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Inna Golodniuk

Financial Systems and Financial Reforms in CIS Countries

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The paper prepared under the project "Commonwealth of Independent States – Regional Human Development Report" on development challenges facing CIS countries, funded by the United Nations Development Programme

The publication was financed by WestLB Bank Polska S.A.

Keywords: **financial reform, transition, banks and banking, capital markets.**

ISSN 1506-1701, ISBN: 83-7178-382-5

Publisher:
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Contents

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Abstract

At the beginning of 1990s the Soviet successor states started to transform their financial sectors to meet the needs of the emerging market economies. Following a decade of transition, results differ. Although the Baltic States were able to build quite successful financial systems, in the CIS countries financial systems remain a major obstacle to economic growth. The hyperinflations of the early 1990s, the financial scandals that followed the collapse of monobank systems, and subsequent incomplete progress in constructing non-bank financial institutions and effective regulatory structures have had adverse consequences. These include weak bank balances sheets, high real interest rates, and poor access to capital for small enterprises and start ups. With a few exceptions, non-transparent regulation, inadequate disclosure frameworks, and weak protection of shareholders rights continue to limit investor participation in CIS financial markets. The absence of effective three-pillar pension systems further limits the demand for domestic debt and equities.

Fortunately, there are signs of improvement. Bank lending and deposits are growing in many CIS economies, the proportion of bad debt in bank credit portfolio is falling, and lending and deposit interest rate spreads are diminishing. The solid economic growth recorded since 1999 in many CIS countries is helping memories of the 1998 financial crisis to fade, and stock exchanges in some CIS countries are currently at or near record levels. Financial systems in CIS economies may be moving toward the successful frameworks put in place in the new EU member states. However, because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe, financial stability in many CIS countries remains open to question.

This paper is built as follows. Chapter 2 overviews major reforms in bank and non-bank financial institutions after 1991 followed by analysis of changes in ownership (Chapter 3) and changes in market structure (Chapter 4). Chapter 5 discusses the major trends in the CIS financial sectors and Chapter 6 concludes.

1. Introduction

At the beginning of 1990s the Soviet successor states started to transform their financial sectors to meet the needs of the emerging market economies.

The nature of economic relations under central planning left little role for financial intermediation, as it is understood in mature market economies. Banks were the only source of external funding in the socialist economies. State enterprises had virtually no budget constraints and when they experienced credit or liquidity shortages a bank would provide credit based on investment and production decisions by central planning bodies. Because banks merely implemented credit allocation decisions of the central planner, they did not evaluate risks, make their own credit allocation decisions, or monitor the use of credits after their issuance.

The start of transition meant that banks had to supply increasingly sophisticated financial services – without the capacity to do so. Banks had to learn how to assess, pool, and diversify risks, collect and process information on their clientele, and to exercise control over borrowers. The tasks facing policymakers were equally challenging. These included the imperative of introducing the market-oriented regulatory institutions needed to protect the rights of creditors and shareholders; setting up independent and strong prudential supervision; maintaining a level playing field in terms of tax policies; and privatizing state banks. Second, governments had to learn to carry out policies in a manner friendly to the financial sector. The early attainment and subsequent maintenance of macroeconomic stability were also critically important.

Following a decade of transition, results differ. Although the Baltic states were able to build quite successful financial systems, in the CIS countries financial systems remain a major obstacle to sustainable economic growth. The hyperinflations of the early 1990s, the financial scandals that followed the collapse of monobank systems, and subsequent incomplete progress in constructing non-bank financial institutions and effective regulatory structures have had adverse consequences. These include weak bank balances sheets, high real interest rates, and poor access to capital for small enterprises and start ups. With a few exceptions, non-transparent regulation, inadequate disclosure frameworks, and weak protection of shareholders rights continue to limit investor participation in CIS financial markets. Despite significant investor interest in emerging market debt, only Kazakhstan has been willing and able to float new Eurobonds since 1998. The absence (Kazakhstan again is the exception) of effective three-pillar pension systems in CIS countries further limits the demand for domestic debt and equities.

Fortunately, there are signs of improvement, thanks in large measure to the region’s recovery from the effects of the August 1998 Russian financial crisis. Bank lending and deposits are growing in many CIS economies, the proportion of bad debt in bank credit portfolio is falling, and lending and deposit interest rate spreads are diminishing. The solid economic growth recorded since 1999 in many CIS countries is helping memories of the 1998 financial crisis to fade, and stock exchanges in some CIS countries are currently at or near record levels. Financial systems in CIS economies may be moving toward the successful frameworks put in place in the new EU member states. However, because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe, financial stability in many CIS countries remains open to question.

2. Overview of post-1991 reforms in bank and non-bank financial institutions in CIS countries

2.1. Early stage developments: 1991-1997

With the collapse of Soviet Union, the CIS economies inherited financial sectors consisting of several specialized state banks with large portfolios of bad debt that required recapitalization and restructuring. Bank regulation was virtually nonexistent. The situation aggravated by the onset of hyperinflation, which caused tremendous macroeconomic unbalances and uncertainty.

These circumstances made credit allocation decisions extremely flawed. Shares of non-performing loans in bank portfolios grew as was the solvency of financial institutions deteriorated. Banks also faced enormous difficulties in attracting deposits – households avoided holding bank accounts as inflation quickly eroded their purchasing power. Keeping savings in hard currency under the mattress proved to be the winning strategy. Curbing inflation, achieving macroeconomic stability, and privatization were therefore the highest reform priorities in CIS countries until 1997-1998. During this time all countries implemented restrictive monetary policies and eventually were able to defeat high and unstable inflation rates. The introduction of national currencies was likewise completed by the mid-1990s, as was the replacement of monobanks by two-tier banking systems. But despite sharp growth in the number of commercial banks, bank lending to enterprises declined substantially, particularly in real terms. Due to high risk of the economic environment, interest rates were extremely high (ranging between 50% and 145% per annum) and enterprises were unwilling to borrow. Most enterprises financed investments from retained earnings, while banks invested in treasury bills. For example, by the end of 1997, commercial banks in Russia had invested almost three-quarters of ruble deposits in federal government securities. Similar pictures were observed in many other CIS countries.

The preponderant role of state banks in the CIS countries led to pervasive politically tied lending. Intended to support loss-making state enterprises, this lending led to the accumulation of huge losses. By 1995 the proportion of bad loans (as a percentage of credit portfolio) ranged from 2.4%[1] in Georgia to 72% in Kyrgyzstan. The true picture in the sector was much worse, but hard to measure due to absence of strict accounting standards, poor audit capacities, and inadequate supervision. Governments did not possess the institutional capacity or political will needed to stop this soft lending. For example, because loose accounting standards allowed bad loans to be treated as overdue loans, the share of bad loans reported in CIS countries generally did not rise above 20%. By contrast, even successful reformers, like Hungary, reported more than 20% of bad loans during the first years of transition. In addition to inappropriate policies and poor regulations,

[1] Here and further the figures are taken from statistics of the central banks of respective countries unless other source is explicitly cited

bank managers lacked the education and experience needed to operate in the rapidly changing commercial environment. Their companies did not possess modern infrastructure and information technologies, and corporate cultures were short on such fundamental values as confidentiality, client privacy, and mutual trust.

During the first reform stage, most countries began introducing accounting systems and supervisory practices compatible with international standards. These efforts however were fragmented, uncoordinated, and lacked strict and uniform enforcement. Despite the weaknesses in accounting and supervision standards and lack of enforcement procedures, the first attempts to rationalize banking systems were made during this time. For example, the Kyrgyz Republic during 1993-1996 strengthened bank licensing requirements and minimum capital requirements, which led several small banks to exit the market and deterred the appearance of potentially nonviable banks. The authorities then concentrated on the solvency problems facing the two largest banks and two state giants (Savings Bank and Promstroibank), which were subsequently liquidated. By the end of 1997 the share of non-performing assets in Kyrgyzstan had decreased to 7% from 75% in 1994 (Bokros, 2001).

Kazakhstan's early attempts at bank restructuring were less successful. Kazakhstani banks had by the end of 1995 accumulated a large stock of bad assets – 50% of total bank loans, or 11% of GDP (*ibid*). The government then initiated a restructuring program and began withdrawing licenses from troubled banks. The country's largest banks were restructured by transferring their bad assets to special debt recovery agencies. Despite this, a year later bad assets still comprised about 11% of GDP.

In 1997-1998 governments began addressing problems fundamental to financial intermediation by creating sector friendly environment and infrastructure. Higher minimum capital requirements and the introduction of international supervision practices, combined with accounting and auditing reforms, better management of non-performing loans, the restructuring of insolvent financial institutions and enterprises, and the strengthening of creditor rights moved to the top of the reform agenda.

As privatization gained momentum, stock markets were established. Although Armenia, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Uzbekistan all introduced mass privatization, they permitted the exchange of privatization certificates outside of the stock exchange. The development of stock markets therefore began later, when the government started selling majority ownership stakes to strategic investors.

2.2. 1998 Russian financial crisis

The Russian financial crisis of 1998 had a dramatic impact on CIS financial systems during the late 1990s. This was most apparent in terms of slowing or halting growth in government debt markets, as well as the consequences of the sharp real devaluations of the ruble and other CIS currencies. Although the crisis was precipitated by the August 1998 developments in Russia, most other CIS financial systems had similar problems. These developments seriously reduced the capitalization of financial institutions: aggregate bank equity capital in Russia had fallen to half its pre-crisis levels by mid 1999. The total capital of the Ukrainian banking system dropped by almost one third during 1998; in the Kyrgyz Republic, it fell by more than half between 1998 and 2000 (EBRD, Transition Report, 1999). In addition to the currency crises, banks were also affected by the collapse of markets for government debt – which occupied a significant position in their balance sheets. This increased macroeconomic uncertainty and undermined already weak banks. Even those banks that kept their money in foreign currency denominated assets were hit by crisis. Georgian banks, for instance, had 60% of their deposits in foreign currency, and most of their loans were denominated in US dollars. Despite this, most companies had difficulties servicing these loans. Total deposits fell by 20% in the second half of 1998, with domestic currency denominated deposits dropping by 30%. Perhaps most importantly, the 1998 financial crisis ruined the fragile culture of trust between households and financial intermediaries that had emerged during the recovery from the hyperinflations of the early 1990s. Those who did not entrust their savings to the financial sector and kept them in hard currency under the mattresses were again the winners after August 1998. Restoring this trust comes at a high cost – banks had to offer much higher interest rates to attract deposits, and were unable to increase their capital as quickly as had previously been the case.

It is noteworthy that Kazakhstan was the only CIS country that attempted to compensate households for the value of their lost savings.

2.3. Post crisis reforms

After the 1998 crisis the pendulum gradually swung back toward fundamental reforms. By 1999 Armenia, Georgia, Moldova, Tajikistan, and Ukraine had tightened their minimum capital requirements for commercial banks. This was expected to bring much needed consolidation in banking sector by forcing small, undercapitalized banks either to merge with larger banks or exit the market. Efforts to improve the transparency of financial sectors continued: Armenia, Ukraine, Moldova, and Kyrgyzstan had introduced International Accounting Standards before the 1998 financial crisis, and consolidated their supervision around the new accounting system. But while most CIS countries have modernized supervision frameworks, their enforcement generally remains rather loose. Supervisors still do not have enough independence, both political and financial, and selective enforcement of prudential norms is the rule. Banks with strong political connections and large banks enjoy noticeable supervisory forbearance and various favors from the governments, such as exclusive rights to service government transactions and large projects.

Smaller banks, by contrast, had to struggle to remain in business, as the sources of easy, speculative profit that were abundant early in transition began to disappear. Banks had to introduce new (more costly) products like payment cards, mortgages, microloans, as well as target new audiences. The overall risk associated with banking remains high, although the situation has been improving since 1998.

There is a wide agreement (see, for example, De Nicolo et. al., 2003) that the main causes of high banking risks are common for all economies. These are generally weak legal and judicial frameworks, which result in weak protection of creditor, investor, and taxpayer rights. While most

CIS countries have capital market and creditor rights legislation that is comparable to what can be found in the European Union, these laws are often not enforced. Claessens (2001) points out that Armenia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Ukraine, and Uzbekistan have received technical assistance from the US in drafting their capital market legislation, so that formally, all these countries have the same level of shareholders protection as the US. But compliance with these laws is about one quarter of the US level for Uzbekistan, Kyrgyz Republic, Armenia and Azerbaijan, and about one half for Kazakhstan, Moldova, Russia and Ukraine (*ibid*.). The major reasons are, again, common for all countries – corruption, weak judicial systems, limited disclosure of information. Solving these problems should be a reform priority for the next several years if the governments are serious about the development of financial intermediation.

High risks in lending activities inflate operational costs and put upward pressures on interest rates. Although interest rates on credits have been steadily declining in all CIS countries (see Subsection V below), many households and businesses (especially SMEs) avoid official financial institutions, thereby weakening banks' intermediating function.

Raising funds on stock markets is even more complicated, even for large and established companies. The evolution of stock markets in CIS countries were shaped by the same factors influencing banking systems: weak *de facto* protection of investors, high interest rates, inadequate infrastructure, and the overall risky commercial environment. Stock markets in most CIS countries (with the exception of Russia and Kazakhstan) are small relative to their banking sectors, and trivial by international standards (see Figure 1 below). The bulk of trading takes place off the stock exchanges; most enterprises would rather not trade publicly to avoid taxes. Also, the cost of raising external capital remains high relative to the cost of bank credit. Demand side impediments to capital market development are even more serious. Individual investors are discouraged by poor protection of minority shareholders, and the small size of non-banking financial institutions (pension funds, investment funds, insurance companies, mutual funds) in the CIS limits their role on the capital markets.

Box 1: Kazakhstan's financial sector

Kazakhstan's financial sector is considered to be the most advanced in the CIS. Although small by developed countries' standards, it is rapidly growing owing to thoughtful regulation and the introduction of Western financial products.

Since its 1998 introduction, Kazakhstan's pension reform has moved the country away from a pay-as-you-go to a funded system, financed by mandatory contributions of 10% of salary. As of 2004 70% of workforce was paying in to the funded pillar (Economist, 2003) which had accumulated some $2 billion (about 8.4% of GDP). (There is also a third tier financed by voluntary contributions, but its size is fairly small.)

Mortgages were introduced in 2001, under the aegis of the state-run Kazakhstan Mortgage Company. Combined with the issuance of a new financial instrument – securitized mortgage bonds – mortgages have greatly facilitated financial sector development. In addition securitized car loans and credit cards are currently being introduced.

Financial regulation and supervision in Kazakhstan are consistent with best international practices. Consolidated financial supervision was created and has recently vested in an independent agency. Deposit insurance is effective since 1999 and became compulsory in January 2004. Individual deposits are insured up to $2,900 per bank, which cements household trust in the banking system. The future reform agenda is also ambitious: it includes the implementation of robust bank liquidation procedures and risk-based supervision. Protection of creditor and minority shareholder rights remains weak, however.

These reforms have helped the financial sector to be one of fastest growing sectors in Kazakhstan. Commercial bank assets (as a percentage of GDP) grew from some 11% in 1998 to about 40% in 2003. Assets managed by private pension funds for the same period increased from about 1% to 8%, while capital market capitalization rose from 30% to 52% (IMF, 2004).

Investment and mutual funds are the largest among non-banking financial institutions in the CIS countries (except for Kazakhstan and Ukraine, where pension funds are largest). The primary business of these funds, which emerged after mass privatization began, was pooling privatization certificates and investing them into the enterprises being privatized. Although both groups of institutions have undergone significant modernization since then, they are at rudimentary development stage and their assets are less than 5% of GDP for the CIS countries. The absence of effective three-pillar pension systems hinders the development of pension funds in CIS countries and further limits the demand for domestic debt and equities. Kazakhstan is the only exception of successful introduction of operational pension system; funds accumulated in these vehicles amounted to some 8% of GDP in 2004 (IMF, 2004).

3. Changes in ownership structures

3.1. Evolution of state ownership

Continued state ownership threatens the efficiency of financial intermediation by banks. Even in developed market economies, the costs of state owned banks are generally quite high. In transition economies, where financial sectors are more fragmented and property rights weaker, the costs are much higher. Recent research indicates that government ownership of banks is typically associated with slow financial development and low growth in output and productivity (La Porta et al. 2000).

State banks in CIS countries often enjoy preferential treatment in the form of exclusive rights to service government projects and accounts. This undermines competition and promotes rent seeking and corruption. Until the late 1990s, tied and politically connected lending by state banks was pervasive in all CIS countries and led to the rapid accumulation of bad debt.[2] In countries where problem persisted, most of these banks became insolvent, but their large size and "strategic importance" kept governments from taking radical measures. Large bailouts and lower interest rates on deposits were the inevitable results. These costs to depositors and taxpayers could have been avoided if the governments had more promptly reformed troubled state banks. Countries that successfully privatized their banks (or at least majority of banks) typically have more competitive banking sectors, and tied lending problems are not as severe.

Among CIS countries only Armenia and Georgia have been able to fully eliminate state ownership in the banking sector, while the Kyrgyz Republic has only three state banks accounting for about 10% of the system's assets (Table 1). Kazakhstan has been able to substantially reduce the share of state bank assets since 1998, and Moldova's banking sector will be fully privatized as soon as the state shares in the former savings bank are sold. Tajikistan privatized four of its five state banks by 1998, accompanied with the government program prohibiting further direct lending.

[2] Typically these were specialized agricultural and industrial banks forced by the government or powerful influence groups to finance troubled state enterprises.

Table 1. Asset share of state owned banks for selected transition economies. 1995 – 2002, end of a year, % of total banking sector assets

	1995	1996	1997	1998	1999	2000	2001	2002
Armenia	2.4	3.2	3.4	5.7	3.5	3.8	0.0	0.0
Azerbaijan	80.5	77.6	80.9	65.5	82.5	60.4	62.0	
Belarus	62.3	54.1	55.2	59.5	66.6	66.0	53.2	67.6
Georgia	48.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Kazakhstan	24.3	28.4	44.8	23.0	19.9	1.9	3.5	
Kyrgyz Republic	69.7	5.0	10.3	10.4	25.8	15.8	16.6	9.7
Moldova				0.3	7.9	9.8	10.2	13.4
Tajikistan		5.3	30.3	29.2	6.9	6.8	4.8	4.5
Turkmenistan	26.1	64.1	68.3	77.8	96.9	97.1	96.5	95.7
Russia			37.0	41.9		44.1		
Ukraine			13.5	13.7	12.5	11.9	11.8	14.4
Uzbekistan	38.4	75.5	70.6	67.3	65.8	77.5	96.0	
Latvia	9.9	6.9	6.8	8.5	2.6	2.9	3.2	4.0
Poland	71.7	69.8	51.6	48.0	24.9	23.9	24.4	26.6
Hungary	49.0	15.3	3.5	9.8	7.8	7.7	9.1	10.8

Source: EBRD Transition Report

Ukraine at the end of 2004 had two state banks, whose assets accounted for about 14% of the sectoral total. Although the huge state agricultural bank "Ukrayina" underwent liquidation in 2001, the share of state banks has not dropped since, and has even slightly increased. This is somewhat surprising, since one of the two state banks is the loss-making Oschadny (savings) bank. Experts question whether Oschadny can become competitive without significant assistance from the government. Preliminary estimates in early 2001 indicated that Oschadny would need to reduce its costs by about 40% in order to be profitable (Sherif *et al.,* 2001).

Banking sectors in Azerbaijan, Belarus, Russia, Uzbekistan and Turkmenistan remain dominated by large state banks (Table 1). Still, on average, assets of state banks have been declining since the mid-1990s, thanks mainly to the large scale privatization or liquidation of state banks in countries like Georgia, Kazakhstan, and Kyrgyzstan. The introduction and better enforcement of prudential standards is combining with competition to favor more efficient private banks.

3.2. Role of foreign capital

The role of foreign capital in CIS banking sectors is very limited. In Uzbekistan, Turkmenistan, Belarus, and Georgia, foreign banks are embryonic and their share of total banking assets is less than 10%.[3] With a few exceptions, foreign banking activities are small in scale and cannot bring substantial competitive pressures to bear on domestic banks. They are also too small to bring new (Western) corporate management techniques and technologies. Moreover, Western banks are not the only – or even most important – foreign banks in the CIS: Russian banks are becoming more aggressive.

A number of CIS countries use banking sector regulations to restrict entry by foreign banks. In Russia an official limit to the participation of foreign banks has been in place since 1992. Foreign bank capital share cannot exceed certain proportion of total capital of the Russian banking system

[3] In Georgia, this share has remained around 1% since 2000. For Belarus the figure was 4.4% at the end of 2002; assets of Western banks comprised only 0.2%.

– 12% until 2001, when the limit for foreign ownership in the banking industry was raised to 25%. It is therefore unsurprising that the share of foreign bank assets in recent years never exceeded 10%. Foreign penetration in the lending and deposit markets has remain trivial since 2001, with foreign banks accounting for only 5-6% and 1-2%, respectively, of these markets.

Perspectives are somewhat better in Kazakhstan and Ukraine, where the role of foreign banks has been gradually growing since 1999. About half of Kazakhstan's banks have some foreign capital in them. Total assets of foreign banks in Ukraine currently make about 16% of total Ukrainian banking assets.

Foreign banks operating in CIS countries can be classified into two groups. The first group contains several foreign-owned banks, which are trying to foster business with strong local companies having good growth prospects. This is a challenging business and most foreign banks generally do not risk entering it. The second group concentrates mainly on servicing the subsidiaries of their multinational clients or established domestic companies, thereby limiting their own future growth potential. Some foreign banks are now moving from the second to the first group, particularly in those CIS countries where foreign banks already play a non-trivial role. Increased competition within this sector would further consolidate this healthy trend.

4. Changes in market structure

During the early stages of transition, CIS countries converted their monobank into a two –tier system, consisting of a central bank and the former monobank's departments, which were spun off and became commercial banks. Initially all these banks remained in state hands and retained dominant market positions. As banking reforms were introduce some of these banks were privatized; others were restructured or liquidated. At the same time new private banks entered the market, not overburdened with bad loans as former system banks and with better management and information technologies. In Ukraine, Georgia, and Russia, state banks have been gradually losing market share to more advanced new private banks and banking markets have became less concentrated. Still, the pace of change is quite slow.

Other countries where reforms have been less decisive (Turkmenistan, Uzbekistan, Belarus) still have extremely concentrated banking sectors. In Turkmenistan, where the government controls the entire banking sector, seven banks control 95% of all commercial bank loans in the local currency and 100% of all hard currency denominated loans. Similarly, in Belarus and Uzbekistan banking sectors are still heavily concentrated with six largest banks accounting for 90-95% of all bank credit. Despite the positive change in its financial sector, Kazakhstan's banking system remains highly concentrated: the three largest banks hold about 65% of all household deposits.

Russian banking is also quite concentrated: the top five banks control a bit more than 40% of company loans, about 50% of household loans, and about 70% of household deposits (end 2003, BOFIT).[4] Sberbank's share of household deposits had slipped to some 60% at the end of 2003, as

[4] This concentration has been declining. The top five banks accounted for more than 80% of household deposits in 2000.

small banks managed to increase their share. In Ukraine, market concentration is declining even faster: between 1999 and 2003 the share of the largest six banks in household deposits dropped from about 73% to 54%. Market shares in loans likewise fell from 50% to 40%

The implications of high concentration in the banking markets are ambiguous. On the one hand, the presence of giant banks with dominant market position can adversely affect competition and market discipline. Because bank regulators' often show forbearance towards big banks in transition economies, banking sectors with high concentration ratios often show worse performance in terms of capital adequacy, quality of loan portfolio, liquidity, etc. On the other hand, some research has found a significant positive association between more concentrated banking markets and greater efficiency in offering banking services (Grigorian and Manole, 2002). Therefore, it is hard to draw conclusions about the impact of high concentration in CIS banking systems: the two effects work in the opposite directions.

Stock markets have remained concentrated since their establishment. The concentration of market turnover, defined as turnover of the top 5 listed companies as a percentage of total turnover, is very high. Armenia, Azerbaijan, Kazakhstan, Moldova, Ukraine, and Uzbekistan all have market concentration above 80%. Russia has the least concentrated stock market turnover (about 65%). This state of affairs is similar to other transition economies, where concentration of market turnover averages about 75% (Bokros, 2001).

5. Recent trends

Data indicate that financial systems in CIS countries remain shallow compared to the successful transition countries and non-banking financial institutions, with a few exceptions, are fragmented and underdeveloped. Fortunately, there are signs of improvement. Financial systems in all CIS economies are deepening, and bank lending and deposits are growing faster than inflation in many CIS economies. Spreads between lending and deposit interest rates are diminishing, and the share of credit allocate to the private sector is increasing. The solid economic growth recorded since 1999 in many CIS countries is helping memories of the August 1998 financial crisis to fade, and stock exchanges in some CIS countries are currently at or near record levels.

5.1. Financial Deepening

Financial sectors in CIS countries, despite wide differences among them, have remained quite shallow compared to the Baltic States, Hungary and Poland. In most high income countries financial depth (the ratio of broad money to GDP) is at least 60%. For CIS countries financial depth currently ranges from some 8 to 30% (Table 3). Although the level is still low, all countries show noticeable progress recently. Cross-country differences can be explained primarily by household credit and mortgage market trends, particularly since higher ratios are found in countries with more developed consumer lending. It is noteworthy that the dispersion in financial depth among CIS countries is increasing over time (see standard deviation, Table 2)

Table 2. Dynamics of financial depth for selected transition economies. 1995 – 2002, end of a year, M2 as % of GDP

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Armenia	6.2	7.2	7.7	8.7	10.4	12.7	13.2	13.6	13.8
Azerbaijan	11.1	10.4	11.8	11.7	10.8	12.8	13.7	12.2	13.0
Belarus	10.2	11.8	11.6	19.6	11.9	11.6	12.2	12.7	14.1
Georgia	..	5.8	6.8	7.4	7.2	8.9	10.3	10.8	11.5
Kazakhstan	8.4	9.0	9.3	9.3	10.5	12.9	14.7	17.0	18.6
Kyrgyz Republic	..	12.7	12.1	13.4	11.9	10.7	10.6	12.8	15.6
Moldova	15.4	17.2	18.8	20.2	17.4	19.0	22.1	25.7	28.4
Russia	14.2	15.8	17.5	20.8	16.9	17.5	20.7	23.1	25.6
Tajikistan	..	..	..	..	6.1	6.6	6.9	7.2	8.3
Turkmenistan	11.1	4.8	8.0	11.5	11.6	14.1	14.9	14.0	14.0
Ukraine	9.3	10.0	11.7	13.7	14.3	15.7	18.8	24.2	30.1
St.deviation (CIS)	2.98	4.04	3.98	4.95	3.50	3.61	4.63	6.02	7.25
Latvia	26.8	21.5	23.8	25.9	25.7	27.1	30.1	33.4	38.1
Hungary	44.2	43.8	42.7	42.5	43.5	42.9	43.7	44.8	45.6
Poland	29.5	31.1	31.0	33.7	37.1	38.5	41.6	42.8	41.6

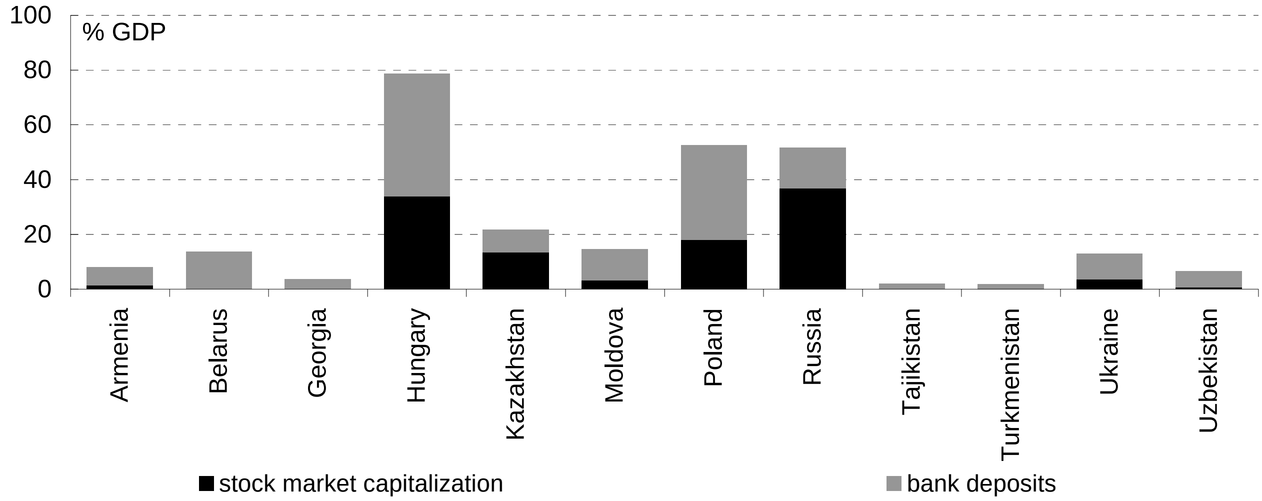
Source: World Development Indicators, World Bank

5.2. Bank dominance and development of stock markets

Non-banking financial institutions are in a rudimentary state in the CIS, dwarfed in importance by commercial banks. Only in Russia, Kazakhstan, and the Kyrgyz Republic has stock market size remained comparable to banks' size. In developed countries both bank and non-bank financial institutions play more significant roles. Market capitalization of listed companies (commonly used as a proxy for stock market size) is comparable to the size of total deposits with banking financial institutions.

Figure 1 illustrates also the small size of financial intermediation in the CIS compared to advanced transition economies.

Figure 1. Structure of the financial sector, 2000, end year



Source: WDI World Bank, IMF International Financial Statistics.

Optimistically, the revival of economic growth after 1999 stimulated stock market activity (Table 3) and stock markets in Kazakhstan, Russia and Moldova operate at the near record level.

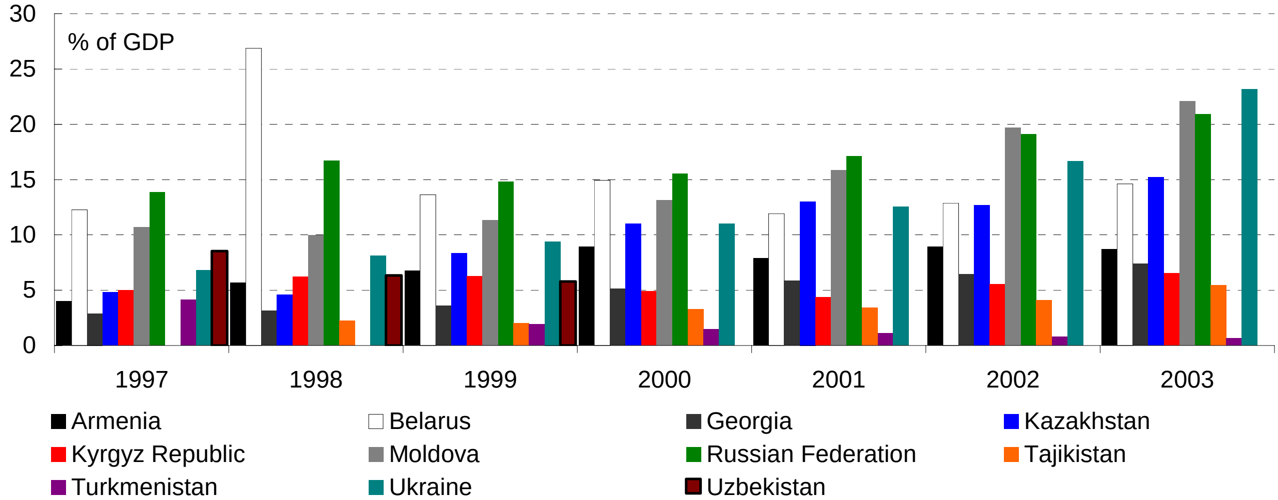
Table 3. Stocks traded, total value, end of year, % of GDP

	1995	1996	1997	1998	1999	2000	2001	2002
Hungary	0.79	3.63	16.34	34.09	29.96	26.02	9.29	9.15
Kazakhstan	..	..	0.00	0.11	0.11	0.48	1.44	..
Latvia	..	0.23	1.49	1.39	0.67	3.17	2.15	1.47
Moldova	..	0.11	2.02	4.76	2.98	1.93	14.19	..
Poland	2.17	3.85	5.17	5.28	6.77	8.78	4.00	3.05
Russia	0.11	0.75	4.00	3.87	1.44	7.82	7.47	10.45
Ukraine	..	..	..	0.22	0.39	0.92	0.59	0.29
Uzbekistan	..	0.50	0.29	..	0.21	0.13	..	..

5.3. Bank Credit and Deposits

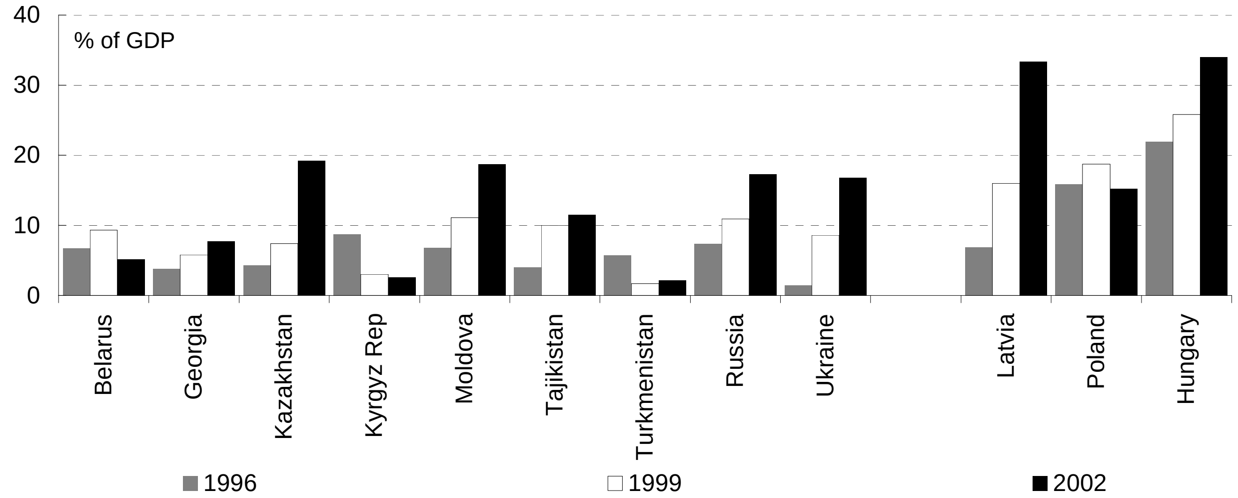
Banks' abilities to attract deposits are improving and bank deposits are steadily growing in all countries, except Turkmenistan and Belarus (Figure 2). This growth is most remarkable in Ukraine, Kazakhstan and Moldova. Deposit trends indicate that public trust in the banks is recovering after Russian financial crisis events and the trend persists.

Figure 2. Dynamics of bank deposits, CIS, 1997- 2003, end year



Source: WDI World Bank.

Figure 3. Domestic credits to the private sector 1996, 1999, 2002, end year, selected CIS countries



Source: EBRD Transition Report.

A shift towards financing the private sector is apparent in almost all CIS countries. The share of credit allocated to the private sector is a good proxy for the overall health of the financial sector.

The literature finds a positive relationship between credits to the private sector and economic growth, because decisions about crediting the private sector are generally made on the basis of economic rather than political considerations. With the exception of Turkmenistan, Belarus, and the Kyrgyz Republic, shares of credits allocated to the private sector have been steadily increasing (Figure 3).

5.4. Interest rate spread

The difference between interest rates earned on credits and offered on deposits shows a bank's efficiency as a financial intermediary. This spread measures the proportion of funds raised from crediting that is absorbed by the banking system, rather than acquired by the investor (owner of a deposit). The interest rate spread has been persistently diminishing since 1997 in all countries of the region. The only exception is Turkmenistan, where the interest rate is not meaningful as such since banks operate as payment agents to subsidize the economy from the Central Bank of Turkmenistan.

Table 4. Spread between lending and deposit interest rate 1997-2003, %

	1997	1998	1999	2000	2001	2002	2003
Armenia	28.2	23.5	11.5	13.5	11.8	11.5	14.0
Azerbaijan	..	..	7.4	6.8	11.2	8.7	5.9
Belarus	16.2	12.7	27.2	30.1	12.8	10.0	6.5
Georgia	36.9	29.0	18.8	22.6	19.5	22.0	23.0
Hungary	4.8	4.9	4.4	3.1	3.7	2.8	-1.4
Kyrgyz Republic	9.8	37.7	25.3	33.5	24.8	18.9	16.8
Latvia	9.4	9.0	9.2	7.5	5.9	4.7	2.4
Moldova	9.9	9.2	8.0	8.9	7.8	9.3	6.7
Poland	5.6	6.3	5.8	5.8	6.6	5.8	3.6
Russia	15.3	24.7	26.0	17.9	13.1	10.8	8.5
Tajikistan	51.6	41.1	21.0	24.3	15.9	5.0	6.9
Ukraine	30.9	32.2	34.3	27.8	21.3	17.4	10.9

Source: World development indicators, World Bank

The declining spread is an extremely positive development. First, high spreads usually imply high lending rates, which can have substantial adverse economic implications, especially for small and medium sized enterprises (SMEs). Second, declining spreads are most likely associated with the increasing competition in the sector. These trends suggest that financial systems in CIS economies are moving toward the successful frameworks put in place in the new EU member states. Financial sectors are improving their services to enterprises, lending has been growing as a percentage of GDP, and economic growth rates are solid. Public trust in the financial sector is firming. Interest rate spreads are converging toward levels observed in the new EU countries, and such modern financial products as payment cards, microloans, and credit lines are being constantly introduced. Regulatory and supervisory standards are also converging toward best international practices, although their enforcement is still weak. However, because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe, financial stability in many CIS countries remains an open question.

6. Conclusions

Efficient, mature financial sectors play an important role in economic development. By pooling savings and channelling them to investors with the best chances of succeeding in their investment activities, the financial sector promotes technological progress and supports economic growth.

Financial systems in many CIS countries remain quite small and inefficient by international standards. The hyperinflations of the early 1990s, soft lending to state enterprises, the lost deposits after the 1998 financial crisis – all this has had unfortunate consequences. Many households and businesses (especially SMEs) avoid official financial systems. Lending – particularly by state-owned banks – is often subject to political influences, while many private banks are too small to effectively pool risk. Although financial market supervision and regulation are now quite progressive, banks continue to operate in an overly risky environment due to hostile attitudes of tax authorities and inadequate protection of creditor rights. Weak balances sheets, high real interest rates, and poor access to capital for start ups remain matters of concern, although the situation has been improving for the past several years.

The problems of banking systems in CIS economies are compounded by a general absence of effective non-bank institutions for financial intermediation. Mutual and investment funds remain in an embryonic stage, as do insurance companies. Their small size is a major impediment to stock market development, since institutional investors are the driving forces for stock markets in any economy. The absence of effective three-pillar pension systems in most CIS countries further limits the demand for domestic debt and equities. Kazakhstan is to date the only example of successful three-pillar pension reform that contributes also to the development of non-banking intermediation.

Fortunately, there are signs of improvement. Bank lending and deposits are growing as a percentage of GDP, even as GDP itself it growing rapidly. The share of domestic credit allocated to the private sector has been increasing, implying better credit allocation decisions by financial institutions. Interest rate spreads have likewise been declining. But because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe and the Baltic states, financial stability in many CIS countries remains open to question.

The further development of the financial sector in CIS countries will largely depend on the reform agenda of their respective governments. Priority in this respect should be given to:

- Strict enforcement of legislation defining and protecting creditor rights;
- Protection of minority shareholders and disclosure of information on publicly trading companies;
- Protecting financial institutions from abuse by tax authorities; improving transparency of tax administration procedures;
- Strengthening discipline in bank supervision, especially with respect to large, state, and former-state banks;
- Discontinue tied lending practices and minimize government interference in the activities of financial intermediaries; and
- Reduce state ownership in the financial sector, particularly in countries where shares of state owned banks are extremely high.

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