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Globalization and the Role of Foreign Banks in Economies in Transition

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Summary

There is an ongoing debate as to the net benefit of the financial sector in developing countries (DEs). The potential positive contribution to growth via financial intermediation must be weighed against the potential negative impact on macroeconomic stabilization and on moral hazard. Such dangers clearly exist also in economies in transition (TEs) and have indeed materialized in several of them, as well as in some developing economies (DEs). The development of market oriented financial services in TEs may well be more difficult than in DEs. While in the later financial services have to be developed from scratch, in TEs there existed the socialist variety of so called "banks" under the old regime, with completely different mission and operating culture, a tradition that is extremely difficult to alter.

An existing domestic banking sector may therefore present an even greater destabilizing danger and hindrance to restructuring. Furthermore, in most DEs one can conceive of informal financial networks, such as family and friends, as substitutes for banks as the main source of financing of small and medium size businesses, the most important engine of growth. Most TEs, on the other hand have rather sophisticated production sectors dominated by large and complex firms that cannot survive, let alone restructure (as most of them need to) without an elaborate and effective banking sector.

Globalization, and in particular the information and communication revolution, helped to develop a multinational industry of trade and FDI in financial flows and in financial services. This industry may provide one promising option of helping TEs to acquire modern financial services abroad and, through FDI to build a modern financial sector in their countries, thereby to expedite restructuring in the production sector and the resumption of economic growth, not only through the provision of finance but also through the enforcement of a better governance regime. The above discussion leads one to conjecture that FDI in financial services may be the best option for TEs. The paper intends to test this hypothesis.

Following an expanded exposition of the above, the paper will present a comparative conceptual or theoretical analysis of the options in the sphere of financial services open to TEs. It will then study and compare the experience of a number of TEs (Hungary, Russia, Poland and a few others) with different strategies and policies for the creation of a banking sector and financial services during the first transition decade, and the impact of these experiences on macroeconomic stability, restructuring and economic growth.

1. Introduction

The main argument of this paper consists of three connected parts: First, there is a deep comparative (and absolute) disadvantage of transition economies (TEs) in the provision of financial services, including banking services, caused by the heritage of central planning and the particular roles of banks in that system. Second, in TEs there is a particularly large need for financial and banking services, both for short and long-term operations. This emanates from two related sources: first, the highly developed, "modern" and complex production sector inherited from the old regime in most TEs, and the high level of urbanization; and second, the great need for restructuring and privatization, and for the adaptation of the economy to the new conditions of an open market economy. The third part of the main argument is that foreign banks are much better equipped to provide the needed services than domestic banks and that the recent development of global, multinational banking services, provides a great opportunity for TEs, by bringing them in to expedite the transition and to encourage higher levels of economic growth.

The debate in the literature regarding the advantages and disadvantages of the operation of foreign banks in developing economies (DEs) has not yet been fully settled. While the World Bank reports that "recent studies have confirmed the economic benefits of admitting foreign-owned banks" (2001, Vol. II, Working Paper no. 11, p. 187), an opposite view is quoted by Abel and Siklos (2001, p. 5).[1] We claim that there is little doubt that the arguments in favor of banking FDI in TEs are much stronger than for DEs.[2]

At the very time that the transition started and the need for foreign banks emerged, technological changes followed by organizational changes made it possible to integrate financial and banking services across national borders. The global financial and banking community was developing the advanced infrastructure, tools and capabilities to move abroad with relative ease and efficiency. The trend of openness and liberalization policies, embodied in international trade agreements, as well as the rapid technological changes in transport communications and information technology led to the rapid expansion of trade in goods over the last generation or two, followed in recent years by FDI and trade in services. A significant share of the financial and banking activities of the individual developed countries became global. Transition came about just when the process of globalization of financial and other services was taking off.

There is little wonder, given the triple argument, that in quite a few TEs nearly the entire banking sector has been taken over by foreign banks (Table 1 below). This is true with respect to the Baltic states, the Czech Republic, Croatia, Hungary and Poland, and the process is advancing rapidly also in Slovakia, Romania and Bulgaria. What may be somewhat surprising is that it took nearly 10 years of transition for this process to be completed. We come back to the latter question below. However, the phenomenon of a virtual takeover of an entire sector by foreign owners in a number of countries is very unusual for any sector, but even more so for the banking sector. At the same time one cannot escape noticing the very small involvement of foreign banks in CIS countries, and especially Russia. If the need is so great and there is capability and interest on the supply side, what has held up the entry of foreign banks to TEs in Central and Eastern Europe for so long? What is still holding it from happening in Russia and most other CIS countries? The search for an answer to this question is one purpose of this paper. One possible answer is that it took that long to overcome the usual "nationalist" sentiment against FDI in general and the "penetration" of foreign banks in particular. The nationalist argument is in many cases also a cover for more material vested

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[1] Abel and Siklos claim that only Chile, among the DEs, welcomes foreign banks in a big way.

[2] Our 2002 paper focuses on the comparison between the TEs and the DEs with regard to FDI in banking and commerce.

interests of the owners of the domestic “banking” sector, those of their related corporate clients and close political interests. An alternative explanation is that it is the level of market and legal infrastructure in general, as well as the prudential and supervisory environment in particular, that hampered the improvement in the functioning of domestic banks and the entry of foreign banks. The main claim of the paper is that the socialist heritage made the domestic banking sector in TEs a big part of the problem rather than of the solution and that the two alternative explanations for the late introduction of foreign banks are actually two sides of one and the same explanation.

There is a vast literature on the development of the financial sector in TEs but only few studies are dealing directly with the role of foreign banks in this process. Among these is a paper by Derviz (1997), who advocates an intensive policy of attracting foreign banks to dominate and guide the banking sector in the Czech Republic and other TEs. De Pointbriand (2001) has a section on “A key role of foreign banks in enhancing banking system performance [in TEs]”. In addition to theoretical arguments, the section also shows how foreign investment helped reduce interest spread, introduce modern services and give a hand in providing risk assessment and investment loans. He also reports on the development of a nationalist backlash against this trend. The World Bank has a working paper on the desirability of bringing foreign banks to participate in the restructuring of the banking sector in Russia (World Bank, 2001, chapter 11), whose authors are mildly favorable to the idea but emphasize strongly that the establishment of a credible and effective legal environment is a precondition for any such move. When these conditions are met, so it is implied, domestic banks can also improve their performance. Bonin and Wachtel (2001) show how, recently, during the late 1990s, following some failures to restructure their banking sector domestically, a number of TEs finally resorted to the selling of state banks to foreign banks. They list the advantages of such a move but state that this may be a proper solution to medium size countries but not to bigger ones like Russia and China. Finally, papers by Opiela (2001) on Poland; Abel and Siklos (2001), on Hungary; and Galac and Kraft (2000); and Vujcic and Jermic (2001), on Croatia, all show some advantages in the performance of foreign banks.[3] The particular message of this paper goes to some extent beyond the above: it envisages an innovative, future development of the global economy created by the particular economic situation that TEs found themselves in as they embarked on a transition to the market, and in conjunction with the global technological developments in banking and financial services.

The structure of the paper is as follows. We open with a theoretical framework, which explains the needs of transition for a modern banking sector and the potential of FDI to supply them (section 2). Section 3 is a stylized analysis of the history of the banking sector in TEs, before and during the transition. Section 4 examines the potential contribution of foreign banks in TEs and section 5 evaluates the advantage of banks compared to other instruments of the capital market in TEs. Section 5 follows empirically the process of penetration of foreign banks to TEs in the context of changes in ownership of banks in TEs, and analyzes the correlation between foreign bank penetration and the performance of the banking sectors. The concluding section discusses the potential connection between improvements in the legal environment of TEs and in their banking sectors and the involvement of foreign banks. Which is the egg and which is the chicken?

2. A theoretical background

The comparative perspective that we employ requires a brief theoretical overview of the economics of banking FDI as it relates to TEs. We base ourselves on the Diamond model (1984 and 1996), which solves the basic agency problem of the banking system in a market

[3] There are additional references on the topic in the papers listed above.

economy. We do, however, have to include a wider array of institutional elements of the financial system in the model, and lead down all the way to the firms in the so-called productive sphere. Our problem lies with the latter: their governance has to be improved if they are to restructure and adjust to competitive market conditions. Banks can force transparency and profit-seeking behavior on firms that are in need of financing, but to do so agency problems in banks have to be solved first. If they are not, banks may help perpetuate malfunctioning enterprises. This is the reason why we believe that the reform of the banking system as a whole is such a priority task.

Consider the firm first. It is sufficient for now to think of the firm as a manager, $m \in M$ who has a set of available projects, T^m at his command. Project $t \in T$ requires an investment of 1 unit today and produces a stochastic outcome of $\phi^t \in \left\{\underline{\phi}^t, \overline{\phi}^t\right\}$, where the probability of the good outcome $\overline{\phi}^t$ is p^t. The optimal loan agreement advances m a loan of 1 unit, requiring a fixed repayment of f, $\underline{\phi}^t < f < \overline{\phi}^t$, such that whenever $\phi < f$ the firm is bankrupt and is dissolved, and whenever $\phi \geq f$ the loan is repaid (Diamond, 1984 and 1996). Furthermore, there exists a large number of individual depositors who are ready to lend to banks at the interest rate r, so that

$$p^t \overline{\phi} \geq p^t f \geq r: \tag{1.1}$$

on average the bank's expected interest income covers its interest payments.

The banker faces several pitfalls that may make it impossible to cover its interest costs. Suppose the set M is composed of two subsets, M^h and M^d, of honest and dishonest managers. Honest managers repay their loans whenever they are able to, and dishonest ones do not. Banker b incurs a cost of $c_a{}^b$, where the subscript a refers to adverse selection, when she checks the honesty of a manager, but once the check is undertaken she can be sure that m is honest and belongs to M^h, or dishonest and belongs to M^d. The second threat lies in m's choice of projects. Assuming that m does not suffer any loss when he is bankrupt, which occurs whenever $\phi < f$, his maximand is

$$E\left[\phi - f\right] = p^t\left(\overline{\phi} - f\right). \tag{1.2}$$

Moral hazard may therefore lead him to select highly risky projects, which compensate for a low probability of success p^t with a very high $\overline{\phi}^t$. In this case the lender bears all the costs of failure, and the borrower pockets the gains of success. This is one of the reasons the price system, i.e., an interest rate, is not sufficient to allocate credit, and credit rationing is needed (Stiglitz and Weiss, 1981). In Diamond's model, to prevent such a choice, the banker b has to spend $c_m{}^b$ in screening and monitoring m. Let $c^b = c_a^b + c_m^b$.

Diamond shows that a well-functioning competitive banking system leads to an equilibrium solution,

$$f^t = \frac{r + c^b}{p^t}. \tag{1.3}$$

As a result only projects profitable to both the firms and to the banks would be funded. Let the list of approved projects be designated T^B*, and let $\tau^* = |\ T^B*|$, i.e., τ^* is the number of all approved projects, which also equals their value. Observe that the expected value of non-performing loans is $\left(1 - p^*\right)\tau^*$, where p^* is the average probability of success of the approved projects. Thus

$$\sum_{t \in T^{B*}} p^t \overline{\phi} \geq \sum_{t \in T^{B*}} p^t f \geq \left(r + c^b\right)\tau^*, \tag{1.4}$$

and the banks stay solvent. When the banking sector is competitive the last inequality on the right of (1.4) becomes an equality.

This model cannot be applied un-amended to banks in socialist economies, nor to their successors in transition countries. Socialist banks are used to serve as passive financiers of existing state firms. Ministries, not banks approve projects , and much of the financing is to cover current losses, i.e., projects where $\underline{\phi}^t = \overline{\phi}^t = 0$. We, therefore, need another player, the government bureau, which may be a ministry or a department of the central bank. In particular, banks are not supposed to bankrupt enterprises, or to threaten them with bankruptcy. Thus enterprise *m* selects project *t* in consultation with the ministry, and the criterion of profitability plays a very minor role in this choice. Enterprise *m* tries to make the project as undemanding on its capacity, so that there will remain the possibility of consumption on the job. Symbolically, let us denote the list of approved projects by $\tilde{T}^B$, where the wiggle denotes selection by the bureau. The bureau exercises adverse selection, since it gives priority to loss-making firms whose projects are sure to fail, i.e., whose $p^t = 0$, and the quality of $\tilde{T}^B$ is inferior to that of T^B*. Let the total number of approved projects and their total value be denoted $\tilde{\tau}$, and let $\tilde{p}$ denote the proportion of loans that are expected to be repaid and $(1 - \tilde{p})$ the proportion of non-performing loans. Clearly, $\tilde{p} < p$*, and the proportion of non-performing loans is substantially higher in socialist economies than in market economies. Furthermore, we cannot expect solvency condition (1.1) or (1.4) to hold. It is probable that

$$\sum_{t \in \tilde{T}^B} p^t \overline{\phi}^t \geq \sum_{t \in \tilde{T}^B} p^t f^t < r\tilde{\tau}, \qquad (1.5)$$

that is, that total receipts of the banking system will not cover interest outlays (even if the socialist interest rate should be lower than the market rate *r*, and socialist banks cannot be considered solvent).

For the socialist system that has been described above to be able to survive over time, it has to have a soft budget constraint (SBC). I.e., for banks to continue granting loans that do not conform to constraint (1.1) and that they do not expect to be repaid, they have to be kept in funds in spite of their outgoings exceeding their incomes, as in (1.5). The government bureau covers the banks' deficit of

$$\Delta^B \equiv r\tau - \sum_{t \in \tilde{T}^B} p^t f^t \ .$$

The government bureau is used to supplying funds to banks as the need arises, i.e., whenever these are needed, given the instructions the banks have to follow when distributing funds. The banks then distribute the funds to firms in accordance to the needs of the physical production plan, and when needed, whenever firms are short of funds: in case of unplanned shortages, the need is used to signal to superordinates that the firm in question needs special monitoring.

Come transition, to adjust to the new environment, both bank and enterprise should change their routines: the enterprise or firm has to restructure itself, i.e., invest in profitable projects that may save it from bankruptcy. The bank's task becomes to pressure the firm by not advancing any funds, except when it is sure that these will be used for investment in projects that are profitable. But to do so it has to transform itself into a profit-seeking organization. It has to learn to monitor. The problem is that when transition starts, both the government bureau and the banks tend to continue their routines, unless forced to change their act.

The first requirement is to harden the budget constraint. That is, to eliminate the ability of the bureau to transfer funds to the banks, and of the banks to bail out sick firms. This obvious solution is not easy to enforce, since all banks are insolvent because of past non-performing loans, and its enforcement would mean that the whole banking system would cease to operate, threatening to bring economic life to a standstill. Furthermore, even if this solution was adopted, and some of the banks would stay alive, they totally lack monitoring skills. Both c_a^b and c_m^b would be extremely high and we could not assume that once monitored, banks would be sure that adverse selection and moral hazard of borrowers have really been averted. Suppose c^b of equation (1.3) were replaced by $\hat{c}^b > c^b$, and p^t by $\hat{p}^t > p^t$. Then

$$\hat{f}^t = \frac{r + \hat{c}^b}{\hat{p}^t} > \frac{r + c^b}{p^t} = f^t.$$

Consequently *f*, the fixed repayment rate of (1.2) would be extremely high, and the advantages of monitoring are seriously diminished. We thus have two obstacles on the way to turning the banking system from a protector of the old system into a force for restructuring: the first is incentives, which are stuck because of the difficulties of getting rid of the SBC. The second is the lack of skills.

The basic reason state banks are insolvent lies in the legacy of loans extended during the old regime. It may therefore seem that the solution to SBC is simple: relieve the banks' balance sheet of the burden of the old debts by taking them over in return for government bonds (Portes and Begg, 1993). Once this is done, the banks would know that the rules of the game have changed and that the budget constraint has hardened, and would henceforth lend only to deserving customers and projects. The problem is that any such one-time-only relief of non-performing loans is a signal that a repeat will come when necessary.[4]

Another way would be to privatize the banks. The banks can be sold net of the non-performing loans, leaving the private owners with a solvent portfolio of loans to firms that have to be monitored, but that on average are expected to repay their loans. But this route is risky: if a bank is to be a catalyst of restructuring, it is essential that it should aim at its own profitability. It may have different aims: if it is sold to a producing firm, the latter may be more interested in its own survivability than in that of the bank. If *m* acts in his own interests or that of a part of the bank's new owners, he may be involved in *tunneling*, i.e., siphoning out funds to other parties or to her own accounts in foreign banks (Glaeser, Johnson and Shleifer, 2000; Coffee, 1996; Bures, 2002; Weiss and Nikitin, 2001). Thus another change is also needed, that of an added bank supervision, i.e., turning the upper tier of the split mono-bank into the comptroller of the commercial banking system. This too is not free of problems: the central bank too has to spend resources to make sure that the commercial bank's funds are not being diverted, and that its lending is not concentrated on a narrow sector of risk-correlated borrowers – which is not simple, given the origin of these new banks in the specialized departments of the mono-bank – and in particular, not on its owners.

Foreign banks could be an essential part of the solution, were they to buy into the existing banking system and acquire some of the existing state banks. Lacking the old channels of influence in the bureau that used to assure the old banks of the SBC, their own budget constraints are hard. Once the budget constraints of local banks have hardened and foreign banks enter, the competition of the latter should force local banks to strive for profitability in order to survive. As a result, all banks tend to concentrate lending on borrowers who maintain transparency and good governance. They also import the monitoring skills which local banks lack, but these skills, once taught to local personnel, tend to flow to competitors and enrich the economy as a whole.

3. History: from the socialist mono-bank to transitional banks

The legacy of the banking sector during the old regime can be characterized as strictly orthogonal to the mission of banks in a market economy. The sole similarity between the two

[4] See the relevant Israeli experience, reported in Kislev (1993) and Keren and Levhari (1993).

institutions is their common name, and this in itself was an obstacle for reform during the first years of the transition. During the socialist period the government-owned mono-bank operated strictly under government instructions to clear transactions among firms and government agencies, to collect taxes and to provide grants and loans to the production sector. It provided accounting services to enterprises and had some control authority in the name of the government. Very little decision-making power was endowed to banks in terms of project selection or risk assessment, and the accounting and auditing rules were those of a centrally-planned system. In many cases the bank failed to collect loans (which were later written off by the government). Departments of the mono-bank specialized in particular industries or functions, and did not accumulate economy-wide knowledge. The savings bank, a department of the mono-bank, (*Sberbank* in Russia, for example) collected household savings but did not develop other services included under retail banking in a market economy, such as checking accounts, consumers' loans and mortgages. Corruption crept in between the banks and their clients and between the banks and their immediate superiors, especially when the discipline imposed by the government and the fear of its sanctions weakened during the last decades of the old regime. All the elements and functions of a banking sector in a market economy were absent.

Most of these deficiencies were gradually revealed in the early stages of the transition. It was generally recognized by both insiders and foreign advisers that an early reform of the banking sector is essential in order to move to a market economy. This reform was particularly important in order to facilitate privatization and restructuring, as well as for the opening of the economies. (World Bank, 1993, quoted in World Bank, 2001, p. 9.).[5] What was not recognized by most was that the so-called domestic banks left over from the old regime needed much more than "reforms" and that they were incapable of self-transformation into real banks.[6]

During the early stages of transition, many TEs converted the mono-bank into a double-tier system, with a central bank at the top and the departments of the mono-bank now renamed commercial banks. At the start all these banks remained in state hands. At a later stage some banks were fully or partially privatized. In any case, most of the managers and personnel of the "new" banks were the same people as under the old regime. Because of the specialized structure of the mono-bank, the portfolio of the new banks was highly correlated and risky.

In addition, a liberal policy regarding the establishing and licensing of new, private banks was followed, and many newly created private banks were allowed to enter. In most countries there were initially few restrictions on entry: capital and know-how requirements were relatively liberal and lax, and banking supervision was weak and ineffective. Although new legislation to adapt the system to the market environment was introduced, enforcement was scarce. Under such conditions, the performance of the banking sector further deteriorated.

This liberal approach to the development of the banking sector emanated from the general, naïve belief that prevailed in many TEs at the time, in free enterprise and competitive markets. It failed to consider the accepted view among economists that a preferred industrial organization for a banking sector is a more concentrated one with larger banks and with somewhat limited competition and higher profits. In this way banks can develop their own

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[5] "Transformation of the financial sector ahead of the enterprise sector is a unique feature of the Russian reforms and entails both considerable opportunities as well as risks. In the absence of a functioning capital market the commercial banks are likely to play a key role in the transformation and restructuring of the Russian economy" (World Bank, 2001a, p. 9).

[6] The next sentence in the above mentioned report did recognize risks, but did not go far enough: "The central role of the banks in the transition process also entails considerable risks: poor lending decisions and inadequate monitoring of borrowers could expose banks to substantial losses and could lead to systemic instability" (World Bank, 2001a p. 9).

reputation that has to be preserved, thus limiting them from engaging in activities leading to negative selection and moral hazard (Stiglitz, 1994). The relationship between numbers and the supervising authorities should not be neglected either. A multitude of weak banks puts an extremely heavy supervisory burden on the new and inexperienced central bank and government agencies, working with yet-to-be-consolidated legal and enforcement tools. Many banks had to spread thinly the very small number of capable people who knew how to operate market-oriented banks. The counter argument against limiting the number of banks is that too large banks and too concentrated industry cause a moral hazard of a different kind – of a "too large to fail" de-facto government guaranty against failure (WB Russian banks, Bonin and Wachtel, 2000). It is true that one has to strike a cleverly balanced concentration in order to minimize both dangers. In TEs, however, the main problem of a too high concentration is that of remaining state-owned banks rather than monopolistic private banks. In this case the moral hazard due to size is particularly risky to the health of the banking sector.

The main heritage of the past was the large stock of bad loans carried over from the last years of the old regime. But many of the banks continued to lend to enterprises pretty much as before, in some cases on instructions of and resources supplied by the central banks and the governments, and thus continued to accumulate more bad loans. These developments defeated the efforts to privatize the banks. Keeping the bad loans in the banks scared potential buyers, but shifting them away to various "consolidation" banks (as in the Czech Republic) or other arrangements (as in Hungary) created a serious problem of moral hazard that perpetuated the problem. Other bad loans were accumulated due to the general absence of the needed knowledge of the domestic banks to assess risk and distinguish between good and bad projects and the weak corporate governance of enterprises. The complex economic environment during the early stages of the transition imposed exceptional demand on such skills. There was little effective supervision to prevent such developments.

> Hence, weak banks with no expertise in restructuring large companies wound up taking ownership stakes in their weak clients, bank credit was provided regularly, to ailing enterprises and no meaningful enterprise restructuring was promoted (Gray and Holle, 1996).

The expansion of risky loans under a regime of soft budget constraint led in a number of countries to financial crises in the banking sector, with damaging results not only to banks but also to macroeconomic stability and to the real growth of GDP (Bonin and Wachtel, 1999).

Second, in many cases the old-new specialized or sectoral banks continued to work with the enterprises belonging to the same sectors, a situation that encouraged internal deals, lack of effective risk assessment and prudent supervision, and absence of transparency. That in turn encouraged and facilitated discrimination against (private) minority shareholders, and scared away foreign investors. In Russia, many groups of enterprises formed *Financial Industrial Groups*, the so-called FIGs, with banks in their center serving as a source of finance and deals, getting most of their resources from the newly created central bank or the Ministry of Finance. The FIGs engaged in insider deals and to a large extent also in corrupt and unlawful transactions, among others also with government officials and agencies. In many cases such behavior helped both banks and enterprises to avoid "biting the bullet" of restructuring. The sectoral organization of many banks also caused severe segmentation of the financial sector, making it difficult to transfer funds from industries with surplus resources and cash (like the energy sector in Russia) to sectors starving for funds for restructuring.[7]

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[7] The historical verdict is not out yet on whether industrial financial groupings enhance or retard growth, and we come back to this issue below. It is quite clear, however, that in the case of Tes, whenever old-fashioned banks played a role, many such groups enhanced survival of old practices, prevented investment by outside investors and inhibited restructuring. FIGs lead by foreign, prudent banks may be a different story altogether.

Third, during the first years of transition most banks, old and new, refrained from servicing the production sector or the household sector and concentrated mostly on transactions in foreign exchange and in government bonds, activities which were much more lucrative and safe. In this manner they contributed in a number of countries to fiscal deficits and to inflation, raising doubts regarding the justification of their existence. Only a small number of banks developed modern retail services for the emerging small and medium business sector and for households, e.g., attractive savings and loan schemes.

Finally, in most of the TEs only a small segment of the banking sector was privatized during the early years (See Table 1) and most government banks continue to operate, following more or less their old routines and traditions.

It can be concluded that during the early and crucial years of the transition, the domestic banking sectors, even in their privatized part, failed to provide the production sector, the emerging sector of small and medium sized enterprises (SMEs) and the household sector, with the kind of services that a normally functioning market economy sector could probably offer to help the privatization and restructuring efforts and support the emerging new sector of SMEs. As a result countries found themselves busy trying to cure the ills of the banking sector. Instead of becoming part of the solution to problems of transition and transformation, the banking sector in most countries occupied a prominent position on the list of problems, an urgently needed bed in the emergency ward. Furthermore, in several countries the old-new domestic banking sector cemented its links with their industrial clients, and joined up with political allies, preferably those trumpeting nationalistic creeds, to fend off the entry of foreign banks. The potential aid of the latter, in serving as leaders in the reform of the banking sector and contributors to the process of transition, was thereby aborted, or at least delayed. Such a lobby, whose creation was catalyzed by the erroneous early steps of reform of the banking sector, was also not interested in effective and transparent bank supervision and in the prudent supervision of banks over the governance of the enterprises. This lobby thus became an obstacle to domestic reform, whose absence helped scare off foreign banks (Abel and Siklos, 2001).

4. The potential contribution of foreign banks

What can foreign banks offer to TEs? As mentioned above, it is now generally accepted that foreign banks can contribute to the efficiency and economic growth of emerging markets. A World Bank report states the following:

> Recent studies have confirmed the economic benefits from admitting foreign-owned banks. Introduction of foreign banks can provide a powerful means of stimulating both operational efficiency and competition and eventually stabilizing the financial sector**.** The entry of foreign banks has generally been associated with improvements in the quality of both regulation and transparency, particularly if the entry of foreign banks is accompanied by the introduction of international standards of accounting and auditing. The pressure of competition from foreign banks may encourage local banks and less than reputable local banks to take higher risks thereby weakening the banking sector. This emphasizes the urgency in strengthening prudential regulation of the banking sector.[8]

In particular foreign banks can bring to TEs the entire package of services needed for restructuring:[9]

- a state-of-the-art economy-wide payment and transaction system;
- mobilization of household savings, and channeling resources;

[8] World Bank. 2001b, *Finance for Growth: Policy Choices in a Volatile World*, World Bank Policy Research Report. Washington, D.C.

[9] Based, among others, on Reininger et. al. (2001) and World Bank, 2001a, Introduction.

- short and long term intermediary saving and credit services across the economy;
- proper risk assessment and evaluation, risk transformation and risk sharing;
- advice, training and assistance in financial management;
- supervising the proper corporate management of enterprises;
- guidance in the spheres of accounting and auditing;
- monitoring the performance of loans and repayment schedules;
- lobbying for and helping to introduce the proper regulatory regime for the entire banking sector;
- reducing transaction costs and improving information.

In addition to their knowledge and experience, foreign banks bring with them trust, of both households and businesses – trust that is based on their record and reputation in their home countries and in the global economy. Trust and reputation are gravely missing in the local financial sector and this severely hinders their ability to fulfill their mission, unlike foreign banks who bring with them their international reputation and can hardly afford to compromise it. The World Bank Study on the Russian Bank Sector is entitled "Building Trust" (World Bank, 2001). Trust cannot be reborn without an intensive initial involvement of and setting the norms by foreign banks. All these can increase savings, or at least the willingness to trust them to the banks, raise the level of (proper) investment and will allocate investment funds in a more efficient way throughout the economy. Finally, foreign banks bring with them the lifeline of the global economy, investment resources, potential entrepreneurs and investors for other industries, and networking links for foreign trade.

The ability and willingness of foreign banks to step in depends to a large extent on the legal and law-enforcement environment prevailing in the target countries. There are several aspects to this general term. First, there is the general legal and law-enforcement infrastructure that makes it possible for an outsider to operate. Second, there is the more particular aspect of the financial and banking laws and regulations that set the capitalization requirements, the prudential regulations of risk management, the bank supervision structure, the accounting norms and credit protection and bankruptcy laws. A legal infrastructure is also the basis of an environment of equal opportunity, a "level playing field" for foreign and local banks (World Bank, 2001, Vol. I., Chapter 2). Third, in order for foreign banks to be able to be productive, a sound regime of corporate governance of the potential client firms must be established. All these are the responsibilities of the government and in many TEs this process takes time.

The lack of such a universal and transparent environment gives a clear advantage to local banks that can rely much better on connections, insider networks, discretion and corruption. This is why most (honest) foreign banks considering moving into TEs are, or should be, interested in effective supervision on their operations as well. Delays in legislation and enforcement partially explain the relative late arrival of the foreign banks to most TEs. The obverse side of this picture has already been mentioned in section 3: the domestic banks and their patrons, allied to the many who believe that foreign banks harm the economy, worked against attempts at improving the legal environment of financial transactions in order to leave foreign banks out. Domestic banks and their political supporters, and foreign banks may thus have a completely orthogonal legal and law-enforcement agendas of merit vs. "connections". A decision to encourage foreign banks to step in thus forces the government to expedite the formation of a minimum necessary legal environment, which is, of course, an added bonus. Once in, foreign banks become a natural lobby in favor of continuous tightening the regulatory regime. This is definitely true with respect to the protection of creditors and the improvement of corporate governance in enterprises. It is, however, most likely also true with respect to an efficient legal environment and supervision for the banking sector itself. Only in this way they can hope to overcome the advantage of the domestic banks.

In summary, the dominance of the domestic banks may result in a vicious circle that leads, as it has in a number of countries, to financial crises. Bringing in foreign banks early may generate a virtuous circle of improving regulation that improves performance.[10]

5. Why priority to (foreign) banks?

The literature on financial services in TEs usually discusses in parallel banks and other financial services, especially capital markets, as two equally appropriate tools for the needs of TEs. It is our claim that for TEs the use of (foreign) banks as the main operators and regulators in the financial market is a much better alternative.

The advantage of well functioning (foreign) banks is that they enable a relatively small number of intermediaries to navigate, guide, control and supervise a large number of restructuring enterprises. The main input in short supply in TEs is human capital, the skills needed to properly operate banks in the difficult environment of TEs, capable, among others, of screening investment projects and risk, guiding enterprises, imposing on them a proper corporate governance and supervising their activities. Large and experienced foreign banks can therefore provide the skills needed to direct the investment activities of the business sector. La Porta and colleagues in a series of papers on the issue of investor (and creditor) protection in emerging markets, including TEs, make two major arguments that support the above proposition, though they focus mostly on the capital market rather than on banks. First, that the new rules to be created should not be the ideal but those that can realistically be enforced. Second, that the instruments used should be economical in their use of scarce skilled human resources and relatively easy to control. It is for these reasons that the authors prefer an administrative regulatory agency to a court system as the main supervisory authority to the capital market. Despite the danger of biased incentives to administrative regulators, they can do a better job than the judicial personnel trained and corrupted under the old system and the distorted and vast court system (La Porta et al., pp. 25–7; Glaeser, Johnson and Shleifer, 2000). The ability of foreign banks to supply the needed skills and to utilize them in the most economical way meets both these demands. A proper banking sector meets these demands much better than a capital (stock) market. The latter requires many more trained people, and a much more elaborate regulatory and supervision systems. This is clearly the lesson learned from advanced countries.

Another type of human capital, or institutional input in short supply in TEs that is required for the regulation and supervision of the corporate sector, banking included, comprises well functioning governments. Large and experienced foreign banks are the most convenient agents for the government regulator to supervise and control, in a manner that local banks cannot do. In a sense a well functioning banking sector described here can also replace some of the functions of the government, functions that most governments in TEs are not yet capable to perform

A banking sector as suggested here is the most economical in the use of the needed skills and the best positioned to disseminate these and related skills downward to the enterprise level, sidewise to other banks, especially partner banks or in the framework of joint ventures, and upward, to the legislative, regulatory and supervisory agencies of the

[10] La Porta, Lopes-de-Silvanes, Shleifer, Vishny (2000). With respect to the capital market in general, the authors write as follows: "With the legal reform slow and halting in most countries 'functional convergence' (with foreign countries) may play a role in improving investor protection. The liberalization of capital markets in many countries increased… but also the economic and political pressure to create financial instruments acceptable to foreign investors" (p. 28).

government. All these functions cannot be performed properly by a multitude of individual agents organized in networks of multi-level ownership structures.

6. Foreign banks in TEs: the empirical record

Table 1 describes the penetration over time of foreign banks into the various TEs. The penetration is measured here by two variables, by the number of banks and by the asset share of banks with more than 50 per cent foreign ownership. We compare these two variables with the same measures for domestic banks, subdivided into state banks and private ones. Most TEs had very few foreign banks before 1993 or 1994, if any. The exception is Hungary, which already in 1989 had 7 foreign banks, in control of over 6 per cent of the assets of the banking sector. However, the process of the establishment of new private banks in most western TEs – and in some, also the privatization of state banks – had started by 1993 or 1994,. Many small private banks were established in the Czech Republic, in Hungary, Poland, in the Baltic States, and the former European CIS countries.

As we said in section 3, the breakdown of the socialist mono-bank into a system of two-tier banking created in most TEs a sector of state banks divided along industrial, sectoral or regional lines. Usually they were large banks and thus limited in numbers. By 1993 or 1994, state banks controlled 70 per cent or more of banking-sector assets in Hungary, Poland, Slovakia, Albania, Bulgaria, Romania and Russia. In Lithuania and Slovenia, state banks' share was lower, around half of the assets. Only in the Czech Republic and Estonia, state banks were reduced to less than 20 per cent and 30 per cent, respectively, of the assets of the banking sector, through privatization and the entry of private banks, including foreign ones. The proliferation of private banks and some amount of privatization also reduced the share of state banks in Russia, Ukraine and other CIS countries, although there is no precise information for the early 1990s in their case.[11]

Within a few years of the transition, private banks became the owners of the greater part of banks in most TEs and gained control of more than 50 per cent of the banking sector in a number of them (again, measured by the share of assets with more than 50 per cent private control). The interesting exception to the first observation is Hungary (and Slovakia and Latvia) who brought in a significant number of foreign banks and restricted the establishment of new domestic banks. Among the TEs with clear majority ownership of private domestic banks we find the Czech Republic, Estonia and Latvia, and possibly also Ukraine and Russia, the latter with more than 2000 private banks as early as 1993.

Since the mid-1990s the transformation of the banking sector in TEs had some common features, but the pace and in some cases the strategies diverged. The main common trend was that of an increase in the number of foreign banks and a decline in the number of domestic private banks. The data show that more and more governments realized the beneficial potential of foreign banks and reduced barriers to their operation. The decline in the number of domestic banks resulted from failures in a number of countries following general financial crises of the banking sector,[12] consolidations and mergers, and purchase by foreign banks. In this way the ill effects of the initial naïve approach of a free-for-all type were somewhat corrected. These two trends made relatively small changes in the ownership composition of the banking sector. The crucial change was caused by a process of privatization of the large state banks, sold to foreign banks. This process started in Hungary in 1995, was followed in 1995/96 by the Baltic States,[13] and later, sometimes in the aftermath of

[11] By 1997 state banks controlled 37 per cent of all bank assets in Russia and only 13.5 per cent in Ukraine, but some privatization took place during the mid 1990s (EBRD data base).

[12] Croatia, the Czech Republic, Latvia, Russia, and others.

[13] Some of the foreign banks in Latvia and Lithuania were Russian, and therefore didn't really fulfill the role of market oriented foreign banks.

a crisis, by the Czech Republic, Romania, Croatia, Poland and Bulgaria. By 2000, there were six TEs with more than two-thirds of the banking assets under foreign control. In Estonia almost the entire sector, and in Croatia 85 per cent were foreign-owned, but in Lithuania, Slovakia and Romania, foreign control amounted to only about 50 per cent. The foreign takeover continued into 2001,[14] at the same time state ownership declined. By 2000, the state was still in control of nearly half of the banking sector in Romania and Slovakia, of more than a third in Lithuania, and between 20 and 25 per cent in the Czech Republic, Poland and Bulgaria.

In Eastern Europe, the glaring exception to this trend is Slovenia, with, by 2002, only 15 per cent of foreign-owned bank assets, and government ownership of over 40 per cent. Russia and other CIS States did not join this trend, either. There was a decline in the number of domestic privately-owned banks and an increase in the number of foreign banks in both Russia and Ukraine, but there was no privatization of major state banks to foreign owners. Indeed, following the crisis of 1998, the stake of the state in the banking sector in Russia even increased (World Bank, 2001, Vol. II. Working papers 2 and 4; Iskyan and Besedin, 2001; Ivanov, 2001).

The sale of state banks to foreign owners helped a number of TEs to stop the cycle of accumulation of bad loans, re-capitalization of banks, and further accumulation. In Hungary and the Czech Republic, banks were sold to foreigners after cleaning them from bad loans, while in Poland the banks were asked to take care of their non-performing loans by themselves, and when Poland decided to sell state banks to foreign ones, it insisted on selling them with their bad loans as a condition for entry.[15] The same motivation probably played a role in other TEs (Pointbriand, 2001, pp. 409–10).

The trend in Eastern Europe was beneficial to the economies in a number of ways: first, the consolidation of the private banking sector eliminated weak and "non-bank" banks, improved the concentration (section 3) and the conduct of the sector and also – even though it may sound contradictory – the competitiveness of the sector, and, what is no less important, made control more feasible and more effective. Second, the decline of the share of state banks helped create a more even playing field for competition and reduced the incidence of internal deals and of soft loans directed by the government. The relative weight of these two trends differed between TEs: while the Czech Republic and the Baltic States suffered mostly from the proliferation of weak private banks, Poland and to a lesser extent Hungary avoided most of that problem but suffered, and this is especially true for Poland, from the monopolistic position of the archaic state banks. Third, the introduction of foreign banks enhanced competition, expertise and know-how, assured better lending to the production sector, and improved banking conduct and standards. Russia and the other CIS members, with the possible exception of Tajikistan, did not follow this process and lagged behind, not only in banking reform but also in the ability of the banking sector to contribute to restructuring and growth (see more on this below).

The significance of this trend of wholesale transfer of the banking sector to foreign banks can be even better appreciated when compared to the much smaller presence of foreign banks in other emerging markets. Among all DEs, only in Argentina one finds nearly half of the banking sector in foreign hands. Otherwise, there is no emerging country – or a developed one for that matter (New Zealand is an exception) – with more than 30 per cent foreign control (WB 2001, p. 196; Abel and Siklos, p. 5). There is no reason to believe that TEs are

[15] Privatization of state banks to foreign banks continued during 2001 in Albania, Croatia, The Czech Republic, Lithuania, Romania, The Slovak Republic, and Slovenia, *Transition Report 2001*, individual country survey.

[15] "Foreign banks have been required, in most cases, to take over existing troubled Polish banks in order to obtain licenses. However, remaining restrictions on the entry of foreign banks will be lifted in 1999" (*TR* 1998, p. 183).

more cosmopolitan by ideology or less averse to foreign “control”. Nor is it likely that the legal infrastructure, widely defined, is better in emerging markets than in long-standing market economies, but this issue will be examined further below. Assuming that the above two statements are correct, this phenomenon can only be explained by the benefits that can accrue to both sides, the inviting countries and the incoming foreign banks.

As we showed above, with the exception of Hungary, the presence of large foreign banks at the expense of state banks is a relatively recent phenomenon. Most studies seem to show better performance of foreign banks as compared with local ones, in terms of efficiency, including labor productivity, profitability, the extent of financial products offered, etc. A number of studies also credit to foreign entry the decline of interest spreads, and through the increased competition, the improved performance of the domestic segment of the sector, as well as the increased financing of the production and household sectors and the increasing levels of monetization. A more prudent supervision of loans contributed to the decline of the shares of bad loans (see, among others, World Bank, 2001; Galac and Kraft, 2000; Opiela, 2001; Reininger et. al., 2001).

We are able to support several of these statements with empirical data. It has to be recognized though that the causal connection between some of these developments and the share of foreign banks is only circumstantial. Furthermore, in some cases the recorded performance of foreign banks may formally look less encouraging than that of local banks. For example, foreign banks may direct a higher share of their portfolios to credit to the business sector and therefore encounter more bad loans, let alone the bad loans that they have to swallow in order to be allowed to operate. In addition, one of the main deficiencies in the performance of domestic banks during the first decade was that they refrained from making resources available to the production sector. Under such conditions, there are also fewer bad loans.

Table 2 traces the dynamics of bad loans during the 1990s. These dynamics are related to some extent to the policy implemented in order to minimize the phenomenon. Some countries, e.g., Hungary and the Czech Republic, followed the policy of repeatedly re-capitalizing the banks by removing their bad loans into special state entities. The fiscal costs of this strategy were significant, but lower in Hungary than in the Czech Republic, due possibly to the earlier involvement of foreign banks (Reininger et al., 2001, Tables 1 and 12), although the relatively high level of financing of the business sector in the Czech Republic may have contributed to this outcome, alongside the mode of privatization that linked banks with enterprises and encouraged internal deals and *tunneling*. In Slovakia, which had been moving much more slowly to sell banks and state banks to foreigners, the level of bad loans is the highest in Central Europe, and their slow decline started only in the late 1990s. Poland fought bad loans by pressuring state banks into collecting them themselves from the original debtors. This minimized the fiscal costs of re-capitalization and apparently helped to reduce bad loans since 1994 to moderate levels. However, bad loans have been picking up since 1997, and this may have been a factor in tilting the state toward foreign privatization of state banks. The decline of bad loans in Latvia and Lithuania – in Estonia they had been low all along – coincided more or less with the process of bringing in foreign banks. Slovenia had all along a moderate level of bad loans but with no improvement over time, and almost no foreign banks. In Russia and the CIS bad loans actually rose until they peeked in the 1998 crisis. Russia has managed to halve their level since.

Data in Table 3 present a picture of economic changes in TEs that can be credited to the improved banking sector, in some cases with added international comparisons. Most of the observations are for a recent year (mostly 1999 or 2000). The main observations are as follows:

(a) The level of monetization (M2/GDP) in the countries of CEE is not significantly lower than that of developed countries (Table 3, column 1). The range for all countries is between one half and more than total GDP. In Russia, however, it is only 22 per cent.
(b) The relative size of the banking sector, as measured by the ratio of total assets to GDP, assumes in CEE similar magnitudes as above, much lower than those in Western Europe (in the US, the banking sector is notoriously small). In Russia, at just 16 per cent of GDP, this ratio is extremely small (Table 3, column 2).
(c) Claims of the banking sector on the private sector, or "credits" to the private sector, represent between a quarter and half of GDP in CEE, as compared with three quarters to 1.3 of GDP in Western Europe (ca. 90 per cent as average for OECD) and 35 per cent in a group of lower-middle income DEs (LMIs). The same ratio stands at just around 12 per cent in Russia and is the same or lower in other Western CIS (Table 3, Column 3). It has to be emphasized that the differences between the more advanced CEEs and Russia (and between well functioning banks and less well functioning banks everywhere) are not only quantitative. Many loans to the private sector in Russia are still made without proper risk assessment and in the framework of insider deals between banks and enterprises belonging to the same financing industrial group (FIG). Indeed, there is very little cross-sector or cross-FIG transfer of funds. These circumstances lead to gross misallocation of resources (World Bank 2001, Vol. II. Working Paper no. 2, pp. 17–18).
(d) The weight of deposits in banks in GDP stood at 40–60 per cent in CEEs, at less than 20 per cent in Russia, and half that amount in Ukraine. The average OECD level was about 80 per cent and that of lower-to-middle income countries was around 40 per cent (Table 3, Column 4).
(e) The interest rate spread was lowest in 2000 in the Czech Republic, Hungary and Estonia (at 3–4 per cent) and somewhat higher in other CEEs, between 6–8 per cent. These rates are compared with 18 per cent in Russia and 28 per cent in Ukraine (Table 3, Column 5). Many countries report on significant narrowing of the spread during recent years and credit much of the decline to the entrance of foreign banks (Galac and Kraft, 2000; Opiela, 2001; Reininger et. al., 2001).

7. Conclusions: Foreign banks and the legal infrastructure – the chicken or the egg?

In this paper we have argued that in order to achieve transformation, there is no escape from an early and intensive use of a reformed banking sector. Unreformed, or superficially reformed, the old banks will in effect continue to maintain the firms' soft budget constraint, thereby hampering rather than enhancing restructuring. The enormous restructuring task of a complex production sector inherited from the old regime singles out the TEs among all emerging markets as being in need for modern and efficient banking services. Recent development and expansion of global banking, just when the needs for transition emerged, provided a golden opportunity for a strategy of using foreign banks to facilitate this reform. The takeover of almost entire banking sectors in a number of advanced TEs is a new phenomenon, unique among both emerging and developed economies, an innovative and exciting aspect of globalization.

Banking services have an advantage over other financial services due to their ability to economize on the particular human capital skills required that are in short supply in TEs; they provide a simpler and better institutional structure, amenable to more efficient regulation and supervision, and they are a better tool to oversee and guide corporate governance of enterprises. Given the typical weakness of governments and of the judicial system in many TEs, a well organized banking system working on the basis of Western patterns and with the reputation and resource support of Western mother banks, can substitute and improve on some government functions. The early entry of foreign banks into TEs is the best method of achieving banking reform and of harnessing the financial sector to the transition effort.

Having said this, we have seen in the paper that most foreign banks came into CEE relatively late and, with a partial exception of Hungary and a few other limited cases, the purchase of large state banks came even later, during the last two to four years. Furthermore, there are very few important foreign banks present in Russia and other CIS countries. Given the general recognition of the importance of banks to the transition to the market, to privatization and to restructuring, this must be considered strange.

There could be a number of explanations. First, there may have been the perception that domestic banks – whether new, state or privatized – can do the job once a newly installed legal system is in place. Until this had been proven at least partially wrong, there was a resistance to let foreign banks in, for the normal economic reasons and nationalistic views common throughout the world. The opening-up of the banking sector to liberal entrance, in the name of a free market and the reluctance, or inability, to privatize large state banks, added new difficulties on top of the inherited ones.

The second explanation of the delay in the entry of foreign banks is by a combination of the strong vested interests of the domestic banking sector and by the partial nature of the legal reform in general and that of the financial sector in particular. The incompleteness of the reform is due to the lack of political pressure and skills, but also results from counter pressures of the domestic banking sector, which is concerned with the pursuit of inside deals and tunneling activities, and with the maintenance of protection by personal networks in a corrupt political system. These banks thus avoid serving the production sector. Such a situation prevents the advance of proper legal and banking reform as well as the entry of foreign banks. This is how the domestic banking sector becomes an obstacle to rather than a facilitator of growth and restructuring.

An alternative, third explanation for the delay, the most straightforward one, which also complements the others above, is that it takes time to create and effectively enforce the legal, regulatory and supervisory institutional environment needed for either domestic or foreign banks to operate properly. This process takes longer time in some countries than in others.

All TEs experienced a dose of problems related to the first explanation. Russia and other CIS economies were particularly affected by the friction involved in the second. In Central and Eastern Europe, all three occurred in varying doses, but by the mid- or later part of the 1990s, the danger of the third scenario materializing was realized by the governments, which moved to admit foreign banks.

The last explanation above tells us that foreign banks will move in only when the proper legal infrastructure has been put into place. However, the negative influence of the delay raises an interesting question: was there an alternative policy option available, of inviting foreign banks at an earlier stage in order to be part of the reform process of the banking system, including an earlier privatization of state banks? The only case where such a policy was tried relatively early is Hungary. In all the other cases the empirical question that can be raised is a double one. First, was the quality of the legal infrastructure required for the operation of a sound banking system attained by the time the critical mass of foreign banks moved in? Did any substantial part of the improvement in this infrastructure take place subsequent to the foreign entry? A related empirical question is what were the dynamics of formal and informal barriers to the entrance of foreign banks up to and beyond the date of entry for each country.

Most of the available information on the legal status and strength of the banking sector in Eastern Europe indicates a very high correlation between indexes of law and governance and the performance of the banking sector, including the involvement of foreign banks. This is true with respect to the transition indexes compiled by the EBRD for the financial sector (see for example TR 2001, pp. 14, 38), and to the quality and preparedness of the financial and banking sector as compiled in the *World Competitiveness Yearbook* (2000) of the International Institute for Management Development (IMD), and shown for TEs in Table 3 of Keren and Ofer, 2002.[16] This evidence however does not solve the chicken-and-egg puzzle posed above, of the sequencing, of the dynamics of foreign bank entrance and of the improvement in the legal environment for the operation of banks. This will have to be left for future research.

[16] Glaeser et. al. (2000, p. 37) says that "… the evidence corroborates recent research arguing that financial markets are helped by the legal protection of outside investors – both shareholders and creditors".

Table 1: Banks by ownership type

Part a: Banks with foreign ownership of more than 50 per cent

	1993		1997		2000	
EU accession countries	**Banks, number**	**Assets, per cent**	**Banks, number**	**Assets, per cent**	**Banks, number**	**Assets, per cent**
Czech Republic	12	4.7	15	23.7	16	66.5
Estonia	1	0.4	3	28.8	4	97.4
Hungary	15	12.0	30	59.7	30	67.4
Latvia	n/a	N/a	15	70.6	12	74.4
Lithuania	0	N/a	4	40.6	6	54.7
Poland	10	2.8	29	16.0	47	72.5
Slovak Republic	13	N/a	13	19.3	13	42.7
Slovenia	5	N/a	4	5.4	n/a	15.6
Other Eastern Europe						
Albania	n/a	N/a	3	n/a	12	35.2
Bulgaria	0	N/a	7	n/a	25	75.3
Croatia	n/a	N/a	7	3.0	20	84.1
Romania	n/a	N/a	13	11.5	21	46.7
Former SU						
Belarus	n/a	N/a	2	1.4	6	4.3
Moldova	n/a	N/a	4	n/a	11	39.8
Russia	n/a	N/a	26	6.7	33	n/a
Ukraine	n/a	N/a	12	8.2	14	11.1

Part b: Banks with government ownership of more than 50 per cent

EU accession countries (first round)						
Czech Republic	2	11.9	4	17.5	5	28.2
Estonia	3	25.7	0	0.0	0	0.0
Hungary	16	74.9	8	10.8	6	8.6
Latvia	4	N/a	2	6.8	1	2.9
Lithuania	n/a	53.6	3	48.8	2	38.9
Poland	29	86.2	15	51.6	7	24.0
Slovak Republic	4	70.7	5	48.7	6	49.1
Slovenia	n/a	47.8	3	40.1	3	42.2
Other Eastern Europe						
Albania	n/a	N/a	n/a	89.9	1	64.8
Bulgaria	n/a	N/a	n/a	66.0	4	19.8
Croatia	n/a	58.9	7	32.6	3	5.7
Romania	n/a	N/a	7	80.0	4	50.0
Former SU						
Belarus	n/a	N/a	n/a	55.2	7	66.0
Moldova	n/a	1.0	n/a	n/a	2	9.8
Russia	n/a	N/a	n/a	37.0	n/a	n/a
Ukraine	n/a	N/a	2	13.5	2	11.9

Part c: Banks with more than 50 per cent domestic non-government ownership

	EU accession countries					
Czech Republic	38	83.4	31	58.9	19	5.3
Estonia	17	73.9	9	71.2	3	2.6
Hungary	9	13.1	3	29.5	2	24.0
Latvia	n/a	N/a	14	22.6	14	22.7
Lithuania	n/a	N/a	5	10.6	5	6.4
Poland	48	11.0	39	32.4	20	3.5
Slovak Republic	11	N/a	11	32.0	4	8.3
Slovenia	n/a	N/a	27	54.5	n/a	42.3
Other Eastern Europe						
Albania	n/a	N/a	n/a	n/a	12	0.0
Bulgaria	n/a	N/a	n/a	n/a	31	4.9
Croatia	n/a	N/a	54	64.5	41	10.2
Romania	n/a	N/a	26	8.5	29	3.3
Former SU						
Belarus	n/a	N/a	n/a	43.5	18	29.7
Moldova	n/a	N/a	n/a	n/a	7	50.4
Russia	n/a	N/a	n/a	56.3	n/a	n/a
Ukraine	n/a	N/a	213	78.3	138	77.0

Source: EBRD data base.

Table 2: Non-performing loans of banks (% of total loans)

	1993	1995	1998	2000
EU accession countries (first round)				
Czech Republic	n/a	26.6	20	19
Estonia	n/a	2.4	4	2
Hungary	29.6	12.1	7	3
Latvia	n/a	19.0	7	5
Lithuania	n/a	17.3	12	11
Poland	36.4	23.9	12	16
Slovak Republic	12.2	41.3	44	26
Slovenia	n/a	9.3	9	9
Other Eastern Europe				
Albania	n/a	34.9	35	43
Bulgaria	6.7	12.5	12	11
Croatia	n/a	12.9	13	20
Romania	n/a	37.9	59	4
Former SU				
Belarus	n/a	11.8	17	15
Moldova	n/a	39.1	32	21
Russia	n/a	12.3	31	15
Ukraine	n/a	n/a	35	33

Source: EBRD data base.

Table 3: Banking sector's effects on economy

	M2 (Money and Quasi-Money)	Total bank assets / GDP (per cent)	Credit to Private Sector	Total Deposits	Interest Rate Spread, 2000
	% GDP	% GDP	% GDP	% GDP	% p.a.
	(1)	**(2)**	**(3)**	**(4)**	**(5)**
EU accession countries (first wave)					
Czech Republic	76	125	51	65	3.74
Estonia		59	27		3.86
Hungary	44		29		2.97
Latvia			19		7.49
Lithuania			12		8.29
Poland	41	54	25	36	5.83
Slovak Republic	94	n/a	31		6.44
Slovenia		66			
Eastern Europe Avg.			22	36.8	
Other Eastern Europe					
Bulgaria			16		8.42
Romania		25			
Former SU					
Azerbaijan			8		17.6
Belarus			7	11	
Moldova		25	13		8.91
Russia	22	16	12	17	17.92
Ukraine		n/a	10	11	27.81
For comparison					
France	51		73		
Germany	63	313	122		
Italy	56	358	72		
Netherlands	89	66	137		
United Kingdom	111		134		
United States	61		49		
Lower middle income countries			37	38	

Sources: Column 1: World Bank, 2001, Vol. I, "Executive Summary", Table 1. Column 2: Barth, Caprio and Levine, 2001, Table 2. Column 3: World Bank, 2001, Vol. I, "Executive Summary", Table 1, Vol. II. "Introduction", Table 1.1, "Working Paper no. 2", Table 2.6, Working Paper no. 10", Table 10.2. Column 4: World Bank 2001, Vol. II. "Introduction", Table 1.1, "Working Paper no. 2", Table 2.6. Column 5: World Bank, 2001, Vol. II. Working Paper no. 10", Table 10.3.

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