

EUIJ Scholarship Report

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Banking System Development in Transition Countries

The subject of my study is the economic transition of countries in Central-Eastern Europe (CEE), with particular focus on the financial system development and central banking of these countries.

On May 1, 2004, countries in CEE, such as the Czech Republic, Hungary, Poland, the Slovak Republic, Slovenia, and the Baltic States entered the European Union (EU). In the process of negotiations to unite the EU, the European Commission judged these countries as functioning market economies. From the viewpoint of economic transition, this meant that they had achieved the crucial transition from a socialist economy to a market economy.

However, this economic transformation was an extremely difficult process. Television channels aired and reminded the people of the large-scale unemployment in the former GDR and the hyperinflation and currency crisis in Russia. Other countries in CEE also faced similar difficulties in varying degree.

However, the Czech Republic appeared to be the exception. Under Prime Minister Klaus's regime, the Czech economic transition with low inflation, unemployment rate, relatively high GDP growth rate, stabilized exchange rate, and rapid privatization due to the distributed coupon was assessed by international organizations in the mid 90s to be an exemplary case.

Nevertheless, a currency crisis occurred in 1997. At this time, a political finance scandal in the ruling party Obanská demokratická strana (the Civic Democratic Party, ODS) was brought to the fore, resulting in the resignation of the Klaus regime. This implied the fall of the Czech economic transition. Economic growth reached a record negative and price development tended toward deflation.

Klaus was an advocate of economic liberalism; yet, at the same time, he was known for being a Euroskeptic. He was very critical of economic integration, one of the demands of EU regulations. It was partly for this reason that Czech application for EU membership was later than that for other countries in CEE.

If this was the case, why did the Czech transition collapse even though they outwardly emphasized liberalism?

The key to answering this question lies in the banking sector development during the Czech transition period. At the initial stage, the Czech authorities adopted liberal banking regulations such as maintaining a low minimum capital. This was done to encourage new entries into the market in order to promote competition. However, there was only a partial privatization of large state banks, and these quasi state-run banks functioned as a tool to sustain inefficient (former) state enterprises by providing them with bank loans. Banks that were burdened with accumulated non-performing loan were repeatedly bailed out by

public funds. This type of economic system, sarcastically termed as banking socialism, might have played a role in mitigating the shocks encountered during transition; however, this system was also responsible for the moral hazard that arose in the Czech banking sector, which in turn, led to the sporadic failures of small banks in the mid 90s and a serious crisis for large banks from 1998-2000.

The Slovak Republic under populist Mečiar also postponed economic reforms to alleviate the difficulties. Similar to the case in the Czech Republic, the relationship between the banking sector and state enterprises exacerbated the banking crisis in the Slovak Republic. However, after the establishment of the new government in 1998, large banks were quickly privatized by selling foreign capital, thus accelerating the transition process. This case has been interpreted as evidence of the serious situation prevailing in the Slovak Republic; therefore, drastic solutions were required. From the viewpoint of the author, in order to assess the Czech economic transition, an effective analytical approach would be to investigate and compare cases between the Czech and Slovak Republics because both these republics were on similar footing.

Keeping this in mind, I applied for the EUJ scholarship. From October to November 2004, I visited related authorities and institutions in the Czech and Slovak Republics as well as Austria in order to exchange opinions and gather the background information necessary to carry out my study.

When visiting the Czech Republic, at an affiliated library of the Czech National Bank (CNB), I collected annual reports and documents pertaining to the Czech banking system. I also visited Dr. Jan Kláček (ex-director, Institute of Economics, CNB) who had previously visited the Institute of Economic Research at Hitotsubashi University (IER), from whom I accepted official and personal favors. My discussion with him involved an exchange of subjective views on the Czech banking system and the primary causes of the recent Czech and Japanese deflation. He also provided me with some suggestions on writing my paper. On one of my free weekends, he invited me to visit his cottage, which was situated near Poland.

Through his introduction, I visited Ing. Jaroslav Kroiher at the Czech Banking Association that provided me with related material for my study. I also approached three of the largest banks in the Czech Republic – Komerční banka, eskoslovenská obchodní banka and eská spořitelna that provided me with their annual reports so that I could collect their balance sheets and other supplementary data.

In the Slovak Republic, I met Ms. Eva Michalíková, who served at the Public Relations Department of the National Bank of Slovakia (NBS). I was permitted to access the NBS database of materials on the banking system and monetary policy. I was also offered the annual reports of the NBS and other relevant papers.

At the Vienna Institute for International Economic Studies in Austria, I held a discussion with Dr. Havlík (Deputy Director) who had also previously visited IER. Our discussion was concerning the economic transformation and reforms pertaining to the banking system of countries in CEE.

Although it was a relatively short research trip, I managed to collect background material and

documents. I presented a paper on the results of my study "Banking Crisis in the Czech Republic during the Transition" (in Japanese) at the Japan Association for Comparative Economic Studies. This paper was published in the Japanese Journal of Comparative Economics (downloadable from <http://wwwsoc.nii.ac.jp/jaces/422matu.pdf>).

In 2004, the Czech and Slovak Republics joined the EU; it was in this very year that I was the recipient of the first EUJ scholarship. I was given this opportunity as a direct benefit of the inclusion of these eastern countries in the EU. In order to return the favor to them as well as to the EUJ staff, I would like to make a contribution toward fostering greater understanding of the new EU member states in CEE through further research.