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FINANCIAL SECTOR DEVELOPMENT IN TRANSITION ECONOMIES IN THE NEXT DECADE

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Introduction :

1. The role of the financial sector in all countries is of paramount importance. Banks are the intermediation agents between savings and investment. Only solid institutions are able to attract deposits and to channel them in a professional way towards productive opportunities.

   The efficiency of the banking sector and of the financial markets is a well recognized factor of lasting growth.

2. Freedom of capital flows is now a general feature in almost all countries. Combined with deregulation and a more and more integrated international financial system, this freedom is creating many opportunities for emerging economies (net financial flows to emerging countries have enormously increased over the past years and have boosted economic growth). But it is also leading to more vulnerability. Indeed, short term capital is volatile and, as South East Asian experience has shown, the lack of a robust, well capitalized and properly managed and monitored banking system can be a major source of weakness when investor's sentiment changes and when capital movements start to shift.

I shall divide my remarks in two sections :

1. First, I shall attempt to show how these trends are affecting transition economies and what progress has been made in terms of their financial institutions.

2. I shall then turn to the future and try to outline the possible avenues offered to transition countries regarding banking systems and capital markets. This will be, of course, in the light of the European Union accession process.

I. WHAT HAVE BEEN THE DEVELOPMENTS OF THE FINANCIAL SECTOR IN TRANSITION ECONOMIES IN A WORLD OF FREE CAPITAL MOVEMENTS ?

1. Where do the transition economies come from in terms of their financial sector ?

If one wants to understand what have been the developments of the financial sector in those countries, it is useful to look back at the starting point.

Under central planning, the financial system was little more than "a book keeping mechanism for tabulating the authorities decisions about the resources to be allocated to different enterprises and sectors[1]." And securities markets were absent since there were no marketable securities available. Therefore there was no need for prudential and supervisory regulations.

Hence, the challenge for the transition economies after 1989 was huge : to create from scratch a functioning financial system.

2. The progress made in the banking system has been in general quite significant albeit uneven and incomplete.

The problem was all the more difficult to resolve that state-banks had portfolios dominated by non performing loans and that their personnel had little technical skills in the field of banking.

In the aftermath of 1990, transition countries acted towards creating a true banking system in different directions :

- privatization of state-banks,
- development of new banks (private).

Methods of privatization varied from country to country. For instance, in the Czech Republic we saw a rapid move towards privatization based on the voucher scheme which had the political advantage of speed but led to a number of problems related to the absence of new equity and know-how inherent to that method. Other countries like Hungary or Poland took more time to privatize their banks but did it by allowing strategic partners (most often foreign) to participate in the privatization process which eventually

[1] EBRD Transition Report – 1998

brought significant benefits (equity, corporate governance, worldwide presence…). The EBRD played a useful role in the process.

In Russia, the weakness of the regulatory authorities allowed the creation of numerous small private banks which were generally not prepared to perform the banking functions in a professional way.

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

The causes of those crises were different from country to country but in all cases one can see the combination of two factors :

- **accumulation of bad loans** (either inherited of the past communist period or developed under the new conditions and in particular because of the insistence of governments to protect loss making companies) ;
- **insufficient regulation and supervision of the banking system.**

Therefore the "repair" of the banking sectors in transition countries has been a major task that has developed over the years and is still not completed in all countries. It has implied massive capital injection by the states. In order to make privatization possible the governments have to either provide directly equity to the ailing privatizing banks or to "carve out" impaired assets from their balance sheets.

The costs of these actions to repair the banking systems in transition countries have typically cumulated to figures of the order of 10 % of GDP per country. But one must immediately add that this is by no means unique to transition economies. Banking sectors in other countries, be they industrialized (cf Scandinavian countries and Japan) or emerging (Latin America, South East Asia) have also been subject to crises which have led in some cases to more heavy equity injections than in transition countries.

One could also add that these banking crises in transition countries did not always produce the very severe economic disruptions typical to many other countries. This is probably because transition economies have a relatively underdeveloped financial intermediation system.

If one looks indeed at the ratio of bank credit to the private sector relative to GDP by the countries level of per capital income, one observes that transition economies, except for the Czech Republic, are well below the corresponding market economies. But this gap is gradually eroding with the progress made over the last years in strengthening the banking systems in transition countries.

Indeed enormous progress has been made in a number of transition countries in terms of banking supervision, privatization and consolidation. Hungary for instance is characteristic for the very wide privatization of its banking system which is now largely controlled by foreign strategic partners and well supervised. Poland is also very much advanced in that direction and the Czech republic is catching up rapidly with the privatization of its banking system.

In Russia, the systemic crisis of the banking sector is not yet overcome and the restructuring process needs more clarity.

In a number of less advanced transition countries bank consolidation and privatization is one of the major tasks ahead and one which is most often at the center piece of IMF programs.

3. **The progress made in building local financial markets has been less striking.**

It is notable that financial systems in transition economies have less depth and breadth than those of market economies at comparable levels of development (where development is measured by per capita GNP).

If one looks at market capitalization of local corporates and compare it with other emerging market economies one sees that **the stock market capitalization in transition economies remains relatively low**, although it has developed over the recent years in countries like Czech Republic, Hungary, Poland, Slovenia. The stock markets in the region have also seen considerable volatility in recent years.

In this regard, it is interesting to look at the balance between risk and return offered by the stock markets in transition economies. The industrialized market economies and developing countries have tended to offer a more favorable balance between risk and return over the past four years than have the transition economies as a group. Except for Hungary, the price-to-book-value ratios are lower in the transition group than in developing countries. It is clear that firms that are successful in investing their capital as well as their borrowings will tend to have strong prospects for earning growth and will have low discount rates applied to their future earnings (slide 1)[2]. In a way, one could read those price-to-book-value ratio as a reflection of the business climate in the interested countries.

[2] cf. EBRD-Transition Report – 2000 update.

II. LOOKING TO THE FUTURE : AVENUES OFFERED TO TRANSITION COUNTRIES REGARDING BANKING SYSTEMS AND CAPITAL MARKETS.

1. General considerations :

It seems clear that long lasting growth in transition economies requires the conjunction of two major elements :

- stronger local savings,
- higher investment in the productive sector.

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

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

One could have imagined that, starting from scratch, their financial systems would have adapted to the new trends, thus circumventing the process of rebuilding a classical network of commercial banks. But that would not have been possible given the existence of banking systems (albeit inefficient) in those countries.

Therefore the transition countries will have to reinforce their financial systems and allow them to adapt to the changing trends and to adopt new technologies and best industry practices.

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

As far as the development of capital markets is concerned, one must insist on the importance of :

- **clear regulation,**
- **strong supervision,**
- **protection of minorities' rights,**
- **progress of privatization,**
- **improving the business climate and openness towards foreign investors,**
- **developing pensions systems,**
- **strengthening macroeconomic fundamentals….**

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

Transition countries need a modern capital market and a good banking system to help their corporates and their many SME's raise funds more easily.

2. EU accession :

In 1993, the European Council in Copenhagen adopted the principle of the European Union enlargement. Ten countries : Czech Republic, Estonia, Hungary, Poland, Slovenia, followed by Bulgaria, Latvia, Lithuania, Romania, Slovak Republic, are now in the negotiation process.

a) Principles and procedures.

The process has started in December 1998 with the first wave of five candidates followed later by the second wave.

The "pre-accessions strategy" consists in combining reforms by the candidate countries and some financial assistance by the Union. The idea is to help the candidates before accession to conform with the "acquis communautaire".

The procedure is based on the negotiation with each country of an "accession partnership". These partnerships outline the list of priorities - short and medium term- which have to be met before accession. The partnerships also lay out the amount of resources that will be allocated to each candidate (total of 3 billion Euros per year starting in year 2000). This financial assistance is conditional upon progress achieved in terms of reforms : it can be suspended in case of non satisfactory performance.

Each country is being assessed continuously according to its performance and will become member of the Union when it will have met the obligations that apply to all member states. Negotiations are conducted on a bilateral basis between the Union and each candidate.

b) State of the negotiation :

Each country is assessed towards the month of November of each year in terms of its progress towards accession.

The last November 1999 Commission's Paper stressed for example that : "apart from Hungary and Poland, all of the candidate countries need to make major efforts to ensure financial control. The development of internal control system requires particular attention".

More recently, the European Commission has proposed to strengthen the process regarding financial institutions. The Commission notes : "that from the moment at which their countries join the EU, financial institutions from Central and Eastern Europe countries should receive an "European passport" allowing them to operate under home country supervision in the entire EU. In view of this, the accession countries will have to fully adopt all EU financial services legislation. The Commission therefore will continue its current efforts to monitor the transposition of the "acquis communautaire". **However, formal transposition of the "acquis" into national law is not all that is required. There will also have to be supervisory bodies with sufficient "administrative capacity" to implement the national law in actual practice.** It will therefore be necessary :

- to lend “technical assistance” to candidate countries, helping them to build this capacity,
- and to assess the resources, experience and prudential techniques of supervisory bodies in theses countries, possibly by way of “peer review procedures”.

Since the Commission cannot by itself provide the necessary assistance to the financial services supervisors in those countries, nor check their efficiency, **it is therefore looking to “the Member States” prudential authorities” for assistance and advice.**

Evaluation in this context should be based on reviews carried out by supervisors from EU countries and/or on assessments made under the “Financial Services Action Program” of the International Monetary Fund in co-operation with the World Bank.

The results should either determine further needs for institution building or should help to judge the effective transposition of the “acquis” by a given country. In view of this, the results should, after being seen by the appropriate contact bodies of supervisors at EU level, be transmitted by the Commission to the Enlargement Group of the Council”.

I very much hope that this most sensible proposal will be quickly and effectively adopted by the EU member States.

c) Timetable :

Contrary to the wish of certain candidates, the European Council has not fixed a timetable for the enlargement nor an objective date for the first accession. What the fifteen countries have agreed upon is that the European Union would be ready from the end of 2002 to accept new members if three conditions are met :

- sufficient financial resources,
- completion of the institutional reform of the Union,
- satisfactory bilateral negotiations on accession.

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

One has to add that economic and monetary Union is an integral part of the accession process. Accession implies indeed that the new members commit themselves to participate in the monetary Union (as long as they meet the convergence criteria fixed in the Maastricht Treaty). But the observance of those criteria is not a necessary condition for acceding to the European Union. Therefore candidates will very probably enter the Union first and the monetary Union later on.

I don’t think that one should focus too much in terms of a precise timetable given the complexity of the negotiations and the financial stakes at hand. Each country will have to negotiate thoroughly and, at least in some fields, some may have to go through transition periods.

All in all, as I have tried to show, considerable progress has been made in terms of strengthening the banking and financial institutions in transition countries. And this is all the more remarkable that it has been accomplished in less than ten years from a very low starting point. But there is still quite a lot to work on.

I believe that the accession process is proving a powerful engine to push strategic reforms, consolidate and expand further what has already been achieved.

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

Price-to-book-value ratios in world-wide stock markets, average 1996-99