

6. Capital account liberalization and financial sector development in transition countries

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6.1 INTRODUCTION

The first decade of transition has seen remarkable progress in financial sector reform for the former-socialist countries of Central and Eastern Europe and the former Soviet Union, although this progress has been uneven across regions, countries and market segments. There have been significant achievements in the privatization and restructuring of state banks in most (but not all) of these countries; there has been exit by failing institutions and entry and development of new domestic and foreign banks; there has been improvement in the legal, supervisory and regulatory framework, which has supported enhanced competition in the provision of banking services.

However, even in the most advanced transition countries (including the eight likely early EU accession candidates from the region), the banking sector still lags behind best practice as regards the scale and scope of their provision of financial services. The level of bank intermediation between domestic savers and potential investors in the domestic real economy remains low. The menu of financial products and services offered by the banking sector remains restricted. Even in the most advanced countries of the region much more needs to be done in order to achieve a fully functioning and efficient banking sector (Fries and Taci, 2002). The relative underdevelopment of the banking sector in transition countries is not compensated for by a strong non-bank financial sector or by thriving capital markets. If anything, the degree of underdevelopment of capital markets and non-bank financial institutions is greater than that of the banking system (Claessens et al., 2001).

Enhancing financial stability and reducing the vulnerability of financial systems remain key challenges for all countries in transition. The importance of meeting this challenge, both from the point of view of savers looking for a superior risk–return trade-off and from the point of view of domestic enterprises looking for external sources of finance, cannot be over-emphasized. The integration into the international capital markets that has progressed significantly in some transition countries, especially in the EU accession candidates, reinforces the importance of building strong, stable and efficient domestic financial markets and institutions. The strengthening of the domestic financial sector, particularly the banking sector – the main vehicle for the intermediation of both domestic and international financial flows now and for the foreseeable future – is essential if these countries are to gain the benefits and withstand the risks associated with large, and potentially volatile, gross and net cross-border capital flows.

Without an efficient domestic banking sector and deeper and more liquid domestic financial markets, only the subsidiaries of well-capitalized and liquid foreign enterprises and a few domestic players in the oil and gas sectors could hope to attract significant amounts of external finance. In the more advanced transition countries, the role of the domestic financial sector in supporting domestic investment and stable growth becomes even more important with the EU accession process and the greatly increased financial integration this brings.

Without significant further enhancement of domestic financial intermediation, the superior access to foreign investment opportunities that will become available to domestic savers when accession candidates become full EU members could be at the expense of investment in domestic enterprises, especially in small and medium-sized domestic firms. The well-known risks associated with large and potentially volatile cross-border capital flows introduce an additional dimension and urgency to financial sector reform, especially in the period between EU accession and European Monetary Union (EMU) membership.

Remaining challenges for building a stable and efficient financial sector in transition countries include: (i) strengthening prudential supervision and regulation; (ii) improving risk management of both individual institutions and supervisory agencies; (iii) improving transparency and disclosure of financial activities and market discipline; and (iv) improving the effectiveness of the legal framework.

The chapter is organized as follows. The next section provides an overview of developments in capital market liberalization and cross-border capital flows in transition countries, and their benefits and costs for domestic financial sector development and stability. Section 6.3 discusses the main features of the development of the financial sector in the transition

countries in the last decade, considering both banking sector and securities markets developments. This section compares the reform progress in the financial sector across the different regions/countries, drawing lessons from these regions'/countries' diverse experiences with different dimensions of reform such as privatization and policies towards foreign entry, and examining their implications for financial sector development. The fourth section examines ways of addressing likely future challenges to financial stability, through strategies to enhance the legal and supervisory framework and thus to strengthen the financial sector's ability to manage the risks inevitably associated with exposure to free cross-border capital flows. Section 6.5 concludes.

6.2 CAPITAL ACCOUNT LIBERALIZATION AND CAPITAL FLOWS IN TRANSITION COUNTRIES: BENEFITS AND RISKS

The policy towards capital account liberalization of transition countries has been cautious, despite some differences across the regions as regards the use of individual controls. Most of these countries abolished restrictions on foreign direct investment (FDI) inflows at the beginning of the transition. Since early in the transition process, most countries have also guaranteed the free repatriation of both profits (current account convertibility) and FDI capital. Individuals are allowed to hold and operate foreign exchange accounts at local banks and treatment of trade credits has also been liberal in most countries.

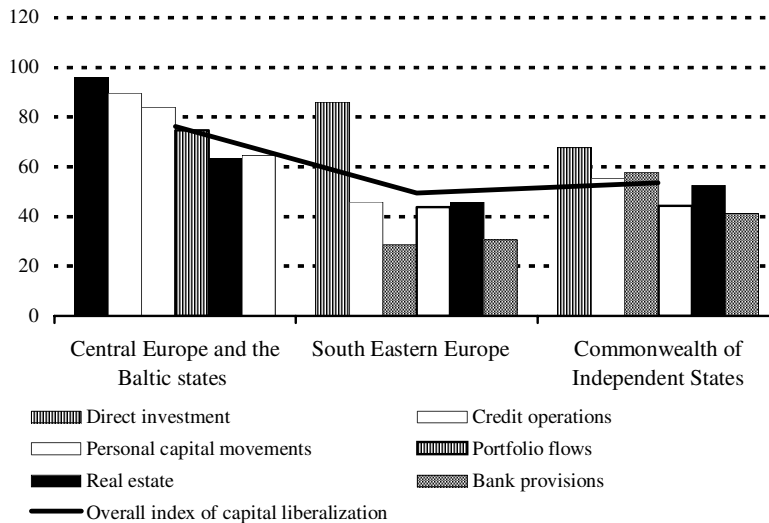
However, non-FDI-related transactions remained restricted in many countries. Only the Baltic states adopted a policy of a high degree of capital account openness at the beginning of the transition process. More severe restrictions were kept on short-term than on long-term transactions and only some advanced transition economies fully liberalized portfolio flows.

Capital controls have been progressively eased in recent years. In the Central European countries this progress in liberalization has been in part due to Organisation for Economic Co-operation and Development (OECD) membership requirements and EU accession commitments. Since 1995 there has been a gradual easing of restrictions on non-FDI-related capital movements, led by the Czech Republic and Hungary as part of their accession to the OECD. The liberalization of portfolio flows is still incomplete in most of the countries.

Figure 6.1 presents the state of liberalization for specific controls on capital account transactions for transition economies as of end 1999. It provides indices of liberalization for all categories of capital flows,

calculated for each country and averaged over three regions: the Central and

*Figure 6.1 Progress in capital account liberalization, end 1999
(index of liberalization)*



Note: * See text for description of index.

Source: International Monetary Fund.

Eastern Europe and Baltic states (CEEB), South-Eastern Europe (SEE), and the Commonwealth of Independent States countries (CIS).¹ The indices can take values between 0 and 100, with 100 representing the maximum degree of liberalization.²

Figure 6.1 shows that capital flows have been liberalized most in the more advanced transition countries. In particular, liberalization in portfolio flows and in provisions specific to commercial banks and other credit institutions has lagged behind in SEE and the CIS, with the exception of Armenia and to some extent Georgia (not shown in Figure 6.1).³ Within CEEB, the three Baltic states, the Czech Republic, Hungary and the Slovak Republic have now largely liberalized their capital accounts, while Poland and Slovenia continue to maintain some short-term capital controls mostly aimed at encouraging non-debt financing and at lengthening the maturity structure of external financing. Upon EU accession, at the latest, remaining

controls will have to be removed, potentially stimulating further capital flows.

Evolution in Structure and Composition of Capital Flows

Over the past decade, transition countries have absorbed a growing share of total net capital flows to emerging markets and developing countries. Capital flows to all three European Bank for Reconstruction and Development (EBRD) regions have followed a path similar to that followed by policies towards liberalization of capital controls. Countries of CEEB that have had more liberalized capital accounts have attracted more foreign capital. The level of (net) capital inflows has been affected, above all, by the degree of macroeconomic stability, the stage of and commitment to reform, and, especially in the CIS and in some of the SEE countries, by political instability and corruption. Reform achievement and efforts have been the most important determinants of private capital flows. The most advanced reformers, such as Hungary, Slovenia, Estonia and the Czech Republic have attracted large amounts of foreign savings (Figure 6.2).⁴

Early on in transition, the capital flows were mainly fiscally driven. They reflected the sharp decline in fiscal revenues and the lack of creditworthiness of some countries. These flows, which often came from bilateral and multilateral sources, made up about 45 per cent of total net flows for the first half of the decade. However, the share of official lending to transition countries declined very quickly. By 1993, private flows exceeded official flows, as transition countries resumed their access to international capital markets.

Central and Eastern Europe and Baltic states

During the second half of the 1990s official flows going to CEEB countries decreased significantly (Poland and Hungary also repaid some official financing). The cumulative amount of net official capital inflows in CEEB for the 1996–2001 period accounted for only 1 per cent of total net inflows. For these countries, the success of earlier reforms meant improved access to international capital markets.

Among the private flows, FDI accounted for a substantial part of net capital inflows in CEEB countries (Figure 6.3). Cumulatively over the 1996–2001 period, FDI accounted for about 64 per cent of total net flows in CEEB countries.

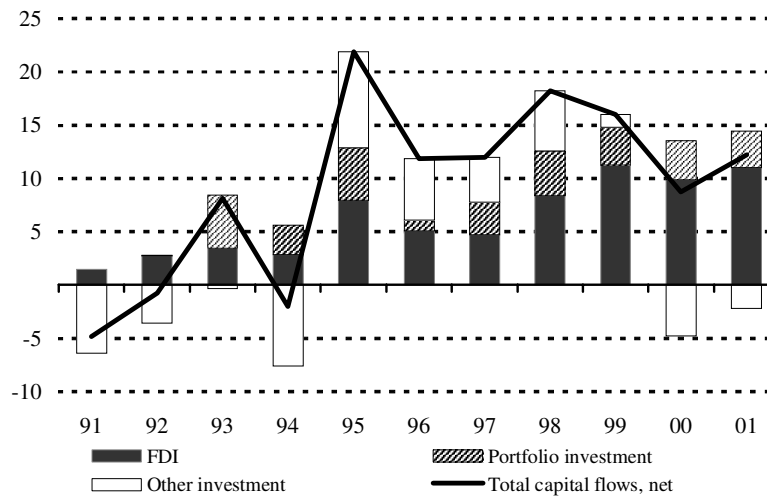
Some accession countries have at times faced a large and sudden surge in short-term capital inflows. In the Czech Republic, for example, net capital inflows in 1995 accounted for about 18 per cent of GDP. Of this, net short-term capital flows⁵ reached about 8 per cent of GDP (and about 5 per cent of

GDP during 1996–97). Eventually, and inevitably, the increase in the current account deficit and a rapid real exchange appreciation (the nominal exchange rate was fixed and about half the flows were sterilized by the central bank), fear of a devaluation caused the sudden and sharp reversal of short-term flows. The resulting financial distress led to a currency crisis in mid-1997 when the currency was devalued and left to float. During 1995–97, short-term liabilities also increased rapidly in the Slovak Republic.

Fig 6.2 here – landscape figure

Total net capital inflows in CEEB countries decreased after the 1998 Russian crisis as foreign investors became more cautious about the region. However, both confidence and capital inflows appear to have recovered in 2001, despite the global slowdown. Debt-creating flows (loans and bonds) remain a key component of external financing in CEEB countries. Within these debt flows, international commercial banks are primary suppliers of capital. The domestic banking system has been the main channel for absorbing that lending. On average over 1996–2001, it accounts for about 47 per cent of lending by international commercial banks.

Figure 6.3 Net capital flows to Central-Eastern Europe and the Baltics (US\$ bn)



Notes:

a: FDI is foreign direct investment.

b: Figures for 2001 are estimates.

Sources: World Economic Outlook Database and European Bank for Reconstruction and Development.

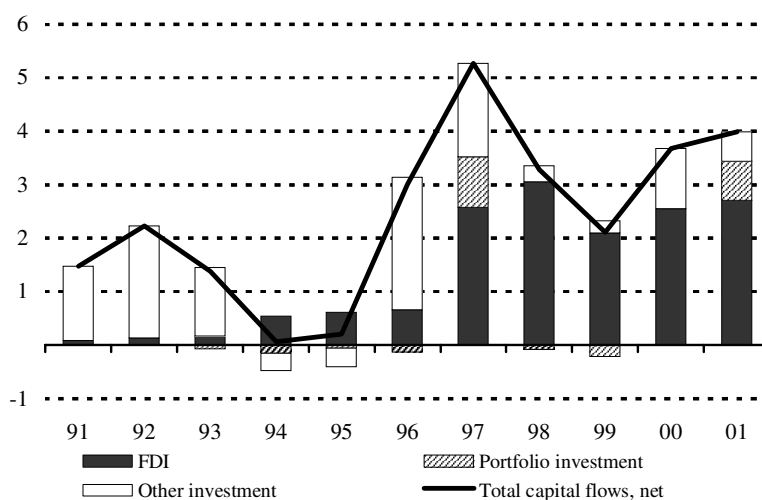
South-Eastern Europe

The reduced reliance on official flows has been more marked in CEEB than in SEE countries and in the CIS. While FDI and portfolio flows were large in CEEB countries by 1991–92 (especially in Hungary and the Czech Republic), they only acquired significance for other transition countries after

1994. Some SEE countries even experienced net private capital outflows (e.g., Bulgaria).

The composition of capital flows in and out of SEE countries has been strongly affected by the political instability in the Balkan region. Official flows, often concessional, continue to support government deficits and external deficits in SEE. Net private inflows have increased, driven by growing FDI as large-scale privatization progressed (Figure 6.4). However, private net inflows are mostly concentrated in Bulgaria and Romania which accounted for 80–85 per cent of total net FDI going to SEE during 1996–2000. This share has decreased over time and reached 66 per cent in 2001, as the other countries in the region are attracting more foreign investors (partly through the privatization of large companies).

Figure 6.4 Net capital flows to South-Eastern Europe (US\$ bn)



Notes:

a: FDI is foreign direct investment.

b: Figures for 2001 are estimates.

Sources: World Economic Outlook Database and European Bank for Reconstruction and Development.

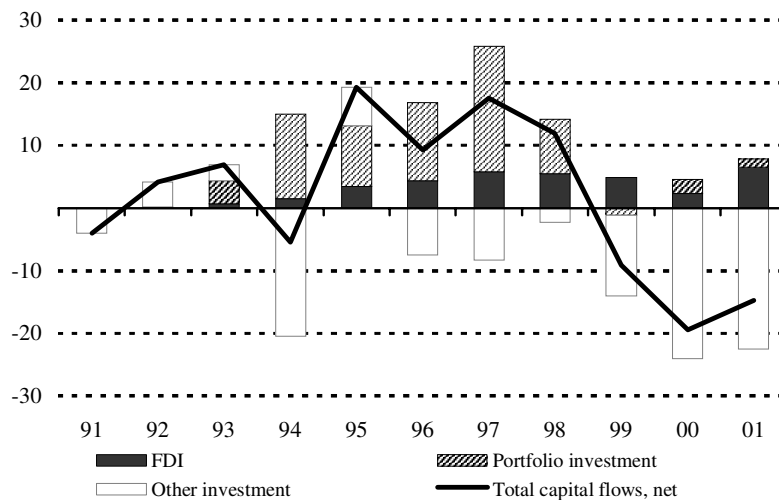
Portfolio and other investments in the region are increasing with Bulgaria and Romania accounting for most of it. Both countries are gradually integrating into international capital markets with Romania successfully issuing two eurobonds in 2001. About 62 per cent of all non-

FDI-related net inflows in SEE during 1996–2001 represent lending by international commercial banks, with the domestic banking sector intermediating about 43 per cent of this total.

Commonwealth of Independent States

Russia accounts for most of total net capital flows into the CIS (see Figure 6.5 and Figure 6A.1 in the Appendix). Ukraine and Kazakhstan were the other two CIS countries that attracted some capital inflows, albeit considerably less than Russia.

Figure 6.5 Net capital flows to the Commonwealth of Independent States (US\$ bn)



Notes:

- a: FDI is foreign direct investment.
- b: Figures for 2001 are estimates.

Sources: World Economic Outlook Database and European Bank for Reconstruction and Development.

The changes in the level and composition of capital flows throughout the CIS region are influenced significantly by developments in Russia. Russia saw increasing net portfolio inflows after 1993, reaching around US\$17.8 billion in 1997, or 4.2 per cent of GDP. Most private capital flows into Russia took the form of foreign private investment in government Treasury bills (T-bills) (GKO), attracted by high interest rates and oblivious to default risk. Portfolio outflows immediately before and after the August

1998 crisis implied a halving of net portfolio inflows in 1998 compared to 1997 and a net outflow in 1999. Since then there has been a slow recovery in inflows. Since 1997, Russia has experienced huge private capital outflows in the form of other investments, a large part of which (about 50 per cent in 2000) are commercial bank placements outside of the country. FDI has accounted for only a very small portion of capital inflows into Russia. FDI flows into other CIS countries (and private capital flows in general) have been mainly concentrated in the natural resource sectors, such as gold in Kyrgyzstan, oil in Kazakhstan and (mainly from Russia) oil refineries in Ukraine.

The record shows that over the past decade there has been an increase in the net short-term external liabilities of transition countries, reaching US\$15 billion in 1997. There was a decline during 1998–2000, reflecting foreign investors' changing assessment of the region after the Russian crisis. However, after decreasing to US\$7.3 billion in 2000, short-term liabilities increased to US\$9.4 billion in 2001, with Russia accounting for almost 80 per cent of the total. The growth in net short-term inflows, although not large as a percentage of GDP, could be a source of concern for policy makers, as short-term flows could be associated with higher volatility and risk of sudden reversals. This may be particularly important for those countries that receive the greater share of these in short-term flows, that is, some CEEB countries, Russia and Kazakhstan – countries that can be expected to experience a steadily rising degree of global financial integration.

Benefits and Risks Associated with Capital Flows

There is general agreement among scholars and practitioners about the benefits and risks associated with cross-border capital flows for economic development in general and for financial sector stability in particular. The benefits include filling the saving–investment gap, allowing portfolio diversification directly and production diversification indirectly (through the more diversified domestic capital formation permitted by access to foreign finance in general and FDI in particular), lowering financing costs, setting and/or raising standards of business and corporate governance, raising the intensity of competition, and enhancing fiscal discipline through the restraining effect of the threat of capital flight. FDI is also supportive of structural reforms, which pay off in terms of a higher productivity growth regardless of the host country's initial conditions.

However, capital inflows can also have less desirable side-effects. In the context of incomplete structural reforms, international capital flows carry considerable risks and may magnify underlying macroeconomic and

structural weaknesses. If capital inflows are in excess of the recipient economy's ability to absorb them productively, they can have a potentially negative impact on the financial sector and, ultimately, on the real economy. Large capital inflows have been associated with rapid credit expansion and riskier lending practices in many countries.

Large inflows can also lead to real exchange rate appreciation, resulting in a loss of competitiveness and a deterioration in the debt servicing capacity of clients in the internationally exposed sectors and thus in the quality of banks' balance sheets.

As the experience of the 1997–98 financial crises in South-East Asia and Russia in 1998 have shown, risks associated with capital inflows also include the sudden (unexpected and large-scale) reversal of some type of flows, particularly short-term inflows. Short-term inflows driven by speculative position-taking aimed at exploiting an interest rate differential or by views on the likely future direction of exchange rate movements can easily be reversed if fundamental or extraneous events cause expectations to change.

While there is general agreement about the nature of the benefits and costs of capital account liberalization, the balance of costs and benefits remains an open issue. There now is general agreement on the following two points. First, that the cost–benefit analysis of international financial integration is highly conditional on the nature and credibility of the exchange rate regime. A less than fully credible peg is a recipe for financial sector instability and economic dislocation. Second, that the sequencing and coordination of capital account liberalization, macroeconomic stabilization and structural reforms aimed at strengthening the domestic financial sector is key. Capital account liberalization should follow domestic financial sector reform and macroeconomic stabilization. Liberalization of FDI should precede liberalization of portfolio investment and cross-border bank lending (for a recent analysis, see Ishii et al., 2002).

Unfortunately, the strategy of financial liberalization in several CIS countries has increased their vulnerability to financial crisis, without any commensurate economic benefits. Liberal policies towards the unregulated entry of (domestic) banks and the development of domestic debt markets, together with an opening of capital accounts (while macroeconomic conditions were dodgy), although not the primary cause of financial crises in countries like Russia or the Ukraine, sharply increased the vulnerability of these countries to crisis (Coricelli, 2001).⁶

Many economists dispute the effectiveness of capital controls in managing the risks associated with capital flows. An alternative approach to managing these risks is not to attempt to control the flows directly, but to limit the vulnerability of the economy to the risks associated with these

flows (Johnston and Otker-Robe, 1999). Prudential policies applied to domestic financial institutions can play a significant role in reducing the risks associated with cross-border capital flows by influencing the risk–return trade-off faced by financial institutions and by improving the robustness of the financial system to external shocks. The past experience of financial crises in emerging countries (especially in Latin America and Asia), underscores the role that a weak financial sector plays in intensifying a crisis. A sound financial system can also provide a useful cushion against major market disturbances affecting the direction and magnitude of capital flows.

The risks associated with cross-border capital flows are greater for countries in transition where institutional development, particularly of the legal system and the financial sector, is still limited, as is the case in all countries of the CIS and SEE. By tackling these domestic institutional development issues now, transition countries stand to gain more of the benefits of financial market integration while at the same time enhancing their capacity to withstand the risks associated with greater financial integration and larger cross-border capital flows. This issue gains importance as these countries undergo increasing integration of their financial sectors into the global financial system.

6.3 FINANCIAL SECTOR DEVELOPMENT IN TRANSITION COUNTRIES

The development of a sound and stable, market-oriented financial sector is of fundamental importance to the post-communist transition. Banks in a market economy play a key role in the monetary payments mechanism, without which markets, financial and nonfinancial, can function only at high cost. Banks also play a key role in the mobilization, intermediation and allocation of capital. An efficient and prudent banking system facilitates the processes of saving and investment and thus promotes long-term growth.

After a decade of transition, maintaining (and in some cases achieving) financial stability and reducing the vulnerability of the financial system remain key challenges. The relative underdevelopment of the banking sector in transition countries is not compensated for by a strong non-bank financial sector or by thriving capital markets. If anything, the degree of underdevelopment of capital markets and non-bank financial institutions is greater than that of the banking system.

The initial conditions and the subsequent strategies and policies followed by different transition countries are important in explaining the level of development of the financial sector in transition countries. Most transition

economies have followed the same broad paradigm for the transformation of their banking sector from the monobank system existing under central planning. The so-called Washington consensus on banking transition advocated the establishment of a two-tier banking system, the abolition of restrictions on the internal convertibility of money, liberalization of interest rates, restructuring and privatization of state banks and their enterprise borrowers, and the entry of new private banks. At the same time, the state had to take on the important new roles of providing effective prudential regulation and supervision of banks.

However, although most countries have followed this broad paradigm, the pace and sequencing of reforms have differed significantly.⁷ In the countries of CEEB the state liberalized the market for banking services and developed its capacity for effective prudential supervision and regulation in step with the growing role of private banks in the system. Unfortunately, in the countries of SEE, the banking sector has remained a source of directed subsidized lending to politically well-connected, financially troubled enterprises. The continuation of such practices well into the second decade of transition constrains the pace of banking reform, including the implementation of prudential regulation and bank privatization. The explosion in the number of nonviable private banks in the CIS in the early 1990s created significant vested interests that favored a 'partial reform equilibrium' and were opposed to sound prudential regulation and mechanisms for the exit of these banks.

In addition, the success of financial market reform has been crucially dependent on progress in real sector adjustment, the establishment of market-sensitive mechanisms of corporate control for enterprises, and the degree of disengagement of the government from the private sector.

Banking Sector

Set against a difficult background of major structural shocks, macroeconomic reforms aiming to establish monetary and fiscal stability, and with no past experience in the sector for any of the key players, the establishment and functioning of efficient financial markets was inevitably subject to high risks. The response to this challenge and the subsequent performance of the financial sector differed significantly across countries. However, several common characteristics of financial sector development have emerged, a decade after the start of market reforms in transition countries.

The financial systems in these countries have developed more as 'bank-based' systems than as 'market-based' systems. Given the insufficient scope and effectiveness of legal contract enforcement and, frequently, with

inappropriately or imprecisely defined property rights, transition countries had no alternative but to develop a relationship-based financial system, with banks as the main financiers. Banking sector assets in transition countries account for about 85 to 95 per cent of overall financial assets, compared to about 50 per cent in the United Kingdom. Banks therefore dominate the provision of financial services.

Nevertheless, the banking sector in transition countries remains small and underdeveloped compared to that of advanced industrial countries. Even in the most advanced transition countries (including the likely early EU accession candidates), the banking sector still lags behind best practice as regards the scale and scope of their provision of financial services. The level of bank intermediation between domestic and foreign savers and potential investors in the domestic real economy remains low. In addition, the menu of financial products and services offered by the banking sector is restricted. Despite the often large number of banks (especially in Russia and some of the other CIS countries), the transition economies remain 'underbanked' and the banking sector continues to be highly concentrated, with a few banks dominating the market. Bank efficiency remains low.

Marked differences are evident in the level of development of the financial sector between CEEB countries, on the one hand, and SEE and CIS countries, on the other. The level of bank intermediation, measured by the ratio of domestic credit to GDP, is low in all transition countries, compared to countries with the same level of development (as measured by GDP per capita.)

Figure 6.6 shows the ratio of the stock of domestic credit provided by banks to the private sector as a percentage of GDP for all transition economies, together with the estimated ratio of domestic credit to private sector relative to GDP for a market economy at a comparable level of development (EBRD, 1998).

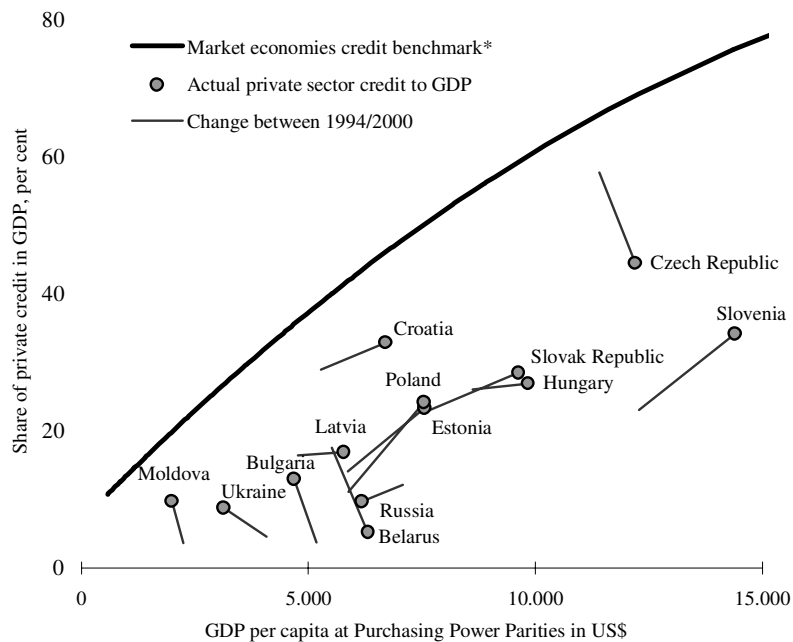
Figure 6.6 indicates that in 2000 all transition economies lie below the market economy benchmark for the ratio of total domestic credit to GDP. However, some countries of CEEB (Croatia, Estonia, Hungary, Latvia, Poland, the Slovak Republic and Slovenia) are gradually converging towards the benchmark for middle-income developing countries and emerging markets. In the countries of SEE and the CIS there was no convergence towards the benchmark between 1994 and 2000, despite the expansion of domestic credit to the private sector in excess of output growth.

Factors that affected banking sector intermediation in transition countries include macroeconomic and fiscal performance, as well as bank-specific characteristics such as ownership, market power and capitalization (Fries and Taci, 2002). Legal enforcement has been another important

factor that has deterred banking intermediation to the private sector in transition countries.

Figure 6.7 illustrates the positive relationship between banking credit to the private sector as a percentage of GDP, and progress in the effectiveness of legal reform as measured by the EBRD's legal transition indicator (EBRD Transition Report, various years). Besides concerns about borrowers' creditworthiness and government interference in lending to state-owned enterprises, the issues of creditor rights protection, slow bankruptcy procedures and low realization of collateral have caused banks to lend to 'safer' borrowers such as governments. As Figure 6.7 shows, the legal enforcement issue is more prevalent in CIS and SEE countries.

Figure 6.6 Ratio of private credit to GDP relative to market economy benchmark, 2000



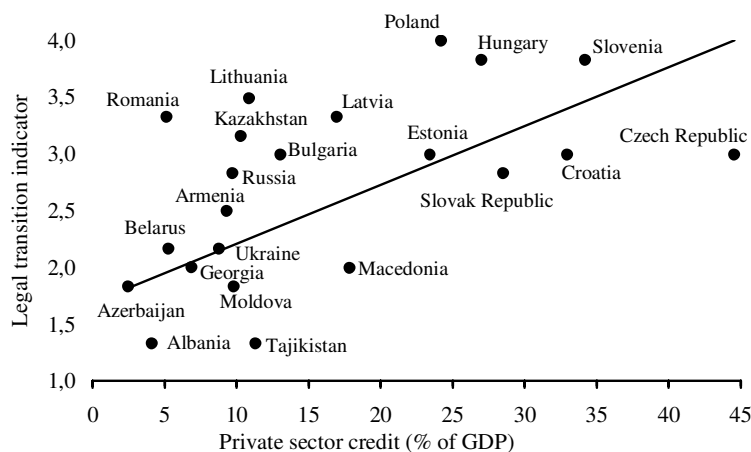
Note: * See text for explanation.

Sources: European Bank for Reconstruction and Development and World Bank.

Apart from the similarity in sector concentration ratios (the five largest banks control 50–90 per cent of the market), the banking systems in the

three transition regions differ in other dimensions of their development, activity and performance. Table 6A.1 in the Appendix presents several commonly used indicators of banking sector development and performance. The share of non-performing loans in total loans, an indicator of inefficiency (or imprudence/lack of caution) in asset management by the banking sector, is high in almost all transition countries compared to EU countries. There are two reasons for this. First, the accession countries had to deal with the issue of the large amount of inherited non-performing loans from the past (the command economy). Second, new non-performing loans mounted up in the balance sheets of commercial banks due to a lack of experience, inappropriate regulation and supervision, government intervention and ill-designed privatization methods (often associated with connected lending).

Figure 6.7 Private sector credit and legal transition, 2000



Source: European Bank for Reconstruction and Development.

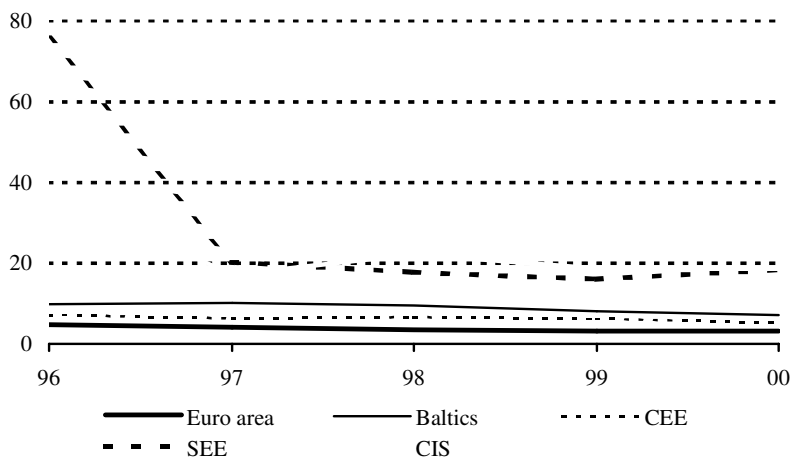
In CEEB countries the amount of non-performing loans has decreased, both through the resolution of the problem of old non-performing loans and through an increase in quality of new loans. In SEE countries the amount of non-performing loans remains high due to the often difficult macroeconomic environment, government intervention through directed lending to loss-making state enterprises, and connected lending by banks to enterprises with which they have shared financial interests (Bosnia and Herzegovina, FYR (Former Yugoslav Republic) of Macedonia, Yugoslavia). The CIS

countries always report a lower share of non-performing loans than CEEB and SEE countries. However, this probably reflects poor accounting and the continued presence of government-directed and guaranteed credit in CIS countries (e.g., Turkmenistan, Uzbekistan).

Table 6A.1 in the Appendix also shows that measured profitability (average return on assets) of banks in the countries of SEE and the CIS is on average higher than in the countries of CEEB. Net interest margins (also shown in the table) are an important determinant of high reported profitability. High profitability of banks in CIS countries can be partly explained by the high inflation which was reflected in higher spreads between borrowing and lending rates. However, the main reason behind the high profitability of banks is the crowding-out effect of high interest government T-bills on bank lending to the more risky and defaulting private sector (see Fries and Taci, 2001). A further factor behind the high reported profitability may be insufficient provisioning for non-performing loans.

Banking efficiency in all transition countries is lower than in EU countries (Figure 6.8). The high spread between lending and deposit rates indicates high inefficiency (as well as greater market power), or greater default risk. Even in the most advanced countries of the region much more needs to be done in order to create an efficient banking sector. Once more, a sharp contrast is evident between on the one hand CEE and Baltic countries, and SEE and CIS countries on the other. CEEB countries are characterized by an average spread not exceeding 10 per cent and are gradually converging to the EU average. In contrast, the spread remains significantly higher in CIS and SEE countries.

Figure 6.8 Differential between lending and deposit rates
(percentage point)



Source : European Bank for Reconstruction and Development.

Competition has, however, strengthened, as evidenced by declining intermediation spreads, a shift in bank portfolios from government securities to private sector lending, and declining bank profitability. The experience of CEEB countries has shown that the driving force for improving efficiency in the banking sector is strong competition achieved through privatization and through the entry of foreign banks.

Countries in transition chose very different strategies for the method and speed of privatization of state-owned enterprises, including banks. These strategies were different even within each of our three transition regions. Consider CEEB countries. While Hungary went for a quick sale of its banks to foreign direct investors, Poland combined public offerings with management buyouts and some placements with foreign strategic investors. The mass voucher privatization strategy of the Czech Republic and the resulting complex cross-ownership structure of banks and enterprises led to an increase in non-performing loans and persistent bank bailouts by the government. The state retained a significant ownership in banks, and only recently opted for their sale to foreign strategic investors.

The process of bank privatization has been slower in the SEE countries (Figure 6.9). However, good progress in bank privatization was made recently in some SEE countries, especially in Romania and Bulgaria where

the remaining state-owned banks are in the process of being privatized. FYR of Macedonia has also made very good progress with bank sales to strategic investors. In the Federal Republic of Yugoslavia, which started the transition process only recently, the privatization process is now under way.

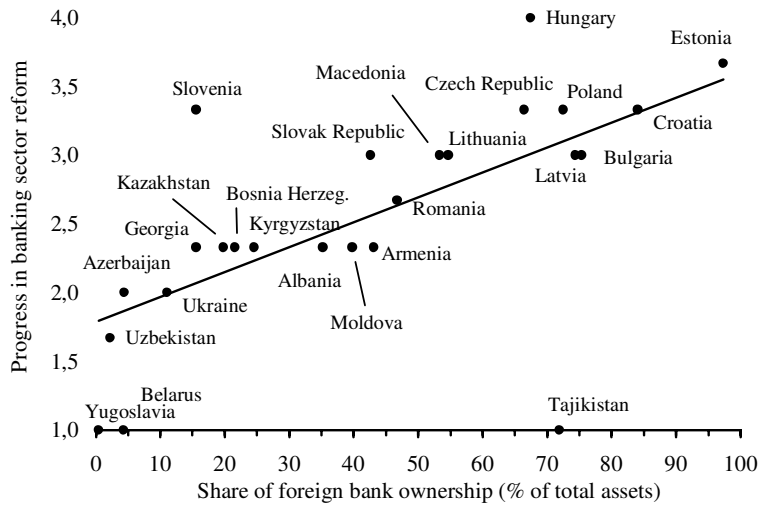
In the CIS, the state still maintains a high degree of control over the banking sector, with the exception of Armenia, Kazakhstan and Tajikistan (Figure 6.9). The issue of government-directed lending is pervasive in these countries. In addition, the mass voucher privatization in some CIS countries, including Russia, and the rapid creation of a large number of small banks established by nonfinancial enterprises create the twin problems of connected lending and excessive sectoral concentration of bank loans.

The entry of foreign banks has been an important factor that has raised the level of development in the sector. Foreign banks spur competition and innovation, often bring stronger corporate governance and management, and render the sector more efficient by introducing new skills, products and technology. The presence of foreign banks that have not just a local but a global reputation at stake may reduce the risk of capital flight or widespread deposit runs. The presence of foreign banks in the banking sector, as shown in Figure 6.10, has also supported reform in the sector.⁸

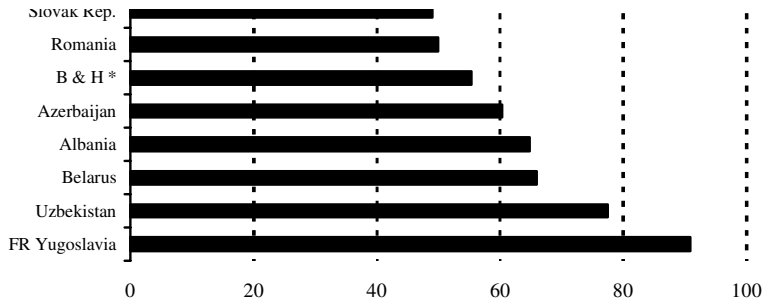
Political as well as economic considerations explain the different country experiences across the region regarding the scope and efficiency-enhancing implications of foreign entry in the banking sector. Foreigners control most of assets of the banking sector in CEEB countries, except Slovenia. Hungary was the first to open its banking sector to foreign participation. Foreigners now control more than 80 per cent of banking assets. The Czech Republic resisted foreign ownership of its larger banks until the failure of several of these banks in the 1996–98 period prompted the sale of all large banks to foreign strategic investors.

The Baltic countries sold their banking sector to foreign strategic investors, mainly from Scandinavian countries. Foreign entry in SEE countries was constrained by the slowness of the privatization process. In the CIS, the entry of foreign banks has been restricted, with liberalization a very

Figure 6.10 Foreign bank presence and banking sector reform, 2000



Source : European Bank for Reconstruction and Development.



Note : * Bosnia and Herzegovina.

Source : European Bank for Reconstruction and Development.

recent phenomenon.

Capital Markets

While banks have evolved gradually to become the main source of external finance for the real economy, securities markets have grown at a more modest pace. Significant improvements in the sector have been made in the last decade in many areas, including the establishment of formal exchanges, the development of legal frameworks and regulatory institutions, the establishment of internationally compatible accounting standards, and improvements in transparency and corporate governance. However, most capital markets are still in their infancy. Many of the small markets remain illiquid or exist only on paper. Even in the advanced countries, there remains considerable room for improving market depth and liquidity, as well as regulations and institutions.

Stock markets

Some of the stock markets in the region date back to the 19th century. After being closed during the socialist regime, the markets' re-emergence was prompted by the privatization programs in the region. The manner and speed of the introduction of stock exchanges in 20 out of 26 countries during the transition period was in part a reflection of the different privatization methods followed by different countries (Claessens et al., 2001). The Czech and Slovak Republics (Czechoslovakia at the time) in 1992, followed by Bulgaria, Lithuania, FYR of Macedonia, Moldova and Romania launched their stock markets in order to enable the transfer of ownership rights following voucher mass privatization. Croatia, Estonia, Hungary, Latvia, Poland and Slovenia established their stock markets with a small number of stocks offered by direct sale through initial public offerings (IPOs) to those outside the business.

Most CIS countries (Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Russia, Ukraine and Uzbekistan) combined the transfer of voucher shares and the listing of companies traded through IPOs. In other CIS countries the stock exchanges are inactive, or only government T-bills are traded, as is the case, for example, in Albania.

As expected, the number of listed companies on the stock exchanges initially increased in countries that used the voucher privatization scheme. After an initial high trading volume, however, many companies were delisted and as the ownership structure became concentrated, the number of shareholders fell. Most stocks became and remained illiquid. Trading volumes remained relatively high in the stock markets of countries that developed their markets through a small number of IPOs.

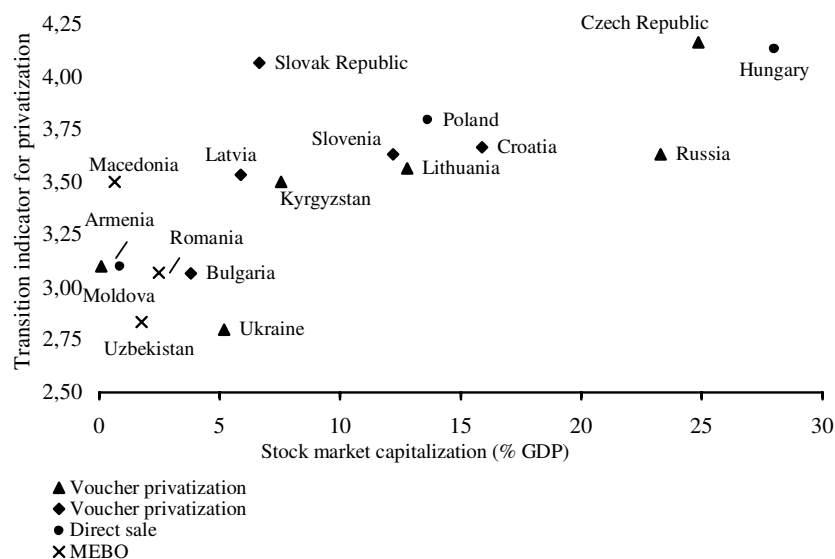
The strength of the reform process in the non-bank financial markets is important for capital market development. Another important factor,

mentioned above, that has shaped the development of capital markets in transition countries has been the privatization process. Figure 6.11 shows that progress in privatization (and often the method chosen) played a major role in the development of capital markets, as measured by the ratio of stock market capitalization to GDP.

Although some progress has been made as regards both institutional reforms and the volume of trading, stock markets in the transition countries remain underdeveloped. The stock market capitalization of the transition economies of Central, Eastern and Southern Europe, as well as the former Soviet Union, increased from about US\$1 billion in 1992 to US\$108 billion in 2000. The average market capitalization to GDP ratio increased from 2 per cent to nearly 25 per cent during the same period. The region, which accounts for almost 8 per cent of the world's population, accounts for 1 per cent of world market capitalization (EBRD, 2001b).

In terms of market size relative to economic activity, the stock market capitalization to GDP ratio reached 22 per cent in the Czech Republic, 26 per cent in Hungary and 20 per cent in Poland (Figures 6.11 and 6.12). By the end of 2001, capitalization was somewhat lower, in line with the global decline in equity markets, in almost all important markets (aside from Russia) in the region. Four markets in the region had a market capitalization close to or over US\$10 billion by the end of 2001: Russia (US\$76 billion), Poland (US\$26 billion), Hungary (US\$10 billion) and the Czech Republic (US\$9 billion).

Figure 6.11 Stock market capitalization and privatization, 2000

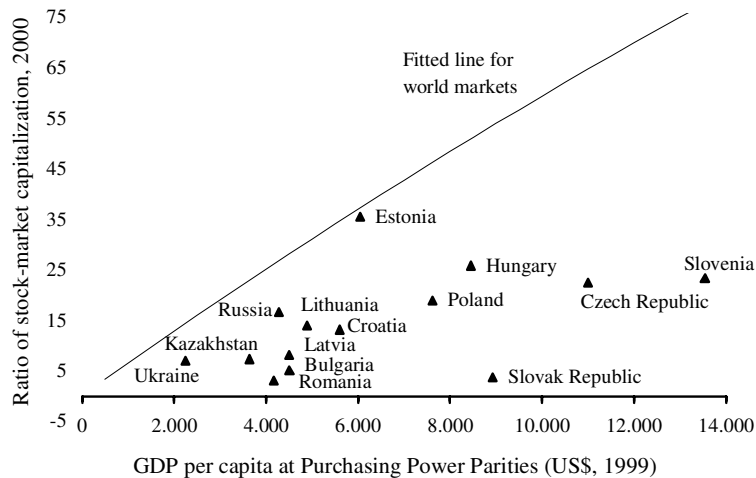


Note : *MEBO = Management/Employee Buy-Outs, Transition indicator is average 1996

Source : European Bank for Reconstruction and Development.

The stock markets in the region have thus not yet reached a level of development commensurate with the size of its population and of the economy. Relative to the size of the economies that they serve, even the largest stock markets in the region are small. For example, capitalization

Figure 6.12 Ratio of stock market capitalization to GDP and per capita income*



Note: * See text for explanation.

Source: European Bank for Reconstruction and Development.

averages around 30 per cent in Latin America and 52 per cent in East Asia, while in the European Union and the United States, market capitalization often exceeds the value of GDP. Compared with a reference group of other emerging markets and industrialized market economies, the ratios of stock market capitalization to GDP for all transition economies lie below the estimated benchmark for market economies at the same level of development (Figure 6.12 and EBRD, 2002).⁹ Among these countries, only Estonia has a ratio of market capitalization to GDP that approaches the average for developing market countries at the same level of per capita income.

As a result, many large firms from the region are seeking foreign listings on larger and more liquid markets. These firms tend to list on pan-European and/or US stock exchanges. By the end of 2001, 61 of the region's large

companies had issued international equity in the forms of global depository receipts (GDRs) and American depository receipts (ADRs).

Market liquidity on the whole has increased in many of the transition economies, but is still modest in comparison to other emerging markets. Market turnover, defined as the value of trading relative to market capitalization, has increased significantly during the decade. In 2000 it was highest in Hungary at 101 per cent, 61 per cent in Czech Republic, 49 per cent in Poland and 54 per cent in Russia. However, most of the smaller markets are illiquid, in particular those in the CIS. Furthermore, concentration in these markets is substantial, with many regional stock markets dominated by a small number of large firms – typically those in the banking, electric power, natural resource and telecommunications sectors.

The price performance of the stock markets has been mixed. In general, equity markets in Central and Eastern Europe are high-yield, volatile, markets. Over the past five years (1996–2000), stocks in transition economies have on average yielded a positive total return (measured as capital gains plus dividend income using Standard and Poor's Total Return indices), but these returns have varied widely over time and across countries. The countries that have achieved positive total returns over the period are Hungary, Russia, Poland and Slovenia. Over the same period, the Eastern Europe indices averaged an annualized return of 14.4 per cent and a standard deviation of returns of 43.7 per cent. At the same time, the correlation of returns with those in the developed markets has been low over the period (although is increasing), pointing to potential diversification gains by investing in the region.

Development of fixed income markets

Fixed income markets tend to be more developed than the stock markets, with a number of governments successfully issuing domestic and international bonds over the decade. Gross new issues of domestic bonds increased from US\$3 billion in 1991 to US\$64 billion in 2000, peaking at US\$147 billion in 1998. International issues have also increased from some US\$1.5 billion in 1991 to US\$10 billion in 2000, with a peak of US\$21 billion in 1998. But both domestic and international bond issues have declined significantly since the 1998 Russian crisis. The total domestic bonds outstanding of the four largest markets (Czech Republic, Hungary, Poland and Russia) at September 2001 was just above US\$86 billion.

Most of the issuers are central governments, government-related enterprises and local authorities. The number of corporate and bank issuers of debt securities is very limited – with perhaps one exception. In the Czech Republic the issuance of corporate, municipal and bank bonds has developed significantly. Until recently, maturities of bond issues, including those by

governments, have rarely extended beyond one year. The most active fixed income markets normally consist of T-bills. However, as macroeconomic stability has improved, the length of maturities has increased in recent years. There has been a sizeable increase of paper with maturities of 2 to 5 years. The Hungarian government notably issued 10-year fixed-rate Treasury bonds denominated in euro in 1999 and since 2000 many Central European countries have issued 10-year eurobonds. The Lithuanian government issued a 10-year Treasury bond denominated in domestic currency in 2001.

Pension reform

As in most other European countries (other than Ireland), the growing demographic challenge of an aging population is putting increasing strain on the government budget in many transition countries.¹⁰ Countries have therefore been forced to reform their pay-as-you-go (PAYG) pension systems. Most CEEB countries are implementing the World Bank's three-pillar model of pension provision, with the Czech Republic and Hungary leading the process. This involves the maintenance of a residual PAYG scheme alongside a mandatory private personal retirement account (PRA) and voluntary private schemes for retirement saving. In most of the countries pension reform is still at an early stage.

Progress in pension reform and rapid growth of the insurance markets in transition countries can support the development of domestic institutional investors (and domestic sources of long-term finance) in the coming years, which should feed through into greater liquidity and turnover on the stock exchanges.

6.4 DEALING WITH CAPITAL FLOWS: FUTURE CHALLENGES FOR THE FINANCIAL SECTOR

The level of development of the financial sector in transition countries is such that improving financial stability and reducing the vulnerability of financial systems remain essential policy challenges for all these countries. The increasing integration of the transition countries into the international capital markets further reinforces the importance of removing the remaining structural problems and developing stable and efficient financial markets. The need for financial sector reform is stressed by additional risks introduced by the possibly large and volatile capital flows analyzed in Section 6.2.

The banking sector needs particular attention due to its dominant position in financial intermediation in transition economies. Moreover, as has been shown, the banking sector has been the major intermediary for

external capital flows in these countries.¹¹ The domestic financial sector needs to be strengthened to ensure an efficient use of capital and to deal with the increased competitive pressure from foreign intermediaries. In some advanced transition economies there is already evidence of disintermediation away from the domestic banking system, with international banks increasing their claims on the nonfinancial sectors in these countries, pointing to growing competition between domestic and international banks (EBRD, 2002). The financial system also has to be able to cope with an increasing willingness by both banks and corporations to take on financial risk. Governments should focus on creating or maintaining macroeconomic environment that enhances the sustainability of financial sector development.

The ability of financial institutions to benefit from and withstand the risks associated with international capital flows depends on their capacity to manage financial risk. The major factors underlying differences in the ability of financial systems to withstand the risks associated with capital flows include among others: (i) prudential regulation and supervision; (ii) the risk management and internal governance of financial institutions; (iii) the legal framework; and (iv) accounting standards. Further, weak and unskilled domestic financial institutions with large amounts of unprovisioned non-performing loans, and/or subject to government interference in lending, will be at a disadvantage in competing with sounder foreign institutions. All these factors jointly determine the state of financial sector development.

Prudential Supervision and Regulation

Strengthening financial sector supervision and increasing the autonomy of the supervisory authorities become more important for financial sector stability in the presence of cross-border capital flows. Supervisors should be able to monitor and control the increasing risk taking by financial institution and the ever more complex instruments associated with international capital flows. Recent experience in Asia showed that appropriately imposed prudential rules for financial institutions dramatically reduce the vulnerability of the financial system as a whole. Strengthening supervision and regulation in transition countries requires full harmonization of prudential rules with those of the European Union. Alleviating the risks associated with large capital inflows (such as excessive risk taking by banks) involves applying and enforcing all EU prudential regulations on foreign currency open positions, on bank loan exposures, on collateral valuations, loan classification, etc. Limits on sectoral concentration of credit exposure help mitigate the risk associated with sector-specific shocks.

EU membership requirements have obliged advanced countries of CEEB (including Bulgaria and Romania) to align their regulations with EU directives. However, much remains to be done in other transition countries. Sectoral credit concentration, exceeding the maximum limit to a single borrower, and poor loan classification and provision, magnified by the perverse incentive of banks driven by government interference in lending, still prevail in the banking sector lending in SEE and CIS countries.

Because banks in transition countries are operating as universal banks, particular emphasis should be put on consolidated supervision of the financial sector. The complex cross-ownership of banks and enterprises resulting from voucher privatization in Russia and other CIS countries (in the Czech Republic as well) has created perverse incentives in banks' activities with their financial affiliates. In Russia, banks' engagement in the practice of covering on-balance sheet exposures by taking offsetting positions with their own subsidiaries, has been a common and recurrent issue. Additional emphasis is required on related party lending, especially to shareholders, and strengthening cross-sectoral supervision. In the SEE countries (especially countries that were part of the former Yugoslav Federation), the interconnected financial system poses additional challenges for supervision. Even in Hungary, the case of Postabank illustrates that without appropriate controls, a mismanaged private bank can accumulate hidden losses and increase the threat of a systemic crisis.¹²

Regulation requiring consolidated reporting is missing in a majority of transition countries. Even in the most advanced countries of CEEB, formal reporting on a consolidated basis is either not required or has only recently been adopted. Therefore, there is as yet little experience in preparing consolidated reporting. In a move towards fully consolidated supervision in 2000, Hungary followed the institutional model applied in the United Kingdom in 1997 when supervision agencies for banking and capital markets, pension funds and insurance funds were merged into one regulatory body, the Hungarian Financial Supervisory Authority (HFSA). A similar model was followed in Latvia where the Financial and Capital Market Commission was established in July 2001 and Estonia where a joint Financial Supervisory Authority started operation in January 2002. Hungary, the Slovak Republic and Lithuania introduced regulation requiring bank consolidated reporting in 2001, and the Czech Republic did so in 1999, but more needs to be done for its effective implementation.

Risk Management and Corporate Governance

International capital flows add an additional external dimension to each category of risk associated with domestic financial transactions (market risk,

credit risk, liquidity risk and operational risk). Therefore, improving risk management practices and corporate governance of individual financial institutions is particularly important for the survival of these institutions in an environment of free capital flows. Moreover, the prudential supervision and regulation framework must adjust continually to changes in market developments and governance in individual institutions. Ensuring an adequate capitalization of banks is central in limiting banking system risks, including those associated with international capital flows.

Reflecting the concern about the risks associated with international capital flows, the new Basle Capital Accord (intended to be effective by 2005) includes revisions in the capital adequacy framework, requires the development of methodologies for credit, interest and operational risk management and modeling, and promotes sound practices for loan accounting and credit risk disclosure, and for bank transparency and internal control systems.

However, much more needs to be done to improve risk management in transition countries. Even in the most advanced countries, only the largest domestic banks have developed risk management models that adequately address credit risk, liquidity risk and market risk. The CIS and some SEE countries with weak supervisory agencies also suffer from weak skills in the financial sector. Directed and connected lending, prevalent in these countries, aggravate the problem of inadequate capacity and perverse incentives for financial institutions to adequately manage risks (as well as for effective corporate governance).

Corporate governance of individual institutions also plays an important role in risk management. Under the right conditions, foreign ownership can improve corporate governance. In addition, foreign bank ownership supports the diversification of financial systems by introducing new technologies, financial instruments, skills and risk management capabilities. It also tends to strengthen the capital structures of financial institutions and to promote competition for financial products.

Again, even in the most advanced transition countries, there is room for improvement in corporate governance. Improvements in corporate governance practices in these countries require that the roles and responsibilities of management, owners and boards of directors be more clearly defined in financial sector legislation (including appropriate penal actions in case of fraudulent activities).

Further, new instruments available in advanced countries, such as derivatives, and new business areas for banks (e.g., retail lending) often create greater opportunities for taking on risk, without any matching enhancement of institutions' risk management capacity. The monitoring of both risk-taking opportunities and risk management capabilities by the

market and by the official supervisory authorities will help enforce discipline on banks and other market participants. In the less-advanced countries of SEE and the CIS, the issues of directed and connected lending (compounded by weaknesses in the legal system and governance) continue to impede effective monitoring by counterparties, shareholders, creditors and supervisors.

Improving transparency and disclosure of financial operations within the banking system is essential for market participants' monitoring and investment decisions. International Accounting Standards (IAS) remain to be adopted in most countries in SEE and the CIS. Even the most advanced countries have only very recently adopted IAS, or are in the process of doing so.¹³

Legal Framework

Financial risks (especially credit risk) are affected by macroeconomic developments and by the legal and regulatory environment (such as bankruptcy laws, collateral recovery, etc.). A strong institutional environment and a stable macroeconomy can contribute significantly to the reduction of financial risks. An important obstacle to enhanced financial development in transition countries is the enforcement of existing laws, rather than the existence of an inadequate formal legal framework.

The EU enlargement process has promoted legal reforms in the financial sector in candidate countries. All accession candidates have accelerated the updating of banking and securities laws to align them with EU laws and directives. However, the enforcement of the legal framework can still be improved significantly.

Figure 6.13 shows that the indicator of effectiveness (substance) of the legal framework is lower than the indicator of extensiveness (form), in all transition countries apart from Poland, which is the only country above the 45 degree line. Remaining problems include slow and inefficient bankruptcy procedures, low collateral recovery, legal restrictions on the disposal of assets (especially assets backed by real estate), and low levels of minority shareholder protection.

In most transition countries, law enforcement suffers from an overburdened judicial process, lack of trained regulatory personnel, and lack of sufficient authority and independence of the supervisory body. Both the development of the legal framework and the effectiveness of law enforcement are major obstacles in many transition countries of SEE and the CIS.

Finally, ensuring financial stability is closely associated with financial market deepening and maturing. The structure of, and ownership diversification in, the financial sector are important sources of strength in

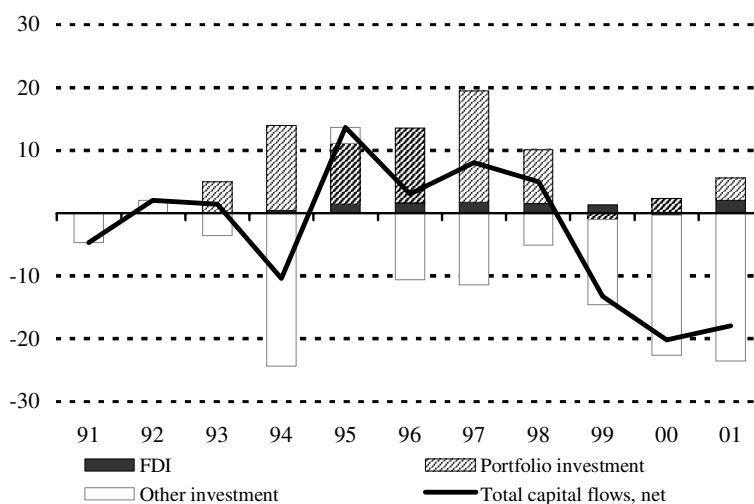
the presence of large and possibly volatile cross-border capital flows. Well-developed capital markets can help to fill the funding gap and dampen the destructive impact of a banking crisis on the real economy.

In addition to the remaining challenges for the banking sector (first and foremost strengthening the institutional capacity of regulators), the adequate protection of the rights of creditors and (minority) shareholders is a major challenge to stock market development in transition countries. Corporate governance has become a key issue in all of the transition economies. Abuses of corporate power by managers, owners and controlling shareholders have seriously hurt potential investors' appetite. The lack of sound corporate practices has damaged the region's investment climate. Significant improvements have been made recently and many of the CEEB countries

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Figure 6A.1 Net capital flows to Russia (US\$ bn)



Notes :

a: FDI is foreign direct investment.

b: Figures for 2001 are estimates.

Sources : World Economic Outlook Database and European Bank for Reconstruction and Development.

have improved their commercial codes and established financial regulations that protect minority shareholders' rights. However, due to the short history of these improvements, much can still be done to enhance effective corporate governance. Hungary and Poland, the first countries to improve shareholder protection, have also enjoyed the most liquid stock markets in the late 1990s.

6.5 CONCLUSION

More than ten years of transition have brought significant progress in restructuring and developing the financial sector in most (but not all) transition countries. However, progress has been quite uneven across different regions, and even in the most advanced transition countries the banking system (and *a fortiori* the rest of the financial system) has not yet progressed to the point that it can be characterized as a mature, fully functioning market-oriented and efficient banking sector (financial system). In none of those countries is the financial sector transition complete.

Growing two-way capital flows indicate an increasing integration in international capital markets, especially for advanced countries of CEEB. This process increases the pressures for strengthening the institutional infrastructure of the domestic financial sectors. Without significant further progress in this area, the accession countries will be unable to benefit fully from international financial integration and will continue to be exposed to the risks associated with international capital flow reversals.

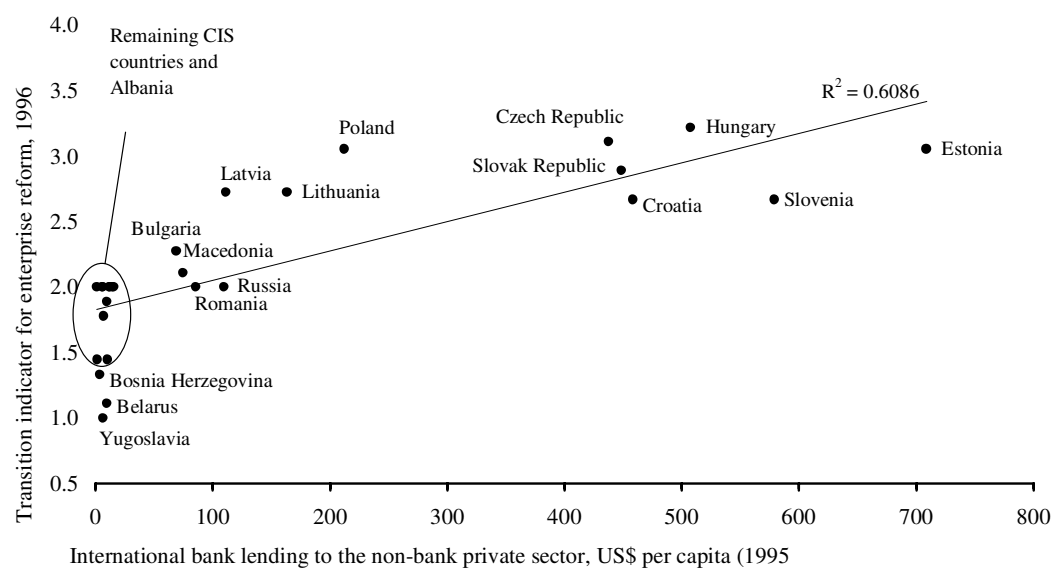
Major challenges for financial reform remain in each of the accession candidates. First, regardless of the level of banking reform that has been achieved, supervision and regulation have to keep pace with the demands of an ever more complex marketplace. In addition, banks themselves must improve their internal risk management practices and accounting standards and design industry-wide codes of conduct to guard against excessive risktaking and fraud.

Second, strengthening the legal framework and tightening enforcement of the laws and enforcement of regulatory guidelines are crucial if the level of bank intermediation between domestic and foreign savers and the domestic enterprise sector is to be increased. Specifically, the legal system has to be strengthened in areas such as collateral enforcement and secure transactions, which provide the foundation for all formal financial sector activity. Inadequate enforcement of creditor rights affects the portfolio decisions of banks and investors throughout the region, forcing them to invest a large share of their portfolio in government securities and to avoid

projects in the real sector, and especially in small and medium-sized enterprises.

Third, the improvement of corporate governance for both banks and non-bank enterprises remains an important challenge in most transition economies. This is a *sine qua non* for ensuring the soundness of the financial sector – and not only in the accession countries. Good corporate governance in enterprises means transparent and bankable clients for banks.

Figure 6A.2 International bank lending to non-banks versus enterprise restructuring



Sources : Bank for International Settlements and European Bank for Reconstruction and Development.

CIS									
Armenia	48.1	52.2	44.3	10.7	6.2	14.6	5.4	2.0	
Azerbaijan	–	–	88.3	16.0	–	15.0	3.9	1.9	
Belarus	–	–	–	10.9	15.2	–	8.6	0.7	
Georgia	53.1	53.3	–	6.9	5.6	33.7	0.1	1.0	
Kazakhstan	65.6	69.3	69.6	12.1	2.1	18.5	5.3	1.4	
Kyrgyzstan	50.2	61.3	55.8	4.1	16.4	20.5	4.6	–	
Moldova	64.5	73.5	71.2	12.8	20.6	30.0	–	8.0	
Russia	41.2	46.6	73.0	16.4	15.3	12.1	–	0.9	
Tajikistan	76.7	92.3	91.9	26.1	10.8	9.3	2.8	1.8	
Turkmenistan	–	–	–	70.0	–	3.0	0.0	0.9	
Ukraine	38.3	38.2	–	10.5	32.5	17.5	–	1.0	
Uzbekistan	90.5	94.6	–	18.3	0.0	16.4	–	–	

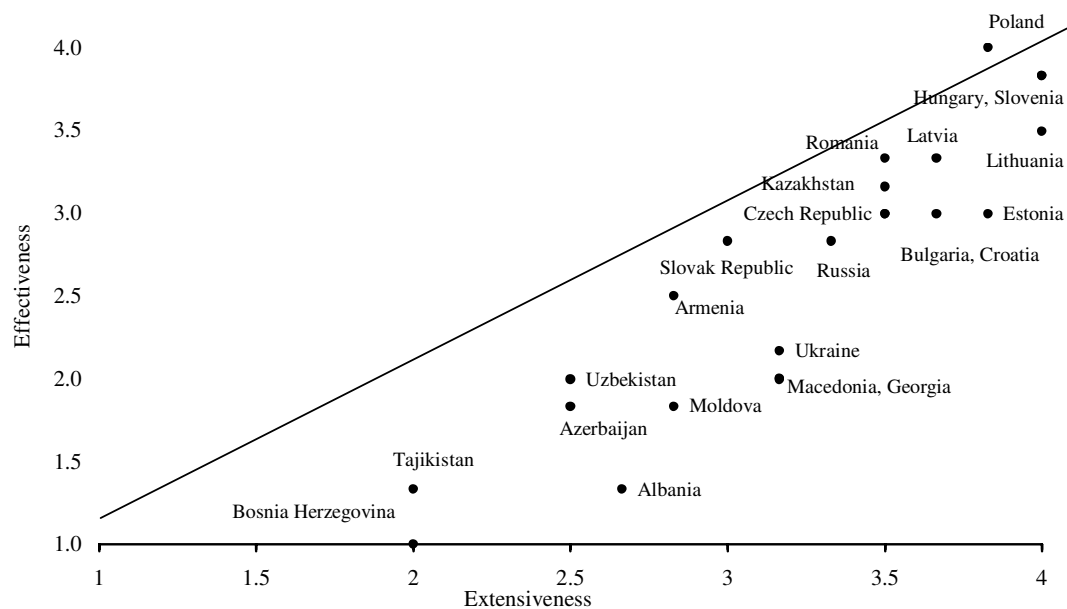
Note : * Includes substandard, doubtful, and non-recoverable loans.

Source : European Bank for Reconstruction and Development.

Table 6A.1 Selected indicators of banking sector development, end 2000

	Five largest banks (share)			Domestic credit (% GDP)	Non-performing loans*	Average capital ratio	Net interest margin (%)	Average rate of return on assets (%)
	Assets	Loans	Deposits					
CEEB								
Croatia	66.3	53.9	69.8	45.7	19.7	10.9	3.9	1.4
Czech Rep.	66.1	67.5	74.5	56.0	19.3	4.6	2.1	0.5
Estonia	98.8	99.5	99.5	38.1	1.5	12.6	0.0	1.1
Hungary	53.3	52.9	61.5	35.2	3.1	8.8	3.7	1.3
Latvia	62.3	71.9	66.2	21.7	5.0	8.4	4.0	2.0
Lithuania	88.5	85.0	93.0	16.8	10.8	10.0	3.6	0.4
Poland	48.6	48.4	49.1	36.5	15.9	8.2	4.0	1.1
Slovak Rep.	63.4	63.8	69.1	61.4	26.2	6.4	1.8	0.5
Slovenia	62.5	49.1	53.2	44.6	8.5	8.1	4.2	1.1
SEE								
Albania	89.1	91.2	91.9	31.4	42.6	6.7	2.9	2.1
Bosnia Herzegovina	57.8	–	–	41.9	15.7	16.5	4.0	-0.9
Bulgaria	60.5	–	–	25.6	10.9	0.1	4.1	4.1
FR Yugoslavia	65.4	–	–	61.1	27.8	3.4	–	–
FYR Macedonia	72.4	73.4	81.0	21.2	26.9	23.3	3.2	1.0
Romania	70.1	65.4	–	8.9	3.8	–	7.4	2.3

Figure 6.13 Effectiveness versus extensiveness of legal transition indicators, 2000

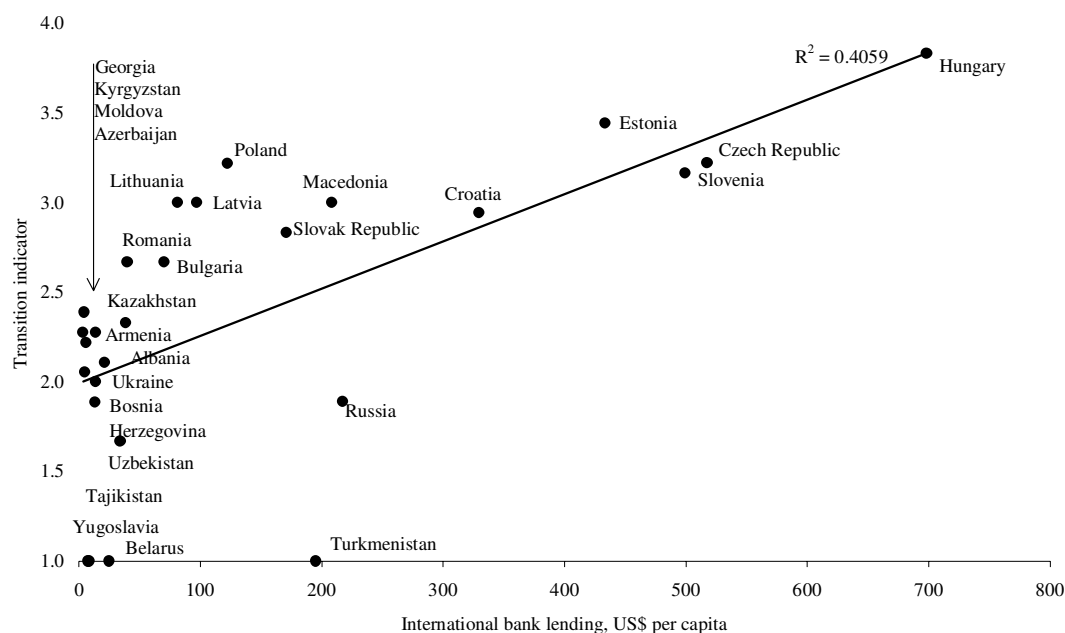


Source : European Bank for Reconstruction and Development.

NOTES

1. CEEB includes Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the

Figure 6.2 International bank lending to the banking sector and banking sector transition.



Sources: Bank for International Settlements and the European Bank for Reconstruction and Development. bailouts; (2) differences in the extent to which large-scale enterprises' coordinated their lobbying efforts for more subsidies and bailouts (Perotti, 1998); (3) differences in governments' ability to raise taxes and other revenues; and (4) differences in countries' geographical proximity and likelihood of accession to the European Union.

8. Figure 6A.2 illustrates the impact of international lending on economic restructuring more generally.
9. The estimated benchmark used in Figure 6.12 for developing and industrialized market economies is calculated by regressing the ratio of stock market capitalization to GDP on per capita income and per capita income squared for a sample of 98 countries. This analysis uses per capita GNP at purchasing power parity exchange rates in 1999, as calculated by the World Bank.
10. Exceptions are the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.
11. Even in the CIS countries, most foreign borrowing was channeled into government securities and domestic banks (e.g., Armenia).
12. Postabank was founded in 1988 as a private bank but was partially owned by state institutions. The bank's management, which had close relations with the government, misled

the auditors, hiding real losses by convoluted guarantee and investment deals, part of which they kept in secret. The revelation of hidden bank losses by the new management in 1998 prompted a government bailout of 152 billion forint (US\$706 million) in December 1998, and a full renationalization of Postabank, the country's third largest bank by assets at the time. The state has bailed out the bank several times in the past two years and acquired a majority in the bank in May 1998 when it raised the bank's capital by 24 billion forint (US\$111 million). After the scandal, Hungary's banking supervision legislation was improved, including via the strengthening of the powers of the financial market watchdog, the APTF.

13. For instance, the Slovak Republic expects to do so by the end of 2002.