127 developing and advanced market economies worldwide, excluding the transition economies with which this chapter is concerned. The relationship is estimated by regressing the ratio of domestic credit to GDP in 1995 on the log of per capita gross national product (GNP) in international U.S. dollars at purchasing power parity for 1995 and its squared value. The transition economies are represented in the figure by their position in 1999 (the solid dots) as well as by the trajectory of change between 1994 and 1999 (the lines connected to the dots). The figure shows clearly that virtually all transition economies lie below the market economy benchmark for the ratio of domestic credit to GDP. Moreover, apart from a few countries in Central Eastern Europe and the Baltic region, there is little convergence toward the benchmark over time.

Figure 16.5 also shows that it is primarily the private sector that suffers from the underdevelopment of the banking sector. It is bank credit to the private sector, rather than credit to the public sector, that is undersupplied relative to that in comparable market economies. Again, the solid lines show the estimated nonlinear relationship between the ratio of bank credit to the private sector to GDP and per capita GNP for a sample of 127 developing and industrial market economies. The transition economies are represented both by their position in 1999 and by the

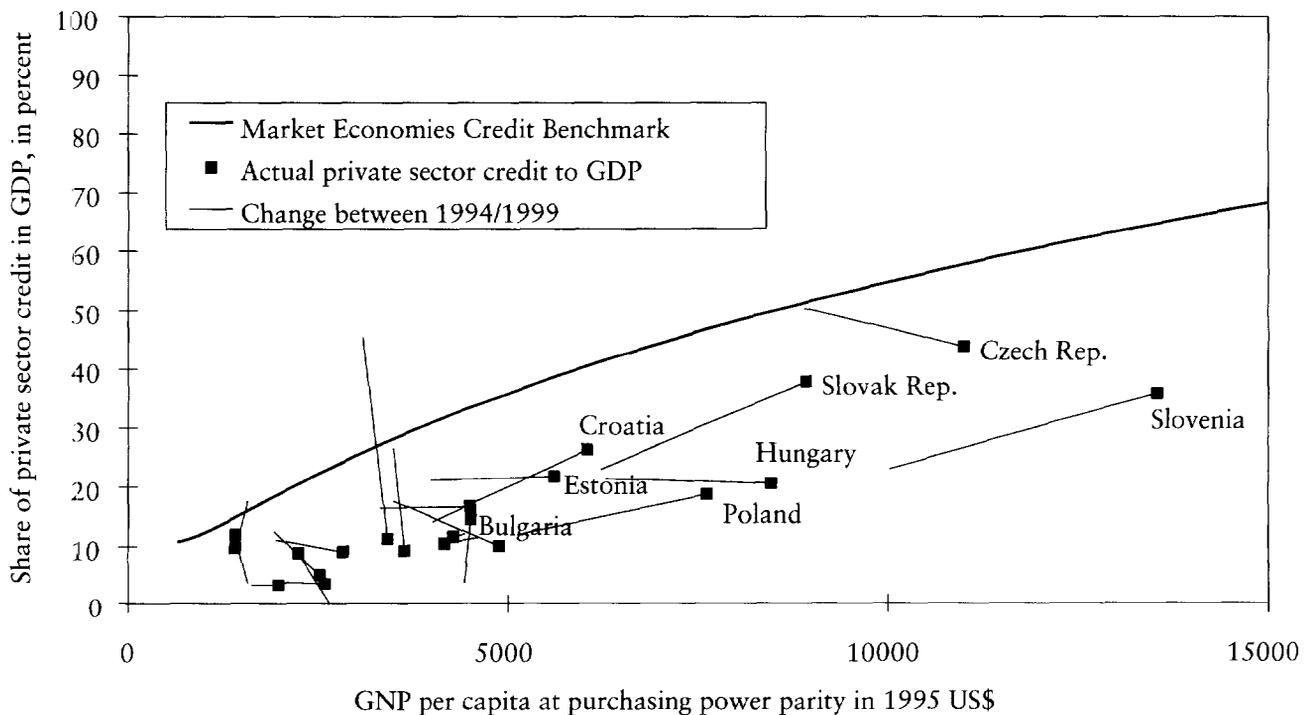
trajectory of change between 1994 and 1999. The share of bank credit to the private sector is well below the market economy benchmark in 1999, and only in Bulgaria (after 1997), Croatia, Poland, the Slovak Republic, and Slovenia is there significant convergence toward the benchmark over time. In contrast, the share of bank credit to the public sector (not shown) is well above the market economy benchmark in 1999, and this ratio has tended to increase over time in many transition economies, reflecting fiscal pressures in transition.

This aggregate assessment of banking development shows that the expansion of credit to the private sector relative to GDP over the period 1994–99 is confined largely to a few countries in Central Eastern Europe and the Baltic region. These countries are also those that have witnessed output growth and significant progress in structural and institutional reform over the period (see EBRD 2000: ch. 2, 3). This association suggests that output growth and reform progress, including that in the banking sector itself, contribute to the development of banking. However, even in the few examples of development at the country level, the response to reforms is relatively weak. This leaves open the possibility that reforms within banking sectors have been insufficient, particularly with respect to spurring a strong supply response by banks. There are also potential constraints from outside the banking sector on the growth of bank lending, including the lack of legal protection of investor rights.

**FIGURE 16.4 RATIO OF TOTAL BANK CREDIT TO GDP IN TRANSITION ECONOMIES RELATIVE TO MARKET ECONOMY BENCHMARKS**



**FIGURE 16.5 RATIO OF PRIVATE SECTOR CREDIT TO GDP RELATIVE TO MARKET ECONOMY BENCHMARKS**



### Growth of Bank Lending to Customers

Given the significant and persistent underprovision of credit to the private sector at the aggregate level, an analysis of the real growth of customer loans to businesses and households by individual banks can help to identify a broader range of factors associated with banking development in transition economies. The observed rate of real growth in customer loans reflects the interaction of the demand for banking loans and their supply by individual institutions. Factors at the country level that are likely to increase the real demand for bank loans by customers (businesses and households) over time are the growth of output and the competing demands for domestic savings by the government. Demand for investment and consumer durable goods and the debt-carrying capacity of businesses and households are likely to increase with output and incomes and to decrease with competing demand for finance by government. The response of banks to the demand for loans is, in turn, likely to be influenced by a number of country-level factors, such as the confidence of depositors in banks and the protection of creditor rights. Both tend to increase with measures of progress in banking reform.

Observable factors at the level of individual banks, such as the extent of competitive pressures (market share), bank capitalization, and the nature of ownership (newly established private, privatized, or state-owned; with or without foreign participation) may also influence the supply response. For example, banks faced with greater competitive pressure may be more responsive to customer demands and offer more competitive terms on loans. Those banks with higher levels of equity capital relative to total assets are likely to be more financially sound and may instill greater confidence in depositors. Highly capitalized banks therefore may be better able to attract financial resources for growth, but not necessarily in the form of lower interest rates on deposits because of comprehensive deposit guarantees in most (but not all) countries. Bank ownership may be associated significantly with the quality of bank management and staff, reflecting in part the functioning of corporate governance and the process of selecting senior management. Bank size is also likely to be related significantly to real loan growth, with smaller banks registering higher rates of real loan growth than larger banks, even though in absolute terms the changes are small. Of course, many other factors unobservable to researchers, such as the quality of bank management and staff and the extent of investment in information technology, are potentially significant as well.

Since the observed real growth of customer loans by banks arises from the interaction of demand and supply

factors over time, it is possible to estimate a reduced-form equation that relates the real growth of bank loans to their customers to observable demand and supply factors. It is important to recognize, however, that the behavior of banks and their customers is not necessarily constant across countries and over time. In fact, there is reason to expect that the supply and demand for bank loans would vary systematically with progress in banking reform. This particular factor is likely to have a significant impact both on the confidence of banks in the repayment of loans by their borrowers and on the confidence of depositors in banks. In particular, where there is little progress in banking reform, the activities of banks are likely to remain stunted or distorted, both in terms of deposit taking or customer lending, even though other factors, such as output growth, may contribute to a rise in demand for bank services.

The appendix to this chapter describes the models deployed and estimation techniques applied. One important finding of this analysis is that the behavior of the supply and demand for bank loans changes significantly with progress in banking reform. It is therefore necessary to estimate the reduced-form equation for the real growth of bank loans to their customers for two separate subsamples. One is for the countries and years in which progress in banking reform has reached a relatively advanced level (2.7 according to the EBRD transition indicator for banking reform), and the other is for countries and years in which progress in banking reform remains below this level.

### Regression Results

Table 16A.1 reports the results of the regressions for the subsample of high-reform countries and years. The model estimations, which allow for country fixed effects, yield a number of significant results:

- Loan growth is significantly and positively associated with growth in real GDP lagged one year, but the estimated coefficient is about 0.60. This means that, on average and across countries and years, in high-reform states, lending to customers is expanding less rapidly than growth in output, which is consistent with aggregate data showing little sign of financial deepening in transition economies. It is not possible to identify on the basis of this reduced-form estimation, however, whether this is due to a demand or a supply constraint.
- There is only weak evidence that general government deficits crowd out real growth in customer lending. The coefficient on general government balance is positively (correctly) signed, but insignificantly different from zero. As an alternative specification (not

reported), the nominal interest rate was used rather than the general government balance. While negatively signed and statistically significant, the interest rate and real GDP variables are highly correlated, and the estimated coefficient on lagged real GDP turns insignificant. In FYR Macedonia, there is a strong statistical association between the general government balance and real growth of bank loans to customers, with a larger government deficit being associated with lower loan growth. This points to significant crowding out of lending to businesses and households by government demand for domestic savings.

- Both the market share of deposits and the size of the total balance sheet are significantly and negatively associated with real growth in customer lending. This may reflect a number of factors. The most simple is the effect of size in calculating percentage rates of loan growth, with a given absolute increase in real lending by a small bank implying a larger percentage increase than for a large bank. It may also be the case that the larger banks tend to be those that emerged from the old regime and must restructure extensively their operations and resources to serve effectively customer demands. The inherited client bases of the old banks tend to be concentrated on the declining sectors and enterprises in the real economy. Finally, a smaller bank is likely to face greater competitive pressure and therefore to be more responsive to customer demands for services (see Fries, Neven, and Seabright 2001 for related evidence on the profitability of banks in transition economies by market share). However, in Estonia, bank size is positively associated with growth in bank lending. This may reflect the early privatization and restructuring as well as the rapid growth of large Estonian banks through mergers with smaller institutions.
- Bank capitalization is positive and significantly associated with the real growth in customer loans. On the surface, this association suggests that those banks that are more financially sound are attracting the resources that enable them to expand their customer loans. This is encouraging from the perspective of financial stability. Further, strong regulatory capital requirements may prevent thinly capitalized banks from expanding their lending activities to the private sector. However, there are potential problems with the measurement of bank capital: some troubled banks may have overstated their capital by not provisioning adequately against their problem loans

and then expanding their lending to conceal or to overcome their bad loans.

- There is no evidence that bank ownership (newly established private, privatized, or state-owned) affects real loan growth. This result stands in sharp contrast to a robust finding from the analyses of enterprise performance in transition economies that newly established private firms in industry and non-financial services grow significantly faster than do either privatized or state-owned enterprises (see, for example, Djankov and Murrell 2000; Carlin and others 2001). One interpretation of the finding for enterprises is that market selection has a strong effect on the performance of firms that remain in the market. In other words, the ability to enter and survive in the market is strongly associated with strong performance, at least as measured by growth. However, there is no evidence of such a market selection effect in transition banking. This may reflect the fact that the panel of banks allows for the entry and exit of banks from the sample, whereas the many cross-sectional studies of enterprises suffer from survivorship bias in the sample. It may also reflect the fact that the regulation of bank entry through the application of minimum capital requirements and licensing tests and the exit of failed banks from banking systems through bankruptcy have not functioned well in many transition economies.
- There is little evidence that foreign bank participation in the ownership of banks is associated with higher rates of loan growth. Only in Croatia is there a strong positive association between foreign ownership and bank lending. This country-specific finding may reflect, in part, the fact that foreign banks benefited from the outflow of customers and depositors from troubled Croatian banks, particularly in 1998. The more general finding is surprising in that foreign investment in banks would be expected to bring with it the transfer of valuable banking skills and technologies and home-country prudential supervision that should help to boost performance. However, foreign banks may face particular obstacles to expanding in local markets, given the information advantages that local bankers may possess. There also may be constraints outside the banking sector on the expansion of bank lending to customers that affect all banks, including those with foreign ownership, such as the lack of legal protection of investor rights.

Table 16A.2 reports the estimation results for the subsample of low-reform countries and years. These results

stand in sharp contrast to those for the high-reform subsample. None of the estimated coefficients is significantly different from zero, with the exception of market share of deposits and size of the total balance sheet. This suggests that the growth of bank lending where there has been little progress in banking reform is not strongly associated with the demand and supply factors that could be expected to influence the growth of bank lending in a market economy. This result raises serious concern about the functioning of banking systems where there has been little progress in reform, as in Belarus, Russia, and Ukraine. Any expansion of bank lending in this environment appears to be significantly influenced by nonmarket factors, including possible government interference.

### Conclusions and Policy Implications

One of the key findings of the analysis of the determinants of real growth in bank lending to customers is that progress in banking reform is the sine qua non of sound development of banks. Moreover, there is evidence that banking regulation and supervision, in particular capital adequacy requirements, are helping to establish a sound foundation for the expansion of customer loans. These efforts must be sustained and intensified. To this extent, the so-called Washington consensus on banking reform has succeeded. However, even where banking reforms have advanced, banking development remains stunted. The real expansion of customer loans has failed, on average, to keep pace with output growth. This may reflect government deficits that crowd out customer lending, although the evidence at the banking level is not significant.

A number of variables expected to be associated with the supply response of banks to increases in demand for customer loans show little sign of significance. Bank ownership is not significantly associated with real growth in bank lending. In contrast to extensive evidence on enterprise performance in transition economies, *ab initio* private banks do not grow more quickly than privatized or state-owned banks. This may reflect inadequate regulatory control of entry into and exit from the banking sector. Although minimum capital and bank licensing requirements have been significantly strengthened in recent years in many transition economies, approaches to the resolution of failed banks remain often highly politicized and haphazard. In addition, foreign banks, which in principle have access to superior banking skills and technologies and benefit from home-country supervision, in general are not expanding more rapidly than other banks. This suggests that foreign banks may face other obstacles to the expansion of their lending, such as an information disadvantage

relative to local banks. Both of these results also are consistent with the presence of constraints outside of the banking sector, such as the functioning of the judiciary and the legal protection of property rights, which can impose a significant constraint on banking development (see, for example, Levine 1999 on evidence worldwide).

At the same time, the dominant banks in most transition economies have emerged from the old regime, and these institutions have been losing their market share. Some have been restructured and privatized, while others remain in state hands. In either case, the main clients of these banks are often the enterprises that existed under the old regime (that is, the privatized and state-owned enterprises), which tend to grow much more slowly than *ab initio* private enterprises. There is, therefore, likely to be a significant mismatch between sound lending opportunities in the private sector and the operational focus of the dominant banks. The combination of profitable lending opportunities and competitive pressures should, in time, shift the operational focus of these banks, although measures aimed at building capacity for lending to small and medium-size enterprises could help this reorientation. For example, the banking sector activities of the EBRD aim to strengthen the supply response of banks to lending opportunities in the real economy. This includes facilities for local banks that are specially designed to provide finance for small and medium-size enterprises and to build the operational capacity for such lending activities.

Taken together, the evidence in this chapter points to the need to strengthen the supply response of banks to progress in banking reform. These measures include the more effective regulation of the entry and exit of banks, improvements in corporate governance of banks, removal of obstacles to the expansion of foreign banks, strengthening of the judiciary, and protection of investor rights. Reforms that focus on strengthening the supply response of banks are essential complements to the Washington-consensus reforms that focused on financial liberalization, separation of commercial banks from the central bank, and effective prudential regulation. The evidence shows that these reforms did not fail; rather the initial reform agenda was too narrowly focused.

Further empirical work, however, is necessary to identify the specific supply constraints on banks. The conclusions that can be drawn on the basis of a reduced-form model for the supply and demand of customer loans and aggregate development of banking systems are inherently limited. The aim is to complement this analysis with related research into other dimensions of banking performance. This includes analyses of factors that influence bank profitability and of cost efficiency in the provision of banking services. These issues are the focus of ongoing research.

## Appendix. Modeling and Estimation

The reduced-form equation for estimation is:

$$\dot{L}_{i,j,t} = \sum_j \alpha_j + \sum_j \beta_j x_{j,t} + \sum_j \delta_j Y_{i,j,t} \quad (1)$$

where  $\dot{L}_{i,j,t}$  denotes real growth in customer loans of bank  $i$  in country  $j$  in year  $t$ ,  $\alpha_j$  are country intercept terms,  $x_{j,t}$  is a vector of country-level explanatory variables, and  $Y_{i,j,t}$  is a vector of bank-level explanatory variables. Real loan growth is measured as the percentage change in total customer loans outstanding, where the stock of customer loans is deflated using the consumer price index. The vector of country-level variables includes the annual rate of growth in real GDP lagged one year, the general government balance in the current year, and the EBRD transition indicator of banking reform for the current year. The bank-level variables include the share of the deposit market (defined as the ratio of a bank's customer deposits to total broad money in that country and year), bank size (defined as total assets in U.S. dollars at market exchange rates), bank ownership (dummy variables to represent state-owned, privatized, and foreign bank ownership stake above 10 percent), and bank capitalization (ratio of equity to total assets). This general specification allows for both country-specific intercept (country fixed effects) and country-specific slope terms.

Estimation of the reduced-form equation for the real growth of customer loans covers 466 banks from 16 countries over the years 1994–98. Of the total number of banks, 9 are in Belarus, 26 in Bulgaria, 44 in Croatia, 29 in the Czech Republic, 14 in Estonia, 11 in FYR Macedonia, 35 in Hungary, 14 in Kazakhstan, 22 in Latvia, 12 in Lithuania, 49 in Poland, 22 in Romania, 105 in Russia, 20 in the Slovak Republic, 29 in Slovenia, and 25 in Ukraine. The data for individual banks and countries are annual. The source of data on bank balance sheets (loan growth and capitalization) as well as on ownership is the BankScope database produced by the Bureau van Dijk. The BankScope data are supplemented with the data and information from annual reports of the banks and from EBRD banking staff research on bank ownership.

Aggregate data on their banking systems for use in calculating market shares in deposit-taking activities are from the central banks of the countries and from the International Monetary Fund, *International Financial Statistics*. Sources of the macroeconomic data for the countries (output growth, consumer price inflation, and general government deficits) are various issues of the *International Financial Statistics* and of the European Bank

for Reconstruction and Development, *Transition Reports*. The measure of progress in reform of banking laws and regulations is the EBRD transition indicator on banking reform published in the *Transition Reports*.

Two concerns about the quality of the data arise from the wide variation in practices regarding the writing off of nonperforming loans and the lack of consistent information on the extent of nonperforming loans across banks. First, the extent to which measured loan growth is distorted by this consideration depends on how the misreporting of total loans net of write-offs changes over time for each bank. Second, any underprovisioning against nonperforming loans results in an overstatement of both bank equity and total assets. These potential data problems must be recognized when interpreting the regression results.

There is also a problem of multicollinearity between two variables—deposit market share and balance sheet size. These variables are highly correlated and, when entered together in the same model specification, lead to much higher levels of statistical significance than when entered in separate regressions. Therefore, all tests of the reduced-form model of loan growth have been undertaken separately for each of these variables. The results do vary significantly with the choice of variable.

The real loan growth equation is initially estimated for the entire panel of 466 banks over the period 1994–98. The general specification of model 1 is then tested against a version that restricts the country-specific slope terms to be the same across all countries. This model is:

$$\dot{L}_{i,j,t} = \sum_j \alpha_j + \sum_j \beta X_{j,t} + \sum_j \delta Y_{i,j,t} \quad (2)$$

A Wald test comparing the two models strongly rejects the restricted version. This could reflect the fact that the restricted version of the model assumes that the behavior of banks and their customers is the same across countries (and years), even though progress in banking reform varies considerably both across countries and over time. As suggested, there are strong reasons to expect this behavior to change with the progress in banking reform.

The data set is therefore partitioned into two subsamples, one for countries and years in which the EBRD transition indicator for banking reform is in the range 1 to 2.3 and the other for countries and years in which the indicator score ranges from 2.67 to 4.

This is done by constructing a banking reform dummy variable,  $R$ , that takes values of 1 for values of the EBRD transition indicator for banking reform between 1 and 2.33 and 0 otherwise. To check whether the estimation coefficients (both intercepts and slope coefficients) differ for

two ranges of values for the banking reform index, the banking reform dummy variable was introduced in front of all coefficients in the general equation in a more general form as:

$$\dot{L}_{i,j,t} = \sum_j \alpha_j + \sum_j \beta_j x_{j,t} + \sum_j \delta_j Y_{i,j,t} + R\left(\sum_j \phi_j + \sum_j \varphi_j X_{j,t} + \sum_j \gamma_j Y_{i,j,t}\right) \quad (3)$$

The *F*-test of the joint significance of the estimated coefficients on the terms interacted with the banking reform dummy variable, which compares models 3 and 1, does not reject the hypothesis that the behavior of real loan growth depends on the level of banking reform.

The general model 1 must, therefore, be estimated allowing the coefficients to differ for the two subsamples. Whether the model should be estimated in a single regression, as in model 3, or in two separate estimations of model 1 for each subsample depends on whether the variances of the error terms in the two estimates of model 1 differ significantly. If the variances of the error terms differ, pooling together the observations of the two subsamples in model 3 would bias the estimates of the variances of both error terms. In addition, the standard estimate of the variance-covariance matrix would be incorrect.

The likelihood ratio test of group-wise heteroskedasticity comparing the error variances of model 1 estimated over the two subsamples shows that they do, in fact, differ significantly. This estimation excludes the index of banking reform as one of the country-level explanatory variables, because there is relatively little variation in this variable within the subsamples, particularly for low-reform countries and years. Therefore, the reduced-form model of real loan growth is estimated separately for the two subsamples of states with “low” and “high” banking reform. This allows the estimated parameters of the reduced-form model of real loan growth to vary across countries and over time, but in a way that is linked systematically to progress in banking reform.

Using the two subsamples, the general model 1 and restricted model 2 are again compared. We also test for the joint significance of the country-specific intercept terms (country fixed effects). For the subsample of low-reform countries and years, it is not possible to reject a version of the model that restricts both the slope coefficients and the intercept terms to be the same across countries.

In contrast, for the high-reform subsample, it is still possible to reject the version of the model that restricts both the coefficients and intercept terms. To identify possible patterns in the country-specific slope terms, parallel tests

are made of the joint significance of these estimated parameters both by type of explanatory variable and by country, along with tests that all the other estimated parameters for other variables or countries are the same across countries. For example, tests are made that the estimated country-specific parameters on real GDP growth are jointly significant, along with tests that the parameters on all other variables are the same across countries, that the country parameters for each country are jointly significant, and that all other countries have the same estimated parameters. The country-specific slope coefficients are jointly significant for three explanatory variables—general government balance, deposit market share or balance sheet size, and foreign ownership—and for three countries—Croatia, Estonia, and FYR Macedonia. In fact, for each of these countries only one country-specific slope parameter is significantly different from zero: foreign ownership for Croatia, deposit market share or balance sheet size for Estonia, and general government deficit for FYR Macedonia.

If the three country- and variable-specific parameters for the subsample of high-reform countries and years are retained in the model specification, it is not possible to reject the hypothesis that all the other country-specific slope parameters are insignificantly different from zero. The pooling of observations for the high-reform subsample is therefore justified, with the three exceptions of foreign ownership for Croatia, deposit market share or balance sheet size for Estonia, and general government deficit for FYR Macedonia. However, it is not possible to reject the hypothesis that there are significant country fixed effects, so the country intercept terms are retained in the model specification.

A test is also made of a random-effects model specification rather than a fixed-effects model as in equation 1 based on the two subsamples of high- and low-reform states. A random-effects model would allow for country-specific distribution of the error terms rather than for country intercept terms. A Hausman test clearly rejects the random-effects model in favor of the fixed-effects model. A test also is made of the random effect versus a simple regression model with a single constant term. The Breusch and Pagan LM tests reject the hypothesis that the single constant term regression is appropriate for our data. The LM test suggests that the random-effects model is more appropriate for the data set than a single constant term model, and the Hausman test indicates that the fixed-effects terms are not correlated with other regressors. Therefore, the fixed-effects model is better than the random-effects and single intercept specifications.

**TABLE 16A.1 ESTIMATION RESULTS FOR COUNTRIES AND YEARS WITH HIGH BANKING REFORM**

<i>Independent variable</i>	<i>Real loan growth</i>	
	<i>Equation 1</i>	<i>Equation 2</i>
Lagged real GDP growth	0.59* (0.17)	0.58* (0.17)
Deposit market share	-0.16** (0.08)	
Total assets in U.S. dollars		-6.7e-07* (0.00)
General government balance	2.21 (1.61)	2.04 (1.55)
State-owned banks (dummy)	-0.25 (1.72)	-0.32 (1.66)
Ab initio private banks (dummy)	0.19 (3.28)	0.61 (3.29)
Foreign banks (dummy)	-2.11 (1.93)	-1.97 (1.85)
Ratio of equity to total assets	0.16*** (0.09)	0.16** (0.08)
Croatia country dummy and foreign ownership	17.02** (8.01)	17.29** (8.05)
Estonia country dummy and total assets		2.8e-06** (0.00)
FYR Macedonia country dummy and fiscal balance	19.82* (6.36)	20.34* (6.33)
Country dummy (Bulgaria)	-12.05 (8.99)	-12.42 (8.90)
Country dummy (Croatia)	-15.77 (01.95)	-15.62 (10.74)
Country dummy (Czech Republic)	-10.25 (8.91)	-9.32 (8.60)

TABLE 16A.1 (CONTINUED)

<i>Independent variable</i>	<i>Real loan growth</i>	
	<i>Equation 1</i>	<i>Equation 2</i>
Country dummy (Estonia)	-12.65 (10.22)	-14.38 (10.54)
Country dummy (FYR Macedonia)	20.26 (14.81)	20.65 (14.59)
Country dummy (Latvia)	-6.05 (9.06)	-6.53 (8.99)
Country dummy (Lithuania)	-5.68 (4.70)	-7.06 (4.91)
Country dummy (Poland)	-10.67 (6.64)	-10.22 (6.37)
Country dummy (Romania)	-8.48 (5.83)	-8.95 (5.78)
Country dummy (Slovak Republic)	2.58 (3.42)	2.25 (3.38)
Country dummy (Slovenia)	-15.27 (10.09)	-15.25 (9.91)
Constant	15.81 (10.38)	14.94 (9.91)
Number of observations	863	887
Adjusted $R^2$	0.08	0.08

\* Significantly different from zero at the 1 percent level.

\*\* Significantly different from zero at the 5 percent level.

\*\*\* Significantly different from zero at the 10 percent level.

Note: The robust standard errors are in parentheses. The number of observations changes with the substitutions of deposit market share for total assets, since the panel is unbalanced and there are more data for total assets than for deposit market share. Equation 1 includes deposit market share, while equation 2 includes the total assets of banks.

**TABLE 16A.2 ESTIMATION RESULTS FOR COUNTRIES AND YEARS WITH LOW BANKING REFORM**

<i>Independent variable</i>	<i>Real loan growth</i>	
	<i>Equation 1</i>	<i>Equation 2</i>
Lagged real GDP growth	23.7 (17.1)	22.4 (16.0)
Deposit market share	-23.8** (22.8)	
Total assets in U.S. dollars		-4.8e-05* (0.00)
General government balance	43.5 (32.5)	-60.8 (47.4)
State-owned banks (dummy)	545.1 (534.0)	466.6 (454.8)
Ab initio private banks (dummy)	24.7 (130.7)	40.5 (116.2)
Foreign banks (dummy)	-126.1 (132.4)	-130.8 (131.2)
Ratio of equity to total assets	-0.09 (1.34)	1.02 (1.82)
Constant	-69.1 (73.9)	-237.4 (203.1)
Number of observations	337	347
Adjusted R2	0.02	0.02

\*Significantly different from zero at the 1 percent level.

\*\* Significantly different from zero at the 5 percent level.

Note: Robust standard errors are in parentheses. The number of observations changes with the substitutions of deposit market share for total assets, since the panel is unbalanced and there are more data for total assets than for deposit market share. Equation 1 includes deposit market share, while equation 2 includes total assets of banks.

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## Chapter 17

# Financial Deepening and the Role of Financial Crises

*Stephen Peachey and Alan R. Roe*

**S**ocialist, and especially Soviet, banking systems had limited functions compared with those in advanced Western economies. The “banks” of the pre-1989 period were administrative agencies of government rather than banks in the accepted Western sense of the word. So the transition of these banking systems after 1989 was certain to involve some characteristics that Western observers would fail to predict. This chapter identifies how these characteristics have influenced financial deepening in the transition economies. In particular, it examines the role of banking crises in the process of financial deepening. Banking crises that have been seen in many transition economies—for example, the Baltic states in the mid-1990s and the Russian Federation (Russia) and Ukraine in 1998—seem to have been different in nature and generally far less disruptive of productive economic activity than similar crises in other parts of the world, including Mexico (1994) and East Asia (1997). At issue here is whether judgments about the economic consequences of crisis need to be amended to accommodate the peculiarities of transition.

This chapter couches the analysis in terms of three easily measured indicators of banking sector performance—bank deposits, volumes of cash in circulation, and per capita deposits—and then uses them to assess some basic hypotheses about the transition process.

### **Characteristics of Financial Transition**

Paradoxically the socialist banks of the pre-1989 era were quite safe, as were the hybrid “reforming” banks of the early transition period. Since they were owned by the state, as were their major clients and borrowers, failures on loan repayment were contained within the budgetary sphere. Many banks may have been technically insolvent,

but the implicit guarantees of the state diluted the importance of that fact. Concepts such as capital adequacy, the creditworthiness of borrowers, portfolio concentration, and insider lending were of only peripheral relevance to the financial durability of banks—their “failure,” in any case, was not a possibility to be entertained.<sup>1</sup>

This situation was expected to change as general economic reform took hold in these countries through the early 1990s. Considerable emphasis in the first-stage reforms for banks, as articulated by the International Monetary Fund (IMF), the World Bank, the Bank for International Settlements (BIS), and others, was placed on (a) strengthening the regulatory regime under which banks

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1. This proposition has been argued in greater detail in Roe, Siegelbaum, and King (1998).

worked and on (b) improving their own risk management and other banking skills. This advice was posited on the key assumptions that the interlocking between budgetary and banking finance would rapidly diminish, that individual banks would soon face the threat of their own failure, and that this, in turn, would threaten depositors and the economy more generally with significant losses. Strengthening the internal financial soundness of banks and the regulatory regimes within which they worked was seen as an important public good and the obvious way to mitigate these dangers. All transition economies accepted this advice.

In reality, though, only a subset of the Central European and former Soviet Union (FSU) transition economies behaved in a manner fully conformant to this expected pattern of the financial sector transition. A second and significant subset that includes some of the largest and most important countries, such as Russia, Ukraine, and several of the Central Asian states, instead retained significant elements of their pre-1989 patterns of behavior. Certainly these were amended in various ways to accommodate to new patterns of ownership and to new economic incentives and pressures. But a strong bank-state nexus remained in several countries. In most of these, various degrees of protection of “bad” banks via discretionary state interventions paralleled the protection of failing enterprises. Although substantial progress was made in introducing stronger regulation and supervision of banks in almost all transition countries, the improvements arising from these reforms were disappointing in both the quality and quantity of banking services.<sup>2</sup> Certainly, the emergence of serious Western-quality banking, and the associated benefits, was much slower than expected in many transition countries.

### Recovery of Financial Depth: How Quick and How Large?

Most transition economies, certainly those located in the FSU, entered the postsocialist period with very large monetary overhangs associated with the repressed inflation

of the socialist period. In the space of about two to three years, these overhangs were eroded by the combination of price liberalization and near hyperinflation, especially after the January 1992 Yeltsin reforms. The economic theory explaining how the initial shocks of price liberalization affected the size of banking sectors and the ratios of financial depth, such as the ratio of M2 to gross domestic product (GDP), is well documented (see, for example, Conway 1995). Equally, it is clear that the decline in the levels of intermediated savings was a decline in involuntary saving.<sup>3</sup> Since the initial collapse of the monetary overhang during 1989–92, there has been considerable variation in the recovery of the financial depth ratios between countries. This recovery also seems less well understood than the original collapse. The situation through mid-1999 for a representative group of 15 transition countries is summarized in figure 17.1, which contains three basic financial sector indicators:

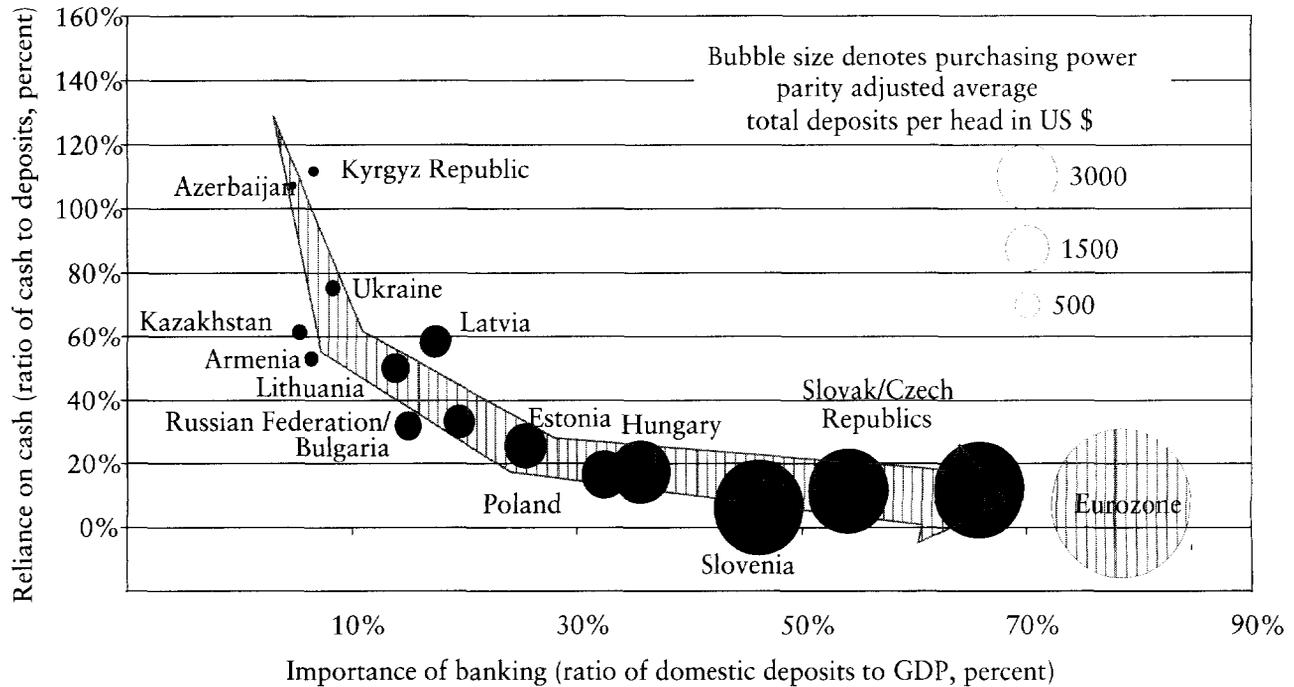
- The ratio of bank deposits to GDP—horizontal axis
- The ratio of cash in circulation to bank deposits—vertical axis<sup>4</sup>
- Average bank deposits per head of population (in dollars adjusted for purchasing power parity)—bubble size.

Figure 17.1 indicates that the transition economies of the Commonwealth of Independent States (CIS) have seen only a limited recovery of the ratio of bank deposits to GDP toward the 1989 levels of around 70–80 percent. In the Baltic states, recovery, although stronger, still has a long way to go to reach the levels of financial depth in the euro zone. Most of these FSU states are still operating with very high ratios of domestic cash to bank deposits, and they mostly have per capita levels of bank deposits that are very small compared with comparator countries in the euro zone. Again, the Baltic states have progressed much further toward normalization than the CIS bloc. The situation in Eastern and Central Europe is significantly different: the initial declines in financial depth ratios were much smaller there, and performance subsequently has been generally better.

2. A report prepared by the International Monetary Fund in 1997 for the countries of the FSU indicated that, in the area of banking supervision, 8 out of 15 countries had made “substantial progress,” three had made “moderate progress,” and only four had made just “limited progress.” In the area of bank restructuring, the corresponding number of countries in each of the three categories was six, four, and five, respectively. However, some countries with strong ratings in both of these categories showed very little progress in deepening their banking sectors. See International Monetary Fund (1997).

3. For that reason, the extremely high pre-1989 levels of M2 to GDP found in the FSU could not meaningfully be compared with the similar levels found in some Western economies.

4. The term “cash” in figure 17.1 and most other figures in this chapter refers only to domestic currency. Many countries in our sample also have significant dollar currency balances. This phenomenon is considered in more detail in box 17.1.

**FIGURE 17.1 COMPARISONS OF FINANCIAL DEPTH IN FIFTEEN TRANSITION COUNTRIES, MID-1999****BOX 17.1 A DIGRESSION ON DOLLARIZATION**

Lack of confidence in domestic money in the first two phases also has been reflected in most transition countries—especially in the FSU—in the significant use of (a) dollar and other foreign currency and (b) foreign-denominated bank accounts. Reliable comparative data on dollar and other foreign currency accounts are not available, but the pattern of this usage in relation to foreign-denominated bank accounts can be observed. This is summarized, for a cross-section of transition countries, in figure 17.2.

Clearly, the higher the degree of dollarization is, generally the lower the level of monetization is. However, this relationship is not linear nor entirely smooth. Dollarization has remained high in most FSU countries and some Eastern European countries such as Bulgaria. This is almost certainly a reflection of how

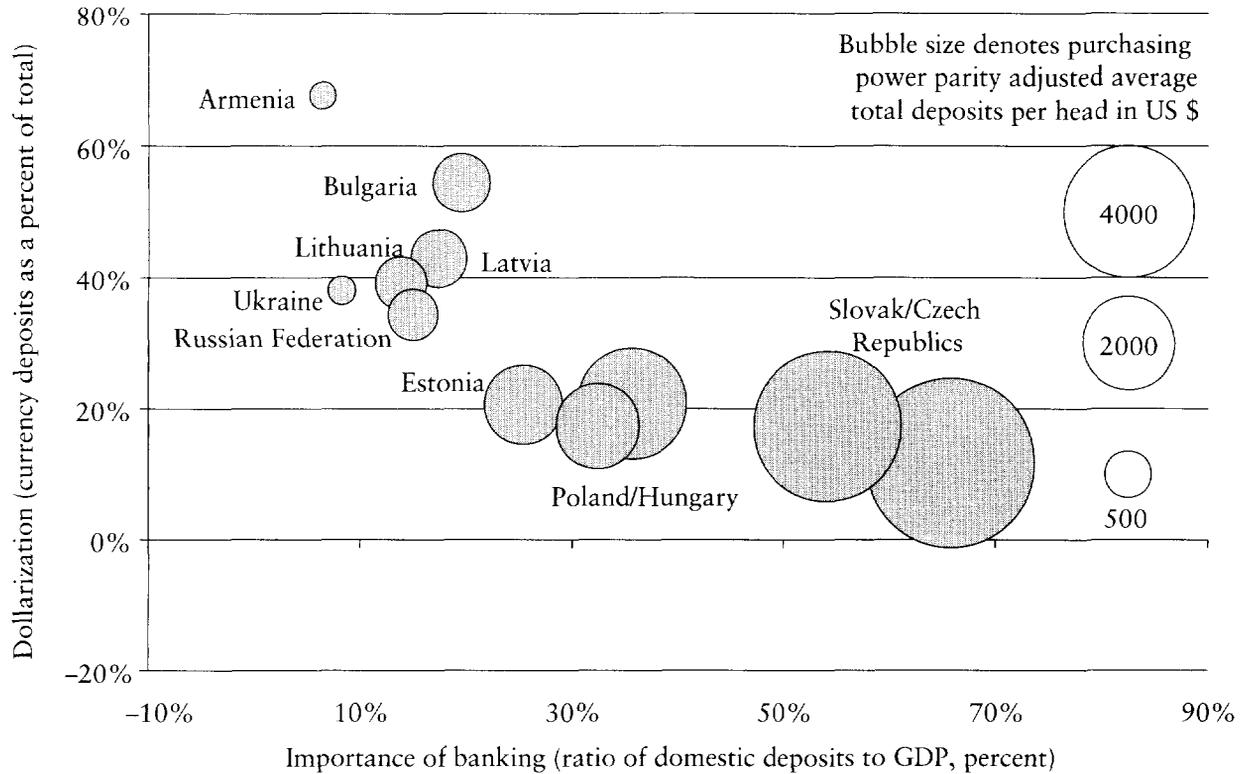
deep-seated dollarization became, especially in the FSU states, during the hyperinflationary period. This was most noticeable when the introduction of a credible national currency was delayed (as in Armenia, Lithuania, and Ukraine, for example). High rates of dollarization persisted in such countries even when the new currencies stabilized, possibly by being pegged against well-known hard currencies (such as the dollar-pegged Lithuanian lita and the Latvian lat, which both have held up well against the U.S. dollar). It is hardly surprising that the reemerged states that came out of the FSU should have more trouble establishing credible domestic currencies after a 50–80 year gap than Central European transition economies (where there was a continuity of their domestic currencies).

To understand how the specifics of this process differ country-by-country requires more than just the snapshot of countries at different stages of demonetization and subsequent remonetization that figure 17.1 represents. A schematic mapping is needed of how the banking sector in a transition economy adjusts to the initial chaos of the early reform period and the subsequent—often faltering—process of stabilization and recovery. This is shown in a

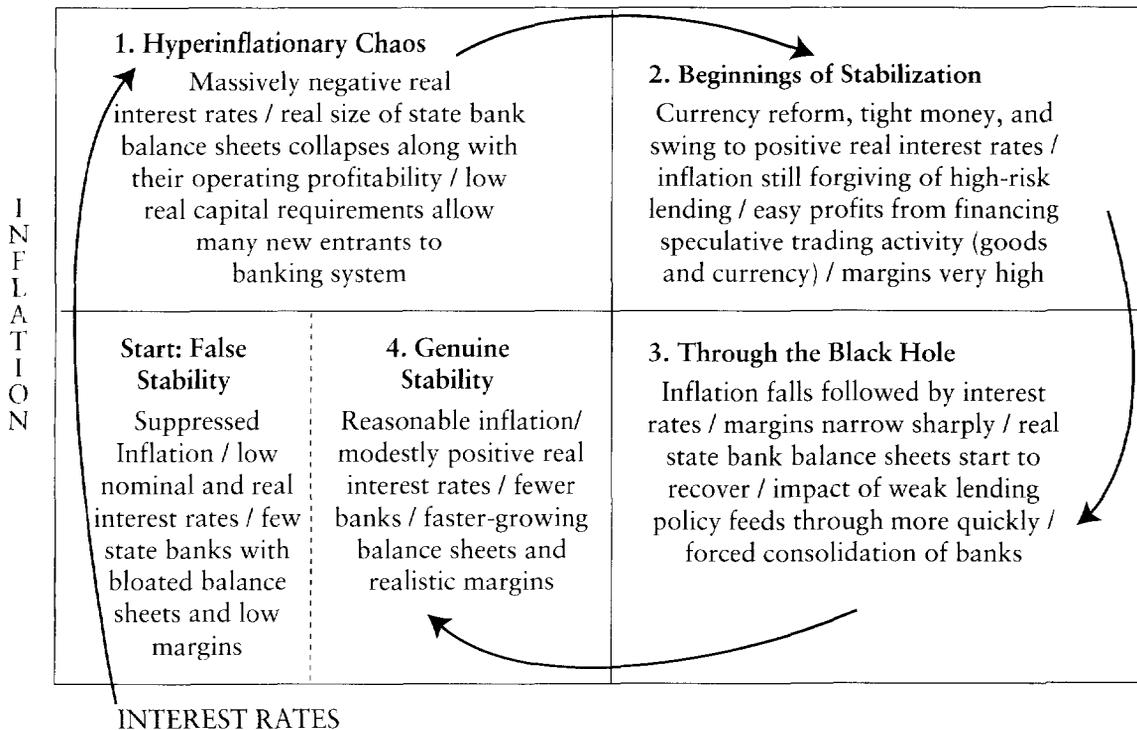
simplified schematic form in figure 17.3, with emphasis placed on inflation (vertical axis) and real interest rates (horizontal axis). The figure shows five stylized steps—the starting point plus four others—in the process of stabilization, together with the pressures on banks that occur at each of these stages.

This simple framework suggests why different countries have progressed at different rates through the process

**FIGURE 17.2 DOLLARIZATION AND BANKING SYSTEMS OF TRANSITION ECONOMIES, 1999**



**FIGURE 17.3 A SCHEMATIC REPRESENTATION OF STABILIZATION OF TRANSITION BANKING SYSTEMS**



of demonetization and remonetization and also why state banks have often survived in some form to be a larger part of transition banking systems than might have been expected. At the heart of this is the move—or, in some cases, the failure to move—through step 3 to step 4. Several factors influence this:

- The willingness, or otherwise, of the authorities to allow—or, better still, encourage—consolidation of the banking system during the “black hole” phase of narrowing bank margins (step 3) described in figure 17.2, even if that sometimes involves bank failures on a significant scale.
- The willingness of bank owners and management—particularly at private banks—to move through the black hole. This means replacing the speculative profits that allow small banks to become rapidly self-capitalizing during the chaotic hyperinflationary and early stabilization phases by making real profits. To the extent that they do this, they enter the much harder phase of making a profit from basic intermediation and using such profits to capitalize fast-growing balance sheets.<sup>5</sup>

One pattern is broadly apparent, certainly in the FSU. The countries where the state retains a high degree of involvement in both state-owned and private banks seem to have had the greatest problems in progressing through the black hole of narrowing bank margins. Such countries have yet to reach a new stability where fewer banks concentrate on doing expanding volumes of traditional intermediation at realistic margins that are compatible with affordable real lending rates.

The impact of progress through these various stages on the overall degree of monetization also can be described as a four-phase process:

- The first phase is one of catastrophic dislocation from near hyperinflation when there is no confidence in any form of money, either cash or deposits.
- The second phase is one where sound cash money is established—possibly through currency reform—combined with more stable inflation, but where the population and many entrepreneurs are not yet confident enough of banks to use deposits. In this phase,

the banking system is still suppressed below its natural level relative to GDP, and the ratio of cash in circulation to deposits can be relatively high.

- The third phase sees the rebuilding of public confidence in the banking sector as an integral part of the new market economy. This occurs initially by reducing the reliance on cash as a medium of exchange and increasing deposit-based transactions. This is greatly helped where real deposit rates turn marginally positive so that deposits offer an inflation-proof home for enterprise working capital and personal spending money.
- And finally, phase 4 sees the slow process of rebuilding confidence in deposits as a store of value, first by getting cash out from “under the mattress” and into bank deposits and ultimately by rebuilding voluntary savings in the economy.

### The Process in the Former Soviet Union

These different phases, and the impact that progressing through them at different speeds has on the degree of remonetization, are illustrated in the four charts presented in figure 17.4. These show the progression through time of the same three variables plotted in figure 17.1 for four FSU countries in different phases of the transition process. These are Ukraine (only just entering the second phase), Armenia (rapidly progressing through the second phase), Russia (stuck in the third phase), and Estonia (now starting the fourth phase).

The contrast between Estonia and the Russian Federation is particularly striking and is discussed in more detail below.

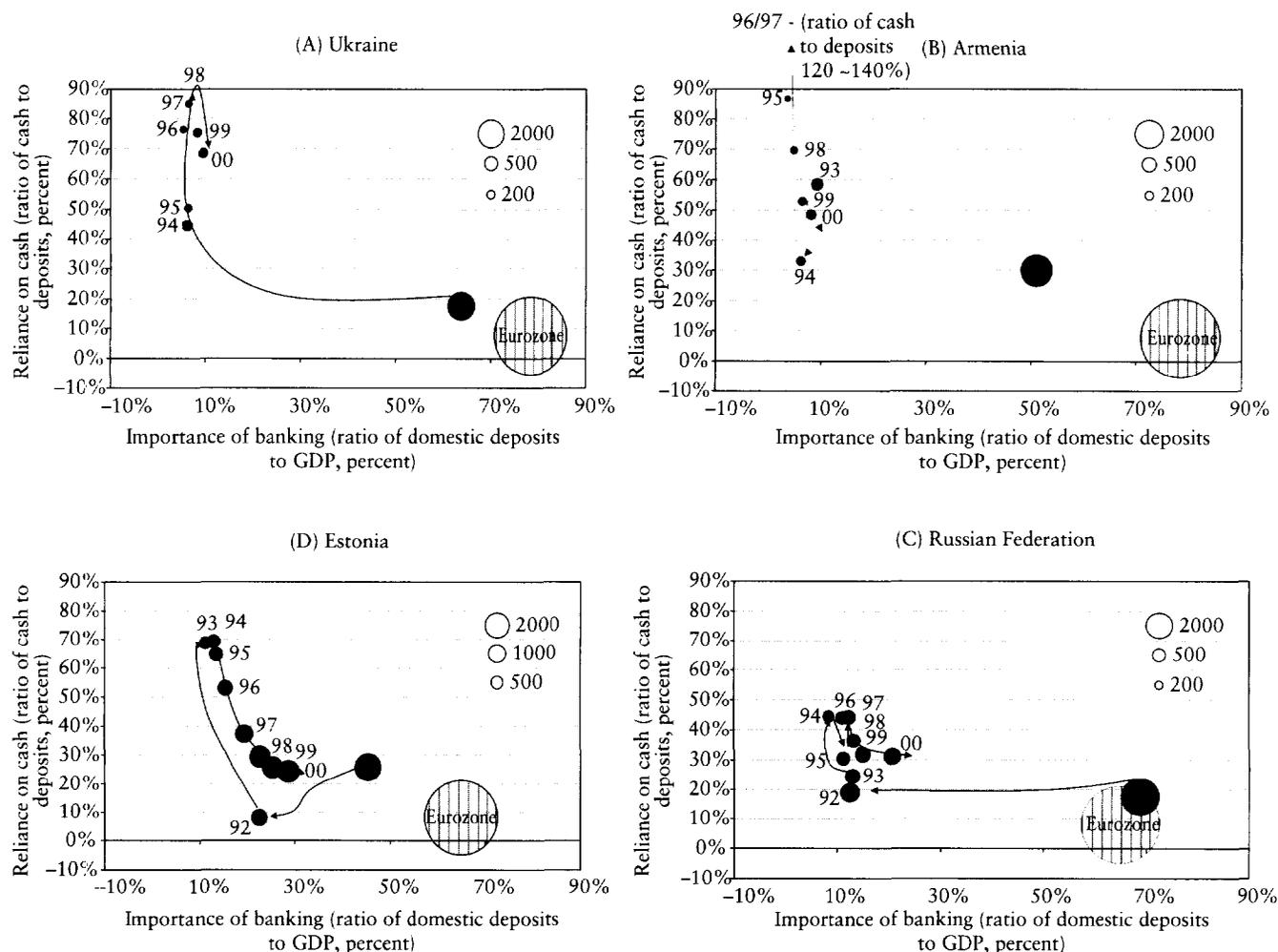
### The Process in the Central European Transition Economies

The situation in the Central European transition economies such as Poland and the Czech Republic is different than the experience in the FSU (see figure 17.5), but it is complicated by country-specific differences in the run-up to transition:

- Poland shows almost exactly the same pattern as Estonia, but played out over a much longer time

5. In many ways, the state banks (or their successors) do not face the same dilemma as their private banking counterparts—they typically have no choice but to be in intermediation because of their large branch networks. Disinflation and the return of positive real deposit rates (step 3) actually help them to rebuild their real liabilities. Provided they control the quality of assets, this should enable them to spread their high fixed costs over a larger base of income-earning assets. Therefore, they should be better placed to cope with falling margins than newer private banks that have only operated with small real balance sheets and high cost bases. The real risk to state banks arises if they lose control of asset quality through either their own poor management or political forces that keep their costs high and their earnings low.

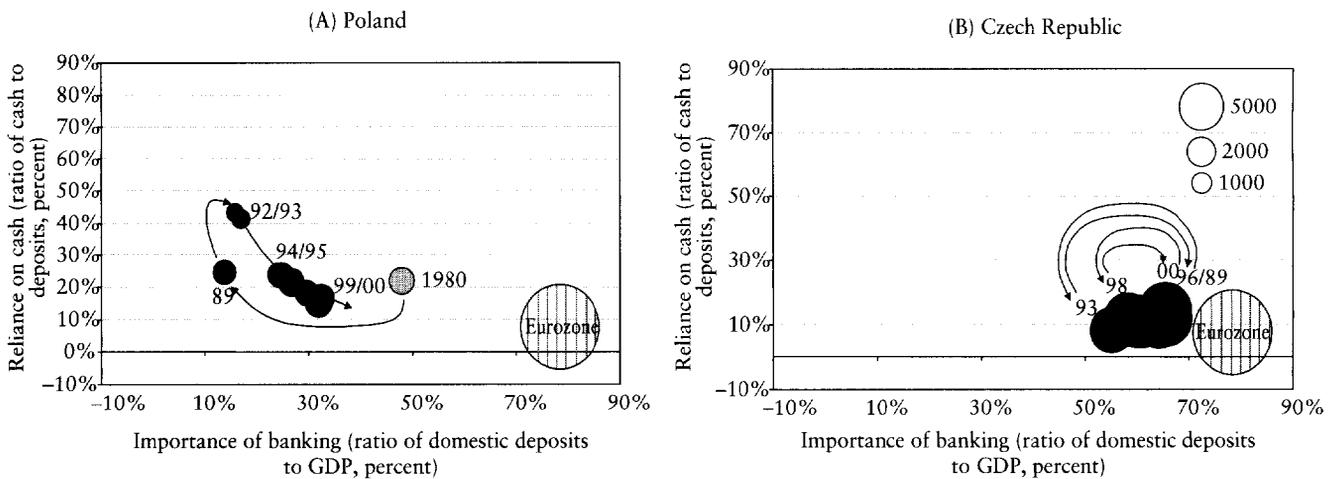
**FIGURE 17.4 DIFFERENTIAL PROGRESS TOWARD REBUILDING THE MONETARY BASE OF FOUR FSU ECONOMIES**



scale—20, not 10, years. Inflation rose significantly at the start of the 1980s, and the sliding exchange rate predated even this. By 1989 the ratio of deposits to GDP had fallen below 15 percent from very nearly 50 percent a decade earlier, and by 1992–93 the ratio of cash to deposits had jumped to 40 percent from 20 percent. Since then, despite relatively high inflation, the exchange rate and inflationary environment have been much more predictable. Together with positive real deposit rates, this has encouraged strong growth in bank deposits and a rapid return to a normal ratio of cash to deposits. Instrumental in this has been a steady consolidation of the banking system, often driven by foreign capital.

- In the Czech and Slovak Republics, the level of forced saving was much lower than under the Soviet regime, and generally higher productivity meant that price repression was less significant. Moreover, the

enterprise sector was heavily indebted to banks because accumulated capital had been stripped out by the state and returned to the household sector, leaving Czechoslovakia with a banking system three times as large relative to its economy as Poland. The initial price liberalization was short-lived, and hyperinflation was avoided. A one-off rapid, but contained, depreciation of the exchange rate created relatively benign conditions for households and enterprises. Only when the need for fundamental restructuring (as opposed to a change of ownership) became apparent in the late 1990s did the system come under sustained pressure. This meant that, while both countries retain large banking systems by regional standards, the gap with Poland has closed significantly. Part of this reflects the failure, until very recently, to push through the restructuring of large state banks.

**FIGURE 17.5 DIFFERENTIAL PROGRESS TOWARD REBUILDING THE MONETARY BASE IN POLAND AND THE CZECH REPUBLIC**

Other Central European economies, apart from Hungary, show a range of outcomes. Bulgaria, with its successful implementation of a currency board arrangement, shows the first signs of a recovery from its 1997 banking and currency crisis that may well be very similar to that of Estonia (also a currency board country). Romania, until recently, has shown the sporadic improvement and reversals displayed by Russia. It, too, may just be starting a more sustained recovery now that its central bank is forcing through meaningful observance of prudent banking ratios, even though this already has involved the failure of some of the largest state- and privately owned banks.

Hungary started with a very low level of banking development (with a ratio of deposits to GDP around 25 percent in the early 1980s) and a high reliance on cash (equivalent to some 50 percent of deposit balances). By 1989 the ratio of deposits to GDP had reached almost 40 percent, and the reliance on cash was reduced somewhat (equivalent to a third of deposits). Probably because of high ongoing inflation (only just covered by deposit rates), Hungary has consistently failed to raise its ratio of deposits to GDP since then, although the country's restructured banking system has mobilized large volumes of new deposits on an annual basis. Two special factors may be at play here. First, Hungary has moved faster than other transition economies to establish a significant nonbank financial sector. Second, the high penetration of foreign ownership may have blunted local pressures to compete more on grounds of cost efficiency. With regards to the latter point, foreign strategic investors tend to view their entry into the transition markets as part of longer-

term pan-European strategies. But even foreign shareholders do not have infinitely deep pockets, and there are signs that some consolidation is beginning to take place, as some of them seek to exit by way of sale to other foreign owners.

### Inhibitors of Banking Sector Development

There are several possible explanations for why different transition economies have experienced such disparate progress in recovering their 1989 levels of financial depth. But one conclusion is certain: reforms in banking regulation and supervision that have been accepted by all transition countries as the appropriate first-stage banking reforms correlate relatively poorly with that recovery. Table 17.1 maps FSU countries by their level of monetization (mid-1998) and the degree to which they had restructured the state banking sector and established BIS-style bank supervisory regimes by that time. The table shows that countries achieving the greatest progress with bank restructuring and supervision (toward the right-hand side of the table) manifest considerable variation in their progress toward restoring financial depth.

Table 17.1 suggests that regulatory reform is not in itself a sufficient condition for ensuring a stable and growing banking system. Nor indeed is regulatory reform a good predictor of the relative speed at which different countries reestablish higher levels of financial depth. Kazakhstan and Moldova, for example, have consistently received high ratings from the IMF and BIS for banking reforms, and yet they are among the worse performers in the comparisons of financial depth shown in figure 17.1.

**TABLE 17.1 MONETIZATION AND PROGRESS ON BANK RESTRUCTURING AND REGULATION IN FSU**

Deposits as a percentage of GDP	Progress on bank restructuring and introduction of BIS-style supervision			
	Limited progress			→ Good progress
> 20 percent				Estonia
10–20 percent			Lithuania Russian Federation	Latvia
< 10 percent	Belarus Tajikistan Ukraine	Azerbaijan Turkmenistan Uzbekistan	Georgia	Kazakhstan Kyrgyz Republic Moldova

Two alternative explanations of country differences in financial depth are suggested here. These explanations are associated with different attitudes and policies toward the following:

- *The protection of loss-making enterprises and the associated tolerance of barter, nonpayment, and mutual offsets as alternatives to money-based payments.*<sup>6</sup> Those countries displaying exceptionally high levels of such tolerance cannot expect to make real progress in banking development.
- *The protection of “bad” banks.* Those countries choosing to offer such protection pay the price by achieving a relatively slow pace of banking consolidation. The evidence from the FSU suggests that significant banking failures—even crises—may be a key element in the consolidation process and not the major negative force that they sometimes are assumed to be.

### *The Nonpayment Phenomenon and the Protection of Enterprises*

The connection between the nonpayment phenomenon and financial sector reform and deepening comprises two main elements:

- The widespread tolerance of nonpayment, as well as the widespread granting of discretionary tax privileges, stifles the incentives for enterprises to pursue greater efficiency as the route to increased market share. Inefficient enterprises are allowed to survive and even to achieve reasonable levels of post-tax profitability. In some cases, these profits can even compare favorably with the post-tax profits of efficient enterprises. In short, enterprise efficiency, on the one hand, and the levels of enterprise after-tax profitability, on the other, are disconnected.<sup>7</sup> Banks as a result lose the empirical basis needed to guide the allocation of scarce funds effectively to the more

6. The countries most implicated in this type of behavior purportedly have achieved a high level of fiscal discipline and have operated for some years with tight monetary policies. The tolerance of barter and nonpayment thus emerges as the new device for transferring subsidies to failing enterprises.

7. This point first came to prominence through the 1999 McKinsey Global Institute study on selected industrial and service sectors in Russia (McKinsey Global Institute 1999). The study found, among other things, that old enterprises from the Soviet days have seen their productivity halved because these enterprises have seen almost no restructuring in spite of large falls in the demand for their products; that the more productive enterprises in world terms are paradoxically often the least profitable and, in general, have not been gaining market share; that in 9 out of 10 sectors studied, the direct cause of poor economic performance is market distortions motivated either by attempts to address social concerns or by corruption; that in the manufacturing sectors, regional governments channel implicit subsidies to unproductive enterprises in the form of lower (even zero) tax and energy payments that are allegedly intended to prevent companies from closing down and laying off workers; that this puts potentially productive enterprises at a serious cost disadvantage and blocks growth and new employment creation by these better enterprises; and that in the service sectors, investments by efficient companies are discouraged by the presence of well-connected incumbents who benefit from favorable regulations, weak law enforcement, and privileged access to land or government procurement.

efficient enterprises. Hence economic growth is also stifled. Banks for this and other reasons find their own performance weakened and so are put under pressure to operate according to the opaque practices of the hybrid economy.<sup>8</sup> This fact becomes especially critical as a determinant of passing (or not passing) from step 3 through step 4, as described in figure 17.3.

- The widespread informal payments also crowd out conventional banking by providing large amounts of cheap (to some users) and wholly unregulated alternatives to the more conventional payment and credit arrangements provided through banks and other financial institutions. Survey evidence for Ukraine, for example, indicates that most enterprises make some use of banking services for both payment and credit, but that the use of parallel arrangements is often dominant, especially in the case of larger enterprises. For example, more than 60 percent of enterprises surveyed in 1998 had overdue trade credits, and more than 50 percent had tax arrears. Almost 99 percent of enterprises used wage arrears as a form of enterprise financing, while only 5 percent used long-term bank credits.<sup>9</sup>

Data to substantiate the connection between a high tolerance of nonpayment or barter and financial sector development are not available for most transition economies. However, it is significant that the incidence of nonpayment or barter is highest in the two largest countries of the FSU, namely Russia and Ukraine.<sup>10</sup> In both

cases, as figures 17.1 and 17.4 confirm, financial sector development also has been particularly weak. Other transition countries where the budget constraint, as measured by the extent of unpaid tax bills, is high include Georgia, Azerbaijan, Armenia, the Kyrgyz Republic, and Moldova. All of these countries also have very low financial depth.<sup>11</sup>

There is a question, however, as to the underlying policies that lead to this high tolerance of barter or nonpayment and so inhibit financial sector development. Recent papers on this phenomenon by Commander and Mumssen (1999) on Russia; Pinto, Drebenstov, and Moroz (1999) also on Russia; and Roe and others (2000) on Ukraine have reached broadly similar conclusions, specifically:

- The tax avoidance motive cannot explain the growth and flourishing of the nonpayments phenomenon. Tax avoidance is certainly an important consequence of nonpayment, but not the initiating cause.
- The perpetuation of soft budget constraints for loss-making enterprises (the alternative to closure or restructuring) is a far more generic explanation. The policy channels through which these implicit subsidies have been channeled (subsequent to 1994–95, when open budgetary subsidies and monetary permissiveness were phased out) are numerous and complex.
- The nonpayments system is incentive-driven, and many economic agents now have strong financial incentives to participate in that system and keep it alive. These beneficiaries include, but are no longer

8. What this means in practice is spelled out more fully in Roe, Siegelbaum, and King (1998). Paradoxically, arbitrary tax concessions and arbitrary hidden subsidies are likely to reduce, rather than increase, credit flows. This is because they add two extra dimensions of uncertainty to credit risk appraisal: concessions to enterprises can be removed as arbitrarily as they are granted, and those concessions distort the allocation of resources, thereby increasing the underlying economic risk of lending as a whole.

9. Preliminary results are from a survey and study by Dr. Volkhart Vincent, Osteuropa Institut Munich, and German Advisory Group at the Government of Ukraine.

10. In Ukraine, for example, (a) around 35 percent of industrial turnover is paid for via barter, (b) a similar percentage involves nonpayment or the use of quasi payment via the issue of *veksels*, (c) more than 20 percent of consolidated government revenues are typically collected through mutual offsets rather than monetary payments, (d) accumulated arrears among enterprises easily exceed nominal GDP; and (e) even wage arrears are the equivalent of more than 6 percent of GDP.

In both Russia and Ukraine, nonpayment is fueled crucially by the rising arrears extended by power companies and especially the electricity-supplying *energots*. The amounts outstanding to such entities in both countries have risen significantly since 1996 and now exceed 7–8 percent of GDP. In Ukraine only about 10 percent of energy bills are paid for in conventional ways.

11. Noncompliance with tax obligations is not a particularly good indicator of the extent of overall financial discipline and the incidence of barter or nonpayment in general. Hence we cannot use this indicator for the purposes of making robust statistical statements about the link between barter or nonpayment and financial development. For example, on this indicator alone, the Czech Republic has a softer budget constraint than either Russia or Ukraine. See Carlin and others (2000).

confined to, financially weak enterprises that were the initial recipients of the hidden subsidies associated with nonpayment.<sup>12</sup>

- The system could not have grown to its present large size and been sustained without the explicit or implicit connivance of the state—by accepting barter payments of taxes, by allowing or requiring the *energos* to operate with such large amounts of nonpayment, by being guilty of substantial amounts of payment arrears for pensions, wages, and so forth. Again the initiating motive was the desire to keep loss-making enterprises in business.

In short, explicit policies linked to the need to protect failing businesses represent a large part of the tolerance toward nonpayment or barter. It follows that such policies need to be fundamentally reformed if those countries are to see financial sector development at the levels already achieved in several comparator countries.

### *The Failure of Bank Consolidation*

Transition countries, and especially those in the FSU, have displayed considerable variation in the speed at which they have consolidated banking systems after the initial burst of unregulated new entry that most countries experienced in the early 1990s. Countries that have moved quite successfully in all three of the dimensions reflected in figure 17.1 have been the most aggressive in this regard. This is best exemplified by comparing the graphs for Estonia and Russia in figure 17.4.

Estonia followed an aggressive reform path, with little or no protection for weak banks. In the early 1990s banks accounting for around 40 percent of total banking system assets failed. This cost the economy the equivalent of 11 percent of GDP in lost real savings, but within five years this had all been recovered. Estonia now boasts the largest and third largest banks in the Baltic states (despite being the smallest of the three economies). Both now have strong strategic investors and are expanding abroad. Additionally, aggregate domestic activity kept growing through the twin shocks of the Asian and Russian crises now appears to be accelerating again. This is despite further bank failures in

1998 and 1999. Cumulatively, the banking system has shrunk from around 50 banks in 1993 to just 5 now. Overall domestic deposits stand at 25 percent of GDP, and over the past four years for which we have data (1996–99 inclusive) the equivalent of 10 percent of GDP annually has been injected into the economy by way of new credit, more than half of which has been domestically funded (table 17.2). Although the banking sector is now predominantly foreign-owned and the leading banks ultimately may become branches of foreign banks, the consolidation took place while the banks concerned were domestically controlled.

These developments have resulted in the smooth improvements in financial depth and deposit growth reflected in figure 17.4d. There is, however, a question as to the mechanism through which this takes place. One suggestion is that there are always huge potential gains to be achieved by closing down high-risk, undercapitalized, high-cost banks during the black hole phase described in figure 17.3. This form of consolidation allows domestic banking activity to concentrate around the better-managed, lower-cost banks, thus improving the overall efficiency of intermediation. Estonia appears to have exploited this fact, and the result has been rapid growth of the banking sector.

By contrast, Russian reform has been sporadic at best, with a large degree of politicization of the banking system involving the overt favoring of selected banks as well as protection for both depositors and shareholders from the consequences of failure. As a result, the Russian Federation has never suffered a single crisis of the same magnitude as the Estonian one in 1993, but neither has it experienced such a strong and sustained recovery. Despite starting 1993 with a banking system 20 percent larger than Estonia's, it now has a system not even two-fifths of Estonia's when measured relative to GDP.<sup>13</sup> Over the past four years, its banking system has injected less than 4 percent of GDP, on average, annually by way of new domestic finance, and less than half of this has gone to the nonbank, nongovernment sector to fund potentially growth-supporting investment (table 17.2). The failure of historic banking reforms to encourage rising market shares for lower-cost banks is

12. Commenting on Russia, Pinto, Drebenstov, and Moroz (1999) write as follows: "The system grew and persisted because profitable companies realized that they could take advantage of it provided that they linked up with unviable companies that were the original targets of the soft budgets. This in turn created natural alliances between the managers of viable and unviable companies, who could personally enrich themselves by siphoning off part of the subsidy. This led nonpayments to spread diffusion-like as ever more complicated networks developed, eventually creating a new form of industrial organization linking suppliers and final goods producers." A similar story for Ukraine is recounted in Roe and others (2000).

13. Based on comparisons of per capita purchasing power parity-adjusted deposits in U.S. dollars.

**TABLE 17.2 LENDING AND NET SUPPLY OF FUNDS BY SECTOR FOR SEVEN TRANSITION ECONOMIES, 1996–99  
(PERCENT OF GDP ANNUALLY)**

Country	(A) New lending to private sector	(B) Net flow to state <sup>a</sup>	(C = A+B) Net lending to economy	(D) New deposits by private sector	(E = A–D) Net finance of private sector	(F) Net foreign finance <sup>b</sup>
<i>Fast adjusters</i>						
Hungary	4.4	2.7	7.2	5.5	–1.1	0.0
Poland	5.8	0.9	6.8	6.8	–1.0	0.7
Estonia	7.2	2.4	9.6	5.0	2.2	3.3
<i>Slow adjusters</i>						
Russian Fed.	1.4	2.4	3.8	2.4	–1.1	–1.2
Ukraine	0.9	0.2	1.1	1.5	–0.6	–0.9
Lithuania	1.6	1.3	2.9	1.7	0.0	0.3
Czech Rep.	–0.6	2.2	1.5	4.4	–5.0	–4.3
Slovak Rep.	3.7	–0.1	3.7	5.2	–1.4	–0.4

a. Includes buildup of cash holdings and reserves at the central bank (ultimately available to fund government).

b. Change in commercial bank net foreign assets, sign reversed (minus means bank export of funds).

Source: IMF International Financial Statistics.

reflected in Russia's very slow and sporadic pace of financial deepening, as indicated in figure 17.4c. Equally, there is a real risk that if the bank restructuring effort currently under way does not soon result in the closure of banks that are no longer viable, then the real preservation of domestic savings that has been achieved since the 1998 crisis will be undermined.

A few other country examples serve to confirm the importance of banking consolidation as a main source of high financial depth. Figure 17.1 shows that Hungary has preserved a relatively high level of financial depth (especially when nonbank financial intermediation is included) and also has avoided excessive dependence on cash. This record is associated, among other things, with Hungary's actions in restructuring its state banking system, privatizing it, and opening the sector to foreign competition. The restructuring of state banks was undertaken while they were still publicly owned. Such a rigorous approach has yielded significant benefits in terms of the ability of banks to finance both government and the enterprise sector—average annual new lending to the economy has been the equivalent of just over 7 percent of GDP based on average

annual new deposit mobilization worth the equivalent of 5.5 percent of GDP. Poland lies in a similar position on figure 17.1 to Hungary, despite having started the 1990s in a much worse position. It too has seen the banking sector consolidate, partly under pressure from foreign capital, but at no cost to the supply of domestic finance. In Poland, an average of 7 percent of GDP has been injected into the domestic economy annually by way of new bank financing, and the bulk of this has been domestically financed. Both countries now have banking systems with ratios of deposits to GDP in the 35–40 percent range: three times the Russian level.

Lithuania offers the contrast of an initially very slow adjustment that failed to keep pace with, for example, Estonia in its overall level of monetary development (figure 17.1).<sup>14</sup> None of the other Baltic governments did more to protect domestic depositors from the consequences of bank failure than did Lithuania. As a result, Lithuania has the lowest ratio of bank deposits to GDP of all three of the Baltic states. In the last few years, this situation has begun to change markedly. Real progress started once Lithuania began serious preprivatization work

14. Currency reform was delayed and staggered over two years. Lithuania had a major banking crisis that eliminated some of its largest banks (state and private).

on the two remaining state banks and established a fully functioning and credible deposit insurance fund. The deposit insurance fund has been operational for two years and has successfully covered two payouts. The ratio of deposits to GDP has risen to recover all of the ground lost over the previous three years, when the Lithuanian government was spending far larger sums on informal bailouts of failed banks. The Lithuanian economy entered 2000 with significant consolidation of its banking system well under way, the two remaining state banks moving toward privatization, and a growing presence of foreign capital. After years of disappointing performance, its banking system is rapidly catching up with that of other Baltic states and, in all probability, has begun to move from the slow- to the fast-adjusting group.

### The Economic Costs of Trying to Avoid Banking Sector Consolidation

Most of the countries with low levels of monetary development (that is, countries located toward the upper-left quadrant of figure 17.1) are characterized by either or both of the following:

- A high level of tolerance of alternative financial arrangements that damage banks
- An unwillingness to see the rapid consolidation of the banking sector.

Both factors have a direct bearing on the efficiency of a country's banking system as a way of mobilizing and intermediating the domestic savings needed to support investment and economic growth. They share one feature—they both raise the costs of the business of banking. This suggests an important avenue of further enquiry in the search for an explanation of intercountry differences in financial depth. This is an enquiry into the cost bases of different banking systems. In doing this, it is analytically helpful to subdivide banking costs into two separate elements:

- *“Policy-induced” costs—costs on banks directly associated with policy interventions and therefore not under the control of the banks themselves.* Examples in the population of countries we are considering include unremunerated reserve requirements, unreasonable taxation arrangements for banks, administrative interventions such as the Kartoteka systems found in Russia and Ukraine, the costs associated with volatility of key money market interest rates, and the costs of large loan losses caused by high levels of state-directed lending.

- *The operational costs of banking that are potentially under the direct control of banks.* These include wages, the costs of owning and operating fixed assets, the burden of nonearning assets, and so forth.

Figure 17.6 assembles some initial evidence on this point for nine of the transition economies shown in figure 17.1.<sup>15</sup> It shows first the share of leading banks' total assets in each country that actually earn income—an indicator that is sensitive to the degree of political interference in what should be commercial decisions. Second, it shows the ratio of operating costs to interest-earning assets. When this ratio is inflated by the existence of too many small banks and too high a burden of policy-induced costs, it ultimately must result in a higher spread between deposit rates and lending rates, thus increasing the real cost of borrowing. Does this affect financial depth? And, if so, how?

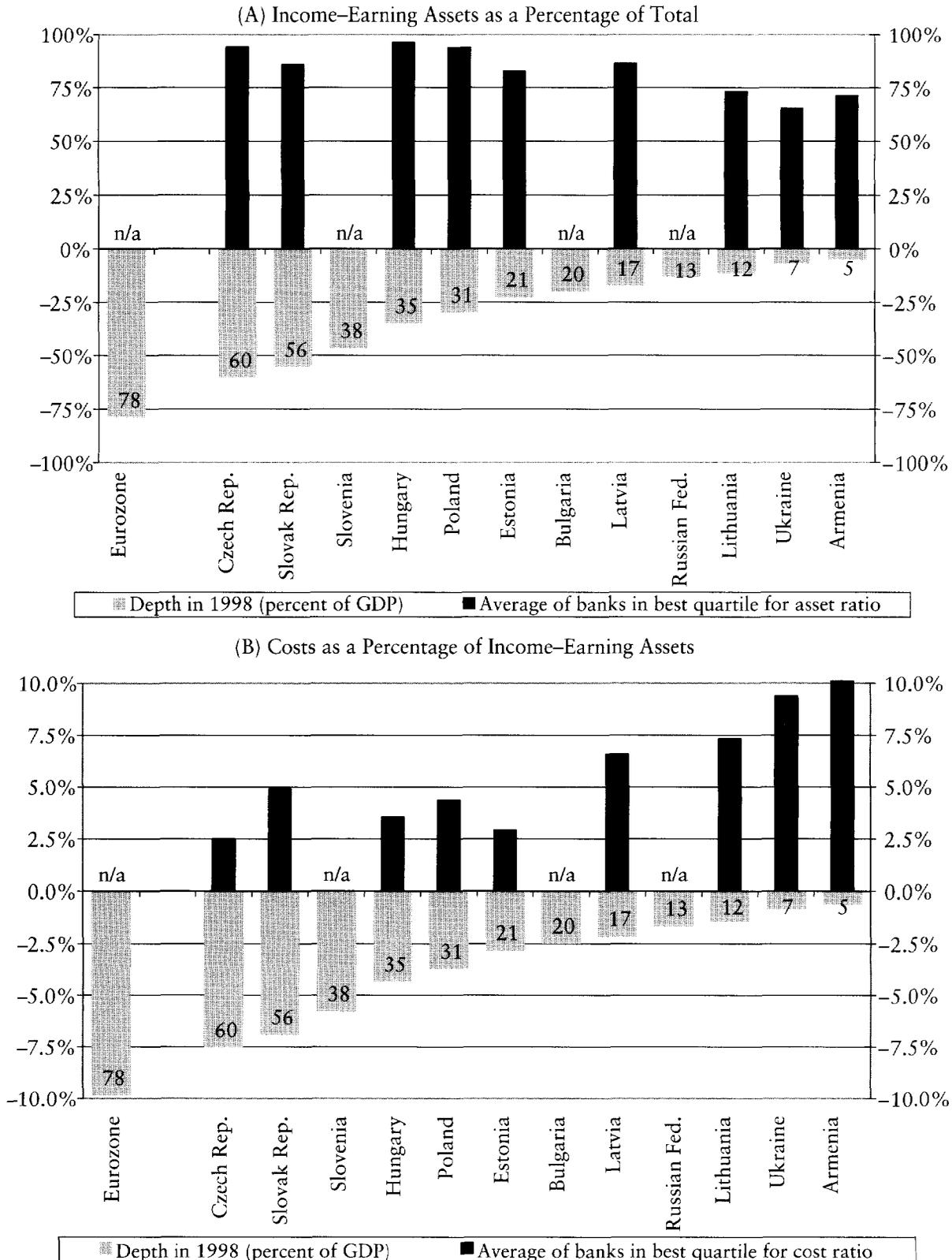
The share of earning assets and the ratio of costs to earning assets for the two least-monetized banking systems in this set—Ukraine and Armenia—are both significantly worse than for more advanced banking systems. The average cost of banking in these least-developed systems is also very high (up to 10 percent) relative to industrial-country norms of around 2–3 percent of total assets. More detailed analysis of the data behind these charts reveals that the best of the large Ukrainian banks has a lower ratio of total assets actually earning income than the weakest banks in comparator countries such as Poland, Estonia, and Latvia. Similarly, cost ratios in even the better banks in the least-monetized countries are high relative even to those in weaker banks in many of the better-performing countries, including Hungary, the Slovak Republic, and Poland. Although these better-performing countries all have some banks with quite high costs, the key point is that they have a sufficient core of efficient banks to support effective and, above all, low-cost intermediation.

These comparisons suggest that high costs in banking must have an obvious and direct impact on spreads (the lending rate relative to the cost of funds) and that these higher spreads must, in turn, exert a significant influence on the ability of the banking system to mobilize saving and thereby increase financial depth. This is confirmed by comparisons of real deposit and lending rates for a similar set of transition economies ranked by their ratio of domestic deposits to GDP, as shown in figure 17.7.

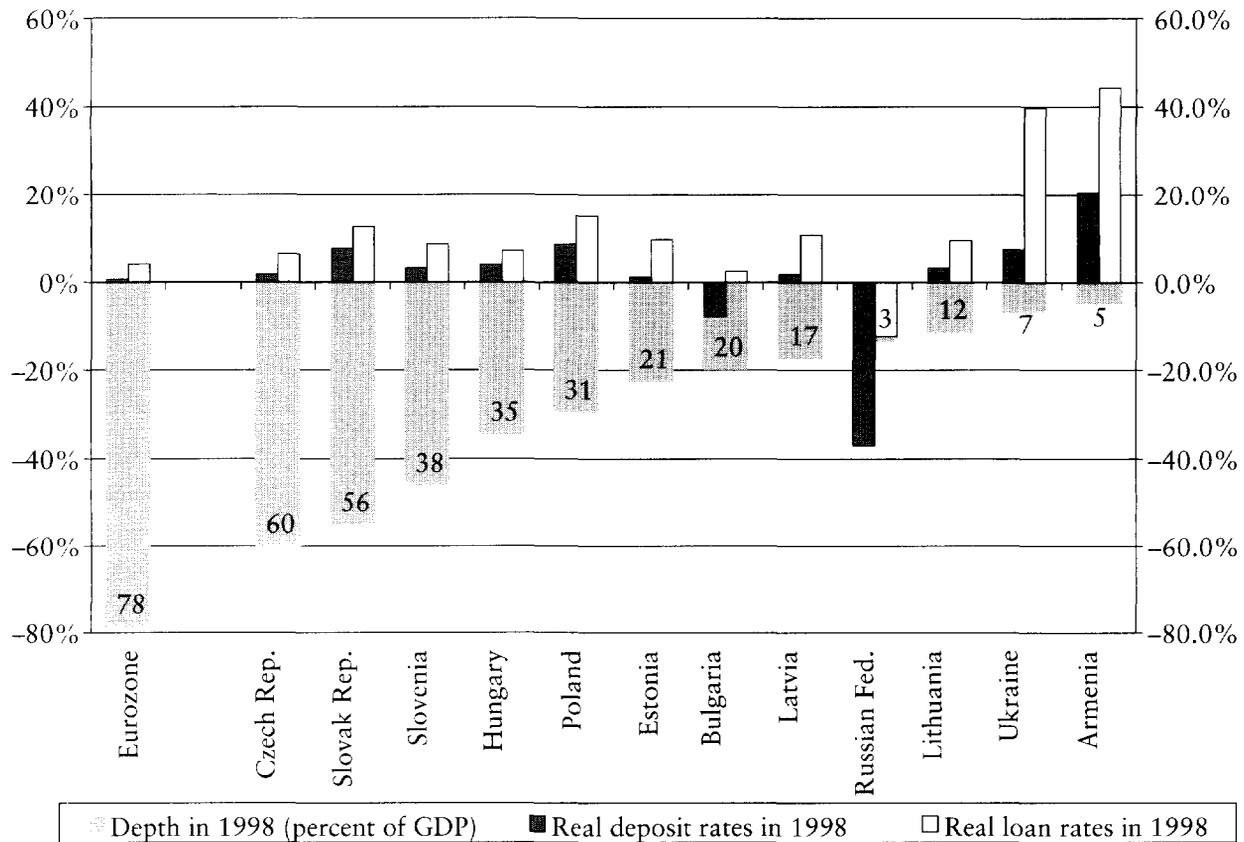
The evidence reveals great variation among countries in their level of real deposit and lending rates as well as

15. The country selections are based merely on the availability of detailed and comparable cost data on individual banks in the countries concerned.

**FIGURE 17.6 KEY BANKING EFFICIENCY RATIOS AND RATIOS OF DEPOSITS TO GDP IN CENTRAL AND EASTERN EUROPE, 1998**



**FIGURE 17.7 REAL INTEREST RATES, SPREADS, AND RATIOS OF DEPOSITS TO GDP IN CENTRAL AND EASTERN EUROPE, 1998**



financial depth—Ukraine and Armenia again stand out as clear outliers. Russia, for these purposes, can also be bracketed with these two countries.<sup>16</sup> But equally clearly there is no simple explanatory link running from high real deposit rates, on the one hand, to financial depth, on the other. Several countries that offer apparently very attractive real deposit rates have small banking sectors. Ukraine, Armenia, and Russia are the obvious examples—all three countries have suffered high real interest rates for several years. Figure 17.7 suggests that there is a stronger correlation between financial depth, on the one hand, and the spread between deposit and lending rates, on the other. In other words, where the cost of intermediation is high and puts a significant wedge between deposit and lending rates, then financial depth seems to be reduced. Pair-wise comparisons between countries with similar levels of real deposit

rates (for example, Ukraine and Poland; Ukraine and the Slovak Republic; Lithuania and Hungary) add further weight to this idea. They hint at the possibility that high real lending rates restrain feasible rates of asset growth and that this is a more critical determinant of financial depth than the adequacy of real deposit rates.

This points to a structural banking industry explanation for the persistence of high real interest rates as a feature of transition economies even after inflation seems to have been brought under control. Standard macroeconomic analysis argues that stabilization should give rise to lower actual inflation, which, after some lag, should also result in lower expectations of future inflation. These more benign expectations should, in turn, encourage increased money holdings that then mean low inflation can be sustained at a lower cost and on an ongoing basis. If real

16. It is worth highlighting the experiences of Russia, which fails to show up in figure 17.7 because of the choice of year. Real interest rates in Russia generally became significantly positive (20 percent or above) in late-1994 and remained at very high levels in real terms for almost three years, until May 1997. There was a further burst of high real rates in the spring of 1998. No country in Eastern Europe had to deal with such protracted periods of such severely high rates.

interest rates stay high during this process and for sustained periods (that is, more than six to nine months), then the macroeconomic programs that have produced these simply are not credible, and a relaxation is called for. But this has proved to be difficult advice to follow, and there are several examples in the FSU where real interest rates have been demonstrably higher than is credible for lengthy periods of time.

Based on this logic and the comparisons among countries presented here, it can be argued that the real cost of borrowing is unlikely to fall to credible levels until the intermediated financial savings of an economy consolidate around a smaller number of lower-cost banks. In effect, the failure to bring about consolidation of the banking sector raises the cost of intermediation to the whole economy and thereby reduces domestic funding of the heavy investment requirements typical of transition economies. This is confirmed by the comparisons in table 17.2. These show the volume of funds mobilized in three fast-adjusting economies where the banking sector operates on a relatively commercial basis and in five other economies where government has used various direct and indirect means to manage the process of consolidation or to protect banks from the consequences of failure.

The evidence presented suggests that a high level of tolerance of alternative financial arrangements that damage banks or an unwillingness to see the rapid consolidation of a country's banking sector ultimately reduce financial depth and starve an economy of affordable domestic finance for investment. There is a strong link between these two points. The protective instincts that lead to implicit subsidies to failing enterprises—provided via mechanisms including barter and nonpayment—are the same instincts that argue in favor of extending the lives of failing banks. In the hybrid stage of transition in which countries such as Russia, Ukraine, and some of the Central Asian states now operate, the motives behind this are no longer attributable directly to the state socialism that drove events before 1989. Today, the residue of such politics interacts with the complex struggles for the private ownership and control of valuable economic assets to generate this type of result. This pattern of behavior seems quite capable of coexisting with apparently good performance in relation to standard scorecards of reform, including reform of banking regulation and supervision. But where this coexistence occurs, the analy-

sis suggest that it is the surface gloss of reform that attracts the good scores—the serious commitment to the real intent of reform is another matter entirely!

### Financial Crisis and Financial Deepening

What, if any, conclusions can be drawn from this analysis about the significance of highly publicized banking crises in the transition economies, such as the Russian crisis in the fall of 1998? Should regulatory and supervisory efforts be intensified to head off such crises, or do they play a different role in the transition economies than they do in more settled banking systems?

In financial systems that remain in phases 1 and 2 of the transition, the economic costs of a financial crisis will be quite low relative to those in the more mature banking systems that sustained crises in Mexico, East Asia, and elsewhere in the 1990s. As figure 17.1 indicates, those banking systems typically have ratios of deposits to GDP of only around 10 percent. Consequently, the capitalization of banks in those systems is unlikely to be more than around 1.5 percent of GDP. Even generous compensation of the depositors of those banks that fail during a crisis is unlikely to involve a cost of more than about 1–2 percent of GDP. This compares with the estimated costs of the crises in other parts of the world, which are frequently more than 10 percent of GDP and can go as high as 50 percent.<sup>17</sup>

Second, in those phase 1 and 2 economies where tolerance of barter and nonpayment is a key part of the explanation of low financial depth, barter intermediaries represent a large alternative source of working capital for productive enterprises. Hence, even a significant short-term interruption in the availability of finance from some banks—or an increase in its cost—will have a muted effect compared to that same shock in a more normal banking system.<sup>18</sup>

The threat of crisis should not be accepted as an argument in favor of enhanced protection to systemically high-cost and “bad” banks. On the contrary, if the authorities have any choice in the timing of a banking crisis, they should let it happen in phases 1 and 2, as indeed was the case in the Baltic states. Whether the benefits of crisis can be achieved—that is, the accelerated consolidation of the banking sector around a lower-cost core—is another matter. The experiences of both Russia and Ukraine in 1998 indicate that it is as easy to let the opportunity presented by crisis slip away as to grasp it.

17. See, for example, Evans (2000), who notes that the 1997 crises in Indonesia and Thailand, for example, involved costs of 40–45 percent of GDP. The crises in Argentina and Israel in the early 1980s had costs of 55 and 30 percent of GDP, respectively.

18. In both Russia and Ukraine, this point and the large exchange rate depreciation associated with the crisis are probably sufficient to explain the recovery in real economic activity seen in both countries in 1999 and 2000.

## Conclusions and Future Prospects

There are significant differences in the level of financial intermediation established in different transition economies across the FSU and in Eastern Europe. These differences are strongly linked both to the nature of the macroeconomic disruptions associated with the early transition years and to the quality of the recovery from those disruptions. In those countries that have suffered from episodes of hyperinflation, a critical factor has been the policy stance in the period following the early inflation-stabilization programs, which almost all such economies have undergone. In this period, banks lose the easy access to profits arising from speculation and delayed debt write-offs and need to earn the profits to fuel future banking sector growth by offering serious banking services at increasingly lower margins.

Several countries in the FSU have side-stepped the macroeconomic pressures coming from tight monetary and fiscal policies by allowing high levels of barter and non-payment in their economies: Russia and Ukraine are the main examples. These practices serve to keep alive failing enterprises even after formal budget and credit subsidies are no longer available. But they also do significant damage to the prospects for the early recovery and deepening of the financial systems of the countries in question. The instinct of some countries to protect high-cost and inefficient banks is a second, very important reason for the slow deepening of financial sectors. This is because, even when positive real deposit interest rates are established, high-cost banking implies lending rates in real terms that are too high for serious enterprises to afford. So banks have little basis on which to expand their businesses. The alternative that seems to be associated with more rapid financial deepening is the expeditious consolidation of banking around a much lower-cost core of banks. This has occurred in some of the Baltic states as well as in several transition countries of Central Europe.

All of the European transition countries seem to have established the basic foundations of improved bank supervision and regulation. But several countries, including some in the FSU that have accomplished reasonably sound supervision and regulation, still find themselves with small banking sectors representing only around 10 percent of GDP. As the comparisons in table 17.2 indicate, these countries are

forgoing a substantial contribution to investment financing and economic growth as a result. Since reasonably developed banking systems are also a prerequisite for the emergence of broad and deep capital markets, those same countries are unlikely to see early progress in capital market development.

The critical questions for the future are whether the lagging countries identified in figure 17.1 can catch up with the more advanced countries. If this is possible, what policy measures are needed to achieve this? Recent econometric research shows that the initial conditions of countries in 1989 (including geographical location) appear to be a significant explanation of differences in growth performance in the period 1989–99. Most of the countries identified by this research as having unfavorable initial conditions also show up prominently in the list of countries with poorly developed financial sectors (for example, in figure 17.1).<sup>19</sup> This suggests that there may be some inevitability and common cause in the different patterns of both economic growth and financial sector development—both being rooted in the geography, the history, the politics, and the cultures of the countries being compared. However, the same econometric research also notes the gradual decay in the effect of initial conditions on growth performance as the forces of market economics take root. This suggests an increasing convergence of growth performance over time. It seems likely that a similar pattern is possible in relation to financial sector development—with the possibility of convergence to levels of financial depth at something like the present levels in Poland and the Baltic states (25–30 percent of GDP) becoming the norm for most FSU countries during the next 5–10 years.

However, the evidence mobilized in this chapter suggests that this convergence is by no means inevitable. If it is to occur in any particular country, reform of the financial sector will have to deepen. The standard indicators of progress with economic reform (whether the general transition indicators of the World Bank and the European Bank for Reconstruction and Development or the specific banking sector indicators of the BIS and IMF) correlate quite poorly with the differences in financial sector development noted in this chapter. The patterns of behavior that lie beneath these indicators seem to matter more than most

19. In a principal components analysis of the European Bank for Reconstruction and Development, for example, the first principal component—explaining almost 50 percent of the variance of initial conditions across countries—is extremely high (unfavorable) for Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. It is low (favorable) for all the Central European economies and moderately low for the Baltic states. Russia and Ukraine both have scores lying between those of Central Asia and those of the Baltics. See, especially, Falcetti, Raiser, and Sanfey (2000).

previous analysis has recognized. Unfortunately, these patterns are inherently much more difficult to measure and compare across countries. The chapter has focused particularly on the costs of different banking systems and has suggested that the convergence of the cost to asset ratio of the typical bank in a country toward industrial-country levels is likely to be required before a lagging country can expect to achieve significant financial sector deepening.

This logic leads naturally to a consistent menu of cost-reducing policy reforms to produce deeper banking systems. That menu comprises, *inter alia*, the following:

- *The reform or elimination of most government policies that contribute to the high cost of banking.* This would include the elimination of all politically directed lending, but it also would include the elimination of institutions such as the Kartoteka in Russia and elsewhere, improved domestic debt management to reduce the volatility and costs of money market operations (a particular problem in Russia and Ukraine after the 1998 crises), improved collateral procedures to lower the costs to banks of collateral enforcement, and lower or better-remunerated reserve requirements.
- *The radical reform of systems of nonpayment or barter in all countries in which these practices are widespread.* These practices also raise the costs of doing conventional banking by (a) obfuscating the information available to banks about potential lending prospects and (b) establishing unregulated alternatives to conventional banks in relation to both the credit and the payment functions.
- *The adoption of an increasingly low supervisory tolerance of the high operating costs and low ratio of earning to total assets that are characteristic of many large state and former state banks in the FSU.* Bank restructuring efforts in relation to such banks have often focused narrowly on rebuilding the capital base of these banks. A broader approach that recognizes the critical role of lower operating costs to support the expansion of banking capacity is now required. Banks that cannot aspire to industrial-country cost ratios will need to be phased out.
- *The adoption of explicit supervisory policies to accelerate bank consolidation to concentrate a bigger percentage of banking business on the lower-cost banks.* This would include a lower degree of supervisory tolerance of marginal performance by smaller banks as well as explicit efforts to broker mergers.

As much banking business as possible should be concentrated on those banks in a system that are able to

operate with costs approaching industrial-country norms. This, in turn, would both expand the potential volumes of new lending that can be provided to sound enterprises and enable those banks to achieve the profits needed to fuel their own more rapid expansion. The alternative protective stance that is still observed in many transition economies short-circuits both of these beneficial developments.

How does this idea relate to some of the more conventional prescriptions for banking sector development, such as the accelerated privatization of banking and increased foreign bank entry? The answer is that it relates to them only indirectly. The analysis presented in this chapter suggests that privatization, for example, would have little substantive impact on financial sector development unless it could be accompanied by all or most of the cost-reduction measures listed in this chapter. Private ownership of banking is common in most of the countries displaying the lowest levels of financial depth. But the private banks are relatively powerless to (a) achieve really low operating costs and (b) increase market share on the back of those low costs because the policy and operating environment for banking prevents this. Equally, the presence of foreign banks in most of those same countries is quite significant (20 percent of total assets in Ukraine, for example). But most foreign banks cannot be expected to push hard to broaden and deepen their operations in these countries when the policy and operating environments have so many features inimical to sound banking.

These and some other standard prescriptions for financial sector development, including stronger regulatory and supervisory structures, are better regarded as necessary conditions for eventual financial sector deepening, but not as sufficient conditions.

While no case has been made that banking crises are an inevitable step along the route to building fundamentally stronger banking systems, this chapter has illustrated that large-scale banking failures should not be seen as invalidating tough regulatory regimes. Rather, banking crises can reinforce strong regulation, provided the end result is intermediation increasingly focused around a smaller group of more efficient banks. In this respect, politicians should not fear crises as much as they do; recovery can be achieved easily within a three- to five-year time horizon, and avoiding necessary consolidation is a high-cost, not a low-cost, solution to banking instability.

The likely outcomes in the next few years in those countries that are presently lagging hinge far more crucially on the willingness of policymakers to embrace systematic cost-reducing and bank-consolidating reforms of the type

advocated here. Once this is done, the lagging countries likely will move rapidly (5–10 years) along the same transition path as has been observed in countries such as Estonia (figure 17.4d) and Poland (figure 17.5a). This will enable them to have ratios of deposits to GDP of around 25–30 percent and an associated annual flow of intermediated finance to the economy several percentage points of GDP higher than is possible today. This development also will bring closer the point at which significant capital market development can be seriously contemplated in these countries.

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## Chapter 18

# Aspects of Banking Supervision

*Christian Durand and Wim Fonteyne*

**T**his chapter addresses the main policy issues relating to the supervision of banks that the ECA countries<sup>1</sup> have met, are now encountering, or are likely to meet according to their stage in the transition process.

### **Main Purposes of Supervision**

Although banks have a semipublic policy role, their main objective is—or should be—to make a profit.<sup>2</sup> However, profit maximization requires taking risks and may often lead banks to undertake actions that go against the public's interest. Therefore, to reconcile banks' profit-maximizing objective with their semipublic policy function, an appropriate regulatory and supervisory framework is required. Such a framework needs to promote prudent banking—among other things, by putting reasonable limits on the risks that banks are allowed to take—in order to reduce the probability that institutions will fail. It also needs to organize competition in an efficient way, so as to prevent banks from gaining monopoly power and to ensure that a wide range of banking services is available at low costs, without placing excessive restrictions on the commercial freedom of banks. A reliable supervisory capacity

is required to enforce the regulation, adapt it to changing circumstances, and help build public confidence.

A healthy banking sector is maintained through the combination of bank licensing rules, which determine the criteria for entry, and banking supervision, which allows the detection of unqualified competitors and forces them out. However, adequate supervision does not guarantee the elimination of failure. A plethora of factors could lead a bank to fail, and it would be unrealistic to seek a system likely to eliminate all of them. Moreover, there is virtually no country that has never experienced a bank failure.

Due to the macroeconomic shocks and structural changes of the transition process, the inheritance of the past, the proliferation of commercial banks after the onset of economic liberalization, and initial limited supervisory capacities, ECA countries experienced an unusually high number of bank failures and banking crises during the 1990s.<sup>3</sup> Major

1. For the purpose of this chapter, ECA countries refer to countries in Europe and Central Asia receiving assistance from the World Bank, namely Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, FYR Macedonia, Poland, Romania, and the Russian Federation.
2. For a discussion of the role of the financial sector in economic development and growth, see, among others, Beck, Levine and Loayza (2000); Demirgüç-Kunt and Maksimovic (1998); Easterly, Islam and Stiglitz (2000); Levine (1997); Levine and Zervos (1998); and Rajan and Zingales (1998).
3. Boot and van Wijnbergen (1995) note the absence of regular commercial banks in Eastern Europe (except in the Federal Republic of Yugoslavia) and the former Soviet Union as recently as 1987. However, by 1994, there were more than 3,600 banks

banking crises occurred in Bulgaria, Estonia, Hungary, Latvia, Poland, Romania, and the Russian Federation (Russia). In Russia alone, more than 200 banks failed in the 1990–95 period. During the same time frame, there were more than 45 bank failures in Kazakhstan and more than 20 each in Armenia, Estonia, and Latvia (see Gorton and Winton 1998).

Banking supervision should not try to prevent risk taking altogether, since risk is a quintessential part of financial intermediation. However, supervision should seek to ensure that banks are able to identify, measure, and monitor the risks they take. This entails ensuring that banks have a well-functioning risk management system. Furthermore, financial sector regulation should not distort the market. It should be designed carefully so as not to favor a particular activity or a specific type of institution (for example, by putting banks at a competitive disadvantage vis-à-vis nonbank financial institutions). In this respect, the tax regime, monetary policy, and exchange regime also play a considerable role. Finally, a strict regulatory framework should foster competition among banks in order to achieve an optimal allocation of resources. Conservative practices aimed at stabilizing banks and their customer base should be avoided.

At no point should supervisors take over management's role. Supervision has to limit itself to making sure that bank managers stay within the constraints set in the regulations and maintain at a reasonable level the risks associated with their banking activity. However, in extreme cases, when strong remedial action is needed, the gap between supervision and management may become very thin. Supervisors may even need to intervene to oust and replace an incompetent management team.

### **Designing a Supervisory System for ECA Countries**

Banking is an unusual business based on confidence between lender and borrower, banker and depositor. This confidence should be supported by a strong regulatory system, particularly in countries with a limited banking culture. Because it takes more time to build credibility than to lose it, it makes sense for the supervisory authorities to build an effective bank regulatory system cautiously and gradually.

However, bank regulation, when excessive, can have adverse effects on the way banks are managed, thus limiting the potential for market development. Examples of such excessively strict regulation could be an insurmount-

able initial licensing process that prevents new entry or sets capital adequacy requirements so high that investment in the banking industry is being discouraged. In this regard, when establishing a banking business, the first major impediment to overcome is the need to meet the required level of minimum capital. The next step would be to decide on the additional capital needed from shareholders to increase business activity within the established key prudential capital ratios.

Capital is the key indicator of banking soundness for two main reasons. First, it is well known that strongly capitalized banks can better withstand shocks than their weaker counterparts. Second, it is a simple indicator to define and use—far simpler than the traditional regulator's rating system based on capital, assets, management, equity, and liabilities (CAMEL). Clearly, imposing a high level of capital tends to reduce banks' return on equity. Therefore, it is advisable to have a balanced approach aimed at requiring the level of capital that is really needed and not more. However, this requires sophisticated tools and a long, consistent series of accurate data, which rarely are available in ECA countries. At the same time, bearing in mind that capital is the only cushion protecting customer deposits, the lower the capital is, the more deposits are at risk. The realization of this risk will depend on the time that the supervisory authorities need to take action when problems occur and losses start eating away at capital. Obviously, the faster the authorities are able to take action, the lower is the minimum level of capital that can safely protect bank deposits. The response time of the authorities will, in turn, depend on the efficiency of their monitoring and a series of elements of the general environment, such as accurate accountancy, absence of political intervention, and good law enforcement.

Another typical capital-based regulation is the limit on large credit exposure to a single borrower. Concentration of lending is sometimes difficult to avoid in countries where the economy is dominated by a limited number of sectors (for example, due to the country specialization prevailing in the centralized organization within the former Comecon framework) served by a limited number of financial institutions. Avoiding concentration of loans is even more difficult when the economy is based on the primary sector. Here again, regulations may hurt by limiting the financing available to large quasi-monopolistic compa-

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in the countries of the former Soviet Union alone, of which more than 2,500 were in Russia (see Dziobek and van der Vossen 1999). Also in 1994, there were about 70 banks in Poland, about 60 in the Czech Republic, about 40 in Hungary, and about 30 each in Bulgaria, the Slovak Republic, and Romania (see Gorton and Winton 1998).

nies. Transitional arrangements such as credit pools could be organized, but such arrangements do not foster competition.

As long as a country's financial markets are not well enough informed to impose market discipline, and the public is not sufficiently educated to distinguish between financial institutions, the problem that regulators face is how to determine the optimal level of regulation among the many tradeoffs between development and stability. To do this well, the authorities must be able to phase in an effective system of bank regulation within the overall reform process. To illustrate the feasibility of such sequencing, the phasing in of bank supervision and financial restructuring measures can be classified into three progressive stages of implementation (see Sundararajan 1999). The first of these stages—the preparatory stage—focuses on the legal basis of bank supervision restructuring, together with a minimal program of financial restructuring to initiate stabilization and prepare the ground for financial market development. As market-based instruments of monetary policy are introduced to initiate financial liberalization in the second stage, a critical mass of reforms in prudential supervision and in bank and business enterprise balance sheets is implemented in parallel. This initial group of reforms helps accelerate the adoption of indirect instruments, improve their effectiveness, and set the stage for more comprehensive reform of prudential supervision and bank restructuring in the medium term. As markets develop, prudential norms, supervisory procedures, and restructuring actions are progressively refined and modified in line with market development and internal governance of financial institutions, thereby helping to consolidate financial market development in the third stage. Throughout this process, an important question is how closely international standards should be followed.

In the ECA countries, major efforts have been undertaken to develop an appropriate regulatory and supervisory framework (for an overview, see Knight et al., 1997, and Dziobek and van der Vossen 1999). In all countries, the central bank also became the banking supervision agency. During the first half of the 1990s, most ECA countries adopted new banking laws, often with rather lenient bank licensing rules. Later on, in many countries and especially in the former Soviet Union, rules had to be made stricter to stem the proliferation of small, weak, and inefficient banks. From 1992–95 onward, minimum capital and capital adequacy requirements were raised throughout the region, licensing and exit policies were tightened, and overall banking supervision capacities were reinforced, contributing to a fall in the number of

banks in the former Soviet Union from 3,600 in 1994 to about 2,500 in 1997 (see Dziobek and van der Vossen 1999).

### *Should International Standards Be Adopted in ECA Countries?*

International standards, established by organizations such as the BIS (Bank for International Settlements) and IOSCO (International Association of Securities Commissions), reflect years of experience. As such, emerging economies can benefit from their expertise in defining the most efficient tools for effective bank supervision. Adhering to international standards also facilitates the dialogue with foreign investors, since all parties involved are “speaking” the same language. However, adopting these standards also raises concerns. On the one hand, it is possible in the early stages of banking system development that banks will have difficulty meeting international standards. It clearly would not be advisable to set high standards that banks would not be able to meet. The solution is usually to phase in reforms in a manner consistent with the type of activity and the level of risks acceptable at a point in time, to maintain international standards as an objective, and to design a step-by-step path to achieve them. Conversely, it is possible that international standards may not be stringent enough to reflect accurately the risk exposure in some countries. This might be the situation in the case of two key ratios: capital adequacy and liquidity. The capital adequacy ratio, together with the large loan exposure ratio, probably should be more stringent when the legal framework for loan recovery is weak.

Moreover, often the capital adequacy ratio chosen by developed-country regulators is calibrated for industrial countries whose economies are generally larger and less vulnerable to exogenous shocks. These ratios may not be strict enough for some transition economies. Imposing higher requirements may appear onerous and possibly pose an impediment to financing development, but it may be inevitable if regulators are to have a realistic chance of intervening in a failing bank before all its capital is eroded. The establishment of appropriate capitalization levels for country circumstances is a matter that needs to be considered on a country-by-country basis. Clearly, there is a risk that increased capital requirements could lead to disintermediation and to banks shifting loans from their books into offshore subsidiaries; issues of international coordination may arise. Capital requirements have been substantially raised in ECA countries since the beginning of the 1990s, and they are currently at or above the BIS

standard of 8 percent of risk-weighted assets in most countries.<sup>4</sup>

Finally, the assignment of a zero risk weighting to a country's own government debt, as is done in industrial countries, may not be appropriate in countries where direct and indirect government arrears are still common or in countries that recently have defaulted on outstanding government bonds, such as the Russian Federation and Ukraine. It often is argued that a government can always print its own money to repay banks, thus never being in default. However, this may not be the case when a currency board is in place, or when a government has rejected the use of monetary financing for external reasons, such as the desire to be part of a monetary union or to adhere to a stabilization program. Even when governments have confronted their loan delinquencies, they have on occasion secured preferential consolidation, which has been tantamount to a partial default, at least as far as the bank's profit and loss account is concerned. In the end, there are sufficient reasons to consider the possibility that lending to a country's own government may not necessarily be free of risks.

Liquidity ratios should reflect the risk that banks may not easily be able to find refinancing when needed, because the monetary market is not efficient or is too narrow or possibly because the secondary market for securities—if present—is not liquid. When this is the case, consideration should be given to whether or not the central bank can act as a lender of last resort.

International standards should no doubt be used as a reference point, although they must be placed in a context. This has been the objective of the joint International Monetary Fund (IMF) and World Bank Financial System Assessment Program (FSAP) in analyzing the different components of the financial system, together with the macro-economic framework, while conducting standards assessments. Results of standards assessments conducted in the context of an FSAP can be disclosed and can provide the international seal of approval needed to promote the need-

ed incentive structure. At the same time, it sometimes is argued that such standards tend to make it more difficult for national institutions to emerge, thus raising the question of sovereignty.

### *Should Local Regulators Welcome Foreign Institutions?*

There is, of course, a tradeoff between sovereignty and efficiency in financial markets. Allowing foreign institutions to compete in the market makes it possible to foster the development of banking by bringing in competent, experienced, and skilled professionals with the requisite know-how. Claessens, Demirgüç-Kunt, and Huizinga (1998) find that, for a sample of 80 countries, increased foreign entry tends to improve the functioning of national banking markets, with positive welfare implications for banking customers. However, as a corollary, they also find that foreign entry makes life harder for domestically owned banks, reducing their profitability. In this regard, Bonin and Wachtel (1999) note that foreign bank entry risks creating a two-tier system in which strong banks with foreign partners attract the best customers and other banks are left with less financially sound and less profitable clients. The challenge for the regulator is to find a level playing field, in which foreign-owned banks can compete with domestically owned banks in a healthy competition that strengthens and improves the entire system. Bonin and Wachtel (1999) argue that one approach to this problem is to promote foreign entry in the form of joint ventures and equity stakes in existing banks. Thus globalization, often thought of as a threat, can become an advantage, potentially strengthening the resilience of a small economy's banking system.

Among ECA countries, the countries of Central and Eastern Europe and the Baltic countries have—in general—been much more open to foreign entry than the countries of the Commonwealth of Independent States (CIS; see Tang, Zoli, and Klytchnikova 2000). In addition, economic developments so far have made the former countries more

4. Armenia, Azerbaijan, Belarus, Estonia, Latvia, and Lithuania have minimum capital adequacy ratios of 10 percent. Bulgaria, Czech Republic, Hungary, Poland, Romania, and the Kyrgyz Republic essentially have adopted the BIS standard capital adequacy ratio of 8 percent. Georgia has introduced a gearing ratio of 10 percent. Kazakhstan has introduced a 12 percent requirement, with a phase-in provision. The decision to opt for 12 percent was adopted in part because of recognized problems with accounting and reporting—by requiring 12 percent, there is some comfort that at least 8 percent is actually achieved. It also may reflect the view that in developing and transition economies commercial exposure should be risk weighted at more than 100 percent and that sovereign debt might properly attract a risk weighting of greater than zero. Russian regulations (Regulation 1) prescribe minimum risk-weighted capital of 10 percent as of January 1, 2000, for banks with own funds of 5 million euros or more (countervalue) and 11 percent for banks with own funds between 1 million euros and 5 million euros (countervalue). They do not require specific banks to meet varying ratios. Ukraine has a capital adequacy ratio of 8 percent. As of January 1, 2000, there were plans to introduce individual solvency ratios for banks, which could be as high as 12 percent. No information is available about whether the plan has materialized.

attractive to foreign banks than the latter. As a result, the relative presence of foreign banks is now highest in the Baltic countries. For example, the consolidation process in Estonia resulted in a series of mergers. After these mergers were completed, two major Swedish banks acquired control of the country's two largest banks—accounting for more than 85 percent of total banking assets—as part of their strategic plans to gain a substantial presence in the Baltic states. Foreign banks also have an increasingly strong presence in Central and Eastern Europe. They account for about 60 percent of the banking system in Hungary and 80 percent in Bulgaria, and they might reach 90 percent in the Czech Republic once the privatization process is finalized there. By contrast, foreign participation remains very limited in the banking systems of the CIS countries, and the existing foreign participation often originates from fellow CIS countries (see also Dziobek and van der Vossen 1999).

In many instances, ECA countries have sought to limit foreign entry in their banking systems. In Poland, the government refused to grant any licenses to foreign banks from 1992 until 1994, an episode that may have contributed to the relatively low share of foreign banks in Poland's financial system, in comparison with other Central and Eastern European countries. In Kazakhstan, foreign banks cannot own more than 25 percent of a domestic bank's stock.

### ***Should Internationalization Be Fostered?***

Although there is much concern that increased globalization of financial markets can increase the volatility of capital flows, globalization also can provide opportunities to diversify some of the risks facing a small financial system. Small economies would do well to develop policies to strengthen the resilience of their financial systems. Innovative risk-sharing financial instruments can help, but achieving the full potential may require stronger ownership links between financial institutions at home and abroad. As the network of financial institutions has become more diverse and more complex, sophisticated financial systems have become more resilient to isolated failure (Honohan and Vittas 1996). Not every country can expect to build a comparable complexity by itself, but by becoming more integrated into the international financial network it can obtain the benefits of increased resilience as well as diversification.

In the end, most *macroeconomic* shocks for a small country are only regional or sectoral shocks for the global economy. The risk of such shocks can, in principle, be diversified. One theoretical option is to diversify through market instruments. Banks might find ways of selling or swapping part of their loan portfolio to banks in other countries. Or

marketed derivative instruments linked to objective indicators correlated to national economic conditions could provide a vehicle for diversification. The alternative, and more practical, option is greater involvement of foreign-owned banks in a country's domestic banking. For example, heavy loan losses at the local branch of a multinational bank will not entail failure of the entire bank.

Similarly, in considering the problems of *macroeconomic* shocks and the pressure of *government ownership*, the advantages of greater participation of foreign banks become clear, since they generally have long experience and come from strong banking systems. Foreign banks are more likely to impose strict controls on their international branches and subsidiaries. Therefore, concentration of lending is less likely to be condoned, especially if it is to parties related to the local management. Local loan approval is also less likely to be given free reign, and government pressure can often be more readily resisted. Such mechanisms of internal control are likely to be much more effective than external regulations and supervision.

An important obstacle to this approach is the common perception that foreign ownership of banks compromises a country's sovereignty. Conversely, when foreign banks are welcomed, they may not always be rushing to enter. Experience to date of foreign-owned banks in transition countries varies, but often such banks have tended to confine themselves mainly to servicing the local activities of foreign enterprises and the trade finance requirements of the largest domestic enterprises. Partly as a result of this, but also because of better management procedures and less pressure from governments, the failure of foreign-owned banks has often been far more rare than among domestic banks—even though foreign banks' lack of local information can sometimes lead them to make hazardous lending decisions. Nevertheless, the relatively modest response to the opportunities created by the changes in Eastern Europe and the Soviet Union, and in the single European market, suggests that industrial-country banks will remain highly selective in their entry decisions.

Obviously, there are no simple and immediate solutions. But the traditional view that liberalization of the capital account needs to be delayed in order to protect the domestic financial system from destabilizing capital flows must be adapted to take into account the argument outlined here, based on the insulating properties of the global financial network.

### ***How Many Supervisory Institutions?***

The debate on the benefits that could be obtained from having a single national financial services regulator

instead of several specialized supervisory agencies is not closed (for an overview, see Fleming and Taylor 1999, 2000; Abrams and Taylor 2000). Goodhart and others (1998) may well be correct in stating that “there is no universal model,” not only because markets have developed differently in various countries, but also because the regulatory framework reflects different cultures of regulation and control. Among the factors to consider before opting for one or another solution are the following:

- The number of institutions to supervise<sup>5</sup>
- The interrelations among the financial sector components<sup>6</sup>
- The complexity of financial business activities
- The number of agencies to merge.

The case for a single integrated financial sector supervisory agency (IFSSA) has, of course, both positive and negative arguments. The most important positive arguments are that one can expect economies of scale and scope from combining regulatory responsibilities within one or two bodies, that supervision of financial conglomerates is better done by an IFSSA, and that an IFSSA guarantees competitive neutrality in the supervision of different types of financial institutions. Among the negative arguments, the most important are that the division of functions and duties among different government agencies could be unclear or even contradictory, that their mutual relationships and supervisory powers could be insufficiently coordinated, and that there could be differences in the level of competence among the supervisory agencies and differences in the powers granted to them by laws and regulations.

The case against unified regulatory agencies argues that it is difficult for an IFSSA to strike an appropriate balance between the different objectives of regulation, that it may suffer from diseconomies of scale, that the different kinds of financial institutions require a very different supervisory approach, and that there is a risk that customers and creditors of nonbank financial institutions will expect all institutions supervised by a single agency to enjoy similar protection (for example, deposit insurance) in case of failure.

In practice, and despite the recent attention given to this approach, few countries have (so far) adopted the IFSSA model. Among developed countries, Denmark, Iceland, Japan, Norway, the Republic of Korea, Sweden, and the United Kingdom have a single supervisory agency. Among ECA countries, Latvia, Estonia, and Bulgaria are considering introducing one.

Whatever the merits of the single regulator approach, before making any decision on the establishment of an IFSSA, the following issues should be considered: (a) what criteria will be used to select the existing institution that will form the backbone of the IFSSA, (b) what are the costs of merging existing supervisory institutions, (c) should there be a specific role for the central bank, and (d) what powers shall the regulator be responsible for? The selection of the regulator, in turn, should take into account the following questions:

- Which agency has the skills at this point in time?
- Which agencies have established a high degree of credibility?
- Which ones are likely to be more independent from politicians and from the professionals supervised?<sup>7</sup>
- Are any of the existing institutions internationally recognized?

Mergers of supervisory institutions present a number of organizational and process challenges. When the agencies involved are mature, the merger process is likely to be more complicated and may involve a loss of efficiency or, even worse, a loss of credibility, at least during the transition phase. The key challenge is to preserve existing and acquired knowledge and experience, on the one hand, while harmonizing the supervisory approach, on the other. To achieve that under the merged structure, each component of the financial sector (such as credit institutions and insurance) needs to be entrusted to a specific team of counselors to help ensure expertise, consistency, and coordination.

Central banks rarely supervise any institutions (for example, insurance and securities firms) other than banks. According to a survey conducted on a sample of 123 coun-

5. A relatively small financial sector could make it possible to realize significant economies of scale from the sharing of information technology platforms, data collection, and administrative support infrastructure of the agencies involved in the regulatory process.

6. A unified supervisory agency would offer improved oversight of financial conglomerates, especially those combining banking and insurance activities.

7. Regulatory independence is important in whatever structure of regulation is adopted. For instance, the Basel core principles explicitly require (CPI) the bank regulatory agency to possess independence and adequate resources. Similar statements appear in both the IOSCO objectives and principles of securities regulation and the International Association of Insurance Supervisors' (IAIS) principles of insurance supervision. Operational independence implies freedom from direct political pressures and influence and is important in all fields of regulation.

tries, central banks were in charge of banking supervision in 89 countries, with the central bank just dealing with banks in 69 countries.<sup>8</sup>

Central banks are responsible for the integrity and stability of the financial system, as a necessary corollary of their monetary policy objectives. There also is a growing recognition of the need to reduce risks in the payment system, particularly credit exposure by the central bank. When central banks are not involved in the supervisory process, they are at a disadvantage, since they often have to provide lender-of-last-resort facilities without first-hand knowledge of the viability of the banks in need of liquidity support. In transition economies, the segmentation of the banking system, and the underdevelopment or absence of an interbank market, may require that the central bank act as a liquidity broker so as to facilitate the exchange of liquidity, for example, through the organization of both credit and deposit auctions. In addition to the use of collateral, precise knowledge of the situation of each bank allows the central bank to limit the risks it takes in such operations. Finally, there is a need to address the question of the three levels of supervision (issuing regulations, implementing the regulations, and taking sanctions when violations occur) and to determine whether the same institution should be in charge of all three functions.

As a whole, no arrangement is ideal. Unifying the role of the central bank and overall responsibility for supervision is probably not feasible and could cause concern over the concentration of power. Coordination between agencies is an option, but it is labor-intensive and limits efficacy in rapidly developing situations. Unification reduces coordination problems in theory but may hinder effective market management and the ability to reduce systemic risk through effective and economical use of lender-of-last-resort facilities.

### Transparency Issues

Bank regulation must be understood by all professionals in the sector. Accordingly, it is important to have them participate in the drafting of new regulations, to have their views heard, and, to the extent possible, to have them accept at least the rationale behind proposed regulations. Experience has shown that regulators often have been too optimistic about the capacity of staff (both in the central

bank and in the commercial banks) to assimilate quickly the new regulatory and accounting concepts proposed. Therefore, once an option is chosen, it is important to inform key participants in the financial sector and the public of the reasons behind the decision as well as the results it is expected to achieve.

Once a regulation is accepted, it must be strictly enforced. Ignoring enforcement procedures is counterproductive, since it reveals the inefficacy of supervisory authorities and thus makes them lose credibility. Sanctions taken must be made public and explained.

A comprehensive approach to transparency issues facing central banks and financial agencies is outlined in the Code of Good Practices on Transparency in Monetary and Financial Policies (the code) designed by the IMF (see box 18.1).<sup>9</sup> This code discusses the need for transparency and identifies the key elements of good practices regarding transparency.

### *The Case for Transparency*

The case for transparency of monetary and financial policies is based on two main premises. The first is that the effectiveness of monetary and financial policies can be strengthened if the goals and instruments of policy are known to the public and if the authorities can make a credible commitment to meeting them. Hence, in making available more information about monetary and financial policies, good transparency practices promote the potential efficiency of markets. The second premise is that good governance requires central banks and financial agencies to be accountable, particularly when they have been granted a high degree of autonomy. In cases where conflicts might arise between or within government units (for example, if the central bank or a financial agency acts as both owner and supervisor of a financial institution, or if the responsibilities for monetary and foreign exchange policy are shared), transparency in mandates and clear rules and procedures in the operations of the agencies can help to avoid and resolve such conflicts, strengthen governance, and facilitate policy consistency.

Transparency by bank supervisors, particularly in clarifying their objectives, should also contribute to policy effectiveness by enabling financial market participants to better assess the context of financial policies, thereby reduc-

8. Courtis (1999). The central bank was supervising banks and insurance companies in 16 countries, banks and securities firms in seven countries, and banks, insurance companies, and securities firms in three countries.

9. The term financial agencies refers to all institutional arrangements for the regulation, supervision, and oversight of the financial and payment systems, including markets and institutions, with a view to promoting financial stability, market efficiency, and client asset and consumer protection. The website address is [www.imf.org/external/np/mae/mft/code/index.htm](http://www.imf.org/external/np/mae/mft/code/index.htm).

### BOX 18.1 KEY ELEMENTS OF GOOD TRANSPARENCY PRACTICES

The code identifies desirable transparency practices for central banks (or other regulatory bodies) in their supervision of banks (see International Monetary Fund 1999). Following the code, these practices can be grouped under four headings:

*1. Clarity of roles, responsibilities, and objectives of financial agencies responsible for financial policies.* The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation. The following points should be publicly disclosed:

- The responsibilities of the financial agencies and the authority to conduct financial policies
- Where applicable, the broad modalities of accountability for financial agencies
- Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies
- The relationship between financial agencies.

*2. Open process for formulating and reporting of financial policies.* It is essential that the following occur:

- The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.
- The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.
- Significant changes in financial policies should be publicly announced and explained in a timely manner.
- Proposed substantive technical changes to the structure of financial regulations should involve consultations with the public within an appropriate time period.

*3. Public availability of information on financial policies.*

This would include the following issues:

- Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.
- Where applicable, financial agencies should publicly disclose their balance sheets on a preannounced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.

- Consistent with confidentiality and privacy of information on individual firms, aggregate information on emergency financial support by financial agencies should be publicly disclosed through an appropriate statement, when such disclosure will not be disruptive to financial stability.
- Financial agencies should establish and maintain public information services.
- Financial agencies should have a publications program, including a periodic public report on their principal activities issued at least annually.
- Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.
- Where there are deposit insurance guarantees, policyholder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, the operating procedures, how the guarantee is financed, and the performance of the arrangement, all should be publicly disclosed.

*4. Accountability and assurances of integrity by financial agencies.* The main practices recommended are the following:

- Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of their policies.
- Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a preannounced schedule.
- Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.
- Standards for the conduct of personal financial affairs of officials and the staff of financial agencies should be publicly disclosed as should rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation.
- Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.

ing uncertainty in their decisionmaking processes. Moreover, by enabling market participants and the general public to understand and evaluate financial policies, transparency is likely to be conducive to good policymaking. This can promote financial and systemic stability. Transparent descriptions of the process of policy formulation provide the public with an understanding of the rules

of the game and an additional mechanism for enhancing the credibility of financial agencies' actions. There also may be circumstances in which public accountability for decisions can reduce the potential for moral hazard.

For countries considering adopting good transparency practices in monetary and financial policies, the benefits have to be weighed against the potential costs. In situations

where increased transparency in monetary and financial policies could endanger the effectiveness of policies or harm market stability or the legitimate interests of supervised and other entities, it may be appropriate to limit the extent of such transparency. Limiting transparency in selected areas needs to be seen, however, in the context of a generally transparent environment.

Some aspects of the transparency of financial policies could raise additional concerns. Considerations of moral hazard, market discipline, and financial market stability may justify limiting both the content and timing of the disclosure of some corrective actions, emergency lending decisions, and market-sensitive or firm-specific information. In particular, there is a need to safeguard the confidentiality and privacy of information on individual firms (commonly referred to as commercial confidentiality), in order to maintain their trust and access to sensitive information. Similarly, it may be inappropriate for financial authorities to make supervisory deliberations and enforcement actions public, when these relate to specific financial institutions, markets, and individuals.

Transparency practices differ not only in substance, but also in form. With regard to informing the public about monetary and financial institutions and their policies, an important issue concerns the modalities under which such public disclosure should take place. In monetary policy in particular, several issues arise, such as whether transparency practices should have a legislative basis in a central bank law, whether they need to be based on other legislation or regulation, or whether they should be adopted through other means.

A variety of arrangements can lead to good practices in transparency. On matters pertaining to the roles, responsibilities, and objectives of central banks (and for principal financial regulatory agencies), it is recommended that key features be specified in the authorizing legislation (for example, a central bank law). Specifying these crucial elements in legislation gives them particular prominence and avoids ad hoc and frequent changes. Rules about less crucial aspects of transparency—such as how policy is formulated and implemented or how and what information is provided—can be specified in other texts. However, all these texts need to be readily accessible, so that the public can obtain and consult them without unreasonable efforts.

Historically, the centrally planned economic systems of the ECA countries were characterized by an inherent lack of transparency. However, since the start of transition, economic policies have become much more transparent, often approaching or even surpassing western levels of transparency. In the area of financial policy, staff from the IMF

and World Bank so far have completed transparency assessments of the banking supervisory agencies in four ECA countries: Bulgaria, the Czech Republic, Estonia, and Russia. For Bulgaria and Estonia, the assessments reveal that overall transparency is quite good and mostly in line with international best practice, although further improvements could be made in several areas. In the Czech Republic and in Russia, the assessments reveal several important areas in which increased transparency would be welcome.

### **Limits to Bank Supervision: Systemic Failures**

In the context of a systemic crisis, when the scope and severity of banking problems threaten the entire system, supervision is not the appropriate answer. In fact, if the banking system as a whole is weak, strengthening the regulatory framework will, at best, spark a banking crisis by exposing the extent of bank weakness to the public, as happened in Latvia. Therefore, in cases where systemic bank restructuring is needed, the first priority must be to implement it quickly and thoroughly.

A wide range of countries have experienced systemic banking problems, and their approaches to handling these problems have varied substantially. A recent IMF working paper looks into the experience of 24 countries and summarizes policies that have proved to be successful in a wide range of circumstances (see Dziobek and Pazarbasioglu 1997).

An important component of successful restructuring programs consists of a thorough and correct diagnosis of the nature, causes, and extent of the problems in the banking system. In all countries, multiple factors contribute to the systemic problems, and the countries that have made the most substantial progress in bank restructuring are the ones that identified the underlying causes and designed a bank restructuring strategy aimed at systematically addressing each of them.

Furthermore, successful bank restructuring requires prompt corrective action and firm exit policies, both of which are essential for a quick resolution of a systemic crisis. Subsequently, continuous monitoring of bank restructuring policies and of individual bank restructuring operations is necessary. Successful restructuring also requires a comprehensive approach, addressing not only the immediate stock and flow problems of weak and insolvent banks, but also correcting shortcomings in the accounting, legal, and regulatory frameworks, while improving supervision and compliance. Structural factors that stand in the way of efficient financial intermediation, such as excessively high reserve or liquidity requirements, interest rate controls,

and distortions in the tax system (for example, a tax exemption for state banks), may need to be removed.

Operational restructuring is a necessary condition for banks to return to profitability and sustained solvency. Management deficiencies were identified as a cause of the banking problems in all sample countries, and progress in bank restructuring was highly correlated with whether or not such deficiencies were addressed.

The central bank must stand ready to provide liquidity support during restructuring to viable banks. However, it should refrain from providing liquidity support that keeps nonviable institutions in business, and it should not provide any long-term financing to banks. Nor should it be involved in commercial banking activities, as this risks creating quasi-fiscal deficits and conflicts with its monetary policy objectives.

Although bank restructuring programs may be initiated and successfully carried out during a time of economic stagnation, positive economic growth helps banks to resume lending and return to profitability.

Furthermore, assuming that the banking system as a whole has been restructured, the maintenance of fair competition and a sound banking system after the successful resolution of a crisis depends on the existence of a favorable environment and the absence of the factors that led to the crisis in the first place.

To varying degrees, all ECA countries experienced banking system distress or banking crises as part of the transition process. Tang, Zoli, and Klytchnikova (2000) study the experience with banking crises in 11 ECA countries plus Ukraine in the 1990–98 time frame.<sup>10</sup> They find that the crisis resolution strategies adopted by these countries depended mainly on macroeconomic conditions at the beginning of transition—in particular, inflation—and on the development of the banking system in the early stages of the transition process. Inflation mattered because in countries that had experienced hyperinflation the real value of pretransition bad loans was drastically reduced. The degree of development of the banking system helped to determine the ease with which banks could be closed.

Hence, countries with similar initial conditions chose similar crisis resolution strategies, leading to three broad categories of strategies: (a) extensive restructuring and recapitalization of banks in the countries of Central and Eastern Europe, which had not gone through a period of hyperinflation and had relatively developed financial systems; (b)

large-scale liquidation of banks in most of the CIS countries, which had experienced hyperinflation and had relatively undeveloped financial systems; and (c) a combination of bank liquidation and restructuring in the Baltic states.

As for the results achieved under these three different strategies, Tang, Zoli, and Klytchnikova (2000) conclude that the countries of Central and Eastern Europe incurred substantially higher fiscal costs but ended up with sounder and more efficient banking systems. The approach in the CIS countries was less costly but resulted in weak banking systems and low levels of intermediation. The Baltic countries incurred modest fiscal costs but substantially improved the soundness and efficiency of their banking systems.

### Limits to Bank Supervision: Political Interference

As stated in a BIS working paper, political interference is the Achilles's heel of any regulatory system (Honohan 1997). Political protection of unsound banks has repeatedly inhibited a quick response to emerging banking problems. The resulting delays have deepened the ensuing crisis and complicated or derailed the macroeconomic stabilization process. All too often, the problem with political interference is not that the supervisors do not know or suspect it, but that the bank owners are too well placed politically for their actions to be curtailed by supervisors without the most conclusive evidence.

Designing institutional and political arrangements that make such protection less likely is a difficult challenge. Different possibilities have been suggested:

- Limited deposit protection, under the assumption that unprotected depositors not only will be more cautious about where they place their funds but also will see the regulators as their agents and support early regulatory intervention
- Increased internationalization and privatization, under the assumption that the management of privatized and foreign-owned banks will not have ready access to political contacts who can forestall or overrule regulators, as often happens in the case of government-owned banks
- Arrangements to ensure the independence of regulators, while at the same time making them accountable so that they have an incentive to do their job properly
- Strict disclosure rules, which may shorten the time interval between the emergence of liquidity and sol-

10. Bulgaria, the Czech Republic, Hungary, FYR Macedonia, Poland, Estonia, Latvia, Lithuania, Georgia, Kazakhstan, and the Kyrgyz Republic.

vency problems, by improving the information on which depositors and other lenders to the banks make their decisions.

- Greater transparency of the supervisory process, which is probably the best solution in the long run.

In some countries, the role and functioning of the banking sector are closely connected with the financing of the government and the financing of the economy on behalf of the government. The government's involvement in the banking sector can take many forms, ranging from government ownership, through programs of directed lending or investment, to complex and distorting tax and subsidy regimes, implicit as well as explicit. As a result of these linkages, government policy objectives permeate the activities and decisionmaking processes of the banks, which are no longer autonomous profit-seeking entities, but—to a greater or lesser extent—quasi-fiscal tools of government policy.

The banking systems in centrally planned economies—which formed the core of the transition economies' initial financial systems—represented an extreme form of government-permeated banking. Under central planning, bankers did not have to assess borrowers' creditworthiness. Their job was merely to implement and monitor a credit plan decided at a higher level—independent of the bank.

The evolution of banking systems in transition has followed a variety of paths (see Claessens 1998). Among the dimensions in which transition systems have diverged are the degree to which new privately owned banks have emerged to deal with new clients, the degree to which such new banks are adequately managed and capitalized, the dependence on central bank refinancing, the extent to which restructuring and recapitalization of state-owned institutions have taken place and hard budget constraints have been imposed, the degree of privatization of these institutions, and the persistence of sector specialization among institutions. On the basis of statistical analysis of expert ratings, Claessens suggests that radical change leads to a healthy banking system more quickly than gradualism.

## Conclusions

The financial system has a key role to play in achieving growth, development, and stability of the economy. Banks constitute the backbone of the financial system and play a specific, semipublic policy role. Therefore, banking supervision is essential for the health of the financial sector and the rest of the economy. However, the introduction and development of banking supervision in transition economies must be seen as part of the overall reform process, which includes structural changes and a reorien-

tation of economic policy. Adopting an exhaustive set of regulations before the economic and political circumstances are ready is a recipe for disaster if the regulations are enforced and will cause a potentially irreparable loss of credibility for the supervisory authorities if they are not enforced.

It is by now well recognized that the timely implementation of bank restructuring and supervisory policies, in addition to adequate stabilization procedures, is essential to avoid major disruptions to growth and stability in the course of financial liberalization. This has led some economists to suggest a delay in interest rate liberalization and external financial liberalization until banking supervision is adequately put in place and banks are sufficiently sound. In practice, however, policies to restructure banks (and enterprises) and to strengthen prudential supervision can—and should—be phased in appropriately alongside interest rate and external liberalization. Appropriate sequencing requires paying attention to technical linkages between bank restructuring and supervisory policies, their macroeconomic effects, and the scope for market discipline and internal governance. Some specific principles govern the proposed sequencing of prudential supervision and bank restructuring policies:

- Policies to strengthen prudential supervision—including the phasing in of prudential regulations, the development of a balanced application of off-site analysis, on-site inspections and external audits, and the enforcement of firm exit policies—should be combined with policies to restructure banks and to establish institutional arrangements for recovering loans and restructuring enterprises. Such a comprehensive package, encompassing both supervisory systems and restructuring options, is necessary to avoid adverse incentives toward excessive risk taking by banks and debtors.
- Reforms of the commercial bank accounting system, the establishment of early warning systems, and the phased introduction of prudential standards for capital adequacy, foreign exchange exposure, loan concentration, and loan classification and provisioning can support stabilization objectives and facilitate financial restructuring of banks. Therefore, these measures should be part of the critical mass of reforms introduced at the outset of financial liberalization.
- A package of financial restructuring policies to strengthen banks' asset portfolios and profitability, reduce the debt-equity ratio of nonfinancial firms, and eliminate interest subsidies and directed credits

also should be implemented early in the process as part of the critical mass of reforms. This elimination of interest rate subsidies would free up funds that could be used to finance the fiscal costs of bank restructuring, thereby containing the overall fiscal burden of bank restructuring in the initial stages. Such a financial restructuring program should be a component of, and be accompanied by, an action plan for comprehensive restructuring of both banks and enterprises that would be phased in over the medium term. The action plan should include steps to develop supporting institutional arrangements to ensure that operational restructuring (including privatization) will be carried out alongside financial restructuring.

In conclusion, a safe banking system has an important role to play in helping transition economies face the challenges of a new era. And banking supervision is an essential component of a safe banking system. Therefore, ECA countries need to establish effective banking supervision, fulfill the prerequisites for its proper functioning, and ensure that its design is consistent with the stage of development of the economic and financial system it oversees. Conversely, the public as a whole and depositors in particular have a right to expect the supervisory authorities to perform their task in a transparent and efficient manner.

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## Chapter 19

# Finance in the New Millennium

*Stijn Claessens, Tom Glaessner, and Daniela Klingebiel*

**E**conomic integration within and across countries, deregulation, advances in telecommunications, and growth of the Internet and wireless communication technologies are dramatically changing the structure and nature of financial services. Drawing on Claessens, Klingebiel, and Glaessner (2000), this chapter illustrates that, because financial services are highly dependent on technology and well suited to remote delivery, technological advances and the advent of the Internet are causing dramatic changes in the industry. Internet and related technologies are more than just a new channel of distribution—they are a different way of providing financial services. This revolution could accelerate financial sector development by lowering costs, increasing breadth and quality, and widening access to financial services.

This chapter analyzes the changes in the industry. It focuses mainly on developed countries but also draws out the implications for transition economies, in particular those related to e-finance. It highlights three implications of these changes for public policy: a need and an opportunity to reduce the financial sector safety net over the longer-term; enhanced measures to limit the extension of the safety net in the short run; and more emphasis on competition policy, consumer protection and education with respect to financial services.

### **Recent Trends in Financial Services**

The globalization of financial markets, as well as technological and structural changes, is driving many of the recent trends in financial services. These changes include the lowering of regulatory barriers.

#### *Globalization*

The globalization of financial services has increased financial integration, increased mergers and acquisitions within and across borders, and lowered barriers between markets.

*Increased financial integration.* Reductions in trade barriers and transportation costs and advances in communication technology have accelerated international economic integration. Between 1987 and 1997 world trade in goods increased from 21 to 30 percent of global gross domestic product (World Bank 1999). The complementarity of trade in financial services with trade in goods and a greater ability to trade services across borders have increased the demand for financial services.

Cross-border capital flows have been the most important mechanism for delivering financial services. Commercial bank claims on foreigners—the largest conduit of international capital flows—increased from \$7.7 trillion in 1980 to \$11.0 trillion in 1999. Private capital flows to emerging markets rose from \$50 billion in 1980 to more than \$200 billion in 1999 (World Bank 2000).

But capital flows are just one way that financial institutions in one country can provide a loan or facilitate a security issue to an entity in another country. A financial institution also can obtain a physical presence in another country by acquiring a financial institution or by opening

a branch or subsidiary. As the costs of establishing a physical presence have declined, cross-border entry has increased.

*Increased mergers and acquisitions within and across borders.* Governments have removed entry barriers through legal and regulatory measures such as the Riegle-Neal Act in the United States and the Single Market Programme in the European Union (EU). Aided by technological developments, these changes have lowered barriers to entry and encouraged bank consolidation and mergers and acquisitions among financial institutions, both within and across borders.

Globally, mergers and acquisitions in financial services jumped from \$85 billion in 1991 to \$534 billion in 1998 (BIS 2000). In the United States, mergers and acquisitions rose from \$25 billion (1998 dollars) in the mid-1980s to \$250 billion in 1998. Since 1980 the number of U.S. banks has dropped 40 percent. In the European Union the number of banks has fallen 25 percent since 1985. Similarly, Argentina, Brazil, Chile, the Republic of Korea, and Mexico have seen a significant decline in the number of domestic banks in recent years.

*Lower barriers between markets.* The dismantling of regulatory barriers separating banking, insurance, and securities activities also is driving consolidation. Boundaries between different financial intermediaries are becoming blurred, and universal (or integrated) banking is becoming the norm. The merger of Citigroup (banking) and Travelers Group (insurance) is the most dramatic example of this trend.

An important market incentive for this reduction in barriers has been the disintermediation of bank assets and liabilities by capital market transactions. Commercial paper and corporate bonds have substituted for bank loans, and mutual funds and securities have substituted for bank deposits. These forces pressure banks to expand their financial services to cater to all customer needs and preferences. Advances in information and communication technology further facilitate the delivery of a broad array of financial services through one provider.

### *The New World of Financial Services*

Technology is revamping the ways in which financial services are produced and delivered. In addition, technology is fundamentally changing the industrial structure of the financial services industry worldwide.

*Technological advances.* Internet and wireless communication technologies are having a profound effect on finan-

cial services. These technologies are more than just a new channel of distribution—they are a completely different way of providing financial services.

Using credit scoring and other data mining techniques, for example, providers can create and tailor products over the Internet without much human input and at very low cost. They can better stratify their customer base through analysis of Internet-collected data and allow consumers to build preference profiles on-line. This not only permits personalization of information and services, it also allows much more personalized pricing of financial services and much more effective identification of credit risks. At the same time, the Internet allows new financial service providers to compete more effectively for customers because it does not distinguish between traditional “bricks and mortar” providers of financial services and those without a physical presence. All these forces are delivering large benefits to consumers at the retail and commercial levels.

*Changes in industry structure.* These technological advances are changing the face of the financial services industry (see box 19.1 and figure 19.1). New types of service providers are entering the market within and across countries, including on-line banks and brokerages and so-called aggregators (which allow consumers to compare financial services such as mortgage loans and insurance policies). Nonfinancial entities also are entering the market, including telecommunication and utility companies that offer payment and other services through their distribution networks and customer relationships. To reap the benefits of the new technology, and in response to this new entry, banks, insurance companies, and the like are joining in the electronic delivery of financial services by setting up in-house on-line activities or completely new ventures such as virtual banks.

Thus, the delivery of financial services is moving away from a brick-and-mortar delivery channel to a multitude of electronic and other channels, with portals and aggregators offering new channels of distribution and advertisement for financial services. Vertically integrated financial service companies are growing rapidly and creating synergies by combining brand names, distribution networks, and financial service production. For example, companies associated with portals (America Online, Yahoo!, Microsoft) and major telecommunication companies (Deutsche Telecom, Telefonica) are developing strategic relationships or ownership links with major financial service companies, with banks (such as the Bank of East Asia with Yahoo!), or with each other (Telefonica and Lycos). At the same time, many major financial institutions (Morgan Lab, Goldman

**BOX 19.1 THE NEW WORLD OF FINANCIAL SERVICE PROVIDERS**

Financial services are now offered through a multitude of delivery channels, from traditional brick-and-mortar branches to wireless devices. Six steps can be distinguished in the production and distribution of financial services, although in practice these steps often overlap or are vertically integrated (see figure 19.1).

*Access devices* (rather than a teller or branch) are becoming many customers' first point of contact with financial services. These devices include personal computers, personal digital assistants (such as Palm Pilots), televisions equipped with Internet access, cellular phones, and other wireless communication devices. In the future, these channels will be complemented by low-cost "branches," kiosks (stand-alone computers connected to bank systems), and other public access devices located in supermarkets, convenience stores, and common areas (airports, train stations).

*Portals* are becoming the critical link between access devices and financial service companies. Portals offer access to a range of financial service providers, often for free or a fixed price; they generate revenue from fees paid by providers referred through the portal. These include specialized portals developed by financial service companies as well as general portals such as the U.S.-based America Online, Lycos, Yahoo!, and Microsoft, along with others in emerging markets (Paxnet and Thinkpool in the Republic of Korea, Terra in Latin America). Portal companies attempt to process and personalize information to capture consumers. Portals are proliferating rapidly, even in emerging markets. The Republic of Korea, for example, is home to 300 portals, many of which function as a gateway for financial service providers. In addition, customers can access financial service providers through many private networks, and some financial service providers have established their own specialized portals.

*Aggregators* complement portals, allowing consumers to compare mortgage, insurance, or lending products offered by suppliers of financial services. In addition, quasi-aggregators are emerging that aggregate or display prices of financial products offered by different suppliers or even conduct single or

block reverse auctions of mortgage loans or insurance products (as with DollarDEX in Singapore). Finally, other specialized companies are undertaking functions on behalf of larger banks or insurance companies and are developing on-line techniques to mine data and offer personalized financial products to consumers.

*Financial institutions* serve as conglomerate providers of financial services that are global brands (Citigroup, Deutsche Bank, Warburg) and as specialized financial service companies. Partly in response to the entry of new competitors and to reap the benefits of new technology, incumbents (banks, large insurance companies) are consolidating around recognized brand names to position themselves in an environment of increased commoditization and electronic delivery. Merrill Lynch and HSBC, for example, recently announced a joint venture in private banking that combines HSBC's network with Merrill Lynch's range of products. Large telecommunication companies that already have access to a large distribution network of customers are starting to provide payment and other services. In addition, telecommunication companies are forming alliances to extend their global network to financial services delivered on-line. Examples include Deutsche Telecom, Telefonica, AT&T, and Telemex. And increasingly specialized financial service providers—so-called mono-liners in all mainline financial service areas, from mortgage lending or personal loans, to insurance, to brokerage, and to payment services—are establishing on-line operations.

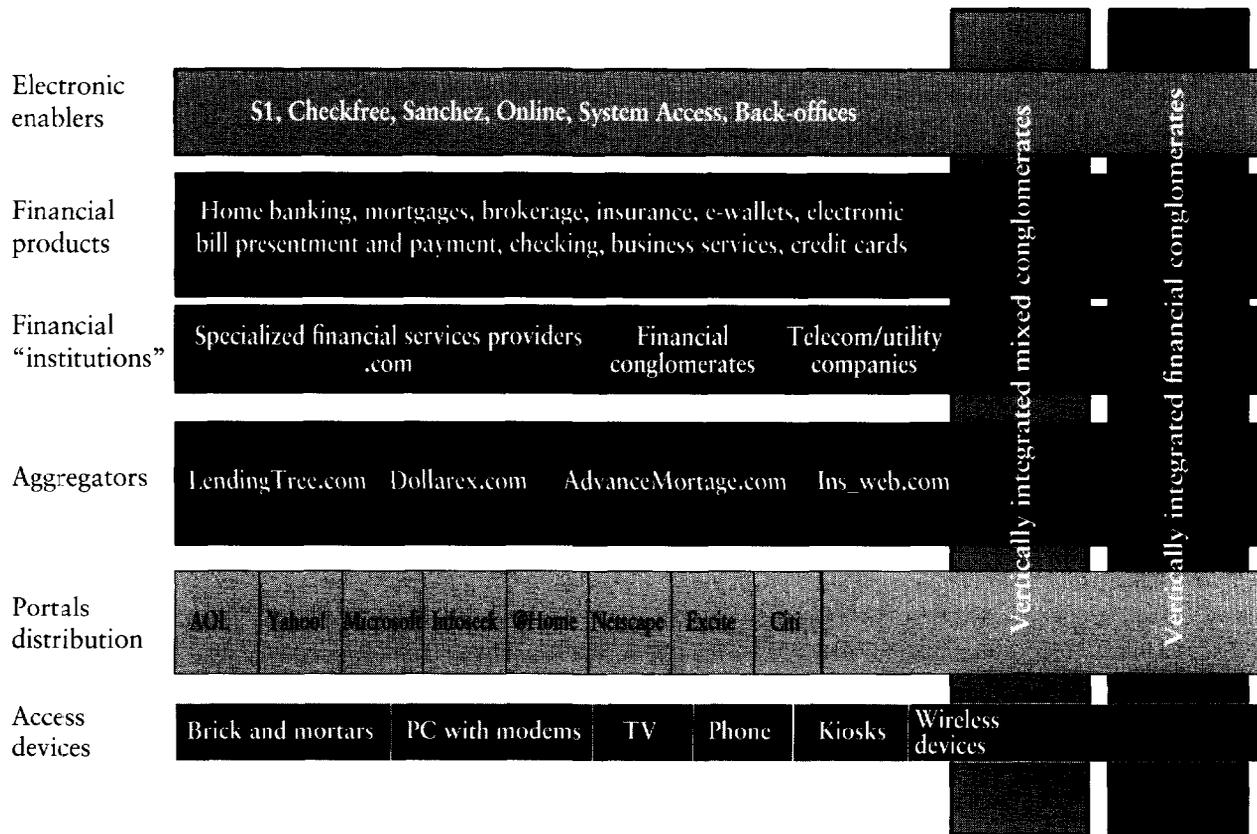
*Financial products* are being commoditized or tailored to the needs of customers. Such products are distributed through specialized financial service providers or financial conglomerates.

*Enabling companies* support existing financial service providers as well as specialized providers and virtual banks. Specialized software engineering companies such as S1, Checkfree, Sanchez, and System Access provide e-finance systems that are completely integrated and permit the rapid adaptation needed in today's world.

Sachs, Chase, Merrill Lynch, Morgan Stanley) are part owners of promising Internet start-ups. And goods-producing companies are taking advantage of bank distribution networks (Citidollars with a variety of consumer-related companies). These developments are changing the competitive landscape for financial services and will continue to erode the franchise value of existing financial service providers that are inefficient or do not adopt competitive business models.

These developments are not confined to developed countries. Electronic finance is now spreading quickly around the globe, including to emerging markets. Through various delivery channels (computers, cell phones, and kiosks), penetration of e-finance has grown quickly everywhere. Although there is some variation by markets and regions—in terms of the preferred media for delivering financial services, the types of financial services provided, and the rate of penetration—there is significant common-

**FIGURE 19.1 THE NEW WORLD OF FINANCIAL SERVICES**



ality across the globe. Several emerging markets have leapfrogged to the new technologies, including Brazil, the Republic of Korea, and some transition economies like Estonia (see box 19.2). One might well see a rapid convergence in e-finance across many countries.

*Changes in trading systems.* Driven by advances in communications technology, trading systems are consolidating and going global. Trading is moving toward electronic platforms not tied to any location. (Nasdaq's computers are based in Turnbull, Connecticut, for example, but traders are located around the globe.) New electronic systems have lowered the transaction costs of trading and improved the determination of prices because electronic execution and matching techniques offer fewer opportunities for market manipulation. These advantages are especially important in markets that have not yet converted to electronic trading (such as the United States) than in those where electronic trading is the norm (such as Europe). The new technology also allows for much easier cross-border trading and, over time, for the development of inter-market trading systems.

Combined with globalization, these forces are putting pressure on incumbent stock exchanges, which have responded with mergers and alliances (table 19.1). Because many exchanges are self-regulating organizations, the pressures for change rarely come from within the industry. Rather they come from users or investors who want to pay smaller commissions, effect trades more quickly, or maintain anonymity on placed orders (box 19.1).

**Effects of the Changes**

Figure 19.2 summarizes recent developments in financial products and services along two dimensions: ease of commoditization and existence of entry barriers. Entry has been particularly strong in financial services that could be easily unbundled and commoditized and that offer attractive initial margins. These include many non-banking financial services, including brokerage, trading systems, some retail banking services, and new services such as bill presentment or even payment gateways for business-to-business (B2B) commerce. Because these services are subject to less regulation, new entrants can easily innovate with new technology and can show limited or

**BOX 19.2 THE MASSIVE SHIFTS IN STOCK MARKETS AND EXCHANGES**

A revolution is under way in the way financial (and nonfinancial) contracts are traded. These changes involve traditional exchanges as well as business-to-business (B2B) transactions.

A number of electronic order routing and trading networks have emerged in recent years. These networks have evolved into order-driven matching systems that are provided electronically to participants seeking anonymity. Electronic communication networks started out as pools of liquidity feeding into existing markets, but they now serve as alternative trading outlets in several developed and some emerging capital markets. In some markets these networks account for a large share of total trading (one-quarter of the dollar volume of Nasdaq in the United States).

Other alternative trading systems are being set up around the world, often with links to existing systems. For example, Instinet began as a local interdealer broker and dealer but now has automatic routings to a number of stock exchanges. There is speculation that a few trading systems soon will allow investors to trade 24 hours a day. Exchanges are recognizing that their services—trading systems—are increasingly becoming a commoditized product offered through other means. Eventually,

traditional stock markets such as the New York Stock Exchange will cease to exist in their current form.

Reflecting these competitive pressures, and the more general desire for increased liquidity through larger markets, many stock exchanges in developed countries have established links, merged, or even demutualized (that is, become for-profit organizations rather than cooperative, not-for-profit organizations). Recent examples include the merger of the Amsterdam, Brussels, and Paris exchanges, joint ventures and alliances between Nasdaq and stock exchanges in Australia, Canada, Hong Kong (China), and Japan, and a joint venture between Nasdaq and the proposed pan-European market that is focused on growth stocks. The Singapore and Australian stock exchanges recently agreed to cross-list all traded shares. The New York Stock Exchange has formed alliances with the Tokyo Stock Exchange, Hong Kong Stock Exchange, Australian Stock Exchange, Toronto Stock Exchange, Mexican Bolsa, São Paulo Bovespa, and Euronext to trade through linked exchanges 24 hours a day. The consolidation of these markets—accounting for more than 60 percent of global market turnover—is leading to a smaller number of very large markets.

no earnings without raising supervisory concern. As these new entrants gain market share and consolidate their position, some start to diversify into more highly regulated banking services. An example is E-trade's acquisition of a bank to provide the full range of financial services to its retail clients.

Services involving sunk costs and low commoditization, such as corporate advisory services or mergers and acquisitions within investment banking, have seen much less new entry. Instead the trend has been toward global consolidation to reap the advantages of reputation, brand name, and economies of scale. Although deposit taking and many traditional payment services exhibit large potential for commoditization—through on-line banks, payment services using “smart” cards, and other technologies—entry has been limited, in part because of regulatory barriers. From a production point of view, however, these services could easily migrate to the high commoditization, low-entry-barrier sector.

Widely available real-time market information lowers the cost of financial services by easing uncertainty, mitigating asymmetric information, and reducing transaction costs associated with paper processing or human error. In addition, new distribution channels have opened up, search

costs have fallen for consumers, and new entities (including telecommunication and utility companies) are providing financial services.

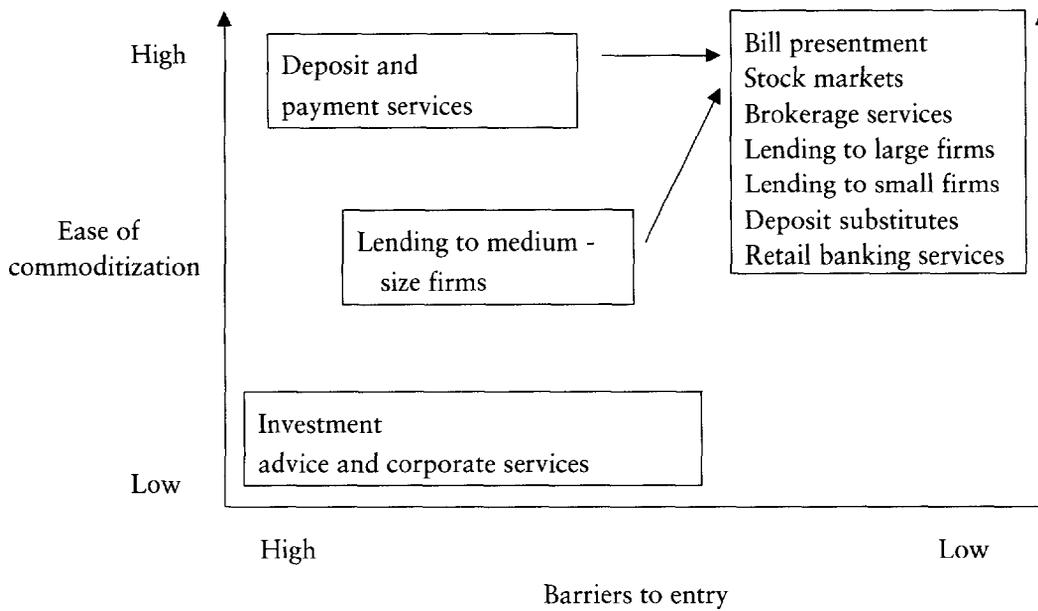
*Lower costs of providing financial services.* The technology on which the financial service industry depends has become much cheaper, and in the past 20 years computer power has risen by a factor of 10,000 (World Bank 1999). Similar changes are occurring in telecommunications—in the past 20 years the cost of voice transmission circuits has fallen by a factor of more than 10,000. Communication costs have fallen sharply in most countries, and the rapidly growing importance of broadband and wireless internet-based communication systems—such as Bluetooth or wireless application protocol—indicate that costs will continue to fall, and Internet access will continue to widen. The Internet eliminates many processing steps and labor costs, while avoiding or reducing the fixed costs of branches and related maintenance. A typical customer transaction through a branch or phone call costs about \$1, but that same transaction costs just \$0.02 on-line (see figure 19.3). Overhead expenses for Internet banks are 1 percent of assets or less, compared with 2 to 3 percent for brick-and-mortar banks.

**TABLE 19.1 FEATURES OF INTERNATIONAL STOCK MARKETS AND EXCHANGES**

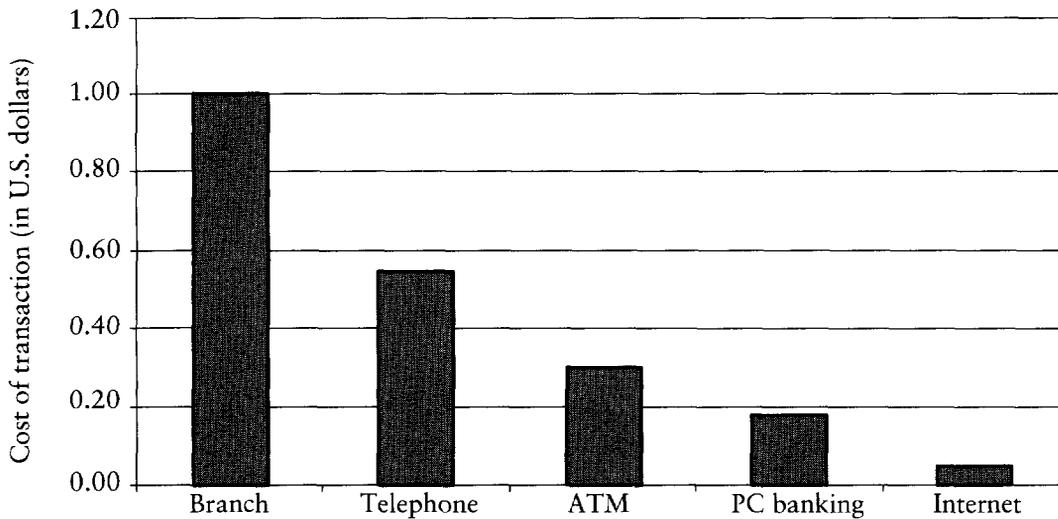
<i>Market or exchange</i>	<i>Average daily trading volume (billions of U.S. dollars)</i>	<i>Market capitalization (billions of U.S. dollars)</i>	<i>Links with other exchanges or electronic communication networks</i>
New York Stock Exchange	35.0	12,000	Talks with Toronto Stock Exchange, Euronext, and Mexico's Bolsa; cooperative links with Tokyo Stock Exchange
Nasdaq Stock Market	41.5	5,020	All electronic communication networks trade Nasdaq stocks; deals with Osaka Stock Exchange, Deutsche Boerse, London Stock Exchange, Quebec, Hong Kong Stock Exchange, and Australian Stock Exchange
Tokyo Stock Exchange	6.8	4,100	Cooperative links with exchanges in the Republic of Korea, the Philippines, Singapore, and Thailand, as well as with the New York Stock Exchange
London Stock Exchange	13.5	2,800	Nasdaq joint venture
Toronto Stock Exchange	2.85	1,700	New York Stock Exchange, Euronext, Hong Kong Stock Exchange, Mexican Bolsa, São Paulo Bovespa
Deutsche Boerse	4.53	1,500	Nasdaq joint venture, MarketXT joint venture
Paris Bourse	4.18	1,500	Euronext alliance
Hong Kong Stock Exchange	1.5	568	Co-listing agreement with Nasdaq, New York Stock Exchange
Australian Stock Exchange	0.8	370	Nasdaq, Singapore Stock Exchange
São Paulo Bovespa	0.4	208	London Stock Exchange, Lisboa Stock Exchange, Argentina's Caja de Valores
Total	148.8	35,005.4	

Source: *Wall Street Journal*; Fédération Internationale de Bourses de Valeurs.

**FIGURE 19.2 POTENTIAL COMPETITION AND COMMODITIZATION IN FINANCIAL SERVICES**



**FIGURE 19.3 THE INTERNET SLASHES THE COST OF TRANSACTIONS**



Source: Goldman Sachs and Boston Consulting Group.

The Internet and other technological advances have shrunk economies of scale in the production of financial services (table 19.2). The main financial service still exhibiting increasing returns to scale is the medium-size loan market, because large databases of credit history are required to build a credit-scoring model for medium-size clients. This gives larger lenders a potential competitive advan-

tage. For most credit, however, economies of scale have become small, because the fixed costs associated with screening small borrowers (less than \$100,000) have dropped significantly.

Financial service providers using the Worldwide Web can avoid many technological conflicts, such as separate interface-to-core systems for transactions through auto-

**TABLE 19.2 CHARACTERISTICS OF FINANCIAL SERVICE PROVISION IN AN INTERNET WORLD**

	<i>Economies of scale</i>	<i>Commoditization</i>	<i>Up-front costs; branding, advertising</i>	<i>Network externalities</i>
<i>Retail services</i>				
Payment	••	••••	••	••••
Lending and mortgage	••	••••	••	•
Discount brokerage services	••	••••	•••	••
Investment advice	••	•••	••••	••
Mutual funds	••	•••	•••	••
Insurance	••	•••	•••	••
<i>Wholesale services</i>				
Commercial lending				
Large	••	•••	••	•
Medium-size	•••	•••	••	•
Corporate services (underwriting, mergers and acquisition advice, risk management)				
Large-value payments systems	•••	•••	••••	••••
<i>Markets</i>				
Trading systems and exchanges	••	••••	•••	••••
B2B exchanges	••	••••	••	••••
<i>New services</i>				
E-payment providers	••	•••	••	••••
Enablers	••	••	••	•••
Financial portals	•	•	•••	••••
Aggregators	••	•••	••	••

- None.
- Low.
- Medium.
- High.

Source: Authors' assessments.

mated teller machines (ATMs), branches, call centers, or kiosks. Web-based financial services unify the Internet as a communication standard by combining a web browser, a display standard, and a web server as the access point into back-end operational systems. As a result, cross-selling of products becomes easier and economies of scope increase.

The lowering of scale economies has heightened competition, particularly among financial services that can easily be unbundled and commoditized through automation (figure 19.2). These include payment and brokerage services, mortgage loans, insurance, and even trade finance. Most of these services require limited initial capital outlays

and no unique technology. Lower transaction costs can substantially increase competition for providers and cost savings for consumers. To retain market share, on-line brokerage firms have been forced to radically restructure the way they deliver brokerage services. Brokerage commissions and fees fell from an average of \$52.89 a trade in early 1996 to \$15.67 in mid-1998—and by end-2000 some on-line brokerage services had reduced their commissions to zero. Commissions on electronic communication networks, now at \$0.05 a share, are continuing to fall. Barriers to entry based on ownership of physical facilities are disappearing, and incumbent institutions are being forced to merge or, in some cases, to demutualize to even have a chance of remaining viable.

In the past, sunk costs were important entry barriers in the financial services industry. Examples of sunk costs include branch networks, knowledge about local borrowers, access to payment systems, branding advantages involving large up-front advertising expenses, perceptions of size and safety, long-lasting customer relationships, and substantial up-front investments in technology. But sunk costs are becoming less important in financial services, partly because electronic delivery does not rely on a branch network (see table 19.2).

At the same time, new entry barriers are being created through first-mover advantages. Once a new entrant is established as a service provider, other new entrants will have to spend a lot on advertising to attract new customers (as E-trade and Ameritrade have done in the United States). In product areas such as underwriting and mergers and acquisitions advice, financial services exhibit low levels of commoditization and still require relationship capital, a certain size, and a brand name to compete effectively. These services enjoy few or no network externalities and are increasingly subject to global competition. The scope for a contestable market will depend on the size of the market. A limited number of financial institutions involved in underwriting, but operating on a global basis, present a very different competitive environment than would a few players in a small market (say, less than \$1 billion).

Although declining economies of scale, increasing standardization and commoditization, and declining up-front costs foster competition, this need not be the case for services that exhibit network externalities. A financial service exhibits network externalities if the value of the service rises with the number of market participants using it. Payment services, for example, have decreasing economies of scale, low up-front costs, and ease of commoditization. But payment services are subject to large network externalities, because the value of electronic payment ser-

vices depends largely on the degree to which users adopt a common standard. The financial service provider that manages to create this common standard will capture a large share of the market, decreasing competition. Similar characteristics apply to trading systems and exchanges (traditional or B2B), financial portals, and, to a lesser extent, e-enablers (table 19.2).

*Benefits for consumers and corporations.* Providers and consumers will share the benefits of cheaper financial services. With the advent of new types of intermediaries, such as aggregators, consumers can increasingly compare prices for financial services. Aggregators can bring together many suppliers of financial services and coordinate information flows in a rational way. Lending Tree in the United States, for example, allows customers to compare a wider base of potential lenders than is possible or cost-effective using traditional loan agents or channels of direct communication. Since Lending Tree prequalifies loan applicants, lenders can find creditworthy customers inexpensively. The Internet also helps consumers to combine financial services from different providers. This is done through comparison-shopping companies and through portals.

Commercial borrowers that undertake B2B transactions and Treasury operations also will benefit from lower transaction and search costs and from increasing access to financial services. In the case of small and medium-size enterprises, new on-line companies such as garage.com and techpacific.com provide a full array of services to start-up companies, including legal services, web design, accounting services to assist in preparing accounts and meeting disclosure standards, branding and advertisement, investor relations, and so on. Investors (venture capital arms of nonfinancial and financial companies) use these companies to screen potential start-up ideas. In addition, the use of the Internet for data mining in lending holds promise for improving the outreach of financial services to very small companies.

### **Implications for Public Policy**

These changes, particularly the emergence of e-finance, offer great benefits to consumers worldwide. The changes can accelerate financial sector development by lowering costs, increasing breadth and quality, and widening access to financial services. But the changes also require a reassessment of the approach to financial sector development, particularly in emerging markets.

All governments, even the most market-oriented, regulate and supervise the financial sector for reasons of safety and soundness, competitiveness and antitrust concerns,

and consumer protection. The recent changes in financial services raise questions about whether the current approach to financial sector regulation is adequate, whether traditional reasons for regulation and supervision remain valid, and what areas (competition policy and consumer protection) deserve more emphasis. The key public policy findings, summarized in table 19.3, relate to three areas: safety and soundness, competition policy, and consumer and investor protection. In addition, new global public policy issues have emerged.

### *Safety and Soundness*

Developments in technology and deregulation are eroding the nature of what has made banks special. On the lending side, e-finance allows nondeposit-taking financial institutions and capital markets to reach far more borrowers, including small and medium-size enterprises. On the deposit and payment side, many deposit substitutes (such as stored value cards issued by merchandisers) are emerging, and many nonbanks (such as mutual funds) are offering payment accounts. These and other changes make banks less special and challenge authorities to reevaluate the need for a financial sector safety net—broadly defined to include public deposit insurance, a lender of last resort facility, and prudential regulation.

Incentives for private parties to challenge the special nature of banks depend on the degree to which governments provide banks with preferential treatment. If the safety net is not shrunk, banks could continue to remain special, but not necessarily for the right reasons. These developments raise a number of issues for public policy.

Over the long run, there may be less need for a financial sector safety net, including prudential regulation and supervision of banks. Authorities should be wary of extending guarantees to new deposit substitutes, as the moral hazard implications could be substantial. Over the short run, authorities could require nonfinancial corporations to provide payment services through bank subsidiaries. Over the long run, authorities may want to consider separating payment from other credit services and allow freer entry in payment services.

Changes make it necessary to adjust traditional supervisory processes (assessment of risk controls, definition of fit and proper tests) and address emerging issues (requirements for opening a virtual bank, requirements for related financial service providers). And most important, e-finance will lower the franchise value of incumbent institutions. Thus failure resolution processes will become more important, and bank assistance systems will have to be reviewed. Stability issues require careful analysis of the degree to

which profits will decline and shift between financial products and institutions.

### *Competition Policy*

From the point of view of competition policy, markets for financial services can be treated like other markets. Technology is reducing asymmetric information—often a reason for treating financial services differently from other products. Risks are being addressed through continuous mark-to-market and collateral arrangements. And products are becoming more homogeneous.

At the same time, the ability to reap the benefits of technological innovations increasingly depends on the degree to which entry is allowed and uncompetitive structures are avoided. Competition policy for financial services thus is both more feasible and more important.

Freer trade in financial services will be critical for consumers to obtain the benefits of technological gains. Defining markets, a critical element of competition tests, is becoming more difficult. Many nonfinancial products are taking on the properties of financial contracts, and many markets are going global. Competition policy for financial services will need to be harmonized worldwide, and different regulators should coordinate sanctions for violations.

For most financial services and markets, economies of scale and scope are unlikely to be sufficient barriers to entry, because technology is reducing the extent of increasing returns to scale. Some sunk costs can be entry barriers, although this should not be overstated. More important, network externalities can create entry barriers. Entry policies for self-regulating organizations involved in network-oriented services, such as trading systems, will become more important. Tradeoffs will arise among preventing first-mover advantages, protecting intellectual property rights, and meeting the desires of consumers for such services.

Links between banking and commerce and increased vertical integration could hamper competition. New strategic alliances—say, between telecommunication companies and financial service providers—could allow for joint control of carriage and content in certain financial services, possibly denying consumers access to a full array of services.

Competition policy will increasingly require authorities simultaneously to define technology and information policies. In some cases, authorities may even need to subsidize the development of technology if the externalities are not adequately internalized (as when a basic technology needs to be shown to be technologically feasible). Mergers and joint ventures by information companies and their relation to financial service companies are one of many areas that will require a lot more scrutiny.

**TABLE 19.3 PUBLIC POLICY ISSUES FOR THE FINANCIAL SECTOR**

<i>Current issues</i>	<i>Future issues</i>	<i>Transition issues</i>
<p><i>Safety net</i></p> <ul style="list-style-type: none"> <li>• Banks are considered special because they extend essential credit to firms, provide payment services, and are inherently fragile and susceptible to runs.</li> <li>• Governments have provided safety nets—regulation and supervision, deposit insurance, lender of last resort facilities—to minimize the adverse effects of bank failures.</li> <li>• Safety and soundness regulation and deposit insurance pose barriers to the entry of new firms and favor incumbent firms. The safety net also raises moral hazard issues.</li> </ul>	<p><i>Safety net</i></p> <ul style="list-style-type: none"> <li>• Banks are no longer special because many substitutes have emerged for deposit and lending products. There may be less of a need for a public safety net and correspondingly less need for prudential regulation and supervision.</li> <li>• Government should increasingly allow the private sector to find mechanisms to curb excessive risk taking.</li> <li>• More efficient interbank markets reduce the need for lender of last resort facilities.</li> <li>• Banks' special role in the payment system is declining as technology allows for the unbundling of payment and credit services. Authorities may want to separate payment from other credit services and allow freer entry to the payment system.</li> </ul>	<p><i>Safety net</i></p> <ul style="list-style-type: none"> <li>• Authorities should be wary of extending the safety net to nondeposit-taking activities and deposit substitutes. They should require financial service providers with nondeposit-taking activities to adopt a bank holding company structure or a narrow banking structure.</li> <li>• With increased competition and the decline in franchise value, decapitalized institutions will have incentives to gamble for resurrection. Governments need to strengthen failure resolution mechanisms and reduce extensive guarantees that often apply to all financial system liabilities.</li> </ul>
<p><i>Competition policy</i></p> <ul style="list-style-type: none"> <li>• Because banks are considered special, competition policy is subsumed under prudential policy. Competition policy aims to ensure an adequate franchise value for banks to enhance their soundness and incentives for prudent behavior.</li> </ul>	<p><i>Competition policy</i></p> <p>As the safety net is eliminated, markets for financial services can be treated like any other product from a competition policy point of view. This means that:</p> <ul style="list-style-type: none"> <li>• Freer trade in financial services will become even more important.</li> </ul>	

(Table continues on the following page.)

**TABLE 19.3 (CONTINUED)**

<i>Current issues</i>	<i>Future issues</i>	<i>Transition issues</i>
<ul style="list-style-type: none"> <li>• Tools of competition policy include minimum capital requirements, capital adequacy, and fit and proper test.</li> </ul>	<ul style="list-style-type: none"> <li>• Scale and scope economies are unlikely to be effective barriers to entry.</li> <li>• Sunk costs, externalities, and vertical integration may be barriers to entry and could hamper competition.</li> <li>• Market and product definitions, which are critical for competition tests, will be difficult to define.</li> <li>• With globalization, competition policy will have to be coordinated worldwide.</li> </ul> <p data-bbox="715 732 953 753"><i>Consumer protection</i></p> <ul style="list-style-type: none"> <li>• Issues relate to security risk, privacy, transparency of information, and investor protection.</li> <li>• Key public policy areas include defining consumer protection standards, defining minimum standards for self-regulating organizations, and ensuring incentives for enforcement of such standards.</li> </ul>	<p data-bbox="1289 732 1527 753"><i>Consumer protection</i></p> <ul style="list-style-type: none"> <li>• A challenge will be to modify legislation and regulations credibly to permit proper enforcement including the area of minimum disclosure.</li> </ul>

### ***Consumer and Investor Protection***

E-finance has made consumer and investor protection a more important function of public policy. Issues include security, privacy, and transparency. Consumer and investor protection raises issues such as the role of standards, who can best develop such standards, and who should enforce them.

Security risks are being dealt with but will continue to require oversight. With technological developments—cryptographic techniques, cards with built-in chips, and other verification techniques—complete security is already or nearly possible. Still, regulators may need to encourage or require operators to adopt best-practice standards. Further protocols and legal changes, including those for digital signatures, will be needed to facilitate electronic transactions.

Privacy issues are becoming more important. The Internet has greatly simplified the collection and sharing of credit and other data on individuals and businesses, and technology has lowered the costs of processing and using such information. Global standards and protocols will be needed to assure desired levels of privacy, to enable cross-border provision of financial services, and to allow global service providers to operate efficiently.

The proliferation of financial products, delivery channels, and institutions, along with the speed of innovation, has improved the ability of consumers to compare prices and products. But the links between infomediaries and financial service providers can lead to less transparency on the service being offered. An important transparency issue in capital markets will be assuring fairness and best execution and trading practices. Solutions likely will vary by country and market.

With increased cross-border transactions, it will be difficult to identify the legislative or regulatory authority for investor protection. Furthermore, the emergence of non-traditional service providers complicates investor protection mechanisms based on current institutional frameworks. Government agencies need not directly intervene to combat these problems, however. Instead, more intense efforts should be made to educate consumers. Authorities should set minimum standards of disclosure for new financial intermediaries and possibly for self-regulating organizations—including entities that certify information providers, such as credit bureaus, credit rating agencies, accounting boards, and auditors.

### ***Global Public Policy***

Although e-finance offers many gains, it may increase risks. Limits on cross-border financial services will become costlier and more distorting as the Internet expands its

reach, the location of providers becomes more difficult to pinpoint, solicitation becomes harder to define, and the definition of a financial service becomes more complex. Regulators will have to decide on the best way to phase out such limits. A comprehensive approach would be the global equivalent of the EU approach of a single license (passport), allowing full cross-border provision with home-rule regulation.

Today competition and market forces resolve many investor protection issues because consumers and investors choose the environments that provide them with the greatest certainty. But as e-finance expands, less-informed consumers will gain access to markets, raising issues for cross-border investor protection and transparency. Even with a global passport approach and harmonized standards, regulators may need to protect consumers who are accessing offshore financial services.

Increased globalization requires increased coordination. Greater use of technology with global externalities involves operational risks (such as computer breakdowns). Access of new trading systems to contingent financing is also unclear, especially on a global basis. In general, the links between operators and resulting systemic risks have become harder to understand. Risk safeguards will have to be extended within and across countries, with greater information sharing among regulators and self-regulating organizations.

The easy spread of information—and misinformation—could make asset prices and capital flows more volatile. Herding, turbulence, and contagion may increase, and countries may become more vulnerable to attacks on their currency. Capital account restrictions will be more difficult under e-finance, and the growing number of creditors complicates coordination prior to or during a financial crisis, particularly in emerging markets. Although these problems are not new, policy solutions have been elusive.

### ***Impact on Transition Economies***

In transition countries, where access to and the quality of financial services are limited, e-finance and globalization offer many important opportunities. E-finance has great potential to improve the quality and scope of financial services and to expand the opportunities for trading risks; it also can widen access to financial services for a much greater set of retail and commercial clients by offering more cost-effective delivery of services. Some transition economies are starting to participate in the e-finance revolution, and this already is having a significant, positive impact in some markets.

To allow this to happen most productively, e-finance will require a reassessment of the approach to financial sector development. E-finance facilitates access to global capital and financial service providers. As financial services are imported, the need for a domestic safety net and for corresponding regulation and supervision declines. The question arises whether small, undiversified economies should have domestic equity and debt markets and, in the extreme, banking systems. Instead, policy issues related to the infrastructure and enabling environment for financial services provision are critical to realizing the benefits of technology and globalization. These include the regulatory framework for providing telecommunication services, the regulatory framework for security and related public and private key infrastructure, the standards and enforcement in place for information and privacy, and the framework for contract enforcement and credit risk assessment.

E-finance will impose limits on these choices, particularly for economies with poorly capitalized banking systems, weak regulations, and extensive guarantees on liabilities. E-finance will accelerate the move of business and profits from incumbents, putting their franchise values, and incentives to act prudently, at risk. To reduce the risk of financial crises, regulatory approaches in transition countries should recognize their weak governance and institutions, scarce human resources, and concentrated ownership structures. These impairments make textbook solutions difficult and argue for simpler approaches. E-finance will make this all the more urgent.

With these changes in policy emphasis in mind, e-finance offers many opportunities. This is especially so for countries with an underdeveloped financial system, as is the

case for many transition economies, where e-finance offers the opportunity to leapfrog. Many transition economies are characterized by relatively unsophisticated financial systems with limited services. To the extent that financial services are being provided, they often reach only selected segments of the economy, such as higher-income segments in urban areas, state-owned enterprises, and large agro-businesses, rather than the general population, small and medium-size firms, and farmers. Many financial systems in transition economies also have poor allocation of resources and relatively high intermediation costs. Furthermore, many have had problems with establishing a credible and independent supervisory system and have had to incur large fiscal costs from the occasional (or repeated) financial recapitalization of banks. Given the low efficiency and poor quality of financial services in many transition economies, migration toward e-finance will be high, leading to more rapid decapitalization of incumbent financial institutions.

For many transition economies with relatively shallow financial sectors, e-finance can be a revolution. There is evidence that this already is happening. Indeed, some transition economies, like Estonia, are at the forefront of e-finance developments, with e-finance penetration on par with or above that in many developed countries (see box 19.3). Other country experiences show that it is possible to leapfrog the technology. In several emerging markets, such as the Czech Republic and the Republic of Korea, on-line brokerage is already above that in developed countries. In several transition economies, electronic cash cards are being introduced that offer savings and payment services to customers who often do not even have a formal bank account. The cards will store customer information and thus become

### BOX 19.3 EXAMPLES OF E-FINANCE IN TRANSITION ECONOMIES: ESTONIA AND RUSSIA

*Estonia's* progress in information technology has been very impressive. After the collapse of communism, this nation of 1.5 million people moved straight to wireless technologies, with almost 30 percent of the population now owning a mobile phone and about 35 percent having access to Internet services. E-finance has taken off similarly. Of the seven Estonian banks, five have on-line services, making for more than 250,000 Internet banking clients, a penetration almost as high as in the Nordic countries. As elsewhere, banks in Estonia see internet banking as a cost-efficient way of expanding, avoiding expensive new branch offices. Hansabank, the largest Estonian bank, is considered among the best of the on-line banks in Europe and a pioneer in personalized finance

management. Today, about 17 percent of 1 million customers bank on-line, and the bank processes 90 percent of its 2 million operations completely electronically—through secured personal computer links for small companies, Internet connections, automatic issuing of debit or credit standing orders, or automated teller machines.

Renaissance Insurance Group was the first Russian insurer to go on-line in 1999. Clients of the company can pay for eight different insurance policies using its CyberPlat payment system. In April 2000, Ingosstrakh, the largest Russian insurance company, launched its internet site allowing clients to apply for an insurance policy on-line. So far, however, payments can be made only in the offices of Ingosstrakh.

the basis for the extension of credit or other financial services to these customers, not just by banks, but also by non-bank institutions. In other transition economies, on-line insurance products are being introduced.

The form in which this e-finance revolution will come about will be shaped by the forces of demand and supply as well as by regulatory and other barriers. In countries like Estonia, the lack of regulatory barriers and existence of favorable initial markets have made new entry attractive. The low development of existing financial services has further facilitated the penetration of e-finance in this country. In other transition economies, entry has been more specialized, in part as existing banking systems have been offering at least basic financial services at reasonable cost and quality. This includes many of the Central European countries. But, in part, incumbents in these countries have been protected in the past from full competition, among others through preferential access to government support. Over time, these countries should expect a rapid rise in the penetration of e-finance, as their telecommunication infrastructures are relatively good and internet penetration is increasing. In the transition economies of Eastern Europe and Central Asia, the quality of financial services is very poor, making e-finance a good opportunity to widen access to and improve financial services, at least in principle. To date, however, the lack of "bankable" demand for finan-

cial services has prevented the entry of new providers. But other barriers also have been large. These countries will need to give far greater priority to improving the framework for financial and other information, modernizing and strengthening their legal systems, and improving technology-related infrastructure (such as telecommunications).

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Part VI

The Roles of the World Bank  
and the  
International Monetary Fund



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## Chapter 20

# The Evolving Role of the World Bank in ECA Financial Sectors

*Paul Siegelbaum and Alexander Fleming*

A decade of financial sector development has taken place in the transition economies. The speed of financial evolution has not been uniform, even though the starting points—for countries of the former Soviet Union at least—were similar in many respects. The process of financial sector transition has raised significant challenges for those international financial institutions that have provided support in this area. Support programs have been tailored to the very specific circumstances of each country. The nature of the World Bank's involvement in the financial sector in the transition economies has evolved over time, reflecting both the changing needs of its clients and changing perceptions in the Bank of what constitutes good practice in analysis and operational design. Given the unique nature of the transition, the type of support provided has been the result of a learning process not only by each country but also by the Bank.

This chapter reviews the challenges of financial transition in the economies of the former Soviet Union and Central and Eastern Europe and how the Bank has sought to address them. It then looks ahead to the next phase of financial sector evolution and examines how the Bank is positioning itself to respond to it. A concluding section draws out the lessons of experience.

### **The Challenges of Financial Sector Transition**

As a backdrop to structuring its initial support for the transition economies, the Bank undertook a range of analytic studies shortly after each country joined the institution. This effort included compiling a country economic memorandum—a broad-based study of the macroeconomy

and each of the main sectors of the economy, including the financial sector—for each country. In many instances, specific in-depth studies of the financial sector also were prepared. These examined the initial conditions of the post-socialist economy, among other issues, and led to a first generation of lending operations, including some that supported early reform in the financial sector.<sup>1</sup> The initial conditions presented a range of complex challenges for project design.

### ***The Starting Point***

The special and limited role of banks and other financial institutions in a centrally planned economy constituted the starting point for financial sector reform in the tran-

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1. Poland and the Federal Republic of Yugoslavia, having been members of the World Bank for years before the transition began, each had lending operations in earlier years, although those operations did not focus on the changing role of the financial sector during the years after the fall of socialism.

sition economies. A significant complicating factor was the absence of the legal, institutional, and business environment necessary for financial institutions to fulfill their role as financial and risk intermediaries in a market economy. Economies that were able to supply these critical supporting frameworks relatively rapidly were more successful than other economies in developing a financial sector capable of driving growth in the real sector. An important challenge for the transition countries was to develop those frameworks.

Under central planning there was no need to provide any special legal infrastructure to support bank operations, since commercial risks of any sort were not a concern of banks. The state budget absorbed credit, market, interest rate, and currency risks, and the system was designed to eliminate all of these risks for domestic transactions.<sup>2</sup> As a result, there was no need for specialized supervisory regulations (other than those, mostly political, applicable to all state organs), collateral legislation, laws on the enforcement of contracts and other property rights, such as leasing and conditional sales, or legislation protecting the rights of creditors or regulating the consequences of the insolvency of debtors. For the most part, these provisions were seen as counterproductive “friction” in a system that adjusted rights and allocated resources centrally and in response to needs identified by politicians and bureaucrats. Many of the Bank’s initial projects in the transition countries supported government policy measures aimed at introducing the basic legal and regulatory frameworks for the financial sector.

It also was significant—possibly more so than was appreciated at the time—that the regulatory and other institutions on which market economies rely so heavily as umpires, facilitators, and providers of public goods were virtually absent at the starting point of the transition. The marriage of politics and commerce under socialism rendered western-style financial regulatory bodies, disclosure systems, law enforcement and administrative systems, self-regulatory bodies, and dispute resolution mechanisms irrelevant. Another challenge in this early period was that, although government entities did exist, or emerged early on, they fulfilled the institutional regulatory functions only nominally, often at the behest of Western aid providers. Yet

without adequate funding, education, training, and experience, not to mention political support and, where necessary, independence, these “institutions” were a shadow of what was required to support an effective market-based financial sector.<sup>3</sup> As the transition progressed, it became a special challenge to dismantle and rebuild these initial efforts at filling the institutional vacuum, often from within and in the face of strong political opposition. Again, this effort was undertaken in a number of early Bank projects.

In this environment, the incentives shaping the behavior of banks were very perverse. Indeed, in the beginning of the transition, the incentive structure favored precisely the opposite of what most would agree are the fundamentals of prudent banking. Box 20.1 illustrates this point.

Overcoming the perverse incentive structure in the context of Bank projects proved to be very difficult. Imposing financial discipline and introducing competition, for instance, required a multisectoral approach to improving energy sector arrears, boosting the collection of tax revenue, and reducing inter-enterprise and wage arrears. These problems have not been fully addressed even today in some of the slower-reforming countries, but in the faster-reforming countries, they were resolved over time. Introducing proper analysis of creditworthiness in the place of connected or directed lending was part of the institutional development effort accompanying many of the Bank’s financial intermediation loans (credit lines channeled through domestic banks). Meanwhile, the policy components of Bank loans supported efforts to strengthen the legal, regulatory, and supervisory framework for banks. But in many cases, it took time to alter the incentive structure in a way that supported the development of a market-based financial sector.

### *Subsequent Financial Sector Developments*

As the financial sector transition got under way, new challenges emerged. In some cases, these were not fully anticipated either by the country concerned or by the Bank. But they had to be addressed, and in many cases the Bank (often in cooperation with other international financial institutions or bilateral donors) developed operational support to deal with them.

2. As it became more common to borrow funds externally and to expand international trade relations, specialized banks were established to deal with these transactions. The inescapable fact was that these borrowings and transactions had to be conducted on a commercial basis, not subject to the plan.
3. Often, in an environment where social and legal controls on the power of corrupt politicians and bureaucrats were weak or nonexistent, these new institutions served little more purpose than rent production and were avoided and circumvented by commercial interests because of that. This situation was almost the worst imaginable starting point from which to develop the trust and cooperation that must exist for effective regulation to operate in a market economy.

**BOX 20.1 THE PERVERSE INCENTIVE STRUCTURE IN TRANSITION BANKING**

*Financial discipline and competition.* In many economies in transition, the most effective competitors of banks are not other banks. They are the tax collector, energy suppliers, employees, and enterprise suppliers, as well as the state budget. For “financing” in the form of accumulated arrears, the rational enterprise manager naturally turns to these informal sources of funds well before considering formal borrowing from banks. Another form of financing is budget subsidies, often through the exploitation of political connections. These atypical sources of financing have clear advantages. Subsidies and tax, wage, energy, and inter-enterprise arrears are usually interest-free, automatic, unsecured, and, as often as not, forgiven in the next round of fiscal “reform.”

*Creditworthiness analysis skills.* In a business environment characterized by a lack of financial discipline, credit analysis skills are seriously devalued in competition with political connections and “relationship banking,” in which shareholdings and other connections give banks some edge in terms of information and customer access, relative to their banking competitors. And where the success of enterprises, particularly

state-owned enterprises, is still a political decision, it is far more important for bankers to understand and influence these political decisions than to understand the financial prospects of potential borrowers.

*Relationships with supervisors.* In an environment characterized by weak and politicized supervision of banks, the best bankers are suspicious of “prudent innovations” like transparent accounting systems, effective auditing processes, and prudential limits on connected and concentrated lending. The operation of these regulations in a highly distorted environment more likely serves as an invitation to rent collection, hostile confiscatory taxation, and penalty enforcement by inexperienced regulators than as a route to lowering banking risk. At the starting point of transition, the prudent banker lent as much as possible to insiders and politically powerful enterprises, worked hard to conceal profits from the tax collector, and tried to keep banking regulators as far as possible from true knowledge of the business. This activity yielded very high rents for some players, but at the expense of the state budget and the new private enterprises trying to expand on commercial terms.

During the early 1990s, four factors had a disproportionate impact on the initial financial sector developments in the transition economies: (1) inflation, (2) the breakup of the all-union banking system in the former Soviet Union, (3) early official efforts to stimulate the growth of the commercial banking sector by lowering barriers to entry, and (4) mass privatization. Financial sectors across Europe and Central Asia (ECA) are still feeling the impact of these developments.

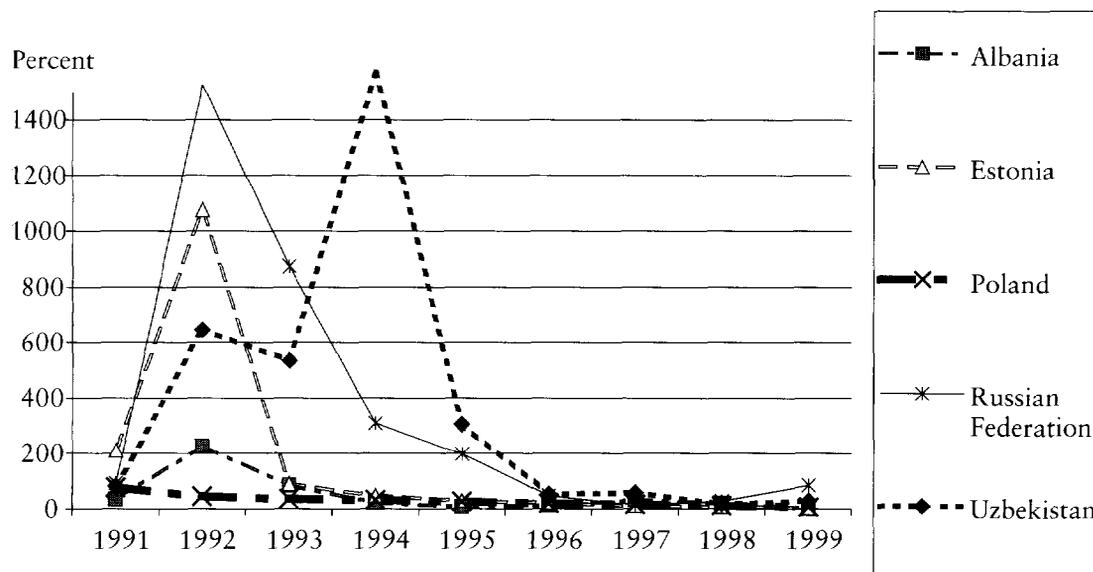
*Inflation.* At the beginning of the transition, the release of pent-up inflationary pressures from the socialist period, coupled with the tendency of many of the transition economy governments to pursue an inflationary monetary policy to compensate for the costs of trade disruptions, fueled a major inflationary surge across the region (see figure 20.1). In some cases, inflation rates surged to hyperinflationary levels. In Central and Eastern Europe and the Baltic states, the inflationary surge lasted from about 1990 to 1993 in most cases,<sup>4</sup> while in the countries of the Commonwealth of Independent States (CIS), a similar, but

much more dramatic, surge lasted from 1991 through 1995. These inflationary pressures significantly weakened the inexperienced banks and eroded public confidence not only in the banks but also in many national currencies, which by this time had been introduced. Inflationary episodes like this had a number of adverse impacts on banks.

As the rate of inflation rose sharply, inexperienced bankers did not realize how important it was to raise their lending rates in parallel, with the result that real lending rates entered negative territory, eliminating real profit margins. In addition, depreciation of the local currency, which accompanied the inflationary surges, had positive and negative impacts. It wiped out the banks’ liabilities, at least in hard currency terms, but it also eliminated the real value of the banks’ assets and thus their capital. In these early stages of the inflationary experience, the only banks that profited were those with long foreign currency positions, which accumulated extraordinary foreign exchange gains in a brief period. This positive factor also sowed the seeds of a later disaster, since it demonstrated to these new bankers

4. The surge of inflation started even earlier in some cases, such as Poland, but never reached the levels of some CIS countries.

**FIGURE 20.1 INFLATION IN SELECTED ECA COUNTRIES 1991–1999 (ANNUAL AVERAGES, PERCENT)**



Source: International Financial Statistics (IFS) and Central Bank websites.

that real wealth could be found in currency speculation, not prudent enterprise lending.

At the crest of the inflationary wave—and particularly in the hyperinflationary countries of the CIS—there were extraordinary profits to be made, although not in traditional banking. Currency speculation was still profitable, as was financing the trade in certain metals and commodities of dubious legality, but the extraordinarily high nominal interest rates the bankers were forced to charge created a serious moral hazard among potential bank borrowers, such that only those enterprises literally facing extinction were willing to pay the quoted rates. Moreover, these unsustainable inflationary levels were typically quite volatile, which exacerbated the challenges of asset-liability management for the bankers. Again, it was precisely the wrong set of skills that proved valuable in this period—skills that would serve to complicate reform efforts long after inflation was tamed.

As inflation rates eased, which occurred when the prudent monetary and fiscal prescriptions provided by the International Monetary Fund and the World Bank took hold, a different dynamic developed—again, one for which these nascent bankers were unprepared. Having learned their lesson on the way up, bankers were reluctant to reduce rates quickly as inflation eased and stabilization was achieved. While this produced highly profitable lending spreads, the positive cash flows also concealed the dragging weight of these banks’ inefficient cost structures.

As before, the presence of very high real lending rates fueled an explosion of moral hazard among bank borrowers, as the most sophisticated and creditworthy simply turned away from bank-based finance until the storm abated. The remaining desperate borrowers sowed the seeds of the problem of nonperforming loans that arose in the mid-1990s.

In the last phase, as stabilization was achieved more broadly and inflation rates sagged to single-digit levels in most transition economies, new challenges emerged for the banks. The profit was squeezed out of currency speculation, and access to profits finally came to depend on good banking—that is, adequate credit analysis skills, workout capabilities, professional asset-liability management, and reasonable cost containment. However, nothing in the past years had taught the banks these essential skills and, burdened with mounting volumes of nonperforming loans and a high fixed cost base, many banks were driven into insolvency. Large state and state-connected banks in several countries frequently were treated differently than other banks—an ambivalent and broadly protective policy stance often standing in place of the decisive closure strategies advocated by most Western advisors (for example, the Russian Federation and Ukraine). This marked the end for many of the smaller commercial banks, but it was, for the larger state-owned and former specialized banks, the beginning of another period of ineffective, and hugely expensive, government bailout efforts.

Strategies for dealing with the monetary and inflationary implications of the transition were supported under World Bank and International Monetary Fund programs in the first years of the transition. In the case of the Bank, macroeconomic conditionality was invariably attached to structural adjustment loans or sectoral adjustment loans. This conditionality typically promoted fiscal restraint, balanced budgets, management of interest rates to positive real levels (followed by liberalization of rates), and cessation of government borrowing from central banks.

At an early stage, institutional strengthening was recognized as critical to controlling the financial sector risks that flowed from the turbulent environment, risks that often had to be carried by the state budget in the final analysis, as inadequate financial and human capital in the banks led to inevitable failures. Thus, building a modern legal infrastructure for central banking, bank supervision, and commercial banking was reflected in both conditionality and technical assistance projects, as were the application and enforcement of prudential regulations, the limitation of directed credits to politically connected and socially significant (but not creditworthy) enterprises, and the building of capacity in the central bank or other supervisory agency for dealing with troubled banks.

The state-owned and formerly state-owned banks bore the brunt of the financial risks that inflation produced, burdened as they were with the legacy of noncommercial lending, weak banking skills, and a customer base heavily weighted toward the largest of the state-owned enterprises, which were the hardest hit by trade disruptions in the early transition. As a result, these large banks were absorbing far too much of the budget's precious resources, so they were targeted early on for intervention by both adjustment loan conditionality and technical assistance. The diagnosis and targeting often were sidetracked by the protective attitudes of local politicians and vested interests toward these banks.

*All-union bank restructuring.* The restructuring of the specialized all-union banks that occurred on the political breakup of the former Soviet Union placed severe stresses on many countries (outside of the Russian Federation). Assets were held in the Russian central office, while liabilities were left in the regional offices, which eventually were reconstituted into independent institutions. Because of the "missing assets," most of these banks—primarily the savings banks—were severely insolvent. For these banks, there was an early and critical need for restructuring, recapitalization, and, in some cases, liquidation. Because they often served powerful political interests and financed critical sec-

tors of the economy, governments were slow to take effective corrective action.

A number of Bank projects sought to address the issues of state bank restructuring. The Bank typically played an important role in structural issues vis-à-vis other international financial institutions. The Bank provided this type of support in various operational contexts. In some cases, it was part of policy-based lending (structural adjustment and sectoral adjustment loans), while in other cases, it was part of financial intermediation loans. Success in restructuring state banks was relatively rare, as governments were politically unable to implement the necessary painful measures. In a number of countries, efforts were made to privatize troubled banks in lieu of restructuring, but this rarely proved to be a viable strategy, at least as it was originally (implicitly) conceived, which was an inexpensive method of selling restructuring responsibilities to private strategic investors. Even the least sophisticated potential investors were reluctant to "purchase" banks with negative net worth, obsolete technology, inadequate procedures, complex and nontransparent governance structures, and unsustainable cost structures.

Where bank privatization did work, it was more in the nature of controlled liquidations, sometimes with foreign banks purchasing the few worthwhile assets, typically branches. The notable exceptions to this general trend occurred in Central Europe and the Baltics, where early decisions were made to replace management, aggressively clean up balance sheets, and provide extensive training and technical assistance to build modern banking skills. The best examples of this process done right are Unibank in Latvia and the North Estonia Bank. Much work remains to be done on bank restructuring in the CIS countries, as well as in Central and Eastern Europe, particularly in the Balkans, where foreign entry presents significant political problems. The Bank is finding, that the delays in dealing with the serious problems faced by these banks have gradually eliminated strategic alternatives to liquidation. A major dilemma for large state banks in oligarch-dominated economies is to avoid privatizations that merely hand the target banks to undesirable elements having little real interest in building sound and stable banks. In many cases, delay and half-hearted efforts to permit insolvent banks to "grow out of their problems" simply transformed potentially recoverable institutions into fiscal black holes.

*Growth in banks; cowboy banking.* Many governments in transition countries initially responded to the lack of commercial banking in their economies by setting excessively

low barriers to entry.<sup>5</sup> Low initial and minimum capital requirements were embraced, and virtually no “fit and proper” restrictions were placed on who could obtain a banking license from the state or how they had to perform once they had this license. At the same time, the privileges of accepting deposits from the public, participating in the

payment system, and maintaining preferred access to government payments, loans, and subsidies were relatively unrestricted, and, without modern accounting and auditing, the condition of the banks was anything but transparent. An excessive number of banks were established in relation to the size of the economy (see table 20.1)

**TABLE 20.1 NUMBER OF BANKS IN CENTRAL AND EASTERN EUROPE AND CENTRAL ASIA, 1993–2000 (YEAR-END)**

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
<i>CEE and Baltics</i>										
Albania	—	—	—	6	6	8	9	10	10	—
Bulgaria	78	59	41	45	47	35	34	34	35	35
Croatia	—	—	43	50	54	58	61	60	53	45
Czech Rep.	—	—	52	55	55	53	50	45	42	40
Estonia	—	—	21	22	18	15	12	6	7	6
FYR Macedonia	—	—	—	6	6	22	22	24	23	21
Hungary	35	35	40	43	42	41	41	40	39	39
Latvia	14	50	62	56	42	35	32	27	23	22
Lithuania	—	—	26	22	15	12	12	12	13	14
Poland	—	—	87	82	81	81	83	83	77	75
Romania	—	—	—	20	24	31	33	36	34	35
Slovak Rep.	—	—	18	19	25	24	25	24	25	22
Slovenia	40	45	45	44	41	36	34	30	31	25
<i>CIS</i>										
Armenia	—	—	—	41	35	33	30	31	32	31
Azerbaijan	43	120	164	210	180	136	99	79	70	59
Belarus	—	—	—	48	42	38	38	37	—	27
Georgia	—	75	179	226	101	61	53	43	34	33
Kazakhstan	72	155	204	184	130	101	81	71	55	48
Kyrgyz Rep.	10	15	20	18	18	18	20	23	23	22
Moldova	15	16	16	21	22	21	22	23	21	20
Russian Fed.	1306	1747	2009	2456	2295	2576	2526	2451	2376	2084
Tajikistan	1	10	15	17	18	23	28	20	20	17
Turkmenistan*	—	—	—	—	67	68	67	13	13	13
Ukraine	76	133	211	228	230	229	227	214	203	195
Uzbekistan	30	30	21	29	31	29	30	33	35	35

— Not available.

\* In 1995, 56 agriculture cooperative banks were established as spin-off of Agroprom Bank. These institutions were eventually remerged into Agroprom Bank in 1998.

Source: Central bank bulletins and web sites.

5. This approach had its antecedents in the 1987 reform of the Soviet Union’s banking laws in which, in response to the Perestroika-induced expansion of “private” cooperative enterprises, citizens were allowed to establish private cooperative banks. The assumption was that the state banks would not be interested in serving private enterprises. The strategy worked all too well, as all manner of entities, including some churches, moved to establish what came to be called “pocket” banks to serve their financial needs, often with funds from household depositors.

Minimal barriers to entry accompanied an unsophisticated supervisory system and ineffective enforcement of prudential regulations. In many countries—particularly in the former Soviet Union—there were virtually no limits on what banks could do and what risks they could take. Many household depositors perceived these risks early (often, however, not early enough to avoid losing their savings in hyperinflationary episodes). As a result, the volume of household deposits at risk was relatively low in early transition banks. Instead, households turned to “mattress banks” for their savings and to foreign currency, especially dollars, for their investments.<sup>6</sup> Enterprises, that required payments services, could not avoid placing funds into banks. As for the banks themselves, in the early transition years few domestic investments were more profitable than simply purchasing and holding hard currency against the rapidly depreciating local currency. As the risks of “cowboy banking” came home to roost, many of these deposits were lost, with a very substantial negative impact on the production, employment, and growth of these enterprises.

The Bank consistently tried to assist the transition countries in moving toward a more consolidated banking sector, proportioned to their economies. Often this involved support for government programs aimed at tightening capital ratios and raising minimum capital standards as a way to rid banking systems of weak banks through mergers or orderly liquidations. Consolidation took place in Central Europe and the Baltics, but this process was less marked in the other ECA countries (table 20.1). Other initiatives with the same goal included pressures to eliminate local barriers to the entry of foreign banks and foreign investors in local banks. Thus far, all of the best results in banking sector restructuring have been driven by the participation in—and even domination of—the local banking sector by foreigners. The earliest of these initiatives was probably the bank twinning program in Poland, supported by the World Bank and other donors, but the Polish success with this strategy has been hard to replicate elsewhere. Even enthusiastic reformers, such as Slovenia, have found it difficult to embrace foreign banks fully. Some foreign banks have secured a foothold in the CIS countries, but, for the most part, they have not competed hard for domestic business. Indeed, considering that the eventual EU accession, which is the goal of most of the Central and Eastern European countries, will eliminate the barriers to foreign participation

in all domestic banking, it would appear that the end game already has been defined. Purely domestic banks, if they have any hope of survival at all, will have to define extremely tight niches for themselves. Whether they can do so and still remain profitable remains to be seen.

*Enterprise privatization.* Privatization was a common denominator in the reform of the real sector in the transition economies. Those countries that opted for one of the models of mass privatization, in which the population received either direct or indirect ownership interests in formerly state-owned enterprises, were immediately faced with the need to establish capital market mechanisms to manage the purchase, sale, and valuation of these equity interests. For the most part, this was not accomplished well, but it did define a specific area of assistance that was to become a focus of Bank attention in the first five years of the transition, a focus that has continued until the present.

As in the banking sector, the earliest interventions were in the form of conditionality and technical assistance in the creation of a modern legal and supervisory system for the capital markets. Rapidly, however, it became clear that one feature critical to the viability of an efficient capital market—timely and accurate information on which to assess the value of investments—was going to be a binding constraint. As a result, the Bank became involved at an early stage in the promotion of modern enterprise accounting and auditing systems (for banks as well as for enterprises), disclosure systems, and market regulation. In retrospect, achievements in this area were modest. Although formal institutions were created in many cases, accompanied by a reasonably complete legal and supervisory infrastructure, capital markets remained extremely thin or nonexistent in most of the ECA countries.

Another significant impact of the privatization programs in the transition economies was a radical change in the risk profile of banking, especially of banks servicing the state-owned enterprises. Before privatization, state-owned enterprises were among the best credits in the system. They were supported by the budget, without regard for their profitability, their efficiency, or their business prospects. There was no need to assess the creditworthiness of these enterprises before lending to them. At most, an assessment of the likelihood of continued government support was needed, and even that was not critical if the bank managers

6. Mattress banks included, in some cases, the savings banks around the ECA region that received at least a nominal government guarantee and retained an element of customer loyalty. For example, in Ukraine in 2000, the average U.S. dollar value of a household deposit account in the banking system was well under \$5.00. Many of these accounts continued to exist because they were too small to bother with, particularly in rural bank branches, where the lack of liquidity resulted in a de facto freeze on withdrawals.

believed that their loans to these enterprises were implicitly guaranteed by the state. And the political analysis was not difficult—the bigger the enterprise, the more visible, and the more citizens it employed, the less likely was the withdrawal of government support.

After privatization, the situation became more complex and demanding for bankers. Some formerly state-owned enterprises were still too big to fail, and they continued business much as usual, often with implicit state subsidies in the form of directed credits, monopoly positions, cheap energy, or tariff protections instead of the traditional direct payments. But the system was becoming less transparent as subtle political pressures were exerted on enterprises in the face of anti-subsidy conditionality and other pressures to reform from the international financial institutions. Other privatized enterprises were simply cut off from both direct and indirect subsidies and were left to flounder, building up significant tax, wage, and inter-enterprise arrears to compete with the banks' claims. Often the large banks had significant exposure to these enterprises, originating in government-directed credits, but the governments typically were reluc-

tant to recognize this in any formal way that would relieve the pressure on bank portfolios (at least until it was too late). In short, traditional banking skills were in demand at a time when they were most severely lacking.

### The World Bank's Operational Response

The varying levels of success with which governments were able to deal with these early challenges began to drive significant differences in financial sector development. Furthermore, the operational response of the Bank was tailored to meet the emerging needs of the different transition countries. The Bank's operational work in the financial sector is summarized in table 20.2. Box 20.2 describes the main lending instruments that the Bank deployed.

Five groups of countries began to emerge as the financial transition unfolded (see box 20.3). The first was what might be called the *rapid reformers* of Central Europe, including Poland, Hungary, the Czech Republic, the Slovak Republic, and Slovenia, where the governments had, for the most part, the political discipline and commitment, as well as the technical capacity, to manage the impact of these

#### BOX 20.2 THE WORLD BANK'S LENDING INSTRUMENTS FOR FINANCIAL SECTOR DEVELOPMENT

The Bank's lending operations comprise what might be divided loosely into top-down and bottom-up lending instruments. The top-down instruments are targeted at the policy environment for finance. These typically are *structural adjustment loans* (SALs), or structural adjustment credits (SACs) in the case of International Development Association countries, with financial sector components or sector adjustment loans that place a heavy emphasis on the financial sector. In the early days of transition, a number of countries received *rehabilitation loans* that were effectively one-tranche SALs. *Sector adjustment loans* (SECALS) can take many forms, but the two main ones are financial sector adjustment loans and enterprise and financial sector adjustment loans. In the case of the latter, the enterprise and financial sectors often are addressed simultaneously in transition economies because the problems of both sectors are interrelated. These types of projects are used to support policy reform for a range of countries at different stages of financial sector development. They typically disburse directly to the government in two or three tranches once specific conditionality has been met.

*Financial intermediary loans* (FILS) also are used in the ECA context for institution building in the financial sector. These bottom-up instruments include credit lines channeled from the Bank through commercial banks in the recipient countries and

on to private sector entities. In the poorer countries—those with rudimentary financial systems—these credit lines often take the form of agricultural credit operations or micro-credit operations that are channeled through special-purpose entities, bypassing the formal financial sector entirely. In the more advanced reforming countries, more broadly based credit lines, catering to the needs of a broader set of private sector borrowers, are put in place. Most credit lines are designed not just to transfer resources to final borrowers but also to encourage institutional development through the strengthening, and in some cases restructuring, of the participating banks and, in some cases, the enterprise subborrowers.

*Institution-building loans* (IBLs) for the financial sector also are deployed in some countries. Such technical assistance loans normally finance experts who assist in strengthening the infrastructure—broadly defined—of the financial sector.

*Guarantees* sometimes are used in the ECA region to cover a range of noncommercial risks that otherwise would impede the flow of finance to private enterprises, but their use in the early transition period was quite rare, since the Bank did not mainstream guarantee operations until the late 1990s and the International Development Association does not yet have full guarantee authority.

**TABLE 20.2 FINANCIAL SECTOR COUNTRY INTERVENTIONS, 1991–2001**

<i>Country and fiscal year</i>	<i>Number of projects</i>	<i>Commercial bank institutional restructuring</i>	<i>State bank restructuring</i>	<i>Central bank</i>	<i>Laws and regulations</i>	<i>Payment system</i>	<i>State bank privatization</i>	<i>Capital markets</i>	<i>Commercial bank restructuring</i>	<i>Creditor rights</i>	<i>Deposit insurance</i>	<i>Nonbank financial institutions</i>
<i>Rapid reformers</i>												
Hungary, 1993–98	3	❖	❖	❖	❖		❖	❖				❖
Poland, 1991–98	4	❖	❖	❖	❖	❖	❖	❖		❖	❖	
Slovak Republic, 1994	1	❖	❖	❖			❖		❖			
Slovenia, 1994	1	❖	❖	❖	❖		❖			❖		❖
<i>Intermediate reformers</i>												
Bulgaria, 1991–99	7	❖	❖	❖	❖	❖	❖	❖	❖	❖	❖	
Croatia, 1996–97	2	❖	❖	❖	❖		❖		❖		❖	
Estonia, 1993–95	2	❖	❖		❖	❖	❖		❖			
Latvia, 1993–95	2	❖	❖				❖	❖				
Lithuania, 1993–95	2	❖	❖	❖	❖	❖	❖					
<i>Hampered reformers</i>												
Albania, 1993–2000	5	❖	❖	❖	❖	❖	❖	❖	❖			❖
Armenia, 1993–98	6	❖	❖	❖	❖		❖	❖	❖	❖		
Azerbaijan, 1996–98	3	❖	❖	❖	❖	❖	❖		❖			❖
Bosnia, 1999	2		❖				❖	❖				
Georgia, 1995–98	6	❖	❖	❖	❖	❖	❖	❖			❖	
FYR Macedonia, 1994–2001	3	❖	❖	❖	❖	❖	❖	❖	❖		❖	
Moldova, 1994–96	3	❖	❖	❖	❖	❖						
<i>Reluctant reformers</i>												
Belarus, 1993–94	2	❖	❖	❖								
Kazakhstan, 1994–95	4	❖	❖	❖	❖	❖	❖	❖	❖	❖	❖	
Kyrgyz Republic, 1993–99	5	❖	❖	❖	❖	❖		❖		❖		❖

*(Table continues on the following page.)*

TABLE 20.2 (CONTINUED)

Country and fiscal year	Number of projects	Commercial bank institutional restructuring	State bank restructuring	Central bank	Laws and regulations	Payment system	State bank privatization	Capital markets	Commercial bank restructuring	Creditor rights	Deposit insurance	Nonbank financial institutions
Tajikistan, 1996–99	2	❖		❖	❖	❖		❖	❖	❖		
Turkmenistan, 1995	1	❖			❖	❖						
Uzbekistan, 1994–99	2	❖	❖	❖		❖	❖					
<i>Chaotic reformers</i>												
Romania, 1992–99	4	❖	❖	❖	❖	❖	❖	❖	❖		❖	
Russian Federation, 1994–99	6	❖	❖	❖	❖	❖		❖	❖	❖		
Ukraine, 1993–98	6	❖	❖	❖	❖	❖		❖	❖		❖	
<i>Total country interventions</i>		24	23	21	20	18	18	14	12	8	8	5

## Explanatory Notes:

The entries in the table show where bank interventions (either individual elements of conditionality or specific areas of financial support) have been concentrated in the context of all of the projects containing financial sector components that have been identified for each country.

**Fiscal Year(s)** The year, or period of years, during which at least one project with financial sector content was launched (the Bank's fiscal year runs from July 1 to June 30)  
**No. of projects** The number of projects with financial sector content that were launched during the year, or years, cited.

*Conditionality or technical assistance provided to the following:*

<b>Commercial Bank Institution Building</b>	To stimulate Institution building within commercial banks (MIS development, credit skills development, etc.);
<b>State Bank Restructure</b>	To audit and restructure state banks;
<b>Central Bank</b>	To develop the infrastructure of the Central Bank (structuring departments, training staff, etc.) and strengthen its banking supervisory capacity;
<b>Law &amp; Regulation</b>	To introduce or strengthen laws and regulations pertaining either to the Central Bank or to the banking sector;
<b>Payments system</b>	To develop the payments system;
<b>State Bank privatization</b>	To privatize state banks;
<b>Capital Markets</b>	To introduce or strengthen laws and regulations pertaining to the capital markets, strengthen supervision, and develop infrastructure such as securities depositories, securities rating agencies, etc.;
<b>Commercial Bank restructuring</b>	To restructure commercial banks;
<b>Creditor Rights</b>	To introduce collateral laws or bankruptcy laws or procedures;
<b>Deposit Insurance</b>	To introduce (or in some instances prevent the introduction of) deposit insurance;
<b>NBFI (nonbank financial institutions)</b>	To develop the legal, regulatory or supervisory framework for insurance companies, pension funds or 3 <sup>rd</sup> pillar pension reform, and the legal, regulatory, or supervisory framework for other NBFIs (such as leasing companies).

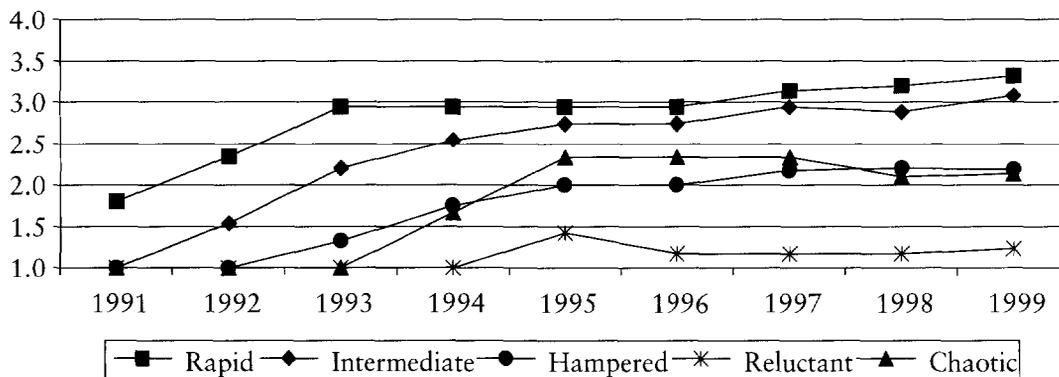
early stresses on their banks, to put competent institutions in place, and to impose discipline in both the financial and the real sectors. This group of countries (with the exception of the Czech Republic, which chose not to borrow from the Bank in support of financial sector reform) benefited greatly from Bank operations such as financial sector adjustment loans supporting institution building in banking regulation, bank privatization, and restructuring.<sup>7</sup> Such loans also provided technical assistance in support of financial accounting reforms, capital market development, tax reform, and the general opening of the financial sector to foreign investment and competition. In this first group, moreover, the challenges of privatizing the real sector were, for the most part, met aggressively and successfully, and privatized enterprises were subjected to a hard budget con-

straint, which both weeded out the worst loss-makers and promoted the commercially oriented business culture on which banking depends.

The second group—which might be called the *intermediate reformers*—was, for a variety of reasons, less successful in dealing with the initial financial sector problems, although progress was made in many areas. This group, which includes Estonia, Latvia, and Lithuania, as well as Eastern European nations such as Bulgaria and Croatia, faced a deeper and more resistant set of problems at the outset, including banking sectors dominated by more deeply insolvent state and former state-owned banks, more intense and more prolonged inflationary periods, a shallower commitment to reform, particularly in privatization, and trade and financial links more oriented to the East and

**BOX 20.3 PROGRESS IN THE TRANSITION OF ECA COUNTRY CATEGORIES, 1991–1999**

**BANKING REFORM**  
(EBRD TRANSITION INDICATORS)



The European Bank for Reconstruction and Development assigns ratings to the status of institutional development in the banking sector in each of the ECA countries. These ratings range from 1 for a very low level of institutional development to 4 for a high level of development. For the purposes of figure 20.1, the grading shown for each category of country is the unweighted average for all countries in that group. Each group has a different ranking and, which is important, a different path of development in its ranking for the decade of the transition.

The *chaotic reformers* are the only group that changed its relative ranking among the country groupings, as it surpassed the *hampered reformers* in mid-decade, only to fall back, relative to that group, by the end of the 10-year period. This was the result of significant progress made by Romania and Ukraine in 1995 in the introduction of new banking legislation and prudential regulations, achievements that were eroded by 1998 as a result of the banking sector problems in Romania and outright financial crisis in Russia.

7. While it is true that Hungary undertook multiple rounds of bank recapitalizations before an appropriately aggressive change in management strategy was accepted, the important points were that (1) reform of the banks' *customers*—that is, the enterprises—continued aggressively and (2) the Hungarian government *did not give up* on the banks, even in the face of multiple failures. As a result of these two factors, problems in the banking sector never deteriorated beyond the point of no return.

its even slower-recovering economies, than to the West, with the contestable competition of the European Union (EU). In some of these countries—notably the Baltics—financial sector reform was punctuated, and indeed driven, by severe banking crises. The Bank provided a significant level of support in the financial sector for this set of countries (table 20.2). Much of it was aimed at restructuring and privatizing state banks as well as providing a sound legal and regulatory framework for development of the private banking sector. Development of the payment system was another area of support. Much of the support for financial sector development was provided under the initial umbrella of rehabilitation loans, but subsequently also sector adjustment loans. Financial intermediation loans also worked well in these countries and provided an effective vehicle for the institutional development of commercial banks.

The third group of countries—the *hampered reformers*—is characterized by comparatively less progress in financial sector reform, largely the result of a web of circumstances, including their small size, history under socialism, geography, shortage of human capital, historical trade links and neighbors, and internal and external conflicts, which dramatically hampered the reform process in the real sector overall. This group includes Albania, Bosnia, Moldova, the Kyrgyz Republic, and Azerbaijan. For these countries, Bank support for the financial sector was provided through the vehicles of structural adjustment credits and institution-building loans. Much of this support was foundational in nature, focusing on restructuring and privatizing state banks, on strengthening the legal and regulatory framework for banking, and on establishing sound accounting for banks. Developing a more robust banking supervision function in the central bank was also a priority.

The fourth group is characterized as the *reluctant reformers*, including Belarus, Uzbekistan, Tajikistan, and Turkmenistan. These countries, through conscious choice, were the most reluctant to let go of the security of the command economy's principles and to risk enduring what they saw as the "chaos of the market" in countries around them. Ironically, many of these countries experienced a relatively shallow drop in output in the earliest stages of the transition. This—and the fact that they refused, in the main, to commercialize, let alone privatize, their real sectors—meant that banks and other financial institutions remained relatively stable and healthy, if their historic, limited role in financial intermediation is taken into account. In countries where commitment to state bank privatization was weak, emphasis was placed on building a sound foundation for finance through support for the

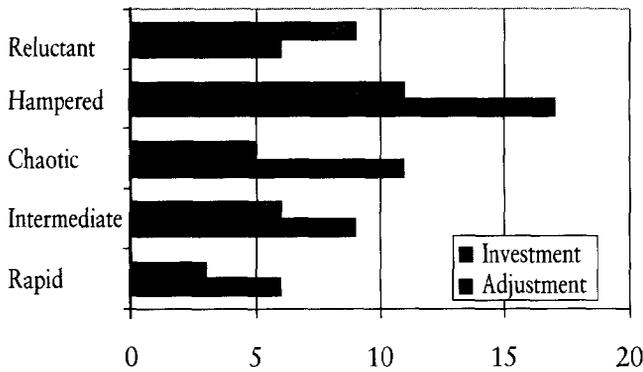
establishment of payment systems, the strengthening of the banking supervision function, and the introduction of bank accounting and audit standards. Much of the Bank's operational involvement in this group of countries came through institution-building loans.

The final group—the *chaotic reformers*—is the most difficult to characterize, although it contains some of the most systemically important countries in the region: Russia, Ukraine, and Romania. The early transition experience in each of these countries was deeply traumatic and long-lasting, with an uncertain and shifting political commitment to reform leading to a long delay in their return to growth. The commitment to financial sector reform, in particular, was shallow, as was the willingness to address problems with state and former state banking institutions. Privatization was often a destabilizing force in these countries, accompanied by significant levels of corruption and organized crime, and they experienced a continuing series of banking crises and near crises, as continuing efforts were made to fit the pretransition, socialist banking model into the new economic model that was emerging. Bank support in these countries straddled a wide range of areas of the financial sector, mainly through the vehicles of structural adjustment loans and sector adjustment loans. Some of this effort was directed toward bank restructuring, although there was little subsequent privatization of these banks (except in Romania). The Bank also sought to develop the foundations for the capital market in these countries (legal, regulatory, and supervisory framework and market infrastructure).

Figures 20.2 and 20.3 summarize the Bank's financial sector involvement in the ECA countries as a whole. Figure 20.2 illustrates that the hampered reformers received more adjustment and investment lending than any other group. This reflects both the willingness of these countries to work closely with the Bank on financial sector reform and the intractability of the problems faced by these countries. The fundamental need to reform the policy environment for the financial sector, coupled with their sometimes significant balance of payments financing requirements, is reflected in the strong emphasis on adjustment lending. The reluctant reformers, in contrast, absorbed more investment lending, aimed at strengthening the infrastructure for the financial sector, and less adjustment lending, given the relatively weak commitment to fundamental policy reform.

Figure 20.3 summarizes where the Bank placed most of its interventions (either individual elements of conditionality or specific areas of financial support) across all ECA countries. The most common interventions were the

**FIGURE 20.2 TYPES OF WORLD BANK LENDING PROJECTS IN ECA COUNTRIES**

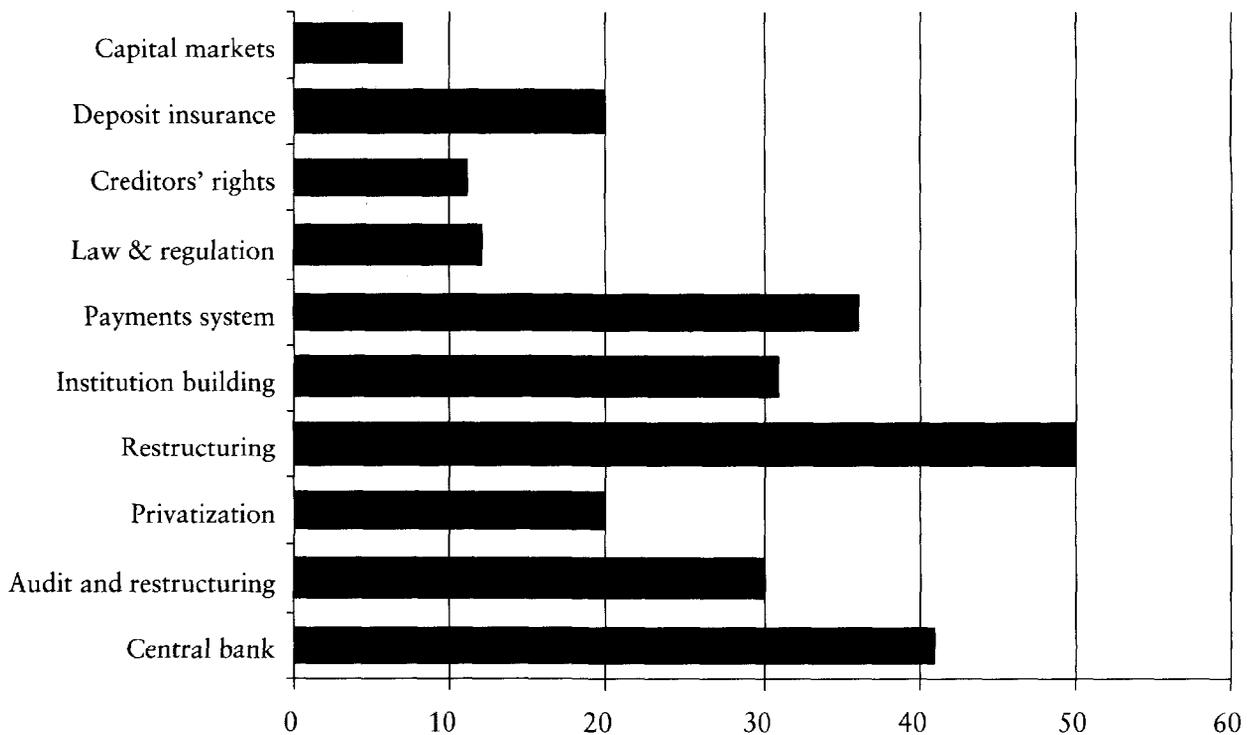


restructuring of state banks and the institution building of commercial banks, along with assistance to central banks (especially the strengthening of bank supervision). This reflects the early realization that (a) adequate regulatory institutions were a key to prudent banking, (b) the state banks, with their inefficient structures, yet monopoly market positions, were crucial obstacles to the growth of commercial banking, and (c) banking skills and structures were seriously deficient, even in the new commercial banks.

Improvement of the legal infrastructure for banking also received attention, except in countries where the task was undertaken outside of Bank projects and in those reluctant reformers where governments were not willing to change existing legislation.

Reform of the payment system was also a common intervention, in light of the enormous monetary float that was available for release to the economy with relatively simple technological improvements in processing payments. Similarly, at least in those countries where privatization was seriously entertained, the state banks became the common subject of privatization strategies. In about half the countries, capital markets and commercial bank restructuring were pursued, although in the case of capital markets, with limited impact. Specific interventions were rarely addressed to improving creditor rights and the infrastructure for non-bank financial institutions (other than in the capital markets, such as insurance companies and pension funds), reflecting country priorities. And there were only eight countries where the Bank was involved in implementing (and in some instances preventing the establishment of) deposit insurance schemes, reflecting the judgment that such schemes were premature in most of the transition banking systems.

**FIGURE 20.3 NUMBER OF WORLD BANK INTERVENTIONS IN ECA COUNTRIES**



### The Next Phase of Financial Sector Transition

Considerable progress was made in financial sector reform in ECA countries over the past decade. This is especially true given the fact that—unlike in other sectors of the economy—the process of financial reform had to start essentially from scratch. This progress subsequently took place at different speeds in different categories of the transition economies. Over this period, a number of ECA countries engineered a consolidation in the number of banks and, in particular, managed to deal with the remnant of the Soviet specialized banking system through their liquidation, merger, or privatization. This led to leaner, more efficient banking systems, especially in the EU accession countries. The institutional framework for the capital markets evolved adequately in most ECA countries, but this was not, by and large, reflected in a significant role for these markets in financing the private sector.

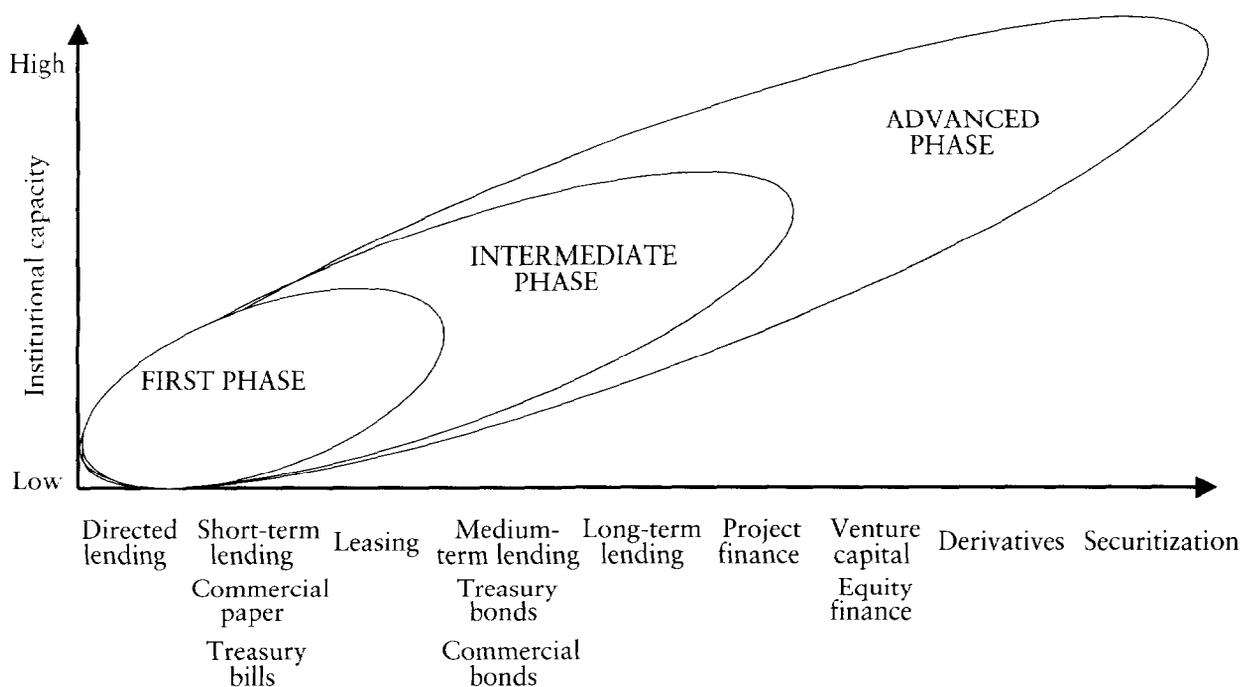
ECA's financial sectors are likely to be subject to a number of significant forces for change over the next 5–10 years. One force will be the strong pull of technological change that will affect all aspects of financial business. Another will be the integration of the financial sectors of the EU countries, particularly under the weight of the move to the euro. The ECA countries are likely to become increasingly polarized in terms of their financial sector development over the next 10 years. The EU accession

countries will increasingly strive to catch up with Western Europe (see also chapters 1 and 2). This will be a significant stimulus to the pace of their financial sector reform. Without this stimulus, the financial sectors in the remaining Eastern European and Central Asian countries will evolve rather more slowly.

In considering how the different categories of countries will evolve over the next few years, it is useful to consider where they are in the sequence of financial sector reform. Figure 20.4 provides one way of illustrating the phases of financial reform. The vertical axis measures the institutional capacity of the financial system—its corporate governance and human resource capacity. Developing this capacity requires a commitment by regulatory authorities and market participants over a number of years. Gradually, as this capacity develops, participants acquire the technical and institutional knowledge to process more sophisticated financial products (as reflected on the horizontal axis).

Under this schema, it is clear that many EU accession countries—that is, the rapid reformers and the intermediate reformers—are now well into the intermediate phase. The involvement of foreign investment in the banking sectors of many EU accession countries is improving institutional capacity. Over the next 5–10 years, therefore, many of these countries will move into the advanced phase. In due course, some could come to closely resemble EU countries in the

**FIGURE 20.4 SEQUENCING OF FINANCIAL SECTOR REFORMS**



breadth and depth of their financial systems. The regulatory challenge that has evolved relates to the fast-changing European financial system and the resulting influence that this will have on the nature of financial business in the EU accession countries. This means that the supervisory framework will have to adapt quite quickly also. This will be a significant challenge for many countries. In some instances, the organization of regulation is already adapting to perceived risks, as some countries move to a unified regulatory model.

It is possible that the Eastern European and Central Asian countries—for the most part, the *hampered reformers*, the *reluctant reformers*, and some of the *chaotic reformers*—will remain in the first phase of figure 20.4. The slower-reforming countries will have to continue addressing many of those problems that the faster reformers tackled in the first 10 years of transition. First, they will have to continue to strengthen the legal, regulatory, and supervisory framework for the financial sector. Second, they will have to encourage the consolidation of their banking sectors and hence reduce the costs of banking, while improving their overall efficiency. Third, they will need to devise contingency plans for dealing with banking crises should they occur as the pressures for consolidation and improved efficiency intensify. Many of the banking problems will remain in the state or semi-state banks in these countries. Dealing with state or former state banks likely will be among the greatest challenges in the financial sectors of these countries during the coming decade.

### *The Future Role of the World Bank*

The Bank's response to the evolving needs of ECA's financial sectors over the coming 5–10 years can be considered under two broad headings: analytic studies and technical assistance, on the one hand, and operational involvement, on the other.

*Analytic studies and technical assistance.* The analytic work that the Bank has undertaken in the financial sector in the past has provided the intellectual backdrop for subsequent operational involvement. Much of the focus in the early days of transition was on diagnostics aimed at the basic legal, regulatory, and supervisory framework for the financial sector and how to develop an infrastructure for a capital market. Other analyses focused on bank restructuring strategy—to assist in converting the Soviet banking institutions into market-based ones—and in studies that sought to understand the web of relationships between the emerging banks and the state and private enterprises.

As the transition evolved, so did the nature of the analytic work the Bank performed in the financial sector. As

the general problems of financial transition were gradually solved in some countries, a number of specific issues pertinent to the later stage of transition required analytic attention. Such issues relate to, for instance, how to develop mortgage markets or how to facilitate the development of second-tier pension funds. A number of second-generation regulatory issues also arose, such as issues relating to the appropriate structure of the organization of regulation. However, many of these issues related more to the advanced transition countries, while those countries in the former Soviet Union (excluding the Baltics) had to continue grappling with the basic issues of financial transition. The nature of the analytic work continued to reflect this.

Another avenue for analytic work furnished by the Bank was occasioned by the Asian financial crisis of 1997 and the Russian financial crisis of 1998. In some countries, where the effects of financial contagion were a concern, interest emerged in having the Bank perform vulnerability reviews that focused on weaknesses in the financial sector or macroeconomic framework that could precipitate crises. In parallel, the boards of the Bank and International Monetary Fund expressed increasing concern that countries worldwide should identify weaknesses in their economic performance and financial sectors and should take precautionary measures to mitigate emerging risks. These concerns gave birth to the joint World Bank and International Monetary Fund Financial Sector Assessment Program (FSAP), which involves a major study of the risks and vulnerabilities in the financial sectors of all 180 member-countries. A significant number of countries from the ECA region were the subject of FSAPs in 2000. These studies seem likely to continue and to displace much of the analytic work that typically was performed in the earlier stage of transition. The FSAP analyses are yielding conclusions regarding weaknesses in the financial sector that require follow-up technical assistance. Some of this assistance will be provided by the Bank or by supportive donor governments.

*Operational work.* During the first 10 years of financial transition, the Bank, as illustrated in table 20.2, was involved in a range of lending operations that affected the financial sector across a wide swathe of transition countries. The Bank's operational work over the next decade is likely to be targeted more finely to a narrower group of countries, specifically the less-advanced transition countries of Eastern and Central Europe. Increasingly, the Bank will withdraw from financial sector work in Central Europe and the Baltics, where the focus will be less on undertaking fundamental structural reform and more on meeting the requirements for joining the EU and the euro system (for

which EU technical assistance will be largely available). This may involve additional help from the Bank in the regulatory and supervisory field. What financial sector operational work remains will likely be in very specialized fields such as housing finance and pension reform. It is possible that from time to time structural adjustment loans—which also serve to assist governments with budget or balance of payments financing—will have elements of financial sector reform as part of them.

The focus of the Bank's financial sector work in Eastern Europe and Central Asia will likely continue to be on dealing with problem banks. In large part this reflects the slow pace of reform of the enterprise sector and hence the impact of poor enterprise performance on the balance sheets of banks. Until the real and financial sectors have effectively stabilized—with the banking sectors consolidating and becoming stronger in terms of both capitalization and efficiency—these countries are likely to experience periodic banking crises. For the foreseeable future, the Bank is likely to have to use the full array of loan products at its disposal to support the financial sector reform effort.

### *Lessons Learned*

The Bank has learned much about the process of financial transition during the 10 years or so in which it has been involved with the ECA countries:

- Financial sector transition is not a linear process. It typically is punctuated by banking crises and other forms of financial dislocation. This is to be expected as part of the “financial sector learning process.”
- Banking crises do not have a profound effect on the real economy during the early phases of transition, yet they do appear to have an enormously salutary impact on the seriousness with which politicians take financial sector issues in the post-crisis period.
- The state of the financial sector cannot be divorced from the condition of the real sector, since banks are

simply warehouses for the problems of their customers. As a result, banking and enterprise reform must move forward in tandem. And this applies as well to the slower reformers. It is pointless to reform the banks if there is no will to reform the real sector more generally.

- Developing a capacity for banking supervision is a time-consuming and costly process, yet risks must be dealt with even before supervisors are trained and experienced enough to do so to the standards of Western economies.
- As a tool for financial sector reform, foreign bank and strategic investments are far more effective than either restructuring or privatization of domestic banks. Indeed, cross-border banking is inevitable in all the transition economies.
- Financial sector reform must be seen holistically in the context of the reform of other parts of the economy that provide support and services analogous to banks, such as wage payments, tax administration, inter-enterprise obligations, and energy payments. Again, all these elements must move to a degree in tandem for effective reform to take hold.
- While the development of capital markets holds out the hope that they will provide alternative new funding sources for the private sector in the longer term, in the initial phases of reform, their most important function is as a mechanism for transferring the ownership of enterprise shares.
- It is important to tailor operational interventions to meet the specific needs of each transition country and to be flexible in the use of lending products to support financial sector development.
- In its most successful financial projects, the Bank typically works closely with partner international financial institutions and donors to provide a groundswell of support for policy reform in client countries.

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## Chapter 21

# Financial Policy in Transition Economies: An IMF Perspective

*Stefan Ingves*

Since the late 1980s, the International Monetary Fund (IMF) has been working with the countries included in the Europe and Central Asia (ECA) region on various aspects of financial sector reform and development. The ECA countries are defined here to include Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Former Yugoslavian Republic of Macedonia (FYR Macedonia), Georgia, Hungary, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, the Russian Federation (Russia), the Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The IMF helped these countries to create two-tier banking systems from the monobanking systems inherited from the formerly centrally planned economies and to develop central banking functions, while promoting the independence of the central banks. A major objective has been to get the countries to the point where they rely on the use of indirect instruments for monetary management. To this end, the countries have been encouraged to develop instruments for open-market operations and to deepen and integrate money, government securities, and foreign exchange markets.

In light of the strong link between the soundness of the banking system and the effectiveness of macroeconomic policy, another objective in assisting the ECA countries has been to develop the fundamentals of bank supervision and regulation: organization and staffing, the legal and regulatory framework, manuals and training programs, reporting and off-site supervision methodology and analytical techniques, and inspection and follow-up procedures. Complementary to this exercise, the IMF also has

encouraged the ECA countries to adopt international accounting standards and has assisted them with drawing up and introducing a modern chart of accounts for their central banks.

In the past few years, especially, when some of the banking systems of the ECA countries have come under stress, the IMF also has assisted the countries with other measures to strengthen their banking systems, both systemically and by improving governance in individual

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banks. This has led not only to enhancing the focus on the basics of bank supervision but also, which is even more important, to supporting bank restructuring efforts of those countries. Among other things, this has involved helping some of the ECA countries in developing the principles and practices involved in the closure of insolvent banks; in agreeing memoranda of understanding with bank management to improve internal governance, limit lending operations, and institute loan recovery programs; and in determining how the cost of restructuring would be distributed among the banks' shareholders, depositors, and the government.

The IMF also has promoted sound and efficient payment systems in the ECA countries. In the process, it has underscored that the payment system influences the speed, financial risk, efficiency, and reliability of domestic and international transactions and that the payment system affects the effectiveness of monetary policy, among other ways through its impact on the transmission process in monetary management, the pace of financial deepening, and the efficiency of financial intermediation.

Particularly over the past two to three years, the IMF has emphasized transparency in data collection and dissemination, as well as transparency and accountability in the governance arrangements for state enterprises, government fiscal policies, and monetary and financial policies. Hence, promoting international standards in the collection and dissemination of statistical data, accounting, and auditing, together with a sound legal framework for monetary and financial policies, has taken on added significance in financial sector reform. The importance of doing so has been heightened by incidences such as the misreporting or misclassification of data or the discovery of nontransparent financial relationships between sectors and institutions that had adverse macroeconomic effects.

All of this work has been done mainly in the context of technical assistance delivered through missions from headquarters, short-term expert visits, long-term residence assignments of experts, and multiple-country (regional) workshops. In this work, the experts used have been drawn not only from IMF staff but also from current and retired staff members of central banks and supervisory agencies. Moreover, in this technical assistance (both in doing the work and in financing it), cooperation with the World Bank and other international financial organizations and with governments, central banks, and the United Nations Development Programme has been extremely important. For obvious reasons, the cooperation with the World Bank has been special, with the two institutions often working as partners in designing a particular program or strategy.

The basic challenge over the next decade, from the standpoint of the IMF, is to have countries complete fundamental tasks, while responding to and assisting them in an appropriate and timely manner when specific problems arise, even where the fundamental institutions, instruments, practices, and procedures are in place. Inevitably, the IMF will be guided by certain international standards and best practices in its assessment of the basic work that remains to be done in a particular context.

The rest of this chapter assesses where ECA countries now stand and the challenges ahead and states some of the likely responses of the IMF. One difficulty confronted at the outset is trying to group into categories, for analysis, such a large number of countries that have grown even more disparate in their policies over the past decade.

### **Banking System Issues**

The ECA countries today face a whole range of challenges in banking and bank supervision. At one extreme are countries, like Bulgaria, Estonia, Latvia, and Lithuania, where the banking systems have been transformed and appear to be reasonably sound, due to recent measures (sometimes in response to crisis) to restructure the banking system and make changes in management of major banks in the system; privatize state-owned banks and foster competition, including via encouraging foreign entry; capitalize banks in order to bring their capital adequacy at least up to the Basle minimum standards; clean up balance sheets and remove existing nonperforming loans, sometimes sending these loans to a work-out unit; strengthen credit appraisal in granting loans; introduce sound prudential regulations that conform to best international practices; and further strengthen supervision, both off-site and on-site. The major challenge for virtually all of these countries is maintaining high standards in bank supervision, including keeping up with new techniques for supervising increasingly complex products and markets and maintaining adequate and well-trained staff. But even among these countries, there are pockets of serious weaknesses in the banking system. For instance, there is a feeling, in one or two cases, that minimum capital requirements are, at times, met by using questionable devices that inflate capital. In addition, attaining and maintaining high standards of transparency and good governance will be a challenge for these and other ECA countries.

At the other extreme are the countries with weak, and sometimes even fragile, banking systems, like Azerbaijan, Belarus, FYR Macedonia, Georgia, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. The qualities that make these systems weak differ greatly from one case to another. Hence generalization is difficult. Depending

on the country, one can find a government that directly influences the lending decisionmaking, state enterprises that dominate the portfolios of banks, state-owned banks that dominate the banking system, capital adequacy measurements that are not risk-weighted, and loan classification systems that are distorted by government guaranteed loans (sometimes resulting from directed credit). In Turkmenistan and Uzbekistan, some old Soviet habits even persist, such as controls on the withdrawal of cash, resistance to the adoption of international accounting standards, and heavy dependence of commercial banks on the central bank for loanable funds. All in all, in the weakest systems, state-owned banks dominate, and their loans are directed overwhelmingly toward state-owned enterprises.

In many of the ECA countries—particularly those of the former Soviet Union outside the Baltics—a substantial portion of bank assets and liabilities are denominated in foreign currencies, raising concerns for the vulnerability of the system to exchange rate movements. In addition, in some of these same countries, slow economic growth and large macroeconomic imbalances (huge budget deficits, unsustainable balance of payments deficits, and inappropriate exchange rate policies that produce disequilibrium exchange rates given the monetary policy stance), together with major structural weaknesses due mainly to slow or incomplete enterprise restructuring, will continue to make banking system reforms slow and prevent bank supervision authorities from accomplishing their desired objectives fully. For banking system soundness and effective bank supervision to become a reality in these countries, fundamental macroeconomic and structural reforms must be pursued resolutely.

Probably a majority of the countries with weak banking systems and weak bank supervision are making efforts to strengthen their systems and their bank supervision. In a basic sense, then, the challenge is getting countries to move resolutely in addressing the weaknesses. The majority of the ECA countries are being encouraged and advised by the World Bank, European Bank for Reconstruction and Development, European Union, and the IMF, and sometimes by the U.S. Agency for International Development and other bilateral donors, (a) to restructure their banking systems, through improving the legal framework governing bankruptcy proceedings, mergers, change of management, revocation of licenses, privatization, and increased participation of foreign banks; (b) to bring their prudential regulations up to the Basle standards; (c) to modernize loan classification and provisioning systems; and (d) to raise the level of their bank supervision and regulation to comply with the Basle Core Principles as soon as realistically possible. Where relevant, countries also are being urged to elim-

inate directed credit and to introduce more sophisticated procedures for analyzing credit. Indeed, the countries are making efforts, but the weak systems are finding it hard to stay the course and to sustain the effort on all fronts. In all such cases, there is a need to sequence measures appropriately and to encourage the authorities to keep politics out of the process to ensure continued progress in strengthening the banking systems and bank supervision.

In Azerbaijan, for example, some bank restructuring has taken place, but privatization is being delayed. Meanwhile, despite some progress in strengthening bank supervision, capacity remains inadequate, especially regarding resolution of weak and insolvent banks. In some countries, the legal framework and procedures (for example, the lack of a framework for prompt corrective action, a slow and ill-defined resolution process for failed banks, or lack of support from the courts in upholding sanctions) are frustrating the process of supervision.

As another example, to illustrate the challenges ahead, in Turkmenistan, the authorities introduced a bank restructuring program (Presidential Decree 3970) in December 1998. As a result, the total number of banks dropped from 67 at the end of 1998 to 13 at the end of 1999. Each state-owned bank was given a specific sector of the economy to service. In addition, the decree formalized segmentation already present in the banking sector: government enterprises and organizations were not permitted to use the nongovernment commercial banks to conduct their bank business, while the nonstate banks were permitted to provide loans to state sectors. Official figures indicate that the solvency of banks may not be an immediate concern. The risk-weighted ratio of capital to assets tends to be well over 20 percent, but this ratio reflects the fact that the bulk of lending is to state sectors with a zero risk weight. Hence, the high capital adequacy ratio could overstate the capital adequacy of the banks. On the positive side, the Central Bank of Turkmenistan has made some important progress in the area of bank supervision, including new regulatory standards for the banks as well as improvements in its off- and on-site supervision capacity.

In between the two extremes are countries like Albania, Croatia, Moldova, Romania, Russia, the Slovak Republic, and Ukraine, that have made good progress in reforming their banking systems and bank supervision but have yet to achieve desirable levels of soundness in both areas. All these countries have access to technical assistance, including from the IMF; the challenge, in a few cases, is to elicit the political will to complete the process that is well under way and to resist pressures to reverse what already has been accomplished.

In Albania, the Savings Bank holds about 80 percent of bank assets. But, since 1997, its operations have been circumscribed by a governance contract imposed by the government. That contract restricts the Savings Bank's operations to deposit taking and investments in Treasury bills. The purpose of this action was to stop the bank's large losses due to mismanagement and to prepare it for privatization. In Romania, in the last year there has been a major cleaning up of balance sheets, some bank mergers, the setting up of an Asset Recovery Agency, and the strengthening of the institutional and organizational framework for bank supervision. But the legal system and enforcement remain weak, and some major state-owned banks need to be privatized.

In the Slovak Republic, important steps have been taken to restructure and privatize state-owned banks and improve the legal framework. The authorities decided to sell a majority of the state's stake in the Slovak Savings Bank and the state's entire stake in the General Credit Bank and the Investment and Development Bank. They also transferred nonperforming loans from these three banks to the Consolidation Agency and the Consolidation Bank, injecting capital into them. The effectiveness of the Bank Privatization Unit has been improved through external technical assistance and the recruitment of additional staff. In addition, the government amended the Banking Act in order to strengthen the supervisory power of the National Bank of Slovakia, and parliament recently approved a number of amendments to strengthen the bankruptcy law.

In Russia, following the banking crisis of 1998, restructuring has been slow. In the context of the authorities' strategy discussed with the IMF and World Bank, the licenses of six large, insolvent Moscow-based banks were withdrawn in mid-1999, and liquidation of three of them is firmly under way. It has on occasion proven difficult to move other elements of the process forward. However, the restructuring agency, ARCO, has made some progress in restructuring a small number of regionally important banks. A total of 20 banks are under ARCO's administration. In order to increase the number of banks undergoing restructuring, there is pressure to increase the financial resources available to ARCO and to ease the criteria for submitting a bank to ARCO. These pressures need to be resisted. Another interesting development in the Russian case is that higher oil prices and stronger macroeconomic performance contributed to an improvement in the financial condition of the banking system during 2000. Many banks that would have been judged insolvent a year ago now appear to be marginally viable. As a result, the need

for further restructuring measures may appear less urgent for some observers. Such complacency risks leaving the banking system in an extremely vulnerable condition should economic conditions begin to deteriorate again. One of the main unresolved issues relates to the future of state-owned banks. The crisis has resulted in a migration of bank customers back toward these banks, and there is substantial support in Moscow for a major expansion in the role of public banks. There is also a need to complete the financial and strategic audits of the savings bank, Sberbank, which dominates the banking system, and to determine the conditions under which private and public banks will be permitted to compete with each other.

In Russia, though, there has been substantial progress in strengthening the regulatory framework. The main task for bank supervisors is to prevent a renewed accumulation of losses in the banking system. The Central Bank of Russia needs to impose prompt corrective actions on weak banks and to initiate liquidation of insolvent ones. Political support is clearly crucial.

In Ukraine, there has been some encouraging progress in both bank restructuring and bank supervision, but vigilance is needed to sustain the effort and continue the reforms. The Bank Supervision Department has been reorganized and staffed, improving efficiency. New capital regulations have been introduced, and provisioning regulations have been strengthened. An examination manual consistent with international best practices has been completed, and inspections are being conducted using CAMEL rating. There remains a need to clarify definitions of insider and related-party transactions and to further strengthen loan loss provision and reserve policy. A new banking law that would facilitate bank liquidation has recently been passed and its effective implementation should significantly improve compliance with the Basle core principles. As regards bank restructuring efforts, the authorities have focused on improving the capitalization and operating efficiency of the seven largest banks based on action plans agreed with the National Bank of Ukraine in 1999. The capital positions of five of the seven banks have thereby improved. Structural deficiencies identified during diagnostic studies are being addressed, with several of the banks receiving technical assistance from EU-Tacis, while others are addressing deficiencies on their own. Of five insolvent banks identified during diagnostic studies, three now have significantly positive capital and are progressing satisfactorily toward capital adequacy. The two remaining banks continue to have negative and deteriorating capital positions and the authorities will urgently need to take appropriate steps to resolve the situation.

## Monetary Operations

In the area of monetary operations, countries could usefully be divided into four groups. First, there are those, like Bosnia-Herzegovina, Bulgaria, Estonia, and Lithuania, that have a currency board arrangement. In principle, this leaves them little or no room for monetary operations. But these countries do have some monetary policy instruments at their disposal. Bulgaria and Bosnia-Herzegovina, for instance, use reserve requirements, but they tend to rationalize them as a prudential tool. Lithuania uses reserve requirements, standing facilities, and open-market operations to achieve its principal objective, namely, the stability of the domestic currency. But it also has backing for the domestic currency in gold and foreign exchange reserves, which it maintains well above 100 percent (the backing is currently equivalent to some 140 percent). Bulgaria also has excess foreign exchange coverage for its domestic currency.

Second, are those countries, like Albania, Croatia, Kazakhstan, Latvia, Moldova, Romania, Russia, and the Slovak Republic, that are well advanced along the road to consistent use of indirect instruments of monetary management and policy, even though the interbank money and exchange markets may be thin and, in some of the countries, poorly developed. In those countries, the central banks typically have adequate instruments of monetary control, have the independence to apply the instruments, have developed a reasonably good framework within which to design policies, and are willing to allow market determination of interest rates, given exchange rate policy.

Of course, even countries in this group typically will leave themselves free to use more direct methods of liquidity management in "emergency" situations. In addition, given the fragile state of the money markets and a lack of real depth and liquidity in those markets, and given a lack of deep trust in the liquidity of government securities, some countries do find that the activity in the money and Treasury bills market can disappear overnight as a result of a slight adverse change in the macroeconomy (especially the government budgetary situation). In Russia, for example, the default on government securities, which precipitated the banking crisis in 1998, as well as the persistence of insolvent and weak banks, has eliminated activity in domestic money markets, and has diminished the ability of the central bank to engage in effective open-market operations for the time being. As a consequence, the main monetary instruments now available to the Central Bank of Russia are variations in reserve requirements and a deposit facility (which is widely used). It has been suggested that the Central Bank of Russia might begin to issue its own paper

for sterilization purposes, but it has not done so due to cost considerations and technical legal impediments.

In Albania, also among the countries in the second group, the Bank of Albania conducts monetary policy with a view to ensuring low inflation consistent with the overall macroeconomic objectives in the framework of the Enhanced Structural Adjustment Facility and Poverty Reduction and Growth Facility and in the context of a flexible exchange rate. Monetary policy is conducted through open-market operations using Treasury bills, typically in the form of repos and reverse repos, supported by minimum lek deposit rates in the Savings Bank. There is only limited participation of private banks in the T-bill and lek deposit markets, where the Savings Bank enjoys a near-monopoly position. The Bank of Albania has been taking steps to develop the secondary T-bill market. In addition, it has been phasing out other instruments of direct monetary control, such as removing the floors on the 12-month deposit interest rates.

The third set of countries are those, like Azerbaijan, Tajikistan, Turkmenistan, and Uzbekistan, that have barely started down the road of sustained transition to the use of indirect monetary management. Depending on the country, this could be for one or more of the following reasons: lack of independence of the central bank; limited range of monetary instruments, particularly to mop up liquidity; and unwillingness to allow market determination of interest rates and exchange rates. Some of these countries continue to rely on direct controls in monetary management or to depend on intervention in foreign exchange markets as their major tool for managing liquidity.

In Tajikistan, since the scaling down of central bank intervention in the foreign exchange market, after adopting a floating exchange rate system, the only instrument available to the National Bank of Tajikistan for managing liquidity has been credit auctions. The auctions, however, have become ineffective because directed lending has been channeled through them, and thus the amount of credit offered is not determined according to the liquidity needs of the system and the interest rate has not been market-determined. Treasury bill auctions were started about three years ago, with the aim of creating a securities market in the country, which would permit open-market operations. So far, however, the T-bills market has failed to reach a critical size to enable a start of these operations.

In Turkmenistan, apart from reserve requirements, three other types of monetary instruments are available, in principle, to the Central Bank of Turkmenistan (CBT): credit auctions, an auxiliary credit facility, and overdrafts (intraday and overnight). Weekly credit auctions are avail-

able, in principle, to allocate CBT refinance credits. Access, which is subject to ceilings, is restricted to banks that comply with reserve requirements and have no overdraft. But credit auctions have been suspended since February 1997; since then, foreign exchange sales have been CBT's main instrument of monetary policy for regulating bank liquidity. The auxiliary credit facility is available on demand, although access is limited on the basis of the same criteria as credit auctions. In addition, banks can use the facility only twice a month, and the credit is subject to a ceiling of 75 percent of required reserves. It is a facility hardly used. As regards overdrafts, intraday overdrafts are interest-free, whereas overnight overdrafts carry a fee (equivalent to 1.7 times the refinance interest rate). No ceiling is imposed, and no collateral is required. The overdraft facility is hardly used at the moment. In contrast, there has been heavy use of directed credits, particularly to the agricultural sector.

In Uzbekistan, the most important commercial banks are controlled by the government and follow policies set by the Republican Monetary Policy Commission, which practices selective credit allocation policies. The monetary instruments available, in principle, to the Central Bank of Uzbekistan—namely, reserve requirements, a refinance facility, sale of certificates of deposit, and credit auctions—are not actively used. The instrument used most potently in liquidity management has been the sale of foreign exchange. But targets for the level of gross international reserves established by the government have limited the ability of the Central Bank of Uzbekistan to use even this instrument over the past couple of years.

Somewhat between the second and the third groups mentioned is a fourth group of countries, namely those, like Armenia, FYR Macedonia, and Ukraine, that have adequate fundamentals for the use of indirect instruments (because of appropriate independence of the central bank, the existence of a fair range of instruments, and a reasonable framework for monetary and liquidity management) but are having difficulty using the instruments consistently for a number of reasons. These include, especially, an unwillingness to allow interest rates and exchange rates to move in line with market forces in difficult economic times.

In FYR Macedonia, in April 2000, the authorities adopted a package of measures with the specific aim of adopting indirect instruments of monetary management and of moving closer to EU standards. The package included the removal of bank-by-bank credit ceilings; the increase in the allowed intraday use of reserve requirements to 60 percent from 40 percent; and changes in the design and procedures for credit auctions and central bank bill auctions. The frequency of credit auctions was reduced from

daily to weekly, the credits were to be collateralized, and interest rates were to be market-determined. Auctions of 28-day central bank bills were to be held weekly, and the interest rate was to be set by the market. Repo operations were to be conducted as soon as the volume of outstanding central bank bills would permit. But implementation of the new system has experienced problems, mainly because of the lack of interest in purchasing central bank bills. In any event, regular credit auctions have been discontinued and are now conducted only to meet seasonal liquidity needs; no auctions have been conducted since April 2000.

In Ukraine, reforms in developing monetary operations initially resulted in substantial progress such as in the development of a secondary market for Treasury bills and improvement in the short-term liquidity management framework. But progress has slowed, and even been reversed, due to a difficult macroeconomic situation. The weak fiscal position has required central bank financing, and the ministry of finance has not been willing to pay market interest rates on Treasury bills. The unattractiveness of Treasury bills has contributed to the drying up of the Treasury bill market and halted progress toward improving the monetary operations of the National Bank of Ukraine in the secondary market. In the absence of a well-functioning Treasury bill market, the National Bank of Ukraine has introduced central bank certificates of deposit for liquidity management and is aiming to develop the use of this instrument.

### Foreign Exchange Operations

The countries in Europe and Central Asia cover almost the whole range of classifications of exchange rate arrangements used by the IMF. The currency board arrangements have been mentioned. There are fixed pegs against a single currency (FYR Macedonia, Turkmenistan) or against a composite (Latvia), managed floating rates with no preannounced path for the exchange rate (Azerbaijan, Belarus, the Czech Republic, the Kyrgyz Republic, Romania, the Slovak Republic, Slovenia, Tajikistan, Ukraine, Uzbekistan), and independently floating rates (Albania, Armenia, Georgia, Kazakhstan, Moldova, Russian Federation).

Virtually all the ECA countries operate within unified exchange markets. Among them are those, like Kazakhstan and Latvia, that, given monetary policy, allow the level of the rate to move in line with market conditions (or have reserves to stabilize the rate via intervention without significant controls), while there are those, like Turkmenistan, that use controls to prevent the rates from attaining equilibrium levels.

In Latvia, for example, the authorities use spot and swap auctions in their foreign exchange operations, offer-

ing a range of maturities in their swap auctions. The market is functioning well. In Turkmenistan, since 1998, when the commercial bank foreign exchange window was closed, the central bank has the only foreign exchange window in the country. There is also a very high surrender requirement. The major challenges over the next decade, in the area of foreign exchange, will be to liberalize the market, creating a regime that permits market determination of the rate, and to liberalize payments and transfers for current international transactions. The president's foreign exchange reserve budget is currently responsible for the management of foreign exchange reserves. The process is not transparent and, to the knowledge of IMF staff, has never been audited.

In Uzbekistan, there is currently an official rate (used mainly for government transactions and imports of high-priority capital goods) and a commercial bank exchange rate. Resistance to adjustment of these controlled rates has fueled an illegal curb market.

In the coming decade, the appropriate response would seem to be to continue the attempt to convince countries with exchange controls and other devices that obstruct market determination of rates to implement supporting policies that would permit flexibility and adjustment in the exchange rates in line with market forces. Such an approach would leave countries free to choose any exchange arrangements they prefer. But then they would be encouraged to design and implement monetary and financial policies that are consistent with ensuring appropriate (sustainable, market-related) exchange rates.

### **Interbank Money and Government Securities Markets**

Interbank money and government securities markets, and especially secondary markets, have been slow to develop in the majority of the ECA countries. Many factors have been at play. In the case of money and government securities markets, first, there were problems with developing the institutional and technological infrastructure (legal, organizational, and accounting framework, depositories, clearing and settlement systems, and telecommunication systems), followed by the microstructure (primary dealers, brokers) for primary and secondary markets. Second, there were risk management issues. Banks took some time to begin to trust each other or to develop appropriate risk management tools for understanding counterparty risks and setting appropriate limits. Countries with weak or fragile banking systems have had particular problems in this regard. Even government securities—assets with zero risk weights in the Basle Accord—often were not considered safe investments when compared to, say, foreign exchange for

investing short-term funds. Third, when a government is running huge budget deficits and financing them via base money creation (borrowing from the central bank), and at the same time there are few safe and profitable local outlets for investment funds and foreign outlets are constrained by a transfer problem (foreign exchange “shortage”), the vast majority of the banks tend to have excess reserves; there is no interbank market to be made. Fourth, governments were sometimes reluctant to allow interest rates on their securities to rise, typically in consideration of the adverse budgetary consequences. Fifth, in the case of government securities, there were sometimes technical problems in the design of the instruments (maturity structures, most notably), deficiencies in the issuance and auction procedures, or restrictions on the transfer or use of the instrument in secondary markets. Sixth, central bank rediscounting and other fairly easily accessible facilities at the central bank sometimes hampered the development of secondary markets.

The success of countries in addressing these problems has greatly affected the development (liquidity, turnover, interest rate spreads, commissions, and use of government securities as collateral and in repo and swap operations) of their interbank money and government securities markets, which in turn has affected the ability of their central banks to develop effective instruments for use in open-market operations. The vast majority of the ECA countries have a long way to go in having well-functioning money and government securities markets, and the Czech Republic, Hungary, and Poland appear to be much further along the way than the others.

### **Payment Systems**

Without exception, the ECA countries accept the importance of the payment system in the financial system, and they are giving serious attention to its overall development. All the countries are paying attention to safety and efficiency in their most systemically important systems, although there are, not surprisingly, often difficulties in determining when particular designs, procedures, and governance arrangements have attained acceptable standards of safety and efficiency. The countries also differ in the appropriateness of the development of their payment systems, given the actual and prospective activity in the financial markets, level and growth of income per capita, and monetization of the economy. The most advanced systems from this perspective seem to be those of the Czech Republic, Latvia, Lithuania, and Poland. In particular, all these countries have a well-functioning, large-value transfer system (which includes real-time gross settlement capability) for large and time-critical payments, while the other

components of their payment systems seem to be working at satisfactory levels of operational efficiency, so that float, processing, and settlement delays are not serious problems.

All the other ECA countries ultimately seem to want to develop RTGS systems to handle large-value and time-critical payments. But for budgetary and technical reasons, many of these countries will continue with deferred net settlement or batch systems or with near substitutes to traditional RTGS systems—all of which seem to work reasonably well for the countries concerned—until they can build RTGS systems. Bosnia-Herzegovina, Croatia, and FYR Macedonia inherited systems of state payment bureaus from Yugoslavia and need to replace them with normal bank-based systems with final settlement at the central banks. In Croatia, in the spring of 1999, the National Bank implemented an RTGS system owned and managed by itself, which operates outside the monopoly state payment bureau (known as the ZAP). In Bosnia-Herzegovina, the payment bureaus were scheduled to close by the end of 2000; the central bank was to have an RTGS system fully operational by that date. In FYR Macedonia, also, the central bank is working toward introduction of an RTGS system. A few countries, notably Armenia and Georgia, have e-mail systems that can settle payments on a gross basis. Many countries, including Albania, Azerbaijan, Estonia, and Russia, are at advanced stages of developing their RTGS systems.

All the ECA countries will be encouraged over the next few years to assess their systemically important systems to ensure that they comply with the Core Principles for Systemically Important Payment Systems. Indeed, these principles are already being discussed with them in workshops and during technical assistance missions of the IMF.

All the countries also seem to want to move away, as soon as it makes economic sense to do so, from paper and toward electronic payments for retail systems. A major issue facing all the countries is deciding the role of the central bank in the development of these retail payment systems. Some countries want the central bank to play an active (hands-on) role in determining which instruments are promoted and encouraged and which are discouraged, as well as in determining the design of the particular instruments and systems. The challenge for the IMF and others advising them is to convince the countries to allow the interplay of market demand and decisionmaking by banks to play the major role, while the central bank and other public authorities confine themselves to developing the legal framework and performing appropriate oversight, for consumer protection and other reasons.

Another issue, likely to be of major importance over the next few years, is credit policy in support of payment settlements. A few of the ECA central banks still see automatic lending to cover shortfalls by banks in settlement balances, particularly at the end of the day, as a necessary part of their role as lender of last resort and as guarantor of financial system stability. For this and other reasons, some of the countries of the region may need technical assistance in the development of credit policy in their payment systems (limits, collateral, interest rates, and intraday, overnight, or longer-term central bank lending) and its relationship with monetary policy.

## Conclusions

The IMF will continue to provide technical assistance to help countries to reform their banking, monetary, and exchange systems, all tailored to the needs of the countries. In doing so, it will continue to work cooperatively with experts from many institutions and organizations, especially current and retired staff members of central banks and supervisory agencies.

In addition, in the next few years, many of the ECA countries will benefit from the Financial Sector Assessment Program (FSAP). The FSAP was launched in mid-1999 in response to calls from the international community, in the aftermath of the Asian and Russian crises, for the IMF and the World Bank to step up their efforts to help strengthen countries' financial systems. The program is designed to identify strengths and vulnerabilities of financial systems so as to reduce the potential for crisis and cross-border contagion. The emphasis of the program is on prevention and mitigation, rather than on crisis resolution, through the preparation and delivery to national authorities of comprehensive assessments of their financial systems. Undertaken jointly with the World Bank, the FSAP also involves experts from national authorities and international standard-setting bodies, particularly in the area of assessing the observance of internationally accepted standards, codes, and good practices. The FSAP is a major enhancement to the work (some of it described here) that the IMF has been doing for some time in strengthening the monitoring of financial systems, in the context of Article IV consultation discussions with member countries. It is also the expectation that the FSAP process will prove an effective means for identifying areas in which countries could use technical assistance from both the IMF and the World Bank.

Finally, economic difficulties often diminish the resolve of countries to sustain reforms, particularly in monetary and exchange policies, while lack of political will and political

interference serve as obstacles in major banking system and bank supervision reforms. For these reasons, the IMF has found the process of reaching understandings in the design of programs to be supported by use of its resources as an

excellent context in which to push for major structural reforms in the financial sector. It is important to keep in mind that the financial reforms and the macroeconomic policy measures in such programs complement each other.



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**T**en years after the fall of the Berlin Wall, the countries in Central and Eastern Europe and the Commonwealth of Independent States still face major challenges: although much has been achieved in the transition to market-based democracies, much remains to be done. The World Bank has been an active partner in helping countries design and implement their reforms.

The region has witnessed many successes, as well as setbacks, in the transition process. This series of publications is part of the Bank's contribution to the debate about the unfinished agenda and possible approaches to future challenges. The first 14 titles in the series cover the issues of resurgent poverty and inequality, the importance of sound corporate citizenship, strategies for better education systems, social and environmental protection, institution building, investments, and livable cities.

This publication was based upon two seminars and a conference on finance in the transition economies that took place, respectively, in Prague and Benešov in the Czech Republic at the time of the World Bank–International Monetary Fund Annual Meetings in September 2000. The seminars and conference took stock of the first decade of financial transition and, with the benefit of hindsight, looked forward to the challenges that will likely be confronted by policymakers over the next ten years.



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