Financial systems in Central and Eastern Europe

Bianka Urbanova – Armin Lucevic

Abstract: Regional financial system is a system that enables lenders and borrowers to exchange funds. In the ex-Soviet-bloc countries there was no need for financial intermediaries and financial institutions, but today regulations of commercial banks through central banks are more noteworthy. Hence, Serbian economy experienced severe difficulties due to its political situation and in Slovakia banking system plays a major role in the financial system, whose success depends on economy of the country. Its national bank is a part of ECB so it must obey its regulations. Considering that the global financial crises are not over yet, therefore it is extremely difficult to determine the possible future of today's financial system in Central and Eastern Europe.

Keywords: financial system, central banks, Serbia, Slovakia

Definitions of Financial Systems

Financial system is the system that allows the transfer of money between savers and borrowers.

A financial system can be defined at the *global, regional* or *firm* specific level. The firm's financial system is the set of implemented procedures that track the financial activities of the company. On a regional scale, the financial system is the system that enables lenders and borrowers to exchange funds. The global financial system is basically a broader regional system that encompasses all financial institutions, borrowers and lenders within the global economy. (Investopedia)

Two *main types* of financial systems:

- market
- bank

Elements of the financial system

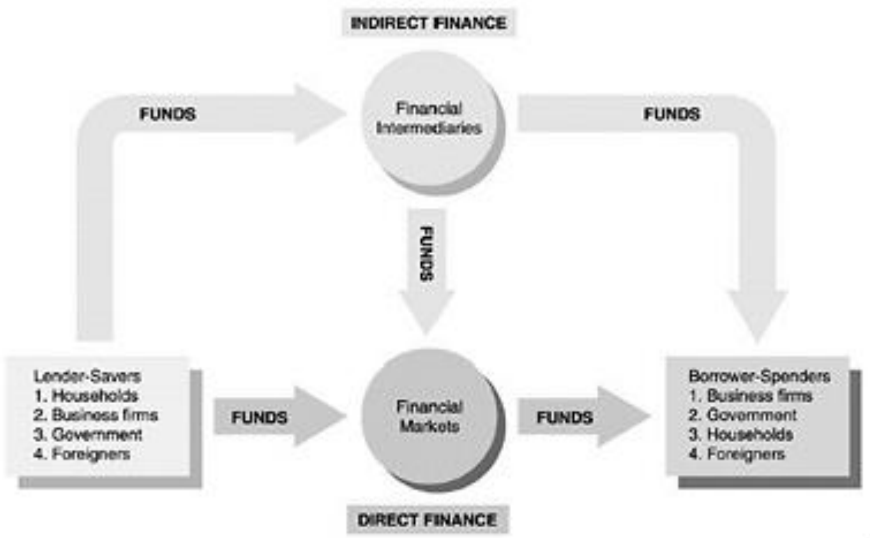
Money, Financial Markets, Financial Institutions, Financial Instruments, Central Bank.

Funds circulation in capitalistic Economy:[1]

From: Households, Business firms, Government, Foreigners

To: Business firms, Government, Households, Foreigners

Via: Financial Intermediaries and Financial Markets



Soviet, post-Soviet Era

In the ex. Soviet bloc countries, banking system did not have a wide range of functions. The most important one was payment function, and in some cases this was only function that banking system performed. Central planning system (government) defined allocation of financial resources, so there was no need for financial intermediaries and financial institutions.

During 1980s, role of the central bank was taken by "monobank", and all banking system had to rely on it. In some limited cases, the role of commercial bank was performed by specialised banks. Main function was financing long-run (term) investments, but bank managers were limited by central planning system. Limitations of central planning system considered interest rates, salaries (wages), prices (of goods)... In the beginning of 1990s and late 1980s liberation of central planning system by imposing market-based economy started. Central banks functions were separated from commercial banks functions. Central banks (from "monobanks") started to have real functions in economy: monetary policy, issues

[1] Financial Systems In Transition – A Flow Of Funds Analysis Of Financial Evolution In Eastern Europe. Alexander E. Fleming and Marcelo Giugale, World Scientific Pub. Co. Inc., December 1, 2011.

banknotes/coins, regulates circulation of money, maintain the reserves, setting up interest rates...

Commercial banks (from specialised banks and/or "monobanks") in most cases were created as state owned, but during the 1990s also privately owned banks started to play an important role in financial markets.

Table 1: Banking Systems' Starting Conditions (source: Thorne, 1993)

	Hungary	Poland	CSFR	Bulgaria	Romania
Date of political opening	1989	April 1989	November 1989	November 1989	December 1989
Date of break-up of the mono-bank and start of the two-tier banking system	January 1987	January 1989	January 1990	January 1990	December 1990
Number of state-owned commercial banks 1/	4	9	2	59	4
Number of private or foreign-owned commercial banks 1/	2	5	0	0	2
Number of specialized banks (excluding foreign exchange banks). 1/	10	1	1	8	2
Number of banks specialized in foreign exchange transactions. 1/	1	3	2	1	1
Number of Savings Banks. 1/	1	1	2	1	1
Date of last revisions of last legislation. 1/	January 1987	January 1989	January 1990	May 1990	April 1991
Ratio of all specialized banks' assets to total assets. 1,2/	47.7	79.1	32.2	54.0	52.3
Ratio of commercial banks' assets to total assets. 1,2/	35.0	8.5	67.8	25.5	18.2
Ratio of total savings bank deposits to total deposits. !/	52.5	12.1	52.3	46.2	80.8

Table 1: (ppt Financial System - Bianca Armin), source: Thorne, 1993

This table is important, as the competition prediction can be seen in the future.

We can notice that Bulgaria has the most interesting example, because in the year of 1989/1990 government created 59 state owned banks, with no privately/foreign owned banks. And Poland divided its monobank in to 9 state owned banks, and privately/foreign 5 owned banks.

Table also shows ratio of all specialised banks/commercial banks assets to total assets. Poland in this case had only 8.5% of assets in the commercial banks. In conclusion, in Poland specialised banks had big importance. As opposite, in Czechoslovakia, 67.8% of all assets was in commercial banks.

During the 1990s, and especially after some of the Central and Eastern Europe counties joined EU, structure of state owned and privately/foreign owned banks were changed. A huge amount of foreign money came in the new EU member counties through FDI, or some other type of investment.

In today's economy, regulations of commercial banks through central banks are taking more and more importance. Not only because of economic crises, but also because of bank's liquidity of funds and liquidity of all financial system (including small/medium enterprise, financial institutions, investment companies). Special attention governments give to sustainability and green investment. Substitution maybe can be found in Islamic banking?

Financial system in Serbia

The National bank of Serbia (Narodna banka Srbije / Народна банка Србије) is the Serbian Central Bank. It was founded on 2 July 1884 as the privileged National Bank of the Kingdom Serbia.

In recent history, it got huge importance after 5 October 2000, when democratic political forces took over the leadership in the country. At the same time Serbia re-established connections with the IMF, WB, IDA, London Club and Club de Paris.

The main functions of the Serbian Central Bank:

- Monetary policy
- Sole issuer of Serbian banknotes and coins
- Exchange rate policy

- Foreign currency reserves
- Price stability
- Stability of the financial system

In the year of 2012 elections took place in Serbia. A new government has been created, composed from parties that had been mainly in opposition after the democratic changes in 2000. Ivica Dačić has been elected for prime minister. Only his party was part of the previous government.[2] Majority of representatives in the Serbian Parliament were coming from SNS – Srpska Napredna Stranka / Serbian Progressive Party. Jorgovanka Tabaković was announced as new governor of the Central Bank (coming from SNS). With colleagues from government/party, she decided to create less flexible policy in connection to dinar exchange rate. Almost immediate critics come from IMF.

After the government was changed, another problem also appeared. In that time Minister of Finance Mlađan Dinkić said that Serbian budget is empty, and it is not sure if it is going to be able to make payments for public administration and pensions. The solution was found with Russian loan which supposed to be used for reconstruction of the Serbian railroads. After changing the agreement, it was used to cover the budget deficit.

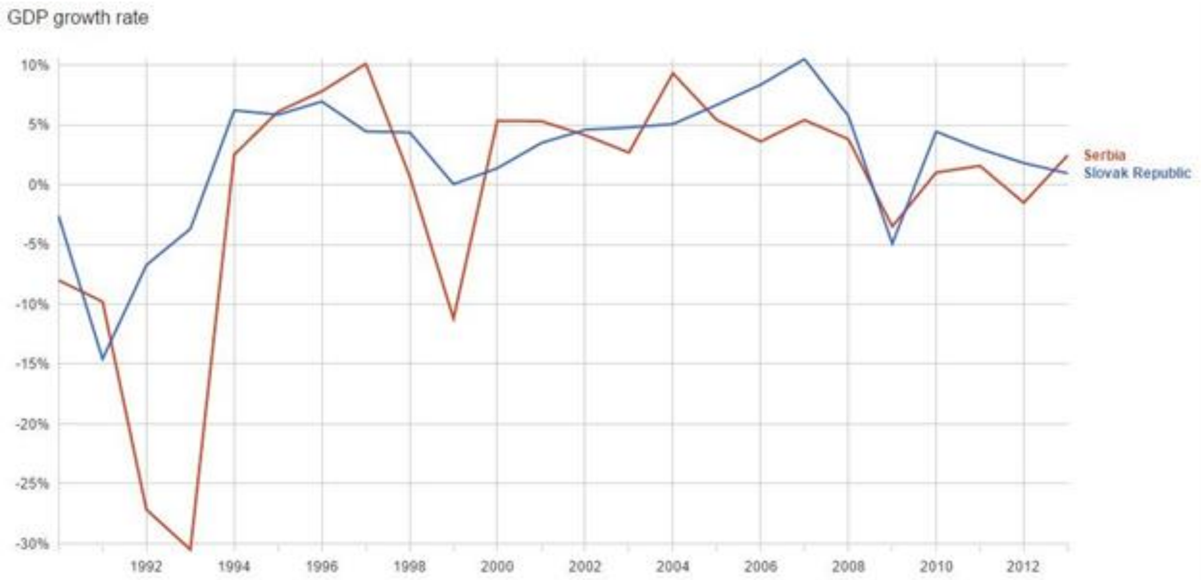
During the mandate of Ivica Dačić, VAT increased from 7% (17%) to 20%. Serbian authorities predicted that with this rise, the huge budget deficit will be repaired.

In order to create better micro-financial stability, and sustainability of Serbian financial system, new Prime Minister[3], Aleksandar Vučić recently imposed long postponed reforms. This includes cutting down the pensions and salaries in public sector, (re)privatisation of public companies which are in big financial problem since the 1990s, and attracting new FDI in banner of better business environment.

Illiquidity of Serbian economy (companies) is highly exposed. Approximately one third of all enterprises in Serbia cannot cover their expenses. This problem is like a vicious circle, because it involves firms, banks, government, and also foreign partners. A lot of firms apply for bank loans just to cover their operational costs.

[2] Not taking in consideration smaller parties.
[3] Government elected in 2014, Majority with Serbian Progressive Party.

GDP growth rate: Serbia – Slovakia

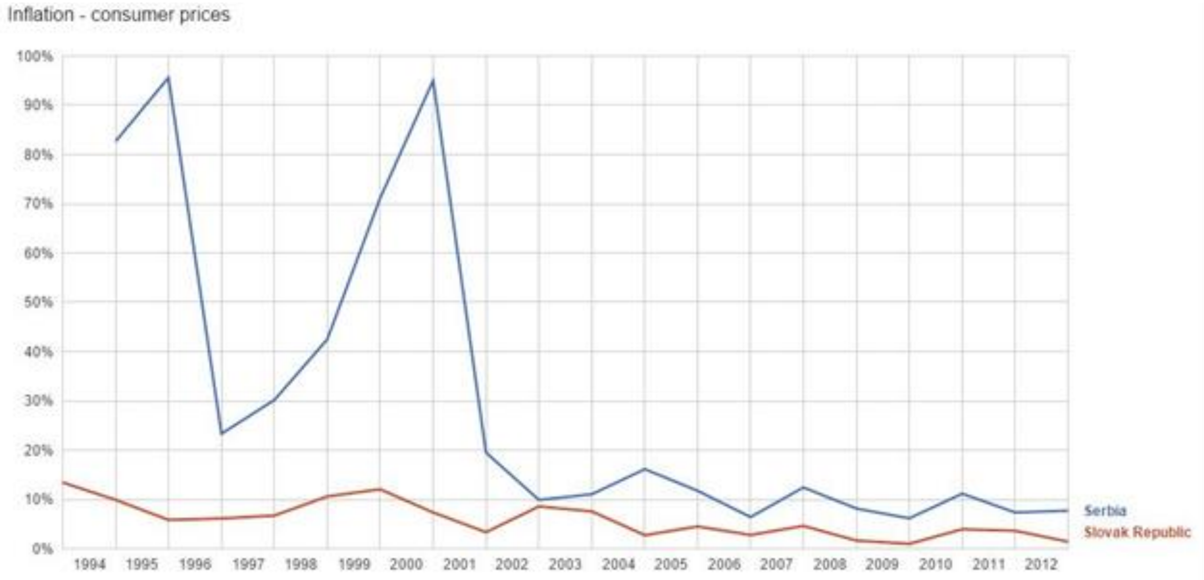


Graph 1

Source: World Bank

When we look at the graph, we can see that huge decline happened with GDP in Serbia from beginning of the 1990s to the year of 1993. The main cause for this decline was the war in Yugoslavia (especially with Bosnia and Croatia), the sanctions from the UN, and decline of export activities. After the end of the war the economy (GDP) seemed to recover, but in the year of 1999 Kosovo crisis started. Another war broke out in which NATO got involved. That resulted the total collapse of the Serbian economy. All main factories were closed, and trade with EU and regional counties was really low. The only exception was Russia, because of the traditional Serbian-Russian relations. Approximately in the year of 2009, when global economic crises came to the EU and Balkan counties, Serbian economy was attacked by bad influences. According to the graph, Serbian economy started to recover after 2012. But on the other side, it is too early to calculate devastating consequences of floods in May 2014 and influence of recently imposed reforms.

Inflation – customer price (Serbia, Slovakia)



Graph 2 Source: World Bank

Very similar as in the previous case, things that happened in Serbia in the last 20 years – war, sanctions, Kosovo crisis – have left a mark also in the customer prices. The government tried with stamping money to cover all the expenses. As growth of money supply in the country was not controlled, it led directly to inflation. After the political changes in the year of 2000, Serbian prime minister (Zoran Đinđić) and Governor of Central Bank (Mlađan Dinkić) implemented anti-inflation measures, and put dinar into the stable frame. Until now, government still tries to control prices of staple food (bread, milk, oil, etc.), but a much bigger problem is that dinar exchange rate directly reflects the situation in Serbian economy. The national currency is constantly getting weaker despite interventions of Central Bank on foreign exchange market.

Future flows of the financial market cannot be predicted, but despite that Serbian people and Serbian government believe that accession to the EU will help to solve not all, but at least huge problems that the Serbian economy confront.

Serbian authorities may start with reform of financial market by allowing euro as paying currency in the stores and shops (dinar is only possible currency that goods can be paid for).

Financial system in Slovakia

The financial system of Slovakia consists of financial markets, financial institutions and intermediaries, financial instruments, creditors and debts and financial transactions. The financial markets are the most important part of the system and therefore they are often referred to as “the heart” of financial system. Financial market is defined as a marketplace that allows people to participate in buying and selling financial securities. The financial market can be divided into capital and money market, and further from the point of view of the participants it can be divided into banking, sharing and stocks.[4]

The growth or failure of the financial system depends on the economy of the country (political, social issues etc.). The main task of it is to relocate money from creditors to debtors. Financial system influences our everyday lives and people depend on it and therefore it needs to be quick, effective and qualitative. Therefore, it should be set up in a way that it encourages economic growth and decreases unemployment.

The banking system in Slovakia

In Slovakia, banking system plays a major role in the financial system and therefore the rest of the report will mainly focus on it. The main function of banks is to act as an intermediary between the debtors and creditors. The banking system in Slovakia is so called two-tier banking system. That means that the system consists of the central bank, which is the National Bank, and the commercial banks. However, the commercial banks differ from the central bank with its functions and objectives. Further, the commercial banks can be divided according to three main criteria: the extent of their business activities, the ownership and the legal form. According to the first criteria they are divided into universal and specialised banks. The majority of the country has universal commercial banks that carry all the types of banking transactions. The specialised commercial banks can be divided into: acceptance bank, deposit banks, foreign banks, mortgage banks, investment banks, municipal banks and guarantee banks. The second division is according to banks’ ownership. They can be private,

[4] Euro Ekonom, http://www.euroekonom.sk/financie/financny-trh/financne-trhy-a-financny-system

state owned or combined (ownership consist of state and private people). The last division is made according to their legal statuses which in Slovakia are always stock corporations.[5]

Narodna Banka Slovenska

The National Bank of Slovakia is called Narodna Banka Slovenska (NBS). It was established due to the division of Czechoslovakia on 1 January 1993. It functions as an independent institution that became a part of the Euro system on 1 January 2009 as Slovakia accepted and started to use the Euro currency.

In 1998, there was a statute created with the help of treaty of establishing the European Community and the European Central Bank (ECB) together with European System of Central Banks (ESCB). The European Central Bank is the major player in the Euro system. ECB is responsible for conducting the monetary policy within the whole euro area (countries that use Euro currency). The European Central Banks works in close cooperation with the other national banks and its corresponding to the public international law.[6]

NBS is governed by the Bank Board that consists of four members. The Governor and Vice-Governor are appointed by the president and the other two members are chosen by the Slovakian Government. The Bank Board is responsible for the organisational units when implementing common European monetary policy (according to given regulations) and for the procedural principles as well as the principles of conduct. In the same time, the Bank Board takes responsibility for the bank’s supervision on financial markets and other issues that are entrusted to the central bank.

According to the amendment about NBS (act no. 149/2001 Coll.) the new objective and the main function of this bank is to maintain the price stability with. This objective is part of the harmonisation of the Slovak legislation together with the EU legislation. In order to achieve this goal successfully, the bank is responsible for the supervision of financial markets which helps to secure the operations in financial markets. In the same time it maintains the credibility of the market and protects its consumers.

[5] http://www.stvrtab-oape.estranky.sk/clanky/bankova-sustava.html
[6] European Central Bank, http://www.ecb.int/ecb/orga/escb/html/index.en.html

A good example that points out the importance of the supervision of financial markets is the problem of commercial banks. The commercial banks work based on the system called the system of fractional reserves. This simply means that banks are borrowing more money than they have in reality and therefore so called fiat money is created. Fiat money are money that cannot be exchanged for real money which means that it has no intrinsic value and it is not backed by the reserves. The risk occurs when customers want to take out money from the bank because as already said the money that the bank has is fiat money. This means that the risk is represented by not having enough money that is required by its customers and therefore there are only two options left for the commercial banks. Either, they go bankrupt as they do not have sufficient amount of money to exist or they are forced to borrow from the central bank. Unfortunately, if too many commercial banks borrow from NBS it results in inflation. Therefore, the central bank is trying to decrease the amount of fiat money created as well as the number of bankruptcies. To be able to do so, NBS created set of rules and obligations that commercial banks have to obey to. The central bank is supervising commercial banks' liquidity, the amount of risk they are taking or their strategies how to deal with stress.[7]

The main functions of NBS are:

- Maintain price stability (economic and currency analysis)
- Common monetary policy (EBC)
- Issuing Euro banknotes/coins
- Regulating the amount of money that is circulating in the economy
- Maintain the reserves
- Establishing the borrowing conditions for other banks
- Manipulating liquidity and interest rates in the financial market
- Supervising financial markets (banks, investment, insurance and pension funds) (ESFS)

However, as mentioned above, NBS is part of the Euro system and therefore its competencies are limited by the European Central Bank. In a way, the National Bank of Slovakia is dependent on ECB's regulations. For an example, even though NBS can be issuing euro currency, it is only a certain amount that it can be issued, and the exact amount is given by ECB. Therefore, the circulation of money within the economy is really controlled by the ECB.

[7] Narodna Banka Slovenska, http://www.nbs.sk/en/home

Due to being a member of the Eurozone and so the part of the Euro system, the banking system is depending and must obey to the regulations and laws given by the ECB. Some economist would say this is a big disadvantage for the country as we do not have hundred percent control over the development of our economy. On the opposing side, some would argue that the ECB is aware of its action and is acting in the best interest of the country.

GDP annual growth rate in Slovakia and Euro Area

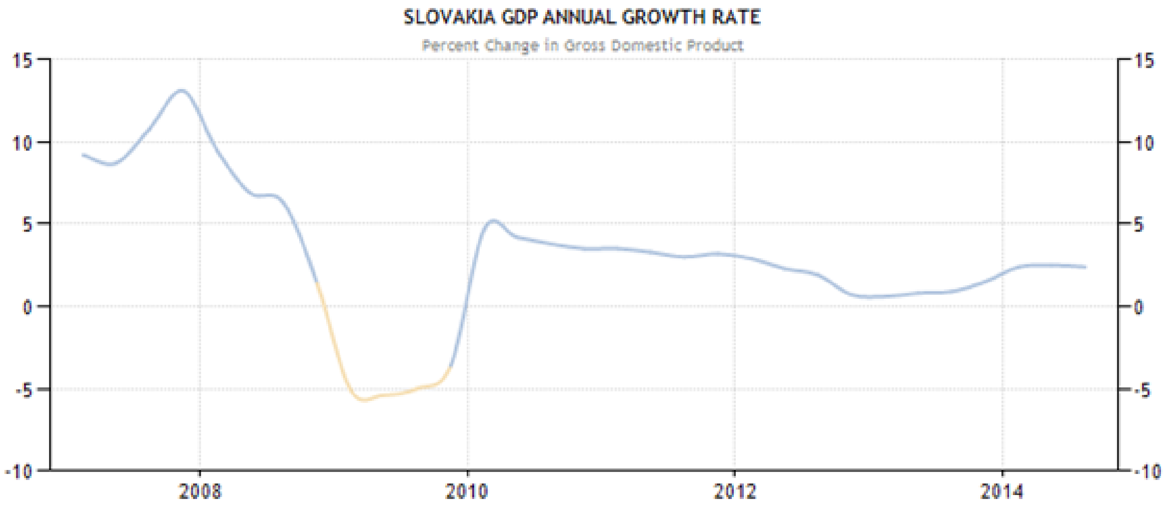


Figure 1

SOURCE: WWW.TRADINGECONOMICS.COM | STATISTICAL OFFICE OF THE SLOVAK REPUBLIC

The highest GDP annual growth rate in Slovakia occurred in 2007 and it was 13.1%. The lowest annual GDP growth rate was negative and appeared in 2009, when it was -5.4%. Slovakia joined the European Union in 2004 and before its GDP annual growth rate had highly fluctuating and did not go over 5%. Since the country became the member of EU, the growth rate stabilised and increased every year until it reached its highest point in 2007 (see Fig. 1). The following slowdown of the GDP growth is mainly explained by the Greek financial crisis in 2008. At the beginning of 2012, Greece needed a bailout that was worth of approximately €130 bn. As Slovakia is a member state of the EU, it also had to contribute with a significant amount of money. This money could have been used for the development of the country instead. However, as the given away contribution was missing in the amount of money that was circulating in the economy, the economic growth rapidly slowed down. The domestic demand decreased which caused the increase in unemployment which resulted in lower consumption and higher savings. After a while, the country started to slowly recover and exports, investments and profits started to increases and GDP annual negative growth rate was becoming smaller and at by the end of 2010 it turned positive. Unfortunately, as the given bailout for Greece was not enough there was a need for second one. Therefore, in 2011, Greece received their second bailout package which effected the GDP annual growth of Slovakia negatively.[8,9]

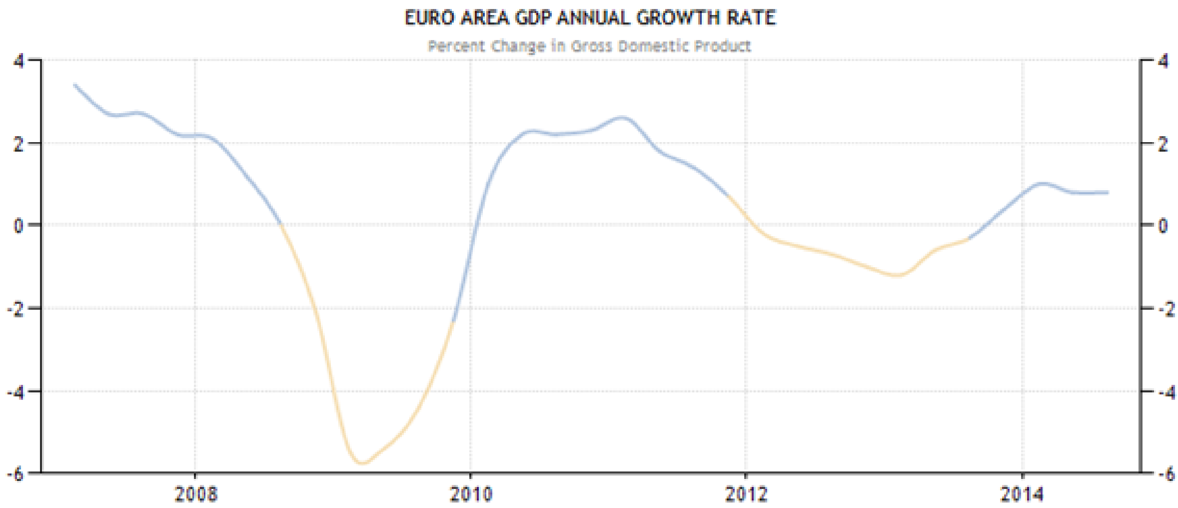


Figure 2

SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

The Figure 2, shows the GDP annual growth rate of the Euro Area. The highest growth was in 1995, when it reached 5% and the lowest in 2009 when it had -5.2%. The GDP growth rate of the Euro Area moves together with the GDP growth rate of Slovakia. This is simply because Slovakia is the part of the Euro system and uses Euro currency. Therefore, the same situations, such as financial crises of one country, have the same effects on Slovakia and the Euro Area.

[8] The World Bank, http://www1.worldbank.org/finance/assets/images/Slovakia_FSA_web.pdf
[9] The New York Times, http://www.nytimes.com/2012/03/15/business/global/greece-gets-formal-approval-for-second-bailout.html?_r=0

The inflation rate in Slovakia and the Eurozone

Figure 3

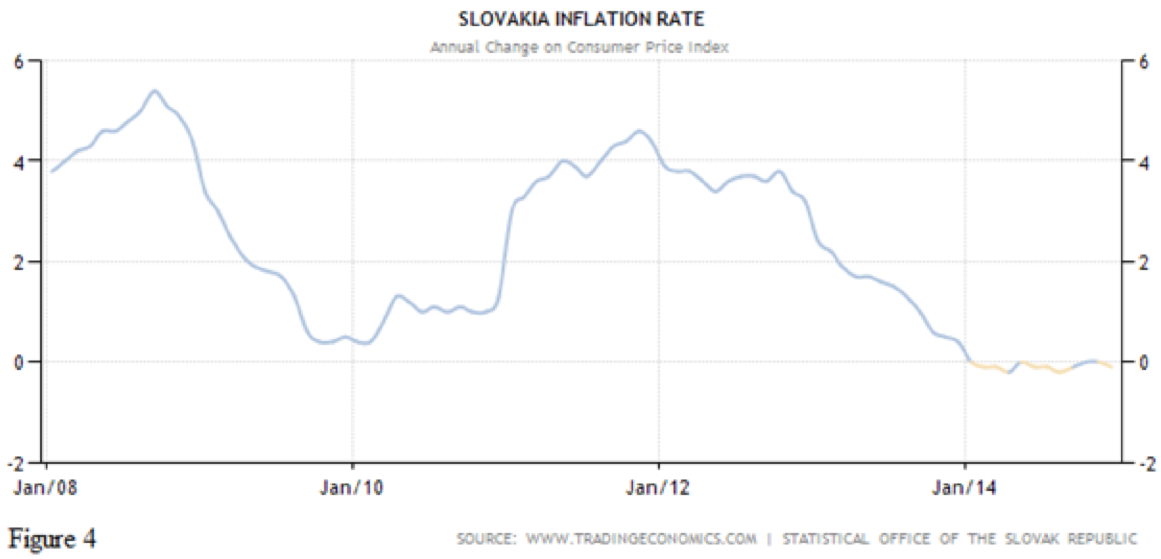


Figure 4

In the same way like GDP annual growth rates of Slovakia and Euro Area move together, the same way it is with inflation. Both pictures that show the inflation (see Fig.3 and Fig.4) prove that the inflation was very high throughout 2009 and beginning of 2012. Once again, the Greek financial crises are mostly responsible for it. Greek crises and bailout caused the devaluation of the Euro currency which increased the inflation.

Afterwards, when the Euro Area was recovering and decreased the inflation, one more bailout was necessary which triggered the increase of inflation again. However, there are many more economical factors that affected the inflation rate. The increase in commodity and energy prices played a huge role in inflation. In the beginning on 2011, the energy prices increased together with non-energy industrial goods and commodity prices (↑€sugar→↑€beverages). The increase in food prices caused the increase in services such as restaurants and the increase in oil prices caused the further increases for transportations.

Nowadays European Union and Slovakia are facing deflation, which is much bigger problem than inflation

The future prospects of the financial system in Central and Eastern Europe

Sadly the global financial crises are not over yet and therefore it is extremely difficult to determine the possible future of today's financial system in Central and Eastern Europe. However, there are two main possible outcomes. The first one is that the system will recover and the second possibility is that it will collapse.

In the first case scenario, if the financial system would recover, it would have to be restructured and especially more focus would have to be shifted on risk. In the same time, all the members of the Euro Area have some regulations and obligations that are given by the ECB and must be fulfilled. Sadly, not all the countries are obeying these laws and therefore it causes inequalities and crises.

The second scenario, the financial system collapses; a new financial system would have to be designed.

Resent decline of oil prices, sanction from both EU and Russia side make very difficult to predict what is going to be outcome and consequences on the financial markets. Serbia as country who did not impose sanction on Russia currently records higher export than before. But is this situation long lasting as Brussels is forcing Belgrade to harmonise foreign policy with EU?

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Resources

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