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FINANCIAL SECTOR DEVELOPMENT IN THE FUTURE EU MEMBER STATES AND RUSSIA[1]

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INTRODUCTION

Financial sector development is an important feature of the long-term real and nominal convergence of the Future EU Member States, and of the successful completion of transition to the market economy in Russia and other "transition" economies. The importance of the development of a strong financial sector, both in the Future EU Member States and in Russia, is strengthened by two factors. First, there is an increased body of empirical and theoretical literature that shows a positive correlation between financial sector liberalization and development for economic growth and stability (see Beck and Levine, 2000). This literature also shows that policies matter: both general macroeconomic conditions and system-specific measures influence the speed and stability of financial deepening and development (see Vinhas de Souza, 2004). Second, the current levels of financial development in the Future EU Member States, and even more in Russia, are far from the levels achieved by advanced countries, which shows the potential for convergence and catch up in this area.

Numerous empirical and theoretical studies demonstrated the link between financial development and economic growth and stability. The theoretical and empirical approaches have highlighted the importance of an efficient use of information in investment decisions and resource allocation, where the financial sector plays a key role in supplying, allocating and monitoring the funds for investment. Advanced financial sectors can raise savings by offering secure and attractive returns to savers and by ensuring that all savings are utilized in their most efficient way guarantying thus that all savings are translated to real investments. There is a positive correlation between the level of financial development and ability of the financial sector to monitor through various sets of arrangements and contracts, and to promote corporate discipline and performance, and stimulate the increase of productivity in the corporate sector. Advanced financial sectors and accelerated financial development can stimulate economic growth by providing the financial tools for growth and investment.

Besides the positive links between finance and growth, financial sector development is also important for the Future EU Member States and in "transition" economies due to their ongoing process of real and nominal convergence to advanced ones. Financial sector development reflecting the increase in the size, depth and efficiency of the financial sector, is closely linked to real convergence, proxied by the catch up of incomes. On the other hand, the financial sectors of the Future EU Member States are likely to be significantly larger and more sophisticated at the end of the real convergence process than today. This can be gauged by looking at the differences between their size in the Future EU Member States and the EU average: in 2002, financial assets to GDP in the former group was *one third* of the EU average, while the GDP per capita level (on PPP rates) was on average around 50% of the EU. This means that, on average, financial sectors still have a huge growth potential in these economies.

Financial development is also important for nominal convergence and the transmission of monetary policy. Deeper financial sectors could contribute to faster and perhaps less costly disinflation[1], could promote bigger exchange rate stability and could help in financing and eventually reducing fiscal deficits and public debt. In case of the monetary policy transmission mechanism, financial sector development could result in the gradual shift of the channels from the currently dominant *exchange rate* channel to the *monetary aggregates* channel (currently prevailing in Russia: see the sister paper of this project by Vinhas de Souza at al., 2003), and later, the *interest rate* channel that prevails in the advanced European economies, which is essential for smooth integration to the common monetary union (as increasingly the case in the Future Member States: see Sepp at al., 2003). The increased

[1] IMF, 2003(b), shows that the disinflation "GDP loss" costs in the Future EU Member States are far smaller than at the CIS.

reliance on the interest rate channel requires well-functioning money markets to ensure an efficient distribution of liquidity in the banking system, a financially sound banking sector, which reacts swiftly to changes in interest conditions, and a more developed financial sector.

In Russia, the banking (and the financial in general) sector has gone through deep changes following its virtual collapse after the August 1998 financial crisis. While several shortcomings leading to the collapse of the banking sector were addressed in recent years, and financial reform progressed rapidly, the banking sector and in general financial development are low compared both to the Future EU Member States and the financing requirement of the Russian economy. The Russian banking sector still faces the problems of underdeveloped structure, simultaneously heavily concentrated and dispersed size, inadequate control over the activity of banks, low quality of supervision and regulation, etc. Taking into account the significant differences in size, history and performance of the banking sector, the recent catch up of the banking sectors in the Future EU Member States could provide some references for Russia and other economies in transition.

On the other hand, financial liberalization and integration can, however, also be dangerous, as has been witnessed in many past and recent financial, currency and banking crises. It can make countries more vulnerable to exogenous shocks. In particular, if serious macroeconomic imbalances exist in a recipient country, and if the financial sector is weak, be it in terms of risk management, prudential regulation and supervision, large capital flows can easily lead to serious financial, banking or currency crises. A number of recent crises, like those in East Asia, Mexico, or Turkey (described, for example, in IMF (2001)), and, to some extent, the Argentinean episode of late 2001, early 2002, have demonstrated the potential risks associated with financial and capital flows liberalization.[2]

The Future EU Member States have a rather different experience concerning the financial liberalization process then other emerging regions, as the process there seems to have been much less crisis-prone – so far, at least- than in, for instance, Asia or Latin America, not to mention Russia. One of the reasons for this is that the current high degree of external and financial liberalization in the Future EU Member States countries, beyond questions of economic allocative efficiency, must be understood in terms of the process of Accession to the European Union, which will lead to the Accession of most of the candidate countries in Eastern Europe already in May 2004 (see Box I below).

The EU integration process implies legally binding, sweeping liberalization measures –not only capital account liberalization, but investment by EU firms in the domestic financial services, and the maintenance of a competitive domestic environment, giving this financial development and liberalization process strong external incentives *and* constraints. Those measures were implemented parallel to the development of a highly sophisticated regulatory and supervisory structure, again based on EU standards[3]. This whole process happened also with the EU's technical and financial support, through specific programs –like the PHARE one, for these so-called "Acceding Countries", and the TACIS, for the former Soviet Union ones- and direct assistance from EU institutions, like the European Commission, the European Parliament and the European Central Bank (also, on a very early stage of the transition process, the influence of the IMF in setting up policies and institutions in several

[2] A good example of a recent work that supports this cautious line on financial liberalization *for emerging markets*, published by no other organization than the IMF itself, and actually co-authored by its them Chief Economist, Kenneth Rogoff, see **Prasad at al, 2003.**

[3] Also, between 1995 and 2000, all "Visegrad" Countries (the Czech Republic, Hungary, Poland and Slovakia) became OECD members, another multilateral "framework provider".

countries in the region –an intervention widely considered to haven been *successful*- was very important: see Hallerberg at al., 2002).

Additionally, the very possibility of EU membership in the near future seems to act as an anchor to market expectations (see Vinhas de Souza, 2004), limiting the possibilities of self-fulfilling financial crises and regional contagion (see Linne, 1999), which had the observed devastating effects in other emerging regions like Asia and Latin America (even a major event, like the Russian collapse of 1998, had very reduced regional side effects in the Acceding Eastern Europe). Several regional episodes of financial systems' instability did happen (see Vinhas de Souza, 2002) but none with the deep, prolonged negative consequences observed in other regions and in Russia itself (which was also due to the effective national policy actions undertaken after those episodes). This "anchoring" role of the European Union in the Future EU Member States, through the perspective of EU membership, and through the effective support of international standards of financial supervision and regulation, may indicate that a greater, pro-active regional stabilizing role of the Union would be advantageous for Russia also[4].

The remaining part of the study is organized as follows. The first chapter provides brief description of the major feature of the financial sectors in the Future EU Member States. The second chapter gives a comparative assessment of the main policy issues affecting financial sector development in these countries. The next part of the study describes the development of the Russia financial sector, the main weaknesses following the currency and banking crisis of August 1998. The fourth chapter summarizes briefly those main lessons that can be learned by Russia and other transition economies form the experiences of the Future EU Member States.

[4]As an effective example of this, one may use the multi-year (and worth millions of Euros) project signed in late 2003, financed by the EU-TACIS and using the ECB –European Central Bank- as the Union's operative agency to transfer financial supervisory skills to the Central Bank of Russia.

Box I: EU Accession

The process of integration of the Baltic and Eastern European countries into the European Union is, after the abandonment of the enforced command economy experiment, the single most important determinant factor in their development throughout the 1990s and early 2000s.

As early as July 1989, a G-7 meeting had decided to ask the European Commission to coordinate economic restructuring measures for Hungary and Poland. This evolved to the European Council meetings of Copenhagen of June 1993 and Essen in December 1994, which defined an overall strategy to bring the associated countries of Eastern Europe closer to the Union.

As a result of this, and of the formal applications for membership from the Eastern European Countries (Poland and Hungary applied as early as 1994), and the publication of the "Agenda 2000" in July 1997 by the European Commission, the EU launched in March 30, 1998 official Accession processes with Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. Substantive negotiations for Accession were opened on November 10, 1998, with the Czech Republic, Estonia, Hungary, Poland and Slovenia. After a European Council meeting, held in Finland in December 1999, substantial negotiations for accession were opened with all the remaining applicant countries in 2000. The official opening of substantive negotiations for Accession with the new Accession Countries happened in February 15, 2000 in Brussels. The Accession negotiations where concluded at the European Summit in Copenhagen on December 12/13, 2002, and the Accession Treaty was signed in April 16, 2003.

The bulk of the ACs (namely, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) will become member states already by May 2004 (subject to ratification of the Accession Treaty by the national parliaments of the current member states and, in some cases, by plebiscite), and with some temporary derogations in terms of the "four freedoms" that underpin the Common Market, namely the one concerning the free movement of labor), while Bulgaria and Romania have been given 2007 as a target date for their Accession.

Accession, of course, implies comprehensive, systemic reforms far beyond the financial system, expressed in the adoption of the *Acquis Communautaire*, the body of legislation of the European Union.

I. KEY FEATURES OF FINANCIAL SECTORS IN THE FUTURE EU MEMBER STATES

When analyzing the structure of the financial sector in Future EU Member States, this study will focus on those common features which make them distinct both from advanced industrial economies and "transition" economies. The description will focus on those common features that ultimately determine the nature of financial sectors, while the differences existing between the individual countries will only be mentioned separately. The main similarities between the Future EU Member States can be found in the generally low (compared with advanced economies) level of financial intermediation, strong dominance of the banking sector within financial intermediation (acceptance of the "Continental European" model of financial development), *very* high degree of foreign (mostly EU) involvement, partially existing or underdeveloped financial market segments or niches, and perhaps a higher financial sector vulnerability to exogenous shocks.

1.Relatively low level of financial intermediation. After a decade of transition and bank restructuring, the level of financial intermediation in Future EU Member States countries is above the CIS level but well below the one observed in mature market economies. While there are differences between the individual economies, all indicators of financial intermediation (private sector credit to GDP, M2 to GDP and others) reveal, that the level of financial intermediation is lower than the current level in advanced countries, and than the latter economies had at similar stages of economic development in the 1960-1970s. The low level of financial sector development is also reflected in the low penetration of both banking assets and capital market securities in the economy.

While, due to the Continental European model of financial development, banks are by far the most important pillar of financial sectors of Central European countries, the banking sector is currently still small relative to GDP. In most countries, the relation of banking assets to GDP amounts to about one-quarter of the corresponding figure of the EU-15: while in the EU-15, bank assets amount to about 265% of GDP, asset volumes amount to between 30% and 100% of GDP in the Future EU Member States. Only the Czech Republic and Slovakia have bigger banking systems with bank assets amounting to about 130% and 95% of their GDP.[5] The limited level of banking intermediation is reflected also in the low share of domestic credit to GDP: in the Future EU Member States, on average, it amounts to around one-third of that in the EU-15. Even in the Czech Republic domestic credit extended by the banking system amounts to only about one-third of the banks' assets and 60% of GDP, which makes it 40% of the corresponding level in the EU-15.

This low financial depth can be traced back to three factors. First, those economies inherited underdeveloped, undercapitalized, badly managed banks from the past and the problems of their restructuring affected strongly developments in the 1990s. Second, banking sectors had to face very serious exogenous and institutional shocks, which kept the level of financial intermediation low. The most important from these shocks were the high and persistent inflation, output collapse, financial and currency crises at home and abroad.

The Future EU Member States took several years to break from the consequences of the undesired banking and macroeconomic difficulties. Even when these shocks and other "transition" related problems were managed with increased success, and those economies shifted to sustainable growth

[5] The high share in these two countries is partially a result of the existence of a significant banking system already under the socialist regime, but partially reflects the existence of bad and non-performing loans.

(with sizeable differences in terms of dynamism and timing), this has so far a relatively reduced impact on financial intermediation. The well known two-sided (demand-led and supply driven) relationship between economic growth and financial development runs in case of the Future EU Member States from growth to financial deepening: output and income growth gradually increase the demand for financial services and lead to higher levels of financial intermediation.

Besides the macroeconomic factors, microeconomic ones also explain low level of banking activity as private banks were newly established with delays in the adequate legal framework. On the liabilities side the low share of deposits to GDP (one-third of the EU-15 as a share of GDP) constrains the role of financial sector. This phenomenon is due mainly to past and long experiences with inflation, low though gradually improving confidence in the banking system and non-attractive returns on deposits, and reflects a limited ability of credit institutions to channel financial savings into investment.

One consequence of this is the more limited presence of the domestic banking sector in financing domestic corporations. In case of bigger firms the investment decisions are financed through cross-border borrowing or foreign direct investment inflows. Domestic banks play a marginal role also in the financing of SMEs (small and medium enterprises), though this sector has much less potential for foreign borrowing due to asymmetric information, lack of credit track record and collateral. These factors also constrain SMEs to borrow from the banks: but the market position is gradually changing, as banks need to find new market niches after the market for medium and big companies has already been divided, which led to increasing lending to SMEs though from low starting values.

2. Strong dominance of the banking sector. The financial systems in the Future EU Member States are bank-based and the dominance of the banking sector –or the corresponding underdevelopment of capital markets– is even more pronounced than in advanced economies. The relation of domestic bank credit to stock market capitalization is about 2.8 in them, compared with about 1.8 in the EU. The gap between bank-provided financing and market-provided financing increases even further in the Future Member States, once international linkages are considered as well. Various data on financial intermediation via foreign banks and foreign stock markets suggest that *bank financing from abroad* is even more important than market financing from abroad[6].

Financial integration, in the form of opening up the banking sector to foreign banks, is seen as being positive, as foreign banks are usually better capitalized and more efficient than their domestic counterparts (see, among other, Tomova at al., 2003), but that the domestic banks are catching-up. Also from a macroeconomic perspective, financial integration is positive for the Eastern European countries, as there are indications that foreign banks do not contract either their credit supply nor their deposit base when faced with economic shocks (see de Haas and Lelyveld, 2003: they find some indication that this is linked to the better capitalization base and prudential ratios, as better capitalized domestic banks behave similarly to foreign banks). Given the "bank-centered" nature of virtually all the financial systems of the future Member States, this is particularly important. The evolution along this bank-centered model is partly related to a "path dependency" reason, as historically these economies have relied more on banking services, and this pattern has re-emerged during the transition period, because newly privatized corporations refrained from going public, and maintained close links with banks. Moreover, corporate sector weaknesses, high and unstable inflation, serious regulatory and supervisory problems prevented the rapid growth of capital markets.

[6]Interestingly enough, the two Central European countries that used voucher type privatization and stimuli for capital market development, the Czech Republic and Slovakia have financial structure most skewed towards banking finance due to the relatively larger size of the banking systems and despite non-negligible capital markets.

In most of the future member states, the initial stage of the creation of the two-tier banking system,[7] modelled on the Western European "universal bank" system,[8] was characterized by rather liberal licensing practices[9] and limited supervision policies (aimed at the fast creation of a *de novo* commercial, private banking sector: see Fleming at al., 1996, Balyozov, 1999, Enoch at al., 2002, Sörg at al., 2003). This caused a mushrooming of new banks in those countries in the early 1990s.

Parallel to this, a series of banking crises, of varied proportions, affected most of those *de novo* banking systems, due to this lax institutional framework, inherited fragilities from the command economy period (the political need to support state-owned, inefficient industries, with the consequent accumulation of bad loans and also the financing of budget deficits), macroeconomic instability, risky expansion and investment strategies and also sheer inexperience, both from the investors and from regulators. Progressively, the re-capitalization, privatization and internationalization of the banking system (mostly into the hands of EU financial conglomerates), coupled with the implementation of a more robust, EU-modeled institutional framework, did away with most of those problems.

Two of the worst cases where the set of Baltic banking crises and the Bulgarian episode, which will be described in more detail on Box II below. Other smaller banking crises happened in Estonia in 1994 and 1998, and in Latvia in 1994. Caprio and Klingebiel, 2003, report smaller episodes of "financial sector distress" in the Czech Republic (94-95), Hungary (93), Poland (91-93),[10] Romania (98-00), Slovakia (97) and Slovenia (92-94).

The initial proliferation of banks was, quite naturally, followed by a process of consolidation and strengthening –parallel to the privatization of the remnant state-owned components of the financial system- of the banking sector in most of those economies (in Bulgaria, from 81 in 1992 to 35 in 2001, in the Czech Republic from 55 in 1995 to 38 in 2001, Estonia, from 42 in 1992 to 7 currently, while Hungary 33 banks in 2002, showing only a very slight decrease,[11] Latvia from 56 in 1994 to 23, Lithuania from 27 in 1993 to 13,[12]in Poland from 81 in 1995 to 71 in 2001,[13] in Romania from 45 in 1998 to 41 in 2001,[14] in Slovakia from 22 in 2000 to 19 in 2001, and in Slovenia, where the number fell from 25 to 21 during 2001 alone[15]).

[7]In the Baltic states, already in 1987, as part of the Gorbachov reforms, the monobank Gosbak (which formed *the* financial system, together with an emissions bank) had spun-off five specialized banks in all URSS republics (Savings, Agriculture, Social, Industry and Construction, and Foreign Trade: a somewhat similar specialization was to be found in most other centrally planned economies, with, at least, a central bank, a savings bank and a foreign trade one).

[8]Levine (2002), after performing a panel analysis of large number of countries, concludes that both bank and market-based (i.e., via stock markets) financial systems can be growth-enhancing: what actually is relevant is the overall development of the financial sector and, specially, *the quality and effectiveness of the institutional framework* (contract enforcement, investor protection, etc.).

[9]Sometimes almost comically so: as an example, in the early 1990s, Latvia allowed the creation of a bank –appropriately called Olympia Bank- just to finance the Latvian Olympic team.

[10]Reininger at al., 2002, estimate the costs of the re-capitalization programs to have reached 12% of the GDP for the Czech Republic, 7% for Hungary and 1.4% for Poland, for the late 1990s. Caviglia *at al.*, 2002, quotes much higher figures (25%, 13% and 8%), but those figures are for the whole 1990s.

[11]Plus 8 credit institutions, and 191 savings and credit cooperatives.

[12]Plus 41 credit unions.

[13]Plus 642 cooperative banks.

[14]Plus 925 credit cooperatives and an astonishing *4,439* credit unions.

[15]Plus 45 savings and loans institutions.

This consolidation process was frequently led by foreign companies, which now hold the majority of the assets of the banking system in virtually all of them –contrary to the situation in the current EU Member States, bar Slovenia.[16] This process now has a component of regional expansion of the Eastern European banks themselves, or, more precisely in most cases, the regional expansion of *Western* banks via some of their locally-owned subsidiaries (see Sörg at al, 2003, ibid). The share of banking assets to GDP, nevertheless, is still far below the Euroarea average (which stood at around 265% of GDP by end 2001), compared with 47% in Bulgaria, 136% in the Czech Republic, 72% in Estonia and Latvia, 32 in Lithuania,[17] 63% in Poland, 60% in Hungary, 30% in Romania, 96% in Slovakia and 94% in Slovenia (data also for 2001).[18]

The supervision system has also substantially improved, and, following recent international –and EU- best practice, is now centered in independent universal supervisory agencies in the most advanced of those countries[19] (Reininger at al., 2002, ibid., estimate that the *formal* regulatory environment for the Czech Republic, Hungary and Poland is actually above the EU, and that its *actual* enforcement level is at its average; Liive, 2003, gives a description of the Estonian experience that culminated in the creation of the EFSA –Estonian Financial Supervisory Authority- in January 2002).

[16]In Bulgaria, around 80% of the assets of the banking system are foreign owned, 95% in the Czech Republic, 63% in Hungary, 70% in Poland, 55% in Romania, 83% in Slovakia. In the Baltic republics, around 98% of assets in Estonia, 68% in Latvia, and 87% in Lithuania are foreign owned (see Sörg at al., 2003, ibid). Especially for Estonia, were 82% of the assets are Swedish-held, this may imply a high likelihood of exposure of its financial system to parent bank country-specific shocks (which also depends on the degree of diversification of assets of the parent bank: see IMF, 2003(b)). Slovenia is the "laggard", with 25.3% of the banking system still state-owned (Romania has the highest share of state-ownership, with 42%), and only 28% foreign owned –which, nevertheless, was an almost doubling of the share, just between 2001 and 2002.

[17]Foreign currency lending to *residents* is very high, especially in the Baltic republics: with 80% of total loans in Estonia, 56% in Latvia and 61% in Lithuania. Also, the Baltic countries have substantial shares of deposits by non residents, with over 10% in Estonia and Lithuania and close to 5% in Latvia (Latvia, with its close trade ties to Russia, has a particular strategy of selling itself as a stable financial services center to CIS depositors: see IMF, 2003(b), ibid). In Hungary, foreign bank loans to the non-bank commercial sector account for almost 60% of all foreign loans towards Hungary, and within the debt of the corporate sector owed to the banking one, foreign loans represent an equal share.

[18]Part of this financial shallowness is due to the fact that a substantial part of the investment financing for companies is done via inter-company financing, due to the large share of foreign ownership, and due to direct commercial financing with non-resident banks. The latter also happens, to smaller degree, with commercial credit to households (see Reininger at al, 2002, ibid., and Caviglia at al, 2002, ibid.)

[19]Nevertheless, Garcia Herrero and Del Rio, 2003, find no significant difference in terms of financial sector stability between central bank-centered and independent financial supervisory authorities. Schinasi, 2003, describes the rationale for central bank-centered financial supervisory authorities.

Box II: Banking Crises in Eastern Europe

The Baltic bank crises were, to different degrees, linked to liquidity difficulties related to relations with Russia (in the November 1992 Estonian case, by the freezing of assets held by some Estonian banks in their former Moscow headquarters, while the Latvian and Lithuanian episodes of, respectively, March and December 1995, were caused by the drying-up of lucrative trade-financing opportunities with Russia, whose export commodities, at that time, were still below world price levels) and regulatory tightening (Latvia, Lithuania), compounded by the elimination of credit opportunities with the implementation of the Estonian and Lithuanian CBAs (Currency Board Arrangements). In Lithuania, as in Bulgaria, the financing of the budget deficit also played a role. In the Estonian and Latvian cases, around 40% of the assets of the banking system where compromised, in the Lithuanian and Bulgarian cases, around a third.

The Bulgarian 1996-1997 crisis eliminated a third of the banking sector, and led the country to hyperinflation (reaching over 2000% in March 1997, see Yotzov, 2002). Its roots lie in the political instability that preceded it (which, on its turn, led to inadequate real sector reform, with state-owned, loss making enterprises being financed via the budget deficit on through arrears with the, at the time, still mostly state-owned part banking sector: those arrears were, in turn, partially monetized by the Bulgarian National Bank –BNB- and the largest state bank, the State Savings Bank -SSB). Periodic foreign exchange crises (March 1994, February 1997) and bank runs (late 1995, late 1996, early 1997) were part of this picture. The implementation of tighter supervisory procedures during 1996 (giving the BNB the power to close insolvent banks), and a tightening of policy actually led to more bank runs. A caretaker government in February 1997 (before a newly elected government took power in May) paved the way to longer lasting reforms and the implementation of the CBA, with its tighter budget constraints towards both the government and the banking sector. This process happened with the support from multilateral institutions (namely, the IMF).

3. Much weaker capital markets Compared to the banking sector, capital markets in the Future Member States are used less as a source of finance (and, in some, *much less*: in Bulgaria, Slovakia and Romania, their average market capitalization in GDP terms is below 5%: see Figure I below). Capitalization of both stock and bond markets relative to GDP, as well as the absolute size of the capital markets is low: total stock market capitalization of the Central European countries only was equal to 5% of total stock market capitalization in the EU-15. The largest stock market is Poland, accounting for about €29 billion, while the capitalization of stock markets in the Czech Republic and Hungary were each about €11 billion. In relative size, the average market capitalization of Central European countries equaled in 2002 16% of GDP and represented less than one-quarter of EU-15 average market capitalization.

Several reasons explain the limited role of stock markets in financial intermediation. First, markets have only been recently set up and their initial years of evolution were accompanied by serious structural changes, comprising enterprise restructuring, privatization and establishment of appropriate legal and regulatory framework. While these developments themselves required some time, they created uncertainty concerning the evolution of capital markets. Second, banks played a more important role in enterprise restructuring than capital markets: on the supply side this was due to the information advantage of banks, while on the demand side to distrust of savers in capital markets, which exceeded that of the banking sector. Third, foreign direct investment has been an important element in both privatization and restructuring of firms and served -due to lack of domestic capital- as the main alternative to capital market financing. Finally, the recent global capital market weaknesses did not help either, as those economies are closely integrated to the global financial markets and the negative developments in advanced countries' stock exchanges rapidly spilled over to them. This slowed down the growth of capital markets even when the positive effects of the expected EU membership are accounted for. Moreover, turnover has been declining on most countries' stock

exchanges in recent years, as the domestic base of institutional and individual investors has remained narrow, and most markets have not reached a sufficient critical mass to attract foreign investors.

Table I: Date of (Re-)Creation of Stock Exchanges.

Country	Date of Creation of Stock Exchange
Bulgaria	-5/92: First Stock Exchange begins trading (up to 20 regional ones created); 10/97: The Bulgarian Stock Exchange-Sofia (resulting from the consolidation of the previous ones) opened. Stock index available from 1/98
Czech Rep.	4/93: Current Stock Exchange begins trading. Stock index available from 5/94
Estonia	-5/96: Foundation of Tallinn Stock Exchange; 2/02: Merge with Helsinki Stock Exchange (HEX). Stock index available from 6/96
Hungary	-6/90: Stock Exchange (re-) established. Stock index available from 2/91
Latvia	-12/93: Stock Exchange established. 8/02: Finnish HEX acquires Riga Stock Exchange and Depositary. Stock index available from 2/96
Lithuania	-9/93: Stock Exchange trading begins. Stock index available from 1/96
Poland	-4/91: Warsaw Stock Exchange re-opened. Stock index available from 5/91
Romania	-11/95: Stock Exchange begins to operate. Stock index available from 5/98
Slovakia	-4/93: Stock Exchange begins trading. Stock index available from 9/93
Slovenia	-12/89: Stock Exchange established. Stock index available from 1/94

All of the Future Member States countries had (re-)established stock markets[20] by the mid-90s[21] (see Table I above). About half of them used those to drive the initial process of re-privatisation, either via mass issues of voucher certificates for residents (the most famous case of this strategy was the Czech Republic), or via IPOs (Initial Public Offerings) re-privatisation processes[22] to lock-in domestic and foreign strategic investors (see Claessens at al., 2000).

In the voucher-driven privatization, the initial large number of investors and traded stocks in those stock markets was soon concentrated in a rather limited number of institutional investors –domestic and foreign- and "blue chip" stocks.[23] In the IPO-driven markets, the number of stocks and investors actually tended to increase with time, albeit from a rather concentrated base. For instance, in Czech and the Slovak Republics, the voucher-type privatization led to an expansion of firms listed on the stock exchange but the widespread ownership limited corporate governance structures and weak enterprise performance lead to corporate delistings, while in Hungary and Poland, enterprises were only listed after the establishment of a framework for securities trading and stock market development was linked to progress in governance and restructuring privatization. The evolution of capital markets was more balanced and slower in the later, and the firms listed on the stock exchanges tend to be more solid companies.

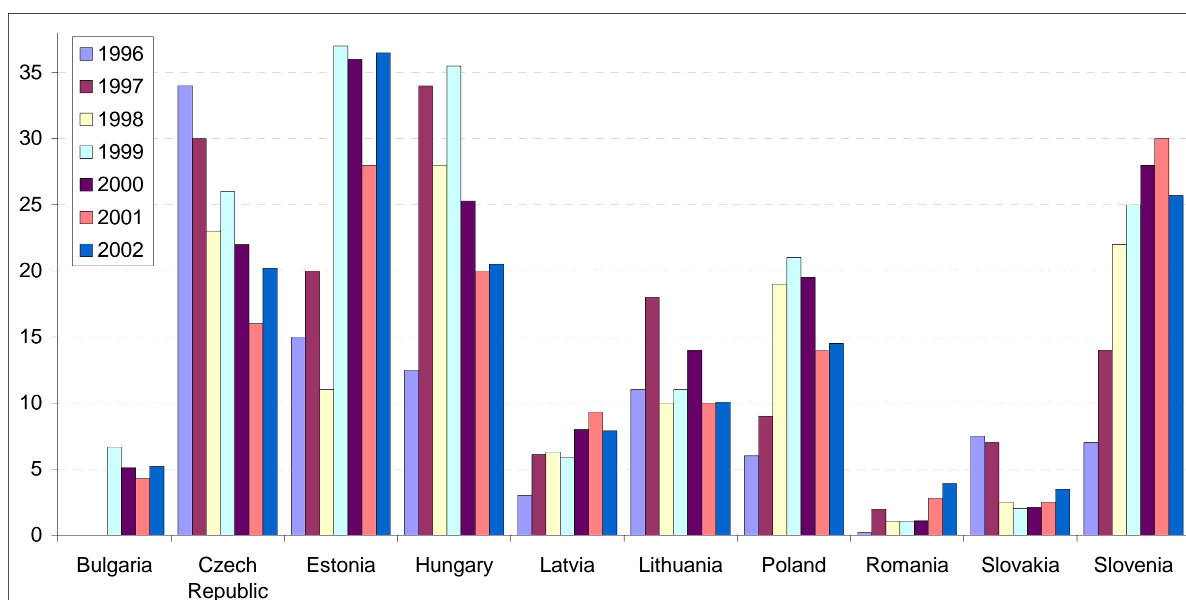
[20]One must not forget that those were mostly integrated market economies before the disruptions caused by the Second World War and the posterior Russian occupation: The Warsaw Stock Exchange was created as early as *1817*, and the first Prague stock market was created in 1871 (see Bhattacharya and Baouk, 2002).

[21]The former Federal Republic of Yugoslavia, of which Slovenia was a part, combined from early on elements of a market economy with its command system: its stock market, was, therefore, created sooner, in 1989.

[22]Namely, in Estonia, Latvia, Hungary, Poland and Slovenia.

[23]Due to this, Ihnat and Prochazka, 2002, put the *real* Czech equity market capitalization at about *half* of its apparent GDP share.

Figure I: Equity Market Capitalisation as a GDP Share, 1996-2002.



Source: Vinhas de Souza, 2004 and Claessens at al., 2003.

As indicated above, even in the largest and better regulated markets, nevertheless, market capitalisation, as a GDP share, was and remains rather low (see Figure I above), and far below the EU average (around 72% of GDP). Only in the Czech Republic, Estonia, Hungary and Slovenia the average market capitalization is above a 20% GDP share, while in Romania is *below* 1% in several years.[24] Also, the average market turnover is equally below the one observed in comparable EU economies.[25] Similarly to what is observed in the banking sector, the initial regulatory environment was deliberately lax, and the regulators were plagued by much the same problems of inexperience and limited number of staff and resources.[26]

[24]Pogonaru and Apostol, 2002, blame this dismal performance on a bungled mass "voucher" privatization process and on a general inconsistency towards reforms.

[25]Estonia, with the highest GDP share -close to 40%, above even Hungary, an "early reformer"- is an interesting case, especially when one considers that this was done basically by attracting strategic foreign investors via IPOs (as indicated above) and *without any significant market for government debt* –contrary to Latvia and Lithuania- as Estonia is constitutionally required to hold a balanced budget (see IMF, 2003(b), ibid.). On the other hand, on the Central European economies with larger stocks of public debt and average public deficits (see Vinhas de Souza and Borbély, 2003), the existence of a public debt market may have helped those stock markets (see Reininger at al., 2002, ibid).

[26]In the limit, regulatory bodies were not even *created*, as was the initial situation in the Czech Republic.

Nevertheless, this domestic "smallness" does not mean that domestic agents in those countries lack access to the financial services provided by stock markets: the very process of opening up, the increase in cross-border trade in financial services, the harmonization of rules for capital trading with the EU (including the ongoing efforts of the Lamfalussy Committee towards a single European market for securities: according to the current proposal, small and medium size firms would be able to use a simplified prospectus valid throughout the EU and choose the country of its approval), plus the development of information technology imply that is not actually necessary –nor economically optimal, given economies of scale- for each individual country to have its own separate stock market.[27] One must also recall that the current national stock markets in the mature developed economies are themselves the result of process of consolidation –and closing- of smaller *regional* stock markets (as was observed in Bulgaria in the early 1990s), which still today coexist with larger, dominant national stock exchanges even in mature markets like Germany and the US.

However, the observed tendency of *domestic* larger companies, with better growth prospects, to list abroad (see Table II below), due to the obvious cost[28] and liquidity advantages of the larger international stock markets, does seems, on balance,[29] to deprive those stock markets of liquidity (see Claessens at al., 2003). On the other hand, non-residents seem to play a major role in most of those markets (accounting for 77% of the capitalization in Estonia, 70% in Hungary, half of the *free-float* capitalization in Lithuania).

[27]As a matter of fact, two of the stock markets in the Future Member States, Estonia and Latvia, had their Stock Exchanges acquired by the Helsinki Stock Exchange –HEX- in 2002. There are also several overlapping regional associations and linkages with other EU stock markets, like the i) co-operation between all Baltic stock exchanges formalized by a memorandum of understanding signed in April 1999, which quotes a joint list of Baltic companies, ii) the establishment of joint index of Central European Stock Exchanges, known as CESI Index, which has been calculated by Budapest Stock Exchange since July 1996 and comprises the most liquid securities from the Bratislava, Budapest, Prague and Warsaw exchanges, or iii) the NEWEX, established in November 2000 as a joint venture of the Frankfurt and Vienna Stock Exchanges to list Central Eastern European stocks. The Bulgarian Stock Exchange and the Athens Stock Exchange also signed a memorandum of understanding in 2001. This actually mirrors developments among stock markets in the more mature EU markets, like the merger of the Belgian, Dutch, French and Portuguese national stock exchanges that resulted in the creation of the EURONEXT, or the more loose association of four of the five Scandinavian stock exchanges –bar the Finnish HEX, which opted to directly acquire smaller Baltic exchanges- that resulted in the NOREX.

[28]Domowitz at al., 2000, estimates that the total trading costs in the Stock Markets of Budapest and Prague were *three times* higher than the ones observed in Germany and the US.

[29]Foreign listing may also increase domestic trading, if the foreign listing is perceived by domestic investors a sign of quality of a particular stock. Also, foreign stock trading may, in principle, also be unwound at the domestic stock market itself.

Table II: Listed Firms and Cross Listings

	Market capitalization of Internationally Listed firms/Total Market Capitalization (%)	Value Traded Abroad/Value Traded Domestically	Number of Cross Listed Firms	Share of Cross Listed Firms	Total Number of Listed Issuers
Bulgaria	N.A	N.A	N.A	N.A	30*
Czech Republic	98.90	11.8	40	36	111[P]
Estonia	95.30	84.7	8	44.4	18
Hungary	99.80	14.6	52	74.3	70
Latvia	0.30	0.6	2	12.5	16
Lithuania	42.40	337.3	5	11.4	44[§]
Poland	81.30	62.5	30	12.2	246[N]
Romania	N.A	N.A	N.A	N.A	63
Slovakia	76.20	N.A	6	23.1	26
Slovenia	7.00	5.9	2	1	189
Average	62.60	73.9	14.5	26.9	81.3

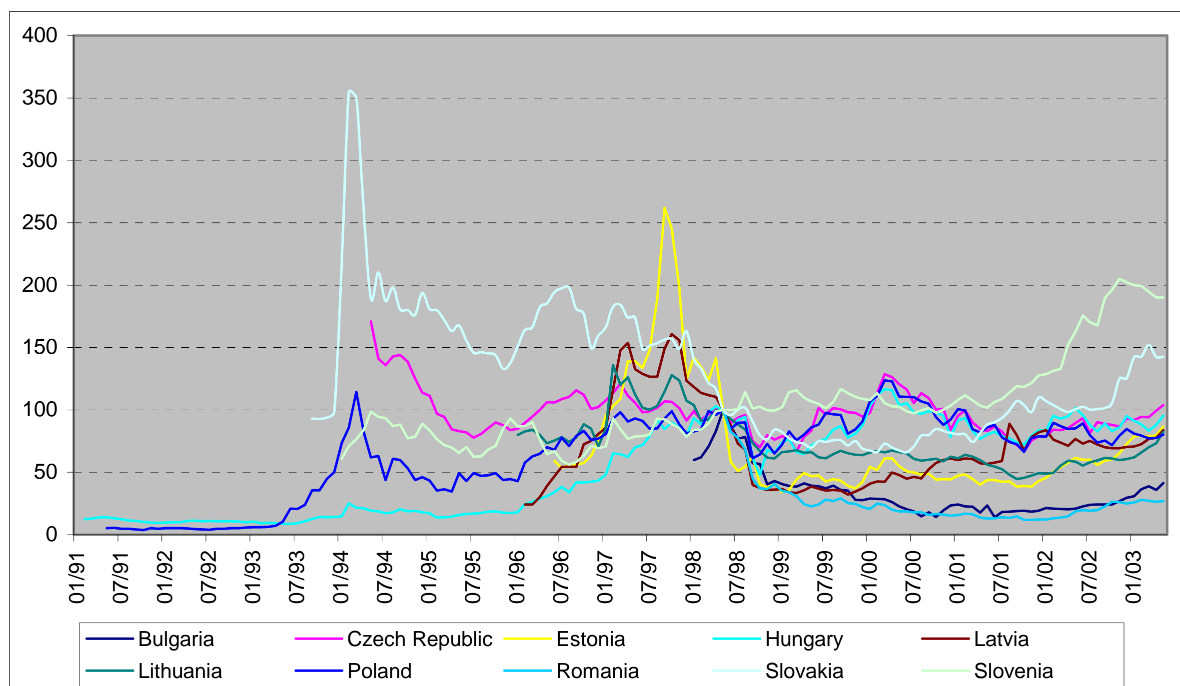
*Source: Vinhas de Souza, 2004, and Claessens at al., 2003; *In the "Official Market", in the "Free Market" for small caps, another 372 (in 2001); [P]It is estimated that only 15 shares are actively traded; [§]In the "Official Market" only* six *companies are listed; [N]Due to legal reasons, major foreign-owned banks are forced to list on the Warsaw Stock Exchange: they are believed to be responsible for a full third of the market capitalization, while 90% of the "free float" is done by 20 stocks.*

Similar to equity markets, the role of bond markets has been in general limited, with the notable exception of government bond markets in countries which had since the early 1990s high public debt and fiscal problems. Even though fiscal deficits have been high in some countries in certain years, the level of general government debt outstanding at end-2001 amounted to only around 37% of GDP (compared with an average of 69% of GDP in the EU-15). While government bond markets are relatively well developed in some Central European economies (with high public debt and public sector borrowing requirement), the growth of both municipal and corporate bond market has been modest.. One reason for this is linked to the preference for bank finance and absence of experience with corporate bond markets. Another reason behind the slow development of corporate bond markets is their low level of liquidity. There is not a liquid and transparent secondary market for these bonds especially as a self reinforcing reason the outstanding volumes of corporate bonds is particularly small. Second the relatively low level of liquidity in government bond markets in the Czech Republic, Slovakia and Slovenia also hampers the development of corporate bond markets due to the absence of government securities that could serve as benchmark instruments for corporate securities.

The existence of stock markets is assumed to be beneficial for economic performance. In principle, it provides a way for companies to raise capital at lower costs than through simple banking intermediation, and because it is not as restricted a source of capital as internal financing. Also, it is assumed that the existence of alternative modes of finance may reduce the likelihood of credit crunches caused by problems with the banking (see Greenspan, 2000). Additionally, the existence of external ownership is (or was, given the recent problems with market-based governance in the US, and the swing towards a more regulated environment) assumed to provide better governance for the management of firms. The majority of economic analyses seems to support the position that a diversified financing mix is positive for economic growth and stability.

All the specific questions described above concerning the way those stock exchanges were founded and their later developments, plus their relative smallness and shallowness, affect the dynamics of their stock market indexes (SMI),[30] and are clearly reflected by them (as one may see in Figure II, below).

Figure II: Stock Market Indexes



Source: Datastream, modified by the author. The price indexes here were converted to US Dollars and re-based to a common reference period were they equal 100, May of 1998. The country codings are as described in the Annexes.

4. High degree of foreign involvement As indicated above, another important feature of the banking sector and capital markets developments in the Future EU Member States is the strong presence of foreign owners and foreign investors, which can be observed in almost all financial market segments of these countries. It is most visible in the domestic banking sector, which is predominantly in foreign ownership, but foreign involvement is significant on bond and equity markets as well.

While these privatization policies differed in their speed, approach, sequencing with other liberalization and reform measures, their outcome has been similar: the majority of assets, balance sheet and capital in the banking sectors is controlled by foreign owners. These economies belong to the small group of those emerging markets, where the share of foreign owners in the banking sectors is the highest.

The reasons for this outcome are similar across the economies: the lack of domestic capital, fiscal and balance of payments problems forcing authorities to attain rapid cash revenues from privatization, higher efficiency of foreign banks and the advantages stemming from the transfer of know-how, human and physical capital associated with the sale of banks to foreign owners. Among the benefits of the overwhelming foreign ownership one may mention the accelerated global integration of these banks, the protection given by experienced, well capitalized banks against exogenous shocks, the rapid

[30]Reininger at al., 2002, ibid., estimate that for the Czech Republic, Hungary and Poland, *five* stocks are responsible for 50% of the weight of the respective stock market indexes.

upgrading of the services and structures of the banking sector. Among the costs the increased exposure to exogenous shocks should be mentioned, but altogether the balance shifts towards the positive end.

While foreign involvement is most visible in the banking system, it is also important for other segments of the financial sector, which itself has an impact on the development of banking sectors. For example, a substantial share of government and enterprise financing comes from abroad and many major firms are listed on stock exchanges outside those countries. This access to bank financing and capital markets abroad is significantly alleviating domestic financing constraints. Many of the larger corporations in the in the Future EU Member States are part of multi-national companies and are mainly funded through their parent companies.

Finally, due to their high degree of financial openness and the accession to the EU and the associated "convergence play", much of the activity on financial markets, including foreign exchange, stock and bond markets, is performed by foreign participants. This leads to further dependency of the financial sectors of in the Future EU Member States from the developments in larger international markets.

II. THE MAIN ISSUES OF BANKING SECTOR DEVELOPMENT IN THE FUTURE EU MEMBER STATES.

While the previous chapter described in brief the main commonalties of financial sector development in the Future EU Member States, this will briefly review the main issues that arose during the growth and development of banking sectors.

Privatization and liberalization. Privatization has been the decisive factor explaining the upgrading of financial services and the banking sector in the Future EU Member States. Notwithstanding the differences in initial approaches, speed and costs of sale, timing and role of domestic/foreign owners, the process resulted in a banking sector overwhelmingly dominated by foreign (EU) private owners. While privatization was costly, and sometimes inadequately managed, the final outcome was positive, as it significantly contributed to the success of banking sector transformation.

An equally important element of the banking sector development has been the again, EU-driven, determination to liberalize the banking sector, to create and maintain competitive market conditions. The presence of dominant players would have reduced the benefits of privatization and opening, would have created distortions in the banking sector. Liberalization meant that both domestic and foreign players were allowed to enter the banking sector, certainly with differences in their ability to buy the equity.

Banking sector restructuring. The high costs of banking sector reforms were another similarity of banking sector development in the Future EU Member States, which stemmed from the described rehabilitation of the troubled banks, and partly from the inefficiencies related to the delayed and misguided reform and policy measures.

Another similarity is the strong competition between banks, and the increasing competition between banks and non-banking financial institutions. Several other reform measures were needed to strengthen competition gradually, but this reflected the gradual progress with banking sector reform. The competition between banks was stimulated by the relatively liberal entry conditions to the banking sector, by the rapid capital account opening, liberalization of access of foreign banks to the domestic banking sector, and rapid sale of public assets to private investors.

Moreover, these banking sectors are regarded as “over-banked” in terms of the number of banks in relation to either the total population or the GDP per capita of these economies. Therefore the process of mergers and acquisitions, the process of exits and consolidation within the banking sector is under way which should reduce the number of market participants.

Slow progress with new or risky market segments. The development of the banking sector has been generally very uneven in the Future EU Member States. Some market segments grew fast already from the beginning of transition, while others lagged behind as their growth was hindered by several factors. The latter group of instruments and activities includes the ones which have either been non-existent prior transition due to the specific institutional and ownership structures under socialism, or the development of which has been hindered by high risks and entry costs. The two most prominent market segments include the housing market and the financing of small and medium sized enterprises.

Slowly developing segment: SME financing. The term “SME financing” includes a broad range of activities, starting from the provision of start-up funds to support the launching of new companies till the funding of further expansion and growth of successful small and medium size enterprises. SME

financing is however difficult to develop and flourish. On the supply side, the riskiness of these ventures is thought to make them unattractive to banks, while on the other hand adverse selection indicates that successful firms do not require access to external credit markets, so there could be a qualitative downgrading of credit recipients leading to enhanced risks for banks and thus to a vicious circle.

These problems are endemic to entrepreneurial finance and various institutions to surmount them have evolved in developed capital markets. In many instances, market imperfections for the financing of SMEs lead to government efforts to provide subsidized programs for start-up financing and micro lending.

The problems have been much bigger in the Future EU Member States than in advanced economies in general. First, the newly emerging private sector entails much more risks than the small and medium sized enterprises functioning in advanced market economies. Closely linked to this was the fact that new start-up firms were partly operating n the black or grey economy due to lack of appropriate funding, regulatory and tax environment, which certainly increased the risks of lending for them to the banking sector. Second, SME financing was more slow to emerge in the Future EU Member States as there were other more attractive market segments not served by the state owned or newly privatized banks. As the banking sectors were dominated by the newly privatized foreign banks and remaining relatively inefficient state banks, the new market participants selected the best market segments starting from wholesale banking and strongly neglecting retail and SME financing. As long as the market for financing multinational and local blue chips was not saturated, banks disregarded these market segments and their attention turned towards them only later.

Finally, government policies were not supportive for the emergence of SME financing. In advanced economies there are several measures to either strengthen the small and medium sized companies or to reduce the risks for the banks with their financing. Both lack of appropriate ideas and public funding prevented government in these countries to adopt a more encouraging approach to SME's development and financing.

Slowly developing segment: housing finance. One of the most prominent capital market instruments in developed counties are mortgages. In large OECD countries the stock of mortgage loans is often over 50 percent of GDP. In the advanced central European economies, this ratio is about 2 or 3 percent. Nevertheless, these markets have grown rapidly since the mid-1990s, often by a factor of three or more.

Mortgage financing has only emerged recently in the Future EU Member States, and it often lacks many of the characteristics found in more advanced markets. Loan to value ratios are small, maturities are short, and the loans are often denominated in foreign currencies to counteract domestic macro instabilities.

Several reasons explain why this element of the financial sector lags behind. First, the privatization of the housing stock has been sometimes slow and ownership rights are often ambiguous, and sometime there are still ambiguities in the legal structure governing housing ownership. Second, the procedures for dealing with mortgage loans in default are likely to involve lengthy legal problems with uncertain outcomes[31]. In the best of circumstances, these institutional problems inhibit the development of housing finance and home-equity loans. Third, the huge gap between disposable incomes and savings on the one hand and the price of real estate on the other prevented the increase of the demand for mortgage loans. Finally, unstable macroeconomic conditions and especially high inflation and interest

[31] For instance, this seems to be the main reason for the widespread usage of "leasing" credit in Estonia.

rates reduced the demand for mortgage loans as long as interest rates declined and attractive government support was offered on mortgage loans.

The successful development of mortgage markets requires a number of elements. First, the legal structure for ownership and the use of mortgage instruments needs to be in place. Second, there needs to be a source of funds from either deposit or through subsidies. There is no lack of deposit sources in the Future EU Member States but the institutional developments must make mortgage holding as attractive as government securities. Finally, macroeconomic stability is required to encourage the use of long-term instruments and to reduce the risks of default of debtors.

Importance of adequate regulatory structures. Neither the legislative framework nor the institutional expertise for regulatory oversight of banks, capital markets, or any other financial sector institutions was in place when “transition” started. Thus, the development of regulatory institutions was one of the biggest steps taken in the Future EU Member States, but the adequate application of these structures was often another matter. The banking sector regulatory failures were more often due to an inability to apply regulatory standards and structures rather than to an absence of institutions and laws. On the other hand, frequently the institutional setup and the legal framework were weak because of the strong political pressures and the lack of independence given to regulatory authorities.

There are several issues that the regulatory reform should solve, starting from the beginning of the reforms. One was the issue of central bank independence, which has been essential both for macroeconomic stability and also for financial sector development. Another issue was related to the location of regulatory powers in the central bank, the finance ministry, or in an independent agency. The preferred organizational structure for regulation was country specific, but a common problem was that the designed institutional framework was not very stable and underwent series of changes. Finally, while the institutions and rules were established less experience has been accumulated about their implementation. So, while the deposit insurance systems have been established, their operation still remains unclear as they were not tested in recent years, except some well known problems in specific banks.

Differences in the Future EU Member States. Besides the aforementioned similarities, sizeable differences characterize the development of the banking sectors in the Future EU Member States. The most important difference is related to the timing and sequencing of the individual reform measures. While there has been initially similar measures at adopting the most important legal and institutional reforms, the two crucial measures, the establishment of financial discipline in the banking sector and the privatization of state-owned banks had a different timing among the Future EU Member States.

Among the Future EU Member States, countries like Estonia and perhaps Poland chose the most cost-efficient way of getting rid of inherited and newly born debt stock problems, but in Poland political opposition to privatization delayed the sale of public assets resulting in slow privatization during the most of 1990s, while Estonia witnessed the swift transfer of assets of virtually all its financial system to Finnish and Swedish firms.

In Hungary, the early measures aimed at establishing financial discipline in the banking sector required, due to the huge centralized losses work-out programs, which, albeit very costly, did resulted in the clean-up of the banking sector. On the other hand, the rapid privatization of public banks was a key element in increasing the viability and efficiency of the banking sector (see Cottarelli at al, 2003). In terms of timing, the Czech Republic had perhaps the worst combination (bar later reformers, like Romania, Slovakia and Slovenia) and, as both privatization and strengthening financial discipline coupled with bank rehabilitation were postponed due to the negative spillover effects of voucher

privatization. This resulted in a rapid accumulation of bad debts and associated losses for the banks, and low efficiency of financial intermediation stemming from the overwhelming role of public banks. Due to this considerable delay, the problems in the Czech banking sector are partly still the ones experienced by Hungary and Poland in the first half of the 1990s: while the delayed privatization of public assets resulted in generally higher prices than in Hungary or in Poland, the losses from the inefficient financial intermediation before the privatization were very sizeable (between 12% and 25% of GDP: see footnote 11) and had to be paid by the tax payers in Czech Republic.

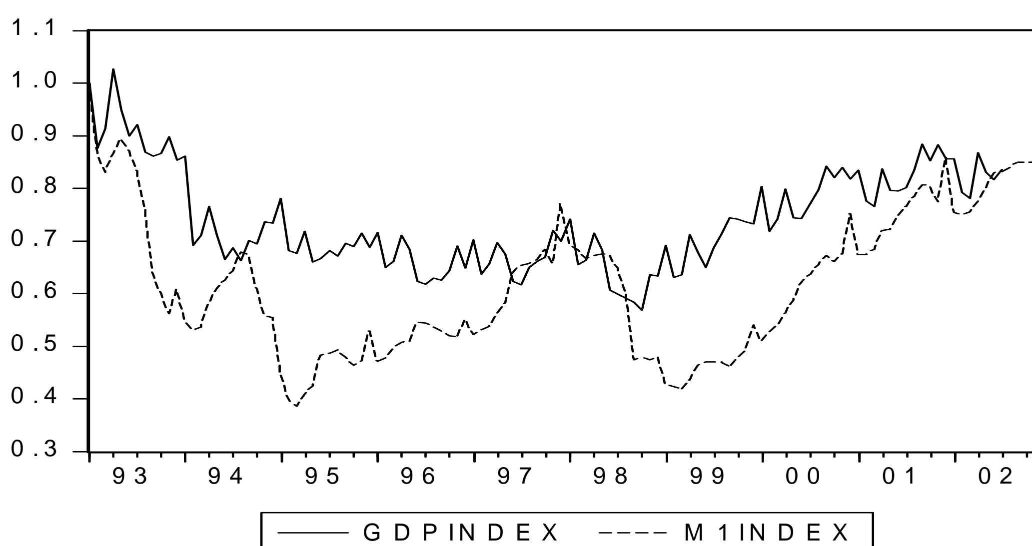
A related difference is the *degree* of financial stability. Among the Future EU Member States, the most stable and sound banking system tend to have greater shares of foreign ownership: they are well capitalized, have sound asset and liability structures and performance indicators. This is mostly related to the advances in the privatization of their banks, opening them to foreign competition. In Romania, Slovakia and partly still in the Czech Republic financial stability is weaker, and the banking sector still faces those costly, but necessary changes that are related to post-privatization restructuring of banks.

It is important to note that there were also differences between the individual economies in the ways they managed the bad loans problems. In Hungary and Czech Republic the centralized approach was chosen, contrary to Poland, which relied on the decentralized one. Looking at the fiscal and banking sector costs, at the speed of resolving the problem, at its impact on the competitiveness of the banking sector, one may conclude that the decentralized approach was a better way of managing the problems. It disallowed the accumulation of the problem, forced the banks and their new owners to share partly the costs of cleanup and prevented the reemergence of the problems. The centralized approach was full of moral hazard, inefficiency, low compliance problems and therefore it turned to be costly for the banking sector in general and for the budget in particular. Therefore – while recent experiences both in emerging (South-East Asian) or advanced (Japan) economies show that in case of banking sectors asset problems the centralized approach receives everywhere preference - the decentralized approach is better both in terms of costs and incentives.

III. THE DEVELOPMENT AND PROBLEMS WITHIN THE RUSSIAN BANKING SECTOR

Russia shares some similarities with Future EU Member States, but also many dissimilarities, some related to structural differences (namely, the fact that is it is a commodity based economy, when the Future EU Member States are mostly producers of middle-range industrial goods), but many linked to the sheer fact that Russia, in spite of its much improved macro-economic situation since the 1998 financial crisis (growth stood at 4%, 2003, down from the brisk, post-crisis 9% in 2000 –see Figure III; the budget is in a surplus of above 2% since 2000, there is a low debt stock, 36% of GDP in 2002, but 80%of this is foreign currency denominated) is still in a substantially lower liberalization and reform level than those countries.

Figure III: Russian GDP and M1



For instance, contrary to the Future EU Member States, Russia still do not have a complete capital account liberalization: there are still external borrowing restrictions, surrender requirements, long term capital controls, limitation on non-residents' Ruble bank balances (which, incidentally, are incongruent with the deep and liquid foreign exchange market that Russia has at the moment). There are still limitations on foreign ownership of banks and insurance companies. The Russian government still uses special state owned banks for some government operations (for instance, VEB manages operations related to the federal external debt). There is no unified national payment system (it is made up of the Central Bank of Russia -CBR- central one, plus several privately owned sub-systems).

Similarly to them, its' banking sector has a low GDP share of (its' M2 GDP share is just 24%, claims on private sector are a mere 17% of GDP, bonds outstanding are 3% of GDP) and a high –but falling- ratio of loans in foreign currency to total loans (70% in 1998, 39.1% in 2002). Currency substitution –Dollarization, in strict sense- also exists but is believed to be more widespread (see Zamulin and Levina, 2003, and Oomes, 2003) than in the Future EU Member States.

The Russia financial sector is not only shallow, but when compared to the Future EU Member States, its is also *more fragmented* (it currently has more than 1300 banks, 64 of which hold 80% of the total

assets[32]), *dominated by state owned banks* (the largest of the 23 banks with majority state participation is the Sberbank Rossii – a bank originally founded in 1841, and which peculiarly has the CBR as its major shareholder, who has 23% of all banking assets, 70% of household deposits, 20% of corporate deposits and 21,000 branches across Russia, the second largest is the VTB[33]), a market position in retail market which was strengthened by the 1998 financial crisis (from 20% of total loans pre-1998, it grew to 35% after it[34]), given the 100% guarantee to household deposits provide by those (which is not yet obligatory for other banks) and with a rather *residual presence of foreign owned banks* (there are 130 foreign-owned banks in Russia, with a mere 7.5% market share[35]). There are similar problems related to limited SME finance as observed with Future EU Member States.

This market structure implies, of course, *serious* governance problems, specially when one notes that the ownership structure of the non-foreign private banks is very non-transparent[36] –this situation is obviously not restricted to the banking sector. The picture is complicated by a non-unified supervision structure (made up of the CBR, FCSM –Federal Commission of Securities Markets, Ministry of Finance and, peculiarly, the Ministry of Labor –which supervises pension funds), in spite of the regulatory improvement observed in recent years.

This said, the banking system now has a *officially* good capitalization level (returns on equity were 3.1% in 2002, from *–3.5%* in 1998, the return on capital was, respectively, 22.4 and *–28.6%*, the capital to assets ratio stands at 14.3%, from 7.3%, and the ratio of bad loans is at 6.5%, from 17.3% in 1998) but with assets of doubtful quality. The spreads are still high, but have fallen considerably (9.3% in 2002, from 19% in 1998).

Similarly to the banking sector, the insurance sector is smaller than the ones at the Future EU Member States (2.42% of the GDP only in premiums), very fragmented (there area over 1300 insurance companies, 90% of premiums on the top 100) and with a low foreign penetration (only 50 firms are foreign participated, and a mere 7 majority-owned).

The Russian equity market capitalization stands at 25% of GDP (2002), which is actually *above the level of* most of the Future EU Member States (bar Estonia and Slovenia). It is similarly *concentrated*: only 32 firms listed on the two major markets (RTS and MICEX[37] in Moscow: there are 11 Russian stock exchanges in total, 9 regional ones), and other 322 firms on the “unlisted” market. Of those listed

[32]From the existing 1697 in 1998, when 227 of those banks were de-licensed, and other 127 in 1999. Individuals could transfer their accounts to Sberbank, with a federal deposit guarantee. The GDP loss of the 1998 banking crisis was estimated to be a mere 3%, but this was due mainly to the small size of the financial system, and also to the prompt –albeit non transparent- lender of last resort action of the CBR (see Vinhas de Souza at al, 2003). The bank liquidation process is long and costly –the CBR can only *revoke* a license, not actually close a bank- and an estimated *600* banks are still in legal procedures for liquidation- even after the 1998 creation of the ARCO -Agency for Restructuring Credit Organizations (a similar situation happened with Bulgaria, after the 1997-1998 wave of bank closures: see Box II).

[33]Which, until late 2002, also was under CBR ownership.

[34]Partially due to a portfolio shift, as Sberbank could no longer invest in government securities after 1999.

[35]The biggest of the foreign-owned and the sixth among all the banks operating in Russia is the International Moscow Bank (IMB). Its shareholders include MERITA Bank (Finland), Bayerische Hypo- und Vereinsbank (Germany) and the European Bank for Reconstruction and Development (EBRD).

[36]Of which the famous “pocket banks”, banks founded to act as financial arm of specific corporations, are only one example.

[37]Only 38% of total trading is conducted on those two exchanges, around 60% of the trading is OTC (over-the-counter).

firms, the top ten[38] have 85% of the total capitalization (and only Gazprom, a company that is still 40% state-owned, has 16% of total market capitalization). Those large firms are also ADR (American Depository Receipts) issuers abroad. Pensions funds and insurance companies do not usually invest in the Russian stock market. Settlement and clearing are still separate, and there is no full electronic trading system yet. The level of international integration of the Russian stock market is also below the one observed in the Future EU Member States.

[38]Which, reflecting Russia's productive structure, are large mineral commodities and/or state-owned companies (like, for instance, Sberbank Rossii).

IV. Some Tentative Lessons from the Experiences of Future EU Member States Banking Sector Development for Russia

While noting the considerable differences in size, history and structure highlighted in the previous section, the financial sector development of the Future EU Member States and the pursued economic policies over the past decade offer some lessons for Russia for its modernization.

1. As the differences in growth performance, efficiency of financial intermediation and also macroeconomic stability between the Future EU Member States demonstrate, the speed and success of banking sector reform is a key element in the outcome of transformation. While the different pattern of growth and macroeconomic imbalances in these three economies is associated with different timing and intensity of transition related shocks, policy reforms, inherited macroeconomic and structural fundamentals, the contribution of the banking sector to them is crucial. The effect of the outcome of banking on economic performance of broader sample of transition economies can be also easily demonstrated, as the sizeable differences between the individual economies in output, productivity, competitiveness, openness growth and spread of the private sector can be traced back to the differences in the banking sector transformation.

2. The experiences of the Future EU Member States with financial sector development confirm the tight links between macroeconomic and banking sector stability both for tranquil and crises periods. Macroeconomic stability is an important precondition for robust development of financial intermediation and financial deepening, while well-capitalized and regulated banks help in achieving macroeconomic stability.

In the Future EU Member States, macroeconomic stability have positively affected financial deepening. Lower inflation, declining interest rates, enhanced exchange rate stability, increased capital inflows supported the growth of the banking sector and accelerated financial deepening. Moreover, macroeconomic stability affected financial intermediation via the growth performance: as the relationship between economic and financial sector growth is demand driven, high output growth, increasing incomes create the demand for banking services and promote financial deepening.

3. As these economies are middle income ones, the shocks affecting banking sectors are unavoidable and the question is how to manage them. The nature of shocks has and will gradually change in the analyzed economies. Initially in the early 1990 the “transition” related exogenous and policy related shocks were the most important one, forcing sizeable ownership, structural and institutional changes in the banking sector. Later, as the effect of these shocks lessened, and the progress with financial and capital account liberalization accelerated, the shocks came from increased external competition, contagion effects of currency and banking sector crises, and all other sources which are typical for middle-income emerging economies.

As all the Future EU Member States are very open in real and financial terms, and the progress with financial liberalization has been very rapid, sometimes being ahead of the level of development of financial sector, one may expect strong shocks in the future too. They will stem from the adjustment needs faced by these economies on their road towards E(M)U membership, the accelerating structural changes in the international and European banking sector (as majority of banks in the four Eastern European economies are owned by foreign, mostly European banks), and initially from the shocks and crisis affecting the middle income economies (the recent experiences with the Argentine and Turkish crisis and their effects are telling in this respect). As these shocks are unavoidable, the main question is

how to manage them and what banking sector fundamentals need to be in place in order to do it with the least costs. The description of country developments has provided some answers to this question.

4. The experiences of the Future EU Member States reflects that the process of financial deepening and increased financial intermediation is a slow and long one. Notwithstanding the progress with privatization, inflow of foreign capital and the establishment of a EU-compatible prudential regulatory framework, financial intermediation increases only slowly. The reasons behind that are the time lag between the effect of income and output growth and financial sector deepening, the high risks associated with lending especially to certain groups of recipients and the slow progress with establishing several non-existing market branches in these economies.

In some areas (mortgage lending for example), active government support is needed to establish a well functioning market, as the risks and the entry costs are too high for the banks to be born alone. On other market segments (lending for small and medium sized companies), active competition between the banks is a *prima facet* condition for the development of market branches.

5. Privatization is an essential element of banking sector restructuring, but without additional regulatory and institutional measures and enhanced competition it is insufficient. The lessons from privatization can be summarized as follows. First, the way privatization is carried out strongly influences its outcome: real owners are needed up-front in order to avoid moral hazard, unclear incentives problems, accumulation of bad and connected loans, lack of financial discipline.

Second, privatization should be carried out without any delays, as the inefficiency of public banks and the shocks hitting the banking sector may produce too costly results. The losses stemming from the delayed privatization have been sizeable, and the higher recent privatization revenues didn't compensate them.

Third, the experiences of the Future EU Member States have confirmed so far that there are sizeable benefits from selling the banking sector to strategic foreign owners, which stem from the import of embodied knowledge and technology, increase in capitalization of banks, improvement in their stock and flow position, adoption of more sound banking practices and increased openness and globalization of the banking sector.

Fourth, privatization of banks may occur with the same speed indirectly, when the newly established private banks crowd out the existing public banks. Therefore, entry conditions should be liberal, but prudential. The banking crises in the Future EU Member States show costs that were incurred from the expansion of inefficient, small private banks.

Finally, banking sector privatization alone may not produce the expected and desired results, as it represents the replacement of public with private monopoly. Therefore, it should be accompanied up-front with internal and external financial liberalization, strong competition and anti-monopolistic policy, strengthening of prudential regulations and competition between banks themselves, and them and non-bank financial intermediaries.

6. There is a natural sequencing in the emergence of earlier non-existing financial services and development of markets, determined by the risks in different markets, cost and revenue considerations, inherited institutions. First, the competition is the most intensive in corporate banking, as the risks are the smallest there. When the demand is saturated and the risks of lending to households decline, banks gradually shift their lending portfolio towards the retail segments and increase the share of households in their portfolio. This is finally followed by the establishment of earlier non-existing lending activities,

including mortgage lending and lending to small and medium sized enterprises. But the expansion of banks to earlier neglected segments as well as the growth of the banking sector in general is stimulated by market reforms and macroeconomic stability, as mentioned earlier.

7. The experiences of the Future EU Member State shows that if the banks are adequately supervised than financial vulnerability may decline and the stability of banking sector may improve. Regulation is also very important at least in three respects. First, regulators should very carefully regulate banks' lending activity and prevent the emergence of connected lending. Therefore the restrictions on the lending portfolio of banks should be taken seriously.

Second, the regulators should always closely follow the evolution of financial vulnerability indicators in order to prevent the emergence of financial crisis. Finally, regulators should make all efforts to promote fair competition in the banking sector and disallow the emergence of monopolies.

8. Finally, it should be noted that even with the high presence of foreign owners and competitive banking environment, rapid growth and real convergence to the EU, the development and upgrading of the banking sector is long-term process. Besides the mentioned low level of financial intermediation this is also reflected in the very slow and hesitant appearance of missing market segments, including mortgages lending or lending to small and medium sized enterprises. Improvements in the macroeconomic conditions, favorable underlying and expected growth performance, long-term structural reforms and policies are needed to progress with the convergence of banking sector services and level of development to the average of the advanced economies.

9. As a final remark, perhaps the only true *irreproducible* element in the –so far successful- experience of financial development of the Future EU Member States, as concerning Russia, is exactly this: Russia cannot benefit from the framework provided by the EU Accession process. Russia, inevitably, will largely have to make it on their own.

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