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Banking transformation (1989 - 2006) in central and eastern Europe - with special reference to Balkans

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Editorial

The South-Eastern European Monetary History Network (SEEMHN) is a community of financial historians, economists and statisticians, established in April 2006 at the initiation of the Bulgarian National Bank and the Bank of Greece. Its objective is to spread knowledge on the economic history of the region in the context of European experience with a specific focus on financial, monetary and banking history. The First and the Second Annual Conferences were held in Sofia (BNB) in 2006 and in Vienna (OeNB) in 2007. Additionally, the SEEMHN Data Collection Task Force aims at establishing a historical data base with 19th and 20th century financial and monetary data for countries in the region. A set of data has already been published as an annex to the 2007 conference proceedings, released by the OeNB (2008, Workshops, no 13).

On 13-14 March 2008, the Third Annual Conference was held in Athens, hosted by the Bank of Greece. The conference was dedicated to *Banking and Finance in South-Eastern Europe: Lessons of Historical Experience*. It was attended by representatives of the Albanian, Austrian, Belgian, Bulgarian, German, Greek, Romanian, Russian, Serbian and Turkish central banks, as well as participants from a number of universities and research institutions. Professor Michael Bordo delivered the key note speech on *Growing up to Financial Stability*. The participants presented, reviewed and assessed the experience of SE Europe with financial development, banking and central banking from a comparative and historical perspective.

The 4th Annual SEEMHN Conference will be hosted by the National Serbian Bank on 27th March 2009 in Belgrade. The topic of the Conference will be *Economic and Financial Stability in SE Europe in a Historical and Comparative Perspective*.

The papers presented at the 2008 SEEMHN Conference are being made available to a wider audience in the Working Paper Series of the Bank of Greece. Here we present the fifth of these papers, by Stephan Barisitz.

June, 2008

Sophia Lazaretou
SEEMHN Coordinator
Member of the Scientific and Organizing Committee

BANKING TRANSFORMATION (1989-2006) IN CENTRAL AND EASTERN EUROPE – WITH SPECIAL REFERENCE TO BALKANS

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ABSTRACT

This paper provides an overview of the history of banking transition (1989-2006) in 13 CEE countries – with particular emphasis on four relatively large Balkan countries (Bulgaria, Croatia, Romania, Serbia and Montenegro). Two "banking reform waves" are distinguished, salient features of which all countries (need to) run through in order to mature. The first reform wave focuses on liberalization measures; the second wave mostly consists of restructuring/institutional adjustment. Western European FDI has come to dominate banking in most countries, including those of the Balkans. Recently, credit booms have unfolded, which, while constituting structural catching-up phenomena, are not without risks. Insufficient rule of law remains widespread.

Keywords: Banking crisis; Banking transformation; Credit boom; FDI; Institutional reforms; Liberalization; Privatization; Structural reforms
JEL classification: G21; G28; P34

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1. Two banking reform waves

The very eventful and crisis-ridden first decade of transition (starting in 1989-1990) featured two "waves" of banking reforms in most of the 13 Central and Eastern European countries analyzed in this paper (Belarus, Bulgaria, Croatia, the Czech Republic, Hungary, Kazakhstan, Poland, Romania, the Russian Federation, Serbia and Montenegro, Slovakia, Ukraine and Uzbekistan). Both reform waves were connected to banking crises. Most often crises preceded or triggered reforms, at times reforms entailed crises. While the first banking reform wave contributed to establishing a market-oriented economy, it retained soft budget constraints, creating at best a temporary equilibrium, unsustainable in the long run. The absence of the concept of bankruptcy in socialism was thus carried over into transition. It was only surmounted in the second reform wave, which helped strengthening contract and property rights and which brought about the – often painful – establishment of hard budget constraints.[1]

1.1. First wave

The first banking reform wave was based on the abolition of central credit and cash plans, price liberalization and the creation of a two-tier banking system. It was accompanied by a general and deep transition recession. The reform wave included the liberalization of bank licensing, initially generous or lenient regulation and supervision, up-front financial recapitalization measures (dealing with bad loans inherited from the past as well as related to the first years of transition, in most cases by exchanging such non-performing claims for government debt), "surface privatization", i.e. partial, insider or non-conventional (e.g. voucher) privatization of banks. These measures favored the continued functioning of soft budget constraints, associated with weak property, contract and creditor rights, which perpetuated propensities to discretionary bureaucratic and government interference in operative decision making of banks.[2] Monetary authorities continued accommodative

[1] Both reform waves might also be interpreted as « régime changes », the way Honohan (1997: 10) does.

[2] Thus, in a certain sense, the state was too weak and too strong at the same time: Too weak, or lacking the will, to design and/or enforce a reliable framework of rules and a level playing field for banks (and enterprises); and too strong, or too immature, to refrain from ad-hoc interventions giving rise to distortions, rent-seeking and waste of resources. In many cases one could argue that financial sectors

refinancing. "Directed credits", whether of a formal or informal nature, served as instruments to maintain lending to SOEs or other well-connected firms or favored projects. The boundaries of corruption were easily crossed. Inflation gathered momentum.

After an initial multiplication of the number of credit institutions, many of whom were attracted by prospects for arbitrage and short-term gains, a tightening of monetary policy, banking rules and oversight followed, which resulted in a consolidation process. However, neither did this alter the domination of the sector by (former) specialized SOBs, nor did it seriously infringe the survival of soft budget constraints. At least until 1992 or 1993, but in most instances until the mid-1990s, banking systems in transition followed quite similar trajectories. Apart from policies in Hungary and Poland, macro stabilization was not accompanied by a critical mass of structural reforms. Although real lending rates had turned positive, margins between deposit and lending rates remained rather wide, pointing to persistent high risks and limited sector development. The Russian monetary squeeze of 1994/95 contributed to the explosion of barter, veksels and other monetary surrogates, but didn't usher in any meaningful bankruptcy rules.

In the majority of countries there was a revival of economic growth around the mid-1990s and the macroeconomic situation at least temporarily stabilized. But the revival most often turned out to be ephemeral. In some cases the difficult environment and lack of rule of law perpetuated advantages connected to the use of pocket banks and to membership in financial-industrial groups as opposed to activities "on the free market". Regardless of the type of ownership, banks were often involved in insider and connected party lending, in capital flight, sometimes also in fraudulent activities. Financial pyramids, where they existed, enjoyed their heyday in the mid-1990s.

Persistent macroeconomic, particularly inflationary, tensions, coupled with unsolved structural and institutional problems and accumulating bad loans set the stage for a new latent or open banking crisis which contributed to a new recession. Sometimes external or exchange rate shocks added to the pressures. Deposit insurance funds were often established to calm savers' concerns, create a level playing field and prepare the sector for a shakeout. Small and medium-sized banks typically were the

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suffered from insufficient implementation of largely adequate financial frameworks (Fink *et al*. 1998: 444).

first victims. The threat or the actual outbreak of a crisis forced the authorities to act. What may have started as crisis management turned into a second reform wave? Central banks as well as governments benefited from their accumulated experiences of trial and error.

1.2. Second wave

Often urgency demanded (renewed) deep and onerous restructuring and recapitalization measures of large banks, in order to stave off a systemic calamity and finally get the financial slate clean. Still, in many cases at least one large credit institution went under – which sent out a signal that budget constraints for banks were hardening. Contrary to usual expectations, this sacrifice and the painful downsizing measures may have enhanced confidence, because they appeared to announce a break with the past. But the crisis tended to be too much for young and fledgling deposit insurance funds, which on some occasions had to be bailed out themselves.

Legislators and central banks/banking supervisors finally became serious in enacting and applying stricter banking rules, upgraded bookkeeping standards and tighter supervision, which contributed to establishing hard budget constraints in the sector.[3] Deposit insurance funds were financially strengthened and limited in their guarantee levels to provide for their viability and to give depositors some incentive to monitor banks. Thus, the authorities aimed at reining in moral hazard in depositors' relations with banks and in banks' relations with clients. To attract banking know-how, corporate governance and capital, most analyzed countries revised or improved earlier strategies and opted for "in-depth privatization", i.e. selling or re-selling credit institutions to renowned "outsiders", in most cases to foreign strategic investors.

Once conditions (notably protection of property rights, rule of law, macro stability) were appropriate, the latter didn't hesitate for long. In a number of cases, foreigners acquired some of the countries' largest credit institutions one after the other, and thus took over the lion's share of the sector in a few years. This "sweep" on the part of mostly Western European and euro area investors fundamentally changed banking in the region and structurally linked it up with EU banks. By the turn of the millennium, the sweep was still going on (Table 1). Following an inflationary

[3] But this doesn't necessarily imply that they were established economy-wide.

intermezzo, real lending rates turned positive again, and margins, while still large, tended to decline. Economic growth returned, and this time on a sounder structural basis.

Table 1

Asset shares of state-owned and foreign-owned banks (early 1990s, 2000)

		Central European countries								South-Eastern European countries					
		Hungary		**Poland**		**Czech Rep.**		**Slovakia**		**Bulgaria**		**Romania**		**Croatia**	
		1992	2000	1993	2000	1995	2000	1993	2000	1996	2000	1994	2000	1993	2000
Shares in total banking assets (%)	Maj. state-owned banks	74,4	7.7	86,2	23,9	.	27,8	70,7	49,1	82,2	19,8	80,4	48.0	58,9	5,7
	Maj. foreign-owned banks	41.8[a)]	66,7	4.2[a)]	69,5	15,9	71,8	32.7[a)]	28.1[b)]	9,5	67,7	20.0[c)]	50,9	1.0[d)]	84,1

		CIS countries									
		Russia		**Ukraine**		**Belarus**		**Kazakh.**		**Uzbek.**	
Shares in total banking assets (%)		1997	2000	1997	2000	1994	2000	1995	2000	1994	2000
	Maj. state-owned banks	37.0	.	13,5	11,9	69,2	66.0	24,3	1,9	46,7	77.5

[a)] 1995
[b)] share in total capital
[c)] 1998
[d)] 1996

Source: EBRD, Bank Austria-Creditanstalt

The above-mentioned scheme of two separate banking reform waves, in most cases both preceded by crises, seems to be valid for the Czech Republic, Slovakia, Bulgaria, Romania, Croatia, Russia and Ukraine. It appears to be only partly applicable to Poland and Kazakhstan, where it is difficult to separate the waves which actually form a continuum of efforts and measures. The scheme is inapplicable to FRY, which only started serious reforms in 2000. Neither is it valid in East Germany, because of the enormous compression of many events there in the swift re-unification with and absorption by West Germany. Belarus at least partially launched its first wave before staging a volte-face in the mid-1990s. Uzbekistan didn't get further than making some initial steps. In sharp contrast, Hungary pursued a path of its own in bringing forward the establishment of hard budget constraints to 1992 (or shortly afterwards), which contributed to accelerating the pace of banking reforms and indeed created one compact sequence of events in that country.[4]

[4] The only other transition country that also appears to have carried through banking reforms in a very expeditious manner (but is not dealt with here owing to its size), is Estonia. Estonia had established a currency board already in 1992. Thus, the central bank's lender-of-last-resort function was strongly restrained from an early moment on (Barisitz 2002: 86-87).

2. Crises and their effects

Full-blown banking and financial crises that precipitated grave economic recessions were suffered by Bulgaria in 1996-97 and Russia in 1998. Less severe, but still substantial crises were experienced by the Czech Republic, Slovakia, Romania, Croatia, Ukraine and Belarus. After the upheavals had been overcome and budget constraints in the sector had been hardened, banks became more cautious in extending credits to the real sector and reshuffled funds to more secure, although less remunerative, placements, like government securities and deposits with the monetary authorities.[5] Particularly long-term investment finance became scarce. Even the fact that many big banks were owned by foreigners didn't alter initial reticence to lend. Lending only hesitantly recovered from a very low point after some years, when banks had become more confident that hard budget constraints had spread to the real sector (Table 2). This underlines the importance of coordinating banking and enterprise reforms. Credit institutions cannot become effective financial intermediaries without a real sector that at least basically responds to market signals.[6] Interest rate spreads slowly declined over time.

Generally, countries that had already tried banking reform prior to transition and/or were geographically nearer to Western Europe, turned out to be more successful in transforming their credit institutions.[7] Hungary's banking reform lead and perseverance in upholding the momentum seems to have paid off. Going by Hungary's and other countries' experiences, the earlier strong measures to strengthen market discipline are taken, the better. While postponing reforms may at least temporarily reduce or put off social costs, stress and unemployment, continued distorted incentives and misallocation of resources almost inevitably entail higher total costs for society in the end. State capture can tighten if reforms are delayed. As some examples demonstrate (Czech Republic, Slovakia, Romania, Croatia), the bill that eventually may have to be picked up by the public purse can turn out to be exorbitant.

[5] This, of course, does not hold for Belarus, which continued to feature soft budget constraints, and does not hold for the Russian crisis, which was triggered by the state's default on its large T-bill debt to banks and other holders.
[6] For a detailed discussion of the links of banking and enterprise reforms see, van Wijnbergen 1998.
[7] Kazakhstan, a quite successful reformer, appears to be the exception to the rule here.

Table 2

Financial intermediation in Central and Eastern Europe (early 1990s and 2000)

	Hungary		Poland		Czech Rep.		Slovakia		Bulgaria		Romania		Croatia	
	1992	2000	1992	2000	1993	2000	1993	2000	1992	2000	1993	2000	1993	2000
Banking assets/GDP (%)	75.0	68,5	52.2[a)]	63,3	131.4[a)]	137.0	103.7[a)]	91,3	123.7[a)]	38,4	45.0[a)]	29,1	70.4[a)]	73,3
Credit to the private sector/GDP (%)	23,4	30,1	39.0	21.5	51.0	27.9	30,4	35,7	5,8	11,6	3,1	7,2	37,7	27,8

	Russia		Ukraine		Belarus		Kazakhstan		Uzbekistan	
	1993	2000	1993	2000	1994	2000	1993	2000	1993	2000
Broad money/GDP (%)	21,4	15,7	33,9	18,9	39.0	17,2	27,9	15,3	53,5	12,2
Credit to the private sector/GDP (%)	11,8	11,9	1.4[b)]	11,2	17,6	8,9	49,3	10,6	.	.

[a)] 1995
[b)] 1996

Source: EBRD, Bank Austria-Creditanstalt

3. Privatization and bank restructuring schemes

Privatization focusing on foreign strategic investors has turned out to be more successful than other strategies in that it modernized banking sectors in a relatively short time.[8] Hungary witnessed a single sequence of banking reforms comprising recapitalization measures (1991-94), the establishment of a strict bankruptcy law in 1992 (among the earliest of all transition countries) and the privatization program of 1994-97. The rationalization process, new technologies and intensified competition led to staff cuts and shrinking margins in Hungary in the second half of the 1990s.

The interesting (but not very often discussed) issue, whether to privatize banks before enterprises or to privatize enterprises before banks raises an important question with respect to the introduction of hard budget constraints. If enterprises are to revert to private ownership first, they may, however still be subject to inherited lenient credit practices and thus soft budget constraints supplied by state-owned banks. If credit institutions are privatized first, they will immediately face difficult portfolios pertaining to firms equipped with non-market-oriented incentives. The above issue has actually been empirically answered. Perhaps owing to the sheer size of the task of privatizing the enterprise sector of a country, as opposed to privatizing its credit institutions (which remained a handful in any former socialist country), the latter

[8] Wladimir Andreff pointed out that in some countries cooperation with and know-how transfer from foreign-owned banks started to make an appreciable difference already in the early 1990s (Andreff 1993: 358-359). This is confirmed by Eric Rugraff, who found the contribution of foreign investors as driving forces of change to be decisive in improving the quality of banking intermediation in Hungary, Poland and the Czech Republic (Rugraff 2000: 114).

measure was practically always concluded prior to the former.[9] Given that in-depth privatization (in most countries) was preceded by crises and accompanied by serious regulatory and prudential tightening, banks' lending behavior seems to have broken with the past, which points to an overall success of the practice of privatizing banks first.

Compared to other bank restructuring schemes, the Polish decentralized "Program on Financial Restructuring of State Enterprises and Banks" of 1993-95 managed to change incentives by promptly establishing, at least to some degree, market-oriented credit relations between banks and their clients in the real sector. It forced credit institutions to develop risk assessment capacities and it strengthened financial discipline at a relatively early stage. It thus contributed to introducing hard budget constraints. On the other hand, it required considerable logistical preparation and took time to deliver results.

Centralized programs (e.g. the Konsolidacní / Konsolidacná banka in the Czech and Slovak Republics and the Treuhandanstalt in Germany) were easier to organize, but often included extensive bad debt carve-outs and eventually turned out to be more costly, particularly for the public purse. In many instances there was less pressure on the central hospital bank or debt recovery agency to move ahead with collecting its claims. The Czech authorities have so far achieved but very modest revenues in selling packages of their Consolidation Agency's claims. The Kazakhstani attempt to combine the two models apparently failed due to overburdening of the central agencies with microeconomic tasks.

The EBRD's index of banking sector reform[10] shows Hungary (with a value of 4) ahead of other countries at the turn of the millennium (1999 and 2000). Next are Poland, the Czech Republic and Croatia (respectively 3.3). Among CIS countries, Kazakhstan chalks up the best EBRD mark (2.3).

[9] One could argue that Czechoslovakia/ the Czech and Slovak Republics – in their early stages of reforms, featuring voucher privatization campaigns that were not fully extended to banks – bucked this trend. But the non-sustainability of their strategies was soon apparent.

[10] This indicator measures reform activities by the liberalization of interest rates and the credit allocation process, the volume of lending to the private sector, private ownership of the banking system, the level of competition between banks, bank solvency, the establishment of a framework of regulation and prudential supervision. The indicator can take values between 1 and 4+, with 1 representing little progress, and 4+ corresponding to full convergence of banking laws and regulations with BIS standards and a full set of banking services (EBRD 2006: 199).

4. Reform-driven sustained expansion

Following the turbulent 1990s, which featured major banking crises and partly painful structural transformation, around the turn of the millennium the environment stabilized and banking activities entered a path of sustained expansion, boosted by the resumption of robust economic growth and the anchor of EU integration or proximity. As of late 2006, the second banking reform wave (extending from crisis-induced restructuring and recapitalization measures, via the upgrading of regulation and supervision, the introduction of hard budget constraints in banking, to in-depth privatization measures) appears to have subsided in a number of countries. The latter include all Central European and at least some South-Eastern European ones (Bulgaria, Croatia). The second wave seems to have progressed far or to be almost over in Romania and Kazakhstan, but is certainly still in full swing in Serbia and Montenegro (which since 2000 have managed to push through key elements of both waves), Russia and Ukraine. Belarus and Uzbekistan essentially still have both waves before them. The experiences of Hungary, and partly, Poland demonstrate that a (separate) second reform wave does not appear to be absolutely necessary if structural reforms in the financial and real sectors go deep enough early enough.

Table 3 gives an illustration of the most important stages of banking reforms, including the structures of the two waves as the author sees them. The Table focuses on approx. when (which year), and how long, in the author's assessment, it took which of the analyzed transition countries to go through which stage.

Table 3

Going through the two "banking reform waves" and their consequences: a country-to-country comparison (year or period of policy measure/event)[a]

Analyzed countries[b]	HUN	POL	CZR	SLK	E.GER	BUL	ROM	CRO	S&M	RUS	UKR	BELA	KAZ	UZB
Point of departure: state-owned[c] banking system, soft budget constraints, regime change, external shocks, weak rule of law	89-90	89-90	90	90	89-90	90	90	90-91	90-92	91-92	91-92	92	92	92
Transition recession and banking crises	90-93	90-91	90-92	90-93	90-91	90-93	90-92	90-93	90-93	90-96	90-97	90-95	90-95	90-95
"First wave" of banking reform														
- Liberalization of licensing policies, establishment of generous/lenient regulatory and supervisory systems	89-91	90-92	90-93	90-93	-	90-94	90-94	90-92	90-94	91-94	91-94	91-94	91-94	91-94[d]
- Up-front rehabilitation measures (e.g. swap of inherited and new non-performing loans for government securities)	91	91	91	91	-	91-94	91-93	91-92	-	-	-	-	94-95	-
- Surface privatization of banks (e.g. mass privatization, MEBOs)	-	93-96	92-94	92-97	-	-	-	-	-	92-94	93-94	-	92-94	-
- Initial tightening of banking regulation and supervision	-	-	93-94	94-95	-	-	95-96	93-94	96-97	94-95	94	94	94-95	94-96
- Temporary stabilization of macroeconomic and banking situation	-	-	95-96	96-97	-	94-95	94-95	94-97	95-97	96-97	-	97-98	-	-
- Renewed accumulation of bad loans and structural problems, sometimes complemented by new external shocks	-	-	92-97	93-98	-	92-96	93-96	93-97	-00	-98	-98	91-	94-97	91-
- Establishment of deposit insurance fund	93	95	94	96	90	95	96	94	-	04	01	95	99	02
New transition banking crises and (or) recession	-	-	97-98	97-99	-	96-97	97-99	98-99	99-00[e]	98-99	98-99	98-99	-	-
"Second wave" of banking reform														
- Important restructuring, resolution and recapitalization measures: in most cases at least one large bank goes under	92-93	93-96	97-00	98-00	90-91	96-97	98-00	98-00	01-02	98-99	98-01	99	95-97	-
- Establishment of hard budget constraints for banks	92-93	93-94	98-99	99	90-91	96-97	99-00	99	02	99	01	-	97-98	-
- Banks become much more cautious in lending	92-93	93-94	98	98-99	90-91	97-98	00	98-99	02-03	98-99	99	99	97-98	02-03
- Substantial tightening of banking regulation and supervision, upgrading of bookkeeping standards	92-94	94-95	96-98	98-99	90-91	96-97	98-99	98-99	01-02	99-04	00-01	-	96-03	-
- Strengthening of property and creditor rights, hard budget constraints spread to real sector	95-96	96-97	99-00	00-01	91	98-99	01	00	03	-	-	-	-	-
- In-depth privatization (e.g. takeover by strategic investor), FDI boom in banking	94-97	97-00	99-01	01-02	90-91	97-03	99-05	99-02	03-	04-	05-	-	-	-
- Introduction of credit registers/bureaux	99	-	02	04	91	00	99	-	-	05	-	-	-	-
Bank lending gathers momentum or turns into credit boom	99	98	04	04	-	01	02	01	04	01	01	04	00	-
Authorities' reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)	-	-	-	-	-	03-	03-	03-	05-	-	-	-	05-	-

[a] for example: 91 stands for 1991, 03 stands for 2003, -98 stands for a policy measure/ event going on until 1998, but with no clear starting point, 02- stands for a policy measure/ event starting in 2002 and not yet over
[b] HUN = Hungary, POL = Poland, CZR = Czech Republic, SLK = Slovakia, E.GER = East Germany, BUL = Bulgaria, ROM = Romania, CRO = Croatia, S&M = Serbia and Montenegro, RUS = Russia, UKR = Ukraine, BELA = Belarus, KAZ = Kazakhstan, UZB = Uzbekistan
[c] in former Yugoslavia: socially-owned banking system
[d] selective and temporary liberalization of licensing policies, but not of central state oversight of banks
[e] in former Yugoslavia: slump triggered by the Kosovo war, which contributed to pushing the banking sector to the verge of collapse

5. FDI - a key to success

Bank privatization is all but finished in the majority of countries. Foreign-owned banks have acquired dominating competitive positions in all analyzed countries except in slower, late or non-reformers (Russia, Ukraine, Belarus and Uzbekistan) and except in Kazakhstan (Table 4). In other words, after Serbia and Montenegro caught up in 2005, all central and South-Eastern European countries' banking sectors are majority foreign-owned today. In contrast, CIS countries' banking sectors - for all their structural and systemic heterogeneities - remain dominated by domestic players and/or the state. Countries that are already EU members or are about to join or are candidates for membership or that otherwise have a reasonable perspective of accession seem to be more attractive for foreign investors than those that don't have these attributes. This may be related to the large market these countries have joined/are joining, but probably even more to the clear requirements with respect to the rule of law and observance of the *acquis communautaire*, which constitute elements of EU membership.[11]

Table 4

Asset shares of state-owned banks and foreign-owned banks (2005)

		Central European countries				South-Eastern European countries				CIS countries					Euro area
		Hun	Pol	CzR	Slk	Bul	Rom	Cro	Ser	Rus	Ukr	Bela	Kaz	Uzb	
Shares in total banking assets in %	Maj. state-owned banks	7.0	21.5	2.5	1.1	1.7	6.5	3.4	23.9	38.1[a)]	8.0[a)]	75.2	3.1	67.6[a)]	.
	Maj. foreign-owned banks	84.5	74.2	94.5	97.3	72.8	59.2	91.2	66.0	11.2[b)]	21.4	16.2	7.3	3.4[c)]	15.5[a)]

[a)] 2004
[b)] share in registered statutory capital
[c)] end-February 2006
Hun = Hungary, Pol = Poland, CzR = Czech Republic, Slk = Slovakia, Bul = Bulgaria, Rom = Romania, Cro = Croatia, Ser = Serbia, Rus = Russia, Ukr = Ukraine, Bel = Belarus, Kaz = Kazakhstan, Uzb = Uzbekistan

Source: EBRD, Raiffeisen Zentralbank, Bank Austria-Creditanstalt, IMF

In some countries, like Slovakia and the Czech Republic, foreign-owned banks' positions are overwhelming. Foreign investors had often entered the markets during or immediately after a major sector clean-up (preceded by a crisis) and as soon as a reasonable degree of rule of law had been established. Foreign-owned banks' average share in total assets is much higher in Central and Eastern Europe than in the euro area (where it comes to over a fifth). As of end-2004, adding up all Central and Eastern European countries, the strongest foreign presence (in terms of assets) was boasted by Austrian, Italian, Belgian, German and French investors (Table 5). Greek investors also enjoyed a prominent position, particularly in South-Eastern Europe.

[11] Or to put it differently: According to Andreff, « La convergence économique des pays d'Europe centrale et orientale vers l'Union européenne y crée un bon climat d'investissement, bien meilleur que celui dont bénéficient les autres économies en transition, notamment les pays de la Communauté des Etats Indépendents » (Andreff 2003: 30).

The largest privatization deal in the history of the entire region (so far) has been the sale of Banca Comercială Română (BCR) in Romania in late 2005, which was purchased by Erste Bank for an unprecedented EUR 3.75 billion. In this and other most recent cases of bank takeovers in the region, book multiples (multiples of prices paid over book values) have strongly expanded, reflecting continuing high demand from strategic investors and dwindling supply of (privatizable) banks on the market.

The share of state-owned banks is still relatively high (a quarter or more of total assets) in Russia and Serbia. It is very high in Belarus and Uzbekistan. The state retains important minority stakes in Romanian and Ukrainian credit institutions. In many analyzed countries, the space remaining for domestically-owned private competitors is modest; the latter often tend to specialize in certain niche activities. Bank ownership remains rather opaque in some countries, incl. Kazakhstan. Six of the largest ten banks (in terms of assets) in entire Central and Eastern Europe are majority privately-owned, five of which by foreign strategic investors. Four of the largest ten credit institutions – including the two biggest of all, namely Sberbank and Vneshtorgbank – continue to be majority state-owned.

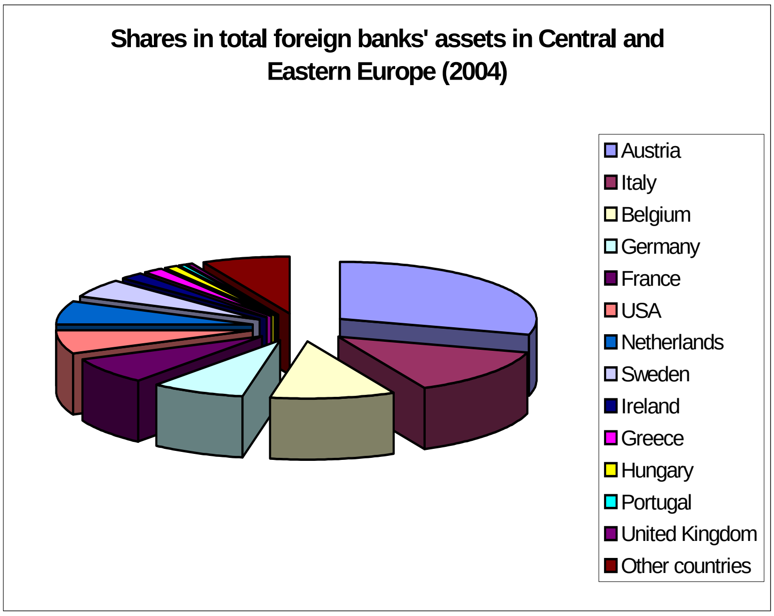
Selling banks to foreign strategic investors has generally paid off, because the latter injected know-how, experience, technology, corporate governance and money, thus boosted competitiveness, stimulated competition and enhanced fragile confidence in the sector. The improvement of risk management techniques has been a major achievement of banking FDI in Central and Eastern Europe.[12] In some instances, foreign parent banks have acted as de facto lenders of last resort to their subsidiaries in the region (see e.g. KBC's assistance to Kredytbank), although this cannot be taken for granted (see the case of Riječka banka). This is not to say that foreign takeovers are the only feasible route for establishing viable and competitive credit institutions in the region (or other emerging markets). But if development is to be essentially home-grown, the necessary accumulation and transfer of human and financial capital will probably take longer. Large-scale foreign takeovers may also trigger potential problems linked to the emergence of risk transmission channels and of possible contagion.

[12] Still, many smaller domestically-owned credit institutions need to enhance their risk management practices.

Table 5

Presence of foreign direct investors in Central and Eastern European banking according to countries of origin (2004)

Country of origin	Share in total foreign banks' assets in CEE (end-2004)*
Austria	29,4
Italy	13,3
Belgium	10,3
Germany	7,7
France	7,5
USA	6,9
Netherlands	6,5
Sweden	5,4
Ireland	1,8
Greece	1,7
Hungary	1,1
Portugal	0,7
United Kingdom	0,5
Other countries	7,2



* The reference area referred to does not fully correspond to the countries analyzed in this study. Apart from the latter, the above table/chart also deals with Slovenia, Bosnia-Herzegovina, Estonia, Latvia and Lithuania, while it does not cover Belarus, Kazakhstan and Uzbekistan.

Source: Bank Austria-Creditanstalt

There are not many examples of successful large domestically-owned banks in Central and Eastern Europe. Perhaps the most prominent, OTP, appears to owe its strong position in the Hungarian market and its relatively efficient structure to the impact of the relentless competition from foreign-owned institutions which compelled it to drastically streamline and modernize its operations. Furthermore, OTP has become an important foreign direct investor in the banking sectors of some of Hungary's neighbors. Kazakhstani credit institutions (notably Kazkommertsbank) have taken over a number of banks in countries adjacent to the Central Asian republic. Some of the largest Russian banks (Alfabank, Vneshtorgbank) have also extended their activities abroad. Given their size, social and political importance, the former state-owned savings banks were often privatized in a slower or different manner from other credit institutions. Some of the savings banks, like the Russian Sberbank or the Romanian CEC, are still in public ownership.

6. Elements of structural modernization

Practically every analyzed country still seems to be “overbanked” and “underbanked” at the same time - overbanked in the sense of harboring too many, particularly small, credit institutions; - underbanked in the sense that access to/use of banking services is much below the EU average. But the tightening of minimum capital requirements and intensifying competition are contributing to ongoing consolidation processes, which in some countries include sizeable cuts in banking employment, despite expansion of banking activity. In other countries, employment in credit institutions is still on the rise, while banks continue to establish new outlets.

Modernization and rationalization of banking structures and networks, notably in Central European and in some South-Eastern European countries, comprise the swift dissemination of IT (expansion of use of credit and debit cards, cash dispensers, internet-, tele- and mobile phone banking), which may serve to reconcile the above-mentioned apparent contradictory tendencies on the basis of enhanced productivity and efficiency. In some areas where there is still large untapped demand, particularly in the retail sector, increased penetration through the “traditional” means of expanding operations of brick-and-mortar branches may be more promising. Cross-border ownership ties in the spheres of banking as well as industry appear to be creating a hub of pan-European structural integration. In recent years, credit institutions in a number of analyzed countries have contributed to shoring up the profitability of Western European banks, e.g. Austrian banks.

One of the reasons for the favorable development of profits in Central and Eastern Europe is the genuine credit boom that has been unfolding in most countries. However, the boom was preceded by a sharp curtailment or collapse of the traditionally lax crediting policies inherited from the past. The bank restructuring programs of the 1990s, including in most cases the failure of at least one large bank per country, the concomitant tightening of regulations and supervision as well as the improvement of bookkeeping rules essentially established hard budget constraints for credit institutions. Due to delays in the implementation of creditor rights in the real sector, banks initially became more cautious in lending and partly reshuffled their portfolios toward low-risk investments, like government securities, central bank bills and foreign placements.

7. Credit expansion and boom

Then, based on a number of factors, lending recovered, eventually leading to a credit boom (Table 6).[13] The factors were: strong growth, improved macroeconomic conditions (declining inflation and interest rates), strengthened structural and institutional conditions, rising confidence, demonetization tendencies, jumps in deposit levels as a result of the euro cash changeover 2001/2002, as well as, in most – but not all - countries, substantial FDI inflows into the banking sector.[14] Risk management improved. The maturity structure of loans moved from predominantly short-term to medium-term. The credit boom has largely been financed by growing deposits and by banks' reshuffling of assets, including the drawdown of foreign assets and the acquisition/ accumulation of foreign debt. The latter was quite easy in the case of subsidiaries and branches of foreign-owned credit institutions whose headquarters took up funds on Western financial markets. Although many analyzed countries' ratios of credit to GDP appear to be on a steep catching-up path, they are still far behind the corresponding euro area average (115 per cent in 2005). In some countries, notably Central European ones and Croatia, higher yielding if riskier mutual funds have been absorbing increasing shares of households' savings in recent years, thus somewhat curbing the expansion of deposits there. Most countries have featured modest, but declining or even vanishing deposit overhangs (over loans).

The authorities concerned generally perceive the boom as a welcome advance on the path of structural catching up and convergence. Although it is accompanied by a decline of capital adequacy ratios, the latter remain relatively high and bad loans don't seem to be a serious problem, at least for the time being (late 2006). In a number of countries, particularly Central European ones featuring a strong presence of foreign investors in various sectors of the economy, important clients and large companies have often also had access to cross-border loans from foreign banks or to intra-company loans, or have been able to finance themselves via capital markets. These activities have thus substituted themselves for some of the domestic credit expansion potential and have gathered momentum. Pushed by competition and rising mass incomes, credits spread to new areas, like retail - particularly mortgage – lending, where they multiplied from a base of almost zero. Indeed, consumer loans – notably

[13] The only analyzed country that has not at all shared in the credit boom is Uzbekistan.
[14] As the examples of Ukraine and Kazakhstan vividly demonstrate, FDI is not a necessary precondition for very swift credit expansion.

housing loans – eventually became the main drivers of credit expansion in Central and Eastern Europe. Mortgage lending has also been facilitated by the setting up of land registers. Notwithstanding the establishment of credit information bureau in most countries, as well as some public incitements, SME lending has not yet taken off, except in Hungary.

Table 6

Financial intermediation in Central and Eastern Europe (1999 and 2005)

	Hungary		Poland		Czech Rep.		Slovakia		Bulgaria		Romania		Croatia	
	1999	2005	1999	2005	1999	2005	1999	2005	1999	2005	1999	2005	1999	2005
Banking assets/GDP (%)	68.1	91.0	61.9	66.3	124.1	97.9	92.7	95.5	36.1	78.3	34.9	45.4	66.1	114.0
Deposits of the private sector/GDP (%)[a]	36.4	40.1	35.4	34.6[b]	66.1	55.9[b]	57.1	47.7[b]	21.3	36.0[b]	20.5	26.1	34.0	59.8[b]
Credit to the private sector/GDP (%)[a]	24.6	44.8	27.1	27.4[b]	44.6	30.4	48.4	36.3	10.7	42.3	10.6	20.9	35.7	65.4

	Serbia		Russia		Ukraine		Belarus		Kazakhstan		Uzbekistan		Euro area
	1999	2005	1999	2005	1999	2005	1999	2005	1999	2005	1999	2005	2004
Banking assets/GDP (%)	79.8	46.4	33.3	45.1	19.6	51.1	29.5[c]	32.2	16.9	60.6	39.7[c]	37.8[e]	202
Deposits of the private sector/GDP (%)[a]	9.7	25.1	10.2	17.7	9.6	31.7	11.9[d]	16.3	8.5	22.6[b]	8.6[c]	8.0[b]	89.9
Credit to the private sector/GDP (%)[a]	29.6	25.0	13.1	25.7	9.0	35.3	18.6[c]	19.6	7.6	35.6	22.0	20.4	110.6

a) for Russia, Ukraine, Belarus, Kazakhstan and Uzbekistan volume of deposits/GDP resp. credit volume/GDP.
b) 2004
c) 2000
d) 2001
e) 2003

Source: EBRD, Raiffeisen Zentralbank, Bank Austria-Creditanstalt, IMF

8. Risks of the credit boom and authorities' reaction

The credit boom has given rise to concern in a number of countries (e.g. Bulgaria, Romania, Croatia, Ukraine and Kazakhstan). It may set off financial and macroeconomic risks. Owing to the sheer speed of the expansion, careful screening of individual loans may not be possible. This heightens the danger that some loans could turn non-performing in the next economic downturn. Moreover, the credit boom swells already strong aggregate demand, which can fan inflation; with loans often being used to purchase imported consumer goods, pressure is put on the trade and current accounts and on external liabilities (procyclicality of credits).

Increasing economic interdependence and informal euroization reflect large shares of foreign currency- (mostly euro- or US dollar-) denominated deposits in total deposits. Banks also tend to procure foreign currency funds at relatively low interest rates abroad, sometimes from parent banks. Given lower rates on forex loans and relatively stable domestic currencies which have lately even come under appreciation pressure, foreign currency borrowing or foreign currency-indexed borrowing on the part of enterprises and households has become popular in a number of countries. Relatively large shares of foreign currency liabilities thus at least partly match sizable forex-denominated or –indexed assets on the part of banks. However, domestic currencies' appreciation tendencies may not continue uninterruptedly, increased exchange rate volatility has made itself felt in 2006, and many of banks' debtors, particularly households, are probably insufficiently hedged against forex risks. On the other hand, in some cases, private remittances or tourism revenues can reduce households' exposure.

The particularly dynamic expansion (multiplication) of mortgage lending benefits from collateral (real estate) that may be more easily sizeable and saleable than that of firms, particularly SMEs, but there may be a danger of real estate (asset price) bubbles. In some countries, maturity mismatches have been building up between loans that have become medium-term and deposits that have largely remained short-term. Overall credit expansion appears to have been particularly robust in countries with currency boards or exchange rate pegs.

Authorities have tended to react to the boom somewhat hesitantly (see Table 3). In many instances, regulatory and supervisory rules were further strengthened, partly with a focus on reining in forex credits and mortgage loans. Minimum reserve requirements often served as an instrument. In some cases, budgetary stances were considerably tightened to reduce circulating liquidity and dampen inflationary pressures. Monetary policy measures (e.g. interest rate hikes) were not always available or were ineffective, given that some countries had currency boards or hard peg exchange rate regimes and that in many instances, capital controls were not feasible. Croatia seems to have been the first (2003) to resort to administrative restrictions, like credit ceilings, followed by Bulgaria, Romania, and most recently (2006) by Serbia. Croatia's intervention proved effective in cooling down the overheating market, but at a cost and only temporarily. 2005 saw a re-acceleration of loan activities. The effectiveness of other countries' tightening measures is also doubtful. Given Hungary's most recent macroeconomic difficulties (expanding twin deficits in 2006), the country's banks, which have been among the most eager to expand foreign currency-denominated lending, have been accumulating indirect exchange rate risks. In some cases, controls seem to have been circumvented by resorting to unregulated or less regulated activities, like those of leasing companies, asset management entities, investment funds. Or money has been directly borrowed from abroad.[15]

9. Lingering shortcomings and potential

Agent banks or pocket banks, i.e. extended treasuries or financial departments of owner firms or enterprise groups whose ownership structures tend to be in transparent, still play an appreciable role in some countries, especially Russia, Ukraine and some other CIS members, where they prevail. The structure and relationship "agent bank" – "principal firm" may at least partly reflect a reaction to protect business interests in a continually distorted environment; on the other hand, extensive insider lending, excessive portfolio concentrations and bank captivity to owners entail high risks and in all likelihood embody a considerable waste of resources.

Banking supervision has generally been moving forward from the formal verification of regulations to substantive risk-based approaches, including the overhaul of accounting methods toward IFRS[16] or EU-compatible standards. The EU accession process and legal harmonization with the acquis communautaire has contributed to improving and stabilizing the environment for many banks. However, lingering shortcomings in the implementation of regulations and in surveillance activity (incl. in some cases, the handling of IFRS), and deficiencies of the courts (e.g. weak enforcement of contracts, difficult access to collateral) are still felt in a majority of countries. Due to intensifying competition, there is a general tendency toward decline of interest rate spreads, even if the latter clearly exceed margins in the euro

[15] For a detailed analysis of the development of credit activity in Central Europe and the Baltics see, Backé and Zumer 2005.

[16] International Financial Reporting Standards, formerly called IAS (International Accounting Standards).

area because average risks are higher. Higher interest income coupled with the credit boom contributes to higher profitability of transition economies' banking sectors. Still, narrowing margins have been pushing banks to diversify earnings with fee- and commission-based products.

The streamlining of deposit insurance schemes seems to have been successful in most cases, in that their revenue base and expenditure contingencies were brought into a healthier relationship. Notwithstanding important progress in banking transformation and persisting high growth rates of income and financial intermediation, the banking markets in Central and Eastern Europe retain generous expansion potential, as witnessed by the still much lower per capita income and supply of banking services (e.g. bank accounts per 1000 inhabitants) than in the euro area or in Western Europe. Even in relation to income levels (GDP), consumption of banking products (volumes of banking deposits, credits, and assets) is lower in Central and Eastern Europe. Thus, while the gap is shrinking, it is still considerable (Table 6).

Judging by the EBRD banking reform index, since the turn of the millennium, the Czech Republic and Croatia have fully caught up with Hungary (as of 2005 and 2006, all three countries are marked 4), and other contenders - Poland, Slovakia and Bulgaria - have also made good some ground (they have all reached 3.7). In relative terms, not surprisingly, most progress has been achieved by FRY/Serbia and Montenegro (advancing from the lowest reform level of 1.0 in 2000 to 2.7 in 2006. Russia and Ukraine have also made remarkable progress in recent years (moving to 2.7 and 3.0 in 2006). In contrast, Belarus and Uzbekistan continue to occupy the most backward positions (respectively 1.7) (EBRD 2006: 94-106).

10. Comparative snapshot

All in all, as of the fall of 2006, the 13 countries analyzed in this study offer an impressive diversity of banking systems, which range from advanced and strongly market-oriented to traditional and predominantly centrally administered (see also comparison of trajectories in Table 3). After having adopted the *acquis communautaire* in connection with entering the EU, Central European countries are most advanced in terms of legal and institutional reforms and convergence, even if enforcement is not without flaws. The region features, on average, the highest degree of financial intermediation, with Poland somewhat trailing its peers. High levels of economy-wide FDI, including companies whose liquidity flows and funding needs are managed on an international basis, may be largely responsible for a relatively moderate speed of (domestic) corporate credit growth in most of Central Europe in recent years. In contrast, household – and notably housing - loans are in full expansion. As new EU members, Central European countries are exposed to increased banking competition, but can also benefit from expanded access to EU markets, thanks to the "single license rule".

South-Eastern European countries (as of late 2006) are EU candidate or potential candidate countries. While Croatia is most developed with respect to financial intermediation in this region – and even ahead of some Central European peers - the banking sector on average is at an earlier stage of development in South-Eastern Europe than in Central Europe. Still, the South-East has made huge catching-up strides in recent years, whether in terms of institutional and structural adjustment or of credit activity (see Table 6). The Serbian authorities, for instance, carried out courageous bank resolution measures at the beginning of 2002, when chronically insolvent credit institutions accounting for 60% of the official book value of total sector assets were finally declared bankrupt. This may well constitute the most incisive single banking reform act of entire transition history (see, Barisitz 2003: 198-199). Having gotten hold of almost all analyzed countries, the credit boom appears to be particularly pronounced in South-Eastern Europe. The countries of this region have resorted to various prudential and administrative measures to contain the boom – as yet without convincing or durable success.

Catching up and credit boom are also fair descriptions for the dynamics of Russian, Ukrainian and Kazakhstani banking developments in recent years. The Kazakhstani credit boom has been the swiftest in the CIS, closely followed by Ukraine's. Whereas the Kazakhstani authorities have been actively intervening, the Ukrainian authorities may have only started to react. On the other hand, most recently foreign strategic investors have made important inroads in Ukraine, which portends well for the modernization of this country's banking sector. Important advances in banking reform have lately propelled Russian credit institutions to expand and modernize, and have raised foreign investors' interest in the large Russian market. Yet the rule of law remains relatively weak (or selective) in all analyzed CIS countries. Sectors are still marked by an abundance of small undercapitalized outfits; transparency of ownership leaves a lot to be desired and pocket banks and insider lending hold sway. Notwithstanding intermittent timid reform efforts, Belarus and Uzbekistan continue to display key elements of the Soviet economic system, including pervasive state ownership and concentration, price controls, directed credits or state orders, various types of financial repression and repetitive but unsustainable bailing out operations.

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