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THE TRANSITION TIMES OF THE BANKING SYSTEM IN SOUTH-EASTERN EUROPE – FROM SYSTEMIC COLLAPSE TO STABILISATION

The paper analyses the commercial banking sector's development in south-eastern Europe during the transition period. The transition of the banking sector evolved - or is still evolving - parallel with the general economic transition. However, due to its complexity and the widespread factors that influence its activity, its development was a slow and gradual process with occasional systemic meltdowns. The paper proves that despite the different legacies, initial condition, applied economic policies, and historical events, the banking sector's structure became similar in all country cases by the end of the transition period. This similarity could be explained by the mutual challenges and the financial globalisation.

INTRODUCTION

The paper aims at proving that despite the different starting points, applied economic policies, and historical circumstances, the banking sector's structure in all south-eastern European[1] (SEE) country cases became similar by the end of the transitional process. It can be concluded, that despite the different political attempts and applied policies, a rather similar template could be outlined for the banking sector's development path by the end of the transition process. This was due both to the similar challenges and the financial globalisation.

The paper focuses on the transition and stabilisation of the commercial banking system in SEE. Following the introduction, the sector's transformation process is reviewed. This includes a brief overview of the main legacies of the socialist time period. This is followed by a chapter on the role of foreign banks, incorporating a relevant literature review. This topic is particularly important in SEE, as large foreign banking groups played a pivotal role during the transition process, since they gradually gained terrain and became the dominant actors of the sector in all country cases. Finally, a comparative overview helps to conclude. Throughout the paper, comparative analysis is used as a primary tool for the analytical work. It is worth emphasising that strict time limits cannot be drawn for the transition, as the process has still not been concluded in certain aspects. Nevertheless, the paper includes analysis only up to 2007. It must be mentioned that despite its importance, the regulatory and supervisory framework is excluded from the analysis or

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1 SEE refers to Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia and Kosovo. Though Kosovo's status is disputable, it is treated here as a separate country. The term SEE is used in the jargon of the European Union and refers to the region of the candidate and potential candidate countries. SEE is often used as a synonym for the "Western Balkans".

it is only briefly mentioned. The same applies for the macroeconomic environment.

The region of SEE is particularly important for various international actors. Among them is the European Union (EU), not only because of its geographical closeness, but also due to the strong economic linkages that have been built in the previous years. Furthermore, all countries in SEE participate in the EU accession process, which also means that economic integration becomes a core element. The banking system itself can be considered as a pillar of this integration and the catching-up process. Analysing the transition of this sector is inevitable for understanding the current structures, operations and challenges.

1. THE TRANSFORMATION OF THE BANKING SECTOR

During the socialist period, Albania and the Socialist Federal Republic of Yugoslavia (SFRY) implemented two completely different economic models. The former country represented a special case within the European socialist bloc, with its constant loyalty to the classical socialist system and its isolation. SFRY shifted to the other end and became probably the most unique socialist prototype, due to the fact that it became an odd mixture of market oriented and socialist elements.[2] The same applied for the banking system: while the Albanian banking system remained in line with the classical socialist model, in SFRY the banking sector developed parallel with the general economic reform waves and incorporated various market economic elements over time. To mention one of the fundamental differences, SFRY established a two-tier banking system from the 1960s, when local banks were established and it was prohibited for the central bank to channel credits directly.[3] However, during the transition period, both Albania and the successor states of SFRY had to tackle the same challenges. It can be concluded that throughout the socialist years the banking system in the countries had limited or no experience

- as a financial intermediary, because its role was rather limited on recording transactions in Albania and remained narrow in SFRY,
- in the credit evaluation and risk management methods and tools,
- in international accounting, as accounting rather served the monitoring of the plan fulfilments,
- in – generally speaking – banking in a "real" market economy [Cani–Hadëri, 2002].

Likewise, in case of the general economic transition process, a range of tasks could be listed for the banking sector's transformation. This means that a certain kind of "Washington consensus" could be set up for the banking sector as well. This included the separation of the commercial banks and the central bank, the

2 To read more on these economies, see e.g. Kornai (1992), Gligorov (1998), Schnytzer (1982), Singleton (1976), Sjöberg–Wyzan (eds, 1991) or Uvalic (2010).

3 For more details on the banking systems, see for instance Cani - Hadëri (2002), Gedeon (1987), Lydall (1984) or Šević et al (2002).

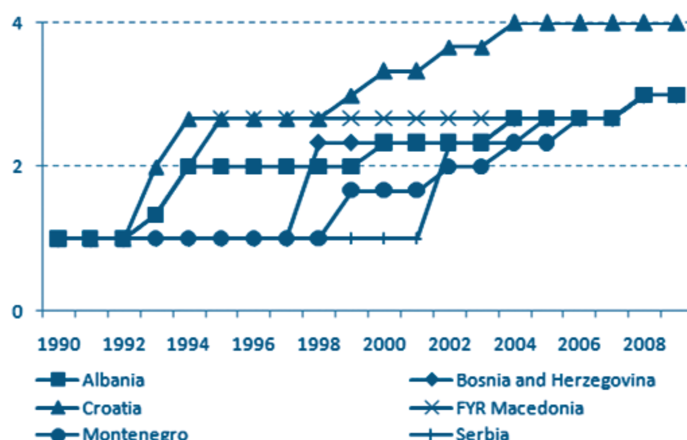
abolition of restrictions on the internal convertibility of money, the interest rate liberalisation, the restructuring and privatisation of state banks including their enterprise borrowers, the entry of new private banks. Parallel with these tasks, in order to curtail the risk of the rapid market liberalisation process, which could not be achieved in case of SEE, the state played a crucial role in building the regulatory and supervisory system. This also included the building of the physical and human capacity of related authorities and courts. As a further pillar, the enterprise reforms could be considered complementary to the banking reforms. Particularly the areas of bankruptcy and corporate governance were crucial for the banking sector's sound development. Not only in SEE, but generally within the range of transition economies, both the pace and sequencing of these steps showed great differences [Fries–Taci, 2002]. Nevertheless, the institutional framework had to remain dynamic in order to adapt to the changing market environment. This required a continuous development process from the side of policy makers. All in all, the primary and theoretical goal of the reforms was to build a sound banking system which fulfils the tasks that are required in a well-functioning market economy. These are the improvement of risk management, the allocation of resources, monitoring managers and exerting corporate control, the mobilisation of savings, facilitating the exchange of goods and services, and absorbing financial and real economic shocks [Levine 1997, ECB 2010].

The stabilisation and the establishment of a market-oriented banking system was usually part of the general stability and reform programs. Before the transition, banks in SEE were characterised by a very high ratio of non-performing loans, high lending rates, and lack of competition, which was coupled with an environment of transitional recession and high inflation. Furthermore, in case of the successor states of Yugoslavia, the banking system had to cope with the aftermaths of the "frozen" FX savings trauma.[4] Taking all these into consideration, it is quite evident that the inherited banking system collapsed in each SEE country and had to be consolidated and rebuilt with large state support. Nevertheless, the starting positions, the particular mechanisms, sequencing, timing, and duration showed great differences.

The EBRD index of banking sector reform summarises the level of banking reform and interest rate liberalisation for transitional countries with a single score. The scores are available from 1 to 4+, whereby 1 refers to minor progress beyond the establishment of the two-tier banking system, while 4+ means the adaption of

4 From the 1970s and 1980s, credit institutions borrowed FX loans on international markets with sovereign guarantees, and financed projects that were supported by the authorities related to these funds. Meanwhile, fostered by the growing amount of remittances and incomes from tourism, the increasing sum of FX deposits was to a large extent redeposited at the national bank in exchange for dinar credits. However, from the 1980s the dinar was often devalued as inflation gained momentum, while as a further risk, the central bank's FX reserves started to decline. The large amount of households' FX deposits that were previously transferred to the central bank in Belgrade – as a consequence of the monetary system's problems – became irretrievable and "frozen" [Barisitz 2008]. This was the first major shock that undermined the confidence in the banking sector for long-term, while the compensation of the household sector is still an unsettled issue in most of the successor states.

the advanced industrial economies' norms.[5] With the help of this index, Chart 1 reflects an overview of the banking system's transition dynamism in the SEE countries. The mentioned differences of timing and development level can be very well observed. The starting date of the major restructuring varied over a decade, but all countries converged to the same development level and reached index 3, with the exception of Croatia, which achieved a more dynamic progress and a higher score compared to the rest of the SEE countries. The background of these differences and similarities will be highlighted in the following.



Source: EBRD statistics
Note: No data for Kosovo.

Chart 1: EBRD index of banking sector reform for SEE countries

Starting with the country, which inherited a "classical" socialist system, in Albania, as part of the stabilisation program and implemented in 1992, the two-tier banking system was established following the adoption of the central bank and commercial banking laws. On the remains of the former monobank, a central bank

5 The following explanation is provided for the specific scores related to the banking reform and interest rate liberalisation:
"1: Little progress beyond establishment of a two-tier system.
2: Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
3: Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
4: Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
4+: Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services."
(Source: Transition indicators methodology,
http://www.ebrd.com/pages/research/economics/data/macro/ti_methodology.shtml, downloaded: 15/04/2011)

and three universal banks were created (the Agriculture and Development Bank, the Savings Bank and the Import-Export Commercial Bank). Furthermore, the central bank was separated from both the commercial banks and the fiscal authority, abolishing automatic budget deficit financing by law.[6] This meant that the central bank, renamed as the Bank of Albania, gained a completely new ground and remained in charge only of the monetary policy with strict rules on issuing money. During the first years of transition, bankruptcy procedures could not be initiated and most medium and large-enterprises were still not privatised. These features led to a massive inter-enterprise crediting activity of which a substantial amount became bad debt. Furthermore, just as in the previous regime, the still non-privatised firms continued to require funds from the government or as a secondary solution they borrowed at negative interest rates [Pashko 1996, Dushku 2010].[7] The transition process of the banking sector lasted a decade. During the early 1990s, the three state-owned commercial banks dominated the market accumulating large debts. One of them was liquidated in 1998 and another was privatised in 2000, while the largest of the three with broad national coverage was privatised to a foreign investor only in 2003. Beside these, several foreign banks penetrated the market by acquiring licences with the fulfilment of the requirements of the banking law, which was gradually strengthened throughout the years [Šević et al 2002].

The favourable development in Albania, which started after the stabilisation of the economy, was abruptly shattered by the collapse of several large pyramid schemes, which held a large part of the population's savings. Pyramid companies in Albania operated already from the early 1990s, but their activities culminated in 1996. Many people even sold their belongings, including for instance farms or homes, expecting 50–100 percent interest within a matter of weeks. The growth of the large pyramid companies was supported by their coordinated publicity campaigns and was not interrupted by warnings or measures from the government or authorities [Biberaj 1998]. Based on conservative estimations, almost USD 0.5 billion was invested in various pyramid funds [Biberaj 1998, p. 317]. The collapse of these pyramid schemes in 1997 led again to a major turmoil in Albania, including social unrest and governmental failure. According to estimations, the amount of the affected total liabilities reached almost half of the annual GDP [Šević et al 2002, p. 28]. Due to the fact that the people have lost their savings, the consumption fell sharply, the real GDP contracted by 11 percent, while inflation exceeded 33 percent [EBRD statistics]. Foreign intervention was needed to regain a certain level of public order, and thanks to an economic recovery program, the country was able to return to a period of low inflation and fair GDP growth within a year. The new program focused on a wide range of fields, including the development of the institutional system, the social and economic policies and boosting the economic activity [Šević et al 2002]. However, just as in the case of the "frozen" FX savings in Yugoslavia, the collapse of the pyramid schemes had a similar, long lasting psychological effect on the financial behaviour of the Albanian population. To conclude,

6 A credit ceiling was implied, which was 10% of the previous year's revenues.

7 These phenomena fuelled the rapid growth of broad money and inflation.

after the transition process with its temporary shock waves the banking sector gained stability, but the financial deepening remained low, with one of the highest ratio of cash per GDP among the transition countries [Šević et al 2002].

Croatia's case showed many similarities with the Albanian experience. The Croatian banking system was insolvent or had problems related to the settlement of claims by 1990, domestic savings were either part of the "frozen" amounts or were transferred to other countries during the upheaval. The first Banking Law that was adopted in 1993 has set up the minimum capital requirements of the system and liberalised the entry for new banks. Rehabilitation measures were taken already in 1991, but this was rather a one-off bookkeeping operation. In 1994, the State Agency for Bank Rehabilitation and Deposit Insurance was established which started a case-by-case rehabilitation for the largest banks in the sector [Barisitz 2008]. Following this period, the amount of savings – especially FX deposits – increased sharply, proving the growing confidence in the system. Attracted by the higher interest rates, savings from foreign banks were transferred to domestic banks and savings from "mattresses" were deposited [Šonje–Vujčić 1999]. The deposit base of the banks became FX dominated again. At the same time, a large part of the enterprise sector was unable to repay its debts to the banks by 1995. The government supported these companies by issuing special bonds, which were used for the repayment of the debts. This resulted in the large amount of public debts in the banking sector's balance sheets [Šević et al 2002].

All in all, the rehabilitation of Croatian banks featured cash payments and required large amount of sovereign issuing. Meanwhile, prudent lending policy was still lacking and loan repayments remained problematic. Furthermore, the bankruptcy policies were applied in a poor manner. In cases of mergers and acquisitions the experience was often missing. With the dominance of FX base, banks became particularly vulnerable to FX market movements. In addition, small and medium-sized banks offered higher interest rates for FX deposits to outperform their competitors. These were coupled by the international financial crisis of 1997–98, which limited the access to foreign credits. All these weaknesses and vulnerabilities led to a second major banking crisis in 1998 [Barisitz 2008, Šević et al 2002]. Few banks were rehabilitated and, following a budget revision, insured deposits of bankrupt banks were paid out. According to estimations, in the period of 1991–99 the cumulative government debt that was issued for bank rehabilitation reached around 32 percent of the GDP [Barisitz 2008, p. 51]. This second wave of the banking crisis brought a major shift in both the government's and the banking sector's policy and practice. The banking market swiftly changed, as many small and medium-sized bank exited, the state gradually withdrew from the sector while foreign strategic investors entered the market by acquiring stakes in leading credit institutions that have been rehabilitated in the former years. After this period, the supervision strengthened and banks became more cautious in their banking activity, noting that the creditor rights were still insufficient in the real sector [Barisitz, 2008].

Turning to Former Yugoslav Republic of Macedonia (FYRM), the privatisation in the banking sector was conducted within the programme of enterprise privatisation, but additional special measures were not taken. The Banks and Saving

Banks Act came into force in 1993 and it determined the capital requirement for the sector. It was quite widespread that banks continued to finance loss-making enterprises with low debt servicing capacity, which could partly be explained by debt-equity swaps, where banks collected enterprise stocks. To respond to these problems, in 1995 the policy makers took measures to restructure and rehabilitate the banking sector. In the previous year a rehabilitation agency was established to collect bad loans from the enterprise sector and link it with the rehabilitation of the banks. The cost of rehabilitation reached 42 percent of the GDP, with 12 percent referring to the cleaning of bad loans from the banks' balance sheets and 30 percent to the repayment of the "frozen" foreign saving [Šević et al 2002, p. 277]. However, the stabilisation of the system took place only after the banks' were restructured as well by new owners. These steps gradually pointed to the banking system's increasing profitability, led to comfortable capitalisation ratios and the drop of bad loans [Šević et al 2002].

One of Bosnia and Herzegovina's (BH) most notable differentiating feature stems from its unique state structure. This means that, just as in case of the general economic development, the banking system in the two entities (in the Federation of Bosnia and Herzegovina (FBH) and in Republika Srpska (RS)) developed separately. The lag in the sector's rehabilitation and restructuring originated from the war and the unclear state structure. A further delay was caused by different priorities, as healing the banking system was not included in the initial economic stability measures. The Federation Banking Agency started its operation in 1997 and the legislation for bank privatisation was passed the next year. The Banking Agency for the RS was established in 1998 and the privatisation started somewhat later, but with a quicker pace. The privatisation or liquidation of the banks began by the preparation of opening balance sheets. The insolvent banks were shut down in 2000. The banks' impaired assets and liabilities were transferred to the Ministry of Finance, with the balance sheets cut by 80 percent. The amount of the "frozen" foreign currency deposits reached more than 80 percent of the total assets. Capitalisation was low at the beginning, thus the capacity for the lending activity was limited [Šević et al 2002]. However, a gradual development started from the 2000s in both entities. It is worth mentioning that even the supervisory and regulatory system mirrors the scattered state structure, since separate agencies operate in both entities, but even a state-level coordinating authority became necessary. Moreover, separate agencies have been established for the banking, insurance, and securities sector. This means that nine agencies need to cooperate with each other to cover the complete financial sector, which can be considered unique even within SEE.

Among the countries of the region, the largest lag in the banking sector's development could be observed within the group of Federal Republic of Yugoslavia (FRY). This implies that the "lost decade" term does not only refer to the general economic reforms, but also for the complete financial sector's transition process. During the 1990s, no major banking sector restructuring took place, only certain legal documents were passed. Such document was the Law on Banks and Other Financial Organisations, which came into force in 1993 and applied a new regulatory framework for the system. During the years of hyperinflation, the value of the

dinar assets and liabilities were wiped out of the banks' balance sheets. By the second half of the 1990s, the banking sector was in a catastrophic shape, as the ratio of bad loans amounted to around 90 percent and the sector was saddled with negative capital. Despite these features, the central bank required the largest banks to keep the credit lines open for the reviving real sector [Barisitz 2008].

Within the group of FRY, fundamental reforms in Serbia started only in the 2000s after the fall of the Milošević regime. 2001 was spent for the assessment of the system and plans were set for the restructuring strategy with the help of the international financial institutions. Likewise in other SEE cases, the confidence regarding the banking system became very low, due to the painful experience of "frozen" FX deposits and the various pyramid scheme scandals of the 1990s. The level of public mistrust could be well measured by the euro cash changeover in 2002, as the cash needed to be deposited for the conversion process. EUR 4 billion was paid in and converted, but following this action three-quarter of the amount was withdrawn again. In 2002, the authorities issued state bonds in exchange for the repayment of the "frozen" savings, and the restructuring of the banking system was launched. As a first set of the actions, a few banks were closed or equity capital was written off. Later in 2002, the authorities converted state claims to shares in many medium-sized banks, thus nationalising them and prepared them for the privatisation or resolution. The consolidation and privatisation of the largest banks was carried out case-by-case, thus requiring a longer time period [Barisitz 2008], but by 2010 the process still remained incomplete.[8] Nevertheless, by the end of the day the sector regained its stability and started its way on the regular transitional SEE development path.

Montenegro also had to experience the boom and bust of large pyramid schemes in the late 1990s. This shock took the banking sector to the verge of meltdown and further ruined public confidence [Barisitz 2008]. In case of the tiny Montenegrin market, the banking sector's assessment and the start of the consolidation took place in 2001. So compared to Serbia, the starting date was the same but the sequencing was somewhat different. Two banks were liquidated, a few banks were nationalised and prepared for privatisation or resolution. The largest bank was temporarily put under the central bank's administration, its balance sheet was cleared and was sold to foreign investors in 2003 [Barisitz 2008]. Public confidence was further enhanced by the Deposit Protection Fund, which was established in 2006. As in the case of Serbia, the Montenegrin banking system was able to recover and gained its stability as a result of the implemented measures. Parallel with this, public confidence slowly started to recover. Both Serbia and Montenegro experienced reviving credit growth and increasing deposit base from the mid-2000s.

In Kosovo, after the NATO bombing, the banking infrastructure was missing, meaning both the physical presence and the framework. This means that the financial sector and its supervisory and regulatory system had to be built from scratch.

8 The privatisation of the largest state-owned bank - Komercijalna Banka - has been planned for years, but in mid-2011 it was still not carried out. For a hint on the related public debate, see http://www.ekonomskisavetdss.com/english/2011/01/ivan-ninic-dangerous-intentions-of-the-regime/.

Kosovo's banking sector recovered under the administration of the United Nations Interim Administration Mission in Kosovo (UNMIK) and the guidance of international financial institutions. Many microfinance institutions were established by the support of international institutions and had an important role in building the banking sector[9] [Barisitz 2008], which was less typical in other SEE countries. Likewise in case of Serbia and Montenegro, Kosovo's banking industry had a swift development from the mid-2000s, although from a very tiny base and low sophistication. Foreign banks penetrated the market and local banks were established. The central bank became responsible for all licensing, supervisory, and regulatory functions. The gradual development of the banking system represents the growing confidence in the system in a typically cash-based economy. Likewise in case of other SEE countries, Kosovo's banking system became dominated by foreign-owned banks [CBK 2010].

2. THE ENTRY OF FOREIGN BANKS – A WIN-WIN SITUATION?

Both the socialist Albania and SFRY provided a challenging legacy for the countries of SEE. There was a lack of experience regarding modern capitalist banking techniques and environment. However, through the parent bank-subsidiary channel, foreign banks contributed to the region's economic transition from a socialist model to a market economy. This channel was supported by the brisk globalisation of the banking sector.

Generally, the foreign banks in transition economies were able to enhance the transfer of various benefits and resources, including, know-how, international accounting and auditing standards, managerial skills, IT technology, risk management techniques, loan monitoring methods, business network, relevant market information, product innovation [Barisitz 2008, Fries–Taci 2002, Karas et al 2010]. As for the latter, during the development process the banking sector penetrated to everyday life, while the range of products and services widened: new investment products, mortgage loans, credit cards, alternatives for consumer finance, dedicated products for small and medium-sized enterprises became more and more widespread in the region. Via the product innovation, banks "teach" the household and the corporate sector to use new products, all leading to an increasing degree of intermediation.[10] Furthermore, for a region that was poor in capital, the foreign funding played an important role in the expansion and development of the banking sector. Through their parent banks, subsidiaries were able to have market access to cheaper funding from more developed financial markets and to a certain kind of implicit deposit insurance [Barisitz 2008, Karas et al 2010, EBRD 2004]. Generally, as competition intensified, interest spreads narrowed and efficiency increased in the sector [Kraft 2002, Vujčić–Jemrić 2001]. The bottom line of the lit-

9 For instance, in mid-2010 8 commercial banks (of which 6 were foreign-owned), 11 insurance companies, 2 pension funds, 29 financial auxiliaries and 17 microfinance institutions operated in Kosovo [CBK 2010, p. 25].

10 To read an overview on the access to domestic finance, see e.g. EBRD (2004).

erature on the efficiency of the transition economies' banking system is that foreign banks are usually more efficient than their domestic partners [Fries–Taci 2004], whereas there is mixed evidence on the comparison of the domestic private and public institutions.[11] It is also important that in almost all transitional countries there was lack of trust and confidence in the local banking system, which was particularly true for SEE, so the entry of foreign banks with good international reputation helped to increase the amount of domestic savings that could be then channelled to proper investments [Keren–Ofer 2003]. Keren and Ofer (2003) argue that foreign banks may improve even the financial regulatory system, as it is their own interest to create a transparent environment where insider networks and corruption does not provide advantage for local actors. They even describe a vicious circle, where foreign banks are not willing to enter the new market until the legal environment and supervision allows unrealistic advantages for domestic banks, which finally leads to a potential financial crisis. On the other hand, the entry of foreign banks may support the improvement of the regulatory and supervisory system, thus generating the vicious circle.

All in all, these facts do not imply that foreign takeovers provide the one and only route for the establishment of a well-functioning banking sector, moreover it even incorporates particular risks[12], but nevertheless it definitely bolsters the development process compared to a home-grown system [Barisitz 2008]. As a macroeconomic result of the banking system's transition, the complete economies' transaction and payment system developed, while savings and resources were mobilised across the economy [Keren–Ofer 2003]. Despite the dominance of these positive effects, political motivations or nationalistic creeds often blocked the entry of foreign banks but even the privatisation process, which was then often enforced by a banking crisis [Bokros 2001, Keren–Ofer 2003]. This caused great differences in the development of the country cases, even within SEE. However, in a matter of time, finally most of the transition economies and all SEE countries started a rather similar financial development path with the dominance of a foreign-owned banking sector.

As Hryckiewicz and Kowalewski (2008) demonstrate in their empirical study on central European countries, foreign banks' engagement depends on the potential of the market and the degree of financial sophistication. While in developed

11 For a literature review on this topic, see e.g. Karas et al (2010).

12 There is a wide range of risks that became particularly relevant during the current global crisis period. Such risks can be highlighted as e.g. the case of a banking group pulling out from a specific country, the import of home country shocks or the too strong pressure of competition indicating to take too high risks by the banks. Many of the risks can be mitigated, but can never be completely avoided by the regulatory and supervisory framework.

Stiglitz et al (1993), for instance has three arguments in favour of restrictions on the competition from foreign banks; a certain kind of infant industry argument can be adapted for the domestic banking sector, discrepancies can be observed between social and private returns in case of lending that leads to different investment patterns, international banking groups have the advantage of not having so strong pressure or control from the governments. Stiglitz describes seven market failures in the financial sector and is in favour of governmental intervention, which however can generate corruption and assumes "wise" governments.

countries the banks usually rather expand in developed markets, the case is just the opposite in central Europe. According to Williams' (2002) "defensive expansion hypothesis", banks follow their clients abroad, as information on clients is among the most important values of the banks. However, according to Mérő–Valentinyi (2003), this hypothesis does not apply for the emerging markets. It is rather the need for monitoring via physical presence. Hryckiewicz and Kowalewski (2008) find that in the beginning of the transition process the "defensive expansion hypothesis" holds, while this motivation is replaced by the "search for client's behaviours" at a later phase. They also show that the poor creditor rights, the common law, and the geographical distance are among the main determinants of foreign bank entries. The latter can be very well seen in case of SEE as well. Furthermore, it is interesting that evidence can also be found for religious links, as e.g. in Bosnia and Herzegovina banks operate also from Muslim countries.

Based on the literature and empirical evidence, from the large European banking groups' point of view, the privatisation process in SEE offered a unique opportunity to gain new markets in a neighbouring region that is better known and understandable for the European culture. In most of the economies, gradually a more stable and thus tempting legal and regulatory environment has been established. Moreover, SEE countries are taking part in the EU accession process, which provides the advantages of the EU common policies and the financial support of the programmes. Beside these factors, the most important is that foreign banks were able to start building up stable market positions at an early stage of the catching-up and real convergence process. This offers a higher growth potential[13] even on long-term and higher profitability indicators, which are able to compensate the higher risk factors that emerging economies carry. In addition, large banking groups were also motivated to diversify their portfolios in a further European region [Clarke et al 2001, Haas–Lelyveld 2003]. Finally, it must be mentioned that when analysing market entry and the increase of capital flows, it is also important to bear in mind the home countries' market conditions. The strategic opening of EU banks regarding the emerging European countries was underpinned by the stable economic environment in the home countries, which included low money market rates, thus low funding costs, and healthy financial conditions without capital pressure. All these resulted in the fact that SEE became one of the most dynamic and profitable banking regions in Europe, with very favourable outlook. As market competition intensified[14] and the banking market became more mature, profitability indicators slightly decreased and converged to the euro area's average, but this impact was well compensated by the effect of dynamically increasing volumes.

13 Albertazzi and Gambacorta (2006) analyse the pro-cyclical nature of banking profitability. Among other conclusions, not surprisingly, they find that GDP affects both the net interest income through the lending activity and the loan loss provisions by the credit portfolio quality.

14 It is assumed that the higher market concentration indicates bigger profits. However, empirical studies contradict to this belief (see e.g. Havrylchyk-Jurzyk, 2006), as foreign banks might charge lower interest rates in order to increase market share, thus generating competition. One can find mixed evidence when comparing the profitability of domestic and foreign-owned banks (see e.g. Mérő-Valentinyi, 2003).

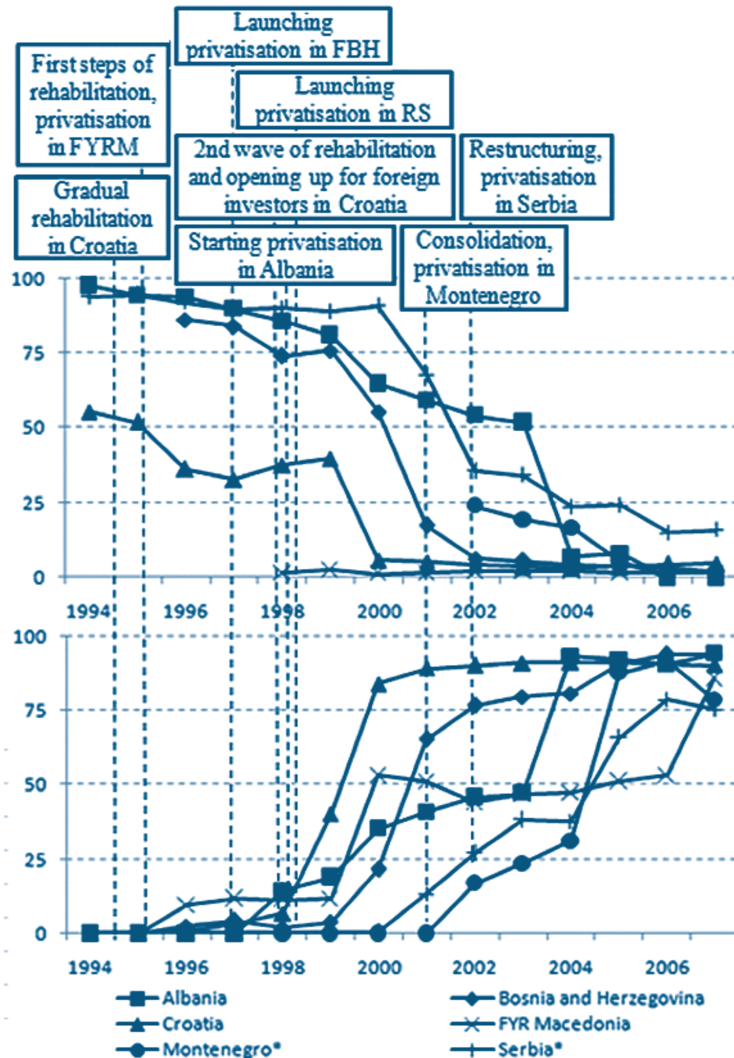
3. CONCLUSIONS AND COMPARATIVE OVERVIEW

The SEE countries started their transition process with completely different starting points and legacies, but they still faced similar tasks and challenges. Albania isolated itself from the rest of the world and implied a "classical" socialist system with the lack of democratic traditions. In contrast to the SFRY, Albania remained the poorest[15] and probably the most backward country in Europe. Regarding the successor states of Yugoslavia, the countries had to face double fundamental changes during the first half of the 1990s. First of all, Yugoslavia broke up to several new countries, which was coupled by devastating military actions in many areas. From an economic perspective, new independent units had to be created and the scenes of destruction had to be rebuilt. In addition, the countries were occasionally directly or indirectly affected by the embargos on Serbia and FYR Macedonia. Secondly, parallel with these processes, Yugoslavia and the new states had to address the challenges of the "classical" transition process. Although SFRY represented a unique case among the European socialist countries with its system of self-management and various implemented market-economic elements, a completely new institutional framework had to be established, while actors still did not have ample experience with real capitalist mechanisms. Even during the socialist time period, large differences were present regarding the development of the republics, but following the dissolution of Yugoslavia this heterogeneity increased further, due to the new countries' applied policies, and their internal and external shocks. To add up, the following three groups of factors differentiated the countries of SEE:

- the initial development level, institutional system and self-sustainability,
- the impacts of military conflicts, sanctions and embargos,
- the starting date, sequencing, duration and methods of the stabilising and restructuring policies.

Regarding the banking system, the institutional structure that the former-socialist system has left behind was completely different in Albania than in the successor states of Yugoslavia. In the former case, the socialist monobank was the ground for the restructuring. Regarding the latter, a two-tier and scattered banking system with large number of small local banks has been inherited. However, the problems and tasks remained similar; a socialist model had to be transformed into a market-led capitalist system. During the transition process, a range of country-specific internal and external shocks affected the banking sector's operation. In certain countries even a second banking crisis or the collapse of large pyramid schemes caused shockwaves or meltdown in the financial sector. As already discussed, the methodology, pace, and sequencing of the banking sector's restructuring showed great variety. Still, at the end of the day, the institutional structure became similar, so despite the great differences in the starting points, one can specify a regional template for the banking industry's development: following a systemic collapse large European banking groups penetrated the local markets, swiftly gained terrain at an initial phase, contributed to the sector's restructuring and fuelled rapid credit growth in a next stage.

15 See for instance the statistics from the EBRD or the IMF.

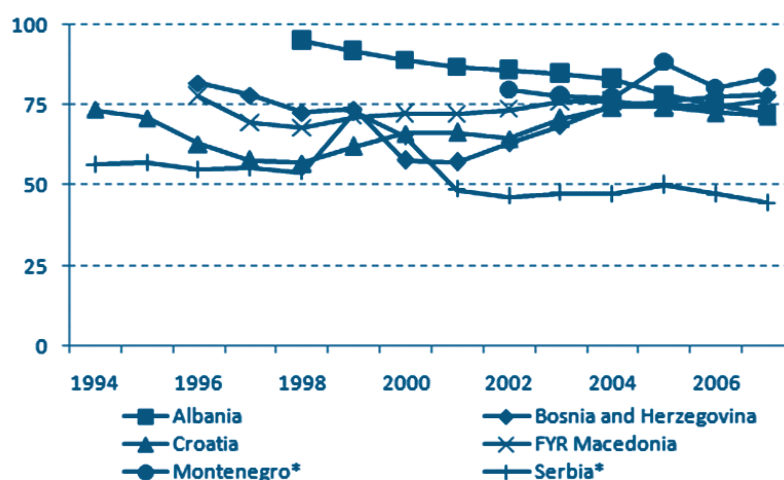


*1994–2001: FR Yugoslavia
Note: Time series are not available for Kosovo, but for instance in June 2010 the share of foreign-owned bank assets amounted to 89.8 percent of the total banking sector assets [CBK 2010, p. 28].
Source: EBRD Transition reports (various years) and EBRD statistics

Chart 2: Decreasing asset share of banks with state ownership exceeding 50 percent (%) and increasing asset share of banks with foreign ownership exceeding 50 percent (%)

Chart 2 reflects the different starting dates of the banking sector's rehabilitation and privatisation. The lines and boxes represent the milestones in each country. Generally, rehabilitation was conducted before the privatisation, but in some cases the privatisation could be considered as the cornerstone, or the two processes have been run in a parallel form. The slopes show the different paces of these

processes. The most important outcome is that in each and every case, the asset share of banks with a majority foreign ownership converges to the range over 75 percent. With the exception of Montenegro and Serbia, it is even over 85 percent. In the latter case, this lower number can be explained by the lag regarding the starting date of the sector's restructuring, which resulted that despite the plans, one of the largest state-owned banks has still not been privatised. So the decreasing trend of state-ownership, and parallel with this the increase of foreign-ownership proves well that the large foreign banking groups penetrated the markets in SEE and achieved dominant positions. Furthermore, Chart 3 shows that the market concentration is high. With the exception of Serbia, the asset share of the largest banks is around 75 percent, which means that a limited number of large European banking groups[16] dominate the market in SEE.

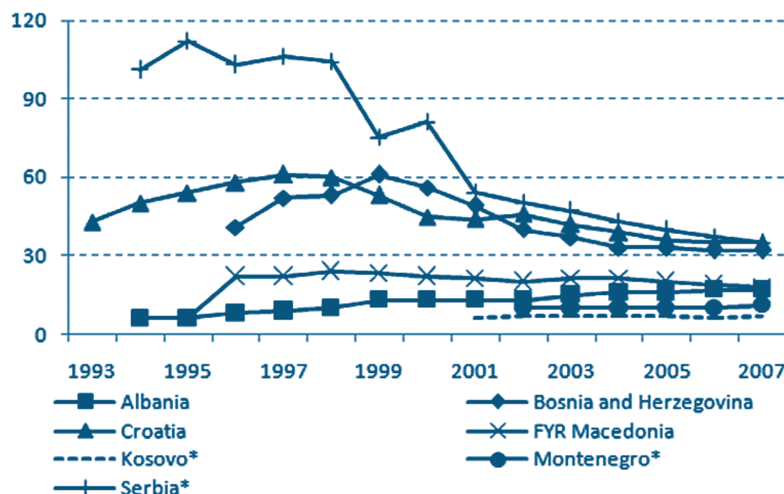


*1994–2001: FR Yugoslavia
Note: Time series are not available for Kosovo.
Source: EBRD Transition reports (various years) and EBRD statistics

Chart 3: Share of total assets of five largest banks

The market structure is further elaborated by Chart 4 and shows how the number of banks stabilised in the region. This chart demonstrates well the different initial market structure of Albania and the former-Yugoslav states. The former started its transition process from a monobank system and has gradually increased the number of banks. The latter inherited large number of local banks, while their numbers decreased as the result of bankruptcies, and the active mergers and acquisition process. Nevertheless, Table 1 reflects that the number of banks per capita shows significant differences.

16 For more information on the ownership structure, please see the respective central banks' homepage.



*1994–2001: FR Yugoslavia
Note: Includes branches of foreign banks
Source: EBRD Transition reports (various years), EBRD statistics and various statistical bulletins of the Central Bank of the Republic of Kosovo

Chart 4: Total number of banks

Table 1: Number of banks per capita (2007, multiplied by 1 million)

Albania	5.31
Bosnia and Herzegovina	8.42
Croatia	7.95
FYR Macedonia	9.00
Kosovo	3.50
Montenegro	15.71
Serbia	4.67

Source: EBRD Transition reports (various years), Statistical Office of Kosovo, own calculations

It can be concluded that, the banking system played a primary role in the economic development in two senses throughout the transition process. During its stabilisation and restructuring, it has put extra burden on the fiscal authorities, while on the other hand, once it was able to fulfil its market-oriented primary roles, it was able to support the economic development in various fields. This includes, for instance the support of economic growth or the channel of monetary policy. Foreign banks played a particular role within this financial development process: they contributed to the system's transition through the transfer of various benefits and resources, and the enhancement of competition. They also played a pivotal role in the banking sector's penetration to everyday life, both horizontally and vertically, via financial deepening and product innovation. Furthermore, they con-

tributed in restoring public confidence in a region where a significant part of the population has lost their savings more than once – due to e.g. hyperinflation, "frozen" FX savings or collapse of pyramid schemes. Foreign banks also underpinned the system's stabilisation, as during the 1990s non-performing loan ratios skyrocketed and capitalisation remained low, while during the next decade these indicators reached acceptable levels.[17] On the other hand, one must also stress the related systemic risks that foreign banks carry. For instance, foreign banks had a major role in the rapid credit growth in SEE, which could be considered as a primary macroeconomic and systemic risk factor that became particularly relevant during the global crisis.

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17 On this topic, see the various additions of EBRD's Transition reports.

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