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A Review of Banking Sector Reforms in Transition Economies

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1. Introduction

Transformation of the centrally planned economies (CPEs) into market economies implied embarking on a wide range of reforms in every aspect of economic life. In particular, since money and banks served different purposes under central planning compared to a market economy, these institutions too required fundamental restructuring. When transforming their banking sectors most transition economies (TEs) followed policy recommendations, known in the literature as the 'Washington consensus on banking transition', associated mainly with the International Monetary Fund (IMF) and the World Bank (Fries and Taci, 2001, p. 173).

Unfortunately, the implementation of these policies failed to deliver the expected results in a consistent manner. Price liberalisation led to hyperinflation in most TEs, which in turn damaged the public's trust in money and banks. As a result, the prospects for banking development were set back. The newly-created banking sector failed to fill the gap left by the monobank system, resulting in a credit crunch, an inter-enterprise payments crisis and the development of inefficient money surrogates and barter transactions, which had direct implications for production and output. Similarly, gradual removal of controls over capital account transactions, combined with the aggressive entry of foreign banks to gain market share, fuelled the inflow of foreign capital into these economies. But, the sudden reversal of these flows

caused problems in banking sectors of most TEs in the late 1990s and more recently following the Global Financial Crisis (GFC).

The purpose of this chapter is to offer an explanation for these outcomes from an institutional perspective. We start by describing briefly the essence of the problems in the organisation of the monetary and banking sector under central planning to which reforms were addressed. This is followed by an account of the policy proposals initiated by the international financial institutions (IFIs) to transform the monobank sector into effective market-based financial intermediaries. Then we examine the nature and source of the unintended consequences of liberalisation policies. Lessons will also be dawn for economic thinking and policy recommendations for TEs in light of the current GFC. Although the chapter discusses banking system transformation in TEs, it particularly focuses on economies of the former Soviet Union (FSU).

2. Reforming the Banking Sector in CPEs: The Nature of the Problem

The organisation and functions of money and banks were fundamentally different in CPEs compared to market economies. Socialist money circulation was composed of two separate and semi-independent circuits, cash (coins and notes in circulation) and non-cash money (bank deposits) respectively, each with its own characteristics and peculiarities. While cash money served as a medium of exchange, non-cash money was used only for accounting purposes, such as financing and resource transfer to different sectors of the economy. Cash money and non-cash money were not freely interchangeable. Non-cash money was exchanged for cash money only through payroll withdrawals, and sundry transfer payments such as pensions and social security benefits to the household sector. In addition to being only partially convertible into cash money, non-cash money was not freely convertible into goods and services (Zwass, 1979). If enterprises were entitled to buy goods according to

their input plans but were short of a means of payment, non-cash money would be supplied by the banking sector. On the other hand, enterprises could not spend their extra non-cash money holdings if they did not have an authorisation to buy. Nevertheless, since some manoeuvring was possible within administratively set plan targets, enterprises would convert their redundant non-cash balances into inventory (Garvy 1977, p. 42). Furthermore, if any retail businesses had surplus cash money by the end of business, they were required by law to deposit it with the banking system. In short, what was called money under central planning did not represent universalised title to goods and services and its role in the economic process was reduced to the function of a '*numeraire'*.

Banks were designed to facilitate the process of planning and production. The monobank system did not distinguish between central banking and commercial banking and its role was limited to the organisation of the payments system and pumping short-term credits to the enterprise sector to facilitate inter-enterprise trade. Since all enterprises held their accounts with banks, banks controlled their financial flows, monitored their performance, and supplied all necessary information to the authorities.

The enterprise sector depended heavily upon short-term bank credit to finance their working capital. For example, as Table 1 shows, in the FSU in the main sectors of the economy such as industry, agriculture and trade, more than 50 percent of enterprise working capital was financed by bank credit. Distribution of credit was according to instructions from the planners and without any reference to the creditworthiness of the recipient firms or any risk assessment. Moreover, long-term financing for the start-up capital of new enterprises, or new investment expansions in existing ones, was provided from the state budget as non-repayable grants.

<Table 1>

Although bank credit was the main source of external finance for enterprises, the monobank did not intermediate between savers and investors as banks do in market economies. Notions such as market-determined interest rates, the cost of funds, collateral and creditworthiness were irrelevant to the banking practice of centrally planned economies. An inevitable feature of this system was that the enterprise sector did not face market-type financial constraints, leading to the inefficient allocation of resources, giving rise to the so called phenomenon of the soft budget constraints (Kornai, 1982). Therefore, inevitably, along with the other fundamental macroeconomic reforms, the process of transition to a market economy also necessitated a fundamental restructuring of the banking sector.

Another particularity of banking under central planning was the separation of corporate banking from retail (or household) banking. As a rule, three big banks specialised in individual sectors, such as industry, agriculture, and foreign trade provided corporate banking services. The provision of retail banking services to households was the primary function of the state savings bank. The general public's confidence in this bank was high because it was the only financial institution that offered depositors financial gain and readily exchanged deposits for cash money at a one-to-one ratio on demand. Indeed, the pre-transition ratio of total bank deposits to GDP was about 70 percent in the FSU and even higher in Eastern European countries (Peachey and Roe, 2001). For households, these deposits would appear to perform the functions of money (unlike corporate bank deposits), being universalised title to goods and services. However, a substantial part of household wealth was in fact forced saving, known in the literature as the 'monetary overhang' - the result of a higher rate of growth in household financial assets compared to that in available

goods and services over the years. Household sector financial assets accumulated in this way were estimated to be no less than half of household deposits in the FSU (Fischer and Gelb, 1991, p. 95). The monetary overhang represented suppressed inflation, which was contained by administratively-set prices, and was seen as a potential source of macroeconomic imbalance.

3. Policy Recommendations and Intended Outcomes

The transformation of the banking sector was one of the building blocks of the grand plan of macroeconomic transformation in CPEs which comprised 'the Holy Trinity' of liberalisation, stabilisation, and privatisation (Ellman 2005, p. 595). When transforming their banking sectors, most transition countries followed policy recommendations associated predominantly with the IMF and the World Bank. These recommendations called for price liberalisation, abolition of the distinction between cash money and non-cash money, the establishment of a two-tier banking sector (i.e. the separation of commercial banking from central banking), liberalisation of interest rates, restructuring and privatisation of commercial banks, entry of new private banks, domestic and foreign, regulated by minimum capital and licensing requirements, provision of effective prudential regulation, and sequential liberalisation of controls over current and capital account transactions (see among others Calvo and Frenkel, 1991a, 1991b, and Fischer and Gelb, 1991).

It was intended that these reforms would help to achieve a number of goals that were fundamental in successful transformation of the monobank system into a market-based two-tier banking sector. First, it was anticipated that the liberalisation of administratively-set prices (which did not represent relative scarcities), combined with the monetary overhang would lead to a jump in the price level. However, since the price jump was expected to be only a one-off event, it was thought to be natural

because setting market-determined prices was paramount for providing the right signals to market participants; these signals were to be the driving force of production and determining force of consumption.

Second, it was argued that, with the abolition of the separation between cash money and non-cash money, money would become universalised title to goods and services; this in turn would help monetization of the economy and hence the process of wealth formation, and facilitate financial intermediation.

Third, the establishment of a two-tier banking system and liberalisation of interest rates were seen as necessary for building an efficient market-based banking sector that was capable of imposing financial discipline and hardening the infamous soft budget constraints on the enterprise sector.

Fourth, privatisation of state-owned commercial banks, entry of new private banks, and provision of effective prudential regulation were expected to increase competition in banking services and facilitate banking development by increasing the interest paid on deposits and reducing the cost of lending to enterprises. In particular, involving foreign banks in the bank privatisation process was also encouraged. It was argued that entry of foreign banks would increase competition, reduce cost of lending, and open up access to international financial markets. And more importantly, by bringing new technologies, risk management methodologies, and new products and services, they would generate positive externalities vital to the development of the overall banking sector (EBRD, 2006).

And fifth, achieving current account convertibility and abandoning controls on long-term inward capital flows were expected to stimulate the inflow of long-term foreign direct investments. Sequential liberalisation of capital controls over medium and short-term capital flows, to be implemented only after establishing a sound

supervisory and regulatory system, was thought to be desirable as free movement of capital would ensure internationally efficient allocation of financial resources in favour of TEs, thereby removing financing constraints on economic growth in these economies (Fischer and Reinsen, 1992; EBRD, 2006; Ruziev, 2012).

All in all, the reform policies were intended to get rid of macroeconomic imbalances such as monetary overhang and repressed inflation, help monetisation of the economy and wealth formation, facilitate financial deepening, and establish a market-based banking sector capable of filling the gap left by the monobank sector and imposing hard budget constraints on the enterprise sector which would guarantee more efficient use of resources.

Given the nature of the CPEs' macroeconomic problems, as well as the way banks operate in market economies, the policy recommendations and expected outcomes offered under the Washington Consensus on banking transition seemed to be logical and make perfect sense, albeit only in the long run, judging by the slow and time consuming process of the banking sector development experienced by the market economies themselves (Chick, 1986 and 1993).[1] Regrettably, these recommendations failed to address a number of important issues such as (i) the enterprise sector's heavy reliance on bank credit, (ii) the opportunity of maintaining, and building upon, the existing public trust in banks, (iii) the time-consuming nature of the institution-building process, and (iv) the possibility of sudden reversals of international capital inflows, which are all of paramount importance in successful transformation of the banking sector. In other words, although the Washington Consensus on banking transition correctly identified major weaknesses in banking under central planning and attempted to explain what to expect from implementing the suggested policy

[1] An application of Chick's analysis to transition economies is developed in Dow *et al*. (2008).

recommendations, it did not appropriately address how to use the existing institutional settings and experience to best effect.

Moreover, all the former CPEs were assumed to be a homogenous group, and hence the policy advocates saw no reason to differentiate policy advice in the transformation of their banking sectors, as if the heterogeneity of initial conditions across TEs did not matter. In fact, the whole transition package itself was inspired by the 'success' of the stabilisation policies implemented in some of the Latin American countries (Yergin and Stanislaw, 2002) which were structurally and fundamentally different from the CPEs. As a result, the implementation of the recommendations developed within the context of this universal framework resulted in a number of serious unintended consequences. As Abalkin (1997, p. 6) observed in the context of Russia, 'Lacking both the appropriate experience and the specialists familiar (not merely by hearsay) with Russia's realities, the IMF has followed the path of using universal models with certain corrections. A serious contradiction arose between universalism, which was elevated to the rank of an unshakable principle, and the necessity for a nonstandard, creative approach to solving a problem of a qualitatively new type'. In the following section, we will discuss the main unintended consequences of the banking sector reforms common to most of the TEs, and explain why they happened and why the degree and intensity of the problems were substantially different between the Eastern European and FSU countries.

4. Reforms and Unintended Consequences

4.1 Macroeconomic Chaos and Collapse of Trust in Money and Banks

It was implicitly, and perhaps naively, assumed that price liberalisation would not affect the general public's trust in banks and the restructured banking sector would not face any problem in filling the gap left by the monobank in meeting the credit needs

of enterprises. In fact, the nature of discussions on banking reform in the early 1990s suggests that policy advisors were more concerned with making the banking sector create *less* credit, not the other way around. Since, as we have seen, the working capital of the enterprise sector depended heavily upon bank credit under central planning, the possibility of a credit shortage threatened the sustainability of inter-enterprise payments and thus the scope for production, output, and employment to avoid social and economic shocks.

Policy recommendations offered under the Washington Consensus were formed on the basis of the general equilibrium framework; hence it has been suggested that in order to get the system working properly it was necessary that reforms started with the immediate elimination of such macroeconomic imbalances as repressed inflation and monetary overhang.[2] Following these recommendations most transition countries immediately liberalised prices of almost all goods and services.[3] Price reforms were especially spontaneous in Russia, and were also followed, somewhat reluctantly, by all other members of the FSU because of their membership of the rouble zone; any member country not following suit would import inflation from the rest of the rouble zone. As expected, price liberalisation led to hyperinflation in almost all transition economies. However, the unprecedented level of this inflation and its persistence in

[2] A study by Kim (1999) estimated the size of the monetary overhang in the FSU in 1991 to be around 40 percent of the household sector's monetary balances. Since the monetary overhang was seen as financial assets not backed by goods and services, it was thought to represent suppressed inflation, which was seen as a source of imbalance, and needed to be unleashed sooner or later. Kim (1999) argued that more than 60 percent adjustment in the price level would be necessary to remove it. However, the monetary overhang did not need to cause any inflationary pressure if it was perceived as title also to private property, which was banned in almost all forms under central planning, not simply to goods and services alone. In other words, by allowing private proprietorship and the gradual sale of public assets to the private sector through step-by-step privatisation, any possible inflationary consequences of the monetary overhang could have been prevented. Furthermore, the existence of the grey economy in general, also referred to as 'the second economy' (Grossman, 1981), and the kolkhoz market in particular in the Soviet Union casts shadow on the accuracy of the estimated size of monetary overhang. Since prices in these markets were determined freely by market forces of supply and demand, one would expect them to have played an equilibrating.

[3] For instance, Russia and Poland chose a shock therapy approach to transition and removed almost all price controls overnight.

most TEs was unexpected and thus turned out to be the first unintended consequence of this policy. Table 2 compares the annual inflation rates in selected TEs in the 1990s to the average inflation rate for the pre-GFC crisis period of 2000-2006. As can be seen from the table, the annual inflation figures in the Commonwealth of Independent States (CIS) jumped from around 100 percent in 1991 to about 1060 percent in 1992. It increased further in the following couple of years: to about 1860 percent in 1993 and over 2650 percent in 1994 respectively. Even after the introduction of national currencies, inflation remained high in the CIS; inflation was moderated only after 1999. The Baltic States were more successful in managing to curb inflation. They responded to this shock by setting their sights firmly on macro-stabilisation policies. After the introduction of their national currencies in 1992-3, they arranged currency-board type institutions to combat inflation; Estonia pegged her currency to the Deutsche Mark, Latvia to a basket of currencies, and Lithuania to the US dollar. As a result, inflation was reduced to two digit figures by 1994 and to single digit figures by 1998.

Although the experience of Bulgaria and Romania was not as bad as for the CIS countries, high inflation persisted in these countries until the late 1990s. Although inflation was also persistent in the Czech Republic, Hungary, and Poland, these countries experienced the mildest inflationary shock amongst all TEs. The highest rate of inflation recorded since 1991 was about 70 percent in Poland, 52 percent in the Czech Republic, and 35 percent in Hungary (all in 1991).

<Table 2>

The high rate of inflation that persisted in most of the TEs in the 1990s played the role of a catalyst in the development of further unintended consequences. It wiped out the real value of financial wealth and thus severely shattered the general public's

trust in deposit taking institutions. This was especially the case for the countries of the FSU. This in turn hampered the banking sector's ability to attract deposits. Because inflation eroded the real value of business deposits and simultaneously increased the nominal value of payments under contractual obligations, it also made enterprises more and more dependent upon external finance, thus putting strain on inter-enterprise payments. Since banks were experiencing a crisis of their own at this time, enterprises had to resort to alternative ways of financing their working capital, which gave rise to the phenomenon known in the literature as barterisation of transactions.

This phenomenon, which included not only pure barter transactions, but also transactions in promissory notes and mutual debt write-offs, was observed in almost all of the twenty plus transition economies in the 1990s (Carlin *et al*., 2000). However, it was most severe in Russia and Ukraine where, at its peak in 1998, barter accounted for more than 50 percent of all industrial transactions. According to the survey data provided by the Russian Economic Barometer, the number of Russian respondents citing shortage of working capital as the main reason for barterisation increased from 47 percent in 1994 to 61 percent in 1998 (Aukutsionek 1998, p. 181). Moreover, enterprise managers noted that both their own liquidity and that of their business partners were equally an important reason for resorting to non-monetary transactions (Ivanenko and Mikheyev 2002, p. 409).

As banks struggled to gain the general public's confidence, their ability to create credit declined and economies became more and more reliant upon cash transactions. The pattern of change was similar during transition for all members of the FSU: reliance on cash transactions increased initially and the importance of banking subsequently decreased (for detailed discussion, see Dow *et al*.,2008). The existence of trust in money and financial institutions is vital in a free enterprise system. In fact,

the entire financial superstructure in market economies is built upon the notion of confidence. As a rule, commercial banks hold their reserves with the central bank, whereas non-bank financial intermediaries (NBFIs) hold their reserves with commercial banks. As shown in Figure 1, the whole financial system can be seen as an inverted pyramid built upon confidence in outside money, held as reserves in the central bank by commercial banks.[4] If confidence in outside money falls, then there is a danger that the entire inverted pyramid of the private financial sector may collapse.

<Figure 1>

On the other hand, if agents do not have confidence in inside money, the size of the inverted pyramid (which can be seen as a proxy for financial deepening) in Figure 1 will not expand regardless of the level of return promised on the liabilities of banks and NBFIs. Therefore, raising the real rate of interest paid on deposits is not a sufficient tool to attract idle savings into the formal financial system to boost financial intermediation. Policies directed towards building confidence in inside money, and its issuer - the private financial sector, play an important role too. In addition, if saving in inside money is a new 'culture' for agents, then, naturally the confidence-building period may take even longer. Another issue that highlights the peculiarity of banking is that losing and regaining the general public's trust in inside as well as outside money are not necessarily symmetric processes: trust may be lost very quickly, but it may take years to restore it.

It is beyond the scope of this chapter to survey the experience of individual countries. However, we would like to touch briefly upon how the general public's

[4] The distinction between outside and inside money, originally made by Gurley and Shaw (1970, pp. 72-3), is as follows. Inside money is both an asset and liability of the private sector, whereas outside money is its asset only. Outside money may be a pure asset (such as gold) or an asset that is the liability of the central bank. For instance, while the fiat money of the central bank and gold can be classified as outside money, bank deposits can be classified as inside money.

trust was hit repeatedly in Russia, one of the biggest TEs, and draw our conclusions on this unique experience.

Russia's experience with reforms and how this affected the general public's trust in deposit-taking institutions is quite remarkable. The household sector's confidence in domestic currency as well as domestic financial institutions was hit several times between 1991 and 2000.[5] Unprompted decentralisation of the economic process by the ad hoc mass privatisation and price liberalisation was followed by hyperinflation; the annual rate of inflation was about 1500 percent in 1992 and almost 900 percent in 1993. It was during this period that the general public's trust in banks was hit the hardest. During this period the economy experienced a shortage of cash (notes and coins) in circulation, which also led to a temporary freeze on deposit withdrawals from the state-owned banks. Since no measures were taken to protect the real value of financial assets, hyperinflation wiped out the real value of the household sector's bank deposits very quickly. As a result, confidence in the banking sector plunged to a record low; households attempted to protect their purchasing power in non-rouble and non-deposit forms.

Hyperinflation quickly eroded the working capital of the enterprise sector too, making businesses heavily reliant on external financing, specifically on bank credit. With their deposit base shrinking, commercial banks were not in a position to meet the enterprise sector's demand for credit. As a result, enterprises started having difficulties in financing their working capital. In order to prevent the looming

[5] The first of these shocks came before the political meltdown of the FSU in early 1991 and therefore was common to all other members of the FSU. During *perestroika* (and *glasnost* – freedom of information) it became public knowledge that corruption and bribery were deeply rooted in society. Since owning private property was banned in the FSU and keeping substantial amounts in bank accounts was not desirable, again for political reasons, it was believed that the bulk of wealth generated by individuals through various 'dubious' activities was hoarded in high-denomination banknotes. Therefore, in early 1991 the decision was taken to confiscate part of cash hoards of 'unjustifiably' wealthy individuals by withdrawing the high-denomination banknotes from circulation. As a result, individuals, who either did not bother about financial return offered on bank deposits or did not trust the political system and thus kept their wealth in cash hoards, suffered heavily.

payment crisis, the authorities were forced to grant centralised and directed credit to banks. Nonetheless, with the banks' intermediary role steadily declining, these policies did not prove entirely successful. As a result non-payments and inter-enterprise indebtedness started rising. It is recorded that by the end of 1994 only 3 percent of working capital was financed through own capital, 7 percent through loans, and 90 percent through accounts payable and other liabilities (Glaz`ev, 1998, p. 75).

As a result of liberal entry rules and weak regulation, numerous non-bank financial institutions entered the banking market in the early 1990s. Unfortunately, most of these NBFIs were fraudulent Ponzi-pyramid schemes, which could stay in business as long as their contractual outflows did not exceed contractual inflows. They offered unrealistically high rates of interest on deposits and would have collapsed soon under normal macroeconomic conditions. However, by engaging in speculative activities, especially in the foreign exchange market, they were able to extend their lifecycle. In mid 1995, the monetary authorities formally replaced the floating exchange rate regime with a managed regime, as an anchor to curb inflation. These policies seriously limited the ability of Ponzi-pyramid schemes to fund their contractual outflows in the foreign exchange market, which accelerated their downfall. Since these schemes stayed afloat longer than expected, even very cautious households were caught up in them (Rock and Solodkov, 2001).

Ironically, although the authorities' attempt to curb inflation brought an end to unsound NBFIs, it also contributed to the creation of another type of Ponzi-pyramid scheme, this time initiated by the fiscal authorities. To coordinate anti-inflationary policies, the fiscal authorities decided to issue short-term government bonds (GKOs)

so that the private sector would finance the continuing fiscal deficit.[6] Unfortunately, however, with the economy still contracting, and with record low world prices for oil, tax revenues failed to increase by any significant amount (tax avoidance and evasion were also widespread), resulting in the government's inability to meet its obligations. As a result, the government announced default on its obligations on 17 August 1998. Since GKOs had paid a high positive real return and in the environment of increased uncertainty and high risk associated with lending to businesses, these bonds had proved to be very popular among banks. The moratorium on the government's debt obligations shook the banking sector severely; hundreds of banks collapsed again and as a result the general public's trust hit a new low.

Another drawback of the stabilisation policies introduced in 1995 was that low risk, high return GKOs 'crowded out' bank credit, the volume of which was already low, from the enterprise sector and further worsened the non-payment problem, resulting in a payments crisis. At its peak in 1998, non-monetary transactions such as mutual write-offs, promissory notes, and pure barter transactions constituted more than 50 percent of industrial transactions in Russia. After the crisis of 1998, annual rate of inflation was finally controlled and was reduced to about 20 percent. The steady rise of oil prices also contributed towards macroeconomic stabilisation. As a result, since 1999 the economy's reliance on cash money began to decline and the importance of banking started to rise slowly.

Although the Russian experience was not typical of many TEs, development of events in Russia affected the speed of progress in most of the FSU countries.

[6]By 1997 total short-term and long-term debt issue had reached 296 trillion roubles ($51.3 billion), of which 25 percent was held by foreign investors. The growing fiscal deficit financed in this way meant that the resulting obligations were financed in Ponzi fashion by sales of new GKOs (Poirot, 2001). The only way out of this situation was to either return to printing huge amounts of money or to cut government spending and improve tax collection. As the consequence of the former option was clear from the hyperinflation of the early 1990s, successive governments decided to choose the latter option (Gros and Steinherr, 2004, pp. 252-53).

Furthermore, most TEs pursued initial reforms almost in the same manner and faced similar consequences: hyperinflation, collapse of confidence in banks, a credit crunch and payments crisis.

4.2 Heterogeneity of Initial Conditions, Removal of Capital Controls, and Subsequent Developments

Most TEs shared a broad spectrum of problems in transforming their financial sectors, started the process of transition with comparable reform strategies, and faced similar consequences. Nonetheless, the degree of initial shock and the recovery that followed differed substantially depending on the initial conditions and subsequent experiences in terms of pace and sequencing of reforms. In terms of initial conditions, the economies of the FSU and Eastern Europe were different in a number of areas. Countries in Eastern Europe had fewer than 50 years of central planning experience, whereas countries of the FSU had more than 70 years of central planning experience.[7] In addition, most of the countries of the FSU did not have any experience of independent nationhood for the last couple of centuries, which meant that the transition process in these economies involved not only the development of markets but also the development of the state (Marangos, 2003, p. 453).

In the FSU, private ownership of property was not tolerated and the entire economic process, from production to distribution, was centrally planned and managed at ministerial level. In contrast, the former republic of Yugoslavia (FRY) had long been known as the most decentralised of all communist economies. In the FRY, tolerance of limited private ownership and decentralisation resulted in self-management of the process of production at the enterprise level. Hungary and Poland made a move towards this type of economic management well before the dramatic

[7]Except for Estonia, Latvia, Lithuania, and Moldova which joined the Soviet Union in 1940 but effectively started central planning experience after World War II.

political changes of the late 1980s (by 1968 and 1981 respectively). Even within the Eastern European countries, there were differences; Bulgaria and Romania were less fortunate, inheriting a Stalinist type of centralised economy (Fischer and Gelb 1991, pp. 92-3). In a nutshell, since Eastern European countries were more decentralised and their economies were more productive compared to their counterparts in the FSU, the degree of price distortion and monetary overhang was less severe. Arguably, these factors partly explain why inflation was milder and its impact less severe in countries like Hungary, Poland, and the Czech Republic.

In terms of the preparation of banks for a free enterprise system, again, the countries of Eastern Europe started the process earlier. The FRY had a market-type two-tier banking sector since 1965, and Hungary and Poland since 1987 and 1988 respectively. In Hungary, where partial reforms were initiated in the late 1960s, the first bank with foreign participation was established in 1979. This was the Central European Bank Ltd, a joint venture with six international banks and the National Bank of Hungary (NBH). In 1986 Citibank Budapest was established as a joint venture with Citibank, which held 80 percent of the bank's capital, and NBH (Anderson and Kegels 1998, p. 75). By and large, by the second half of the 1980s, most Eastern European countries had established two-tier banking systems. Member countries of the FSU effectively underwent this process only in the early 1990s (Bonin *et al*., 1998).

In terms of the pace and sequencing of reforms, most of the TEs also reduced barriers to capital account transactions at quite an early stage. In particular, the possibility of joining the European Union (EU), where free movement of capital is a legal requirement, provided an added incentive for carrying out fast and consistent liberalisation reforms in Eastern European countries. In particular, most of the Eastern

European economies attempted to restructure their banking sectors by offering their state-owned banks to strategic foreign investors. Since these countries had comparatively high per capita income, had inherited less severe macroeconomic distortions, and were located nearest to the market economies of the EU, they were attractive for foreign bank entry. Following the example of Hungary, soon Poland, the Czech Republic, Bulgaria, Romania and the Baltic States also sold their largest banks to strategic foreign investors.

The share of foreign-owned bank assets in total banking sector assets rose from virtually zero in the late 1980s to more than half a decade later in most Eastern European countries; by 2005, they accounted for around 85 percent of banking sector assets in Central Eastern Europe and over 60 percent in South Eastern Europe (Bonin *et al.*, 2010). Leading up to the GFC, the share of foreign-owned bank assets in total bank assets in Eastern Europe as a whole was estimated to be more than five times higher than that in Western Europe (EBRD, 2009, p. 43; 2012, p. 45). In contrast, with the exception of the Baltic countries, foreign banks do not have significant presence in the FSU countries. For example, in Russia, foreign banks accounted for less than 20 percent of banking sector assets in 2010 (IMF, 2011, p.12).

Before the crisis, this general trend of increasing foreign ownership of banks was viewed in a positive light as a driver of economic growth in the region (EBRD, 2006) although the previous studies had already suggested that economic and financial problems in the home country of parent banks can result in economically and statistically significant reduction in commercial lending by foreign-owned banks in host countries (Peek and Rosengren, 1997). Arguably foreign banks brought market expertise and efficient corporate governance, assisted with payments system modernisation, and increased competition and efficiency. Moreover, the dominance of

foreign banks, coupled with the relaxation of capital controls, is thought to have helped these economies to gain access to international financial markets, thereby easing liquidity constraints and hence facilitating economic growth. In its annual transition report in 2006, the EBRD noted that in terms of its impact on growth, the 'provision of financial services, irrespective of the channels through which they are provided, is more important' and that 'the total amount of finance that matters more than its composition' (EBRD, 2006, p. 43).

Subsequently, starting from the early 2000s, bank credit to the private sector increased significantly in most transition countries, reaching peak levels in 2005-07 (EBRD, 2009, p. 42). In Eastern European counties, the trend was driven mostly by foreign-owned banks which had easy access to cheap funds from parent banks eager to expand their market share in the region. In the FSU countries, where foreign bank presence is not significant, domestically owned banks borrowed directly from the international financial markets. In countries such as Kazakhstan and Russia, international wholesale credit markets became a significant source of funding to support domestic credit expansion.

However, these developments had several undesirable consequences, some ,more fundamental than others. First, the credit boom was not directed at financing production as it eluded the enterprise sector. According to the Business Environment and Enterprise Performance Survey data as reported in Table 3 (generated by the World Bank and EBRD), only around 10 percent of the surveyed enterprises in TEs were able to obtain bank credit to finance their working capital needs in 2005 compared to over 50 percent in the pre-transition period (see Table 1). Bank financing of fixed capital expansion was similarly low although it was marginally better in Eastern European countries.

<Table 3>

Second, contrary to expectations, foreign banks in Eastern European countries were more actively involved in lending to households, which traditionally requires relatively less sophistication and expertise compared to lending to businesses. For the 2000-05 period, the growth rate of household loans was higher than that of enterprise loans throughout the transition region and accounted for more than half of total credit to the private sector in some countries (EBRD, 2006, p.48; Bonin *et al.*, 2010, p.18). A significant proportion of these loans in turn were directed towards mortgage financing in the real estate and construction sectors which became important drivers of economic growth. As a result, the construction sector's share in gross value added rose in most countries; in countries such as Estonia, Lithuania, Kazakhstan, and Romania, it increased almost twice between 2000 and 2007 (EBRD, 2009, p.46). Because of the heightened interest in investing in the sector, real estate prices increased dramatically, also partly due to speculation.

When sub-prime borrowers started to default on their mortgage obligations systematically in the US in the first half of 2007, values of these mortgages as well as all other assets derived from them went down, resulting in huge losses for investors internationally. In response, international investors increased their perception of risk on other emerging market assets too. As a result, external loans to both foreign as well as domestically owned banks, which were of paramount importance in supporting the unprecedented credit growth in the region, suddenly dried up and the cost of available ones increased dramatically. Hungary in Eastern Europe (EBRD, 2012) and Kazakhstan in the FSU (Ruziev and Majidov, *forthcoming*) were affected particularly badly from the housing market crisis. The bursting of the credit bubble also led to

reduction in economic growth in TEs, with countries in the Central and South-East Europe and the Baltic regions suffering the most.

Third, a foreign-currency-driven lending boom was a feature of the banking systems in the majority of TEs throughout the 2001-08 period (EBRD, 2010, p.49). Dependence on foreign borrowing, including for speculative currency carry trade purposes, exposed the banking sectors of these countries to significant foreign exchange risk (Gabor, 2012). At the end of 2009, more than half of loans and deposits in most TEs were denominated in foreign currency; the Czech Republic, Russia, and Poland were the only three countries where local currency loans and deposits exceeded 60 percent (EBRD, 2010, p. 48).[8] Borrowing in foreign currencies was attractive to households and enterprises as traditionally high domestic nominal interest rates coupled with decreasing inflation rates and appreciating domestic currencies in TEs made it more expensive to borrow in domestic currencies. Although individual banks passed on foreign exchange risk to borrowers in this way, the systemic risk did not disappear as the repayment source of these loans, i.e. enterprise and household earnings, was in domestic currency. When the tide of capital flows reversed following the onset of the GFC, exchange rates of these economies came under pressure leading to significant depreciation of domestic currencies (e.g. over 20 percent in countries like Russia and Kazakhstan), making it difficult for households and corporations to repay foreign currency loans.

Last but not least, the availability of cheap foreign-currency-denominated loans from international financial markets reduced banks' reliance on the domestic deposit base in their capacity to create credit, thereby delaying the process of building trust in outside as well as inside money (Dow *et al.*, 2008). It also increased the vulnerability

[8] In comparison, foreign currency loans and deposits are only of marginal importance in advanced economies where the general public's trust in outside money as well as inside money is strong.

of TEs to external financial shocks as the GFC was transmitted to these economies by multinational banks mostly through the financial flows channel. Although both internationally-borrowing domestic banks and foreign-owned banks cut their lending in response to the crisis, empirical studies have shown that foreign-owned banks reduced their lending earlier and faster (Claessens and Van Horen, 2012; De Haas and Van Lelyveld, 2011). Moreover, it was also found that, in countries where most of the lending was in local currency and funded from the domestic deposit base, the reduction in the supply of credit was less severe (Kamil and Rai, 2010; Ongena *et al.*, 2012).

5. Concluding Remarks

In summary, following the policy recommendations of IFIs, all TEs abolished the distinction between cash money and non-cash money and gradually modernised their payments systems, starting with corporate banking and then extending the process to retail banking. They established two-tier banking sectors, liberalised interest rates, restructured their commercial banks, and gradually removed capital controls. Under normal circumstances, these policies would have improved the general public's trust in banks and facilitated banking sector development.

However, the impact of these developments was overshadowed by the ill-thought-out and uncoordinated policies pursued in the early 1990s. The shock-therapy type of policy recommendations promoted under the Washington Consensus and pursued in most TEs in the early 1990s resulted in unexpected and unintended consequences, such as persistent inflation, macroeconomic chaos, and the general public's loss of trust in money and banks, which had clear implications for credit creation, and thus for production, output, and employment.

Although the removal of capital controls increased capital inflow to TEs and eased financing constraints on economic growth, internationally-borrowed funds eluded the enterprise sector as they were used mostly to finance household consumption and construction development. Excessive reliance on international borrowing, especially leading up to the GFC, not only increased the exposure of the banking sectors of these economies to sudden reversal of capital flows and hence foreign currency risk, but also made them more vulnerable to external financial shocks. Furthermore, while access to international financial markets allowed banks to increase the supply of credit to the economy, it reduced their reliance on the domestic deposit base to create credit, which, although time-consuming to build upon, is a more stable source of credit growth as confirmed by empirical studies. Table 4 summarises key aspects of our discussion on policy recommendations, intentions, and unintended consequences.

In general, our analysis shows that, particularly for the FSU countries, the introduction of gradual changes would have been more suitable for guaranteeing a smoother transition from the monobank system to the market-based two-tier system; policies should have been designed to build upon existing trust in money and banks and to take into account the existing institutional settings and initial conditions.

<Table 4>

The experience of TEs shows that policy recommendations based upon a perception of a problem which is much more simplistic than the real problem are bound to result in unintended and undesirable consequences. But does this mean less policy prescription? Not necessarily. The implication is that we cannot rely on particular economic dogmas as if they were universal truths. Economics is a social science; like its subject matter, it evolves over time. With it, our approach to tackling

contemporary economic problems must also change. Since we have shown here that policy based on neoclassical theory did not have the intended outcome for TEs, the time is ripe to move away from the fictional assumptions of neoclassical orthodoxy such as perfect information and perfect knowledge, which ensure the smooth functioning of markets. We should move towards a more realist approach where we recognise the importance of history and experience, and appreciate both the complexity of economic systems and the time-consuming nature of institutional development. The result would be that we would be more realistic about our policy recommendations, and more cautious about the expected outcomes.

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Tables and Figures

Table 1 Sources of enterprise working capital financing in the FSU in 1980

	National economy	Industry	Agriculture	Trade
Own resources	24.0	33.0	22.8	28.0
Bank credits	46.3	50.2	55.7	56.6
Other	29.7	16.8	21.5	15.4
Total	100.0	100.0	100.0	100.0

Source: Geraschenko and Lavrushin (1982, p. 20)

Table 2 Inflation in Selected Transition Economies

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000-2006[a]
CIS region	***110.4***	***1055.0***	***1860.4***	***2656.8***	***350.3***	***151.4***	***34.5***	***19.8***	***48.2***	***14.3***
Armenia	274.0	1346.0	1822.0	4962.0	175.8	18.7	14.0	8.7	0.7	2.7
Azerbaijan	107.0	912.0	1129.0	1664.0	412.0	19.7	3.5	-0.8	-8.5	4.7
Belarus	94.1	970.8	1190.2	2221.0	709.3	52.7	63.8	73.2	293.8	48.0
Georgia	79.0	887.4	3125.4	15606.5	162.7	39.4	7.1	3.6	19.2	6.1
Kazakhstan	78.8	1381.0	1662.0	1892.0	176.3	39.1	17.4	7.1	8.3	8.1
Kyrgyz Rep	85.0	855.0	772.4	180.7	43.5	31.9	23.4	10.5	35.9	6.4
Moldova	98.0	1276.4	1184.0	487.0	30.2	23.5	11.8	7.7	39.3	13.5
Russia	92.7	1526.0	875.0	311.4	197.7	47.8	14.7	27.6	86.1	15.0
Tajikistan	112.0	1157.0	2195.0	350.0	609.0	418.0	88.0	43.2	27.6	17.6
Turkmenistan	103.0	493.0	3102.0	1748.0	1005.3	992.4	83.7	16.8	24.2	8.8
Ukraine	91.0	1210.0	4734.0	891.0	377.0	80.0	15.9	10.6	22.7	11.1
Uzbekistan	109.7	645.2	534.2	1568.3	304.6	54.0	70.9	29.0	29.1	29.0
Baltic States	***202.5***	***1015.9***	***203.1***	***51.9***	***31.2***	***21.8***	***9.5***	***6.0***	***2.2***	***2.9***
Estonia	210.5	1076.0	89.8	47.7	29.0	23.1	11.2	8.1	3.3	3.7
Latvia	172.2	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	3.6
Lithuania	224.7	1020.5	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.3
SEE region	***251.9***	***146.2***	***164.6***	***116.5***	***47.2***	***80.9***	***618.4***	***40.7***	***23.3***	***13.6***
Bulgaria	333.5	82.0	73.0	96.3	62.0	123.0	1082.0	22.2	0.7	6.3
Romania	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	20.9
CEE region	***52.4***	***25.7***	***26.2***	***20.3***	***21.7***	***17.4***	***13.9***	***12.3***	***6.5***	***4.2***
Czech Rep	52.0	11.1	20.8	9.9	9.1	8.8	8.5	10.7	2.1	2.5
Hungary	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	6.2
Poland	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	3.8

Note: a. simple average
Source: EBRD (Various Years)

Table 3 Enterprise Financing Sources in TEs in 2005

(As a Percentage of Total Financing)

		Central Europe and Baltic States	***South East Europe Region***	***Commonwealth of Independent States***
Working Capital	*Internal Finance*	68.0	73.2	77.3
	Borrowing from Banks	10.1	12.9	10.1
	Equity	6.9	1.0	2.0
	Trade Credit	6.2	5.6	4.0
	Other	8.8	7.3	6.6
Fixed Capital	*Internal Finance*	62.4	70.8	77.2
	Borrowing from Banks	14.3	17.7	11.6
	Equity	6.5	0.9	1.9
	Trade Credit	1.9	2.4	1.8
	Other	14.9	8.2	7.5

Source: EBRD (2006, p.48)

Table 4 Brief Summary of Policy Recommendations, Intentions and Unintended Consequences

Policy Recommendations	Intended Outcomes	Unintended Consequences
Liberalise prices	One-off increase in price level	Macroeconomic chaos and persistent hyperinflation with consequences on trust building in outside as well as inside money
Abolish the separation between non-cash and cash money	Improves monetisation and wealth formation and facilitates financial intermediation	Hyperinflation wipes out the value of savings; importance of banking declines and reliance on cash transactions increase
Establish two-tier banking sector	Commercial banking: leads to efficient allocation of resources, imposition of financial discipline on enterprises, and hardening soft budget constraints	General public loses trust in banks which then fail to fill the gap left by the monobank, leading to credit shortages, proliferation inter-enterprise non-payments and subsequent development of barterisation of transactions
	Central banking: provides effective prudential regulation and supervision of the activities of commercial banks	Banking sector troubles are also partly due to weak and ineffective supervision and prudential regulation, which in turn is explained by time consuming nature of building up competent and adequately trained human capital
Privatise state-owned banks, involving foreign banks if possible; encourage entry of new private banks	Improves competition which should lead to higher return on deposits and lower cost of lending to enterprises	Lax regulation and supervision leads to propagation of inadequately capitalised private banks and spread of Ponzi pyramid schemes in some countries (e.g. Russia and Albania); contrary to expectations, foreign banks prefer lending to household sector which requires less sophistication and expertise
After achieving macroeconomic stability, gradually liberalise capital account transactions	Represents optimizing household and firm decisions that support internationally efficient resource allocations; removes financing constraints on economic growth;	Instead of basing their credit creation capacity on domestic deposit base, banks increasingly rely on international markets as a source of credit expansion with implications to the sector's exposure to foreign exchange risk; speculative demand for international loans to seek profit from currency carry trade is also in the rise; sudden reversal of capital flowsincreased the vulnerability of TEs to external financial shocks

Figure 1 Outside Money, Inside Money, and the Financial Superstructure (Adapted from Dow, 1998, p. 22)