TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER Working Paper Series

No. 23

The Financial Sector in Transition Economies Ten Years After: The Issues, the Record, and the Challenges

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Warsaw, August 2002

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The Financial Sector in Transition Economies Ten Years After: The Issues, the Record, and the Challenges[1]

Summary

Most studies dealing with banking in transition focus on the initial shortcomings that these economies confront in the pursuit of a sound financial system. Typical limiting factors include: initial lack of financial skills, inadequate regulatory framework, related lending, ineffective supervision, high real interest rates, and reckless bankers and oligarchs that cheat on depositors, lenders, and minority shareholders.

For many countries all this is true .In this paper, nevertheless, we attempt to illustrate the proposition that, even assuming away all these limiting factors, banking in transition may be a money losing proposition until a **threshold** or critical mass **of transformation** has been achieved. We focus on two central factors that impede sound banking before that **threshold of transformation** has been achieved: **lack of established reputations of borrowers and intermediaries and high uncertainty**. Banking is based on reputations and a reasonable degree of predictability. In contrast, transition means rapidly changing reputations and high uncertainty. It takes a great deal of successful transformation for uncertainty to subside to a manageable range. In parallel, it takes successive "repeated games" among economic agents to establish their "credit reputations", good or bad.

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[1] The views expressed in this paper are those of the author alone and do not necessarily reflect the views of the EBRD. I thank Alan Bevan and Michel Jernov for their comments.

1. Introduction

Most studies dealing with banking in transition focus on the initial shortcomings that these economies confront in the pursuit of a sound financial system. Typical limiting factors include: initial lack of financial skills, inadequate regulatory framework, weak procedures to repossess collateral, related lending practices, ineffective supervision, under-capitalised banks, macroeconomic instability, and reckless bankers and oligarchs that cheat on depositors, lenders, and minority shareholders. The menu is sometimes completed with subservient central bankers ready to bail out the government, the bankers, and the depositors, with yet one more run of "inflation tax" levied on the pockets of citizens.

For many countries all this is true, but in this paper we take a completely different angle. Let us assume for a moment that, in the beginning of transition, countries were endowed with American bankers, British supervisors, German auditors, French legal framework, and Swiss supervisory boards. Further, let us also grant them Allan Greespan as chairman of the central bank and Paul Volker as minister of finance. Well, the claim of this paper is that even if all these generous assumptions were to hold, banking still has a high chance of being a money-losing proposition for some time. At least until the point at which a *critical threshold* of transformation and relative stability had been achieved.

The obligated departure for any analysis of the financial sector in transition is Janos Kornai's four simple principles that define the "hard budget constraint":

1. *buyers* pay for the goods they buy;
2. *debtors* pay back their debts;
3. *taxpayers* pay their taxes;
4. *and enterprises* pay for their costs out of revenues[2].

A sound financial system is central to enforcing "hard budget constraints". In effect, banks and other intermediaries are at the centre stage in ensuring that payments for transactions take place as due and that economic agents abide by the relevant solvency constraints. Far from mechanical, both tasks are a difficult endeavour. First, banks are complex enterprises, subject to pathologies in their incentive structure. Second, developing the institutions necessary to address these pathologies takes a great deal of design, commitment, implementation and trial

and error. Further, the process of development and evolution of the required institutions is open-ended and hence never fully completed (the recent scams of ENRON, Worldcom, Arthur Andersen, Adelphia, Global Crossings in the USA, eloquently illustrate the imperfections in the detection and prevention capabilities of the Securities Exchange Commission, even in the most advanced market economy of the world). And third, the assessment of the ability and willingness of debtors to repay their debts during transition - particularly in the initial stages - is an exercise elusive at best.

Banking is based on reputations and a reasonable degree of predictability. In contrast, transition means rapidly changing reputations and high uncertainty. It takes a great deal of successful transformation for uncertainty to subside to a manageable range. In parallel, it takes successive "repeated games" among economic agents to establish their "credit reputations", good or bad.

In other words, screening out the eventual viability of individual enterprises and investments is as unfeasible an objective as is defining the reputation of borrowers and banks. These two factors are formidable enemies of banking during transition.

2. Financial inter-mediation as a cornerstone of the market economy

Sound financial intermediaries and a stable valued "currency" are *sine qua non* conditions for a working market economy. Financial instruments - including money - and intermediaries are central to spurring multilateral trade, division of labour, and efficient mobilisation and allocation of scarce saving resources.

This is so because financial intermediaries:

(i) enforce *financial discipline* (hard budget constraints);
(ii) manage the *settlement of payments* (exchange of property rights);
(iii) intermediate between *savers and investors* (provide the link between the present and the future); and
(iv) present economic agents with the relevant choice between *returns and risks*.

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[2] See Kornai (1993), page 315.

The so-called “banks” existing under communism did not performed these roles. They simply carried out *ex-post*-record keeping of transactions and investment dictated by the central "plan”. Since capital was owned by the state, there was no capital market. The "plan" also decided on the squeeze on consumption to be forced upon consumers-workers in order to reach the target of investment and its sectoral composition.

Budget and solvency constraints did not count and the choice between individual returns and risks was irrelevant. The state acted as a highly inefficient "big insurance company”. Only the state foreign trade bank (i.e. Russia’s Vnestorbank) and the financial agent of the Treasury were subject to credit and solvency constraints when dealing with non-CMEA western lenders and exporters.

Hence, the task for transition economies was not to reform the existing financial sector but rather to build one from scratch where there had been none.

3. The real costs of financial inter-mediation

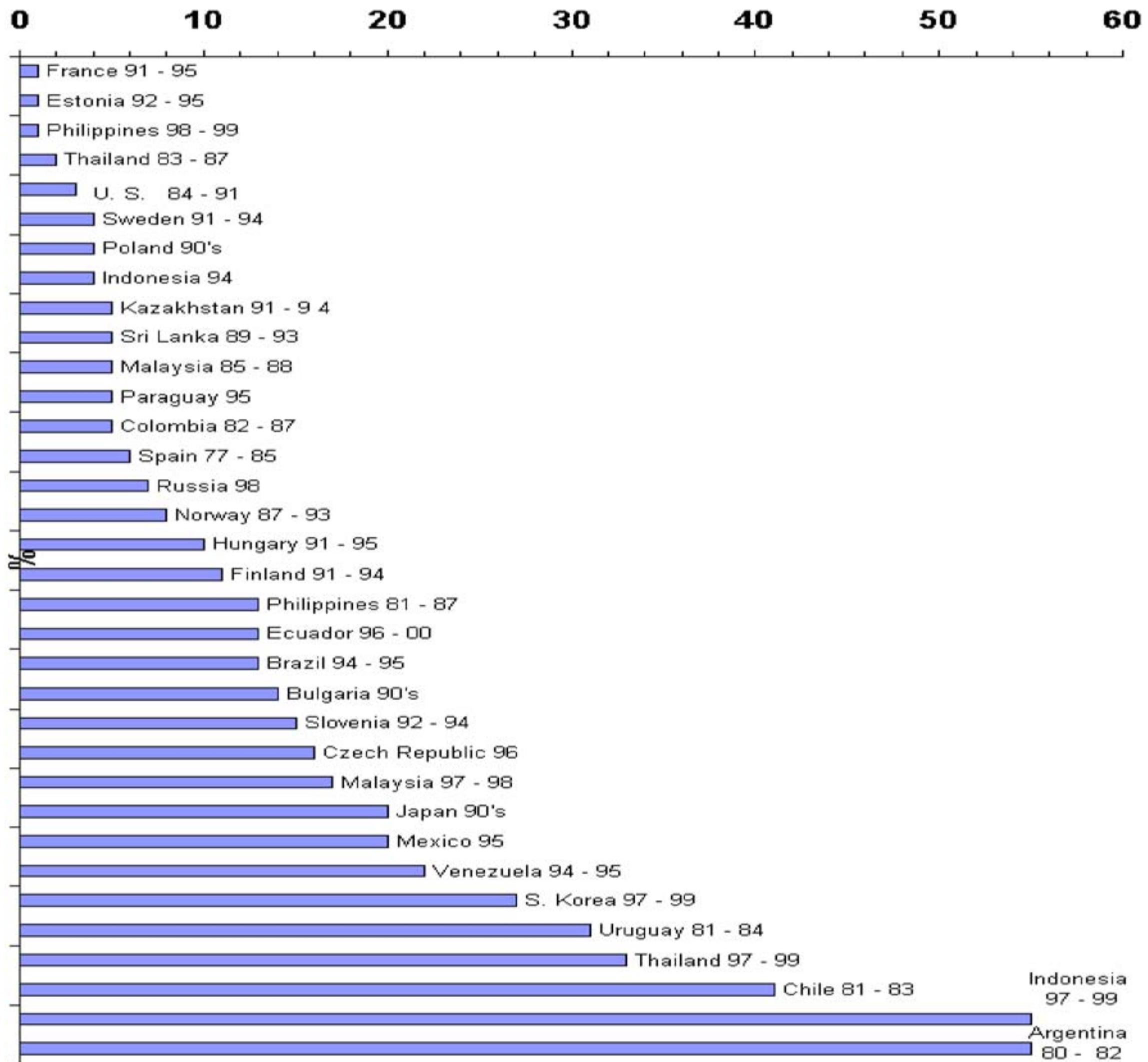
The transaction costs incurred in inter-mediation and in managing the payments systems of the economy are straightforward, obvious costs. The level of costs depends on the market structure, competition, entry rules, and efficiency of the intermediaries.

High as these may be in some transition and emerging economies, these costs often pale compared to the "bill" paid by depositors and taxpayers arising in recurrent banking failures as the current financial crisis in Argentina (2001-2002) bears witness.

Chart 1

Bail out cost of banking failures

(Percent of GDP)



Source : IMF, World Bank, and author's calculations.

In Chart 1, we present an overview of the bills in "bail outs" paid by the Treasuries and/or Central Banks of different countries over the last three decades. These costs need to be added to the strict inter-mediation costs in order to calculate the total cost of financial inter-mediation in the economy.

Why do banks fail so often in emerging markets? The short answer is because of the combination of the fragility of banks as enterprises with the instability, uncertainty, and weaker institutions of emerging markets. Let us first examine the characteristics of banks.

Compared to other types of firms, banks are fragile because they are highly leveraged and illiquid. Their capital-to-assets ratio is low and their liabilities bear much shorter maturities than their assets. Further, banks deal with a non-homogeneous "commodity“: loans, the value of which resists mechanical valuation. One Euro (or dollar) lent to one borrower is a different "commodity" from another Euro lent to another borrower .The true value of the transactions and of the portfolio of a bank is difficult to ascertain for it depends on the credit quality of each and every single loan.

To compound the picture, banks function under a complex chain of principal-agent relationships among its stake-holders. Bankers and back office staff are *agents* of their managers (principals); managers are *agents* of shareholders; shareholders are *agents* of creditors and depositors. Each agent tends to pursue his objectives at least as much as those of her principal, unless effectively constrained by law enforcement, supervision, or disclosure. The stronger (weaker) these institutions are, the closer (less) agents abide by the objectives of their *principals.*

Further, in the presence of explicit or *implicit* deposit insurance, the State is also a *principal* of all the others stake holders, because it takes a big portion of the downside in case of bankruptcy. Indeed, deposit insurance can elicit high risk taking behaviour by managers and/or shareholders and heavy deposit taking by unsound banks. This is one of the reasons why banks need to be subject to tight prudential rules and strong supervision by the state.

Over the years, advanced market economies have developed institutions to deal with both the fragility of banks as enterprises, and the potential moral hazard resulting from the complex chain of principal-agent relations. These institutions range from accounting and auditing rules to prudential and disclosure requirements; from the discipline of enforceable corporate, securities and banking laws to the oversight of banking supervisors and rating agencies. As noted above, however, recently in the wake of the ENRON and other scandals the effectiveness of these institutions has been called into question, even in the USA, the country with the most advanced market-based institutions.

One of the problems during transition is that these institutions are at best in the making and at worst completely absent. Therefore, the inherent fragility of banks becomes fully exposed. And often-banking failures follow.

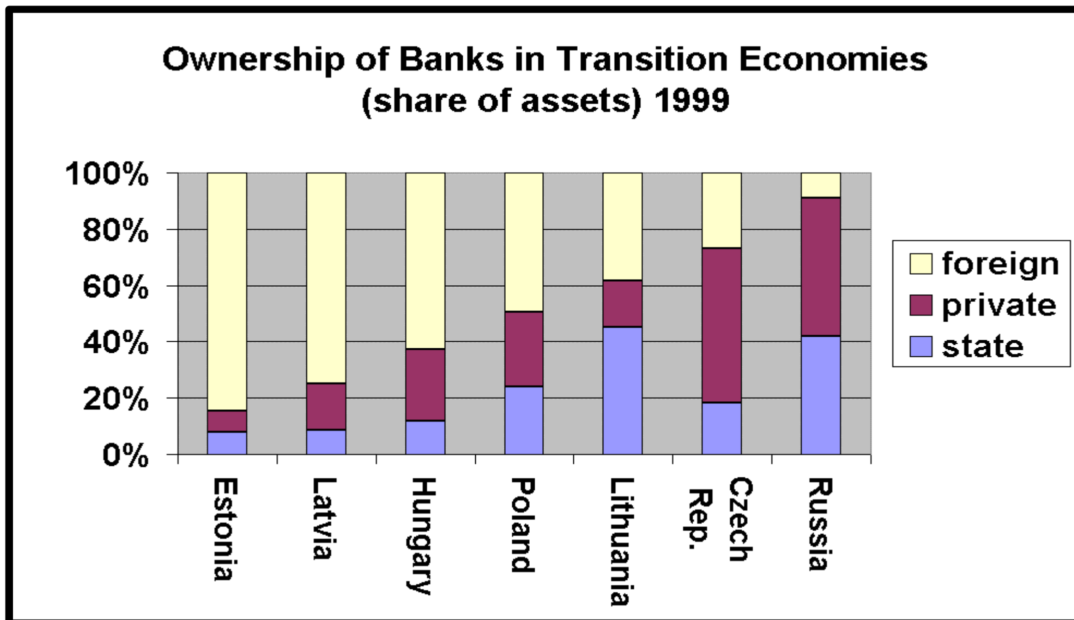
It is here where financial intermediaries with a "strong reputation" play a central role. Preserving the value of their reputation may be conceived as a partial substitute for weak institutions and surveillance. This is the model that Hungary pioneered in Eastern Europe in 1995: the privatisation of public banks to strategic investors with strong "names" to put at stake. Since initially local investors inevitably lacked the necessary "track record" and reputation, banks were sold largely to foreign investors. Later, as Chart 2 shows, the same strategy was adopted in earnest by the Baltic, Poland, and other countries.

By contrast, the Czech Republic opted until recently (1998-9) for keeping the large banks in state hands. Further, some of these banks created investment funds to intermediate vouchers for privatisation. This approach left not only the banks but also, indirectly, many enterprises vulnerable to political lending and influence peddling. The outcome was the delay of restructuring and a massive financial crisis in 197-98.

In turn, Russia followed since 1991 an approach of liberal entry to local banks - some of them linked to financial-industrial groups- and restrictive entry to foreign banks. All this in a framework of weak supervision and unsustainable fiscal deficit, and treasury bill financing. This model led to the total collapse of the financial system in August 1998, when the government defaulted on its bonds, GKOs, and the rouble lost three quarters of its value.

As we explained below, however, even if all the necessary institution and/or highly reputable banks were in place during transition, a central problem would remain high uncertainty. Only when a country has achieved a critical mass of progress in transformation does banking become a commercially viable proposition.

Chart 2



Source: EBRD and author's calculations .

4. Transitional uncertainty

In advanced economies, financial institutions are able to bank on measurable risk and established track records. By contrast, during transition creditors are often exposed to severe counterparty risk as debtors are faced unexpectedly with adverse developments beyond their control. As key relative prices change and new domestic and foreign competitors erode monopoly profits, as new markets emerge and old ones vanish, previously viable enterprises and projects become money losing and previously creditworthy borrowers may become insolvent.

All of these stresses and strains are of course present, qualitatively, even in an economy that has not suffered from macroeconomic instability (i.e. Slovenia throughout its transition). In principle, macroeconomic balance can be consistent - in a dynamic, evolving economic system - with a considerable amount of microeconomic flux at the sectoral and individual firm levels.

During the transformation from plan to market - a process involving macroeconomic stabilisation and structural reform on an unprecedented scale - the problems and uncertainty facing enterprises and banks become acute. This is obviously true as regards the backlog of

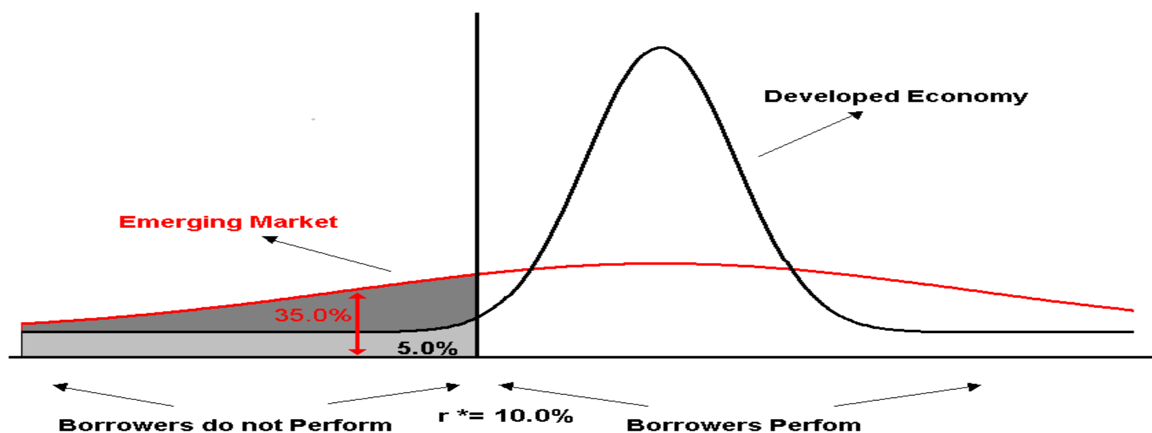
loans incurred during the pre-reform era (the so-called balance sheet or *stock problem*). It remains true too for the new loans, now that reform appears to be here to stay (the *flow problem*).

Even competent, western bankers would have little evidence on which to base their assessment of the creditworthiness of loan applicants. At inception, few potential borrowers have much of a record of accomplishment or credit history. For those that do, the past is likely to be a poor guide to the future: what made for enterprise success under central planning may bear little relationship to what is required for effective enterprise performance in a market regime. Furthermore, throughout the process, the market structure is rapidly evolving and its dynamics bears a high degree of un-measurable uncertainty (as opposed to risk that can be somewhat measured with actuarial tables).

Thus, this *flow problem* of financial inter-mediation stems from the difficulty encountered by banks (and other lenders) in screening out the good from the bad risks when extending new loans.

Chart 3

Returns to investment: developed versus transition /emerging economies

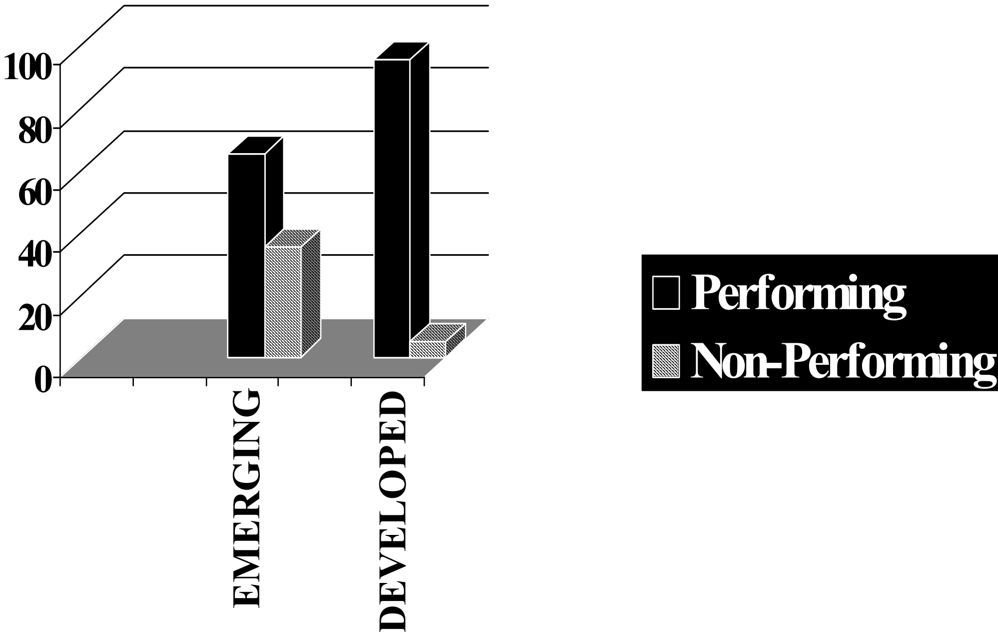


Source: hypothetical illustration produced by the author.

This problem is analysed at length by Buiter, Lago, and Rey (1997, 1999) and here is intuitively illustrated in Charts 3 and 4. In a successful transition or emerging economy, the expected average returns to investments are often higher than the returns of a similar investment in a developed economy. However, as shown in the chart, the dispersion (“the variance“) of the returns is much higher in the transition economy. The reason for is that, in the latter, the pace of change of relative prices and

Chart 4

Loan performance: developed versus transition/emerging economy



Source: it follows from distribution in Figure 3.

Market conditions leads to volatility in the cash flows of enterprises. The implication of this is that the developed economy, of say 100 investment projects only 5 would yield a return lower than the interest rate (in the chart assumed at 10%), whereas in the transition economy as many as 35 would yield lower returns. Such a dispersed distribution of outcomes is often referred to as the "fat tails" problem.

In its presence debt *progressively tends towards equity risk but without upside.* The result is that the ratio of non-performing loans in the transition economy will tend to be hefty. To

compensate for the losses, banks will have to raise spreads. With higher interest rates (in the example in the chart, beyond 10%), however, additional borrowers will be unable to service their debts. In addition, the higher rates will lead to the adverse selection of borrowers: good risks are priced out of the market and unwilling to borrow and those eager to borrow are the ones unlikely to be able to repay.[3]

Hence, transitional uncertainty may render banking commercially non-viable until a critical mass in transformation has been achieved. The experience of transition economies with frequent and recurrent banking failures and re-capitalisation of banks - at a cost presented in Chart 1 - seems to back this hypothesis.

5. Conclusion

In an article of 1999 George Kaufman compared the annual average ratio of failing of banks to total banks in the USA from 1870 to 1995 with the respective ratio for non-banking enterprises. He concluded that, excluding the period of the great depression of 1929-33, both ratios are similar. Thus, he claims that the inherent fragility of banks (as enterprises) does not necessarily imply failure; rather it means, "handle with care". The analogy is that "care" is what makes the breakage rate for fine wine crystal glasses lower than that for ordinary drinking glasses!

That "care" is delivered both by the right institutions for the financial system and by the sustained reforms that take the economy beyond a "critical threshold" of transformation. By 2002, most central and eastern European countries in process of accession to the EU appear to have left behind transitional uncertainty. However, there seems to be a significant way ahead still in the development of the required institutions.

[3] Stiglitz and Weiss (1981) argue that in a situation such as this rationing of credit - at lower interest rates - allocated to the lower risk borrowers is the only possible approach.

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