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SUMMARY OF THESIS

Eszter Kazinczy

THE DEVELOPMENT OF THE BANKING SECTOR AND ITS MACROECONOMIC ENVIRONMENT IN SOUTHEAST EUROPE

Ph.D. thesis

Supervisor:

István Benczes, Ph.D.

Budapest, 2012

Department of World Economy

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Contents

1. Subject of the thesis

The region of Southeast Europe[1] (SEE) has growing importance from various aspects. The reviewed countries can serve as a rich case study for other emerging regions. During the specific time periods, the various challenges and applied policies provide useful lessons. From the international organisations' point of view, the interest is to stabilise and develop the region both in a political and economic sense. The aim is to avoid any security hazard in the area, and gain economic advantages in a region which is on its path to catch up with the more advanced European regions. SEE remains in the focus particularly from the aspect of EU policies, not only because of its geographical closeness, but also due to the strong economic linkages that have been built in the previous years. Furthermore, all countries in SEE participate in the EU accession process, which also means that economic integration becomes a core element. This consists of supporting the economies' real convergence, opening up the markets and harmonising the institutional framework. The dissertation analyses a pillar of this economic process, namely the banking sector's development in SEE.

In every well-functioning market economy, the financial sector has a primary role. In an environment of various market frictions, it supports the efficient allocation of resources, thus bolsters economic growth. Nevertheless, this link is rather bidirectional, as financial development and economic growth influence and reinforce each other. The financial sector is able to cause or contribute to economic downturns, but can also act as stabilising and growth enhancing factor within a well-functioning system. In case of SEE, where the banking system became dominated by large European banking groups, further vital impacts can also be stressed. During the transition process, foreign banks channelled various benefits and resources to the region, they increased the system's capitalisation, enhanced competition, contributed to financial deepening and product innovation, and last but not least, they had an important role in restoring public confidence in the banking sector. On the other hand, foreign banks had a specific impact on various systemic risk factors that became particularly relevant during the global crisis.

[1] Throughout the thesis, SEE refers to the region of Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia and Kosovo. This covers the successor states of the socialist Yugoslavia, but excludes Slovenia and includes Albania. It is important to underline, that although Kosovo's status is disputed by various international actors, here it is treated as a separate country case. When reviewing the socialist time period, SEE covers two countries; Albania and SFRY. The SEE term is used in the jargon of the EU and refers to the region of the candidate and potential candidate countries. SEE is often used as a synonym for the "western Balkans" even in the EU jargon.

When referring to the financial development, the dissertation covers the features of the commercial banking sector, due to the fact that other segments merely have supplementary or minor role. So for instance, the capital market, microfinance institutions, the insurance segment, pension funds and various financial auxiliaries are omitted from the analyses, despite the fact that in certain country cases they have a notable role. Still, it is undisputable that in SEE the financial sector is dominated by the banking sector and can be characterised by a bank-based model, and this feature can be considered persistent. Nonetheless, besides focusing on the banking sector, the most relevant macroeconomic developments are also reviewed for better understanding. The development of the broader economic framework and macroeconomic environment go hand in hand with the development of the banking sector. However, within the dissertation special attention is not given to other important related topics, such as the regulatory and supervisory framework or the corporate sector's restructuring and development.

The dissertation covers the time period starting from the end of the Second World War and ending with 2010, a year of the latest global crisis. Within this timeframe, four blocks can be well separated, providing the ground for the four main chapters of the thesis. The first discusses the socialist time period from the end of the Second World War until the fall of the socialist regimes, covering two peculiar country cases; Albania and SFRY. The goal of this chapter is to demonstrate, that despite the completely different socialist models, both systems have left behind similar legacies and challenges for the transition period. Both countries could be considered unique prototypes within the European socialist bloc, which is revealed during the analysis with the help of Kornai's model of the main line of causality. This model helps to overview the complete framework of the economies, including also the political background and motivations. Albania implemented a classical socialist model, and remained loyal to it throughout the socialist time period. From the late 1970s, Albania chose complete isolation from the rest of the world and remained the poorest country in Europe. SFRY could be considered the other extreme, as it step by step developed its unique model of workers' self-management, and implemented various market economic elements to its system. Nevertheless, the impacts of these elements were always restrained by related regulations. This can be considered as the primary reason for the fact, that despite the two extremely different models, the broader economy and the banking system in both countries inherited similar legacies from the socialist times, and had to tackle almost the same challenges during the transition period.

The second chapter[2] discusses the transition period of SEE, covering seven country cases due to the dissolution of the former-Yugoslavia. The aim of this chapter is to prove, that despite the different starting points – meaning e.g. the initial sectortal structures or the level of economic development – the applied economic policies and the historical circumstances, by the end of the transition process the banking sector's structure became similar in all SEE countries. In this chapter, the most relevant features are demonstrated by the transitional recession, as the important transitional characteristics culminate in this phenomenon, and it is particularly important also from the aspect of the banking sector. During this time period – besides the "classical" transitional tasks – the countries had to face various different challenges, such as the gradual succession of SFRY coupled with military conflicts, civil unrest or embargos. In addition to these circumstances – which can be considered here as exogenous events – each country had its own specific transitional process with different starting conditions, implemented reform measures, sequencing and duration, all leading to great time and development differences within SEE. Moreover, in almost all country cases, more than one systemic collapse occurred, so the transition process rather became a non-linear, long-term and gradual process. These apply not only for the macroeconomic framework, but also for the banking system. However, finally, a rather similar template could be drawn for the outcome of the sector's development structure, with large foreign banking groups playing a pivotal role. This similarity could be explained by the mutual challenges and the financial globalisation.

The first two main chapters provide the background and core information for understanding the further and latest developments of the banking sector. The third chapter[3] analyses the so-called "catching-up" period between 2000 and 2007. The primary goal in this case is to find a common model for the development of the sector in SEE during this period, as an outcome of

[2] Part of this chapter will be published in an edited version:
Kazinczy, Eszter (2013a): The transition times of the banking system in south-eastern Europe. From systemic collapse to stabilisation. *Köz-Gazdaság*, Budapest, Faculty of Economics at the Corvinus University of Budapest, expected date of publication: February 2013

[3] Part of this chapter will be published in an edited version:
Kazinczy, Eszter (2012): The catching-up of the banking sector in south-eastern Europe. A fragile development model dominated by credit growth. *Society and Economy*, Journal of the Corvinus University of Budapest, Budapest, Akadémiai Kiadó, expected date of publication: first semester of 2013 (online version expected from December 2012)

the analysis. This model links the banking sector with its macroeconomic environment, and reflects the primary systemic risk factors. As a further outcome of the analysis, the chapter also reveals specific regional characteristics. The “catching-up” term can refer to the path of converging to the EU’s income levels or proceeding with the EU accession process and applying the required institutional standards. In the thesis, catching-up refers to the convergence of income levels and financial deepening. The former is simply defined and measured by the GDP per capita levels, while the latter is demonstrated by certain banking indicators, such as the ratio of total banking assets in percent of GDP. Drawing the border between the transitional and “catching-up” period is not clear-cut, because there is no strict rule for defining the end of transition, and the process differs to a great extent among the country cases. Nevertheless, regarding the banking sector and its macroeconomic environment, a wide range of characteristics can be well grouped to the pre-global crisis years. In order to represent some of the fundamental characteristics of the banking sector from a micro-level, a case study has been added to this chapter, including the local subsidiaries of two large European banking groups.

Last but not least, the fourth main chapter[4] analyses the most relevant impacts of the global crisis on the region between 2008 and 2010, as the period of data collection has been closed by early 2011. The aim of the chapter is to demonstrate, how the simplified growth pattern of the “catching-up period” collapsed in SEE as a result of the turmoil. During the analysis, the most important common and differentiating features – such as the pace of financial deepening or the applied exchange rate policies – are being outlined, and a number of fundamental questions are being raised that ought to be answered in the near future. In the thesis, the “global crisis” term always refers to the latest global crisis, which started from the “Western” markets and reached SEE by the end of 2008 with its side effects. The strong interconnection between the macroeconomic conditions and the financial sector became very plausible again. Following the years of certain stability, the banking sector in SEE had to tackle extraordinary challenges, such as waves of deposit withdrawals, deteriorating loan portfolios or the risk of a sudden stop in foreign financing. After the period of rapid credit expansion, sharp drop of credit growth was recorded, that could be explained by a number of factors both on the

[4] Part of this chapter will be published in an edited version:
Eszter Kazinczy (2013b): Crisis period in the banking sector of Southeast Europe. The collapse of the former models. *Köz-Gazdaság*, Budapest, Faculty of Economics at the Corvinus University of Budapest, expected date of publication: February 2013

demand and supply side. Within the chapter, a brief case study illustrates some of the sectoral developments from a micro perspective.

The dissertation goes beyond a simple descriptive work and analyses the topic within the specific time period with a range of methodological tools. In order to provide a framework for this analysis, we use the following main hypothesis:

1) Although the countries of SEE had substantially different trajectories during the socialist and transition time period, a similar financial system has been built up by the end of the transition process, due to the similar challenges and financial globalisation.

As already mentioned by the brief discussion of the four main chapters, despite the different legacies from the socialist system, the reviewed country cases had to face similar challenges and tasks at the start of the transition process. Nevertheless, even within the group of the former-Yugoslavian countries great differences evolved. During the succession, their development paths started to diverge. This could be explained by the different historical circumstances, political attempts and applied policies. A certain kind of systemic collapse occurred in all cases, which always shifted somewhat the further development path. Although with great lags, but the countries faced similar challenges, which finally became addressed by similar policies. It is important to stress, that this similarity cannot be considered self-evident, as for instance Slovenia or other transition countries were able to create a different kind of structure within the banking sector. Also the initial attempts of the reviewed cases pointed to different directions. To sum up, the thesis proves that the countries of SEE had to face similar tasks and challenges during the transition process, which finally became addressed by similar policies. These created a specific structure within the banking sector, which led to a common development pattern in the region. This is particularly valid for the activity of the banking sector, but from certain aspects even for its macroeconomic environment.

Besides the hypothesis, there are two main theses or assumptions, which can be well defined. The reason for highlighting them is the fact, that they are discussed within almost all chapters. This is due to the fact, that these two topics are core elements of the banking sector’s development in SEE.

1) As it can be proved for other regions in the world economy, there is a positive correlation between financial development and real GDP growth in SEE.

Generally speaking, a broad literature analyses the correlation between these two elements.[5] As it has already been mentioned, in case of SEE the financial sector is dominated by the commercial banks, so it is rather the banking sector that needs to be analysed. It is very clear, that macroeconomic stability – strongly related with real GDP growth – and financial development go hand in hand. Following the socialist time period, when banks primarily had merely administrative tasks, the banking sector played a significant role within the economic development. When the sector was able to fulfil its market-oriented primary roles, it was able to underpin the general economic development through various fields. On the other hand, during the times of transitional stabilisation, restructuring or crises, it has put extra burden on the fiscal authorities and contributed to the downturn of the economies.

2) Foreign-owned banks played a pivotal role in the banking sector's development in SEE.

As reflected by the hypothesis, the banking system's development reflected a similar pattern in the countries of SEE. The financial development's structure and main features has been determined by foreign investors to a great extent. Once reviewing the structure of the banking sector, it becomes obvious that banks with foreign-ownership exceeding 50% gained dominant positions in the region. The large international banking groups fostered the transitional process of the sector, bolstered financial deepening and contributed to its positive and negative side-effects. This implies that the foreign banks' role ought to be discussed during the analysis of the development. It can be concluded, that the motto of the thesis refers to this latter assumption as well. Exporting stability to SEE can be considered as a well underpinned long-term goal not only from the IFIs point of view, but also from the aspect of large international banking groups present in the region.

The dissertation would like to contribute to the literature on the commercial banking sector's development in SEE, including the relevant analysis of its macroeconomic development. The thesis highlights the most important common and differentiating regional characteristics, and

[5] For a comprehensive overview, see for instance Levine (2003).

– based also on the relevant literature – compiles a general, bank-based economic model for the pre-crisis period. This model stresses the direct link between the banking sector's activity and certain macroeconomic developments. Despite the importance of the topic, the respective literature can still be considered somewhat rare. The region is most often reviewed from a historical point of view. The banking sector of SEE is usually discussed within the group of transition countries. Several publications of the EBRD, the Österreichische Nationalbank or Barisitz (2008) can serve as good examples. A further group of literature analysis a specific time period in SEE, such as e.g. Šević ed (2002); Sjöberg – Wyzan eds (1991) or Uvalic (2010). The literature also provides various country-specific works, see for instance Singleton (1976); Fink et al (2007) or Gligorov (2007). Nevertheless, currently we are not aware of any literature that comprehensively analysis the topic of the thesis within such a broad time span, and dedicates great attention to the macroeconomic environment during the analytical work.

2. Applied methodology

Throughout the dissertation, comparative analysis is used as a primary tool for the analytical work. Nevertheless, the thesis is multidisciplinary, because it includes elements from various scientific fields; generally economic development, macroeconomics, finance, transition economics and Kornai’s system paradigm are used, but historical and political background information are also included occasionally for better understanding. With the help of these mentioned fields, both the banking sector and its macroeconomic environment are analysed. The reason behind this is the strong link between the two. The activity of the banking sector is determined by its macroeconomic conditions, and the other way around, the macroeconomic environment is influenced by the banking sector. Nevertheless, the focus always remains on the banking sector during the analyses.

According to the requirements, the above mentioned scientific fields are used with different weights in each chapter. In case of the first three time periods – namely the socialist, the transition and the pre-crisis years – different methodologies are being used. This can be explained by the completely different systemic backgrounds, the different role of the banking sector, the available datasets and the specific challenges. In case of the period dealing with the effects of the global crisis, almost the same tools can be used for the analytical work as in the pre-crisis chapter.

In case of the socialist time period, two countries are being compared – Albania and SFRY – between the end of the Second World War and the fall of the socialist regimes. In both countries, the complete political and economic model determined the activities of the banking sector. This is the reason, why it is inevitable to analyse and understand the specific systems from a broad perspective. Also due to the lack of relevant banking sector datasets, the qualitative analysis remains dominant within the chapter. The literature on socialist models and on the specific countries is used as the base for the overview, while Kornai’s model on the main line of causality provides a framework for the analysis. Following the review of the classical socialist system as a starting point, the Albanian and SFRY’s prototypes are being compared, with a separate section on the respective banking systems. Various comparative tables are compiled to help to summarise the main differentiating and common characteristics.

Due to the dissolution of former-Yugoslavia, in case of the second time period the sample is expanded to the group of seven countries; Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Kosovo, Montenegro and Serbia. A strict time frame cannot be drawn for the transition period, as the starting date and duration of the fundamental changes differed in all cases. Noteworthy, that in certain aspects the transition process has still not been concluded. The relevant literature on transition policy, on banking sector transition, on the role of foreign banks and country analyses help to review the main developments. The most important features of the transitional recession provide a guideline for the analyses of the macroeconomic framework. Based on the review of the local policies and respective features, the chapter's last section includes a comparative analysis of the development process. Finally, the available banking sector data and charts help to illustrate the main features of the sector's structure within the last section. These data are compiled from the EBRD Transition reports, EBRD statistics and the respective central banks' databases.

The next chapter analyses the pre-crisis years, which is dubbed within the thesis as the "catching-up period". The seven countries are reviewed between 2000 and 2007. The starting date can be marked as the first year, when the market economic developments evolved in all cases, although the transitional process just took off in certain countries. As for the closing date of this period, it was 2007 until the booming years could be observed. The comparative analysis is based on a comprehensive dataset of country level banking sector and macroeconomic data. These are downloaded from the respective central banks' statistics, the IMF, the EBRD, the BIS and the European Commission's Eurostat databases, or are based on own calculations. One-off or exponential effects are usually omitted by using the average or the CAGR indicators of the reviewed period. Certain figures contain the average of the last three year's data, also in order to analyse the most flourishing years. The paper includes various scatterplots to illustrate the most important links. The number of observations is too low for regression analyses, but still, the trends and the connection between the variables can be well illustrated. Also in order to increase the number of observations, the EA is included to the calculations. As an indication, the respective R^2 is always added to the chapter's scatterplots.

Within this chapter, the EU is usually included to the quantitative analysis, for the sake of comparison and to demonstrate the catching-up process. However, in case of the banking sector's analysis, the EU is substituted with the EA, which can be treated as a more developed sub-region. The background of this substitution is the fact, that the broad range of financial data is rather available for the EA. Furthermore, the latter can be considered as the region where SEE and the NMS are aiming to catch-up with. In certain cases, the EU data are divided into two sub-regions, where the EA represents a more "developed" area, while the NMS illustrates the transitional region. All in all, the conclusions of the sectoral and macroeconomic analyses, and the relevant literature – including e.g. European Commission (2009) or Sorsa et al (2007) – help to compile a common, bank-based economic model for the reviewed period valid for all SEE countries. This model links the banking sector with its macroeconomic environment, and reflects the primary systemic risk factors.

Finally, the chapter also contains a case-study to highlight the most important sectoral features from a micro-level perspective. This overviews the main, local subsidiaries of two large, EU-headquartered banking groups; Raiffeisen Bank International AG and UniCredit Group. The required data for the analysis have been downloaded from Bankscope, while the banks' respective annual reports supported the interpretation of the figures. The data have been reviewed from 2005, due to the fact that this was the first year when both banking groups entered all of those SEE countries where they are currently present. This implies that Raiffeisen's subsidiaries in Albania, Bosnia and Herzegovina, Croatia, Kosovo and Serbia can be overviewed, while in case of UniCredit, the local banks in Bosnia and Herzegovina, Croatia and Serbia can be analysed.

Turning to the chapter on the effects of the global crisis, the applied methodology can be considered similar to the previous chapter's methodology. In this case, the seven countries are being analysed between 2008 and 2010. In order to illustrate the changes, country-level banking sector and macroeconomic data are being compared. The analysed data are downloaded from the respective central banks' databases and from the IMF. Various charts help to review and compare the shifts of the indicators and the entire economic system. Most charts also contain the data from 2007, in order to demonstrate the pre-crisis levels as a starting point. The comparative analysis and the relevant literature help to illustrate how the bank-based, pre-crisis growth model collapsed during the financial stress. The compiled chart demonstrates how the model's base and each of its building blocks have been affected by the crisis. Finally, also this chapter contains a brief case study, including the same banks and applying the same methodology as in the previous chapter.

Generally speaking, the dissertation can be considered as an empirical work, where the analyses imply both qualitative and quantitative methodologies. In the latter's case, it is very important to emphasis that the comparison of the exact data might be somewhat influenced by methodological differences. Bearing this in mind, outlining the main features and tendencies is still possible. Last but not least, it should be mentioned that the analyses are generally inductive, as the thesis tries to underpin the initial assumptions with the above mentioned methodologies.

3. Key findings

3.1. Diverging development during the socialist time period

The first main chapter compared two odd socialist prototypes, Albania and SFRY. The former could be considered unique for its constant loyalty to the classical socialist system and its isolation from the rest of the world. The latter gradually created its own special prototype, which included both market oriented and socialist elements. By the 1970s, SFRY shifted closer to a capitalist model, but limited the market-oriented mechanisms by administrative measures. All in all, the two countries could be considered as two extremes within the socialist bloc. Table 1 summarises the fundamental differences between the two models. The table reflects, that such underlying features as the ownership structure or the planning mechanisms differed in the two countries. This compilation is based on the literature of e.g. Gligorov (1998); Kornai (1992); Lavigne (1999); Lydall (1984); Schnytzer (1982); Singleton (1976); Sjöberg – Wyzan, eds (1991); Vaughan-Whitehead (1999).

Table 1: Main differentiating features between the Albanian and SFRY's economic model

	Albanian model	**The model of SFRY** (all valid from the 1970s)
Ownership	State-ownership	Social-ownership
Planning	Central planning system	Social plans
Employment aims	Full employment	No such central aims
Investment priorities	Favouring labour-intensive investments	Favouring capital-intensive investments
Wage constraints	Limited by central plans	Room for bargaining
Managers' dependence	Dependence on superiors	Dependence on superiors and subordinates
Disposal over the firms' own profits	No	Yes

Source: Own compilation

Besides these fundamental elements, the features of the banking system demonstrated basic differences, just as the two countries' general development paths. The relevant literature – including e.g. Barisitz (2008); Clunies-Ross – Sudar (1998); Gedeon (1987); Lydall (1984); Singleton (1976); Vaughan-Whitehead (1999) – provides a good overview on the socialist banking systems' main characteristics. Based on the information, Table 2 compiles the most important (differentiating) features. The table illustrates that the two banking models could be considered completely different. Albania implied a one-tier banking system, which merely had administrative role. On the other hand, SFRY had a two-tier system with a commercial banking sector gradually gaining more and more independence from the bureaucracy. Various capitalist elements have been included to the system, but due to the indirect administrative restrictions, market mechanisms were not able to rule the system.

Table 2: Main differentiating features between the Albanian and SFRY's banking model

	Albanian model	**The model of SFRY** (all valid from the 1970s)
Two-tier banking system	-	√
Bank management led by bureaucracy	-	~
Disposal over the banks' own profits	-	~
Competition in the banking sector	-	(Only in theory)
Channelling savings to investors	-	√
Existence of capital market elements	-	√

Note: - Nonexistent, ~ Partly existent, √ Existent

Source: Own compilation

3.2. Similar challenges before the transition

Table 3 demonstrates, that despite the fact that SFRY implemented various capitalist elements, neither of the two countries' banking sector fulfilled the market oriented functions. It can be concluded, that the banking systems had limited or no experience in banking in a "real" economy, in the credit evaluation and risk management methods, in international accounting or as financial intermediaries. All these imply, that although the development of the two countries diverged, the banking sectors' legacy could be considered similar by the end of the socialist time period, meaning that similar challenges had to be addressed during the transition process. This conclusion can be considered the most interesting finding of the chapter analysing the socialist time period.

Table 3: The role of financial intermediaries in a market economy

	Albanian model	**The model of SFRY** (from the 1970s)
Improving risk management	-	-
Efficiently allocating resources	-	-
Absorbing financial and real economic shocks	-	-
Monitoring managers and exerting corporate control	~	~
Mobilising savings	-	~
Facilitating the exchange of goods and services	√	√

Note: - Nonexistent, ~ Partly existent, √ Existent

The categories of the table are gained from the work of Levine (1997) and ECB (2010b).

Source: Own compilation

3.3. Gradual convergence to a common banking structure

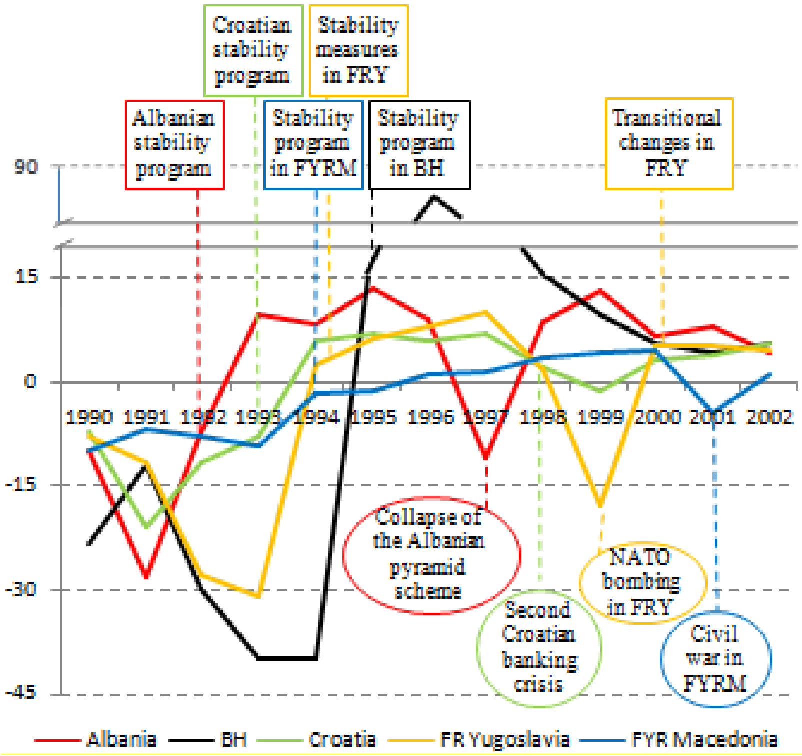
During the years of transition, Albania and the successor states of former-Yugoslavia had to face the "classical" transition tasks. However, the latter group of countries were also affected by the dissolution of a single system, coupled with devastating military conflicts and embargos. Neither of the reviewed countries could achieve long lasting macroeconomic stability and certain systemic collapse occurred in all cases. These internal shocks required more than one stability package during the transition process. Based on the relevant macroeconomic time series and literature – including e.g. Bicanic (1996); the EBRD's Transition reports; Pashko (1996) or Šević et al (2002) – the analysis reveals three groups of factors that differentiated the countries of SEE during the transition period:

- the initial development level, institutional system and self-sustainability,
- the impacts of military conflicts, sanctions and embargos,

- the starting date, sequencing, duration and methods of the stabilising and restructuring policies.

These factors increased the heterogeneity among the SEE countries and caused great lags regarding the transition process. The analysis demonstrates that the transition was a non-linear, long-term and gradual process in all country cases. These facts are illustrated by Chart 1 via the real GDP growth rates and the dates of the respective stability programs.

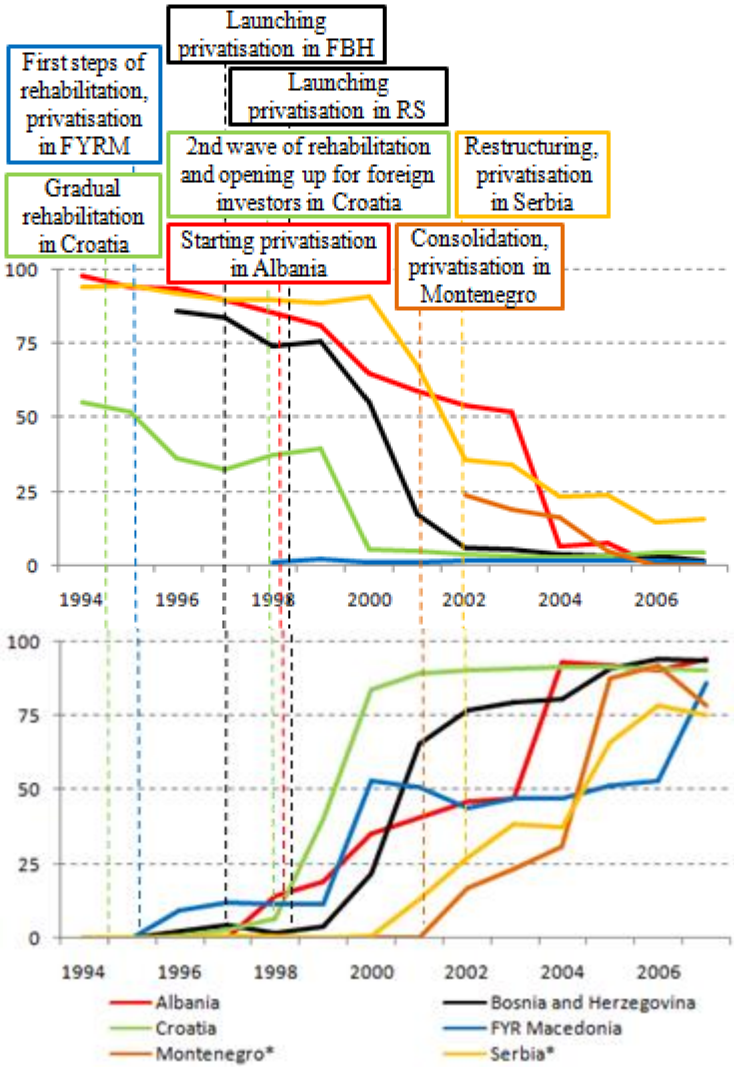
Chart 1: Real GDP growth in SEE during the transition process (%)



Source: EBRD Transition reports (various years) and EBRD statistics

As for the banking sector itself, a range of internal and external shocks affected its activity. In certain cases the authorities had to face more than one banking crisis or the collapse of large pyramid schemes. These caused major shockwaves or even the meltdown of the financial system. With the help of the literature – including for instance Barisitz (2008); Fries – Taci (2002); Keren – Ofer (2003); Pashko (1996) or Šević et al (2002) – it can be concluded, that the methodology, pace and sequencing of the sector's restructuring showed great variety. However, by the end of the transition process the institutional structure of the sector became similar. The main finding for the transition time period is the fact, that despite the great differences of the starting points, a common regional temple could be specified for the banking sector's development: following a systemic collapse, large European banking groups penetrated the local markets and gained terrain at an initial phase, and contributed to the sector's transition process from various aspects. Chart 4 demonstrates the changes of two fundamental indicators – namely the asset share of banks with state ownership exceeding 50% and the asset share of banks with foreign ownership exceeding 50% – and the cornerstones of the sectoral restructuring.

Chart 4: Decreasing asset share of banks with state ownership exceeding 50% (%) and increasing asset share of banks with foreign ownership exceeding 50% (%)



*1994-2001: FR Yugoslavia

Note: Time series are not available for Kosovo, but for instance in June 2010 the share of foreign-owned bank assets amounted to 89.8% of the total banking sector assets [CBK, 2010, p. 28].

Source: EBRD Transition reports (various years), EBRD statistics and the respective central banks' homepage

Generally speaking, the banking sector played a substantial role during the transition time period. As a negative factor, during the sector's stabilisation and restructuring, it has put extra burden on the fiscal authorities. On the other hand, once it was able to fulfil its market-oriented primary roles, it was able to support the economic development in various fields. Chart 4 illustrates that during the transition process the asset share of banks with majority foreign ownership converged to the range over 75%. By the second half of the 2000s, the number of banks stabilised in the region, while the market concentration became high. These imply, that the sector became dominated by a narrow group of large European banking institutions, whereas these banks had a primary role during the banking sector's transition process. Foreign banks transferred various benefits and resources, and enhanced competition. They contributed to the banking sector's penetration to everyday life both horizontally and vertically. As a further factor, they had an important role in restoring public confidence in a region where large part of the population experienced multiple banking crises or shock waves. Furthermore, foreign banks helped to underpin the system's stabilisation, as NPL ratios gradually decreased, while the capitalisation reached fair zones. All in all, the foreign banks' role could be considered rather positive during the transition time period.

3.4. Similar characteristics during the pre-crisis period

Following the years of transition, the reviewed countries' development demonstrated a range of underlying common features, which made SEE a unique region within Europe. The thesis highlights these characteristics via the analysis of a comprehensive dataset and the relevant literature – as for instance, Backé – Walko (2006); the EBRD's Transition reports; European Commission (2009) or Sorsa et al (2007). The following list summarises the most relevant statements for the pre-crisis period:

- Regarding both the banking sector's development and economic growth, a significant convergence process took-off. We highlight – thus underpinning one of the theses of the dissertation – that the well-known correlation between the indicator of the total assets per GDP and the GDP per capita was valid for the case of SEE as well.
- As for further relevant macroeconomic indicators, current account deficits and unemployment rates could be considered very high, while inflation rates reached fair levels with the exception of Serbia.

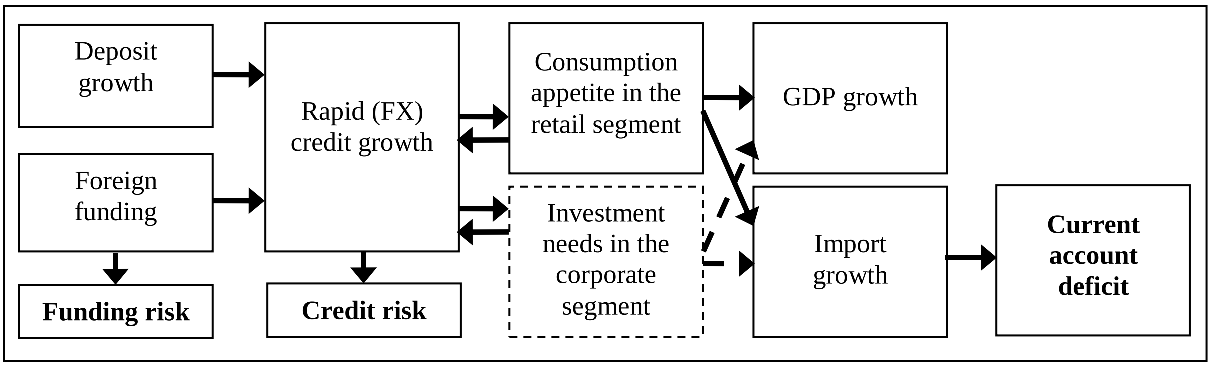
- The banking sector's main KPIs converged to a common zone, including positive profitability indicators and gradually decreasing interest rate spreads. We reveal that the NIMs showed negative correlation with the degree of financial intermediation in the region. Significant capital buffers have been built, while NPL ratios continued to decrease. Noteworthy, that the provisioning policy reflected significant differences within the region.
- Though there is no strict rule for defining the category of excessive credit growth, the rapid pace of credit expansion raised concerns on asset quality and overheating. The credit growth boosted the domestic demand, which underpinned the GDP growth, but also led to various vulnerabilities.
- As a general transitional feature, the gradual crowding-in of the private sector lowered the public sector's share within the loan portfolios.
- Confirming the finding of Backé – Walko (2006), one of the most specific regional characteristics was the fact, that the FX usage was very high on both the asset and liability side. The exceptions were those countries where the euro is being used as a sole legal tender. This somewhat dampened the respective FX risk of the banking sector. Nevertheless, it is an important outcome of the analysis that the applied exchange rate policies did not reflect the degree of FX usage.
- In line with the statement of Backé – Walko (2006), we state that large share of the rapid credit growth has been financed by the swift deposit growth.

It must be emphasised, that during the analysis the dissertation also reveals significant differences among the countries. This refers to the level, structure and quality of the financial deepening. These differences could be explained by the initial conditions and the applied policies. For instance, Croatia could be considered the most developed country within the region, while Kosovo the least developed from various aspects. Serbia remained a latecomer, due to the lost decade of the 1990s. Montenegro became an outlier with the extreme pace of financial deepening, whereas Bosnia and Herzegovina and FYR Macedonia recorded a rather modest growth pace.

3.5. The growth pattern of the pre-crisis period

Based on the mentioned common characteristics, the analysis of the respective data and the relevant literature – e.g. Backé – Walko (2006); European Commission (2009); Sorsa et al (2007) and Vamvakidis (2008) – the thesis compiles a common growth pattern for the region. The model is in line with the well-known problem of pro-cyclicality in bank lending. This pattern also helps to highlight the links between the banking sector and its macroeconomic environment. Chart 5 summarises the main elements of this model in a simplified form. From the banks' point of view, foreign funding and deposit growth underpinned the rapid – often meaning FX – credit growth. As the retail clientele generally had a lower level of disposable income than the propensity to consume, there was a strong demand for loans. On the other hand, the available loan possibilities boosted the household consumption, so the link here was bidirectional. Due to the fact that investments rather had a secondary role, its category is drawn with broken lines in the chart. All in all, these factors fuelled the GDP growth, but also led to large import demand causing soaring current account deficits. This simplified growth model highlights three main risk factors, all written with bold letters in the chart. From the banking sector's side the funding and credit risk should be stressed. The latter refers to the credit quality and the FX risk of unhedged borrowers. From a macroeconomic perspective, the mentioned high level of external imbalances is emphasised. These vulnerabilities became particularly relevant as the first waves of the global crisis reached the region and the illustrated fragile growth pattern collapsed.

Chart 5: A fragile growth pattern



Source: Own compilation

3.6. The collapse of the pre-crisis growth pattern

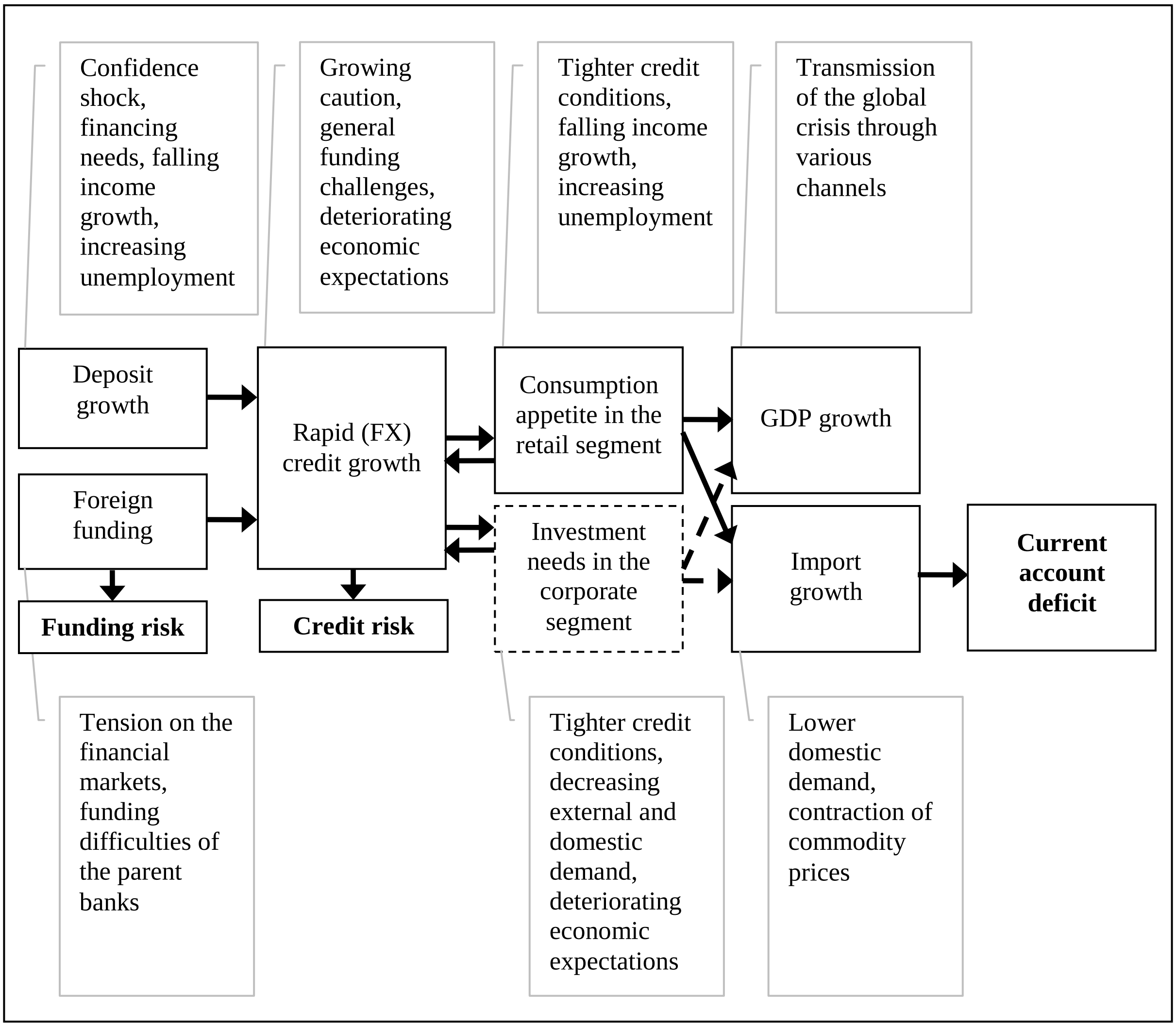
Likewise on a global level, the financial sector in SEE had to face extraordinary challenges as the impacts of the crisis reached the region:

- Due to the widespread confidence shock, waves of deposit withdrawals had to be stopped.
- Also as a result of the negative feedback loops between the real economy and the banking sector, the continuously deteriorating loan portfolios had to be handled. Profitability sharply dropped in the region, though usually remained positive.
- The banks had to face the risk of a sudden-stop in foreign financing. However, during the reviewed time period, parent banks continued to maintain their exposure to their subsidiaries. All in all, during the first years of the crisis the foreign banking groups played at least a neutral or even a positive role, which also reflected their long-term interest in SEE.

As a general feature, a sudden-stop or adjustment occurred in the former financial deepening process in terms of total assets and loans. Nevertheless, the banking sector avoided a systemic meltdown as a result of the former capitalisation, the local authorities' measures, and the international response from private and official institutions.

Due to the widespread negative impacts, the illustrated pre-crisis growth pattern collapsed during the crisis. The intensifying risk aversion and confidence shocks, the deteriorating economic conditions and expectations led to basic changes both on a domestic and international level. As a result, the system's base – the deposit growth, the foreign funding or the credit growth – became hardly hit by the crisis. This had a direct spill-over effect on the further building blocks. However, the grey-coloured boxes in Chart 6 demonstrate that the crisis had a major impact on each and every building block.

Chart 6: A reversal of the "catching-up" growth pattern



Source: Own compilation

The dissertation also reveals, that beside the similar tendencies, certain differentiation could be made among the countries. This could be explained by the different initial conditions, the applied policy measures, the challenges of the real economy or the respective exchange rate regimes. During the analysis we illustrate, that the relevant indicators' tendencies were generally similar, whereas the starting points and the intensity of the changes reflected great variety. We find, that – in line with the statement of European Commission (2009) – the respective economies' development and their international integration level determined the resilience of the countries. Furthermore, the thesis reveals that the regulatory and supervisory authorities' policy had a significant impact on the avoidance of the build-up of boom-bust cycles.

3.7. Fundamental questions for the post-crisis period

Adding up all of the effects of the global crisis, it can be concluded that the former bank-based model collapsed in SEE, opening a new era with various questions:

- What elements will provide the pillars of the new growth model? Will there be a common model for SEE?
- How will the volume of (FX) lending change on long-term?
- Is further financial deepening desired at all or what would be a healthy pace of the financial expansion?
- Will alternative – non-banking – financing take over the banking sector's role?
- Will the large EU-headquartered banking groups continue their activities in SEE?
- What would be the framework of an optimal regulatory and supervisory system? How would the authorities be able to maintain financial stability, and find the balance between cautiousness and economic incentives? How to avoid financial fragilities and boom-bust cycles?

Finding the optimal answers in the near future is inevitable for SEE's further, long-term economic stability and success.

4. Conclusions

The dissertation analysed the commercial banking sector's development in SEE between the end of the Second World War and the current global crisis. Based on the comparative analysis and the relevant literature, the thesis proved that despite the different initial conditions, historical circumstances, political intentions and applied policies, by the end of the transition period a common, bank-based economic growth pattern could be outlined for the region. In addition, various common and differentiating characteristics have been specified. For instance, widespread FX usage could be revealed on both the asset and the liability side in almost all country cases, whereas the pace of financial deepening reflected significant differences. Furthermore, the thesis also included the most important features of the macroeconomic environment and highlighted the strong link between these two fields. Last but not least, the dissertation showed the fundamental role of foreign-owned banks in the economic development of SEE.

Besides the listed questions of the last main chapter, there are three main directions that provide the possibility for further analysis:

- First of all, the reviewed time span can be expanded. The thesis reviews the sectoral development in SEE until 2010, but the analysis should be carried on for the latest episodes of the current global crisis. This is particularly relevant, as new shock waves continuously emerge. These have strong impacts on both the parent banks and their subsidiaries, but influence also the macroeconomic conditions and the policies of various authorities.
- Second of all, the spectrum of the covered regions can be broadened. It would be worth including further regions to the comparative analysis of the banking sector's development. As it has already been mentioned, the literature often reviews SEE within the group of transition countries or CEE. However, comparing SEE with the region of CEE or the CIS would provide a base for further analysis. Although these countries can be tagged as transition cases, great sectoral differences can be outlined. Furthermore, an interesting comparison could be made by including regions from an even broader perspective, as for instance East Asia. In this case, the historical and political background could often be considered completely different, implying specific environment for the various banking groups. In case of these topics, the analysis can be carried out both on a sectoral and micro level, meaning two perspectives.

- A third direction would be the detailed analysis of the banking sector's impact on a specific macroeconomic indicator. The thesis illustrated certain links between the sectoral development and the GDP per capita or the current account balance. The inflation rate is a further variable that can be added to the list of possible variables. A comprehensive analysis can be carried out for each of these links, including even regression analysis. The connections between these variables can be reviewed for one or a number of regions.

We hope, that the thesis may help to understand the unique development of the banking sector in SEE. It demonstrates the region as a single economic unit with its own history, characteristics and development path. On the other hand, we also intended to highlight some of the differentiating features among the country cases to illustrate SEE's diversity. Analysing the region in a broad time frame provides the possibility to understand the roots and background of SEE's economic development, thus it can also support finding the optimal solutions for the current challenges.

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