

# **A TRANSFORMATION MODEL FOR BANKING SYSTEMS IN TRANSITION ECONOMIES**

**Askar Alimkulov**

Swiss Institute of Banking and Finance  
University of St. Gallen

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Askar Alimkulov  
Swiss Institute of Banking and Finance  
Merkurstr. 1  
CH-9000 St. Gallen, Switzerland

Phone: +41-71-2238237

Fax: +41-71-2233258

E-Mail: [Askar.Alimkulov@unisg.ch](mailto:Askar.Alimkulov@unisg.ch)

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Askar Alimkulov  
Swiss Institute of Banking and Finance  
University of St. Gallen  
Merkurstr. 1  
CH-9000 St. Gallen, Switzerland

## **Abstract**

In a number of transition economies the banking systems are at different stages of the transformation process from mostly planned to market economy structures. But the past turbulent year led to further distinctions in development within these countries. While FSU (the former Soviet Union) countries, in particular Russia, were deeply shattered by the South-East Asian financial crisis and have suffered a set-back in the transition process, other more advanced Central European countries have shown resistance and have been able to keep macroeconomic stability. This paper presents a model for the description, analysis, explanation and forecast of the transformation processes in banking systems in Transition Economies. It is argued that the model will help avoid similar financial crises and other set-backs during the transition to market economy.

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## **I. Introduction**

In a number of transition economies the banking systems are at different stages of the transformation process from mostly planned to market economy structures. But the past turbulent year led to further distinctions in developments within these countries. While FSU (the former Soviet Union) countries, in particular Russia, were deeply shattered by the South-East Asian financial crisis and have suffered a set-back in the transition process, other more advanced CEE (Central and Eastern European) countries have shown resistance and have been able to keep macroeconomic stability. The Russian case emphasizes that inconsequent reform measures and delays, especially in the banking system, have led to the financial crisis. Hence, the purpose of this paper is to show a model for the description, analysis, explanation and forecast of the transformation processes in banking systems in transition economies which help to avoid the financial crises and other setbacks during the transition to the market economy.

The structure of the paper is organized as follows: Section II describes the role and the structure of banks in centrally planned economies and finds out main deficiencies of the mono-bank system. Section III presents banking reform approaches in CEE and FSU countries. If the most CEE countries have chosen the rehabilitation approach: split-up of the mono-bank, recapitalization of state banks for eventual privatization, FSU countries have followed the new entry approach: split-up of the mono-bank, liberal entry of new banks and privatization of state banks. Section IV suggests an alternative transformation model for banking systems in transition economies which includes following stages: decentralization, liberalization, restructuring, recapitalization and privatization. It is also emphasized that macroeconomic stabilization and good prudential regulation and supervision should accompany the banking reform in the early stages of the transition. In section V, conclusions are drawn.

## **II. Starting Situation: Mono-Bank System**

### **1. Role and Structure of Banks in Centrally Planned Economies**

In centrally planned economies, unlike market economies, the banks played a passive role. The priority of the plan fulfillment determined all financial transactions. The credit allocation was dependent on central planning and had the pure accounting character. The banks had to support this planning process. Accordingly, the structure of banks was formed as an one-tier mono-bank system. Some specialized credit institutions, for instance, savings, investment and foreign trade banks, were merely the departments of the mono-bank without their own commercial operations. Other financial institutions and markets did not exist. In contrast to market-oriented banking systems the central bank functions and commercial operations were carried out through the mono-bank alone. The mono-bank settled all payments, absorbed private savings, enterprise profits and taxes and channeled them either to the state budget or to state enterprises according to the central plan regardless of fund repayments, supervised the plan fulfillment by state enterprises through movements on their accounts. Thus, the activity of the mono-bank was strongly concentrated on the microeconomic level. The payments of enterprises and of households were strictly separated into a cash and a non-cash circuit and thus the formal macroeconomic stability was created.

### **2. Principal Deficiencies of the Mono-Bank System**

- As a two-tier banking system with an independent central bank and private commercial banks did not exist, a stable monetary policy could not be ensured and bank managers had no incentive to operate effectively as they felt no pressure from shareholders.
- As the credit allocation was dependent on the central planning and enterprises with soft budget constraints and excessive state guarantees could not go bankrupt, the banks could not make decision over the credit allocation independently and did not have any reason to assess the creditworthiness of enterprises which led to insufficient banking skills, inefficient credit allocations and moral hazard problems.
- The mono-bank system implied a poor financial infrastructure: there were no private commercial banks and financial markets, accordingly, competition among banks and markets as well as between banks and markets. Hence, the banking

systems in centrally planned economies lacked an efficient system of prudential regulation and supervision, accounting and payment systems.

### **III. Banking Reform Approaches in Transition Economies: Rehabilitation versus New Entry**

#### **1. Role of Banks in the Transition**

The transition from a centrally planned to a market economy means first of all the change in the allocation mechanism of financial resources: from centralization to decentralization. As a result, the role of banks in the transition will change as well because banks and capital markets play an important role in the allocation of the financial resources in a market economy. Hence, the transformation debate puts up different approaches to the financial system reform in transition economies. On the one hand, Rostowski (1994)<sup>1</sup> argues that former centrally planned economies do not have banking systems in the early stages of the economic transformation and the allocation of capital would become the sphere of new, non-bank institutions because commercial banking skills (above all, credit allocation) and central banking skills (above all, bank supervision) can only be developed over a long period. On the other hand, Blommestein and Spencer (1993)<sup>2</sup> emphasize that the highest priority must be given to banking reform because in market economies banks are the principal source of firms' short-term working and of human capital trained in evaluating credit risk and therefore provide the basis for ensuring an efficient allocation of financial resources. Other authors, for instance, Buch (1993)<sup>3</sup> and Walter and Smith (1992)<sup>4</sup> go further and suggest that banking reforms in transition economies should be oriented towards the establishment of the broad-based German universal banking model or the narrow-based Japanese model. It is at present difficult to predict what kind of financial system models will enforce in transition economies finally. But the empirical evidence show that countries which had established sound banking systems have also developed well-functioning capital markets. Thus, the authorities in transition economies have to put emphasis on the banking reform for following reasons first:

- Transition economies have the bank-dominated structure of the financial sector as an inheritance from the past of central planning.

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<sup>1</sup> Rostowski (1994, p. 7)

<sup>2</sup> Blommestein and Spencer (1993, p. 2)

<sup>3</sup> Buch (1993, p. 16)

<sup>4</sup> Walter and Smith (1992, p. 22)

- Banks are main participants on financial markets, provide liquidity to other financial institutions and maintain confidence in the payment systems.
- Capital markets function effectively when information about the creditworthiness of the issuer is widely available and reliable what is not the case in the early stages of the transition. Therefore, the banks will have informational advantages, provide efficient corporate governance by contrast with the capital markets and prevail over them.

## **2. Importance of Initial Conditions**

Although transition economies have generally received from the past of central planning a similar institutional, legal and regulatory framework as those of developed and developing countries, the banking reform approaches have been substantially different across these countries. If most CEE countries have chosen the rehabilitation approach - split-up of the mono-bank into a number of state commercial banks, recapitalization and eventual privatization of state banks -, FSU countries have launched the new entry approach - split-up of the mono-bank into a number of state specialized banks, liberal entry of new banks and privatization of state banks. Such differences in the banking reform strategies could be attributed to various initial conditions between CEE and FSU countries. For instance, in Hungary it was already possible to found the joint ventures with foreign banks in end-1970s and the split-up of the mono-bank was occurred in 1987.<sup>5</sup> Poland permitted the joint ventures with foreign banks at the beginning of 1980s and split up its mono-bank in 1989.<sup>6</sup> These banks therefore have got an access to know-how, first of all to commercial banking skills and competition from foreign banks earlier than banks in FSU countries. This also reflected relatively lower amounts of non-performing loans and inflation rates in CEE unlike FSU countries in the early stages of the transition (Table 1).

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<sup>5</sup> Hein (1995, p. 181)

<sup>6</sup> Hein (1995, p. 46)

Table 1. End-year inflation in CEE and FSU countries (in per cent)

	1992	1993
Czech Republic	12.7	18.2
Hungary	21.6	21.1
Poland	44.3	37.6
Estonia	953.5	35.6
Kazakhstan	2,984.1	2,169.0
Russia	2,506.1	840.0

Source: EBRD (Transition Report, p. 52).

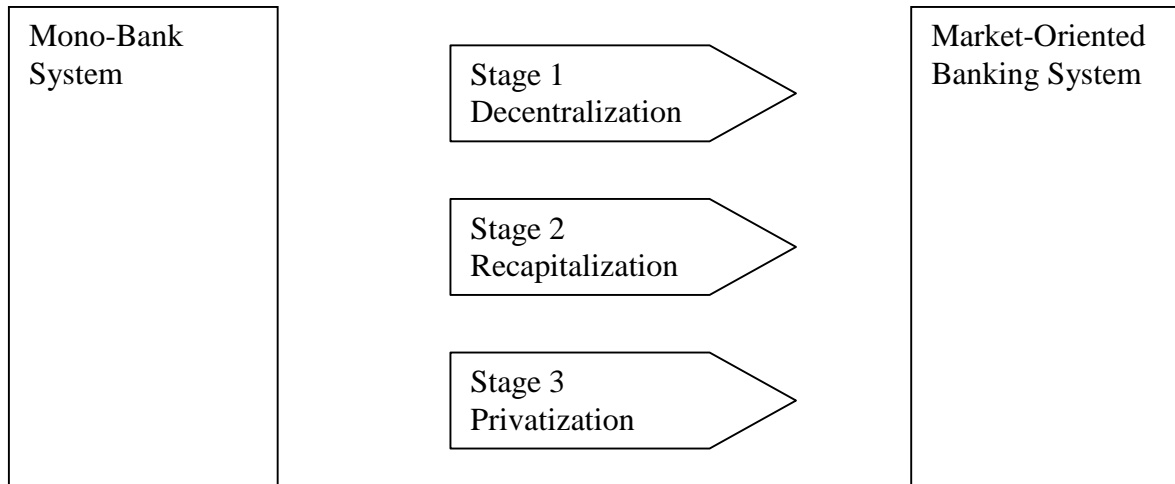
Thus, the hyperinflation has eliminated non-performing loans through negative real interest rates and there were no necessity and funds to recapitalize banks in FSU countries due to the dropped fiscal revenues and because the scale of banking in FSU countries was substantially less than in CEE countries in the early stages of the transition.<sup>7</sup> As a result, authorities in FSU countries had not any other choice than to follow the new entry approach.

### 3. Rehabilitation Approach versus New Entry Approach

The main sequence of the rehabilitation approach to banking reform generally consists of following stages: the split-up of the mono-bank into a number of state-owned commercial banks, recapitalization of state banks for eventual privatization (Chart 1).

Chart 1

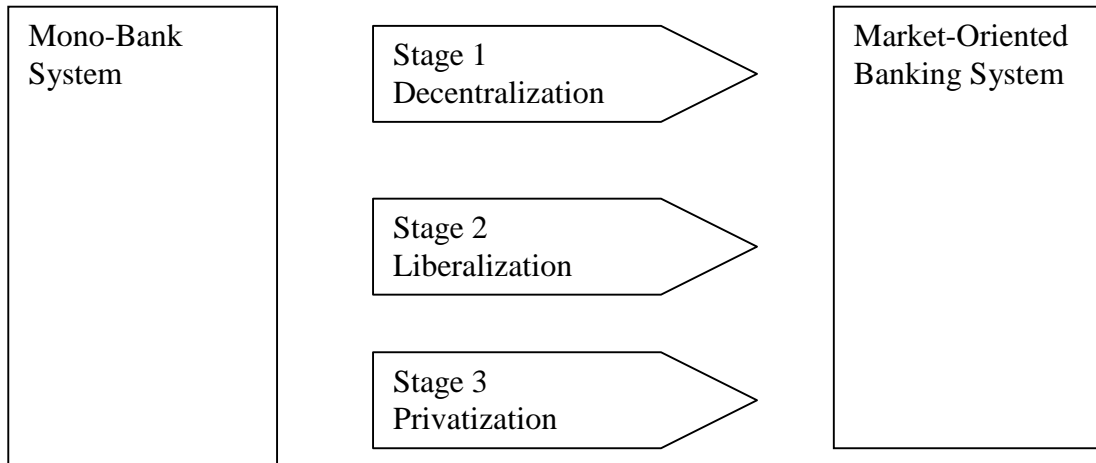
#### REHABILITATION APPROACH TO THE BANKING REFORM



The new entry approach has the same first stage as the rehabilitation approach: the split-up of the mono-bank into a number of state specialized banks, but then follows with the liberal entry of new banks and privatization of state banks (Chart 2).

Chart 2

### NEW ENTRY APPROACH TO THE BANKING REFORM



The principal differences between these both banking reform approaches lie in Stage 2:

- The problem of non-performing loans was resolved in CEE countries through the comprehensive financial and operational restructuring of banks and enterprises, while FSU countries have simply ignored this issue.
- CEE countries have launched a restrictive policy toward entry of new banks which partly limited competition among the banks as well. On the contrary, FSU countries were more liberal toward entry of new banks which led to a large number of small and undercapitalized banks.

CEE and FSU countries have also followed different strategies in regards to Stage 3: Privatization. While in CEE countries state banks have slowly been privatized which was caused by a restructuring of bad loans and recapitalization of state banks, FSU countries have launched a rapid approach to privatization of state banks. The slow privatization of state banks may lead to the recurrence of non-performing loan problems and limit the expansion of efficient banks, while the rapid privatization in the absence of good prudential regulation and supervision may distort the process of competition.

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<sup>7</sup> Ratio of broad money to GDP(1993): Hungary 50% and Poland 36% in contrast to Russia 24% and Estonia 28%, EBRD (Transition Report 1998, p. 119)

#### **4. Outcomes of Banking Reform Approaches**

Although Claessens (1996)<sup>8</sup> argues that the institutional development of banking systems may be faster under the new entry approach than under the rehabilitation approach FSU countries still have the banking systems with a lower level of financial intermediation than CEE countries.<sup>9</sup> This may explain by weaker initial conditions, macroeconomic instability and inconsistent reform measures in FSU countries. The high spreads between loan and deposit rates, especially in FSU countries, show again that the activity of banks in FSU countries is extremely inefficient in comparison with CEE countries.<sup>10</sup> This confirms that is better to restructure and recapitalize the banks than they try to recover losses on non-performing loans by increasing their margins. Although the rehabilitation approach is expensive which could be avoided through a fast privatization and a strict financial discipline of banks, the banking crises in FSU countries show that the resolve of these issues requires not less the fiscal costs than recapitalization of banks.

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<sup>8</sup> Claessens (1996, p. 14)

<sup>9</sup> EBRD (1998, p. 94)

<sup>10</sup> EBRD (1998, p. 95)

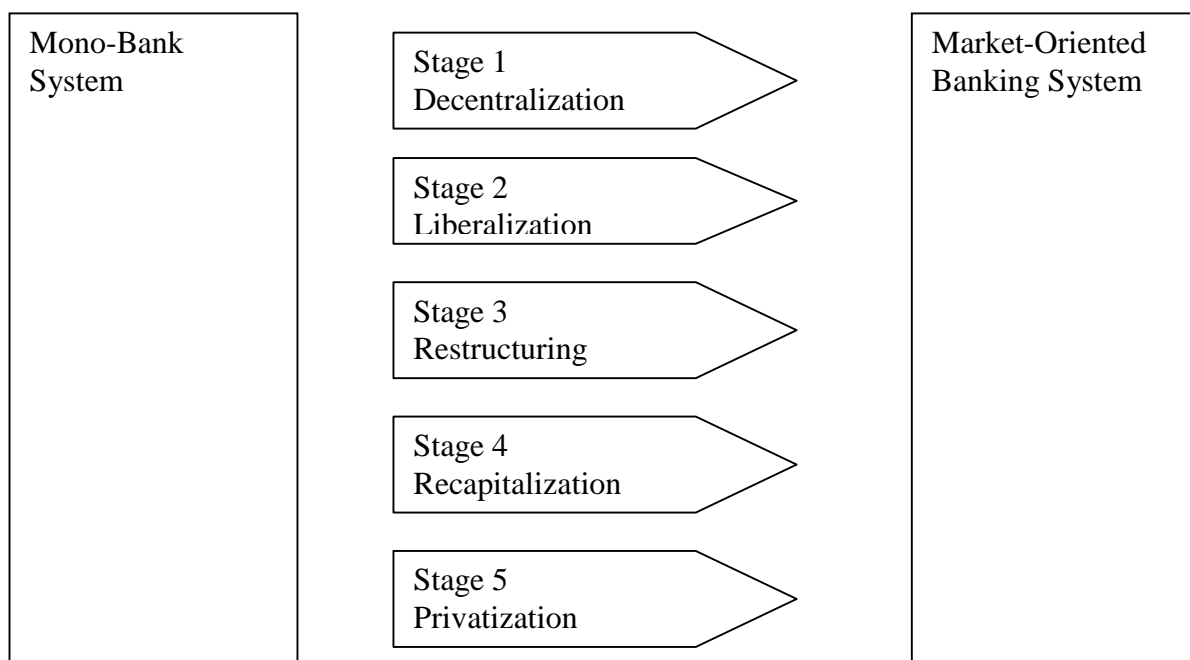
## IV. An Alternative Model for Banking Systems in Transition Economies

### 1. Sequencing of Banking Reforms in Transition Economies

The transition economies unlike the developing countries had to launch comprehensive banking reforms which include following elements: creating new financial institutions, competition, liberalization measures, and introducing and enforcing banking supervision. From the beginning of their banking reforms the transition economies had to split up the mono-bank system into a central bank and state commercial or specialized banks, permit the entry of private and foreign banks and at the same time introduce and enforce a new regulatory and supervisory framework for central and commercial banking operations. The main issue was that state commercial and specialized banks had received in the past of central planning non-performing loans and were already undercapitalized. Thus there was the need to clean up the balance sheets of state commercial and specialized banks from non-performing loans and to prevent the making of new non-performing loans. This can be achieved through restructuring, recapitalization and privatization of state commercial and specialized banks. This transformation model for banking systems in transition economies schematically looks as follows (Chart 3):

Chart 3

#### A TRANSFORMATION MODEL FOR BANKING SYSTEMS IN TRANSITION ECONOMIES



The purpose of Stage 1: Decentralization is to create a two-tier banking system with the independent central bank which concentrates on the stability-oriented monetary policy and state commercial or specialized banks that take over operations with customers. As this step still occurs under central planning one can only tell about the formal two-tier banking system for following reasons:

- The independence of the central bank is greatly limited.
- Commercial and specialized banks are still fully under the state ownership.
- Banking systems are segmented between net borrower and net lender banks, by their geographical and functional specialization.
- Financial transactions are still carried out on the basis of central planning and state commercial and specialized banks are strongly dependent on central bank financing.
- State commercial and specialized banks take over non-performing and non-diversified loans to a particular industrial sector and old insolvent customers from the mono-bank.
- Inappropriate legal, supervisory and regulatory frameworks with soft budget constraints and excessive state guarantees lead to further inefficient credit allocation by banks.

As mentioned above, after the breakup of the mono-bank the banking systems in transition economies remain segmented which limits competition. Increasing competition at this stage of the financial transformation may entail the entry of new private and foreign banks. The empirical evidence shows that new private and foreign banks are able to expand their operations and to place greater competitive pressure on the state commercial and specialized banks. Competition reduces the segmentation of banking systems and spreads between deposit and loan interest rates, promotes the selection of banks on the basis of their ability to serve customers well at the lowest cost and helps to avoid the concentration of the banking sector and the too-big-to-fail problem. But effective competition in banking depends on both the number and the quality of banks. On the one hand the very prudent policy toward entry of new private banks may constrain competition, lead to concentration of banking system and as result to the too-big-to-fail and moral hazard problems. On the other hand the very liberal policy toward entry of new private banks may create a large number of small, undercapitalized, poorly regulated banks which again distorts competition. The resolution of this issue is the enforcement of prudential regulations and licensing requirements at this stage of the financial transformation. Thus one can ensure that new private banks are both prudent and capable.

The next problem is that state commercial and specialized banks have inherited from the past of central planning non-performing loans and were insolvent from the beginning of the transition. To deal with these issues banks had to be restructured. There are the following approaches for restructuring of insolvent banks: bank liquidation, bank forbearance and bank recapitalization.

The banking systems in transition economies are very concentrated in the early stages of the financial transformation. It creates the basis for the too-big-to-fail issue. Hence liquidation of a insolvent bank may cause spill-over effects and a systemic risk for the banking sector as a whole. Therefore the danger of the systemic risk may stimulate the authorities in transition economies to bail out troubled banks what may also distort competition and lead to a moral hazard problem. But the banking crises in transition economies show that the closures of large banks have less negative impacts on the real economy than in other emerging markets because the banking systems in transition economies still have less depth and breadth than in emerging markets. This fact suggests less unconditional bailouts for insolvent banks in transition economies and to avoid the concentration of banking systems.

Bank forbearance is simply the reluctance to face difficult decisions, hoping that a more favorable set of economic conditions will arrive, which will turn-around the fortunes of state enterprises and result in their ability to meet bank interest and principal payments and thus the banks will grow out of their problems. The downside of this approach is the possibility that things will not improve and indeed will get worse. Bank non-performing loan problems will continue to grow and the net worth positions of these banks will become even more negative and insolvent.

If the value of the bank (economically and politically) is greater than its liquidation value the bank has to be recapitalized. Bank recapitalization cleans up a bank`s balance sheet and restores a bank`s solvency. Bank recapitalization can be carried out by shareholders, new private investors and authorities. In the first case, the shareholders of the banks should bear the costs by writing down non-performing loans and then recapitalize the bank with their own sources. But low earnings made recapitalization by bank`s owners impossible and new private investors will not likely inject new capital into negative net worth of banks. The last source that remains is bank recapitalization by authorities that has to be accompanied by changes in bank incentive structures (ownership, management and governance) to avoid moral hazard problems and additional costs.

Changes in bank incentive structures occur by bank privatization as the final and most important stage in this transformation model for banking systems in transition economies for following reasons. Firstly, for a banking system to behave efficiently in the sense that bank privatization helps reduce expectations that banks will be bailed out in the future and hence provides the appropriate incentives for bank managers to minimize risks. Secondly, bank privatization limits the scope for intervention by authorities in the allocation of credit. Thirdly, bank privatization can also be expected to improve productivity at the level of the individual bank, particularly through the introduction of better monitoring. This would not only improve the bank's own performance but should help banks function more effectively as active creditors to enterprises.

## **2. Role of Banking Supervision and Macroeconomic Stability**

A key problem for transition countries is the delay in the introduction and enforcing of appropriate banking supervision. The difficulties are that in these countries supervisory systems did not just have to be improved, they had to be created practically from scratch. There is also no question that the appropriate banking supervision is easier to recommend than to apply in practice. The authorities must be careful that prudential controls and supervision are neither excessive (in this case they may limit competition) nor insufficient (inadequate to protect the soundness of individual institutions and the banking system as a whole). Although banking supervision is more of a process of learning-by-doing than a pre-set activity, there is not the need for transition economies to delay the financial transformation.

Another precondition of the successful financial transformation is a stable macroeconomic environment. High inflation distorts the ability of both borrowers and lenders to perform the financial calculations necessary to carry out long-term transactions. Rapid inflation brings with it highly variable relative prices and increased uncertainty about the financial returns to economic activity. But monetary stabilization with high fiscal deficits and real interest rates also does nothing to encourage the institutional development of banks.

## V. Conclusions

It is difficult to develop a universal transformation model for the best sequence of banking reforms which is suitable for all transition economies. This could be a consequence of the different initial conditions with which these countries are faced at the beginning of the financial transformation. The paradox is that FSU countries with weaker initial conditions have launched the rapid approach to banking reform, while more advanced CEE countries have followed the more gradual approach to banking reform. The outcomes of these approaches show that there are following principles which are valid for all transition economies:

- The financial transformation needs to be accompanied the introduction and the enforcement of an adequate degree of banking supervision in the early stages of the transition.
- Macroeconomic stabilization (especially in the monetary and fiscal areas) – can also help substantially in alleviating the problems of the transition to a market-oriented banking system and in maintaining the efficiency of the banking system once the financial transformation has been completed.

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