ASECU South-Eastern Europe Journal of Economics 2 (2009) 161-180 SEEJE

BANKING TRANSFORMATION 1980-2006 IN CENTRAL AND EASTERN EUROPE – FROM COMMUNISM TO CAPITALISM

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Abstract
This article is a summary of the author's recently published book "Banking in Central and Eastern Europe 1980-2006" and provides an overview of the history of banking transition from communism to capitalism in 14 Central and Eastern European countries (the former Soviet Union, Czechoslovakia, East Germany, Yugoslavia, Belarus, Bulgaria, Croatia, the Czech Republic, Hungary, Kazakhstan, Poland, Romania, the Russian Federation, Serbia and Montenegro, Slovakia, Ukraine and Uzbekistan). The essential functions of credit institutions in the former socialist economic system (monitoring and facilitation of plan fulfillment) are explained. The comprehensive collapse of the former system triggered a sustained weakening of the state structure. In most countries, the 1990s were a decade of major banking upheavals, turmoil and reform. The turn of the millennium featured sector consolidation, or was a culminating point of restructuring efforts. The first years of the new millennium have generally featured calmer, stronger and more open banking sectors than the 1990s. Two "banking reform waves" are distinguished, salient features of which all countries (need to) run through in order to mature. The first reform wave includes extensive liberalization measures and initial limited restructuring and tightening efforts. The macroeconomic situation temporarily stabilizes. But underlying distorted incentives favor the renewed accumulation of bad loans and set the stage for new banking crises. Only the second reform wave ushers in hard budget constraints, in-depth privatization and "real" owners (which are mostly — but not exclusively — foreign direct investors). Banking regulation and supervision improve substantially. Western European FDI has come to dominate banking in all former socialist countries that have either already become members of the EU or are candidates or have been given an official "perspective" to (eventually) join the Union. Recently, dynamic catching-up processes have gathered momentum in many countries. Against the background of strong economic recovery and expansion, credit booms have unfolded, not without considerable risks.

Keywords: banking crisis, banking reform, banking transformation, central and eastern Europe, credit boom, FDI, privatization, restructuring, soft budget constraints

JEL classification: G21, G28, P34

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1. Introduction

This article is a summary of the author's recently published book "Banking in Central and Eastern Europe 1980-2006"[1] and includes some additional short historic references. Chapter 2 focuses on aspects of the role of banking activity in the transition from one socio-economic system to another. Chapter 3 provides an outline of the importance of the financial sector in the former socialist economic systems in Central and Eastern Europe. This leads to the core of the study, chapter 4, which presents salient features of banking sector transformation from socialism to capitalism in the 14 largest Central and Eastern European countries. The selection of countries is based on population size: the five largest in (East) Central Europe: Poland, Czechoslovakia - since 1993 the Czech and Slovak Republics, Hungary and (former) East Germany; the four largest in South-Eastern Europe: Romania, Bulgaria, former Yugoslavia – since the early 1990s Croatia and Serbia and Montenegro; the five largest in Eastern Europe/the former Soviet Union: the Russian Federation, Ukraine, Belarus, Kazakhstan and Uzbekistan. Chapter 4 is divided into two subchapters: The first deals with the crisis-prone transition economies of the 1990s, the second with the reformed transition economies following the turn of the millennium, which turns out to be a threshold in structural development. Conclusions are drawn in chapter 5.

Out of this wealth of facts, quantitative and qualitative material reflecting actual historic developments, the author extracts a generalized pattern and *typical sequence* of events, crises and reforms (empirical induction), which may be interpreted as a kind of itinerary of banking sector transformation in the region.

2. Aspects of the role of banking activity in the transition from one socio-economic system to another

While institutions fulfilling banking functions already existed in pre-capitalist economic systems, banks certainly contributed to driving structural change toward and then within capitalism. Money changers and credit institutions reportedly already existed in ancient Greece. In the Middle Ages, banks played pivotal roles in financing profit-oriented regional and international trade (Bauer and Matis 1988, 124-125). This goes particularly for banks operating in the rich Italian city states of Venice and Genoa, pioneers of old East-West trade. Within the feudal system, banking and international trade may be seen to have *spearheaded the development of market-oriented and capitalist practices* as well as the penetration of money into the economy.

1. Barisitz, Stephan (2007): Banking in Central and Eastern Europe 1980-2006 – From communism to capitalism, Routledge International Studies in Money and Banking no. 41, Abingdon, New York (http://www.routledge.com/books/Banking-in-Central-and-Eastern-Europe-1980-2006-isbn9780415428811)

Expanding (de-facto) capitalist and market institutions and monetization eroded feudalism and serfdom, as well as, much later, socialism and the centrally-planned economy. While credit institutions were largely alien to the core of the feudal autarkic farm economy, they have played a role in socialism; however this role has generally been a passive one of verifying and partly facilitating plan fulfillment. There seems to be a consensus that banks have, through contributing to efficient investment finance, contributed to boosting capitalist productivity and thus intensive economic growth (Wachtel 2001, 335). In contrast, it seems that neither the Roman Empire, nor oriental economic systems, nor feudalism, nor socialism had or have found the tools to emancipate themselves from input-dependent "extensive growth" (see also Bauer and Matis 1988, 85-86, Fink and Haiss 1996, 430, Suret-Canale 1996, 23). Perhaps exaggerating somewhat, one might argue that the penetration of real money and of actual financial intermediation constituted a kind of solvent for out-dated feudal or socialist structures.

3. Outline of the importance of the financial sector in the former socialist economic systems of Central and Eastern Europe

A couple of months before the October Revolution, Vladimir Lenin gave a quite fitting pre-emptive description of what functions banks would be called upon to fulfill once socialism was introduced (cited from Nove 1976, 43): "Capitalism has created an accounting *apparatus* in the shape of the banks, syndicates, postal service, consumers' societies, and office employees' unions. *Without big banks, socialism would be impossible*. The big banks *are* the state apparatus which we *need* to bring about socialism, and which we *take ready-made* from capitalism… A single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the *socialist* apparatus. This will be country-wide *book-keeping*, country-wide *accounting* of the production and distribution of goods, this will be, so to speak, something in the nature of the *skeleton* of socialist society…" (Emphases are Lenin's throughout).

The *centrally-planned economy*, realized at the end of the 1920s under the rule of Stalin and continuing during the next six decades, as well as the Hungarian and Yugoslav systems of market socialism, put into effect in the 1960s, feature, inter alia, the following constituent parts:

- a state-owned (or socially-owned) banking system, essentially consisting of one large institution, the State Bank, often assisted by three or four special purpose units (e.g. Agricultural Bank, Foreign Trade Bank, Savings Bank) with branches across the land (one-tier or monobank system) (see Table 1)
- bank activity aims at *monitoring*, and, if necessary, *facilitating, plan fulfillment* and payment flows (therefore: central credit and cash plans, unscheduled lending)

- strict separation of the circulation of accounting money (for plan control and investment finance) and cash money (for wage payments and the population's purchases of consumer goods), which, however, is not always successful and can lead to monetary overhangs
- omnipresent *soft budget constraints* (referring to Kornai's theory of the "shortage economy" [Kornai 1980]), which implies that the institution of bankruptcy/ insolvency – a trait of a functioning market economy – is non-existent in the socialist economy

The *comprehensive collapse* of this system provided the point of departure for transition:

- collapse of the political system (communist dictatorship)
- collapse of the economic system (centrally-planned economy, socialist market economy)
- breakdown of the former socialist economic integration body (COMECON, CMEA = Council for Mutual Economic Assistance), but also of multinational state structures (USSR, former socialist Yugoslavia)

These major internal and external shocks triggered the unraveling of state power and brought about a *sustained weakening of the rule of law* and public authority. The shocks also gave rise to transition recessions (actually: severe systemic depressions) and caused banking crises, which, in turn, were followed by important reform efforts, incl. banking reforms.

4. Salient features of banking sector transition

Two *"banking reform waves"* are identified, essential elements of which all countries (need to) go through, in order to achieve market-oriented development in a sustainable manner, at least according to the pattern of historical experience. There are also outliers, but most countries follow this process. While the first reform wave largely embodies *liberalization*, the second one predominantly refers to *restructuring and institutionalization*.[2]

2. Both reform waves might also be interpreted as "regime changes", in the way Honohan 1997, 10 does. Before going into further details, one might ask, why two reform waves, not one? This is probably due to the sheer amount of painful transformation to cope with and due to the simultaneous (rather short term-oriented) political rationality weighing on the authorities' decisions in most cases (and pointing to "muddling through" strategies).

4.1. The first reform wave

The first wave essentially consisted of four stages: initial liberalization, initial limited restructuring and tightening measures, an unsustainable equilibrium, and renewed destabilization and crisis.

4.1.1. Initial liberalization

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 (comprising a central bank/ monetary authority and commercial banks). The reform wave included the liberalization of bank licensing and the erstwhile establishment of a generous or lenient regulation and supervision regime. Given the legacy of a state-dominated and monopolized banking system devoid of competition for decades, it is understandable that most countries initially opted for wide-ranging liberalization of regulation and supervision in order to swiftly inject competition into the market. However, as a consequence of this strategy, numerous undercapitalized and weakly managed private banks, typically carrying out short-term, arbitrage-oriented activities, entered the sector.

4.1.2. Initial restructuring and tightening

Authorities soon carried out "up-front rehabilitation measures", typically replacing bad loans in the portfolio of the state-owned banking sector across-the-board by government bonds. Such bad loans had been inherited from the centrally planned economy and/ or accumulated during the transition recession. The credits were transferred to a public "hospital bank" ("bad bank") or debt recovery agency. This exercise rather resembled a major bookkeeping operation than a genuine restructuring measure. Another popular policy of the time was "surface privatization", i.e. partial, insider or non-conventional privatization of banks (and enterprises). This included MEBOs (management and employee buyouts) and voucher privatization (distribution of former public ownership titles to the population). Although expediency and social justice considerations may argue in their favor, these modes of privatization hardly inject any new capital or expertise and also in most cases do not essentially modify the way the bank is managed. In order to combat skyrocketing inflation and rein in the proliferation of credit institutions, some initial tightening of monetary policy and banking oversight was carried out.

Following the deep transition recession, economic growth reappeared around the mid-1990s in most analyzed countries, the macroeconomic and banking situations temporarily stabilized, banking sectors started to consolidate, and one could argue that market-oriented economies had been re-established in the region.

Table 1: Main components of the socialist one-tier banking systems

	Central Bank	*Investment/ Development Bank*	*Foreign Trade Bank 1)*	*State Savings Bank*	*Agricultural banks, other credit institutions*	*Later established specialized state-owned banks 2)*
Soviet Union	Gosudarstvenny bank (Gosbank) SSSR	Stroibank (Construction Bank)	Vneshtorgbank	Sberkassa	–	1987: Promstroibank, Agro-prombank, Zhilsotsbank, Vnesh-ekonombank
Bulgaria	Balgarska narodna banka (BNB)	–	Bulgarian Foreign Trade Bank	Derzhavna spestovna kassa	–	1981: Mineralbank (investment credits for new SMEs), 1987: seven sectoral development banks (incl. Stopanska banka, Bank Biokhim), 1989: 59 regional commercial banks
Czechoslovakia	Státní banka Československá	–	Československá obchodní banka, Živnostenská banka (forex transactions involving individuals)	Česká státní spořitelna, Slovenská štátná sporitelňa	–	–
GDR	Staatsbank der DDR	–	Deutsche Außenhandelsbank AG	Sparkasse	Bank für Landwirtschaft und Nahrungsgüterwirtschaft, Genossenschaftsbanken für Handwerk und Gewerbe (Cooperative Banks for Trade and Industry)	–
Hungary	Magyar Nemzeti Bank (MNB)	Állami Fejlesztési Bank (State Development Bank)	Magyar Külkereskedelmi Bank	Országos Takarék-pénztár és Kereskedelmi Bank (OTP, National Savings Bank)	–	1987: Magyar Hitel Bank (Hungarian Credit Bank), Kereskedelmi és Hitel Bank (Commercial and Credit Bank), Budapest Bank

	Central Bank	***Investment/ Development Bank***	***Foreign Trade Bank 1)***	***State Savings Bank***	***Agricultural banks, other credit institutions***	***Later established specialized state-owned banks 2)***
Poland	Narodowy Bank Polski (NBP)	–	Bank Handlowy SA	Powszechny Kasa Oszczędności Bank Państwowy (PKO BP) (retail banking and financing of housing)	Bank Gospodarki Żywnościowej (BGZ) (Food and Agricultural Industry Bank), Bank Polska Kasa Opieki SA (PEKAO SA) (forex deposits of individuals)	1987: Bank Rozwoju Exportu (Bank for Export Development) 1989: nine regional banks
Romania	Banca Națională a României (BNR)	Investment Bank	Banca Română de Comerț Exterior	Casa de Economii şi Consemnațiuni (Savings and Loans Bank)	Bank for Agriculture and Food Industry	–

1) Carried out foreign exchange operations and financing and in a number of cases was in charge of servicing foreign currency state debt.
2) Carried out quasi-commercial banking activities separated from central bank. Correspond to beginnings of two-tier banking system.

4.1.3. Unsustainable equilibrium

However, soft budget constraints had been retained. This included lax crediting and directed loans granted by (former) state-owned banks on the instructions of the central bank or the government to (former) state-owned firms. The sector remained dominated by (former) state-owned banks, while new privately owned banks and greenfield start-ups were still relatively small. Thus, a temporary and unsustainable equilibrium emerged: The *absence of the concept of bankruptcy* in socialism was carried over into the market-oriented economy.

The continued lack of rule of law favored or necessitated the widespread phenomena of connected lending (lending to people/firms you know, with whom you have established mutual trust, who carry out a similar activity or are linked by ownership connections), and "agent banks" or "pocket banks" (credit institutions serving as de-facto financial departments of their owner-firms). In contrast, "lending on the free market" was quite risky and even unprofitable under such circumstances. Connected lending and pocket banks enable the establishment of *social* or other *control* within groups, which in Russia have often been called "finansovo-promyshlennye gruppy" or "financial-industrial groups". This control can make it possible to carry out economic activity even when facing an environment of weak legality. Thus, the relationship agent bank-principal firm partly reflects a reaction to protect business interests in a continually distorted environment (Andreff 2007, 277-280). Such practices may be perceived as institutional set pieces in the sense of New Institutional Economics (North 1981), in order to reduce very high transaction costs – under framework conditions of state failure.

On the other hand, extensive insider lending, excessive portfolio concentrations and bank captivity to owners also entail high risks and in all likelihood embody a considerable waste of resources. Of course, corruption, capital flight and fraudulent activities abounded in this environment. Financial pyramids, where they existed, enjoyed their heyday in the mid-1990s.[3]

4.1.4. Renewed destabilization and crisis

Underlying incentives favored the re-accumulation of bad loans and structural problems, sometimes complemented by new external shocks (foreign trade, exchange rate, oil prices etc.). This set the stage for renewed macroeconomic destabilization (notably, rising inflation). Often at around this point, deposit insurance funds were

3. At this stage, 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.

established (arguably in a pre-emptive manner to calm savers' concerns, create a level playing field, and prepare the sector for another shakeout). *New banking crises* and, in many cases, recessions, ensued. The crisis-driven recessions were particularly severe in Bulgaria 1996-97 and in Russia 1998.

In this context, it may be interesting to make a historical comparison which refers to the challenges for state development in the transition from one economic system to the other: In Russia, the post-Soviet state of the 1990s had incurred a certain degree of financial dependence on a handful of successful privately-owned banks. The *state* was still *transitioning* to a market-oriented tax system and had, for example, not yet developed a functioning treasury. The well-connected privately-owned banks had become very rich in a short time by participating in very controversial privatization auctions (notably the so-called "shares-for-loans auctions" of 1995-1996). This financial relationship may be comparable to medieval lending by rich bankers to princes/ kings in a situation where the latter were just exiting from feudalism and still structurally weak and confronting the need to construct a mercantilist-capitalist state (in the sense of Polanyi 1944). As a quid-pro-quo, bankers at the time received lucrative mining concessions, customs or banking monopolies or privileges (Weber 1923, 283). The Russian banking crisis itself, which was triggered by the default of the state, appears to be comparable to the grave banking crises at the threshold of the new economic system, caused by the insolvency of medieval monarchs and city states.

4.2. The second reform wave

The second wave also largely consisted of four stages: introduction of the hard budget constraint for banks, extension of the hard budget constraint to the real sector, profound restructuring and acquisition of the lion's share of the banking sector by strategic investors, and catching-up credit booms.

4.2.1. Introduction of hard budget constraint for banks

In order to stave off/tackle systemic crises, central banks/ governments – having already gone through various experiences – resolved to carry out *incisive restructuring*, resolution and recapitalization measures. Interventions often started as crisis management, but quickly grew into major endeavors. As a result, in most cases at least one large bank went under. This sent out a clear signal that bankruptcy conditions for credit institutions were hardening, which corresponded to a necessary break with the past.[4] However, given that hard budget constraints – while now valid for banks – were not yet valid for the real sector, banks became much more cautious in lending,

4. Anderson and Kegels 1998, 262 had already pointed to this requirement for systemic adjustment.

and reshuffled their portfolios toward government securities, central bank bills and foreign placements.

4.2.2. Spreading of the hard budget constraint to the real sector

In the wake of the ad-hoc deep intervention, banking regulation and supervision were substantially tightened, and bookkeeping standards improved. Supervision has generally been moving forward from the formal verification of rules to substantive risk-based approaches, while accounting methods have been upgraded toward IFRS[5] or EU-compatible standards. This contributed to formalizing hard budget constraints for credit institutions. The crises had often proved to be too much for the fledgling deposit insurance funds, which were subsequently bailed out and overhauled by financial strengthening and by streamlining of guarantee levels to provide for viability and adjust incentives. Property, contract and creditor rights gradually spread to the real sector and the *rule of law strengthened*. Hard budget constraints slowly made themselves felt throughout the economy. This constituted a major change: market-oriented lending became possible.

4.2.3. Profound restructuring and inflows of FDI

After other strategies and alternatives had been tried, with the benefit of hindsight, the authorities in most countries took major decisions in favor of opening their banking sectors to renowned outsiders, including foreign strategic investors, often against the background of severe budgetary constraints. This aimed-for *"in-depth privatization"* focused on attracting missing know-how, technology, capital, and improving banks' corporate governance, efficiency and competitiveness. Once institutional and economic framework conditions (protection of property rights, rule of law, macro-stability) were appropriate, foreign investors didn't hesitate to enter in substantial numbers, attracted by the huge untapped catching-up and profit potential for banking activities. Around the turn of the millennium, mostly Western European, particularly Austrian, investors purchased some of the region's largest banks, one after the other, and took over the lion's share of the sector in most of Central and Eastern Europe in a few years (see Table 2). Thus, structural link-ups with the EU or within the enlarged EU were created, and *pan-European microeconomic networks* emerged. 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 3).

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5. International Financial Reporting Standards, formally called IAS (International Accounting Standards)

Table 2: Asset shares of state-owned and foreign-owned banks (early 1990s, 2000 and 2005)

Central European Countries

		Hungary			Poland			Czech Republic			Slovakia		
		1992	2000	2005	1993	2000	2005	1995	2000	2005	1993	2000	2005
Shares in total banking assets (%)	Maj. state-owned banks	74.4	7.7	7.0	86.2	23.9	21.5	–	27.8	2.5	70.7	49.1	1.1
	Maj. foreign-owned banks	41.8[a]	66.7	84.5	4.2[a]	69.5	74.2	15.9	71.8	94.5	32.7[a]	28.1[b]	97.3

South-Eastern European Countries

		Bulgaria			Romania			Croatia			Serbia		
		1996	2000	2005	1994	2000	2005	1993	2000	2005	1994	2000	2005
Shares in total banking assets (%)	Maj. state-owned banks	82.2	19.8	1.7	80.4	48.0	6.5	58.9	5.7	3.4	94.1	90.9	23.9
	Maj. foreign-owned banks	9.5	67.7	72.8	20.0[c]	50.9	59.2	1.0[d]	84.1	91.2	–	13.2[e]	66.0

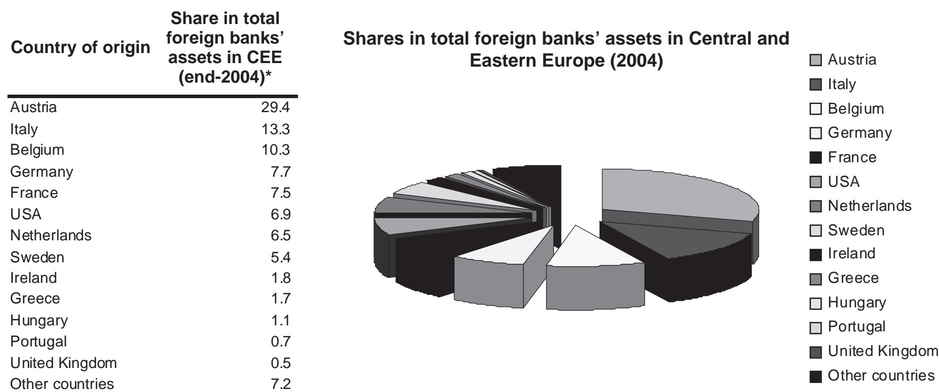
CIS Countries

		Russia			Ukraine			Belarus			Kazakhstan			Uzbekistan		
		1997	2000	2005	1997	2000	2005	1994	2000	2005	1995	2000	2005	1994	2000	2005
Shares in total banking assets (%)	Maj. state-owned banks	37.0	–	38.1[f]	13.5	11.9	8.0[f]	69.2	66.0	75.2	24.3	1.9	3.1	46.7	77.5	67.6[f]
	Maj. foreign-owned banks	–	9.5	11.2[g]	–	11.1	21.4	–	4.5	16.2	–	–	7.3	–	2.2	3.4[h]

[a] 1995
[b] share in total capital
[c] 1998
[d] 1996
[e] 2001
[f] 2004
[g] share in registered statutory capital
[h] end-February 2006

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

Table 3: 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

4.2.4. Catching-up credit booms

After some hesitation, lending recovered, soon gathered momentum and turned into credit booms in almost all transition countries (Table 4). This was because of: strong economic growth (notably since the turn of the millennium), improved macroeconomic conditions, strengthened structural and institutional environments, increased confidence, remonetization tendencies and the euro cash changeover 2001-2002.[6] The latter had mobilized lots of mattress money in euro legacy currencies (e.g. Deutsche mark, Austrian schilling, French franc), which had to be paid into bank accounts in order to be converted to euros. The lion's share of these funds (altogether a couple of billions of euros) remained in the credit sectors of transition countries, indicating a sign of public confidence in banks and providing welcome financial resources to fuel the credit booms.

But the credit booms also gave rise to concerns, notably due to *financial risks* (renewed danger of non-performing loans, unhedged borrowers of forex-denominated loans) and *macroeconomic risks* (inflation, current account deficits, procyclicality of credits). The authorities (central banks and governments), satisfied with the catching-up dynamics, typically reacted with some delay to the continuing booms (see Table 5). They resorted to credit containment policies (including prudential tightening,

6. As the examples of Russia and Kazakhstan vividly demonstrate, substantial FDI inflows are not an indispensable prerequisite for very swift credit expansion.

Table 4: Financial intermediation in Central and Eastern Europe (early 1990s, 2000 and 2005)

Central European Countries

	Hungary			Poland			Czech Republic			Slovakia		
	1992	2000	2005	1992	2000	2005	1993	2000	2005	1993	2000	2005
Banking assets/GDP (%)	75.0	68.5	91.0	52.2[a]	63.3	66.3	131.4[a]	137.0	97.9	103.7[a]	91.3	95.5
Credit to the private sector/GDP (%)	23.4	30.1	44.8	39.0	21.5	27.4[c]	51.0	27.9	30.4	30.4	35.7	36.3

South-Eastern European Countries

	Bulgaria			Romania			Croatia			Serbia		
	1992	2000	2005	1993	2000	2005	1993	2000	2005	–	2000	2005
Banking assets/GDP (%)	123.7[a]	38.4	78.3	45.0[a]	29.1	45.4	70.4[a]	73.3	114.0	–	79.8	46.4
Credit to the private sector/GDP (%)	5.8	11.6	42.3	3.1	7.2	20.9	37.7	27.8	65.4	–	29.6	25.0

CIS Countries

	Russia			Ukraine			Belarus			Kazakhstan			Uzbekistan			Euro area
	1993	2000	2005	1993	2000	2005	1994	2000	2005	1993	2000	2005	1993	2000	2005	2004
Banking assets/GDP (%)[d]	21.4	33.4	45.1	33.9	21.8	51.1	39.0	29.5	32.2	27.9	20.3	60.6	53.5	39.7	37.8[e]	202
Credit to the private sector/GDP (%)[f]	11.8	13.5	25.7	1.4[b]	12.4	35.3	17.6	18.6	19.6	49.3	10.9	35.6	–	28.4	20.4	110.6

a) 1995
b) 1996
c) 2004
d) in 1993/1994: broad money/GDP
e) 2003
f) for Russia, Ukraine, Belarus, Kazakhstan and Uzbekistan credit volume/GDP

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

Table 5: 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	BEL	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, BEL = 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

Source: Barisitz 2007

increase of minimum reserve requirements, administrative restrictions, like credit ceilings – yet the latter gave rise to possibilities of circumvention). The effectiveness of these tightening measures has not been convincing, though.[7]

Notwithstanding undeniable progress, *lingering shortcomings* in the implementation of rules and regulations and in surveillance activity (including in some cases, the handling of IFRS), and deficiencies of the courts (e.g. weak enforcement of contracts, difficult access to collateral) have persisted in a majority of analyzed countries. Furthermore, notwithstanding important advances, as of late 2006, financial intermediation in Central and Eastern Europe retained generous expansion potential, as witnessed by the still much lower consumption of banking services (volumes of credits, assets) in relation to income/GDP levels than in Western Europe or the euro area (Table 4).

Table 5 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.

5. Conclusions from experiences of banking transition

5.1. Reform strategies and interdependencies

It appears essential to *coordinate* banking and enterprise reforms; otherwise, banking activity cannot take off. *Early and strong reforms* have proven to be economically less costly than hesitant or postponed reforms. Thus, early reformers, like Hungary and Poland, incurred relatively low budgetary recapitalization costs, while hesitant reformers, like the Czech Republic, Slovakia, Romania and Croatia, ended up with a high fiscal bill for restructuring their banks (see Barisitz 2007, 82). As mentioned earlier, the trajectory of banking transition from real socialism to capitalism can also be related to more general experiences. Although banking activities have also been repeatedly involved in serious real sector crises (like the current global economic crisis), according to Sylla 1999, a historic structural relationship between financial market development and economic modernization can be found. Gál, Novák and Szabó 2006, 36 arrive at similar conclusions.

5.2. The two reform waves in context

The author's above findings referring to two reform waves, with the second one installing hard budget constraints and capitalism, to some degree resemble Andreff's

7. For a detailed analysis of the development of credit activity in Central Europe and the Baltics see Backé and Žumer 2005.

conclusions *"Vers une deuxième phase de la mutation postsocialiste"* (Andreff 2003, 347). In these conclusions, Andreff points out that following a first phase of post-socialist reforms, important qualitative problems remained to be tackled, including corporate governance, restructuring, institutional adjustment. Therefore, in most transition countries, conditions for the good functioning of financial markets were not assembled before the late 1990s at the earliest (Andreff 2007, 20). A more distant similarity might exist between the concept of two reform waves and the *"Great Divide"* detected by Berglöf and Bolton 2003 between countries plagued with institutional backwardness and instability and those advancing on the paths of successful emerging markets. One would have to presume, however, that the Great Divide is a moving frontier.

5.3. Importance of institutional adjustment

Many policymakers and analysts, including those of international financial organizations, like the IMF, had originally probably underestimated the time it would take to change institutions, and allow new structures to emerge, in order to proceed from the formal introduction of new rules to the actual implementation/enforcement of the rule of law. In this sense, the swift elimination of old structures may have unexpectedly created a *systemic void* that persisted for some years and was taken advantage of by various actors, before the new institutions could grow into and occupy the void. As Fink, Haiss, Orlowski and Salvatore (1998, 444) pointed out ex-ante, only once institution and capacity building as well as economic restructuring were successfully completed could one expect a positive contribution of the banking sector to the economic recovery of the Central and Eastern European countries.

5.4. Key factor FDI

An interesting finding is that Western European, including Austrian, FDI has come to dominate banking in all former socialist countries that have either already become new members of the EU or are European candidates or have been given an official "perspective" to (eventually) join the Union. Where this is not the case – in Russia and other CIS countries – domestic ownership (conglomerates) or the state have strengthened their positions, although foreign strategic investors have made some inroads into Ukraine recently. It would thus appear that new EU member states, candidates or potential candidates are typically more attractive host countries for foreign direct investors than those countries that do not have this EU connection. The *clear requirements and expectations* with respect to the rule of law and observance of the acquis communautaire, which the perspective of EU membership holds, have

certainly helped in this regard.[8] Regarding FDI domination of the sector, new EU members + candidates + potential candidates, i.e. Central Europe + the Baltics + South Eastern Europe, or in other words: a strip of land stretching from Estonia, via Poland and Hungary to Bulgaria constitutes a *unique region in the world*. Nowhere else (possibly except in individual countries, like Mexico or New Zealand - but not in any multistate region) do foreigners wield such a high degree of control over banking systems worldwide.

5.5. Foreign dominance of banking sector – advantages, reactions and drawbacks

So far, privatization focusing on foreign strategic investors has turned out to be *more successful* than other strategies in the sense that it restructured banking sectors and rendered them competitive in a shorter time than other approaches did or conceivably could have done. There are not many examples of successful large domestically-owned banks in the region. Perhaps the most prominent, OTP (Országos Takarék-pénztár és Kereskedelmi Bank), 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 itself become an important foreign direct investor in the banking sectors of some of Hungary's neighbors (Barisitz 2007, 159-161). This is not to say that foreign takeovers are generally 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. Finally, a note of caution: Strong EU ownership links and pan-European banking networks can also bear or heighten dangers of cross-border transmission of risks and economic contagion.

5.6. Classification of experiences of individual countries with respect to the concept of two reform waves

The above-mentioned scheme of two separate banking reform waves (Table 5) appears to fully reflect the reality of institutional change in the majority of analyzed countries, namely in the Czech Republic, Slovakia, Bulgaria, Romania, Croatia, Russia and Ukraine. The scheme essentially, but not totally, reflects reality in Poland and Kazakhstan, where it is difficult to separate the waves which rather seem to form a

8. 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).

continuum of efforts and measures. The scheme only partly reflects reality in Serbia, where serious reforms did not start before the turn of the millennium. The scheme is hardly valid for East Germany because of the enormous compression of many measures and 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 the first half of the 1990s, which contributed to accelerating the pace of banking reforms and indeed created one compact sequence of events in that country.

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