

*Joining the EU –
Impact on The Financial Sector of New Member States*

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On May 1st, 2004, ten countries will join the European Union. Will the transition proceed smoothly? The main concern related to new countries joining the EU, from the point of view of the financial sector, is what impact the enlargement will have on the functioning of financial markets in new member states. Will competition in financial services increase and place a strain on institutions in accession countries or in the EU as well? Will there be visible impact at all? The new member states consist of eight former transition economies and of Malta and Cyprus. I will focus on developments in the transition countries, and especially in the Czech Republic, which I know best. I will also try to make reference to other accession countries to show that the results of developments over the last thirteen years, at least in the financial sector, are not so different.

This brief presentation cannot do more than deliver only a basic description of the past development of financial markets in the transition countries and of their current standing. Hopefully the data from this presentation can serve as background information for those interested in further studies.

The financial sectors of the new Accession Countries have undergone huge and substantial reforms over last 13 years. When communism collapsed, there were no traces of a market economy, no free and legal entrepreneurial economic activity, and no institutions necessary for the functioning of a market economy. If we look at the transition economies - which represent 8 out of 10 acceding countries - today, we see a completely different picture. The basic institutions are in place and running (though sometimes slowly and not always predictably). The private part of the economy flourishes and is the symbol of a new and well functioning economy. How did this happen? And what happened to the financial sector? And what will be the impact of the accession to the EU on the financial sector, which in the accession countries is synonymous with the banking sector.

In 1990, the average starting point for reforms in the former socialist countries, the situation in the financial sector was bleak. There were no services aside from basic banking and insurance functions. The banking sector was comprised of few specialized institutions, each of them a monopoly in its own area [one institution had monopoly on collecting deposits from the public, another institution provided all the foreign trade financing, and yet another institution was allowed to open accounts for individuals with foreign exchange incomes]. Then there was a monobank, the most important financial institution, which performed both functions, of a commercial bank and of the central bank [however skewed that could have been in the centrally planned economy] and of the commercial banks. We should also understand that commercial banking was not about evaluating loan applications and looking at projects' fundamentals or clients' credentials. In the former socialist countries, there was a State Planning Commission that decided how much of certain production would get produced and by whom. The role of the banks was limited only to finding funds for financing the planned production.

It is important to acknowledge the situation at the outset of economic and political reforms. This would also help us to understand some of the problems that the transition economies went through later on. Thirteen years ago there were basically no real banks, no capital markets, no experienced staff and no experienced management. In addition to that, there was no capital in the banks. The ratio of capital to banks' assets was on average well below 1%. At the same time, there was a boom in entrepreneurial activities, with tens of thousands of new companies sprouting up. Their common characteristic was that they had no history, no

experience, no capital, but great need for debt financing. On top of this, all the laws were changing, institutions [such as prudential banking supervision] were built only gradually, and the state as decisive owner in the banking sector was not up to its duties as good manager. As said above, the banking sector represented the crucial part of the financial sector of the country. Therefore, it was also the one to be hit the most seriously in the course of the economic reform, especially on the credit allocation side. On the contrary, deposits continued to grow despite the negative real interest rate.

The economic transformation included deregulation of most prices, thorough foreign trade reorientation [after the collapse of the Soviet Union], enterprise privatization, tax system changes, and foreign exchange liberalization. Given the depth of the economic transformation, the transition countries achieved relatively quickly a generally stable environment after the initial shock.

This could be illustrated on the table describing developments in the Czech Republic, Poland and Hungary in terms of inflation and GDP growth:

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
CPI												
Czech R.	52,0	12,7	18,2	10,2	7,9	8,6	10,0	6,8	2,5	4,0	4,1	0,6
Poland	60,3	44,6	37,7	29,4	21,8	18,8	13,2	8,4	9,8	8,6	3,6	0,8
Hungary	35,0	23,0	21,9	21,6	29,2	20,3	18,8	10,5	11,4	10,2	6,8	4,8
GDP												
Czech R.	-11,6	-0,5	0,1	2,2	5,9	4,3	-0,8	-1,0	0,5	3,3	3,1	2,0
Poland	-7,0	2,6	3,8	5,2	7,0	6,0	6,8	4,8	4,1	4,0	1,0	1,4
Hungary	-11,9	-3,1	-0,6	2,9	1,5	1,3	4,6	4,9	4,2	5,2	3,8	3,3

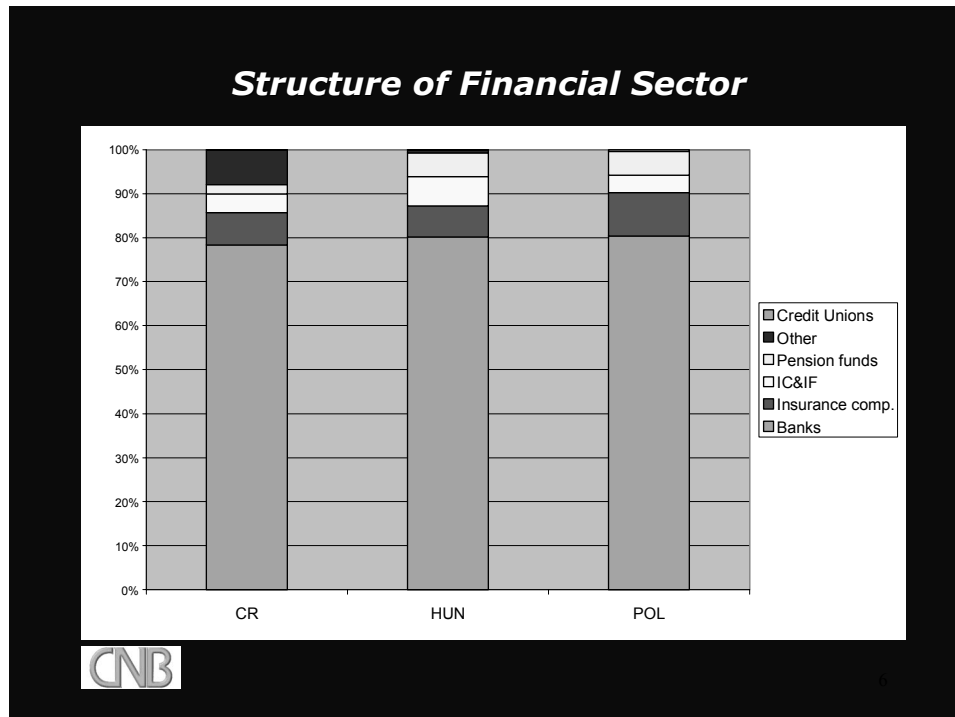
EIU Country data, national statistics

As already mentioned, since the financial sector consisted mainly of the banking sector, the impact of economic reform was felt mainly by the banks. There was no alternative source of financing for corporations, so difficulties in the corporate sector were passed on directly to the banks. The situation was complicated more by the fact that the government owned some of the most important corporations, as well as the main banks. Political rationale preceded economics. In most of the countries, the privatization of most firms happened early in the transformation process. Banks were an exception to this, and in different countries, the approach to privatization of banks varied. In the Czech Republic, the privatization of banks had been delayed for several years due to the government's belief that privatized banks would stop providing soft loans to strategically important firms. This fear was underlined by the experience with foreign banks that were entering the market since 1992 and cherry-picking their clients. After several years, the bad debt burden on banks' balance sheets reached such a scale that government had to step in. Most of the debt ended up with a special governmental agency and the losses are being paid from the state budget. The cost of the bank clean-up in the Czech Republic is estimated at approximately 21% of GDP. In some other countries [Hungary, Poland], the privatization of banks proceeded quicker and the fiscal costs were

substantially smaller [est. 6% for Poland, 13% for Hungary; *in Szapáry, National Bank of Hungary, 2001*].

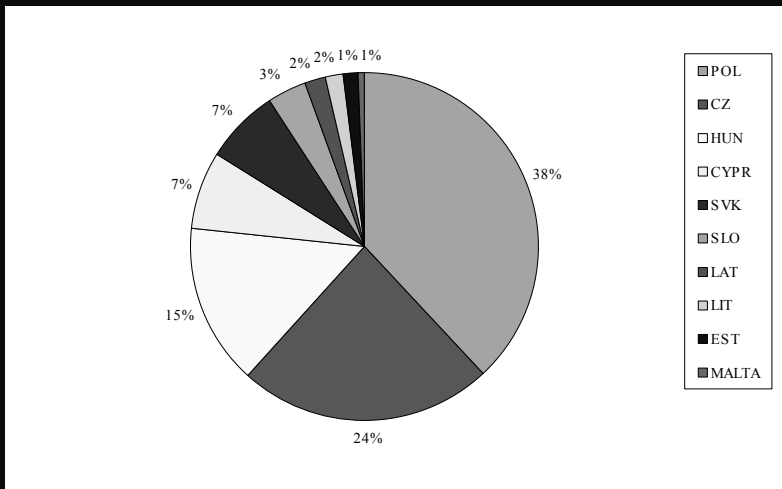
Given what I have just described, the financial sector in the accession countries is nowadays in remarkably good shape. The banking sector is sound and stable, the role of non-banking intermediation is growing, and clients have access to most of the products and services they have in the EU countries.

Following table illustrates the importance of the banking sector in three major accession countries [Czech Republic, Hungary and Poland]:



It is evident that the financial sector in Central European countries relies heavily on the banking sector, which represents approximately 80% of total assets of the whole financial sector. It could be also seen that despite the dominance of banks in all mentioned countries, the structure of other financial institutions differs significantly. This is the result of varying approaches to building these institutions. For instance, in the Czech Republic, we can see the smaller size of the investment business as a result of the quality of the capital markets, the lax regulation at the beginning of the transformation, and the subsequent and rather frequent occurrence of frauds in the past. The delayed start of pension reform has also contributed to this situation.

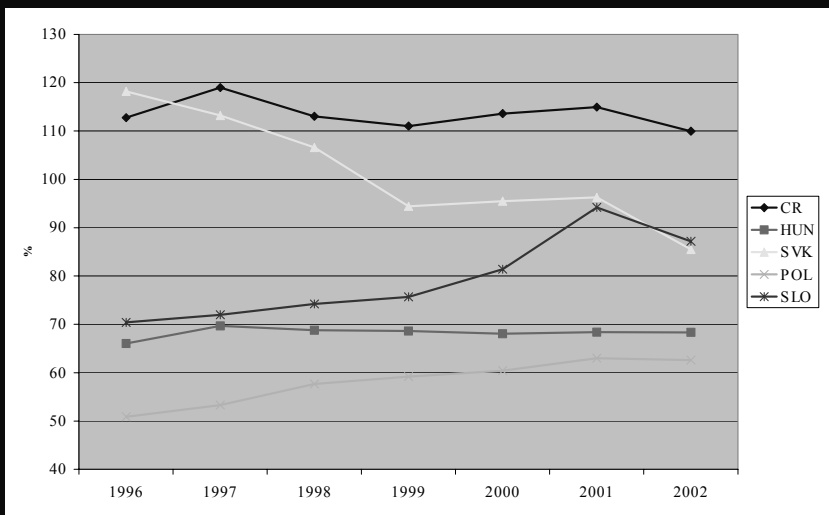
The largest banking sector in the new member states is the Polish one, followed by the Czech and the Hungarian sectors. These three biggest countries account for more than 3/4 of the total new member states banking assets. The banking sector of all new member states is nevertheless very small in comparison with the EU market. The total banking sector assets in all new member states are only 345 USD billions at the end 2002 (thus just 31,5% of Citigroup, or 43,4% of Deutsche bank, or 45,5% of HSBC).



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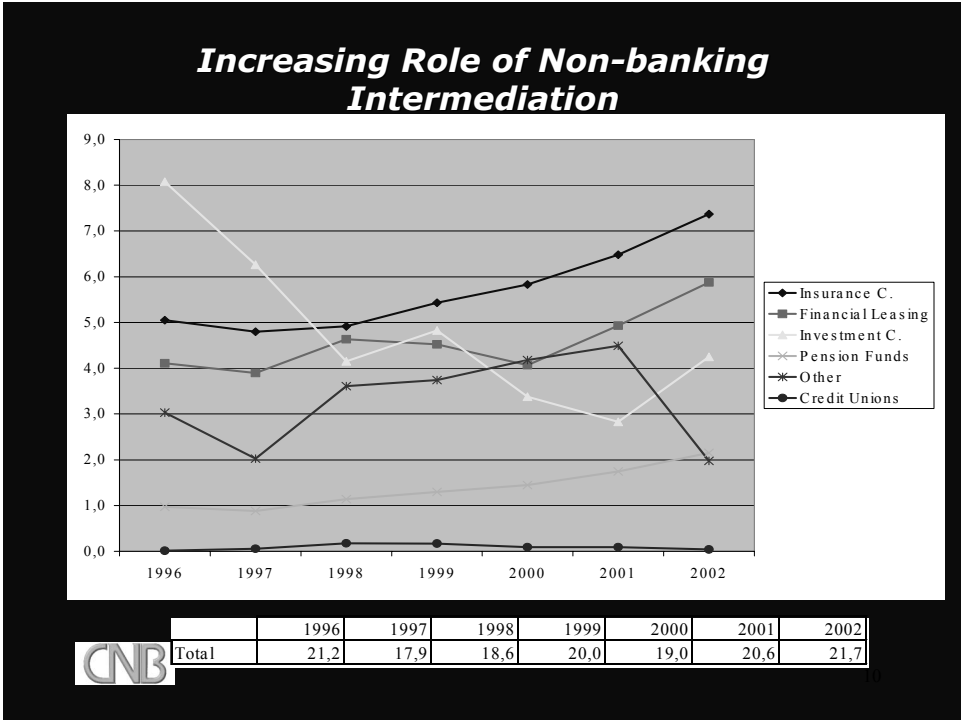
A look at financial depth [as measured by banking sector assets to GDP] of individual markets in five accession countries [Czech Republic, Hungary, Slovakia, Poland and Slovenia] shows that there is still significant space for growth of financial intermediation. Financial depth in the CR is the highest among the transition economies, but it is still significantly lower than in the EU [EU average 270%].

Financial Depth (Bank Assets/GDP in %)

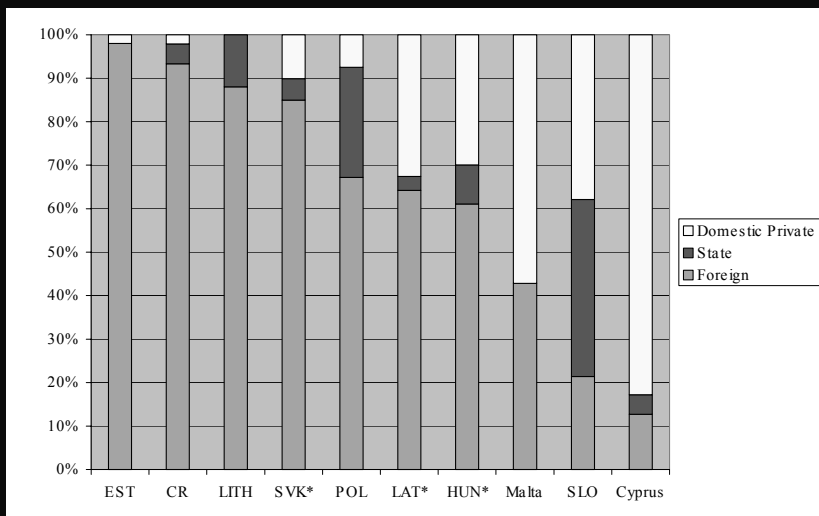


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Besides developments in banking, we can observe continuous growth also in non-banking financial intermediation [illustrated by Czech Republic]. In the Czech Republic, the share of non-banking financial intermediation on GDP increased from 19 to 21,7%. The highest increase was in the share of insurance companies and financial leasing institutions. However, the majority of these non-banking financial intermediators is controlled by financial groups headed by commercial banks. A relatively low share of investment companies and investment funds were negatively influenced by missing regulation and supervision in this field, however, there has been gradual improvement in recent years. In the area of pension funds we also witness gradual improvement caused mostly by government incentives, but we can expect quicker development if the government proceeds with intended pension reform.



The banking sector generally consists of previously state owned banks [since privatized to foreign banks], new banks established after 1990 as private institutions, and subsidiaries and branches of foreign banks. The approach to bank privatization differed in the new member states, but the results are now rather comparable. The banking sector is dominated by institutions governed by foreign banks [mainly from the EU], with exceptions being Slovenia, Malta and Cyprus.



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Who are the main players in the market of the new member states? Among the most influential institutions in the region we find Krediet Bank Bruxelles from Belgium, Erste Bank and Raiffeisen Bank from Austria, HVB Group and Bayerische Landesbank from Germany, Societe Generale from France and Unicredito Italiano from Italy. The limited group of non-EU banks is lead by Citibank and GE Capital. Unlike in Central Europe, in the Baltic states the foreign investors come from the Scandinavian countries, mainly Sweden and Finland -

Role of Foreign Banks

	Hungary	Czech republic	Slovakia	Poland	Slovenia	CEEC 5- Total	Croatia	Bulgaria	Romania
KBC Bank	7	15		3	15	7,5			
Bayerische Landesbank	9	0,2				1,2	0,1		
Intesa Bci	8		18			2,3	14		
HVB Group	6	5	4	7	3	5,9	6	7	2
Raiffeisen	5	1	9	1	2	2,2	7	4	4
GE Capital	3	3		0,6		1,5			
Citibank	3	3	3	6		4,3			3
Erste Bank	3	16	15			6	7		
Societe Generale		9	0,4		9	3,3		5	8
UniCredito			2	8		3,9	27	19	0,5

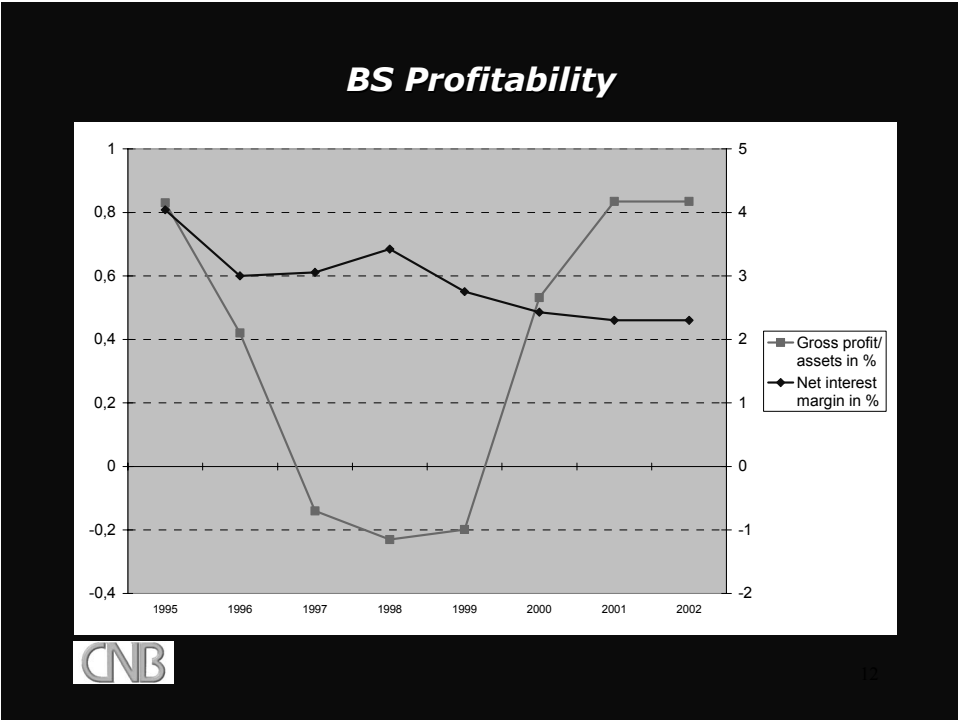
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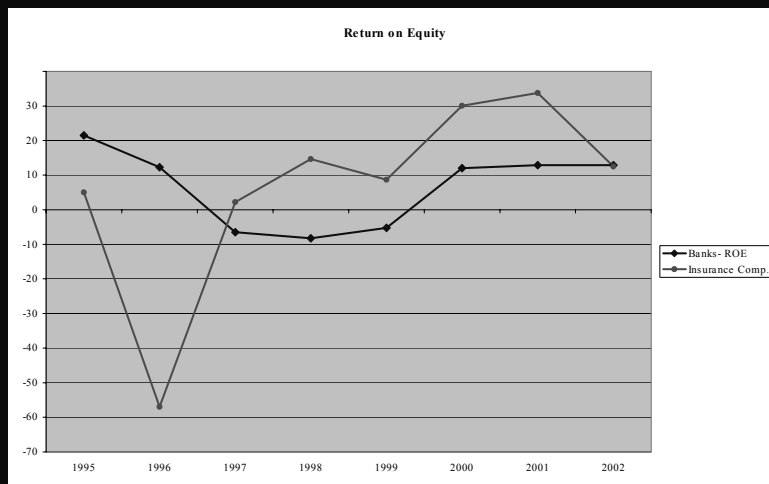
* Market shares of Controlled banks multiplied by their capital share, end of 2002

Hansabank, Group Nordea and Sampo Bank.

As said above, the economic transformation had a large negative impact on balance sheets. Banks tended to lend to previously existing companies undergoing privatization that were faced with a sudden loss of foreign demand (mainly from Soviet Union) and had to restructure themselves by laying off a big part of their workforce. This proved to be a recipe for financial disaster. Financing of newly established companies with no track record, with business plans based more often on good intentions than on thorough analysis was no better. In addition, the political elite, who saw bank financing as the quintessential source of economic growth, encouraged this lending boom. Existing risks were widely disregarded. This inevitably led to a very grim situation in the banking sector, where many of the newly established banks collapsed under the burden of bad debts. The state-owned banks had to have their capital replenished by the government. Balance sheet cleaning was also one of the preconditions for banks' successful privatization in the late 90's.

Nowadays, the existing banks are well capitalized, the level of bad loans is relatively low and adequate provisions and reserves are made. Despite the decreasing net interest margin, the profitability has improved, especially thanks to an increasing portion of banks' income coming from fees and commissions.





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1995 1996 1997 1998 1999 2000 2001 2002 H1 2003

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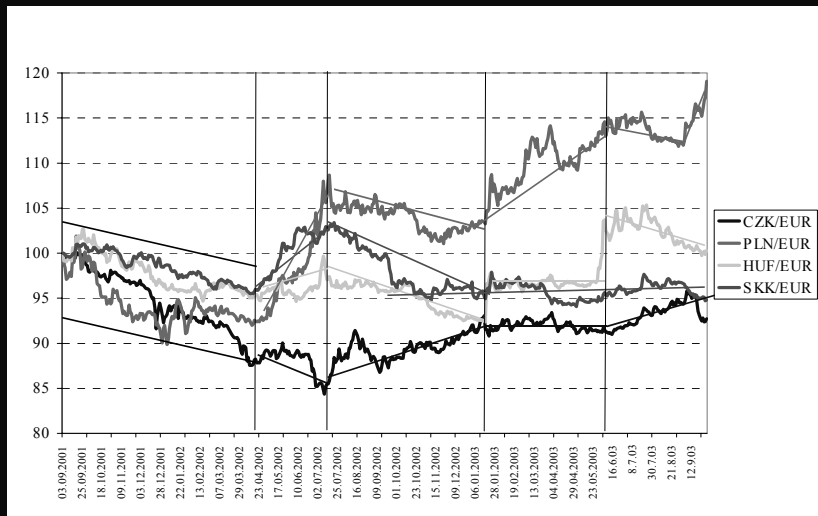
The legislative and regulatory framework has been already harmonized with the EU requirements. Special missions of experts from the EU countries have confirmed this in all of the new member states. However, the *acquis communautaire* are still developing and improving. This represents additional challenge for the new member states, since they must first adopt the existing rules, and also get ready for the coming changes.

The new member states are ready for application of Single Passport policy [it basically means that any bank from any EU country could provide services in the whole EU without additional licensing requirements.]. Since the domestic banking markets in the new member countries are competitive enough and have already a strong presence of foreign institutions, this should not lead to dramatic changes in lending in these countries.

Being a part of larger economic area, with banking sectors dominated by foreign institutions, will represent a new challenge for bank supervisors. The need for greater and more efficient cross-border cooperation will probably lead to changes in focus of the supervisory agencies.

After their accession to the EU, I do not expect any contagion effect among the Central European countries in case of difficulties of one of them. The institutional investors do not any longer view these countries as very coherent group. This assertion can be illustrated on developments of the exchange rate over the past two years. We can observe that the developments in the individual countries have little in common and the exchange rates followed paths reflecting domestic developments in the individual countries.

Contagion Among CEEC Countries?



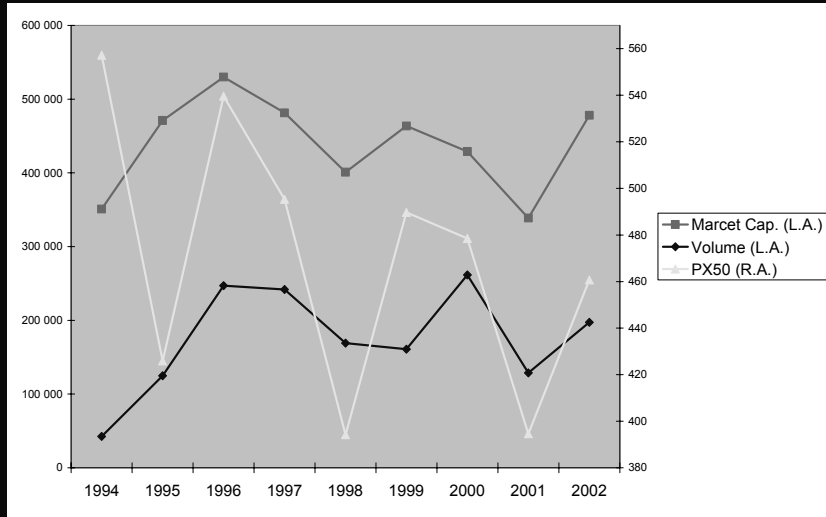
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Discussion needs to continue about potential risks, such as increased competitive pressure or implementation of new sophisticated financial products. It is also expected that some of the most sophisticated risk management techniques will be done on group wide level and thus outside of the host country jurisdictions. There will be some risks and potential threats arising from the changes. But at this time, there is not a single specific risk that would threaten to disrupt the banking and financial services in the new member states after becoming part of the single market.

Capital markets in the new member states were previously non-existent. In the Czech Republic, a capital market was developed as a "byproduct" of the voucher privatization. Introduction of regulation and supervision was delayed and the Securities and Exchange Commission was created only a few years after the market had existed.

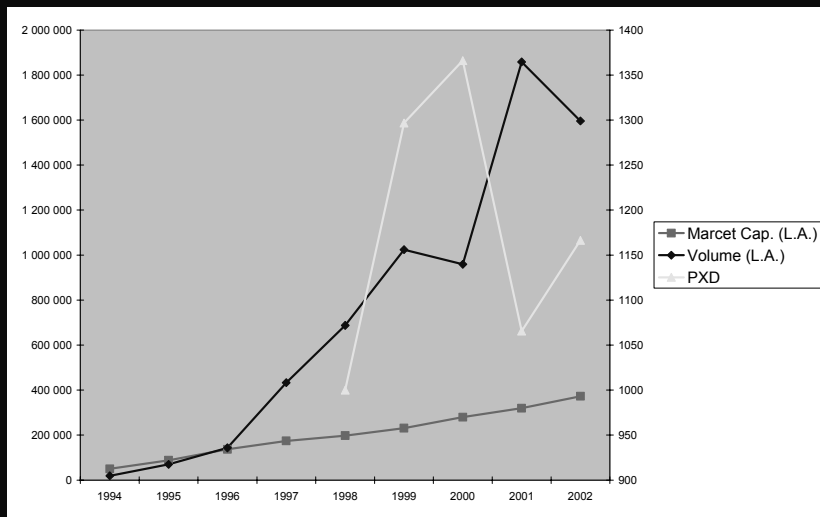
The capital market is stagnating as a result of voucher privatization, during which the number of shares congested the market. This subsequently led to large de-listing of the number of shares from the market (the number of shares traded now is 23 times smaller than in 1995, just after the voucher privatization). The market was also plagued by frauds and non-transparent behavior. The volumes and market capitalization has stagnated, 88,5% of total volume is concentrated into 5 shares. There has never been any IPO, and even the good companies are de-listed from the market after their privatization (such as Ceska Sportelna, the largest Czech retail bank). Capital markets in some of the other new member states function arguably better than the Czech one, nevertheless their significance is also much less than in more developed countries. The aggregate equity market capitalization in all new member states represents less than 2% of market capitalization in the EU. The Warsaw Stock Exchange is the largest one in the region [40% of total].

PSE- Basic Data (Shares)



	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of Traded Shares	1024	1698	1628	300	283	181	142	100	79

In bond trading, the situation is slightly more optimistic. The volume traded is approximately eight times the size of share trading and there is much higher liquidity. Continuous increase in volume is mainly due to the issuance of new public debt.



	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of Traded Bonds	27	48	80	92	98	95	94	82	72

What will the future bring to capital markets? It is evident that with limited share trading, there is not a very rosy future ahead. There are discussions about merging the markets in the region and possibly joining some European Stock Exchange. There are some speculations about the Stock Exchange in Vienna wanting to be the market for the region [Vienna is the second

smallest SE in the EU.]. However, individual countries would prefer to either remain independent, or to cooperate more closely with some bigger partners - such as the Frankfurt Stock Exchange.

As shown above, **the financial sector is generally in good shape**. There are some differences among the individual parts of the financial sector, but the main part [the banking sector] is as sound and strong as never before. This is due to several reasons, such as the improving legal environment, improving management, or even outright government financial assistance in the past. However, the greatest difference is due to the privatization to foreign banking institutions. These institutions have brought all the necessary components for successful long-term banking.

The legislative and regulatory framework has been harmonized with the *acquis communautaire*. The harmonization has been confirmed by EC Peer reviews and by the multinational financial institutions (such as the IMF and World Bank during their FSAP process). Of course, there is still a lot of work to be done. The legislation and regulation shall be more streamlined, the area of law enforcement needs to function more efficiently, changes in accounting standards must be made. But these tasks are not related purely to the EU accession. They would have to be done under any circumstances.

The financial sectors in the new member states are functioning efficiently, and are stable and competitive. The majority of financial sectors are in foreign hands, well capitalized and well managed. Institutions from the EU are governing the largest financial institutions in the new member states. Introduction of the Single Passport policy will mean a change only *de iure*, not *de facto*. Foreign institutions that wanted to provide their services in the new member states are already present there. I do not expect any rush of new players to the new countries of the European Union. It is more probable that with increasing living standards of the population, the space for new financial products' penetration will increase as well. I expect to see increased competition in this area, as already established institutions compete for new clients. It is unlikely that many new financial institutions will enter the market, because the market is already saturated, and players who had a strategic interest in Central Europe have already established themselves.

Authorities from the new countries are already participating in committees and working groups established by the European Commission and European Central Bank, so that rules, as well as the policy thinking are being coordinated and harmonized.

Challenges from the EU accession will therefore not represent any major risk. The problems and challenges that the new member states will face are not any different from those that are faced by the "old" member states, such as implementing the new Basle Capital Accord, implementing the IAS, increasing cross-border cooperation, monitoring activities of large complex financial groups, evaluating new complicated financial products, understanding risk transfer among different financial institutions.

The transition will greatly benefit from the hard work that has been done during the economic transition and during the preparatory stages for the EU accession. It will be smooth and I do not expect any disruption of financial service in the new member states, or in the EU as a whole.

It could be said that the financial sector is already in the European Union.

Useful links

- pavel.racocha@cnb.cz
- www.cnb.cz Czech National Bank
- www.nbp.pl Polish National Bank
- www.nbs.sk Slovak National Bank
- www.mnb.hu Hungarian National Bank
- www.bis.org links to other national banks

