Banking in Central and Eastern Europe since the Turn of the Millennium – An Overview of Structural Modernization in Ten Countries

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This study gives an analytical overview of the evolution of the banking sectors of ten relatively large Central and Eastern European countries (Hungary, Poland, the Czech Republic, Slovakia; Bulgaria, Romania, Croatia, Serbia; Russia and Ukraine) since 1999–2000. Set in the period following the banking crises and painful transformation of the 1990s, the analysis focuses on the newest structural changes and modernization in an environment of generally strong growth. The emphasis is on salient features of the development of banking regulation and supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and FDI. Conclusions sum up the main findings on a comparative basis: Selling banks to foreign strategic investors has generally paid off, although there are some exceptions. The ongoing swift dissemination of IT and e-banking may help reconcile the seeming paradoxes of these countries being "overbanked" and "underbanked" at the same time. The near-ubiquitous credit boom, while embodying a welcome structural catching-up process, is not without dangers and has not yet been fully brought under control. Even in relation to the region's modest income levels, consumption of banking products remains low in Central and Eastern Europe. Thus, there is still ample room for expansion.

1 Introduction

In the context of transition, the banking system can play a pivotal role for growth and catching-up, but can also be at the center of fragility and collapse. All transition economies have gone through more or less costly banking sector cleanup programs, and only after these programs had been carried through did sustainable market-oriented economic expansion set in. Despite the banking sector's volatility, banking reforms have often been at the forefront of structural adjustment, even preceding the spread of hard budget constraints to other parts of the economy. Given that other segments of the financial sector have so far remained rather underdeveloped, the key position of banks in financial intermediation may loom even larger in the process of further real convergence with higher income countries.

This study aims at tracing, comparing and drawing conclusions from the developments of the banking systems since 1999–2000 in ten relatively large Central and Eastern European countries. Section 2 deals with four nations in Central Europe (Hungary, Poland, the Czech Republic, Slovakia), section 3 treats four countries in Southeastern Europe (Bulgaria, Romania, Croatia, Serbia), and section 4 is devoted to two countries in Eastern Europe (Russia, Ukraine). This analysis is done successively, country by country, not simultaneously. The relatively large number of analyzed countries and the variety of experiences merit consecutive treatment in the interest of clarity. The turn of the millennium was taken as a starting point, since the major thrust of market-oriented reforms (plus financial turmoil) had already been in the 1990s in most countries (exception: Serbia). Therefore, the analysis can focus on the newest structural changes and modernization in an environment of strong and partly accelerating growth and in a comparative context.

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Despite the constrained space available, the study attempts to present some salient features of the evolution of legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and foreign direct investment (FDI). Section 5 tries to draw a number of summarizing conclusions.

2 Central European Countries

Of the countries analyzed, the four Central European ones (Hungary, Poland, the Czech Republic, Slovakia) featured among the earliest and swiftest economic and banking reformers. Since May 2004, they have been members of the European Union.

2.1 Hungary

Having benefited from a head start possibly going all the way back to the original inception of market-oriented reforms in 1968, the Hungarian authorities largely upheld reform momentum and opted early on for an efficient strategy of structural transformation of banking and the economy: They had sold the lion's share of the banking sector to foreign strategic investors by 1997 (Bonin et al., 2003, 41). Today the Hungarian banking sector is one of the most mature in the new EU Member States: Lending is expanding to the small and medium-sized enterprise (SME) sector, key Hungarian credit institutions are taking over foreign ones, and spreads between deposit and lending rates compare favorably with those of neighboring countries. However, banking intermediation as measured by the ratio of total domestic deposits or credits to GDP is lower than in some of Hungary's Central European peers.

The total number of banks in Hungary has decreased from 43 in 1999 to 35 at end-2004 (see table 1), which is still relatively large for a country of 10 million people and might point to a degree of overbanking. Yet the number of branches is fairly small. The use of credit cards, telephone and Internet banking is still limited, but is expanding with technical upgrading and the spread of IT systems pushed by rising incomes, demand and competition. Banking regulation and supervision continue to improve, with the basic regulatory framework aligned to the EU's *acquis communautaire* and comparable to that of Western European countries. Consolidated supervision was introduced in 2003. The market for large corporate banking services has become highly competitive in Hungary. Given the degree of dominance of and integration with foreign capital in the real as well as the banking sectors, cross-border loans from nonresident banks or parent companies abroad have been predominant in nonfinancial corporations' borrowing since the mid-1990s (Magyar Nemzeti Bank, 2004, 41). Important elements that facilitated growth of SME lending were the launching of a credit register in 1999, government financial support and guarantees. The share of SME loans grew from a third of total corporate loans in 1999 to almost 45% in mid-2002 before slightly receding in 2003.

Based largely on FDI-injected improvements in efficiency and profitability and on the recasting of risk management systems, costs of financial intermediation have been coming down. But know-how has also been successfully acquired by OTP (Országos Takarékpénztár és Kereskedelmi Bank), the former state-

owned savings bank, which remains the largest Hungarian credit institution and the only major bank of the country not taken over by a foreign strategic investor (Gelegonya, 2003, 120–121). At 19%, its share in total banking sector assets in mid-2004 approximated the joint market shares of the second-placed K&H Bank – created in 2001 by the merger of KBC-owned K&H (Kereskedelmi és Hitel) Bank and ABN Amro Magyar Bank – and the third-placed MKB (Maygar Külkereskedelmi Bank). Furthermore, OTP turned into a foreign strategic investor: Buoyed by modernization-induced high earnings, the bank has expanded into Slovakia, Bulgaria, Romania and Croatia. But OTP is likely to face tougher competition at home. In October 2003, Postabank (the second-largest retail bank) was sold to Erste Bank (of Austria), already present in Hungary (Condon, 2004). As of end-2003, foreign ownership of Hungarian banks exceeded 80% of total banking capital (table 1).

Supported by the introduction of generous state interest subsidies (in 2001) and by other budgetary enticements of various kinds, mortgage lending has ballooned in recent years (+130% in 2002, +70% in 2003), albeit from a very modest point of departure. The market has so far been rather noncompetitive, administered by a limited number of service providers, and has witnessed high spreads (OECD, 2004a, 100–102). Thus, partly subsidized credit expanded at an annual average of over a fifth from 1999 to 2003. But banks' penetration into riskier fields has entailed a decline of the overall capital adequacy ratio in recent years; the ratio still exceeds the regulatory minimum by a comfortable margin, though. The sustained presence of foreign strategic investors mostly from Western European countries has featured instances of "lender-of-last-resort assistance" from parent banks to their Hungarian subsidiaries or branches.

Table 1

Hungary

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	4.2	5.2	3.8	3.5	3.0	4.2
CPI inflation (year-end, %)	11.2	10.1	6.8	5.3	5.7	5.5
Exchange rate (HUF/EUR, annual average)	252.8	260.0	256.7	243.0	253.5	251.7
Number of banks (of which foreign-owned, year-end)	43(29)	42(33)	41(31)	37(27)	36(29)	35(0)
Degree of financial intermediation (bank assets/GDP, %)	68.1	68.5	71.2	71.4	78.2	75.8
Share of foreign-owned banks in total banking capital (%)	65.3	66.7	63.0	78.3	81.9	. .
Credit (credit volume/GDP, %)	25.1	29.3	29.8	31.5	37.2	. .
Share of nonperforming loans in total loans (%)	4.4	3.2	2.9	3.3	3.1	3.2
Deposits (volume of deposits/GDP, %)	68.1	68.5	68.4	69.3	78.1	. .
Return on equity (ROE, %)	6.6	16.8	22.0	20.0	23.5	29.0
Capital adequacy (capital/risk-weighted assets, %)	15.0	15.2	15.6	13.0	11.8	11.2

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.2 Poland

Following major upheavals in the 1990s, the Polish banking sector appears to have entered a path of steady and successful expansion and catching-up with competing markets. Its size may have contributed to the particular dynamism and vigor of the Polish market. While exposing weaknesses, the intermittent slowdown of economic growth in 2001 and 2002 may have helped to trigger efficiency improvements in the sector. Majority foreign-owned banks, which came to dominate the market toward the end of the 1990s, intensified competition, stimulating the consolidation process. The total number of credit institutions shrank from 77 at end-1999 to 57 at end-2004.

Notwithstanding the expansion of the number of their branches, Polish banks have witnessed a sizeable drop of employment over recent years. At end-September 2003, the sector's workforce came to 126,000, approximately 25,000 fewer persons than in 1999. Head office staff cuts have been associated with operational restructuring measures, a new approach to branch staffing, the introduction of modern technology and the increasing use of electronic banking. The country's good economic performance contributed to banks' rising profitability and helped them build up an appropriate capital base.

Despite robust average growth in the last ten years, Poland went through a weak patch in 2001 and 2002, which was overcome in 2003, as table 2 indicates. The share of credit institutions' nonperforming loans in total loans, which was already rather high in Poland, rose from 14% in 1999 to 22% in 2002, before somewhat receding in the following two years.[2] Nonbank financial institutions began to compete more directly with banks, putting pressure on traditional banking practices. Investment and pension funds, for example, proved successful in luring away some depositors by offering more attractive conditions. Credit institutions reacted by more aggressively including investment bank activities in their service portfolios. But banks also increased purchases of low-risk government bonds and stepped up cost-cutting and rationalization measures in this period (Gardó, 2004b, 38). Despite the slowdown, the capital adequacy ratio of Polish banks remained largely unchanged at around 13% from 1999 through 2003 (table 2). Provisions remained substantial (National Bank of Poland, 2004, 5).

Economic recovery in 2003 and 2004 restored profitability. Mortgage loans have witnessed particularly rapid increases lately. As of end-2003, the largest Polish bank was the former state savings bank Powszechna Kasa Oszczędności Bank Państwowy (PKO BP, 100% state-owned), with a share of 16% of total banking assets, followed by Bank Polska Kasa Opieki (Bank Pekao, 53% owned by Italy's UniCredito) and Bank Przemyslowo-Handlowy (BPH, main shareholder: Bank Austria-Creditanstalt, part of HypoVereinsbank Group). Majority foreign-owned credit institutions accounted for over two-thirds of total assets, majority state-owned banks for a quarter.

The financial situation of the last two big publicly owned credit institutions – PKO BP and Bank Gospodarki Żywnościowej (BGZ), the central institution of rural cooperative banks – remained fragile, necessitating further restructuring

[2] *However, the classification of bad loans in Poland has reportedly been more stringent than in many other countries, at least until adjustments were introduced on January 1, 2004 (OECD, 2001, 168–169; National Bank of Poland, 2004, 5–6, 40).*

measures and capital injections prior to their privatization. As part of the recovery program for PKO BP, the finance ministry transferred to the bank at the end of 2000 shares of five listed companies and credit institutions. Narodowy Bank Polski (NBP) temporarily waived reserve obligations, and parliament passed an act authorizing the finance ministry to underwrite 90% of old housing loans, the deterioration of which had negatively influenced the banks' earnings.

In November 2004, the government sold a 39% stake of PKO BP in an initial public offering on the Warsaw stock exchange. The bulk of the stake was reserved for domestic investors. In late 2004, half of BGZ was sold to the Dutch Rabobank (35%) and the European Bank for Reconstruction and Development, the EBRD (15%). Notwithstanding impressive successes in recent years, a general weakness still hampering financial intermediation and economic expansion is the often arbitrary and inefficient application of new regulations in Poland; it also reflects lingering deficiencies of the court system.

Table 2

Poland

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	4.1	4.0	1.0	1.4	3.8	5.4
CPI inflation (year-end, %)	9.8	8.6	3.4	0.7	1.7	4.5
Exchange rate (PLN/EUR, annual average)	4.23	4.01	3.67	3.86	4.40	4.53
Number of banks (of which foreign-owned, year-end)	77(39)	73(46)	69(46)	59(45)	58(46)	57(44)
Degree of financial intermediation (bank assets/GDP, %)	61.9	65.8	66.4	64.3	64.7	65.3
Share of foreign-owned banks in total banking assets (%)	49.3	72.5	72.0	70.9	71.6	75.0
Credit (credit volume/GDP, %)	27.1	28.3	29.0	27.9	28.6	27.3
Share of nonperforming loans in total loans (%)	13.7	15.5	18.6	22.0	21.8	15.5
Deposits (volume of deposits/GDP, %)	36.2	37.6	38.5	36.0	35.7	34.6
Return on equity (ROE, %)	12.9	14.5	12.8	5.2	5.9	..
Capital adequacy (capital/risk-weighted assets, %)	13.2	12.9	15.1	13.8	13.6	15.6[1])

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.3 Czech Republic

Foreign strategic investors had practically "taken over" the largest part of the Czech banking sector in 1998–2001. This contributed to overcoming the lingering financial crisis that had plagued the country since the mid-1990s. Much sounder credit institutions started to steadily expand their activities (Neue Zürcher Zeitung, 2004). The "takeover" had essentially consisted in the purchase of majority stakes in the three largest banks (in terms of assets): in Československá obchodní banka (ČSOB) by KBC Bank (of Belgium), in Česká spořitelna (the Savings Bank) by Erste Bank (Austria), and in Komerční banka by Société Générale.

While this change brought the injection of urgently needed capital as well as know-how, corporate governance and competition, the structural recovery has yet to fully run its course. Considering that investors received substantial state guarantees against future losses related to inherited loans (ringfencing), the total direct cost to the state of resolving the banking problems of the 1990s is not yet definitely known (Bonin and Wachtel, 2004, 15). It could eventually reach up to 20% of annual GDP (Tůma, 2003, 71). This raises concern at a time when budget shortfalls continue to be large. Apart from fiscal and macroeconomic costs, the protracted period of distorted allocation of capital also entailed sizeable structural costs of the banking crisis.

Restructuring measures coupled with the growing importance of alternative distribution channels (like e-banking) caused the number of branch offices to contract by almost half from 1995 to 2003. The number of bank employees plunged in the same period – from 60,800 to 39,000. This reduction was partly connected to efficiency adjustments and staff slashing in the head offices of the largest banks, partly caused by the concentration of strategic activities in parent institutions abroad. As table 3 shows, at the end of 2003 no less than 96% of total banking assets belonged to nonresidents. The traditionally high degree of financial intermediation in the Czech Republic has declined somewhat in recent years, owing to structural reform and the stagnation of lending. Overall lending has stagnated because of tighter prudential regulations and because credit institutions have become cautious in the wake of the crisis, given the lingering difficulties in part of the enterprise sector and given that enforcement of creditor rights has remained insufficient. Furthermore, the sudden widening of the budget deficit triggered an increase in government financing.

Investments in low-risk, highly liquid "quick assets" such as T-bills, Česká národní banka (ČNB) bills and deposits at other banks have featured prominently in recent years. Czech banks are well capitalized. Thanks to the recent robust growth of loans to households (+32% in 2003, of which mortgage credits: +55%), it seems that the weakness of overall lending to the real sector may have come to an end. Credits to SMEs have shown some life, too. The EU accession process and the alignment of legislation and regulations to EU standards, including the recent "harmonization amendment" to the Banking Act, have constituted key elements in improving and stabilizing the environment for banks. This amendment became effective in 2002 and inter alia brought the establishment of a Central Credit Register in November 2002 and the inception of consolidated supervision of financial groups or conglomerates as of the beginning of 2003.

But a breakthrough in lending will probably only materialize once the rule of law improves and courts work more effectively. Transparency of the judiciary may also need some polishing. On a macroeconomic level, limited lending has so far been offset by high inflows of FDI. As of end-2002, Česká konsolidační agentura (the successor to the "hospital bank," Konsolidační banka) administered assets with a book value of EUR 9.5 billion. Attempting to phase out the legacy of the past crisis, the authorities – hesitantly – decided to sell off the agency's claims to private investors on the market. The first auctions of loans were held in 2001 and 2002 and delivered proceeds of 7% and 9% of

the respective nominal values. The state was thus forced to accept huge discounts, but plans are to finish the sales and wind up the agency by 2007 (Anderson, 2004).

Table 3

Czech Republic

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	1.2	3.9	2.6	1.5	3.2	4.4
CPI inflation (year-end, %)	2.6	4.1	4.2	0.6	1.1	2.8
Exchange rate (CZK/EUR, annual average)	36.88	35.61	34.08	30.81	31.84	31.90
Number of banks (of which foreign-owned, year-end)	42(27)	40(26)	38(26)	37(26)	35(26)	35(26)
Degree of financial intermediation (bank assets/GDP, %)	141.7	144.8	130.2	112.8	101.0	97.1
Share of foreign-owned banks in total banking assets (%)	27.1	75.4	93.3	94.2	95.9	96.0
Credit (credit volume/GDP, %)	45.7	43.6	37.9	35.2	35.8	. .
Share of nonperforming loans in total loans (%)	21.5	19.1	13.4	8.1	4.9	4.1
Deposits (volume of deposits/GDP, %)	53.8	53.1	57.1	64.5	62.3	. .
Return on equity (ROE, %)	–4.3	13.1	14.4	27.4	23.7	23.4
Capital adequacy (capital/risk-weighted assets, %)	13.6	14.9	15.4	14.3	14.5	12.7

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.4 Slovakia

Following the deterioration of the economic situation in the second half of the 1990s, the new government tightened policies and relaunched ambitious banking reforms in 1999: The package of measures consisted in the recapitalization, restructuring and privatization of distressed large, systemically important banks, the resolution of troubled small and medium-sized credit institutions and the shaping-up of regulation and supervision. The reform drive continued in the following years and brought about a major change of incentives under which banks operated. Slovakia thus caught up with and, on some indicators, may have overtaken some of its peers.

A major breakthrough was the privatization of the country's two largest banks. After expensive rehabilitation measures, majority ownership of 67% in Slovenská sporitel'ňa went to Erste Bank (of Austria) and a 95% share in Všeobecná úverová banka (VUB) was sold to Banca Intesa in 2001. Given the dominating market shares of the two credit institutions and some other privatization transactions, including the acquisition of Investičná a rozvojová banka (IRB) by Hungary's Országos Takarékpénztár és Kereskedelmi Bank Rt (OTP Bank) in 2002, the share of majority foreign-owned banks in total banking assets increased to around 96% at end-2002. Moreover, quickly expanding Tatra banka, majority-owned by Austria's Raiffeisen Zentralbank, featured as the third-largest credit institution in terms of assets in 2003. As of the end of 2004, foreign capital reportedly controlled about 98% of Slovak banking assets – probably a record position among transition economies, and in Europe (table 4) (Economist Intelligence Unit, 2004, 2).

The revenue from the sales of the three formerly state-owned banks amounted to more than half of the respective cost of recapitalization and of the carve-out of nonperforming loans (14% of GDP) (OECD, 2002, 118). The foreign strategic investors, by injecting know-how and technology, made pivotal contributions to improving corporate governance, enhancing risk management techniques, encouraging competition and modernizing Slovak banking. Rising competitive pressure has prompted increased bank consolidation and a narrowing of interest rate margins.

After its reserves had been depleted by the reimbursement of insured accounts at four failed medium-sized entities, the Deposit Insurance Fund carried out some adjustments: The insurance premium was raised to reestablish financial viability of the fund, the scope of deposit guarantees was somewhat lowered to curb elements of moral hazard and to incite depositors to monitor their bank more closely. Amendments to the Banking Act, which came into force in 2002, moved the legal framework of Slovak banking closer to EU standards; among the key improvements were the introduction of consolidated supervision to forestall any schemes to spin off riskier activities to affiliated nonbanks subject to less oversight. Accounting rules have been upgraded substantially.

Table 4

Slovakia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	1.5	2.0	3.8	4.6	4.5	5.5
CPI inflation (year-end, %)	14.2	8.3	6.2	3.3	9.3	5.9
Exchange rate (SKK/EUR, annual average)	44.12	42.59	43.31	42.70	41.49	40.05
Number of banks (of which foreign-owned, year-end)	25(11)	23(14)	21(13)	20(15)	21(16)	21(. .)[2])
Degree of financial intermediation (bank assets/GDP, %)	91.2	90.7	92.0	92.5	82.0	87.4
Share of foreign-owned banks in total banking assets (%)	37.8	40.6	90.5	95.6	96.3	98.0
Credit (credit volume/GDP, %)	48.6	43.6	33.5	32.1	33.6	. .
Share of nonperforming loans in total loans (%)	32.9	26.2	24.3	11.2	9.1	7.8[2])
Deposits (volume of deposits/GDP, %)	60.6	65.3	67.2	70.4	66.6	. .
Return on equity (ROE, %)	–36.5	25.2	22.7	29.4	27.1	. .
Capital adequacy (capital/risk-weighted assets, %)	12.6	12.5	19.8	21.3	21.6	18.7

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

[2]) End-September 2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

Some important problems remain: Like banks in other countries that experienced the economic shock of bank restructuring and that are moving toward hard budget constraints in the sector, Slovak credit institutions reacted by becoming (very) cautious lenders. Given the banking sector's lead in reforms, the enforcement of hard budget constraints has not yet fully spread to the real sector. Nonperforming loans, while having declined considerably, have remained relatively high (about 8% of total loans at end-September 2004, table 4). So banks adjusted their intermediation role and reshuffled their portfolios toward lower-risk investments, e.g. government securities and Národná

banka Slovenska (NBS) bills. Such placements are not highly profitable, though. Most credit institutions also hiked their fees for diverse transactions, triggering an investigation by the competition authority. Most recently, lending to the private sector seems to have regained some dynamics, albeit from a low base: Household loans (particularly mortgages) have vigorously expanded since 2002, and enterprise credits have also shown some signs of recovery (OECD, 2004b, 111–112). Still, the judicial infrastructure would need an overhaul.

3 Southeastern European Countries

The Southeastern European countries dealt with in this study (Bulgaria, Romania, Croatia and Serbia) were initially slower to push forward with reforms than their Central European peers. Serbia is a special case, since serious transition only started after the regime change in 2000. However, Southeastern Europe did catch up at least to some degree later on, as described below.

3.1 Bulgaria

Bulgaria's impressive economic and banking recovery after the deep crisis of 1996–97 can be taken as an example of what can be achieved if root causes of problems are attacked and fundamental incentives "put right." Of course, the country is still struggling with major challenges (e.g. unemployment, poverty, weak government services and an ineffective judiciary). We can observe a steady overall catching-up process that in some areas has even turned stormy of late. The scars of the crisis of 1996–97 were still visible in the early years of the new millennium, as banks remained very conservative and risk-averse in lending: As of end-2000, loans to the economy still came to only about 11% of GDP (table 5). Credit institutions at that time focused on transforming short-term deposits into relatively liquid and safe assets (like government securities and deposits at foreign banks). This resulted in a very high level of capital adequacy of 36% in 2000.

Regulation and supervisory oversight have much improved since the crisis. The authorities have taken a number of steps to eliminate obstacles to financial intermediation. In early 2000, the Central Credit Registry accessible to banks was made operational (Barisitz, 2002, 49). Bank monitoring was enhanced by the adoption of consolidated supervision in July 2000. In January 2003 International Accounting Standards (IAS) were introduced for banks and other financial institutions. Lending was on the rise and soon accelerated. Driven by the sustained economic recovery, further substantial FDI flows into the banking sector, increased competition and rising confidence, credits grew to 19% of GDP at end-2002, 26% at end-2003 and to around 35% at end-2004 (table 5). Based on 1999 figures, annual real growth rates of credit volumes came to a quarter in 2000 and to a half in 2003 and in 2004, which corresponds to a full-fledged credit boom, albeit from a low point of departure. At their level of 2003 (in relation to GDP), credit volumes in Bulgaria remained rather low, compared to Hungary or Slovakia, but have moved near Polish levels. Amendments to the insolvency section of the commercial code in mid-2003 also made it easier for banks to lend.

Apart from the divestiture of the largest bank (in terms of assets), Bulbank, in 2000, a number of deals served to increase foreign strategic investors' presence in the country. These included the purchase of United Bulgarian Bank (the third-largest credit institution) by the National Bank of Greece in 2000, the sale of Bank Biokhim to Bank Austria Creditanstalt in 2002, and the takeover of Derzhavna spestovna kassa (DSK, the former State Savings Bank and second-largest bank) by Hungary's OTP in 2003, which practically completed the privatization of the sector (European Commission, 2003, 38–39). DSK had been the first major credit institution active in the housing loan market, which expanded particularly fast. As of end-2004, 83% of banking assets were in majority foreign ownership.

The swift and accelerating growth of credit gave rise to concern on the part of the Bulgarian National Bank (Bălgarska narodna banka, BNB) and the IMF: While increased financial intermediation is welcome from a structural perspective, it swells already strong demand and puts pressure on inflation and the current account. With monetary policy operations, particularly interest rate changes, circumscribed because of the currency board arrangement, the authorities had to resort to other measures. They launched a credit growth containment policy in mid-2003. The BNB initially focused on intensifying supervisory activity: The frequency of on-site inspections was stepped up, and provisioning requirements on various types of loans were tightened.

Table 5

Bulgaria

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	2.3	5.4	4.1	4.9	4.5	5.6
CPI inflation (year-end, %)	6.2	11.4	4.8	3 9	5.6	4.0
Exchange rate (BGN/EUR, annual average)	1.956	1.956	1.956	1.956	1.956	1.956
Number of banks (of which foreign-owned, year-end)	34(22)	35(25)	35(26)	34(26)	35(25)	35(. .)
Degree of financial intermediation (bank assets/GDP, %)	34.6	36.5	41.1	45.0	50.3	65.1
Share of foreign-owned banks in total banking assets (%)	28.4	71.5	70.6	72.4	82.2	82.5
Credit (credit volume/GDP, %)	10.1	11.3	14.0	18.7	26.2	35.4
Share of nonperforming loans in total loans (%)	11.7	8.2	7.0	5.5	4.2	3.5
Deposits (volume of deposits/GDP %)	25.7	26.6	32.2	34.9	39.5	. .
Return on equity (ROE, %)	20.9	21.9	20.5	15.6	22.8	20.6
Capital adequacy (capital/risk-weighted assets in %)	41.3	35.5	31.1	25.2	22.2	17.1

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

In view of the persisting sharp rise in bank credit in 2004, the authorities supplemented their strategy with liquidity drainage operations: Minimum reserve requirements were adjusted on three occasions over the year (even doubled in December 2004). In May and June 2004, the government withdrew fiscal reserves, which had been held with commercial banks, and deposited them with the BNB. In July, the BNB broadened the coverage of reserve requirements. While the sector has so far remained generally solid, the quality

of loans somewhat weakened and the capital position declined in late 2004. In an apparent effort at moral suasion, central bankers in early 2005 launched talks with individual banks whose lending practices were regarded as aggressive.

3.2 Romania

After the financial crisis and recession of 1997–99, Romania experienced a breakthrough to economic growth and banking recovery in 2000. While a number of important factors underpinned this turnaround, some fragilities have subsisted. The new banking legislation of 1998 strengthened the independence and supervisory powers of the Banca Națională a României (BNR). The failure and winding up of Bancorex in 1999[3] showed that even large banks were not necessarily "too big to fail." This change of environment was complemented by the first privatizations of major Romanian credit institutions to foreign strategic investors: Banca Română pentru Dezvoltare (BRD) and Banca Agricolă were sold in 1999 and 2001, respectively (Barisitz, 2004b, 90). In 2000, the authorities embarked on prudent macrostabilization efforts. The decade-long conflict in neighboring former Yugoslavia drew to an end. With the strengthening of the economic upswing in 2001 and the following years, market participants gained more confidence and credit institutions started to expand their activities. Still, progress with the restructuring of large and often loss-making state-owned enterprises (SOEs) remained slow.

The assets of the banking sector grew from a low of 29% of GDP in 2000 to 33% at end-2003 (and, according to preliminary data, 39% at end-2004; see table 6). Total loans witnessed a rapid expansion from 9% of GDP to 16% in the corresponding period. But levels are still quite modest. Lower returns on government debt paper, on deposits with the BNR and on forex transactions contributed to the enhanced attractiveness of lending. The increase in loans focused on private and privatized firms, SMEs and households. Consumer credits, particularly mortgage loans and loans for the purchase of durables, have grown extremely fast and have even multiplied, albeit from a basis of almost zero.

The rapidity of the credit expansion, while welcome in the context of a catching-up process, triggered concern on the part of the monetary authorities, given the structural weaknesses of the economy. Banks' risk management capacities still seem to be insufficient. Furthermore, lower interest rates on foreign currency credits and the most recent tendency toward appreciation of the Romanian leu have made particularly euro loans more attractive, boosting foreign currency lending to more than half of total lending at present. Since it is doubtful that most borrowers have substantial hard currency proceeds, the exchange rate risk could turn into a credit risk for banks. Starting in 2002, the BNR has attempted to rein in the growth of credit, particularly forex loans.

As of end-2004, 30 banks (including 7 branches) or 62% of banking assets were majority-owned by foreigners (table 6). Among these were seven of the top ten credit institutions, including BRD (the second-largest bank, owned by Société Générale), Raiffeisen Bank (former Banca Agricolă), ABN Amro

[3] *The removal of Bancorex is reflected in the strong decline of nonperforming loans from 1999 to 2000, as can be seen in table 6.*

Bank Romania and the Bucharest branch of ING Bank. The state held majority stakes in two institutions comprising 7% of total assets. Seven banks accounting for 31% of total assets were in domestic private ownership.

The largest bank, BCR (Banca Comercială Română, accounting for about 30% of assets) continues to hold an important state minority participation (37%). In the wake of two previously failed attempts to privatize the bank, the authorities in October 2003 sold a quarter of BCR's share capital, 12.5% to the EBRD and 12.5% to the International Finance Corporation (IFC). The bank's employees acquired 8%, and five domestic investment funds together took 30%. The two international institutions are expected to stimulate modernization of the bank prior to the planned sale of a majority stake to a foreign strategic investor by 2006. The third-largest bank, CEC (Casa de Economii şi Consemnaţiuni, Savings Bank), is currently undergoing a restructuring program and is to be privatized by 2005 or 2006. In early 2003, the BNR tightened loan classification and loss provisioning rules.[4] The new Banking Act passed in December 2003 constituted a move toward full compatibility with EU norms (National Bank of Romania, 2004, 19). But the environment still features weak corporate governance, limited contract enforcement capacities and insufficient rule of law.

Table 6

Romania

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	–1.2	2.1	5.7	5.0	5.2	8.3
CPI inflation (year-end, %)	54.8	40.7	30.2	17.9	14.1	9.3
Exchange rate (ROL/EUR, annual average)	16296	19956	26027	31255	37556	40532
Number of banks (of which foreign-owned, year-end)	41(26)	41(29)	41(32)	39(32)	38(29)	39(30)
Degree of financial intermediation (bank assets/GDP, %)	34.9	29.2	30.5	31.6	32.7	39.5
Share of foreign-owned banks in total banking assets (%)	47.8	50.9	55.2	56.4	58.3	62.0
Credit (credit volume/GDP, %)	11.1	9.4	10.2	11.8	16.0	17.9
Share of nonperforming loans in total loans (%)	35.4	3.8	3.4	2.3	8.3	8.1
Deposits (volume of deposits/GDP, %)	22.4	20.0	20.4	21.7	21.3	. .
Return on equity (ROE, %)	–15.3	12.5	21.8	18.3	15.8	17.0
Capital adequacy (capital/risk-weighted assets, %)	17.9	23.8	28.8	25.0	21.1	18.8

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

3.3 Croatia

The banking crisis of 1998–99 and the exit of a number of smaller and medium-sized credit institutions, the hardening of budget constraints, the withdrawal of the state from the sector and the infusion of foreign financial and human capital have contributed to the robust recovery and expansion of Croatian banking activity since the turn of the millennium. Following their privatization at the end of 1999, the two largest banks changed owners again: A consortium of

[4] *This largely explains the sharp increase of nonperforming loans in 2003.*

UniCredito and Allianz AG purchased market leader Zagrebačka banka in March 2002. As a condition for this transaction, Hrvatska narodna banka (HNB) required UniCredito to relinquish its stake in Splitska banka (the third-largest Croatian bank), as the Italian institution would otherwise have acquired a dominating competitive position. Splitska banka was taken over by Bank Austria Creditanstalt (HypoVereinsbank Group). Banca Intesa became the majority owner of Privredna banka Zagreb (the second-largest bank).

The authorities swiftly handled a crisis that had broken out in March 2002 at Riječka banka, which had been saddled with hidden losses of around EUR 100 million by a rogue trader. Upon discovery of the losses, the HNB quickly came up with liquidity to calm the markets, and the government purchased a 60% stake of Riječka for USD 1 from its owner, Bayerische Landesbank. Following Riječka's recapitalization, the authorities sold a majority stake in the institution to Erste Bank (Austria). The market share of foreign-owned credit institutions, essentially consisting of six large banks or banking groups, climbed from 40% of total assets at end-1999 to 91% at end-2004. Today Croatia is in the vanguard of transition economies with respect to the level of financial intermediation achieved: Total banking assets grew from an already high 66% of GDP in 1999 to about 109% at end-2004. Credits expanded in the corresponding period from 39% to 61% of GDP (table 7). This happened despite the still tenuous rule of law and slow-working, overburdened courts. The HNB has been strengthening supervision by moving from the formal verification of regulations to a more substantive risk-based approach.

Notwithstanding the authorities' impressive low inflation record – now sustained for over a decade – Croatians continue to maintain about two-thirds of their bank deposits in euro, complemented by sizeable euro cash holdings outside the sector. This is one of the highest levels of currency substitution and informal euroization recorded in Europe. It partly owes to lingering memories of high inflation or hyperinflation during the 1970s and 1980s in former Yugoslavia and the burst of inflation in the early 1990s. It also stems from the fact that the bulk of tourism revenues as well as guest workers' remittances are held in foreign currency (Gardó, 2004a, 31–32). The total value of household bank accounts almost doubled from 1999 to 2001, which can be explained by the impact of the euro area's "cash changeover" from the Deutsche mark (and other legacy currencies) to the euro at the beginning of 2002. In order to carry out the conversion, people had to pay their Deutsche mark cash into bank accounts, which were then converted. On the whole, EUR 2.5 billion were exchanged, the lion's share of which (EUR 2.1 billion) stayed in the accounts, which documented the population's enhanced trust in the banking sector.

While credit growth doubtlessly stimulated economic recovery and the catching-up process, it contributed to a surge in imports and to forex loans from abroad, which further widened the current account deficit and heightened the country's vulnerability to external shocks. In early 2003, the monetary authorities adopted a decision on the compulsory purchase of HNB bills, under which banks whose credit growth exceeded an annual rate of 16% were required to subscribe to low-yield HNB bills in an amount equal to 200% of the exceeded growth (Croatian National Bank, 2004, 115). This strict measure effectively slowed down the credit boom in 2003 and somewhat dampened

credit institutions' profitability. The measure was repealed in early 2004 and was replaced by tighter prudential requirements and more market-based instruments.

Table 7

Croatia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	2.5	–0.9	4.4	5.2	4.3	3.8
CPI inflation (year-end, %)	4.4	7.4	2.6	2.3	1.7	2.7
Exchange rate (HRK/EUR, annual average)	7.58	7.63	7.47	7.41	7.56	7.50
Number of banks (of which foreign-owned, year-end)	53(13)	43(21)	43(24)	46(23)	41(19)	40(18)
Degree of financial intermediation (bank assets/GDP, %)	66.1	73.3	91.1	98.7	101.1	109.0
Share of foreign-owned banks in total banking assets (%)	39.9	84.1	89.3	90.2	91.0	91.3
Credit (credit volume/GDP, %)	39.1	39.6	45.6	54.5	58.1	61.0
Share of nonperforming loans in total loans (%)	10.3	9.5	7.3	5.8	5.1	4.5
Deposits (volume of deposits/GDP, %)	39.6	47.6	63.1	63.7	64.8	. .
Return on equity (ROE, %)	4.8	10.7	6.6	15.3	14.5	16.6
Capital adequacy (capital/risk-weighted assets, %)	20.6	21.3	18.5	17.2	16.2	14.1

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

3.4 Serbia

After the regime change in late 2000, the Federal Republic of Yugoslavia (FRY) broke with the past and embarked on an ambitious catching-up strategy. While initial results have been impressive, the speed of transformation appears to have slowed down recently. After liberalizing prices and the exchange rate, which produced a jump in the price level and a sharp depreciation of the dinar, the authorities tightened monetary policy, established a managed float for the Yugoslav currency (nominal anchor: Deutsche mark/euro) and brought inflation down. The catastrophic situation of the banking sector in 2000 is illustrated by Yugoslav banks' own (optimistic) assessment of their capital adequacy of 0.7% (which is far below the 8% minimum level corresponding to the Basel Accord of 1988, compare also table 8). Loans granted to shareholders and persons connected to them comprised almost 90% of the total value of large credits. 30 credit institutions (including the 6 largest, out of a total of 80), which together comprised about 70% of the sector's assets, were insolvent or featured negative capital.

Furthermore, the FRY – like Croatia – was saddled with a historic legacy originating in the communist era. But while Zagreb had addressed the problem in the 1990s, not much had happened in Belgrade: Most "old" banks (founded before the collapse of socialist Yugoslavia and predominantly socially-owned) were saddled with large blocks of "frozen liabilities" and "frozen assets." Frozen liabilities referred to citizens' foreign currency accounts that had been transferred to Narodna banka Jugoslavije (NBJ, National Bank of Yugoslavia) and then in fact confiscated and spent by the authorities, and to forex loans received from

commercial or official creditors abroad for onlending to domestic enterprises that then defaulted. Frozen assets referred to banks' corresponding claims on the NBJ for transferred forex accounts and on domestic delinquent firms for onlent forex credits. "New" banks (mostly private) did not have this problem, but they were initially relatively small. With regard to citizens' frozen accounts, the Serbian authorities in the summer of 2002 launched the issue of EUR 4.2 billion of state bonds in exchange for such deposits.

In the first half of 2001 the NBJ carried out a comprehensive assessment of the banking sector and elaborated a restructuring strategy (endorsed by the International Financial Institutions, the IFIs). After enactment of a bankruptcy law in October 2001, 19 relatively small, undercapitalized and inefficient credit institutions were closed. In early 2002, the authorities decided to shut down and liquidate four of the five largest banks (all of them old ones: Beobanka, Beogradska banka, Investbanka and Jugobanka). These four banks accounted for almost 60% of the book value of the sector's assets and for about two-thirds of outstanding commercial credit to the nonfinancial sector.

The intervention certainly constituted one of the boldest bank restructuring measures yet undertaken in transition economies. Far from provoking significant negative repercussions, this step actually improved public confidence and stimulated hope that the sector had finally reached a turning point (Barisitz, 2003, 199). Owing to the huge carve-out, some other structural adjustments and economic expansion, the total book value of the sector shrank drastically from 126% of GDP at end-2001 to 36% a year later (table 8). Following the closures, the NBJ's regulatory and supervisory powers were strengthened by the enactment of a new Banking Act in mid-2002. The central bank has since been focusing on enforcement.

Launching a new restructuring initiative, in late 2002 the authorities converted state claims (related to guarantees for forex liabilities to the Paris and London Clubs) into shares and thus "nationalized" 12 medium-sized socially-owned banks in order to facilitate their privatization or resolution. But subsequent restructuring efforts of these entities, which together accounted for over half of total bank assets, were drawn out due to intermittent political instability. In February 2003, a new, loose confederation – Serbia and Montenegro – replaced the FRY. The NBJ became the NBS (Narodna banka Srbjie); Montenegro, which had unilaterally euroized in 1999–2000, features its own independent fiscal, monetary and banking policies, and will not be treated here. Given the very small size of the banking sector in the wake of the carve-out, foreign-owned credit institutions swiftly gained terrain. Their share in total assets grew from 13% (excluding the four large insolvent banks) at end-2001 to over a third in late 2004. According to preliminary data, as of end-2004, four of the five largest Serbian credit institutions (including Raiffeisenbank, Delta banka and HVB banka) were foreign-owned (Financial Times, 2004). Foreign-owned banks played a particularly prominent role in restoring confidence in the sector and gathered the lion's share of new deposits. The seventh-largest credit institution, Jubanka, was sold to Alpha Bank (Greece) in January 2005.

Table 8

Serbia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	–21.0	5.2	5.1	4.5	2.4	8.6
CPI inflation (year-end, %)	36.5	113.5	40.7	14.8	8.1	12.5
Exchange rate (YUD/EUR, annual average)	11.70	15.30	59.44	60.79	65.26	73.00
Number of banks (of which foreign-owned, year-end)	75(3)	81(3)	54(8)	50(12)	47(16)	43(13)
Degree of financial intermediation (bank assets/GDP, %)	79.8	185.0	127.0	36.4	31.5	38.8
Share of foreign-owned banks in total banking assets (%)	. .	0.3	2.1	12.8	22.9	37.0
Private sector credit (credit volume/GDP, %)	29.6	56.6	31.7	17.2	16.0	21.5
Share of nonperforming assets in total assets (%)	. .	30.9	12.6	24.3	22.5	23.0
Private sector deposits (volume of deposits/GDP, %)	9.7	14.7	13.4	15.5	17.7	20.7
Return on equity (ROE, %)	. .	–78.5	–26.0	–34.5	–1.2	–5.0
Capital adequacy (capital/risk-weighted assets, %)	. .	0.6	21.9	30.6	31.3	27.9

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

4 Russia and Ukraine

As members of the Commonwealth of Independent States, Russia and Ukraine have been bound together by a common legacy and various similarities in economic policies and banking evolution since independence. More recently, they seem to have increasingly chosen their own paths of reform and development.

4.1 Russia

The impressive Russian recovery that followed the severe crisis of 1998 enabled banks to begin anew, although initially they hardly contributed to the recovery. The expansion was supported by the significant easing of monetary conditions, as the ruble had strongly devalued in real-effective terms, which boosted competitiveness of domestic manufacturing and kick-started import substitution. Then, importantly, oil and raw material prices recovered again and rose strongly. Political stability was gained and retained under the Putin presidency (since January 2000), prudent macroeconomic policies were carried out and some positive effects of structural reforms, e.g. tax reforms, made themselves felt. As from 2000, an uninterrupted string of federal budgets featured surpluses.

Rising earnings and wealth of raw material extractors, exporters and linked industries attracted banks and provided a new financial base for the banking business. This was later complemented by the steady recovery of wages and salaries and pronounced adjustments of pensions. Sberbank was the first to react by expanding its credit portfolio (already in mid-1999), other banks followed suit (in 2000). According to the monetary authorities, by the end of 2001, the Russian banking sector had more than offset the losses caused by the crisis, and its profitability had been restored. As of end-2004, total banking assets in real terms were 75% to 80% higher than in July 1998 (just before the crisis) and reached 41% of GDP (EUR 185 billion to EUR 190 billion). The total volume of

loans more than doubled from July 1998 to end-2003 and attained 22% of GDP (table 9). Household deposits climbed 60% during that period. Yet these data are based on official Russian accounting standards (RAS), which tend to put greater emphasis on formal reporting requirements than on material elements and economic meaning. A (still) not infrequent way of dressing up the books appears to be that banks lend to their owners, who then use the funds to "boost" capital.[5]

When the dust of the crisis had settled, it was clear that state-owned credit institutions had – once again – become the dominant players in Russia. Coming to 1,299 as of end-December 2004, the total number of Russian banks is still very high, even for a country of 144 million with an immense territory. However, the majority of credit institutions have only very few branches. Today, Russian banks can be subdivided into four basic groups: First, there are the big state-owned institutions Sberbank and Vneshtorgbank. Sberbank remains by far the biggest player in the market. It still has about 190,000 employees and entertains around 20,000 branches and service posts across the land, which is more than all other banks taken together. In October 2004, Sberbank held about 62% of all household deposits, thus retaining a quasi-monopoly in the area. Over recent years, Sberbank as well as Vneshtorgbank, the former foreign trade bank of the Russian Federation and second-largest bank (measured by assets), have strongly expanded their exposure to the corporate sector, particularly the oil and gas industries. At end-2003, majority state-owned banks together accounted for 38% of loans to the real sector.

The second group contains the next 15 to 20 mostly privately owned institutions, currently dominated by banks owned by big raw material producers. Among the largest "RawMat banks" are Gazprombank (the third bank, associated with the majority state-owned natural gas monopolist Gazprom), Rosbank (attached to the Interros financial-industrial group, including the huge Norilsk Nickel Corporation) and Bank Petrokommerts (linked to Lukoil). The largest privately owned credit institution (ranking fourth) is Alfabank, connected to Alfagroup, a diversified financial-industrial group. Most private banks function as "pocket banks" or "agent banks," i.e. extended treasuries or financial departments of owner firms or conglomerates. The third group of banks is numerically overwhelming, consisting of over 1,200 small or even tiny institutions. Many of these are undercapitalized regional outfits or providers of niche services. Despite reform progress, the insufficient protection of creditors, the problems in securing collateral and the generally weak or selective rule of law make it difficult for Russian banks to lend on the free market.

FDI and foreign ownership account for the fourth group of banks. This group only plays a minor role in Russian banking. At end-2003, 41 majority foreign-owned credit institutions accounted for 7% of total banking assets in Russia (table 9). Citibank, Raiffeisenbank and Hypo-Vereinsbank (which participates in Mezhdunarodny moskovsky bank) feature among the top 15 Russian banks. The relatively weak presence of foreign capital in the Russian sector is certainly in part due to the still lingering impact of the crisis of 1998,

[5] *This is also dubbed "roundtripping of loans to shareholders" (Odling-Smee and Thomson, 2003).*

when many foreigners lost a lot of money. Although many restrictions for FDI in banking have been abolished, some still exist, like a (de facto) ban on the opening of branches of foreign banks. There also seems to be an underlying resistance to allowing foreigners to buy significant stakes in large local institutions (Trofimova et al., 2004, 64).

Since late 2003, the authorities have passed a number of important banking reforms, thereby stepping up the pace of change. The Central Bank of the Russian Federation (Bank Rossii, Bank of Russia) radically revised its general instruction "On banks' mandatory norms," which entered into force in April 2004. The new rule exemplifies efforts to shift from form to substance in regulation and, according to experts, may bring about a real improvement in the quality of Bank of Russia supervision in that it reduces opportunities for banks to manipulate their accounts in order to meet prudential ratios. But implementation promises to be difficult. After long discussions and hesitations, household deposit insurance legislation was finally signed into law in December 2003. To counter moral hazard, the Bank of Russia has limited deposit coverage and made access to insurance subject to stringent inspections and conditions. Banks that do not meet the admission criteria will no longer be allowed to accept deposits. Around 1,140 credit institutions applied to take part in the deposit insurance scheme. The Bank of Russia engaged in what was bound to be the first serious review for the overwhelming majority of Russian banks in years (Barisitz, 2004a, 147, 149).

Table 9

Russian Federation

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	6.4	10.0	5.1	4.7	7.3	7.2
CPI inflation (year-end, %)	36.8	20.1	18.6	15.1	12.0	11.7
Exchange rate (RUB/EUR, annual average)	26.24	26.03	26.13	29.65	34.55	35.81
Number of banks (of which foreign-owned, year-end)	1,349(32)	1,311(33)	1,319(35)	1,329(37)	1,329 (41)	1,299(42)
Degree of financial intermediation (bank assets/GDP, %)	35.4	33.4	34.9	37.8	39.3	40.6
Share of foreign-owned banks in total banking assets (%)	10.6	9.5	8.8	8.1	7.4	..
Credit (credit volume/GDP, %)	13.1	13.5	16.2	18.5	21.7	23.0[2])
Share of nonperforming loans in total loans (%)	13.4	7.7	6.2	5.6	5.0	..
Deposits (volume of deposits/GDP, %)	10.2	9.9	10.7	12.4	14.4	16.0[3])
Return on equity (ROE, %)	–4.0	8.0	19.4	18.0	17.8	..
Capital adequacy (capital/risk-weighted assets, %)	26.7	24.9	24.3	22.2	19.1	17.0[2])

Source: NCB, IMF, RZB, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

[2]) June 30, 2004.

[3]) March 31, 2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

It was in this particular environment of examinations and nervousness that two smaller banks' licenses were revoked in connection with money laundering charges in May 2004. This triggered turbulences that culminated in the illiquidity or insolvency of a medium-sized bank, Gutabank, and sizeable withdrawals even from Alfabank in July 2004. The central bank reacted by repealing the licenses of ten smaller banks, halving its reserve requirements, and supporting the takeover of Gutabank by Vneshtorgbank with a low-interest loan. Gutabank was thus effectively nationalized. In mid-July, parliament passed a special law providing for a limited interim guarantee for all existing – but not for any new – bank deposits of private individuals. These measures calmed the situation. In the fall of 2004, banking activities resumed their – fragile – expansion. The Bank of Russia took action against about 190 banks found to have artificially inflated their capital. In mid-March 2005, the central bank published a list of around 820 banks, accounting for 98% of all private deposits, which had passed the inspections and will be admitted to the scheme.

4.2 Ukraine

After a decade of uninterrupted and deep economic contraction, 1999 marked a turning point, and 2000 was the first year of a steep and sustained recovery. While the depression had been even more pronounced than in Russia, so was the rebound, which accelerated to provide double-digit annual growth in 2004 (table 10). Apart from the base effect, some of the driving forces of Ukrainian economic expansion are the following: After the financial crisis of 1998, the hryvnia continued to decline throughout the following year, which favored import substitution. Strong rises in world market prices for some of Ukraine's prime exports (steel, chemical products) served to ignite export-led growth in 2000. Later on, domestic demand gathered momentum, and an impressive credit boom contributed to financing the expansion. Moreover, a reform-oriented, if short-lived, government came to power in Kiev in early 2000 and initiated important adjustments: Macrostabilization was strengthened, subsidies were cut, tax rules simplified and enforced. The authorities stepped up privatization and enacted a new banking law.

Notwithstanding the undercapitalized and precarious state of large parts of the sector, banking activity started to expand strongly in 1999. The new Law on Banks and Banking Activity became effective in January 2001 and strengthened the powers of the National Bank of Ukraine (Natsionalny bank Ukraini, NBU) as supervisor and improved the regulatory environment for banks. After years of difficulties in trying to ensure greater compliance of the former state-owned Bank Ukraina (focusing on agriculture) with prudential regulations, the central bank finally overcame political barriers and decided to liquidate the bank in July 2001 (Loehmus, 2002, 18). Buoyed by the favorable economic environment, a credible exchange rate anchor, which stabilized expectations,[6] the quick decline of inflation, which bolstered confidence, and strong money demand growth, which paved the way for rapid remonetization, Ukraine experienced a credit boom.

[6] *In 2000, the U.S. dollar was chosen as a de facto nominal anchor for the hryvnia within the framework of a managed float.*

From 1999 to mid-2004, average annual commercial bank credit growth to the economy exceeded 50% in real terms. The loans-to-GDP ratio more than tripled from 9% at end-1999 to 30% in June 2004, which corresponds to one of the most rapid such expansions in transition economies (table 10). Deposit growth financed the lion's share of the expansion. Most recently, inflation has been on the rise again (to 12.3% at end-2004), and the credit boom has raised serious concerns about credit risk in the banking sector. Ukraine's loans-to-GDP ratio has reached a level well within the average range of the more advanced transition countries (like Poland) and above average for transition countries with a similar institutional quality in the sector.

Increasing competition has brought about losses of market shares for the two large remaining state-owned banks – Oshchadny bank (Savings Bank, the fourth-largest measured by assets) and Ukreximbank – as well as for former state-owned banks saddled with nonperforming claims, e.g. Prominvestbank (the third-largest) and Ukrsotsbank. The two big private banks unburdened by the past, Avalbank and Privatbank, became the largest credit institutions in Ukraine. As of end-2004, there were still 160 banks in the country. Particularly the smaller ones functioned as pocket banks of enterprise groups whose ownership structures have often been difficult to trace, notably where ownership has been "layered" or "packaged" through several companies (IMF, 2003, 7).

Table 10

Ukraine

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004[1])
GDP growth (real, %)	–0.2	5.9	9.2	5.2	9.6	12.1
CPI inflation (year-end, %)	19.2	25.8	6.1	–0.6	8.2	12.3
Exchange rate (UAH/EUR, annual average)	4.393	5.029	4.814	5.030	6.024	6.609
Number of banks (of which foreign-owned, year-end)	161(15)	154(14)	152(16)	157(15)	157(19)	160(19)
Degree of financial intermediation (bank assets/GDP, %)	19.6	21.8	23.3	28.3	37.9	43.5
Share of foreign-owned banks in total banking assets (%)	..	..	..	16.0	17.0	..
Credit (credit volume/GDP, %)	9.0	12.4	14.5	19.4	27.0	27.1
Share of nonperforming loans in total loans (%)[2])	35.8	29.6	25.1	21.9	28.3	30.0
Deposits (volume of deposits/GDP, %)	9.6	11.4	12.8	16.9	23.4	26.2[3])
Return on equity (ROE, %)	8.7	–0.5	7.5	8.0	7.6	8.4
Capital adequacy (capital/risk-weighted assets, %)	19.6	15.5	20.7	18.0	15.2	16.8

Source: NCB, IMF, EBRD, ECB, wiiw, OeNB.

[1]) Preliminary data.

[2]) IMF estimate.

[3]) Mid-2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

Notwithstanding the new banking law, insider lending practices went on, and according to IMF estimates, more than a quarter of total loans were nonperforming in mid-2004 (Schaechter, 2004, 14, 23).[7] To counter weak-

[7] *This is the highest level observed in all analyzed countries. The Ukrainian indicator is reposted to have risen further to 30% at end-2004.*

nesses in capitalization and stimulate consolidation, the NBU raised the minimum capital adequacy ratio from 8% to 10%, effective March 2004. Various areas need further strengthening: banks' risk management capacities, creditor rights, the court system, transparency and banking supervision. Given this environment and the ban on opening foreign bank branches (similar to that in Russia), it is not surprising that – despite the boom – foreign banks' presence is modest. As of end-2004, there were 19 majority foreign-owned credit institutions in Ukraine (many of them Russian), which accounted for about a sixth of total banking assets. Raiffeisenbank was the only foreign-owned bank among the ten largest credit institutions of the country.

5 Conclusions

After the collapse of the communist system, most of the ten analyzed countries (Hungary, Poland, the Czech Republic, Slovakia, Bulgaria, Romania, Croatia, Serbia, Russia and Ukraine) experienced the 1990s as a volatile decade featuring major banking crises and partly painful structural transformation. Around the turn of the millennium, the environment stabilized and banking activities entered a path of sustained expansion, boosted by the resumption of robust economic growth and the anchor of EU integration or proximity.

Some of the findings of this study can be summarized as follows:

Foreign-owned banks have acquired dominating competitive positions in all analyzed countries except slower or late reformers (Russia, Ukraine, Serbia). In some countries, like Slovakia and the Czech Republic, foreign-owned banks' positions are overwhelming. Foreign investors had often entered the markets during or immediately after a major sector clean-up (preceded by a crisis) and as soon as a reasonable degree of rule of law had been established. Foreign-owned banks' average share in total assets is much higher in Central and Eastern Europe than in the euro area (where it comes to about a quarter). Bank privatization is all but finished in most countries. The strongest foreign presence (in terms of assets) is that of Austrian, Italian, Belgian, German and French banks. The share of state-owned banks is still relatively high (over 30% of assets) in Russia and Serbia. The state retains important minority stakes in Romanian and Ukrainian credit institutions.

Selling banks to foreign strategic investors has generally paid off, because it has contributed to enhancing the sector's competitiveness and efficiency. Foreign strategic investors have injected know-how, technology, corporate governance and money, thus boosting competitiveness, stimulating competition and bolstering fragile confidence in the sector. In some instances, foreign parent banks have also acted as de facto lenders of last resort to their subsidiaries in the region, although this cannot be taken for granted (see the case of Riječka banka). This does not mean that foreign takeovers are the only feasible route for establishing viable and competitive credit institutions in the region (or other emerging markets). But if development is to be essentially homegrown, the necessary accumulation and transfer of human and financial capital will probably take longer. There are only few examples of successful large domestically owned banks in Central and Eastern Europe. Perhaps the most prominent, OTP, appears to owe its strong position in the Hungarian market and its relatively

efficient structure to the impact of the relentless competition from foreign-owned institutions, which compelled it to drastically streamline and modernize its operations.

Practically every analyzed country seems to be overbanked and underbanked at the same time – overbanked in that it harbors too many, particularly small, credit institutions and underbanked in that access to and use of banking services is far below the EU average. But the tightening of minimum capital requirements and intensifying competition are contributing to ongoing consolidation processes, which in some countries include sizeable cuts of banking employment. Modernization and rationalization of banking structures and networks, notably in Central European countries, comprise the swift dissemination of IT (greater use of credit cards, telebanking, e-banking) and may reconcile the above-mentioned apparent contradictory tendencies through enhanced productivity and efficiency.

In recent years, a genuine credit boom has unfolded in most countries. However, the boom was preceded by a sharp curtailment or collapse of the traditionally lax credit policies inherited from the past. The bank restructuring programs of the 1990s, the concomitant tightening of regulations and supervision as well as the improvement of bookkeeping rules essentially established hard budget constraints for credit institutions. Due to delays in the implementation of creditor rights in the real sector, banks initially became more cautious in lending and partly reshuffled their portfolios toward low-risk investments, like government securities and central bank bills.

Based on strong growth and improved macroeconomic and structural conditions, rising confidence, jumps in deposit levels as a result of the euro cash changeover 2001–02 as well as, in most countries, substantial FDI inflows into the banking sector, lending subsequently recovered, eventually leading into a credit boom. The authorities concerned perceive the boom as a welcome advance on the path of structural catching-up and convergence. Although the boom is accompanied by a decline of capital adequacy ratios, the latter remain relatively high, and bad loans do not seem to be a serious problem. Pushed by competition, credits spread to hitherto less covered areas, like retail – particularly mortgage – lending, where they have multiplied from a base of almost zero. Notwithstanding the establishment of credit information bureaux in most countries, SME lending has not yet taken off, except in Hungary.

But the credit boom does give rise to concern at least in some countries (e.g. Bulgaria, Romania, Croatia, Ukraine). Owing to the sheer speed of the expansion, careful screening of individual loans may not be possible. This heightens the danger that some loans could turn nonperforming in the next economic downturn. Moreover, the credit boom has swelled already strong aggregate demand, which can fan inflation; with loans often being used to purchase imported consumer goods, pressure is put on the trade and current accounts and on external liabilities. Authorities have tended to react somewhat hesitantly to the boom. In many instances, regulatory and supervisory rules were further

tightened, notably minimum reserve requirements. Croatia resorted to temporary administrative restrictions, which proved effective, but at a cost. Apart from Croatia, the effectiveness of the tightening measures is not yet clear.[8]

"Agent banks" or "pocket banks," i.e. extended treasuries or financial departments of owner firms or enterprise groups whose ownership structures tend to be opaque, still play an appreciable role in some countries, especially in Russia and Ukraine, where they prevail. The "agent bank – principal firm" structure and relationship may at least partly reflect an approach to protect business interests in a continually distorted environment; on the other hand, extensive insider lending, excessive portfolio concentrations and bank captivity to owners entail high risks.

Banking supervision has generally been moving forward from the formal verification of regulations to substantive risk-based approaches, including the overhaul of accounting methods toward IAS or EU-compatible standards. The EU accession process and legal harmonization with the *acquis communautaire* has contributed to improving and stabilizing the environment for banks. However, lingering deficiencies of the courts (e.g. weak enforcement of contracts, difficult access to collateral) are still felt in a number of countries. Due to intensifying competition, there is a general tendency for interest rate spreads to decline, even if they clearly exceed margins in the euro area because risks are higher. Higher margins also correspond to higher average profitability of transition economies' banking sectors.

Notwithstanding important progress in banking transformation and persisting high growth rates of income and financial intermediation, the banking markets in Central and Eastern Europe retain generous expansion potential, as witnessed by the still much lower per capita income and access to banking services than in the euro area or in Western Europe. Even in relation to income levels, consumption of banking products is lower in Central and Eastern Europe. Thus, while the gap is shrinking, it is still wide.

All in all, after adopting the *acquis communautaire* in connection with entering the EU, Central European countries are most advanced in terms of legal and institutional reforms and convergence. They feature the smallest shares of the state and the highest shares of foreign investors in total banking assets. They boast, on average, the highest degree of financial intermediation. Southeastern European countries are EU candidate or potential candidate countries. While Croatia is clearly most developed with respect to financial intermediation in Southeastern Europe, the banking sector on average is at an earlier stage of development than in Central Europe. Although foreign-owned banks dominate the sector (apart from Serbia), state-owned banks are still important in some countries (Romania, Serbia). Russia and Ukraine are particularly large countries and markets; given their stage of development, they possess the highest potential for further banking expansion. However, despite improvements, the rule of law remains weakest (or most selective) in these two countries. Sectors are still

[8] *For detailed information on the determinants, impact and monetary policy implications of credit expansion in Central and Eastern European EU Member States, see Backé and Zumer (2005) in this publication.*

marked by an abundance of small undercapitalized outfits, transparency of ownership leaves a lot to be desired, and pocket banks and insider lending hold sway.

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