

FINANCIAL SYSTEM STRUCTURE AND STABILITY DURING TRANSITION

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The process of transition from socialist economy to market economy was not considered an end in itself, but a necessity, and standing proof to achieve high levels of sustainable development. All former socialist countries are characterized by an early transition recession transformation result of the restructuring, loss of markets, tough competition from foreign products, best quality, or in other cases cheaper. To express the financial system structure in transition we take into discussion data that reflects representatives mutations and restructuring in Central and Eastern European countries, such Bulgaria, Czech Republic, Hungary, Poland and Romania. For all countries we show some important changes of financial system during transition and construct an image matrix that illustrates important indicators of financial system structure and their adjustment.

Keywords: financial system structure, financial system stability, transition, banking systems.

JEL: E44, G01, G21

Financial system functions and its role in assuring stability during transition

Functions of financial system

Modern economic analysis explains the existence of financial intermediation through the banking operation (as financial intermediaries), and specific functions lie in the function of reducing transaction cost, function to reduce information asymmetry by providing liquidity and the economy (Lobez, F., 1997, p. 191). The existence of financial intermediaries in the current economy allows the manifestation of their specific functions that are fulfilled and that the specific functions of the financial system (Fîrțescu, 2010, p. 161). The main functions of financial intermediaries found in the literature, are considered the following: function to transform the structure of attracted funds ("maturity transformation"), function "risk transformation", collection and distribution function (the resource - funds raised)

For the first function attributed the financial system, financial intermediaries can reduce transaction costs by making significant savings that come from specialization benefits financial intermediaries (Andreff, 2007, p. 12). When an intermediary specializing in one type of activity or a sector, this situation allows it to offer cheaper services tailored to customer needs. However, recording of important savings and diversified range of customer services. This is why financial intermediaries (in this case, banks) seeking to diversify their product offerings, so as to optimize the costs of intermediation (Andreff et al., 1998, p. 25),

Regarding the second function - reducing asymmetric information - should be considered the relationship between debtors and creditors, meaning that the latter have more information than the first. However, the financial intermediary guarantees confidentiality, which can be a decisive advantage for creditors. Because of these characteristics, financial intermediaries have a comparative advantage in funding made in the market. Among financial intermediaries, banks have crucial role in reducing asymmetric information as maintain long-term relationships with their customers by the very nature of functions performed.

The third function of providing liquidity concerns that the economy in an uncertain world, businesses need to hold liquid assets to meet two characteristics: their value must be stable and uncontested, respectively, are readily available to be transformed into goods and / or services. Liquidity insurance function, which is characteristic of banking intermediation is not possible unless the banking system has a high degree of organization and regulation, which gives banks a guarantee to the overall lack of liquidity risk, also known as systemic risk (Neave E.H, 2010, p. 10). In the financial system, banks as financial intermediaries perform a range of classic and

traditional features, types of operations aimed at closely linked, namely: loan distribution function, the function of collecting deposits, office management means of payment.

Role of financing during transition

The importance of the financial system is widely discussed in recent literature, being addressed in the interdependence of economic growth, resulting in the conclusion that the proper functioning of financial intermediaries have a significant impact on economic growth. In planned economies, the financing was achieved through administrative measures financial institutions present in the pre-planned economies in transition were banks, which acted as record-keepers for planning and paying agents among state enterprises rather than as financial intermediaries. Although these banks had appearances of real banks, they haven't worked as the banks from a genuine market based economy. There are many modes of financing and different types of institutions to facilitate these. The modes can be grouped into three broad categories (Bonin J, Wachtel, P, 2003, p. 2): entrepreneurial finance; bank lending (bank – based financial system); capital market financing (capital market based financial system). Economic literature discuss same types of financing, namely auto-financing or self-financing financing through banks, or through capital market. Recent approaches discuss the financing with the participation of financial intermediaries, referring at financial through banks.

As a conclusion, important authors suggests that in early stages of transition post-communist countries evolve from a central planned financial system to a bank-based financial system.

Financial system structure during transition and its stability

Data and indicators related to financial system structure

We take into discussion some data that reflects representative mutations and restructuring in Central and Eastern European countries, such Bulgaria, Czech Republic, Hungary, Poland and Romania. For all countries we take into discussion some important changes of financial system during transition and construct an image matrix that shows the most important indicators of financial system structure:

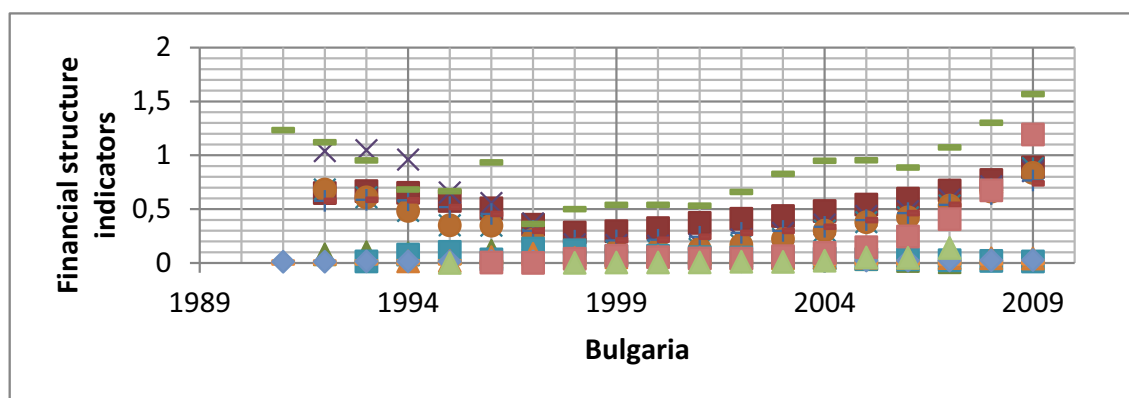


Bulgaria

The banking system in Bulgaria in the early years of transition faced many serious structural problems. At that time, two specialized banks dominated the banking sector in Bulgaria. Bulbank, state foreign trade bank, did not participate actively in the process of credit, resulting in that less than 1% of its assets were loans for non-financial sector. Spetstovna Derzhavna Kassa (DSK), bank and savings institution dominant sector was specialized mainly on transactions in government securities and interbank deposits as assets. Together, these two state banks constituted about half of total banking assets in Bulgaria. A financial sistem structure matrix,

composed by most important financial structure ratios is shown in graphic and table (data only for 2009) below:

Figure 1. Financial system structure in Bulgaria



Source: World Bank Database,

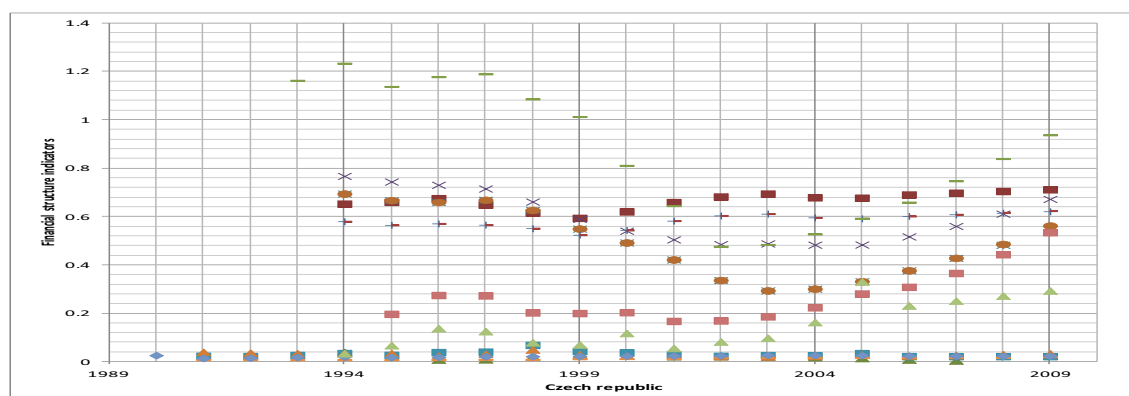
<http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html>.

Some observations results from figure 1: major indicators shows an improvement of financial system structure, and an increase of stock market capitalization - the indicator LIQUID LIABILITIES / GDP fluctuates from a minimum value in 1998 - 0.2822 to a maximum in 2009 - 0.8877 suggesting an increase of overall financial liquidity, indicator FINANCIAL SYSTEM DEPOSITS / GDP is within 0.2067 (1998) and 0.7388 (2009), illustrating an strengthen in bank financing.

Czech Republic

The early recapitalization of the four large state-owned Czech banks was a little avail. Major factor was identified as soft lending practices that continued even though banks passed accumulated bad debts to a newly created “hospital” bank. Some estimates suggest that the final cost of bank bailout in the Czech Republic was 30% of GDP as compared to just over 10 per cent for Hungary. In 1999, classified credits reached 32% of the total. Interestingly, the Czech government's protectionist policy had allowed domestic banks to maintain high spreads and, hence, they had the potential to be profitable. Although the banks could self-capitalize, they did not do so because soft lending practices and poor risk assessment continued. Nor did the several rounds of cleaning up the banks' balance sheets strengthen the big four Czech banks because they did not achieve independence either from the state or from their unrestructured clients. Financial sistem structure matrix indicators is shown in graphic below:

Figure 2. Financial system structure in Czech Republic



Source: World Bank Database,

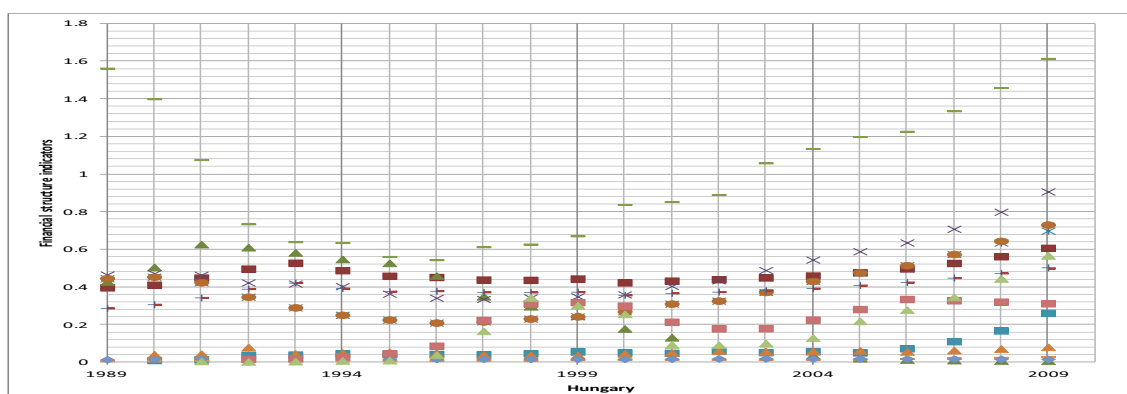
As figure 2 suggests indicators shows a lesser improvement of financial system structure, and an increase of stock market capitalization in 2008 and 2009- the indicator LIQUID LIABILITIES / GDP fluctuates from a minimum value in 1994 - 0.651 to a maximum in 2009 - 0.7103 suggesting a small increase of overall financial liquidity, indicator FINANCIAL SYSTEM DEPOSITS / GDP is within 0.5636 (1994) and 0.6228 (2009), illustrating an strengthen in bank financing.

Hungary

Hungarian bank with the largest exposure to loss-making industrial customers was buffet Magyar Bank (MHB). MHB's bad loan portfolio was put into a separate organizational unit, a bank within a bank, in an effort to recoup a portion of the loan. The remaining part of the good bank was privatized with a transaction was structured to attract a foreign strategic investor, which would increase the bank capital. Shortly after purchasing a package of 90%, ABN Amro subsidiary merged with MHB own Hungarian branch. Therefore, now bears the name MHB parent company is Dutch and financially with foreign bank. MHB's experience highlights the importance of shedding unwanted customers.

The largest Hungarian bank is now Kereskedelmi Bank Országos Takarékpénztár (OTP), National Savings Bank. OTP was privatized in 1995, but without a dominant strategic foreign investor. When the bank dominated the Hungarian retail market and although its market share declined, is still the largest retail bank and the largest bank in the country.

Figure 3. Financial system structure in Hungary



Source: **World Bank Database**

<http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html>

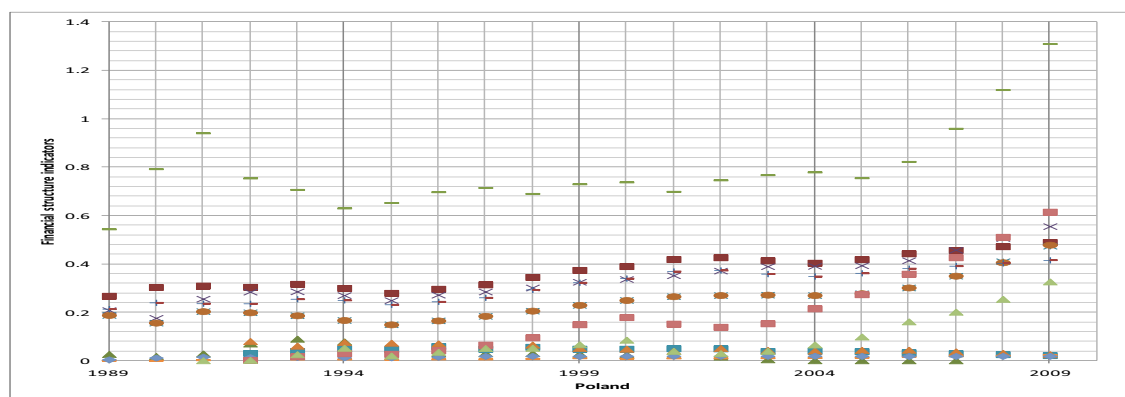
In concordance with Figure 3, in Hungarian financial system, a set of indicators almost double their an value: LIQUID LIABILITIES / GDP fluctuates from a minimum value in 1994 - 0.395 to a maximum in 2009 - 0.651 suggesting a boost increase of overall financial liquidity, indicator FINANCIAL SYSTEM DEPOSITS / GDP is within 0.286 (1989) and 0.4978 (2009), illustrating an strengthen in bank financing, suggesting that actions during transition had achieved their goals.

Poland

Polish banking sector entered a second phase in the late 1990s with a series of post-privatization consolidations (see Kokoszczynski, 2000). A series of mergers took place 1999 - 2001, in two of the four cases, foreign banks acquiring a portfolio of minority as part of the initial privatization process, then followed further acquisitions of shares before the merger. Poland has allowed foreign strategic investors to take controlling interests in the large commercial banks. At the end of 1994, foreign institutions controlled only 2.1% of Polish banking assets. By 2000, 63.7% of

commercial bank assets in Poland were held by banks controlled by foreign owners. The evolution of fsi is presented in Figure 4.

Figure 4. Financial system structure in Poland



Source: World Bank Database,

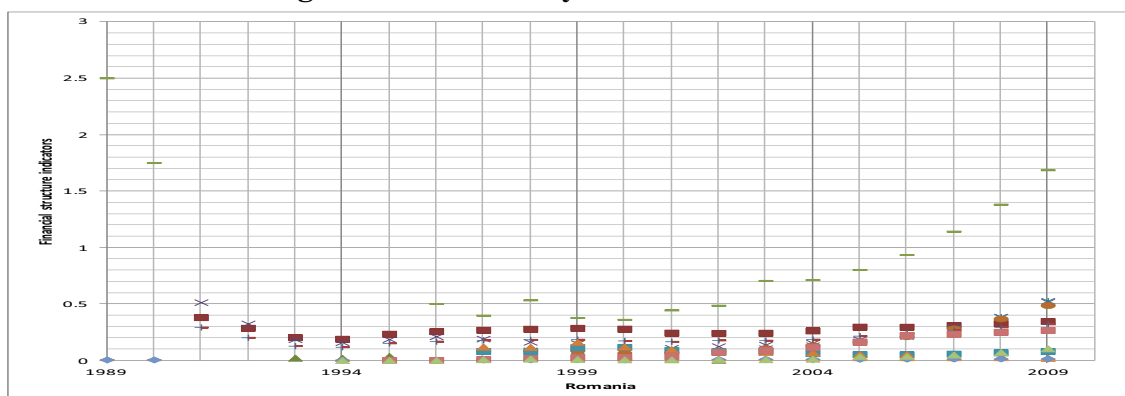
<http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html>

As displayed in Figure 4, a set of Polish financial system indicators almost double their value: LIQUID LIABILITIES / GDP fluctuates from a minimum value in 1994 - 0.2672 to a maximum in 2009 - 0.651 suggesting a boost increase of overall financial liquidity, indicator FINANCIAL SYSTEM DEPOSITS / GDP is within 0.214 (1989) and 0.4164 (2009), illustrating an strengthen in bank financing and largest improvement (of all analyzed countries related to stock market capitalization to GDP – 0,6149.

Romania

The structure of the financial system, before 1990, in Romania was similar to that of other centralized economies. Since 1991 the Romanian financial system metamorphosis took place at the changes taking that premise to introduce a system organized on two levels - National Bank of Romania, the central bank independent, commercial banks - and banking legislation that boosted the role of commercial banks in the economy, a role closely related to their role as principal intermediary in relation to savings - investment, crucial to economic growth relationship. In Romania, the funding system was heavily dominated by the banking sector, here manifested prominent financial intermediation. Dominance of the banking sector in financing the economy is explained by several factors such as underdevelopment of capital markets, taxation still disadvantageous exchange, saving more attractive offers banking, investment culture, etc. Financial market development and growth is observed market capitalization to GDP. An overview of financial system structure is presented below:

Figure 5. Financial system structure in Romania



Source: World Bank Database,

As displayed in Figure 5, indicators in 2009 are closer to values from 1991: LIQUID LIABILITIES / GDP fluctuates from 0.3804 in 1991 depreciated to 0,3454 in 2009 - 0.651 suggesting a boost increase of overall financial liquidity, indicator FINANCIAL SYSTEM DEPOSITS / GDP is within 0.2932 (1989) and 0.3212 (2009).

Conclusions

An important conclusion concerns the need of breaking the linkage between banks and uncertain customers. For small countries, Hungarian experience indicates that foreign participation in bank privatization is an effective approach to a strong financial system. Hungary was the first to apply this rule, followed by Poland, which experienced a series of bad experiences and the Czech Republic that finally focused in this direction. Another conclusion refers to the importance of proper control of banking institutions. Experiences indicate the importance of developing the regulatory structure, especially in unstable macroeconomic environment. Hyperinflation leads to disintermediation and a significant contraction of the monetary base of the economy. Macroeconomic stability and stronger banking supervision are necessary conditions for the restoration of banking sectors in these countries. The experience of transition economies, large and small, fast or not, indicates that the entry of many private banks undercapitalized promote systemic instability. For small countries, open foreign participation in domestic banking sector is a more effective means of promoting both competition and sector development. However, stability is a prerequisite for sufficient foreign capital entry and strong regulation is a necessary condition for effective supervision, but also require large amount of resources and know-how to complement legislation. Larger economies have greater flexibility in designing efficient banking sectors. Bulgaria or Romania were forced to a quick reform their banking systems as quickly as possible to meet the major objective of EU accession. This objective required the development of a regulatory system that respects the guidelines of the EU and opening the domestic banking sector to foreign competition.

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