

*The Great Divide and Beyond –  
Financial Architecture in Transition*

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## **Introduction**

A growing and deepening divide has opened up between countries where economic development have “taken off” and those caught in a vicious cycle of institutional backwardness and macroeconomic instability. This “Great Divide” is visible in almost every measure of economic performance, such as GDP growth, investment, government finances, growth in inequality and general institutional infrastructure, and increasingly in measures of financial development. In the countries that made it to the “right” side of the divide (Hungary, Poland, Slovenia, the Baltic States), a remarkable diversity of policies for financial development has been pursued. Yet, strikingly, today the basic financial architectures of these frontrunners are remarkably similar. These financial systems are strongly dominated by commercial banks, increasingly foreign owned, which lend primarily to government. Stock markets are highly volatile and illiquid, and their sustainability is in question as the numbers of listed firms are stagnating or even falling. Enterprises rely primarily on internally generated funds, and essentially all external long-term finance comes from foreign direct investment.

The Great Divide in economic and financial development and the convergence in financial architecture among the successful countries raise fundamental questions of how institutional reforms and financial development have interacted with economic growth. Does financial development lead to economic growth, or do financial institutions and markets develop in response to pressures from the real sector? Or are both financial development and economic growth driven by some underlying variable? Is it possible to jump stages of financial development or must all countries go through a phase of bank-oriented financial architecture? Financial transition represents a unique opportunity to shed new light on these important issues.

The paper concludes that financial development does not explain why a small group of countries developed and grew while the majority of transition economies remained mired in recession and economic decline. Some countries experienced financial development, at least as traditionally measured, without economic growth. In fact, financial development in several cases undermined real sector development. Other countries grew without much financial development. In general, the financial sector has played a small role in the restructuring of the manufacturing sector in the transition world.

We argue that the Great Divide opened up in the wake of price liberalization and the ensuing banking crises and bailouts. It was the ability of governments to achieve macro stability, fiscal responsibility together with a commitment to refrain from excessively bailing out failing banks or loss making enterprises that determined whether economic *and* financial development “took off”. In other words, strong government with a sound fiscal base is the main predictor of positive future economic performance in transition economies. Fiscal responsibility promotes both financial development and economic growth through two important channels: it limits the extent of crowding out of private investment by government borrowing and it makes it credible that the government will be able to maintain the macro stability that is essential for private investment. Of course, specific initial conditions and underlying country characteristics facilitate the emergence of strong and fiscally sound governments capable of enforcing the rule of law. We speculate what these conditions might be.

The convergence in financial architecture in the frontrunners is consistent with a view in the literature suggesting a link between the level of economic development and the design of financial systems. The countries that have attempted to jump-start the development of financial markets have all reverted into more bank-oriented financial systems. In the weak institutional environment of transition depositors must be convinced that banks will not abscond with their money or get involved in excessively risky projects. This may also help explain why banks lend to governments rather than to enterprises.

We start by briefly describing the salient features of financial transition. The paper then proceeds to discuss the main ideas and findings of the financial development literature and determine the extent to which financial transition conforms to the dominant financial development scenario. We conclude by identifying some lessons from a decade of financial transition.

### **Price liberalization, banking crises and the Great Divide**

All banking systems in transition economies have evolved from a single institution, the mono-bank, which was responsible for both monetary policy and commercial banking. A few countries got a head start in separating out these two functions and creating a two-tier banking system. The first was Yugoslavia during the 1960s. In the mid-1980s a few other socialist economies followed, Hungary in a more controlled way than the Soviet Union and Poland (see Sgard, 1996).

In an attempt to foster competition among banks and inducing greater transparency, the commercial banking wing of the former mono-bank was also broken up into a handful of state-owned commercial banks. These banks inherited segments of the old bureaucratic network and staff, balance sheets of household deposits, loans from the savings bank or the central bank, plus a portfolio of enterprise credits of unknown quality. Given the poor supervisory environment, this decentralization of bank management to institutions with so little genuine banking experience and such a portfolio of assets was bound to lead to inefficient allocation decisions. In addition, these newly created banks remained under state ownership and most clients had yet to be privatized. As expected, lax lending practices to state-owned industry became an important source of inflationary pressure during the early phase of transition.

With the move away from central planning to more market based transactions the role for money and credit in economic transactions increased, especially following price liberalization. Unfortunately, most Eastern European economies inherited a massive monetary overhang (that is, forced savings in deposit accounts) at the start of transition. Following price liberalization this monetary overhang turned into open inflation, which resulted in disintermediation and hoarding of goods and undermined the fledgling banking structures that had just grown out of the mono-bank.

The separation of central and commercial banking brought with it some rudiments of monetary policy (like credit ceilings and refinancing windows). However, the commercial banking side remained for a while essentially an accounting construction. Although commercial banks were holding deposits and appeared to channel household savings to enterprises, lending policies were not based on any financial or economic logic. There was little attempt to lend only to creditworthy borrowers and loan losses were automatically refinanced. This was done increasingly by printing money, thus further fuelling inflation.

The first test of institutional strength came when attempts to control monetary growth sharply reduced real credit and created a severe “credit crunch” (Calvo and Coricelli, 1995). In all countries the initial response from enterprises was inertia, with mounting unpaid bills to suppliers and in some cases to workers. Some countries (mostly in Central Europe and in the Baltic states) managed to resist the pressures to bail out banks and enterprises, thus achieving stabilization. After the initial pain of the “credit crunch” and several banking crises, a stable monetary and fiscal policy laid the foundation for a virtuous spiral of microeconomic restructuring and

macroeconomic consolidation. With the help of extensive investments these countries managed to successfully re-orient their productive sector and integrate it with world trade, thus restarting the growth process early on.

In other countries (most of the former Soviet Union and Southeast European countries), authorities did not, or could not, resist the pressures for ex-post financial relief. Central banks monetized and inflated the rapidly increasing stocks of credit after only a few months of attempted stabilization. Repeated bailouts and generous direct credits gave rise to expectations of soft budget constraints, a vicious cycle of financial instability, and lack of enterprise restructuring. While moderating the initial fall of output it led to a much more protracted slump than might otherwise have been the case. The Great Divide had opened up.

Unfortunately, data limitations are a serious constraint for a detailed objective analysis of the interaction between economic and financial development in transition. In particular, official GDP statistics for the first years of transition are of dubious quality. Therefore the figures in Table 1, showing the initial output fall in all countries and the resumption of economic growth in most Central and Eastern European countries (and later in the Baltic states) should be interpreted with caution. Note that the decline has been deeper and more protracted in the other countries of the former Soviet Union.

Table 1 (ESSENTIALLY SAME FIGURE AS JAN SVEJNAR IS USING)

Measuring financial development is even more controversial. Standard measures like the size of assets of financial institutions, the amount of money in circulation, and loans to households and enterprises, at best capture only very coarse features of financial systems in developed market economies. They are particularly problematic in the early phase of transition when the quality of financial data was often very poor and systemic changes made comparisons over time more difficult. In addition, above average lending flows to enterprises was more likely to be a symptom of weakness, or softness, than of financial development. It should also be pointed out that credits to households and enterprises

exclude state-owned enterprises; privatization of firms with bank credits is thus registered as financial development according to this measure. Add to this the very high levels of inflation during this period in most countries, which resulted in inflated nominal GDP figures.

**Table 2**  
**Domestic credit to households and enterprises**  
**over GDP (%)**

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bulgaria			5,7	4,1	3,1	10,6	19,0	15,6	11,4	13,2
Czech Rep.					51,8	55,3	55,5	60,0	61,5	56,1
Estonia				7,3	11,1	12,5	15,1	20,0	24,4	26,4
Hungary	44,9	41,9	34,3	28,7	24,7	22,3	20,8	21,4	22,7	23,4
Latvia					14,7	11,8	7,0	8,5	12,3	15,7
Lithuania					13,4	14,0	11,5	9,4	10,6	12,3
Poland	1,6	6,2	9,8	10,2	10,5	10,7	13,0	15,6	17,4	20,6
Romania								8,3	9,0	9,1
Russia					6,8	7,9	7,0	7,7	10,6	10,2
Slovakia					25,8	24,3	28,4	36,1	41,7	39,8
Slovenia					23,1	27,5	28,8	28,6	32,8	35,9
Ukraine				1,1	1,1	1,5	1,3	1,8	4,8	7,6

Sources: IMF International Financial Statistics.

Table 2 shows the development of domestic credit to the private sector during the period 1990-1999 (unfortunately, data for the first four years of this period is only available in a few countries). According to this measure, only Estonia, Poland, Slovakia and Slovenia saw both economic growth and a relatively steady expansion of credit. In the Czech Republic the very high levels of credit do not accurately reflect the relative financial development, but the financial and real sectors seem to move in the same direction. Hungary had four severe banking crises in four years during the first half of the 1990s, but has since then had a more steady development accompanied by economic growth. Latvia and Lithuania also experienced banking crises but have since recovered. The real impact of these crises was moderate as banks had not really been lending to households and enterprises.

In some countries the correlation between financial development and economic growth is even weaker. Bulgaria experienced rapid growth and then a drastic fall in financial

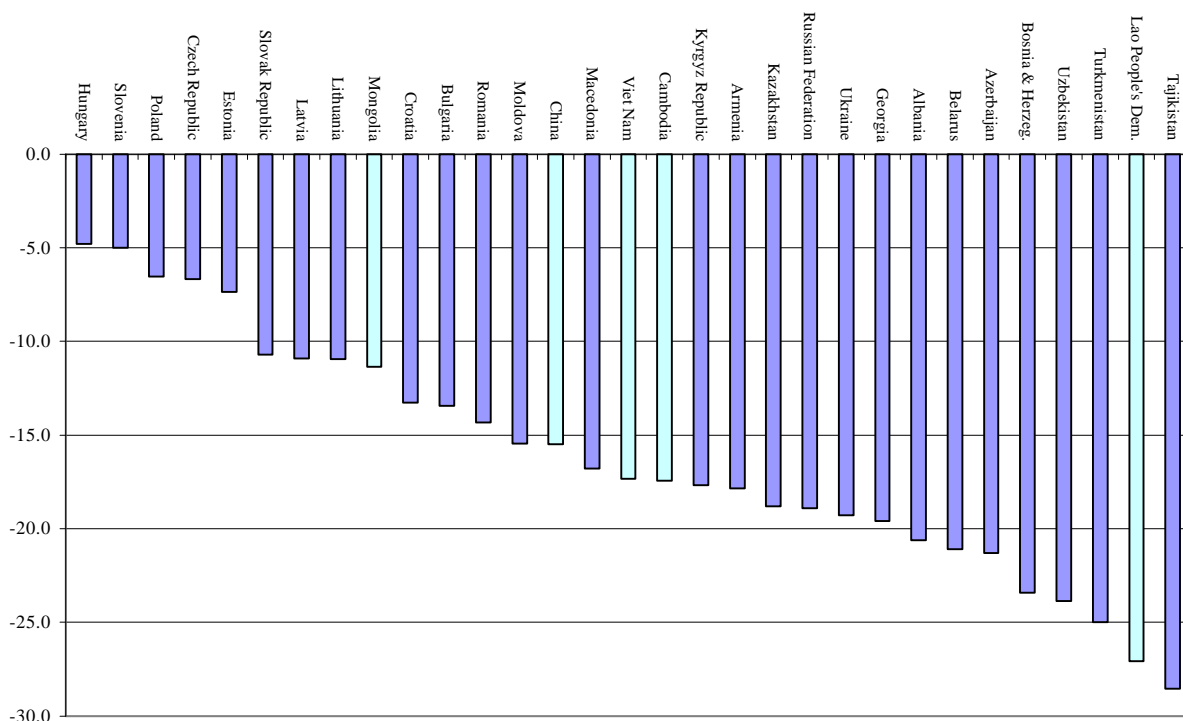
development, measured by credit to households and enterprises. During the same time period the economy declined or showed moderate growth. In Russia, financial markets developed rapidly and credit to households and enterprises increased somewhat while the economy continued to contract. The crisis in August 1998 had little long-term impact on real growth. In 1999 the stock of credit fell but the economy grew rapidly. Ukraine, and many other CIS countries, saw neither financial development nor economic growth. In sum, based on these figures the link between financial development and economic growth does not appear to be very strong during the first decade of transition, even if a Great Divide is visible at the end of the period.

On the other hand, the difference in development stands out more in measures of financial reform (EBRD, 2000) and general institutional quality relating to legal protections of investors (like “law on the books” and “law enforcement” indices) (see Pistor et al, 2000; Kaufmann et al., 2000; and Hellman and Kaufmann, 2001). While most of the countries have adopted increasingly sophisticated legal and regulatory frameworks in the financial area, implementation and enforcement are substantially better in CEE countries than in Russia and Ukraine (Figure 1 and 2). Broader measures of institutional quality, which also deal with corruption, crime and “crony capitalism” reveal a similar pattern (Figure 3). These measures of institutional quality do not only highlight the Great Divide; they have also been good predictors of vulnerability to the recent Asian crisis (see Johnson et al., 2000).<sup>1</sup>

**Figure 3: Deviation of Overall Average Institutional Quality (1997) from the Mean of Industrialized Countries**

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<sup>1</sup> However, the pattern revealed by these latter indices also raises questions of aggregation. For example, Bulgaria and Romania rank higher than Poland in terms of effectiveness of the law, and the Czech Republic comes out as just slightly better than Russia. These rankings are difficult to reconcile with casual observation on the ground on how favorable the business environment is in these countries.



Source: Kaufmann Daniel, Aart Kraay and Paolo Zoido Lobaton(1999b), “Aggregating Governance Indicators”, mimeo, The World Bank.

### **Beyond the Great Divide - Different policies and systemic convergence**

The transition experience of the past decade does not reveal a single magic policy formula guaranteeing a successful financial development path. Indeed, there were major differences in policy responses to the banking crises among the countries that made it to the “right” side of the Great Divide, yet all seem to have converged to the same type of bank-based financial system and to have had similar output performance. The policy differences include the treatment of regulatory barriers to entry into the banking sector, privatization strategies for banks and enterprises, bad loan restructuring procedures, the use of specialized institutions to absorb bad loans, and the policy towards foreign entry in the banking sector. This short piece cannot give a comprehensive picture of the policy differences. We can only provide a few examples to illustrate the point:

- 1) It is well known that the countries in transition opted for very different privatization strategies of state owned enterprises. Hungary started early and followed a case-by-case sales method,

while the Czech Republic opted for a mass voucher privatization scheme, which resulted in a small group of investment funds (tied to large banks) controlling most privatized assets after the repurchase of most dispersed vouchers from households. Poland dragged its feet in implementing mass-privatization. This was due in part due to political gridlock but also to the expressed concern of policymakers that the legal and supervisory environment be strengthened first. Pending these legal reforms many firms were privatized through management buyouts and liquidation schemes. The variation in policy choices is even larger when one looks at the other countries on the “right” side of the Great Divide.

- 2) Bank privatization also followed quite different paths in these countries. In the second half of the 90's bank privatization accelerated in Central Europe, but governments often retained strategic stakes. The Czech Republic included banks in the first wave of voucher privatization. Poland combined managerial buyouts, some public offerings and smaller placements with foreign strategic investors.
- 3) It was not until foreign banks were allowed to acquire strategic stakes in the domestic banking sector that private ownership took a firm hold in most countries. By now several countries have high foreign ownership shares. Hungary went furthest in allowing foreign penetration in the banking sector. Foreigners now control more than 40 per cent of shares in banks accounting for as much as 80 per cent of assets (Abel and Bonin, 2001). The Baltic States also have very high shares of foreign ownership, primarily Scandinavian banks. Poland initially took a positive stance towards foreign ownership of banks, then backtracked, before opening the banking sector again to foreign ownership. The Czech government was initially very resistant to foreign ownership. Its conversion came only after several large bank failures. Today the corresponding shares of foreign owned banks for Poland and the Czech Republic are 52.8 and 50.7 per cent, respectively.
- 4) Most countries experienced significant entry of new banks following the separation of monetary policy and commercial banking (Tang, 1999). In the Baltic States and Russia the number of registered banks increased dramatically in the early years of transition. This wave of new entrants has imposed a heavy supervisory burden on central banks with little experience in the task. Most new entrants were small and were tied to newly privatized enterprises. They quickly became insolvent and contributed to the erosion of the value of bank charters. Following several banking crises the number of banks has now shrunk. In most CEE countries new bank entry has been on a much smaller scale. There has been a moderate increase in the number of banks in Hungary. The number of banks rose somewhat, then fell

again in the Czech Republic, declined slightly in Poland, and fell sharply in Bulgaria. More consolidation is under way.

**Table 3**

Country	Concentration (%, 1997)	Number of banks (1999)	Asset share of state owned banks (%, 1999)	Bad loans/ total loans (%, 1999)	Loan- deposit rate spread (1999)
Bulgaria	86,7	28 <sup>1</sup>	66 <sup>1</sup>	12,9 <sup>1</sup>	9,6
Czech Rep.	74,9	42	23,2	31,4	4,2
Estonia	84,5	7	7,9	3,1	4,5
Hungary	67,4	39	9,1	2,8	3,0
Latvia	53,1	23	8,5 <sup>2</sup>	6,3 <sup>2</sup>	9,2
Lithuania	69,7	13	41,9	11,9	8,2
Poland	42,3	77	25,0	14,5	5,8
Romania	85,0	34	50,3	36,6	
Russia	53,7	2376	41,9 <sup>2</sup>	13,1	26,0
Slovakia	84,5	25	50,7	40,0	6,7
Slovenia	71,7	31	41,7	10,2	5,1
Ukraine	64,4	161	12,5	3,3	34,3

Notes:

1 data for 1997

2 data for 1998

Sources: IMF International Financial Statistics, WB Database on Financial Development and Structure, EBRD Transition Report 2000

- 5) The approach to cleaning up bank balance sheets has also been very different across countries (Table 3 provides the official numbers for the percentage of bad loans). Hungary adopted a bankruptcy law to deal with the growing problem of payment delays. It had an automatic trigger which more or less over night forced much of the country's industry into court-led bankruptcy procedures. The sheer number of cases resulted in a paralysis of the courts (Mitchell, 1993 characterizes this as a "too many to fail" situation). The Czech Republic adopted a bankruptcy code just after its mass privatization program, but suspended its application for two years in response to political pressure from many unprofitable state-owned and privatized firms. Once the law came into force it led to a wave of takeovers of smaller, not necessarily less efficient, firms by large, politically connected firms. Poland opted for informal workouts outside courts under a moratorium on bankruptcy, with the government offering to give up the seniority of its tax claims to provide incentives for banks and firms to agree on restructuring.

6) In the early stages of transition many countries have pursued a policy of stock market development (see Claessens, Djankov and Klingebiel, 2000). One group of countries, Czech and Slovak Republics, Bulgaria, Lithuania, FYR Macedonia, Moldova and Romania made heavy use of stock markets to transfer ownership through mass-privatization. The number of firms listed on these exchanges first increased dramatically, but after an initial phase of high trade volumes most stocks remained illiquid. Over time many companies have been delisted, and the number of shareholders fell with ownership becoming increasingly concentrated. Regulation of exchanges was minimal. In the Czech Republic a formal regulator was not even established. A second group of countries – Croatia, Estonia, Hungary, Latvia, Poland, and Slovenia – developed their stock exchanges mainly through a small number of initial public offerings (IPOs). Trading in most of these shares remained relatively high. A third group of countries of the former Soviet Union – Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine and Uzbekistan – developed stock markets through both privatization and IPOs. All these countries had mass-privatizations, but the exchange of vouchers took place outside the official stock markets. Only six transition countries – Albania, Belarus, Bosnia-Herzegovina, Georgia, Tajikistan, and Turkmenistan – have not established stock markets.

**Table 4**  
**Number of Listed Equities in Transition Economies 1994-2000**

Country	1994	1995	1996	1997	1998	1999	2000 (March)
Bulgaria	16	26	15	15	998	828	842
Czech Rep.	1,024	1,635	1,588	276	261	164	154
Estonia	0	0	0	22	26	25	23
Hungary	40	42	45	49	55	66	65
Latvia	0	17	34	50	69	70	64
Lithuania	13	357	460	607	60	54	54
Poland	44	65	83	143	198	221	221
Romania	4	7	17	76	5,753	5,825	5,578
Russia	72	170	73	208	237	207	218
Slovakia	19	21	816	872	837	845	843
Slovenia	25	17	21	26	28	28	34
Ukraine	0	96	99	102	113	117	120

Sources: Emerging Markets Factbook, International Finance Corporation  
 Claessens, Stijn, Simeon Djankov and Daniela Klingebiel, 2000, "Stock Markets in Transition," Financial Sector Discussion Paper No. 5

Despite these marked differences in policies the financial systems in the more advanced transition countries have converged and now share many features. First, the financial sector is strongly dominated by banks, which lend primarily to governments and other financial institutions. Banks provide some working capital finance to the corporate sector but play virtually no role in financing investments. Investment finance comes almost exclusively from retained earnings, and most external finance comes through foreign direct investment (IMF, 2000).

Second, ownership structures in individual firms are concentrated and turnover of shares is low. Only the stock markets in Czech Republic, Estonia, and Hungary have capitalization-to-GDP ratios comparable to other emerging markets. But most exchanges are very illiquid with trade concentrated in a small number of firms (Claessens, Djankov, and Klingebiel, 2000). The number of listed firms has decreased as a result of foreign acquisitions, domestic mergers and delisting. The best firms show limited interest in listing on local exchanges preferring the quality stamp and liquidity of the international stock markets in Europe and the United States. At the end of 1999, 72 corporations from transition economies were listed on the New York Stock Exchange or Nasdaq, and companies listed abroad accounted for about one-third of domestic market capitalization in Estonia, Hungary, Latvia and the Slovak Republics. The long-term sustainability of some of the local exchanges is clearly in doubt given the growing financial markets integration in Europe and the World.

Third, bank spreads (the difference between lending and borrowing rates) have declined significantly, both in level and volatility in the advanced group of countries (in most CEE countries). Nevertheless they remain high by the standards of developed market economies (see Table 3). In the other countries like Russia and Ukraine, on the other hand, spreads have if anything increased. While some transition countries have progressed more than others in developing and strengthening their banking system no country has yet completed the process of financial transition. All these countries remain risky places for doing business and future banking crises cannot be ruled out.

To summarize, the countries that find themselves on the right side of the Great Divide have now established the basic structure of their financial systems. They all have converged to mainly bank-based financial systems with a significant fraction of foreign bank ownership. Local equity markets have gradually declined and have been overshadowed by European or US exchanges. Important vulnerabilities, however, remain and some of the countries still require major, potentially difficult, reforms. The group of leading reformers includes Poland, Estonia, and Hungary, countries where most banks are essentially sound, have good governance and offer a reasonably wide range of services. Capital markets in these countries are relatively large and

liquid. Laws and regulations on the books are adequate and enforcement is improving. A second group comprises the Czech Republic, Slovenia, Latvia and Lithuania. These countries have also made important advances in terms of banking reform, and loan portfolios are relatively healthy. But the largest banks are still under government control, and foreign strategic investors were only let in recently. The range of services offered remains narrow, but retail banking is developing quickly. The regulatory framework is reasonably sophisticated, but enforcement needs to be improved.

Among the countries that have ended up on the “wrong” side of the Great Divide two groups can be identified. In one group, which includes Russia and the Ukraine, most banks are in private hands. However, most of these are insolvent and should be closed down. Financial markets in these two countries have almost been wiped out by the financial crisis in 1998. Also, corruption, crime and cronyism undermine enforcement of the legal and regulatory framework, and political resistance towards further reforms remains strong. A second group of countries, including Bulgaria, Croatia, Romania and Slovakia have made several partial attempts to reform. The largest banks in these countries are still predominantly state-owned. In addition, the presence of a large number of insolvent banks undermines competition. Finally, the regulatory environment in this second group is improving, but enforcement remains weak.

### **Financial transition and financial development: different starting points and moving targets**

How can this pattern of financial transition be explained? Can it be reconciled with the main ideas of the financial development literature? We now turn to a discussion of these questions. We begin by briefly reviewing the main findings of the financial development literature and then discuss how well they explain the episode of financial transition of the past decade.

### **Financial development and Economic Growth**

A number of empirical studies based on cross country regressions have found that financial development at any given point in time – as measured by the ratio of bank lending to GDP, and/or the ratio of stock market turnover to GDP - is positively correlated with future per-capita economic growth (see e.g. King and Levine 1993a,b and Levine and Zervos 1998). The conclusion generally drawn from these studies is that “well-functioning financial intermediaries

and markets promote long-run economic growth” (Beck, Demirguc-Kunt and Levine, 2001 pp 1). The implied prescription for transition economies is to focus on financial reform in order to achieve economic growth.

Another set of recent empirical studies have found a statistical relation between legal origin (common versus civil law traditions and/or British versus French, German or Scandinavian legal tradition) and financial development. These studies find that countries with a French legal tradition tend to be less financially developed (see LaPorta, Lopez-de-Silanes, Shleifer and Vishny 1997, 1998; Levine 2000 and Beck, Demirguc-Kunt and Levine, 2001). The policy implications from these contributions are less clear; legal traditions are not easy to change. But the findings suggest a link between a country’s legal infrastructure and financial development. Most intriguingly, these studies also suggest that legal origin has persistent long-run effects on financial development.

Looking beyond legal origin, some of these studies also find a direct positive relation between financial development and various indices of investor protection (see LaPorta, Lopez-de-Silanes, Shleifer and Vishny 1997, 1998). Other studies find a positive relation between per-capita income and various indices of investor protection (Levine 2000, and Acemoglu, Johnson and Robinson, 2000). The implied prescription of these studies is that, irrespective of legal origin, greater investor protection is required to obtain greater financial development.

The view that legal origin has persistent effects on financial development, however, is difficult to reconcile with the observation of Rajan and Zingales (2001) that financial development in 1913 was significantly higher in France than in the United States. Or, with their observation that financial development peaked before WW1, then declined until well after WW2, before growing back to a new peak at the turn of the century. This financial history suggests that other important factors affect financial development besides legal investor protection.

What might these factors be? Rajan and Zingales (2001) invoke the political power of incumbents. They propose that insiders are inherently opposed to financial development as it would bring about greater competition from new entrants. In times of crisis or conflict these insiders gain more political influence and are able to push through legislation protecting their interests and inhibiting the growth of financial markets. With greater prosperity, however, these interest groups lose their grip on political power. So much so that eventually new legislation is passed fostering the development of financial markets. Although this story is broadly consistent with the U-shaped pattern of financial development of advanced economies in the 20<sup>th</sup> century, a deeper analysis is clearly required before one can say with any confidence whether financial development is mainly driven by such a political struggle between insiders and outsiders.

Another relevant factor that has probably contributed to the observed pattern of financial development is the rise of the welfare state in the 1930 and after WW2, which has had the important effect of removing retirement savings from capital markets. It is only in the 1980s that important new changes in retirement plans have been introduced (mainly in the US and the UK), which have had a well-recognized impact on the growth of the private pension fund industry.

A related factor has been the growth of the public sector, partly in response to the great slump, partly as a result of the war production effort, and partly through nationalizations following WW2. A larger public sector meant that a smaller fraction of corporate investments required funding from private sources, thus limiting the extent of the private sector. Again, it is only since the beginning of the 1980 that the public sector has been scaled back through large-scale privatization programs (see Bortolotti, Fantini and Siniscalco, 2001).

A third potentially important factor limiting financial development has been the growth of government debt, which in some countries (e.g. Italy or Belgium) has had the effect of crowding out private investment. This factor is of particular importance for some transition economies, where the high yield on government bonds seems to have had a negative effect on bank lending to the private sector. One piece of evidence consistent with this view is the growth in private lending witnessed in Russia following the default on government bonds in 1998 (see e.g. Huang, Marin and Xu, 2001).

Besides the link between legal infrastructure and aggregate investment another central issue in financial development concerns the relative strengths of so-called bank-based versus market-based systems. Again, the experience of financial transition of the past decade raises interesting new issues on this question.

Most developing economies have bank-based financial systems and financial markets play a relatively minor role. It is only at more advanced stages of development that one sees financial markets play an increasingly important role. Various explanations have been given for why this is so. One influential view by Gerschenkron (1962) and more recently Rajan and Zingales (1998) is that when accounting rules and more generally regulatory and contractual enforcement institutions are weak, banks are better placed to protect creditor rights. Small investors are deterred from investing in the stock market for fear of being exploited by unscrupulous stock price manipulators and insider traders. They feel that their savings are better protected in deposit or savings accounts at banks, which are generally subject to some form of supervision by the state.

On the corporate side most firms are too small and risky at early stages of development to be able to issue shares or bonds on an organized exchange at a competitive cost of capital. It is

only the more advanced economies that may have a sufficient number of large and stable firms benefiting from raising funds from capital markets to be able to create the thick market externalities necessary to sustain efficient stock markets (see Pagano, 1993). Stock markets also tend to develop when there is a culture of equity investment and private pension plans, over and above regulatory protections to limit price manipulation and fraud. Finally, stock markets require well-trained professionals, market makers, traders, fund managers, financial regulators none of which were present at the beginning of transition.

Surprisingly, although a casual look at financial architecture in developing countries suggests that as the real economy develops there is only a gradual and partial shift from bank-based to market-based corporate finance, the empirical literature exploring the link between bank-based or market-based financial systems and per-capita growth produces mixed evidence. An early set of studies finds that greater financial intermediation is associated with greater future growth (see King and Levine 1993). But Levine and Zervos (1998) find that stock market development (as measured by turnover) is also positively related with future growth. More recently Tadasse (2000) has refined these findings by highlighting that for the less financially developed countries greater emphasis on financial intermediation impacts future growth positively, while for the more financially developed countries it is greater emphasis on market finance that has a positive impact on growth. On the other hand, Levine (2000) finds that the relative weight of bank versus market finance is not significantly related to economic growth in cross-developing country regressions.

While exploring the link between legal infrastructure, investor protection and aggregate investment some researchers have found that the legal infrastructure and the extent of investor protection are actually proxies of broader underlying country characteristics. In particular, they may be related to wealth inequalities, political polarization and macro-instability. Thus, for example, Perotti (1996) has found that the risk of expropriation of investors is related to political polarization and conflict, which itself is linked to wealth inequalities. Similarly, several empirical studies have found that “protection of property rights” is weakened when there is greater income inequality and that greater political instability tends to decrease investment and growth (see Benabou 1997 for a survey). Finally, in a study of financial development in Latin American countries Padilla and Requejo (1998) have found that macroeconomic stability is a more important factor determining development of lending to the corporate sector than creditor protection. The experience of financial transition of the past decade corroborates some of these findings as we explain below.

## **Explaining the Great Divide and Systemic Convergence**

Economic reform following the collapse of the Soviet Union offered a unique experiment in financial development as a policy to foster future investment and growth. In the early phase of transition there was in fact a tremendous sense of possibility and optimism as to what economic reform and financial development could achieve. Alas, the pattern of financial transition of the past decade has been a very sobering experience. The emergence of the Great Divide unfortunately illustrates how difficult it is to implement sustainable financial development and how much underlying country characteristics matter. Indeed, the reason why some countries ended up on the “right” side of the Great Divide and others did not must be sought to a large extent outside the financial and legal system per se.

A leading explanation for the observed variation in financial and economic development across countries in the region can be found in the difference in fiscal discipline and enforcement capacity of governments. Without fiscal discipline government borrowing crowds out investment in the private sector and increases macroeconomic uncertainty. This explanation is consistent with the findings of Padilla and Requejo (1998) for Latin American countries.

As sensible as this diagnosis may be it is not all that helpful if one does not ask why some governments are fiscally irresponsible but not others. Presumably all governments are aiming to be fiscally responsible but not all may be able to control their finances. What then determines whether fiscal discipline can be established? To address this question we must return to the situation facing transition countries in the early phase of transition once the first step towards financial development had been taken. One heritage of the Soviet past was that governments were locked into financial relationships with a large number of firms facing daunting restructuring tasks. The pressure to keep many loss-making firms afloat through subsidies was tremendous. Whether governments were able to resist the pressure to bailout loss making banks and enterprises depended on several factors.

One simple reason why some countries ended up on the wrong side of the Great Divide was that political and economic costs of resisting calls for bailouts were too great. To appreciate the challenge facing some of these countries, particularly those that were part of the Soviet Union, one must go back to the Soviet system of production (Berliner, 1976; and Kornai, 1992). This system was based on a very high degree of specialization, in many cases only one firm producing or assembling a particular good. It was partly a political decision by Stalin and later Soviet leaders to over-specialize enterprises and regions to make them more interdependent and to increase the costs of separation of a particular Republic. On top of this extreme specialization,

the entire Soviet economy had a disproportionately large military-industrial sector. The sediments of these arrangements are visible in today's Russia in the many "one-factory-towns" and the large population living in economically non-viable areas of the country (in contrast China relied much more on a strategy of regional decentralization; for an interesting comparison of Chinese and Russian planning see Qian and Xu, 1993). Thus, following the break-up of the Soviet Union most newly independent States were faced with a highly concentrated economically non-viable industrial base, which they had little choice but to keep afloat.

But the size of the restructuring task does not uniquely determine whether some governments are able to impose fiscal discipline and others not. There is also an element of multiple equilibria and coordination of enterprises' lobbying efforts for more subsidies and bailouts (Perotti, 1998). In many countries more or less formalized groups of financial and industrial firms have formed (partly because they were previously connected the same administrative structure) to enhance the members ability to extract benefits from the government. Several studies in Russia have shown that, while such groups may be able to relieve credit constraints of individual member firms, they also serve the purpose of extracting inefficiently large resource transfers from the state (Perotti and Gelfer, 2001; and Volchkova, 2000).

On the other side of the budget equation, another important factor affecting government fiscal discipline was its ability to raise taxes and other revenues. Several countries on the right side of the Great Divide have been able to raise significant revenues through privatization of state assets. But, perhaps, a more important common denominator of these countries is that the government had considerable legitimacy. These countries also have had some experience with democracy before WWII and have generally a greater respect for "the rule of law". These factors are obviously of critical importance to limit tax evasion and to facilitate the enforcement of existing rules and regulations. As Pistor and Raiser (2001) have pointed out the main obstacle towards greater financial development is the lack of enforcement of existing laws rather than the existence of an inadequate legal framework.

For the countries on the wrong side of the Great Divide one of the main handicaps inherited from the communist past has been the lack of legitimacy of the state combined with the lack of experience with democratic government. Within the ex Soviet-Union, only the Baltic States have had a relatively recent experience with democracy. Similarly, in Central and Eastern Europe Bulgaria and Romania – two countries on the wrong side of the Great Divide – have had virtually no experience with democracy even if they have not lived under communism for as long as the Soviet Union.

These observations can go a long way towards explaining the emergence of “crony capitalism” in some of these countries as well as the lack of fiscal responsibility. They also provide a reasonably good fit for which countries made it to the “right” side of the Divide. On the other hand, they are probably less useful for understanding the differences in policies pursued among the group of countries on the right side of the Great Divide, or the subsequent convergence in their systemic features. In interpreting the large variation in policies in these countries it is important to remember the genuine uncertainty about aggregate outcomes and results from specific policies in the transition context facing policymakers at the time.

The governments’ ability to implement fiscal restraint has also undoubtedly been influenced by the country’s geographical proximity and likelihood of accession to the European Union. Trade naturally gravitates to markets with large and rich populations. When countries are located close to such markets, the potential benefits from trade are greater, and thus the expected net costs of restructuring are lower. Recent research also suggests that prior experience of trade with the West is a predictor of whether enterprise restructuring has been undertaken or not. Most of the growth in Central and Eastern Europe has come from new firms or firms with extensive trade links with the West during the communist era (Walsh and Duffy, 2000).

The possibility of joining the European Union has played an extremely important role in relaxing domestic political constraints to the reform process in much Central and Eastern Europe. The greater, the more certain and the sooner the possibility of joining the Union, assuming of course that membership is not already ensured, the stronger has been the leverage of this outside anchor (see Berglof and Roland, 2001).

Finally, another important development that has had a major impact on the pattern of financial transition is the evolution of the market economies, the ultimate target for the formerly centrally planned economies. Ironically, at approximately the same time as the Berlin Wall fell and the former socialist economies embarked on the transition journey deep shifts gradually emerged in the financial systems of the developed market economies. During the 1990s the developed market economies put greater reliance on stock markets and pushed financial market integration to levels not seen since the end of the XIX<sup>th</sup> century. This meant that policies aimed at developing stock markets in transition economies became rapidly outdated and counterproductive. Similarly, the greater financial integration of the European Union (following monetary union) and the world at large increased the desirability and sustainability of foreign banks in transition economies.

The ongoing globalization of the financial industry raises the issue of whether it is meaningful any longer to talk about national financial systems. The remarkable presence of

foreign commercial banks in the transition economies in Central and Eastern Europe integrates these systems into the global strategies of a small number of large financial institutions. What is the role of Hansabank and Unibanka, commercial banks active in the Baltic states, in the strategies of their Swedish parent banks? To what extent can we talk about domestic financial intermediation when external finance for investments come mostly from foreign savings? What influence do domestic regulators and regulation in transition economies have on the behavior of these institutions with global reach? These are some of the new questions for financial development posed by the current trends of world financial integration.

### **Ten years later, what have we learned?**

One of the most striking observations of the past decade of financial transition is the importance of fiscal discipline at the initial juncture, the critical point when the Great Divide opens up. Countries on the “wrong” side of this divide get caught in a vicious circle of macro instability and repeated relapses in financial development. Financial development in these countries at best has little effect on economic growth, and may even be counterproductive by softening firms’ budget constraints. In the countries on the “right” side of the Great Divide, on the other hand, financial development seems to have been positively correlated with economic growth. However, despite a great variety of financial transition policies pursued in these countries, financial architecture appears to have converged to a bank-based system with substantial foreign ownership. On the positive side, the financial sector has contributed to the hardening of budget constraints, but on the negative side, banks have not yet begun extending significant long-term finance nor have they actively promoted restructuring in the industrial sector.

Even though the transition process has been recognized as in essence a problem of institutional reform and build-up, the early economic literature on transition mainly took a macroeconomic perspective emphasizing price liberalization and policies towards macroeconomic stability (e.g., Lipton and Sachs, 1990 and 1992). Ironically, although this perspective has been criticized for ignoring underlying institutions (and the role of the financial sector in development) the financial transition pattern of the past decade suggests that the focus on macroeconomic stability and fiscal responsibility turn out to have been well placed. Sound government finances create favorable conditions not only for financial development but also for proper enforcement of the law. Writing new laws or transferring them more or less wholesale from abroad is relatively easy. Ensuring

proper enforcement is much more difficult. In our view lack of enforcement emanates from the same weakness of government and fiscal irresponsibility that undermines financial development.

Western Europe can play an important role in providing outside anchors for the financial and economic development of transition countries. The accession process to the European Union has made a critical contribution in relieving domestic political constraints in the transition countries of Central and Eastern Europe. The pressure to meet the criteria for EU membership was essential for the adoption and enforcement of laws and regulations, and for building the basic institutions. Perhaps even more importantly, the widely shared aspiration to “rejoin Europe” has given strong direction to, and strengthened the commitment of, the governments of these countries. Providing such anchors for the countries on the “wrong” side of the Great Divide is a major challenge for the future.

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Figure 3: EBRD index of reforms of non-banking financial institutions (1991-1999)

