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# Financial structure of central and eastern European countries: development trends and role of the banks

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# FINANCIAL STRUCTURE OF CENTRAL AND EASTERN EUROPEAN COUNTRIES: DEVELOPMENT TRENDS AND ROLE OF THE BANKS

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# 1. Introduction[*]

The aim of this report is to analyse the financial structure—and in particular the banking systems—of eight countries in central and eastern Europe (hereinafter the CEEC8), of which five gained EU membership in May 2004 (Poland, the Czech Republic, Slovakia, Slovenia and Hungary), two are potential entrants (Bulgaria and Romania) and one is an official candidate (Croatia). This analysis is useful as a means of interpreting and forecasting the growth potential of the economy in this region, as well as the financial context in which domestic and international companies operate.

The development of the financial sector will be a crucial factor in bringing about real and nominal convergence for the new and future EU members, given the positive correlation between financial structure and growth. Literature on economic growth has long shown a positive and significant association between the financial structure of a country—that is, its financial instruments, markets and institutions as a whole—and economic stability and growth. This causal relationship is not unequivocally determined by the theory: while an evolved financial structure ensures the mobilisation of savings and an efficient allocation of funds, reduces the costs of accessing external finance and thus boosts real investment[1], the positive effects of economic development on demand for increasingly sophisticated financial products and services are also undeniable[2].

Empirical analyses generally bear out the view that financial structure influences economic growth, although the evidence shows only weak significance as regards countries in transition, which include the new EU member states. Studies conducted on transition economies show an unusually low degree of financial sector development in these countries when set against current levels of per capita wealth and despite the enormous efforts made to reform the institutions (EBRD, 1998; Berglöf and Roland, 1995; Berglöf and Bolton, 2003). There are numerous reasons (some of which will be examined in detail in the next section) for this state of under-development, including unfavourable economic conditions inherited from the former planned economies, episodes of financial and currency instability that in some cases led to banking collapses, and the lack of a legislative and regulatory framework to protect financial institutions and savers. As a result, corporate investment in transitional countries has mainly been financed through cash flows, foreign direct investment and intra-group transfers (in the case of companies controlled by foreign multinationals). These have replaced alternative forms of domestic financing, further holding back the development of the system.

As we describe in the first part of this report, CEECs have a lower degree of economic development—but higher growth rates—than the EU average, and their financial services sectors make only a modest contribution to domestic GDP. We can therefore conclude that the financial sector has enormous growth potential linked to both economic convergence (as measured by per capita income) and a

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1 *Levine (1998) provides an extensive review of theoretical and empirical literature. Please see also Rajan and Zingales (1998), Beck and Levine (2002), IMF (2004), and Dolar and Meh (2002).*

2 *Gertler (1993), Berthelemy and Varoudakis (1996), and others.*

degree of financial services development that is in keeping with the new levels of wealth.

The report is divided into three parts. In the first (section 2) we analyse indicators that measure the degree of financial services development within the economy, and the role of the banks compared with other, non-banking intermediaries. Section 3 describes the main structural features and trends of the region's banking systems, while section 4 examines the relationship between institutional reforms and the development of banking activities. Section 5 contains our conclusions.

## 2. Financial structure of central and eastern European countries

Our comparative analysis of the financial structure of the CEEC8 looks at some of the main characteristics that all the countries examined have in common: a small size and low depth of the financial system, predominance of the banking sector coupled with a marginal role played by the capital markets and other non-banking intermediaries, and heavy involvement of private foreign investors (mainly European). Tables 1 and 2 show a number of indicators of economic and financial services development[3] for the CEEC8 and the eurozone.

An examination of the data reveals two general points. First, the positive correlation between wealth and financial depth, as measured by the financial assets to GDP ratio, is confirmed: countries with higher per capita GDP, like the Czech Republic, Hungary and Slovenia, show on average higher ratios (table 1). Second, all the CEEC8 have less evolved financial systems in terms of size and role of more sophisticated financial intermediaries (table 2). The reasons for this backwardness have to do with the recent history of the CEECs, which in the last decade or so have moved from planned to market-based economies. The transition economies inherited a system in which none of their financial institutions had a market-based approach. They also lacked the civil and financial legal and regulatory framework necessary for the development of a financial market. The adoption of EU legislation in the financial sector was crucial in order to allow the level of financial services development to increase, although it still remains low.

Even though there are significant variations, all the indicators show the relatively small size and low depth of the CEEC8 financial system: in 2004 the M2/GDP ratio, used to measure savings mobilisation capacity, stood at 53% on average, against 74% in the eurozone.

Even more marked is the gap evidenced between the size of the two regions' capital and banking intermediation markets. Stock market capitalisation is still very low, while the equity markets are illiquid and suffer from competition from their main European counterparts (Claessens et al., 2003). In all the CEEC8 the stock exchanges were created from scratch or reopened after a long period (the Warsaw stock exchange was originally founded in 1817, and the Prague exchange in 1871) only at the beginning of the 1990s. In some countries, such as Slovenia, the Czech Republic and Slovakia, the reopening of the stock market coincided with the launch of the privatisation process, which in many sectors (including banking) was implemented via the issue of shares reserved for

[3] *All the indicators of financial development used are widely accepted in literature on this subject. For an analytical description of the indicators, please see IMF (2005).*

domestic residents. In these countries there was an initial rapid rise in floatations and trading volumes, followed by numerous delistings due to weak performances from the companies themselves, a lack of trading liquidity and an absence of adequate corporate governance mechanisms[4]. Other countries like Croatia, Poland and Hungary preferred to create a strong regulatory framework and modern trading infrastructure before allowing a few, more solid companies, to gain access to the market through IPOs. This latter approach appears to have led to more lasting equity market expansion: in 2004 stock market capitalisation totalled 25-30% of GDP in these countries[5] (table 1).

**Table 1 – Economic development and financial intermediation (data as of Dec. 2004)**

| | GDP per capita at PPP (*) | GDP growth rate (%) | M2/GDP (%) | Domestic credit/GDP (%) | Financial assets (**)/GDP (%) | Market Cap/GDP (%) |
|---|---|---|---|---|---|---|
| **BULGARIA** | 29.8 | 5.6 | 54.7 | 36.2 | 53.0 | 10.6 |
| **CROATIA** | 46.0 | 3.8 | 67.0 | 68.2 | 121.0 | 29.8 |
| **CZECH REP.** | 70.4 | 4.0 | 70.0 | 45.7 | 106.8 | 21.8 |
| **HUNGARY** | 60.9 | 4.2 | 47.8 | 59.3 | 105.5 | 25.4 |
| **POLAND** | 46.7 | 5.4 | 42.0 | 34.6 | 73.5 | 24.2 |
| **ROMANIA** | 31.6 | 8.3 | 28.1 | 15.9 | 44.0 | 13.8 |
| **SLOVACK REP.** | 52.1 | 5.5 | 61.5 | 44.0 | n.a | 5.2 |
| **SLOVENIA** | 78.6 | 4.6 | 54.2 | 55.8 | 119.7 | 27.6 |
| **EURO AREA** | 107.1 | 2.1 | 73.8 | 141.5 | n.a | 57.2 |

*Own calculations on data from EIU, IMF (International Financial Statistics), World Federation of Stock Exchanges.*

*(*) European Union (25) = 100; (**) Financial assets are defined as the sum of banking assets, total gross insurance premiums, assets under management of investment funds and assets of pensions funds.*

Like most of the major western European countries, the CEEC8' financial structure is bank-based: the total domestic credit/stock market capitalisation ratio varies little from that of the eurozone[6] and in all eight countries bank assets account for more than 80% of total financial assets (table 2). Here, banks represent the sole channel for the transfer of financial flows, and only in recent years have the foundations been laid for the creation and growth of institutional investors, which still play only a minor role in all the CEEC8. In some countries, the insurance sector and pension funds are fairly well developed, while in others they are still at the fledgling stage. The number of investment funds and asset management companies is on the rise, but the amount of assets managed is low in both absolute terms and as a percentage of GDP.

4 *For a detailed analysis of the negative effects of mass privatisations on the capital markets, see Fungáčová (2005).*

5 *Note, however, that the modest size of their domestic equity markets has not stopped companies from listing on international markets, and thus benefiting from lower access costs and higher liquidity (Claessens et al., 2003; Gaspar–Vinhas de Souza, 2003).*

6 *In countries with a more market-based structure, such as the US and the UK, the ratio of total domestic credit to stock market capitalisation is about 1.8, compared with 2.5 in the eurozone.*

**Table 2 – Banks and other financial intermediaries (data as of Dec. 2004)**

| | Domestic credit/ Mkt cap | Banking assets /Financial assets(*) (%) | Banking assets /GDP (%) | Assets under management/ GDP (%) | Gross insurance premiums/GDP (%) | Pension funds assests/GDP (%) |
|---|---|---|---|---|---|---|
| **BULGARIA** | 3.4 | 91.4 | 46.5 | 0.1 | 2.2 | 2.1 |
| **CROATIA** | 2.2 | 91.9 | 108.9 | 2.7 | 3.2 | 3.8 |
| **CZECH REP.** | 2.1 | 89.7 | 95.8 | 3.9 | 4.1 | 3.0 |
| **HUNGARY** | 2.3 | 84.9 | 82.4 | 5.2 | 2.9 | 6.6 |
| **POLAND** | 2.1(*) | 80.8 | 60.8 | 4.2 | 3.1 | 7.1 |
| **ROMANIA** | 2.7(*) | 95.8 | 39.8 | 0.2 | 1.5 | 0.0 |
| **SLOVACK REP.** | n.a | n.a | 87.7 | 4.7 | 3.6. | n.a. |
| **SLOVENIA** | 2.0 | 85.4 | 91.2 | 8.1 | 5.6 | 1.8 |
| **EURO AREA** | 2.5 | n.a | 267.6 | 46.5 | n.a. | n.a. |

*Own calculations on data from EIU, World Federation of Stock Exchanges, national central banks, BCE, CZSO, MFCR, KNUIFE, FSC, HFSA, Croatian SEC, Dinados, IMF, UFT.*

*(*) Financial assets are defined as the sum of banking assets, total gross insurance premiums, assets under management of investment funds and assets of pensions funds.*

Despite the central role of the banks, traditional banking activities are still under-developed in the CEEC8 compared with the European Union: on average, the total domestic credit/GDP ratio is a third of that registered by the eurozone countries (table 1), while total bank assets to GDP varies from 40% in Romania to 109% in Croatia—far short of the 2004 eurozone figure of 268% (table 2).

**Table 3 – Bank deposits and claims (data as of Dec. 2004)**

| | Claims(*)/GDP (%) | Deposits/GDP (%) |
|---|---|---|
| **BULGARIA** | 36.2 | 38.9 |
| **CROATIA** | 57.8 | 61.7 |
| **CZECH REP.** | 38.3 | 61.3 |
| **HUNGARY** | 57.2 | 41.1 |
| **POLAND** | 32.4 | 35.6 |
| **ROMANIA** | 18.2 | 14.6 |
| **SLOVACK REP.** | 31.6(**) | 54.2 |
| **SLOVENIA** | 51.3 | 51.3 |
| **EURO AREA** | 113.7 | 84.0 |

*Own calculations on data from EIU, national central banks, BCE, IMF.*

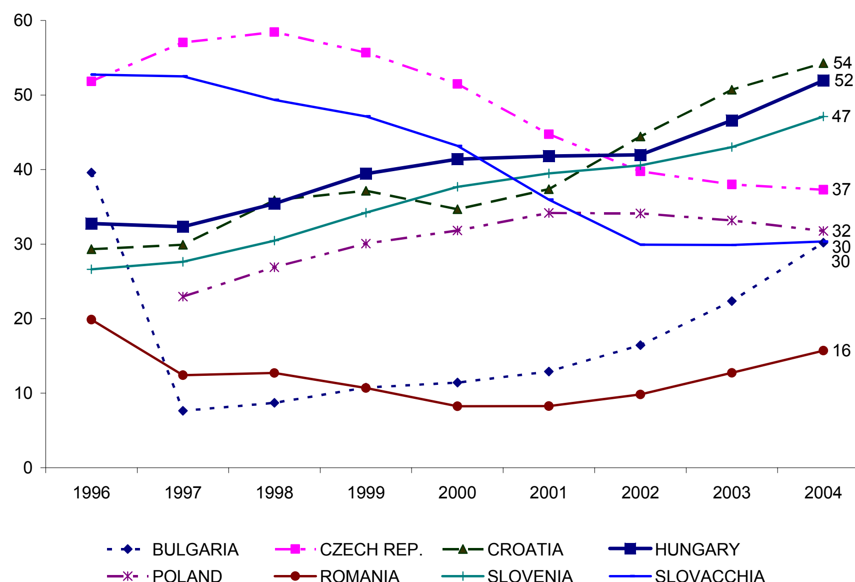
*(*) Total non-goverment claims; (**) Local currency claims.*

Similar conclusions can be drawn from deposits/GDP[7] and loans/GDP (table 3), the latter of which ranges from 18% in Romania to 57% in Croatia and Hungary,

7 *The much smaller gap highlighted by the deposits/GDP ratio is in reality due to the fact that in more financially developed countries bank deposits are the least efficient form of savings.*

compared with 113.7% in the eurozone. Such low values once again show the gap in banking activity development, although in some countries this has narrowed since the second half of the 1990s. Chart 1 shows the trend of the loans/GDP ratio in the period 1996-2004. The CEEC8 can be divided into two groups as regards this indicator: the first (Czech Republic, Slovakia, Bulgaria and Romania) registered a reduction in bank loans from 1996 to 2001, followed by growth until 2004, while the second has posted fairly constant growth in loans since 1996.

**Chart 1 – Loans(*) to GDP ratio in the last decade**




*Sources: EIU, national central banks.*

*The ratio is computed as* $(((Loans_t + Loans_{t-1})/2)/GDP_t)*100$

*(*) Total non-government loans.*

Economic factors were the main reasons for the decline in lending activity in the first group of countries.

The sharp drop in the loans/GDP ratio in the Czech Republic, for example, was due to the economic downturn seen during the period, which dampened banking activity, loan portfolio restructuring measures, such as the transfer of non-performing loans to the state-owned bad bank, and the implementation of more stringent risk evaluation systems.

In Slovakia, the loans/GDP ratio declined in 1996-2000, but increased over the following two years. The reduction in the ratio was chiefly due to a sharp fall in loans to the private sector from 1999.

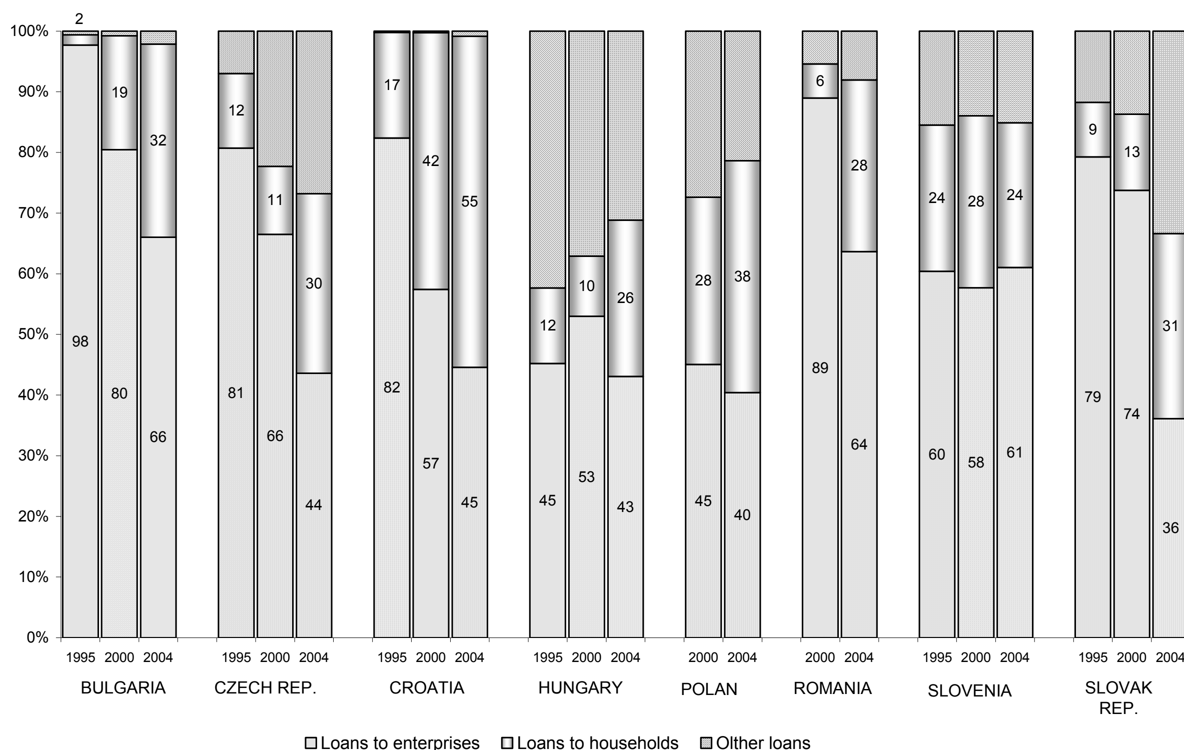
In Bulgaria too, the low level of lending in the period 1997-1999 was the result of the deep economic and financial crisis of the previous two years. Numerous bankruptcies resulting from lending policies not based on careful credit assessment triggered several bank runs and collapses, and seriously undermined savers' confidence in the financial institutions. However, the Bulgarian banking system was given a boost by renewed stability and dynamic economic growth, as well as by increased confidence in the lending system and the arrival of new foreign investors.

Finally, the drop in lending activity in Romania continued until 2001 owing to the 1997-1999 recession, and more importantly to the high riskiness of companies, which prompted the banks to allocate funds on money market instruments. In the second half of 2001, however, the Romanian economy began growing at a very rapid pace in real terms, owing to increasing commercial integration with the EU countries and a huge influx of foreign direct investment.

The reasons for the rapid expansion in bank loans in Romania and Bulgaria are to some extent shared (Duenwald et al., 2005) and relate to the structure of both supply and demand in the area of financial products and services. Both countries have lately benefited from their status as potential EU entrants, attracting foreign investors to their banking sectors. Recently-privatised banks have helped boost lending activity as they work towards increasing their profitability and market shares. Their high capital levels have allowed them to restructure their activities, increasing the proportion of customer loans in comparison to investments in more liquid assets. Generally improved confidence has fuelled demand for loans (both consumer credit and mortgages) from households.

In Hungary, Poland, Croatia and Slovenia, the level of banking activity has grown significantly since 1996, and will advance further in future. The increase in the loans/GDP ratio has been due first and foremost to the expansion of activity into new market segments, especially SMEs and households (chart 2), and to the improved quality of financial services and products aimed at companies. Large firms, however, continue to finance their activities through commercial loans, self-financing and payments from their parent companies (often multinationals), or through bank loans from non-resident intermediaries. This could hold back any sharp growth in banking activity development.

**Chart 2 – Loan distribution by sector**




*Sources:* *national central banks.*

*Notes:* *for Slovak Republic local currency loans ; for Slovenia loans to households in local currency; for Czech Republic loans to CNB are included.*

*(*) Total non-goverment loans.*

Over the next few years, intermediation activities are expected to expand at a brisk pace in all the CEEC8, since growth prospects remain buoyant and banking reform measures have yet to bear their full fruits, especially in countries that began the process late. Liberalisation, privatisation and, most importantly, the reform of banking and bankruptcy laws have come only recently in some countries, but should give a significant boost to growth in loans and deposits.

# 3. Structural features and development trends in the banking sector

Since the early 1990s, the banking systems of the CEEC8 have been involved in widespread privatisation and restructuring[8]—in some cases following serious crises. As a result, the structure of the banking sector has changed significantly in the last decade or so. The first phase in the transition saw an increase in the number of banks, as the state banks hived off their commercial activities to newly-created state-owned commercial banks (SOCBs) which were established under new licences. The second phase consisted of a period of major restructuring, asset clean-up and large-scale recapitalisation that preceded the launch of privatisation programmes[9]. The number of banks declined during this phase as the weaker institutions exited the market[10] and the process of mergers and acquisitions took off.

As shown in chart 3, the number of banks decreased considerably in all the CEEC8[11].

The gradual liberalisation and privatisation of the banking sector enabled foreign investors to buy into local banks at different times and in various ways, often as controlling shareholders. The main feature that all the CEEC8 banking sectors have in common is the high involvement of foreign (mainly European) investors and the speed at which this happened. Foreign capital was needed as there were few CEEC8 investors (institutional or private) with the requisite financial resources and managerial and technical know-how to restructure and relaunch the privatised banks, a process that required a huge amount of capital. Moreover, the absence of a developed and efficient capital market in the region made it more difficult to privatise the banks via share placements, with a few rare exceptions (e.g. OTP Bank in Hungary).

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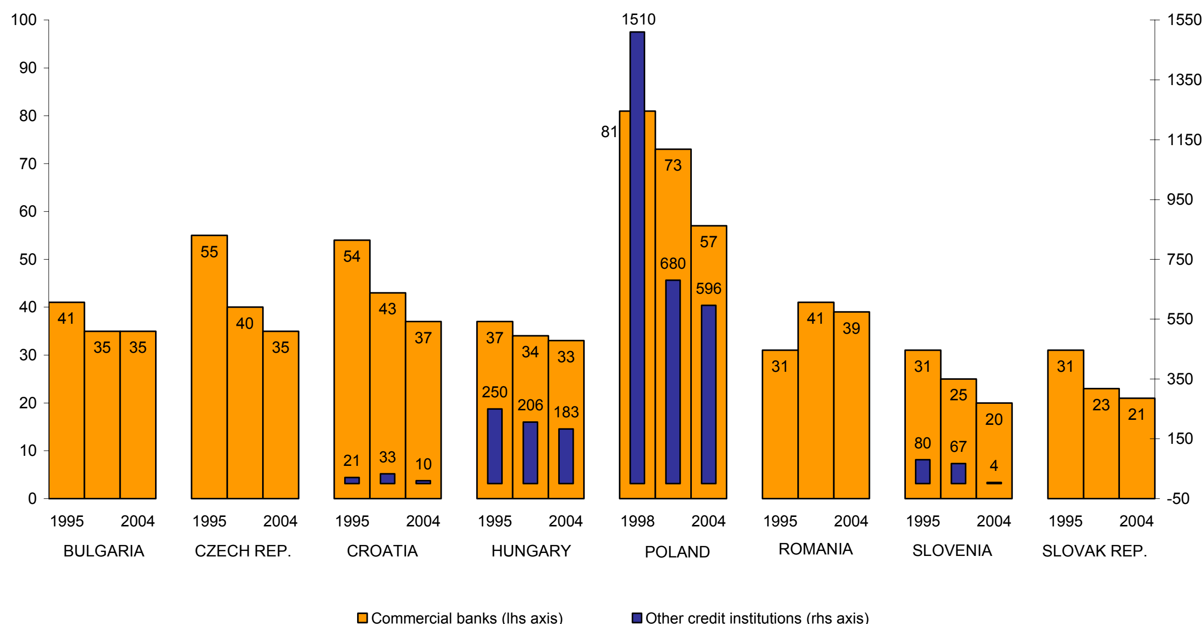
8 *See Coletti et al. (2003) for a detailed analysis of the restructuring and privatisation measures implemented in a number of central and eastern European countries.*

9 *See Wagner and Iakova (2001) for a description of the types and costs of restructuring in some central and eastern European countries.*

10 *Exit from the market was due to bankruptcy in some cases and to the annulment of the bank's licence in others (e.g. in the Czech Republic following the crisis in 1997-1998). The consolidation process involved mergers between both domestic banks and foreign parent companies.*

11 *Hungary and Poland have many co-operative banks, representing the absolute majority of banks in numerical terms. The share of assets held by the co-operatives is, however, very low as a percentage of total bank assets in both Poland and Hungary (5.3% and 4.9% respectively in 2004).*

**Chart 3 – Number of credit institutions**

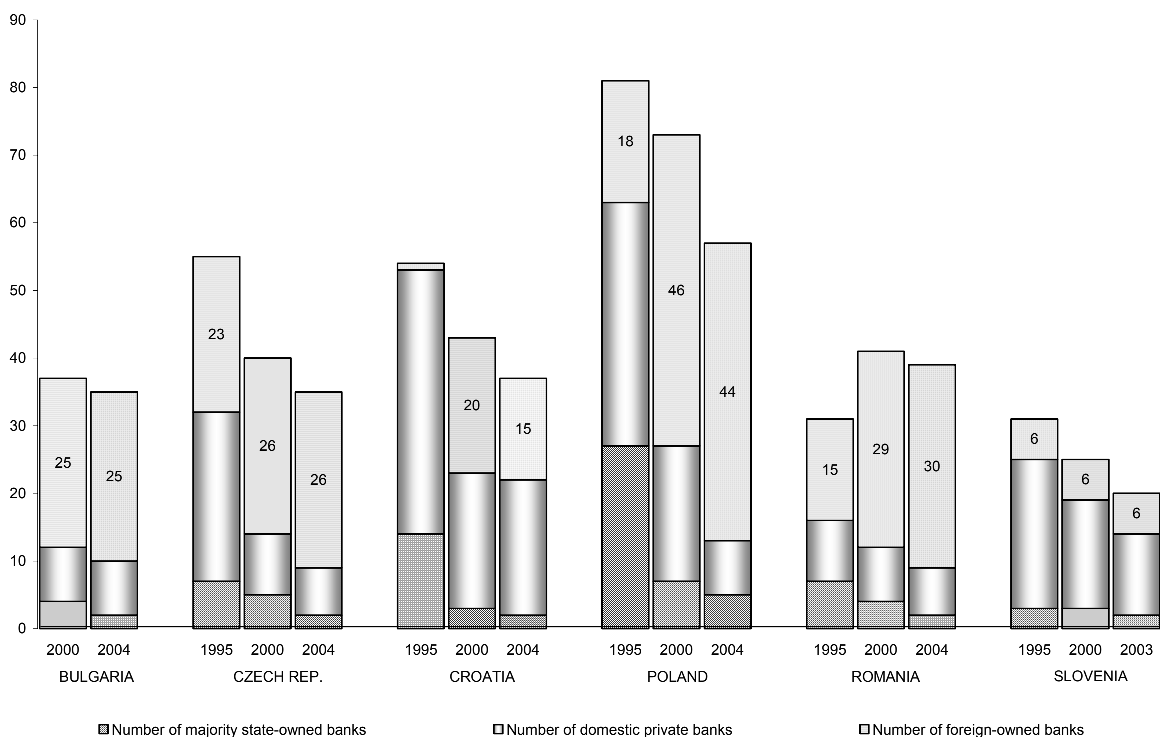



*Sources: national central banks, BRSA*

*Notes: for Slovak Rep. and Czech Rep. the number of banks includes the building societies; the data for Croatia (1995) include the number of housing savings associations; for Romania there are no data available referred to "other credit institutions".*

At the same time, privatisations offered EU banks an unprecedented opportunity to enter markets with high growth potential, allowing them to develop a widespread and significant presence in a short space of time.

**Chart 4 – Number of commercial banks by ownership**



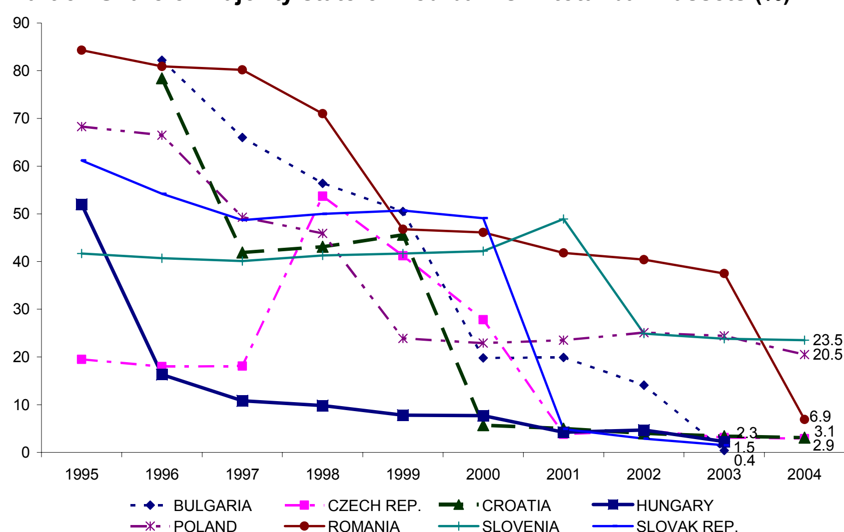

*Sources: national central banks*

Difficulties in achieving growth on the rather highly-consolidated domestic banking markets, and obstacles to expansion on other EU markets drove many medium-sized and large banking groups towards the new eastern European markets. This led to significant internationalisation of the banking systems in the CEEC8. These trends are strongly backed up by the figures.

The number of foreign-controlled commercial banks increased in some countries, but in all the CEEC8 they increased as a percentage of the total number of banks (chart 4). Some 26 of the 35 Czech banks, 44 of the 57 Polish banks and 30 of the 39 Romanian banks are now under foreign control.

Public ownership decreased markedly during the period 1995-2004 (chart 5), falling from around 70% to 20% in Poland, 52% to 7.4% in Hungary and 84% to 7% in Romania in 2003, for example. The banking sector is completely privatised in Croatia, Bulgaria and the Czech Republic.

**Chart 5 - Share of majority state-owned banks in total bank assets (%)**




*Sources: EBRD, national central banks*

*Note: for Poland the data refer to commercial banks only.*

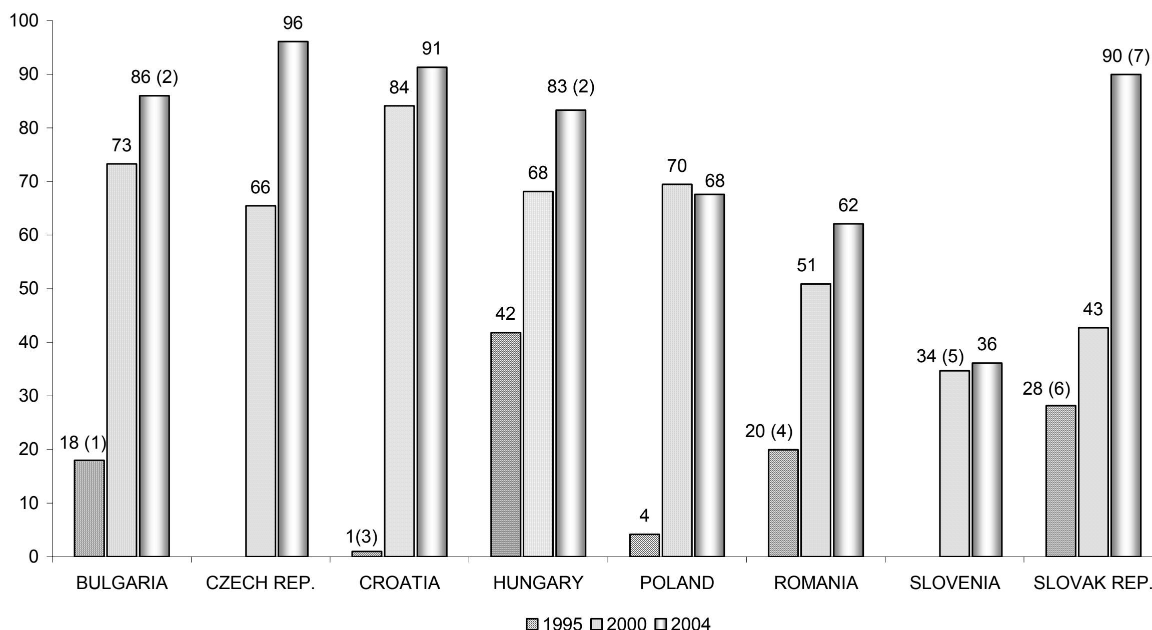
Meanwhile, the share of assets belonging to banks controlled by foreign investors (generally each country's largest banks) as a proportion of total banking assets shot up in nearly all the countries, approaching or exceeding 90% in four of them (chart 6). The only exception is Slovenia, where the share of assets belonging to foreign investors is only 36%. Liberalisation measures allowing the entry of foreign banks were passed later in Slovenia than in the other countries in the region (in 1999), however, and significant stakes in the country's two main banks remain in public ownership.

Note, though, that foreign control is not exerted via 100% ownership: a look at the shareholding structure of the sector[12] shows that the percentage of capital in foreign investors' hands is lower than their market share. One example is the

12 *Figures are not given in the text, but are available on request.*

Czech Republic where foreign investors control 96% of bank assets through only 83% of banking capital.

**Chart 6 – Share of foreign-owned banks in total bank assets (%)**




*Sources: BA, national central banks.*

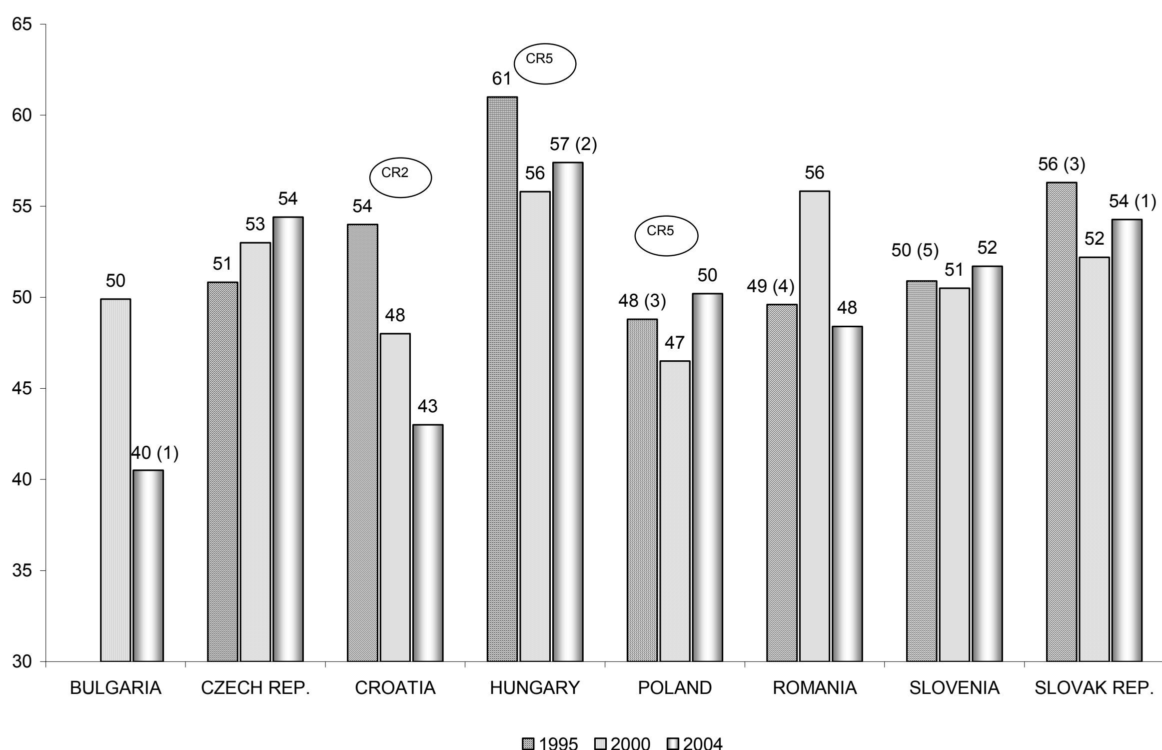
*Note: for Poland data refer to commercial banks only.*

*(1) 1997 (2) 2003 (3) 1996 (4) 1998 (5) 2002 (6) 1999 (7) 2001*

Looking at the banking sector in the CEEC8, one feature that is common to all is the high degree of concentration, although this trend has decreased since 1995 for both deposits and loans (chart 7). In the Czech Republic, Slovakia and Slovenia, over 50% of total banking assets belongs to the three largest banks. In the more developed markets, such as Hungary and Poland, the same percentage is held by the five biggest banks. The most concentrated market is Croatia, where the top two banks own 43% of bank assets. This high degree of banking market concentration is due partly to the small size of the countries and partly to the original monopolistic structure of their credit industries. This trend towards consolidation is expected to develop further in the future through M&A activity, which has already seen some countries' largest banks involved in takeovers not only on the domestic markets but also in neighbouring countries[13].

[13] *For example, OTP, Hungary's biggest bank by size, acquired the Czech IRB (Investment and Development Bank) in December 2001, the Slovakian IRB in 2002, DSK Bank (Bulgaria) in 2003, Robank (Romania) in 2004 and Nova Banka (Croatia) in 2005.*

**Chart 7 – Banking market concentration (CR3 Total assets)**



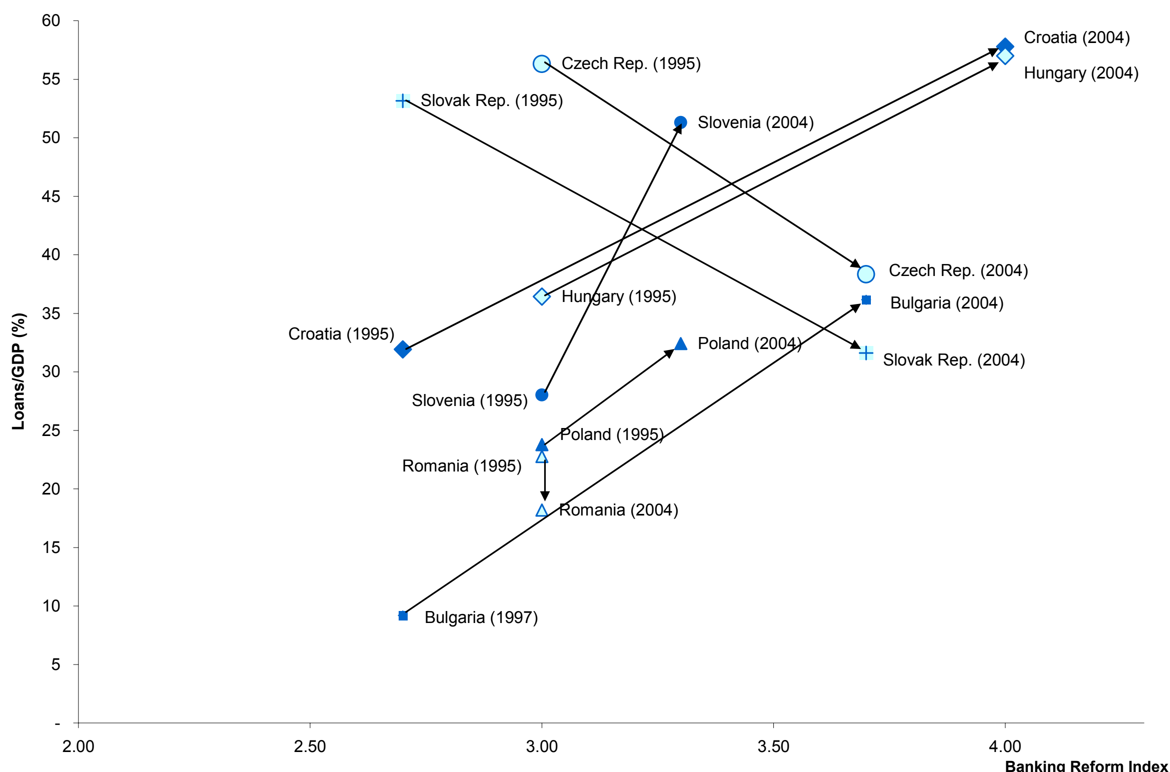

*Sources: BA, national central banks*
*(1) 2003 (2) Sept. 2003 (3) 1996 (4) 1998 (5) 1997*

## 4. Institutional reforms and development of banking activity

The importance of the institutional framework for economic and financial development is well documented, and recently led to a series of studies investigating the origins of institutional differences between countries, and the ways in which financial institutions—broadly speaking—influence economic development. One of the main conclusions from these studies is that there is a close positive correlation between banking structure and financial market development. A large body of empirical analysis carried out on market economies supports the hypothesis that financial regulation and corporate governance law (and the legal system more generally) are essential for the development of the banking and financial markets (La Porta, Lopez-de-Silanes, Schleifer and Vishny, 1998; Beck and Levine, 2002; Levine, 1998 and 1999, and others). A positive correlation between institutional reform and financial sector development has also been demonstrated for the transition economies (EBRD, 1998; Cottarelli et al., 2005), which helps to explain the differing levels of sector advancement in the CEEC8: Hungary, Poland and Croatia, for example, which started the reform process earlier, have a higher degree of financial services development than the other countries.

In all the transition countries, the changeover to a market economy has required thorough and extensive reforms to the institutions, which has also involved the financial system. For the central and eastern European countries, the prospect of EU accession has bolstered and accelerated the transition, guiding economic policy decisions and harnessing the efforts of the candidate countries to bring their banking and financial regulations in line with international standards. All the candidate countries have made undeniable efforts to harmonise the legislative and institutional frameworks that regulate the functioning of the domestic financial markets. This harmonisation was necessary both to enable foreign investors to participate in the privatisation process, and to rebuild confidence in the financial institutions, itself essential for banking sector advancement. A key factor here is the full implementation of the reform of prudential supervision, which plays an especially important role in transition economies where market practices and reputation need time to become established. Moreover, the creation of solid, well-regulated systems subject to close supervision is a pre-requisite for facilitating integration into the single European market in order to fulfil its objectives of complete freedom of establishment and provision of services, and the free circulation of capital.

**Chart 8 – Banking intermediation and reform**




*Sources: EBRD, EIU, national central banks*

The relationship between banking activity development and reform is shown for the countries under analysis in chart 8 below. Structural and institutional reform are measured by the index of banking reform and interest rate liberalisation drawn up for each country every year by the EBRD. This index measures the progress made in bringing banking legislation in line with international standards and

regulations, as well as advances in the liberalisation of interest rates, the allocation of credit, privatisation and mechanisms of prudential supervision[14]. The level of banking activity development is measured by the loans/GDP ratio[15].

The banking sector clearly made significant progress in structural and institutional reforms in 1995-2004, and those countries that were the first to introduce real, decisive changes (led by Hungary and Croatia) show a much higher loans/GDP ratio. The case of Bulgaria is equally significant, as reforms here were introduced later than in other countries in the region, but have been followed by a real boom in banking activity since 2000.

The Czech Republic and Slovakia represent something of an exception: partly for historical reasons, their banking sectors were already fairly developed in 1995, and both countries right from the beginning formally adopted much of the EU's banking legislation and launched privatisation programmes. However, banking volumes declined significantly as a result of the economic downturn in 1997-1999, which, even in the years immediately afterwards, had an impact on banking asset quality, and necessitated costly operations to clean up assets on the balance sheet and restructure loan portfolios. Banking activity therefore declined, despite progress in reforms.

Note that, for all countries under analysis, reforms must not only be formally accepted but fully operational for financial institutions to operate properly according to market principles, and for the confidence of investors and savers to increase over time as their rights are protected. Structural and institutional reforms are a necessary condition, but not enough on their own to drive a country's financial development.

## 5. Conclusions

The development of the financial sector will be a crucial factor in bringing about real and nominal convergence for the new and future EU members, as it will help boost economic growth and bring them in line with the EU more quickly. Financial activities in these countries have very high growth potential, given both the economic gap between their economies and the eurozone average, and the current level of financial services development in the CEEC8.

Despite high average growth in GDP and banking intermediation in the last few years, the level of development in the sector remains very low. The capital market is still in its infancy, and its size and role in all countries is limited. Institutional investors have a modest presence, and only in the most advanced companies do the insurance and pension funds sectors have any significance in relation to GDP. The number of non-banking financial intermediaries, particularly investment funds, is growing, but total managed assets remain low. Traditional banking intermediation activities are also much less developed than in the eurozone. This is the case even in countries that have for some time benefited from full economic

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14 *The indicator has a high positive correlation with other measures of institutional quality, such as political stability, absence of violence and accountability of political institutions, and is therefore a good proxy both of structural reforms in the sector and wider institutional reforms. The index ranges from 1 (minimum) to 4 (maximum). For further details on the methods used to allocate scores, please refer to EBRD, 1998.*

15 *The correlation between banking sector development and degree of reform remains strong irrespective of how the level of banking sector development is measured.*

stability and a sound banking sector, and despite the central role of banks in moving capital flows.

The banking development gap is very wide in all CEEC8 countries, but a positive growth trend is expected in the next few years. Projected economic growth and the consequent continuous expansion of credit institutions into new market segments (SMEs and households) and businesses (consumer credit, asset management, pensions and investment banking services) suggest that banking intermediation in these countries will increase significantly in the near future. Greater competitiveness also heralds an increase in loan volumes: banks, particularly those controlled by foreign investors looking to improve the profitability of their subsidiaries abroad, will be forced to increase loans in relation to investments in more liquid, but less profitable assets. Finally, the consolidation of structural and institutional reform, coupled with the full implementation of financial legislation, will ensure greater savings protection and better monitoring and governance procedures for the banks, which should lead to a permanent increase in banking intermediation volumes.

**Acronyms**

| | |
|---|---|
| BA | Bank Austria |
| BNB | Bulgarian National Bank |
| BS | Bank of Slovenia |
| CNB | Czech National Bank |
| CROSEC | Croatian Securities Commission |
| CZSO | Czech Statistical Office |
| DINADOS | Insurance Companies Supervisory Authority (Croatia) |
| ECB | European Central Bank |
| EBRD | European Bank for Reconstruction and Development |
| EIU | Economist Intelligence Unit |
| FIBV | International Federation of Stock Exchanges |
| FSC | Financial Supervision Commission (Bulgaria) |
| HFSA | Hungarian Financial Supervisory Authority |
| IMF | International Monetary Fund |
| KNUIFE | The Insurance and Pension Funds Supervisory Commission (Poland) |
| MFCR | Ministry of Finance of the Czech Republic |
| NBH | National Bank of Hungary |
| NBP | National Bank of Poland |
| NBR | National Bank of Romania |
| NBS | National Bank of Slovakia |
| OeNB | Oesterreichische Nationalbank |
| UFT | The Financial Market Authority (Slovakia) |

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