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Financial Development in the CIS-7 Countries: Bridging the Great Divide

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Abstract

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This paper documents the great divide in the level of financial development between the Commonwealth of Independent States (CIS)-7 countries and the more advanced economies in transition, in particular those of Central and Eastern Europe and Baltic states. It discusses the roots of financial underdevelopment in the CIS-7 countries by examining the differentials in interest rate spreads between the CIS-7 countries and the transition economies that have achieved faster financial development. The roots of the divide are traced to weaknesses in the institutional infrastructure for financial intermediation, which lead to a combination of low depositor trust in the banking system and high credit risk. High credit risk stems mainly from the poor creditor-rights protection and weak auditing and accounting standards. Financial sector reform strategies that fail to give priority to the resolution of weaknesses in the basic financial infrastructure are unlikely to be successful in letting the CIS-7 countries bridge the great divide.

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I. INTRODUCTION

“A growing and deepening divide has opened up between transition economies where economic development has taken off and those caught in a vicious cycle of institutional backwardness and macroeconomic instability. This “Great Divide” is visible in almost every measure of economic performance.” Eric Berglof and Patrick Bolton, *Journal of Economic Perspectives*, Winter 2002.

Berglof and Bolton’s stark statement was prompted by the experience of transition countries in the 1990s. In the past three years, the CIS-7 countries—seven members of the Commonwealth of Independent States including Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan—have made remarkable progress in attaining macroeconomic stability. Yet, under any measure of financial development, CIS-7 countries are still on the wrong side of the divide.

This paper discusses the roots of the great divide in financial development by examining the differential in interest rate spreads between the CIS-7 countries and the transition economies that have achieved faster financial development—in particular, countries of the Central and Eastern Europe and the Baltic states. It argues that the roots of the divide can be traced to a combination of low depositor trust in the banking system and high credit risk. Low depositor trust forces banks to raise funds at a high cost, owing to a “confidence premium” demanded by depositors. High credit risk appears unrelated to macroeconomic conditions. Rather, it stems mainly from the high cost of assessing credit owing to poor creditor rights protection and weak auditing and accounting standards. In essence, weaknesses in the basic financial infrastructure are key roots of the divide. Financial sector reform strategies that fail to give priority to the resolution of such weaknesses are unlikely to be successful in letting the CIS-7 countries bridge the great divide.

The remainder of the paper is composed of three sections. Section II documents aspects of the great divide. Section III discusses its roots. Section IV overviews the main impediments to financial development in the CIS-7 countries and outlines some of the policies likely to be successful in allowing CIS-7 countries to bridge the divide

II. THE DIVIDE IN FINANCIAL DEVELOPMENT

The importance of financial development as a determinant of countries’ growth performance is by now established by a substantial literature that has scrutinized a wide variety of country experiences.² Growth in real activity and incomes may, in turn, spur financial development, albeit not necessarily. As shown in Table 1, during the 1995-2002 period, CIS-7 countries have on average grown faster than other CIS countries, the transition economies in South

² For a recent review of research on the finance-growth nexus, see Wachtel (2003).

Eastern Europe (SEE), and those in Central and Eastern Europe and the Baltics (CEE+B).³ This faster growth is consistent with a partial catching-up of CIS-7 countries, since they started with a lower level of GDP per capita in 1995. Yet, as will be shown momentarily, the divide in financial development has not shrunk.⁴

Table 1. GDP Per Capita and Average Annual Real GDP Growth Rate, 1995–2002

	Average 1995 GDP per capita (in US\$)	Average 2002 GDP per capita (in US\$)	Average Annual Real GDP growth rate 1995–2002	Average Annual Real GDP growth rate 1999–2002
CIS-7	388	468	3.9	4.5
Other CIS	847	1,371	3.5	6.2
SEE	1,796	1,872	2.0	2.7
CEE+B	3,158	4,809	3.4	3.0

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

One indicator of financial development is monetary depth, as measured by the ratio of M2 to GDP. As shown in Table 2, CIS-7 countries recorded the lowest average M2/GDP ratio in 2002, despite the fact that monetization may have been favored by allowing high levels of dollarization in virtually every CIS-7 country.⁵ Moreover, the distance between the CIS-7 ratio and that of those transition countries that have developed most rapidly, the CEE+B countries, has significantly widened since 1995. More generally, the dispersion in monetary depth among the four groups of transition economies considered has slightly increased, as shown by the increasing standard deviation of the M2/GDP ratio among the four groups.

³ SEE countries include Albania, Bosnia and Herzegovina, Bulgaria, the Former Republic of Yugoslavia, the Former Yugoslav Republic of Macedonia, and Romania. CEE countries include Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia. Given their similarity of financial development with the CEE countries, the Baltic countries—Estonia, Latvia, and Lithuania—are grouped with the CEE countries in the aggregate called CEE+B.

⁴ We discuss data averages for groups of transition countries to focus on broad trends. Although some indicators of financial development differ *within* CIS-7 countries, the conclusions reached on the basis of averages are essentially unchanged when these differences are taken into account.

⁵ On the benefits and potential risks of dollarization, see De Nicoló, Honohan, and Ize (2003).

Table 2. Average M2-to-GDP Ratio

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	14.1	12.6	13.0	11.9	12.0	12.6	12.9	13.8	-2.1
Other CIS	15.3	11.0	11.6	12.9	14.4	16.2	18.1	22.1	44.1
SEE	37.6	42.0	30.9	29.3	31.6	32.2	38.1	35.4	-5.9
CEE+B	39.1	40.0	42.2	42.2	43.7	45.5	48.1	49.3	26.0
<i>Standard Deviation</i>	<i>13.7</i>	<i>16.9</i>	<i>14.7</i>	<i>14.5</i>	<i>15.0</i>	<i>15.2</i>	<i>16.6</i>	<i>15.6</i>	<i>13.7</i>

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

Banks are the dominant intermediaries in the CIS-7 countries. Non-bank financial intermediaries and capital markets are either at a very low level of development or non-existent. While nonbank intermediaries and capital markets have developed in several transition economies, the banking sector is still the central pillar of financial intermediation in all transition economies. Thus, comparisons of banking sector structures provide the most appropriate gauge of differential financial development. As shown in Table 3, the overall depth of bank intermediation activity, as measured by the ratio of total banking sector assets to GDP, was lowest in the CIS-7 countries as of end 2002. Since 1995, the average CIS-7 ratio has grown no faster than that of the other transition economies except the SEE countries. The divide between CIS-7 countries and the best performing transition economies has widened further.

Table 3. Average Bank Assets-to-GDP Ratio

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	15.9	13.4	13.3	13.8	15.7	17.4	16.7	18.3	15.2
Other CIS	16.2	15.4	17.2	26.3	22.6	23.8	25.3	29.5	81.7
SEE	57.3	61.2	48.4	42.5	41.9	42.1	44.8	45.5	-20.7
CEE+B	53.1	55.2	63.0	61.1	61.5	65.2	71.0	74.4	40.2
<i>Std. Dev.</i>	<i>22.7</i>	<i>25.4</i>	<i>24.2</i>	<i>20.5</i>	<i>20.6</i>	<i>21.5</i>	<i>24.1</i>	<i>24.4</i>	<i>7.6</i>

Sources: IMF, *International Financial Statistics* and IMF staff estimates.

A measure of success of banking systems in providing financial services to household, in the form of payment services and saving vehicles, is their capacity to attract deposits. As shown in Table 4, deposits as a percentage of GDP in the CIS-7 countries are the lowest in comparison with the other transition economies. As a percentage of GDP, deposits have grown fastest in the CIS-7 countries, but from very low initial levels in 1995. In absolute terms, the difference between the CIS-7 ratio and that of the other transition economies has on average widened since 1995.

Table 4. Average Bank Deposits-to-GDP Ratio

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	6.0	5.0	6.5	5.8	6.4	8.2	7.8	10.7	78.4
Other CIS	9.6	8.5	9.2	13.8	11.6	13.1	13.7	15.9	66.5
SEE	26.8	24.1	16.7	16.6	18.8	19.3	22.7	23.5	-12.2
CEE+B	34.4	36.2	38.3	38.1	38.7	42.4	47.1	47.9	39.1
<i>Std. Dev.</i>	<i>13.6</i>	<i>14.5</i>	<i>14.4</i>	<i>13.8</i>	<i>14.2</i>	<i>15.1</i>	<i>17.3</i>	<i>16.5</i>	<i>20.8</i>

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

A limited capacity to attract deposits may hamper bank's ability to intermediate funds to the most productive uses and at the lowest cost. The capacity of CIS-7 banking systems to direct credit to the private sector compares unfavorably with the other transition economies, particularly with those that have made the most rapid progress in banking development. As shown in Table 5, the ratio of private sector credit to GDP in the CIS-7 countries has grown more slowly than that in the other CIS and SEE economies, although faster than for the CEE+B group. However, its level remains well below that of the other transition economies.

Table 5. Ratio of Average Bank Credit to the Private Sector to GDP

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	6.8	5.3	4.5	7.8	7.6	9.0	8.9	9.7	43.6
Other CIS	5.8	5.1	6.3	10.6	9.1	10.7	13.1	15.8	170.9
SEE	12.0	19.3	20.7	19.4	18.2	17.5	18.3	19.2	60.6
CEE+B	25.6	26.1	29.9	30.4	30.0	29.9	30.1	31.4	22.4
<i>Std. Dev.</i>	<i>9.1</i>	<i>10.5</i>	<i>12.1</i>	<i>10.2</i>	<i>10.3</i>	<i>9.5</i>	<i>9.2</i>	<i>9.1</i>	<i>-0.1</i>

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

III. THE ROOTS OF THE DIVIDE

An informative single indicator of a banking system's success in intermediating funds between savers and investors is the spread between lending and deposit rates. For given levels of inflation, interest rates and the phase of the business cycle, the level of spreads is determined by, and is positively related to three factors: (i) funding, operating, and regulatory costs; (ii) rents accruing from banks' market power on both the lending and deposit side; and (iii) the level of credit risk. High spreads induced by high costs, market power rents and credit risk may result in either a high cost of credit, which discourages investment, or a low remuneration of deposits, which discourages intermediation of savings, or both.

High spreads, usually associated with high lending rates and collateral requirements, may be extremely harmful for economic development in the CIS-7 countries, particularly in those countries in which small and medium-sized enterprises (SMEs) are, or are likely to become, the most dynamic sectors of the economy.⁶ Specifically, they make it difficult or nearly impossible for viable SMEs to obtain necessary funds either because of high borrowing costs and collateral requirements, or because banks ration credit as a result of their poor capacity to distinguish good from bad credits.

As shown in Table 6, average CIS-7 countries' spreads in 2002 were lower than in the other CIS countries. Yet, they were about 200 basis points higher than those in the SEE countries, and 730 basis points higher than those in the CEE+B countries as of end-2002. The declining dynamics and dispersion of spreads reflects the significant reduction in inflation and macroeconomic volatility witnessed in all transition countries.

Table 6. Average Domestic Currency Lending-Deposit Spread
(in percent)

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	48.7	25.2	27.3	28.1	15.3	18.3	15.2	12.6	-74.2
Other CIS	63.3	38.1	20.8	23.2	29.2	25.3	15.7	13.5	-78.6
SEE	13.8	20.7	21.2	14.8	12.5	13.3	12.6	10.7	-22.6
CEE+B	9.5	8.5	6.7	6.3	6.5	6.0	5.4	5.3	-44.8
<i>Std. Dev.</i>	26.3	12.3	8.7	9.6	9.6	8.1	4.8	3.7	-86.0

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

Which of the determinants of spreads listed above is likely to be important in accounting for the hefty 730 basis point *differential* in spreads between the CIS-7 countries and the most advanced transition economies, the CEE+B group? This differential equals the difference between a lending rate differential and a deposit rate differential. That is, $730 = [\text{Lending rate}(\text{CIS7}) - \text{Lending Rate}(\text{CEE+B})] \text{ minus } [\text{Deposit rate}(\text{CIS7}) - \text{Deposit Rate}(\text{CEE+B})]$. Looking at differentials in deposit and lending rates separately throws light on the roots of the divide.

In comparing deposit rates across countries, differences in inflation rates and short term interest rates need to be taken into account. As shown in Table 7, average real deposit rates in the CIS-7 countries, although they declined substantially since 1996, were still 480 basis points larger than in the CEE+B countries in 2002 (that is, $[\text{Deposit rate}(\text{CIS7}) - \text{Deposit Rate}(\text{CEE+B})] = 480$). A portion of this 480 basis point differential is in part due to the higher short term interest rates in the CIS-7 countries compared to rates in the CEE+B

⁶ SMEs appear the most dynamic sectors relative to large firms in many Central and Eastern European countries (see Klapper, Sarria-Allende, and Sulla (2002)).

countries.⁷ The remaining portion of this differential cannot be attributed to lower competition in CIS-7 deposit markets, since banks with market power would be capable to obtain deposits at low cost by offering a low remuneration. Likewise, it is unlikely that higher costs incurred in the provision of financial services by CIS-7 banks may explain this differential, since banks passing onto depositors such higher costs would pay them lower rather than higher rates. Thus, a relevant portion of the difference in average real deposit rates between CIS-7 and CEE+B countries is likely due to a “confidence premium” CIS-7 banks must pay to attract deposits. Depositors require this premium as a compensation for the risk associated with their perceived inability of redeeming their deposits at par in some (crisis) circumstances.⁸ Of course, higher bank funding costs are passed onto borrowers in the form of higher lending rates.

Table 7. Average Inflation and Real Deposit Rates
(in percent)

	1996	1997	1998	1999	2000	2001	2002
<i>Inflation</i>							
CIS-7	30.3	13.6	6.9	17.7	13.9	6.3	3.6
CEE+B	14.7	10.6	8.6	5.3	5.3	4.9	3.5
<i>Real deposit rates</i>							
CIS-7	0.0	11.1	16.0	5.7	2.9	6.6	6.0
CEE+B	-2.4	0.1	1.7	2.3	1.5	1.3	1.2

Sources: IMF, *International Financial Statistics*, and IMF staff estimates.

Since the difference in average real deposit rates between CIS-7 and CEE+B countries is 480 basis points, the differential in lending rates for these two groups of transition countries is a huge 1210 basis points (that is, [Lending rate(CIS-7)–Lending Rate(CEE+B)] = 730+480 = 1210). As noted, about 40 percent of this differential (480 out of 1210) is accounted for by higher differential funding costs for CIS-7 banks. Which of the factors affecting lending rates, namely operating costs, regulatory costs, market power on the lending side, and credit risk, may account for the remaining 60 percent of this differential in lending rates? We examine these factors in turn.

⁷ As of end-2002, average short term interest rates were about 12 percent in the CIS-7 countries and about 5 percent in the CEE+B countries. However, differential in interest rates on short term instruments are only indicative of alternative investment opportunities for depositors, since in no CIS-7 country the public appears to hold a relevant portion, if any, of short term instruments either directly or indirectly through banks.

⁸ As demonstrated in Ennis and Keister (2003), even the perception of a low probability of banking instability may result in detrimental effects on the economy real growth rate, since an amount of savings lower than it would be desirable is channeled to finance productive investment through bank intermediation.

Banks in the CIS-7 countries might incur higher operating costs because they are not large enough to exploit scale economies. If this were the case, higher operating costs would be paid by borrowers in the form of higher lending rates. As shown in Table 8, however, the difference between CIS-7 and CEE+B countries in terms of a standard measure of banking costs, the ratio of operating costs to income, suggests that operating costs are unlikely to explain a significant portion of the 730 basis point differential in lending rates, since banks' average cost-to-income ratios in the CIS-7 countries are not higher than in the CEE+B countries.⁹ Moreover, evidence for a large number of banks for the second half of the nineties does not appear to support the argument that banks in transition countries are likely to exploit scale economies by consolidating through mergers, i.e. by becoming bigger, since banks with larger market shares were found to incur higher costs.¹⁰ In general, the relationship between banking system structure, bank efficiency and soundness is more complicated than often suggested in some policy discussions (Box 1).

Table 8. Average Bank Cost-to-Income Ratio

	1999	2000	2001
CIS-7 Countries	56.7	57.3	64.6
CEE and Baltics	62.6	67.1	71.7

Sources: Bankscope; and IMF staff estimates.

Box 1. Is There An Optimal Banking System Structure?

Banking systems in several transition economies are often considered “overbanked,” in the sense that there are too many small banks. A policy implication of “overbanking” is that bank consolidation *per se* should be strongly encouraged, or even *forced*. Without qualifications, however, this policy tenet is unlikely to be helpful in assessing desirable sequencing of banking sector reform.

It is important to distinguish between bank *consolidation via exit* of nonviable or failed banks, as opposed to bank *consolidation via mergers*. Efficiency and soundness arguments strongly support the desirability of consolidation via exit. This consolidation has occurred in some CIS-7 countries and other transition economies, often as a result of crises that have exposed the detrimental incentives for sound banking of certain lax entry policies and weak regulatory standards. Many “entities” set up a bank in order to exploit specific advantages and/or subsidies granted by a banking license. In several CIS-7 countries some nonviable banks still continue to survive owing to incomplete liquidations and/or restructuring, as well as lags in the implementation of best practice regulatory, prudential, and accounting standards.

As shown in Table 9, banking system density, as measured by the number of banks per million inhabitants, substantially declined in the CIS-7 countries since 1995, and was lower than in the CEE+B countries in 2002. On the other hand, average bank size in the CIS-7 countries is significantly smaller than that in the CEE+B countries, most likely because of the lower level of banking development in the former.

⁹ Recent evidence based on bank-by-bank data for some CIS-7 countries also shows that operating costs of small banks are not significantly higher, and in many instances are lower, than those incurred by large banks.

¹⁰ See Fries, Neven, and Seabright (2002).

Table 9. Average Number of Banks Per Million Inhabitants

	1995	1996	1997	1998	1999	2000	2001	2002	% Change 1995-2002
CIS-7	9.3	7.4	6.6	6.3	5.4	4.9	4.5	3.9	-57.5
Other CIS	8.0	8.9	8.1	5.3	4.8	4.2	4.1	4.1	-48.4
SEE	3.0	2.9	2.5	2.9	3.2	3.2	3.2	3.2	7.5
CEE+B	9.1	8.2	7.9	6.9	6.7	6.1	6.4	6.2	-32.1
<i>Std. Dev.</i>	<i>3.0</i>	<i>2.7</i>	<i>2.6</i>	<i>1.8</i>	<i>1.5</i>	<i>1.2</i>	<i>1.3</i>	<i>1.3</i>	<i>-57.1</i>

Sources: IFS, Bankscope, and IMF staff estimates.

An *efficiency* and *soundness* argument for the desirability of bank *consolidation via mergers* rests on the identification of an optimal banking system structure. Yet, such identification, in terms of number of banks or bank size, is difficult for at least five reasons. First, if economies of scale at a firm level could be exploited, it is not necessarily the case that a banking system would be more efficient or stable. Robust evidence regarding the higher profitability, lower costs and more prudent risk management of larger banks is hard to find in developed as well as developing economies (see De Nicoló (2000) and De Nicoló et al. (2003)). On the other hand, if economies of scale are not significant, any size distribution of banks in an economy can be consistent with efficiency, *ceteris paribus*.

Second, the minimum efficient scale of a bank crucially depends on the extent to which its management team can efficiently control a given size and composition of bank activities. In the context of a low level of credit culture, underdeveloped risk management capacity and accounting opacity, managerial dis-economies of scale might set in even at relatively small scales (see Cerasi and Daltung, 2000). Third, if economies of scale exist at a *system* level, it is unlikely that they are going to be exploited by any subset of banks in the system. For example, an adequate payments system infrastructure is a *public* good, since it benefits all banks in terms of their capacity of providing enhanced services at a lower cost. Setting up such infrastructure requires public investment, since any subset of banks would not have either the incentives, or sufficient skills and funds, or both, to invest in an activity that does not yield exclusive private benefits (see Santomero and Seater, 2000). Fourth, increased concentration in banking may, although need not to, have undesirable implications for bank competition and soundness. For example, higher lending rates arising from monopoly rents in the loan market may induce borrowers to take on excessive risks, which in turn may impact negatively on the quality of bank loan portfolios (see Boyd and De Nicoló (2003)). Lastly, consolidation via mergers of two ailing banks, or mergers between a weak and a healthy bank is not necessarily reducing the failure risk of the merged entity (see Shih (2003)).

For these, and possibly other reasons, perhaps the following definition of an optimal banking structure may be useful in guiding banking sector policy: an optimal banking structure is one in which all banks in the system fulfill best practice prudential and regulatory standards, their accounting systems and ownership structure is transparent, they operate on the same level playing field, and they are profitable on average.

Banks in the CIS-7 countries might also incur comparatively higher regulatory costs, which could be passed onto borrowers through higher lending rates. Indeed, there is evidence indicating that high regulatory costs, such as high reserve and capital requirements, have a negative impact on bank interest margins. As shown in Table 10, capital ratios in the CIS-7 countries are significantly larger than those in all other groups of transition economies. These higher ratios may account for a portion of the differential in interest rates. While the higher

ratios witnessed in several of the CIS-7 countries are the result of policies implemented with the objective of strengthening banks' financial position, it is important to recognize that there could be a potential trade-off between policies aimed at strengthening bank solvency and the cost of credit for borrowers.¹¹

Table 10. Average Equity-to-Asset Ratios

	1995	1996	1997	1998	1999	2000	2001	% Change 1995-2001
CIS-7	12.5	13.8	17.6	19.1	17.6	18.9	19.2	53.5
Other CIS	10.4	10.5	17.6	14.9	17.4	16.4	14.5	39.3
SEE	13.9	14.2	18.7	13.5	12.0	13.7	11.2	-19.5
CEE+B	10.9	10.6	10.4	11.4	11.2	11.0	10.5	-3.6

Sources: IFS, Bankscope, and IMF staff estimates.

Ceteris paribus, the stronger is banks' market power, the higher their lending-deposit spread should be, since banks could extract rents either from borrowers, or from depositors, or both. Although market power is difficult to measure, simple bank concentration measures may capture market power outcomes, albeit imperfectly. A small number of banks dominating a large portion of the market, compared to numerous banks serving a relatively small portion of the market, may extract more rents from clients owing to the size of their exposure (and connections) with large borrowers, as well as to the easiness with which they might collude in setting prices and/or in avoiding to compete for each other's market share. A high bank concentration can be also the result of restrictions on bank entry, as well as the outcome of substantial bank state ownership. Indeed, cross-country evidence is supportive of the fact that bank spreads, as well as interest rate margins, are higher in countries with higher bank concentration and bank state ownership.¹²

As shown in table 11, average bank concentration in the CIS-7 countries is not greater than that in the CEE+B countries. By contrast, average bank state-ownership is significantly larger than in the CEE+B countries, although it is of relevance in only three out of the seven CIS-7 countries. This means that state-owned banks have on average a much larger market share in some of the CIS-7 countries relative to the CEE+B countries, and suggests that market power might account for a portion of the differential in lending rates between CIS-7 and CEE+B countries *only when* state-owned banks have a large market share. However, the quantitative

¹¹ See Saunders and Schumaker (2000) and Demirgüç-Kunt, Laeven, and Levine (2003).

¹² See Demirgüç-Kunt and Huizinga (1999) and Demirgüç-Kunt, Laeven, and Levine (2003) for a large cross section of countries, Martinez-Peria and Mody (2003) for Latin America, and Okeahalam (2003) for southern Africa.

relevance of this factor in accounting for a portion of differential lending rates may be confined only to those CIS-7 countries in which the portion of credits to state-owned enterprises extended by state-owned banks at rates at or below “market” rates is not significant.¹³

Table 11. Average Bank Concentration and of State Ownership Banks, 2001

	3-Bank Concentration Ratio	5-Bank Concentration Ratio	State-Owned Bank Assets (in percent of total assets)
CIS-7	49.7	61.0	42.0
Other CIS	46.8	57.3	51.6
SEE	52.2	58.6	30.6
CEE+B	59.2	71.3	19.8

Sources: IFS, Bankscope, and IMF staff estimates.

Finally, we consider the last determinant of spreads in our list, credit risk. Credit risk can be high because of a recession and/or because of macroeconomic uncertainty, as reflected in high inflation and interest rate volatility. Most importantly, credit risk can be high because of structural factors arising from the lack of a credit culture inhibiting the adoption of best practice lending and risk management technologies, as well as weaknesses in the institutional infrastructure. These factors prevent banks from carrying out their monitoring functions efficiently, such as assessing the credit worthiness of borrowers, in part owing to the lack of reliable accounting standards. They may also inhibit banks to rapidly repossess collateral in case of creditors’ default, owing to weak creditors’ legal protection.

Credit risk accounts for a large, and we believe the largest, portion of the divide, as measured by the lending-deposit spread differential between CIS-7 and CEE+B economies. However, credit risk arising from macroeconomic conditions, either in the form of differential business cycle positions of the groups of country considered, or in the form of differential macroeconomic volatility, is unlikely to explain a relevant portion of the current large differential in lending rates, since both groups of countries are in an expansionary phase, their inflation is on average low, and macroeconomic volatility is by and large subdued almost everywhere.

Credit risk arising from a poor or costly institutional infrastructure for intermediation appears a key factor in explaining the persistence of the divide. Table 12 reports averages of several indicators of institutional quality obtained from a large set of survey evidence, relative to those reported for the CEE+B countries, which reported values uniformly higher than all

¹³ Drakos (2003) evidence regarding significantly narrower margins for state-owned banks in 11 transition economies (none of which is a CIS-7 country) suggests that state-ownership may be associated with subsidies to rather than rent extraction from borrowers.

other groups.¹⁴ In all dimensions, the institutional quality of CIS-7 country, as well as the other groups of transition economies, is significantly lower than the one in the CEE+B countries. These indicators reflect either directly or indirectly the sources of “institutional” credit risk we have previously identified, namely poor creditor rights and insufficient transparency in ownership structure and accounting. Thus, lags in developing an efficient institutional structure for financial intermediation appear among the key causes of the divide in financial sector development. A deficient institutional infrastructure appears at the root of excessive lending rates that prevent efficient bank intermediation to take place.¹⁵

Table 12. Indicators of Institutional Quality in 2000/2001
(CEE+B = 100)

	Regulatory Quality	Rule of Law	Control of Corruption	Voice and Accountability	Political Stability	Government Effectiveness
CIS-7	37.0	50.9	53.9	47.3	57.3	46.8
Other CIS	38.5	48.7	45.2	49.0	49.6	39.2
SEE	62.7	58.2	62.2	69.3	61.1	53.0

Source: Kaufmann, Kraay, and Zoido-Lobaton, 2002.

As illustrated in Table 13, the differential level of credit risk is also reflected in the higher average level of non-performing loans (NPLs) in the CIS-7 countries compared to the other transition economies. High NPLs levels impose an extra cost-burden on banks, which are possibly passed on to borrowers. Higher relative NPLs are also indicative of weak supervision and lags in bank restructuring, which in turn affect adversely banks’ capacity to carry out their lending functions effectively.

¹⁴ The institution quality database is due to Kaufmann, Kraay, and Zoido-Lobaton (2002). They compiled information on: (i) *regulatory quality*, i.e., the relative absence of government controls on goods markets, government interference in the banking system, excessive bureaucratic controls on starting new businesses, or excessive regulation of private business and international trade; (ii) *rule of law*, i.e., protection of persons and property against violence or theft, independent and effective judges, contract enforcement; (iii) *control of corruption* – absence of the use of public power for private gain; (iv) *voice and accountability*, i.e., the extent to which citizens can choose their government and enjoy political rights, civil liberties, and an independent press; (v) *political stability*, i.e., a low likelihood that the government will be overthrown by unconstitutional or violent means; and (vi) *government effectiveness*, i.e., the quality of public service delivery, competence of civil servants, and the absence of politicization of the civil service.

¹⁵ As shown in IMF (2003), progress in institutional quality is also likely to be an important determinant of remonetization.

Table 13. Ratio of Nonperforming Loans to Total Loans

	1995	1996	1997	1998	1999	2000	2001
CIS-7 countries	34.0	12.7	7.9	13.2	13.7	10.8	14.5
Other CIS	11.3	12.6	11.3	18.3	20.9	12.2	12.9
SEE	37.7	43.3	42.2	37.5	31.4	17.1	11.5
CEE and Baltics	13.5	14.3	12.7	12.4	11.7	9.9	8.7

Sources: National authorities, and IMF staff estimates.

In sum, low levels of bank intermediation arise because of low confidence in the banking system on the deposit side, and non transparent borrowers, weak credit culture and poor or costly enforcement of financial contracts on the lending side.¹⁶ The low confidence in banks pushes the public to either keep its savings in cash (usually in foreign currency), or, if feasible, in banks abroad. Weak credit culture and poor or costly enforcement of financial contracts makes monitoring of credit risk difficult, credit very costly for borrowers, possibly generating credit rationing.

IV. POLICY PRIORITIES

In examining country experiences in depth, the literature has identified specific impediments to banking development in transition. The common finding is that the countries most successful in achieving financial development are those that have removed these impediments faster.¹⁷ Although the importance of these impediments may differ from country to country, the most important ones, which appear common to most countries, are (i) weak legal and judicial framework (in particular, weak protection of creditor rights, weak protection from tax authorities, etc.); (ii) weak financial sector supervision or enforcement of prudential standards; (iii) lags in the resolution of unviable or failed banks; (iv) weak accounting and auditing standards; (v) weak governance in the banking sector; and (vi) slow bank privatization. Removing these impediments is already a priority of the authorities of some CIS-7 countries, and it should become a priority for all. The question is how best to achieve this goal and how quickly this can be done.

Despite considerable progress in strengthening the legal and judicial framework in most CIS-7 countries, much remain to be done. Particularly pressing are the problems several CIS-7 central banks still face in enforcing rules and regulations, such as implementing closure of

¹⁶ On the depositors' side, other factors may be important, such as the insufficient provision of bank services.

¹⁷ See, for example, Bonin and Wachtel (2003), World Bank (2001), and EBRD (1998). Fischer (2001) notes that in past reform strategies in transition economies "too little thought was given to institution-building, for example, of sound legal and regulatory systems and well functioning tax administrations" (p.4).

failed banks. Legislation incorporating best-practice bankruptcy and creditor resolution procedures is either not yet in place or, if in place, is in many instances at risk of being unevenly or poorly enforced, partly owing to inefficient courts and judges' lack of technical expertise in financial matters.

Most authorities in CIS-7 countries are committed to introducing financial regulation rules and supervision practices consistent with international best practice, although the speed of their introduction has varied across CIS-7 countries. Yet, even best-practice financial sector regulations and supervision, as well as the enforcement of prudential standards, may be jeopardized by a weak legal and judicial framework. For example, absent an adequate legal framework, bank regulations and supervisory practices conforming to Basel Core Principles may turn into "empty shells."¹⁸

As noted above, low confidence in the banking system arising from the uncertainty with which authorities may be perceived to deal with bank failures and crises is one root of low levels of bank intermediation. In many CIS-7 countries, authorities have responded to the need to restore confidence by making plans to introduce systems of depositor protection, such as deposit insurance. Yet, three key preconditions for effective deposit insurance—a sound banking system, effective bank supervision, and legal certainty—are not fully met in the CIS-7 countries yet. There are still nonviable banks surviving in several CIS-7 countries; and in many cases accounting practices do not allow one to judge the true financial strength of institutions, despite the strengthening of banking supervision methods and procedures. Until these weaknesses are fully addressed, the introduction of deposit-insurance systems would be premature and highly risky. Implementing the orderly exit of nonviable banks and ensuring effective and timely monitoring of the viability of existing banks are key policy priorities to fulfill the preconditions for effective deposit insurance, and would make its introduction feasible and sufficiently credible to restore depositors' confidence.

Some CIS-7 countries have moved aggressively to strengthen accounting and auditing standards. For example, IAS accounting standards have been, or are planned to be, introduced for both financial and nonfinancial firms in several CIS-7 countries. These efforts are commendable, and this policy stance, if pursued aggressively by all CIS-7 countries, is

¹⁸ A "suitable legal framework" is first in the List of Core Principles for Effective Banking Supervision (Basel, September 1997): "Principle 1. An effective system of banking supervision will have clear responsibilities for each agency involved in the supervision of banking organizations. *Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors (our italics).* Arrangements for sharing information between supervisors and protecting confidentiality of such information should be in place."

likely to be extremely beneficial. However, building up a sufficient base of accountants and auditors endowed with suitable technical expertise to enable them to understand and use these standards appears a priority, since such expertise is a necessary condition for their effective implementation.

Despite some progress achieved in the past few years, banking sectors in most CIS-7 countries still suffer from weak governance. Nontransparent ownership structures favor connected lending, which may result in either heightened risks or crowding out of borrowers seeking finance for potentially productive projects. In addition, opaque bank ownership structures, in part owing to the lack of enforcement and monitoring of “fit-and-proper” ownership criteria, prevent a market for corporate control trend developing. The lack of such a market is likely to be one key reason for the paucity of market-driven bank reorganizations in the CIS-7 countries—including entry of foreign banks, joint ventures, or mergers of existing viable banks—that might eventually result in improvements in bank efficiency and profitability.

There is substantial cross-country evidence that associates state ownership of banks with slower subsequent financial development, lower subsequent growth of per capita income, and lower growth of productivity in the nonfinancial sector.¹⁹ State ownership is still pervasive in some CIS-7 countries. Intensifying efforts to privatize state-owned banks, while ensuring the adequate provision of financial services that some of these banks supply, appears high on the agenda for financial sector reform. Privatization appears the most urgent in all cases where state-owned banks, by controlling sizable portions of deposit and credit markets, exercise their market power and use their implicit or explicit subsidies to take on excessive risks.

As noted, the transition economies that have achieved faster financial development are those that have removed the foregoing impediments to financial development at a faster pace. These countries have made substantial progress in legal and judicial reform. They have also implemented rapid bank restructuring, decisively aided by effective corporate restructuring.²⁰ They also built strong central banks and financial agencies implementing best-practice regulation and supervision, and overcame initial hesitations to privatize state-owned banks. As a result of liberalized entry of “fit-and-proper” financial firms, they have witnessed substantial entry of foreign banks in their markets. Foreign institutions have speeded up rationalization in the provision of financial services, and increased overall transparency and competition. Although the speed of banking development of these countries may have been increased by initial conditions and other characteristics more favorable than those facing CIS-7 countries at the outset of transition, clear commonalities in the driving forces of financial development emerge among the most successful transition economies.

¹⁹ See, for example, La Porta, Shleifer, and Lopez-de-Silanes (2000).

²⁰ See Djankov and Murrell (2002).

So far, we have focused on banking. We did so because comparisons of banking sectors among transition economies are the most appropriate and because the banking sector is the most important financial sector in all transition economies. In the CIS-7 countries, as well as in most other transition economies, there are several “missing pieces” in financial development—namely the lack of development of non-bank intermediaries and capital markets. However, it is important to note that the development of domestic equity and private debt markets, as well as of nonbank financial institutions, does not appear to have played a major role in the first phase of financial development of the most successful transition economies. Development of private bond markets and nonbank financial institutions, such as insurance and pension funds, appears to have gained momentum only recently.²¹

In theory, a balanced growth in financial development, where bank and nonbank intermediaries develop alongside capital markets, is the most desirable scenario. In practice, however, the development of nonbank intermediaries and capital markets requires the buildup of a sophisticated legal and regulatory infrastructure, as well as a diffused credit and saving culture. Most importantly, it requires a functioning and tested institutional capacity for the efficient enforcement of financial contracts. There are important trade-offs in institutional capacity building that any transition economy faces. In most if not all CIS-7 countries, detailed cost-benefit analyses of financial development in nonbank intermediaries and capital markets aimed at detecting components of financial reforms with the highest “value added” appear necessary to identify the policy-sequencing strategies likely to be most successful in bridging the great divide.

²¹ See Bonin and Wachtel (2003).

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