8

Comment on Henk Brouwer, Ralph de Haas and Bas Kiviet

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In my comment, I would like to touch upon three characteristics of the financial sector of the Central and Eastern European Countries of transition (CEECs), namely, the relatively low degree of financial intermediation, the dominance of the banking sector over the capital markets, and the high degree of foreign ownership. To a large extent, these features are a direct consequence of the transition process. I agree with the authors of the chapter that macroeconomic stability and a strong independent regulatory and supervisory authority are essential for reducing the potential risks to financial stability. However, the special features of the CEECs financial system need to be considered, since in some cases they mitigate, while in others they exacerbate the commonly known potential risks. To make my arguments, I will refer to the experience of Hungary, the country with which I am the most familiar, but most of the points I make are also relevant for the other CEECs.[1]

Low Degree of Financial Intermediation

A typical characteristic of the CEECs is the low level of bank intermediation. In the CEECs-10,[2] banking assets average about 50

[1] For details of the banking sector reform in Hungary see György Szapáry, "Banking Sector Reform in Hungary: What Have We Learned and What Are the Prospects?", In: *Comparative Economic Studies*, XLIV, No. 1, Spring 2002.

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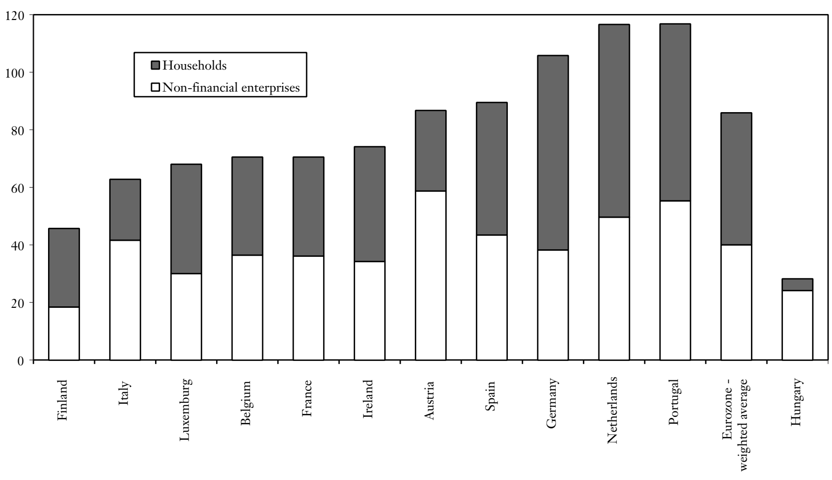
percent of GDP, compared with an average of 240 percent in the euro area. In Hungary that number is 70 percent. Even in Greece, where the depth of the financial sector is the lowest among EMU members, the corresponding figure is twice as high. The low ratio in Hungary is explained by the low level of credit to the private sector. As can be seen from Chart 1, loans extended by the banking sector to the corporate and household sectors totalled about 30 percent of GDP in 2000. That figure in the euro area ranges form close to 50 percent in Finland to almost 120 percent in the Netherlands and Portugal, the weighted average for the whole area being over 80 percent.

Several factors account for the low level of credit in Hungary. First, as a result of the privatisation of enterprises to strategic owners and the inflow of FDI to greenfield projects, a major part of the Hungarian GDP is produced by foreign invested companies, which account for about 70 percent of Hungarian exports, a main driving force behind the dynamic economic growth. These multinational companies tend to borrow from their mother companies or from

Chart 1 Credit to the Private Sector in the Euro Zone and in Hungary, 2000
(in percentages of GDP)



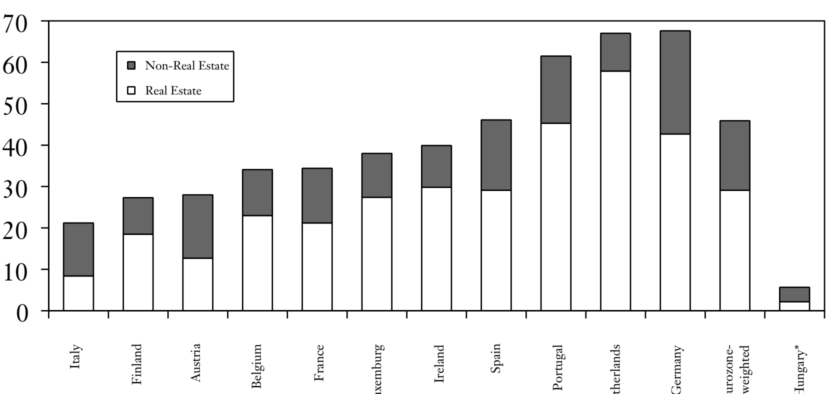
Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

2 All accession counties except Cyprus, Malta and Turkey.

their banks abroad, bypassing the domestic banking system. Second, as illustrated in Chart 2, lending to the household sector is very low by comparison to the euro zone. In the euro area, such loans average 46 percent (weighted) of GDP, while in Hungary they represent a mere 6 percent. Lending to households has been constrained by the low level of incomes and the high risks involved in lending to this sector. Third, the access to bank credit by domestic private firms has been impeded by the lack of sufficiently long track record that would make them acceptable credit risks for banks.

The low level of bank intermediation raises a number of issues from the point of view of potential risks. That situation is partly explained by the fact that banks have shied away from lending to the riskier small and medium-sized enterprise and household markets, concentrating on the more stable corporate sector. This sector is better capitalised and hence more able to withstand the fluctuations in market conditions. Therefore, there are less potential risks to banks from shifts in market conditions. On the other hand, the low level of credit also means that there is "room to expand" into the more risky market segments. This is already happening in Hungary, as the increased competition encourages banks to extend their activities into new markets, particularly the household market. Currently, the capital adequacy ratio of banks in Hungary is satisfactory (12,3 percent in 2001) and the bad loan portfolio is less

Chart 2 Credit to Households in the Euro Zone and in Hungary, 2000
(in percentages of GDP)



Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

than 4 percent. As banks extend their activities to riskier markets, the quality of the loan portfolio might worsen and there might be a need to increase the capital of the banks in order to avoid an undue decline in the capital adequacy ratios. In this respect, it can be considered as an advantage that all but two of the 31 commercial banks are subsidiaries of well known foreign banks. However, there is no guarantee that the mother banks will not get into trouble, in which case they might be less willing to put additional capital into their subsidiaries abroad. Foreign ownership of banks can not, therefore, be an excuse for lax supervision at home.

The foreign currency denominated loans of the banks represent a relatively large proportion (38 percent) of total credit extended by banks in Hungary. Under the narrow-band preannounced crawling peg, there was an incentive to borrow in foreign currency to take advantage of lower interest rates. Since the widening of the exchange rate band in May 2001, foreign currency borrowings have been reduced in response to the appreciation of the Hungarian forint and to the increased exchange rate risk. As a prudential measure, the foreign currency open positions of banks are subject to limits imposed by the authorities, but the foreign currency exposure of domestic borrowers represent a potential risk for banks. That risk is mitigated by the fact that most of the foreign currency borrowing is done by exporting companies whose receipts are in foreign exchange. Nevertheless, the situation needs to be closely monitored since a depreciation of the currency can create problems for the borrowers with attendant implications for banks.

Dominance of the Banking Sector

In Hungary, as in the other CEECs, the financial sector is dominated by the banking sector. The average market capitalisation of the CEECs-10 amounts to 16 percent of GDP, compared to the euro area average of 84 percent. The turnover of the stock exchanges in the Czech Republic, Hungary and Poland *per year* is roughly equivalent to 2, 3 and 5 *days* of turnover at the stock exchanges of Paris or Frankfurt, respectively.[3] One reason for the low market

[3] See, European Central Bank, "Financial Sector Development and Convergence in Accession Countries: An Overview", Background Paper for the

capitalisation is the feeble income levels, another is the low level of institutional savings (e.g. pension funds, insurance companies). While these constraints are expected to loosen with the growth in incomes and the development of the private pension fund and insurance markets, there are impediments to the growth of the stock markets that will take longer to disappear. These impediments reflect the dominance of the Hungarian corporate market by multinational companies, which are naturally listed on the stock exchanges of London, Frankfurt, New York, etc. and not on the stock exchange of Budapest. This means that firms representing dynamic sectors of the economy are not present in the Hungarian stock market. Domestic firms which have the necessary size and a sufficient track record to borrow on the capital market are few and those which do borrow are often also listed on stock exchanges abroad. Another feature of the Hungarian stock markets is that non-residents account for about 70 percent of the market capitalisation, again a reflection of the low level of incomes and institutional savings. It is my view that the above constraints will slow down the development of the equity market in Hungary and the other CEECs for a long time to come.

The small size of the equity market and its dominance by non-residents means that the wealth effects due to equity price fluctuations are limited. The potential risks to banks associated with price bubbles – overconsumption, overinvestment, excessive credit expansion – are thus reduced. On the other hand, the large share of non-residents renders the markets more easily subject to contagion, which can induce greater volatility in exchange rates and interest rates.

Foreign Ownership

As shown in Chart 3, foreign ownership of banks is important in most CEECs. In Hungary, it is one of the most important, with foreign ownership representing about 70 percent of the banking sector's registered capital. This is the result of both privatisation and the greenfield establishment of banks. By increasing competition, foreign ownership led to a remarkable improvement in services and to a

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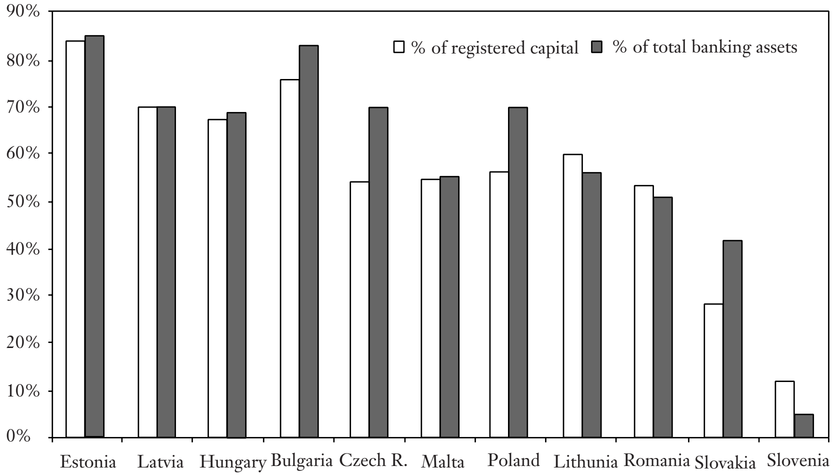
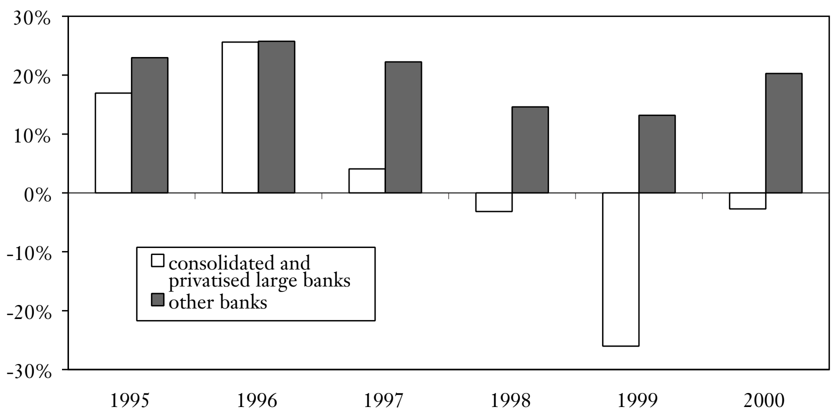
Eurosystem Seminar with Accession Countries' Central Banks, Berlin, December, 2001.

Chart 3 Foreign Ownership of Banks
(in percentages of GDP)



Source: European Central Bank, "Financial Sector Development and Convergence in Accession Countries: An Overview", background paper for the Eurosystem Seminar with Accession Countries' Central Banks, Berlin, December, 2001.

Chart 4 Hungary – Return on Equity of Commercial Banks
(in percentages)



Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

compression of the spreads between deposit and lending rates. This has also helped to improve the monetary transmission process. An interesting lesson from the Hungarian experience is that the profitability of banks, as measured by the pre-tax return on equity (ROE), evolved very differently for large privatised banks and for banks established as greenfield projects (Chart 4). For the latter, the ROE fluctuated but remained positive throughout the period of 1995-2000. For the former, the ROE fell sharply and turned negative during 1998-2000, indicating that the foreign owners face a difficult task in restructuring the former state-owned banks. Bank supervision can play an important role in preventing that a protracted restructuring does not lead to more serious problems, a danger that foreign ownership does not necessarily eliminate.