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**BANKS SOUNDNESS
AND ECONOMIC GROWTH**

Gligor Bishev Ph.D.

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C o n t e n t s

1. Banks soundness and economic growth	<i>1</i>
2. How to achieve sound, stable and efficient financial system?	<i>2</i>
3. Bank Rehabilitation In the Republic of Macedonia	<i>4</i>
4. Banks Efficiency	<i>5</i>
Bibliography	<i>9</i>



1. BANKS SOUNDNESS AND ECONOMIC GROWTH**

The main factor of economic growth is increment of capital stock by the increase of investments. But, de facto this role belongs to the savings due to the identity between the investments and savings ($I = S$). There is theoretical background and empirical evidence supporting the validity of this fact. Countries with high domestic savings simultaneously are the fast growing economies. On a short run, growth can be financed by imported savings, but on a long run there is no fast growth without high domestic savings.

The main role in concentration and allocation of savings belongs to financial markets. Inefficient financial markets do not properly concentrate and allocate savings. Even if domestic savings is high, without an efficient market, growth remains low due to the misallocation of savings.

Banks have traditionally played the key role in the financial system by acting as financial intermediaries between ultimate savers and borrowers. As asset transformers, they have accepted deposits with one set of characteristics and created assets with a different set. In particular, they have engaged in maturity transformation with debt contracts on both sides of balance sheet. They have also been the central mechanism within the payment system. For these and other reasons, banks have traditionally been regarded as "special" within the financial system. For the same reasons they have also been subject to more intensive regulation than other types of financial institutions.

Banks are the key players or spinal column of financial markets. Unlike the USA situation, in Europe, the banks are vehicle of development. Namely, in the USA enterprises provide their external accumulation mainly on the financial markets (equity, bonds etc.), but European enterprises depend on banks which are main suppliers of external accumulation. Most flexible form of risk capital - equity financing is undeveloped in Europe. The level of capitalization of equity markets in European Union countries is 58% of the Gross Domestic Product (GDP), vis a vis 120% of GDP in the USA. In accordance with the level of development of financial markets in USA and Europe, three quarters of required financial support, European enterprises provide from banks and other creditors. Only one quarter of required financial assets, the enterprises in Europe procure from the capital markets. Along the particular countries, the situation is following: in Netherlands, the enterprises procure from banks one half of financial support, in Italy and Germany 70%, in Spain 80% etc. The situation in the United States of America is different because American enterprises provide from banks only one quarter of external accumulation they need, and they procure other three quarters from capital markets.

In transition economies there is outstanding dependence of enterprises on banks. Namely, undeveloped capital markets in these countries determine a situation in which enterprises procure external financial assets exclusively from banks. So, 95% of their needs for financial assets, the enterprises in transition economies provide from banks. In The Republic of Macedonia this percentage is even higher -98,5%.

According to the above-stated, banks are the main vehicle of development in continental Europe, and especially in transition economies. The sound banking system, which provides

* Deputy Governor, National Bank of Macedonia; Docent, Faculty of Economics, Prilep

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efficient allocation and concentration of financial assets is basic precondition for dynamic and stable economic growth. Therefore, dynamics and quality of economic growth mainly depend on the efficiency of projects which are financed by the banks. The main indicator for this is the share of bad loans¹ in the banks credit portfolio. The rate of bad loans on the banks in the countries of Euroland is under 5%. On the other hand, the same rate on banks in transitional economies is at average 17%. There is an inverse relation between the rate of bad loans and the rate of economic growth. In those countries where there is a lower level of bad loans, the dynamics of economic growth is higher and vice versa, in those countries where banks have high rate of bad loans, the rate of economic growth is lower. This relation by particular countries can be seen in the following table:

Table 1**Efficiency of Banking Industry and Economic Growth**

Country	The share of Bad Loans in total credit portfolio on 31.12.1997	In percentage	
		The rate of economic growth in 1997	The rate of economic growth in 1998
Bulgaria	14.0	-6.9	5.0
Czech Republic	18.4	1.0	-1.5
Hungary	3.1	4.4	5.2
Latvia	9.8	6.5	6.0
Lithuania	22.2	5.7	5.3
Poland	10.4	6.9	5.6
Slovenia	5.6	3.8	4.4
Croatia	7.6	6.5	2.4
Macedonia	35.6	1.5	2.9

In countries where banks provide efficient allocation of financial resources (Hungary, Latvia, Slovenia, Croatia and Poland), the dynamics of economic growth is relatively higher. The average rate of economic growth in these countries in 1997 was 5.6%, and in 1998 it was 4.7%. On the other hand, in Czech Republic, for instance, the rate of economic growth in 1998 was -1.5%. The share of bad loans in credit portfolios of Macedonian banks as of 31.12.1997 was 35.6% and rate of economic growth was 1.5%. In 1998 the percentage of bad loans decreased to 32.8% and, on the other hand, the rate of economic growth increased to 2.9%.

2. How to achieve sound, stable and efficient financial system?

The main reasons which cause unsound and inefficient banking system are of domestic origin. Inadequate capitalization of banks, weak internal control systems in banks which are not strong enough to prevent too risky transactions and operational weaknesses, unsound credit and liquidity policies, unsound macroeconomic policies, weak banking supervision etc., might provoke banking crises which will be followed by paralysis of the entire economic life in the particular country and wider. Also, banking crises might be caused by external factors: spreading of international financial crises, decline of export prices etc. In order to prevent widening of systemic risk and decreasing trend of confidence in the banking system, the Government may intervene.

¹ The term "Bad Loans" in this context covers Substandard, Doubtful and Bad (Loss) Loans.



As usual, all countries in transition have made rehabilitation of their banking systems. At the same time, those countries which carried out the rehabilitation successfully, have established sound basis for dynamic and stable economic growth.

The aim of the systemic restructuring or rehabilitation of banks in particular country is to improve the banking industry's performances by improving the capacity of the banking system for intermediation between savers and borrowers, renewal of solvency and profitability of banks as well as restore the confidence in the banking system. Rehabilitation of banking system consists two phases: financial restructuring and operational restructuring.

Main purpose of financial restructuring is renewal of bank's solvency (net worth). The bank could improve it's balance sheet by inflow of new capital (from the present or new shareholders), by reducing the liabilities (for instance, some liabilities to be written-off), or by increasing the value of the assets (for instance, to improve collection of bad claims, to accelerate the realization of collateral for bad loans etc.)

Operational restructuring includes: audit of business strategy of the bank, improvement of corporate governance, establishment of sound management and accounting systems, adoption of better techniques for risk evaluation and assets and liability management, efficient liquidity management and implementation of efficient internal control and audit system as a prevention from different kinds of risks. Operational costs in banks could be reduced by implementation of new technologies, close up of some branches, representative offices, and also, reducing the number of employees.

The first stage of banks restructuring (financial restructuring), usually includes Government intervention by: replacement of bad claims with Government bonds, establishment of Government agency for collection of bad claims undertaken from banks, liquidity support from the Central Bank, acceleration of privatization processes in banks etc. But, the process of rehabilitation and state intervention, does not mean rescue for the bank's shareholders. At the beginning of the process, the present shareholders disappear altogether with their capital which serve to cover the negative financial results and potential losses. After that, Government begins with additional sources in order to renew the bank's solvency. Also, in order to prevent the spreading of moral hazard within the economy, in the process of rehabilitation of the banking system, many of the banks disappeared from the playingfield of banking industry, by their liquidation, mergers or acquisitions with other banks. In the countries which carried out successful rehabilitation programs, the percentage of liquidated, merged or acquired banks varies from 20% to 50%.

The operation of financial restructuring of banks is extremely expensive for the state budget, and of course, the final cost burdens the taxpayers. The experience shows that these costs vary from 4% of GDP in the banking rehabilitation process on Philippines, to 45% of GDP in the case of Kuwait. The average costs for banking rehabilitation processes in the transition economies are on the level of 8% of GDP.

It is extremely important the two phases of the bank rehabilitation process to be successful. In other words, systemic restructuring of banking system may be considered successful if the second stage (operational restructuring), as well as the first stage of financial restructuring, is carried out fully and efficiently. This phase begins with change of management of banks under the rehabilitation program. The new management has to audit the business strategy of the bank, to improve internal control systems, to improve corporate governance, to implement efficient techniques for risks prevention, efficient credit and liquidity policies etc. In this phase of bank's rehabilitation, definitely the confidence in the banking system should be restored. Therefore, the level of restoring of confidence in the banking system, in the same time is the indicator for success of banking rehabilitation program. Also, this stage should lead to strengthening of banking



supervision and implementation of supervisory standards. Therefore, the new management of the banks under rehabilitation, supervisory authorities and governmental institution for managing bad loans, are responsible for the success of this second stage, and in the same time for the success of the full rehabilitation program.

In case of failure of the second stage for operational restructuring, the whole process returns to the beginning with many negative implications for the banking industry and all processes of entire economy in transition. The bank rehabilitation process in The Republic of Macedonia is textbook example for that. Although the costs of rehabilitation reached 12.1% of GDP, due to the lack of the operational restructuring, the rehabilitation operation now once again has to be repeated.

3. Bank Rehabilitation In the Republic of Macedonia

The inherited economic problems and post - independence economic crises in the Republic of Macedonia had an adverse impact on the banking system soundness, leading to accumulation of high amounts of non - performing loans (on the assets side) and the problem of household foreign currency deposits that were frozen by the former SFRY (on the liability side)². The bad loans in banks portfolio had reached 85%. In order to address these problems, in the beginning of 1995, the Government undertook decisive measures for rehabilitation and restructuring of the banking system. These measures can be classified into two groups:

a) Linear rehabilitation of all banks balance sheets, comprising:

- all claims and liabilities for households' "frozen" foreign currency deposits in the amount of USD 1.4 billion were written - off from the banks balance sheets and undertaken by the Government (Budget). Banks were obliged to keep off - balance record of these deposits, and to service them for and on behalf of the Government. However, in the past five years the Government has made enormous efforts for gradual solution of the problem with "frozen" foreign currency deposits, giving the opportunity limited amounts of these deposits to be withdrawn for specific purposes - such as social needs, purchase of Government property, purchase of socially owned flats, education, health, purchase of enterprises shares, etc. In this way, the total debt of the Government to household on the basis of "frozen" foreign currency deposits has been reduced to USD 0.6 billion at the end of March 1999;
- Liabilities to some foreign official and commercial creditors (Paris Club of creditors and Zurich Club of creditors) were written - off from banks balance sheets and undertaken by the Government.

b) Rehabilitation of the largest bank in the country - Stopanska banka a.d. Skopje, that used to have more than two thirds of total loans and deposits of the banking system. These measures comprise:

² In the economic system of former SFRY, the possibility was given to households to have both denar, and foreign currency accounts. Foreign currency deposits were transferred in the international reserves in the Central Bank of SFRY. After the break - down of former SFRY, the assets remained captured in Yugoslavia, while liabilities remained in Macedonian banks. So, the term "frozen" f.c. deposits refers to these deposits, deposited before the monetary independence. There is special Government program for solving the problem with these deposits. However, foreign currency deposits deposited after the monetary independence, are on free disposal to the depositors, in unlimited amount.



- Replacement of due but uncollected denar loans in the Bank balance sheet with Government Bonds, in amount of denar 4.9 billion (USD 123 million);
- Reduction of the size of the Bank through spinning off the five major branches, that were transformed into independent commercial banks. In that way, the current share of Bank assets in entire banking system assets has been reduced to 34% which still can be estimated as a high level of concentration in Macedonian banking industry;
- Privatization of the Bank at the end of December 1998 was completed with 66%. Additional capital inflow is expected with the engagement of potential foreign investors (such as EBRD, IFC and foreign commercial banks), which is in the process of negotiations;
- Measures for strengthening the governance of the Bank;
- The collection of the bad loans (assumed by the Government) from the domestic enterprises was transferred to the Agency for Bank Rehabilitation, established in the beginning of 1994. The Agency assumed the governance over 240 enterprises on the basis of denar claims in total amount of denar 12.7 billion, or USD 317.5 million (for due loans outstanding and doubtful and contested claims on the basis of principal and interest), as of end 1994. In addition, the governance over 189 firms has been assumed by the Agency for Bank Rehabilitation on the basis of loans from Paris and Zurich Club of creditors, in total amount of USD 336 million. The priority has been given not only to the collection of the loans from domestic firms, but also to the restructuring of the enterprises. Main forms used in this process are: 1/ prompt sale of the claims, with discount (the rate of discount depends on the assessed quality of a particular enterprise, if there is appropriate collateral, etc.); 2/ debt rescheduling, with renegotiations for the terms of payment; 3/ sale of the claims to interested investors; and 4/ conversion of the claims in equity. In addition, in order to stimulate this process, and to help solving the problem of “frozen” foreign currency deposits, a possibility has been given for using “frozen” deposits for repayment of these loans. As regards the banks claims to 25 largest loss - making enterprises, they had been converted into equity, in amount of Denar 4.3 billion (USD 107.5 million).
- In addition, the process of rehabilitation of the banking system in the Republic of Macedonia includes the liquidation of the second largest commercial bank and three smaller banks, as well as permanent strengthening of the supervision standards (for capital adequacy, risk and credit portfolio, foreign exchange exposure, maximum amount of credit to a single borrower, maximum total amount of credit etc.) according to the international (Basle) standards. A necessary institutional framework was completed with the establishment of Deposit Insurance Fund at the end of 1996, and the Reforms of the Payment System commenced in the first quarter of 1996.

4. Banks Efficiency

Unfortunately, in this process of bank rehabilitation in The Republic of Macedonia, the first stage of financial restructuring was not followed by the successful operational restructuring of Macedonian banks which results in a continuously low level of efficiency and competitiveness of entire banking system. Many indicators show the previous fact:

a) The participation of **bad loans** in total credit portfolio of Macedonian banks remains very high. Namely, at the end of 1998, the rate of bad loans in total loan portfolio was 33% which means that one third of domestic savings accepted by banks, is inefficiently allocated. For this reason banks are required to make very high provisions for potential loan losses which determines additional



costs and high level of lending interest rates. At 31st of December 1998, 43% of the amount of bad loans (classified in risk categories C,D and E) was covered with provision for potential loan losses. Uncovered part of bad loans in the same period participated in total credit exposure of banks with 18% which means that soundness of the banking system is not put in question, but efficiency is severely damaged. High percentage of inefficiently allocated financial resources has a negative impact on the economic development of the country. The rate of economic growth was only 1.5% in 1997 and 2.9% in 1998.

b) Inefficient financial intermediation by Macedonian banks is one of the key factors for maintaining very **high level of lending interest rates**, which can be seen in the following table:

Table 2

Level of lending and deposit interest rates

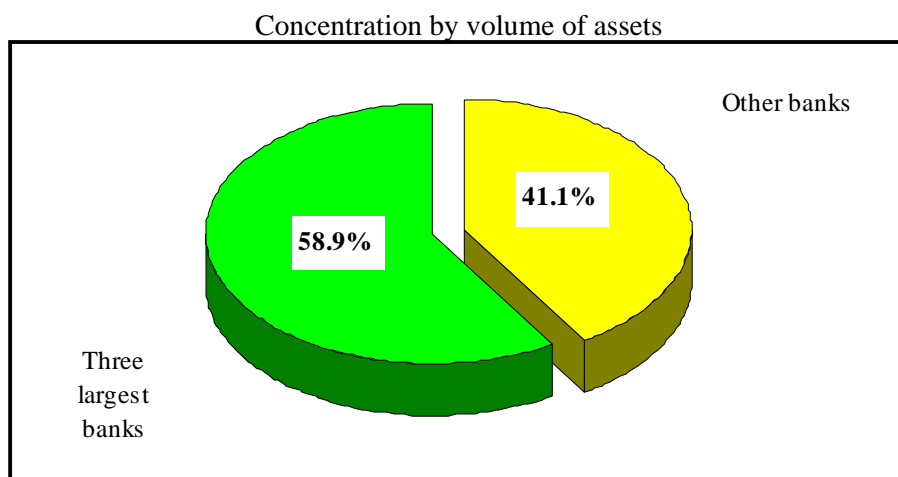
	In percentage					
	1993	1994	1995	1996	1997	1998
Average nominal lending interest rates	599.4	133.0	44.7	22.4	21.2	21.1
Average real lending interest rates	55.5	5.0	24.8	18.8	16.1	20.1
Average nominal deposit interest rates	377.4	67.6	20.9	12.6	11.6	11.7
Average real deposit interest rates	6.1	-24.4	4.3	9.3	6.9	10.8
Interest rate differential	222.0	65.4	23.8	9.8	9.6	9.4

The high level of nominal and real lending interest rates had a breaking down impact on inflation in the period 1994-1996, and after that, in the period 1996-1998, the impact was deflationary. The decline of lending nominal interest rates ceased in 1996 and that level has been maintained until now. On the other hand, although the deflationary pressures on economy, there was incline of real lending interest rates. In 1998 compared with 1997, real lending interest rates increased from 16.1% to 20.1%. Such high level of lending interest rates determines investments in too risky and inefficient projects, which have a negative impact on the economic growth.

c) The third indicator for inefficiency of banking system is **high interest rate margin**. Namely, misallocation of financial resources maintain high interest margin which means, on the one hand, inefficiency of financial intermediation, and on the other hand, **uncompetitiveness** of the banking system. Thus, in 1998 the interest rate margin was 9.4 percentage points which is very high by international standards.

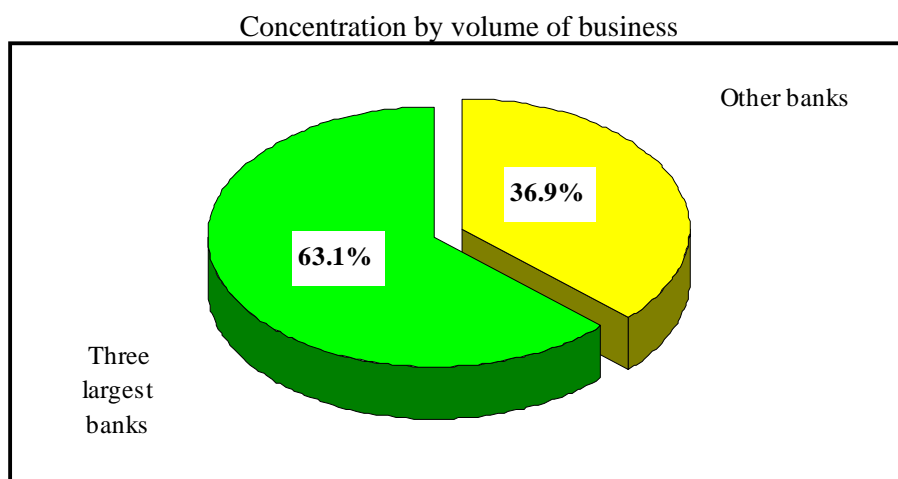
The analysis of the structure of the banking system according to the size of the financial potential, the market share and banks' own assets, shows the asymmetrical structure of the banking sector and relevant concentration. Namely, the three largest banks in the Republic of Macedonia account for 63.1% of the total volume of banking operations, as well as 58.9% of the collected financial potential or total assets. According to the capital strength, the three largest banks have a 39.5% share, which relative to December 1997 is a 4.4 percentage points decline.

Figure 1



d) Traditional banking activities are dominant within the Macedonian banking industry similarly with the banking business in continental Europe. Namely, in the countries of Euroland, the size of financial sector can be identified with its supply of financial assets to the other sectors of economy. But also, there is a trend of increasing of off-balance sheet activities such as derivative products and trend of diversifying and implementation of new financial products and services in order to survive in the extremely competitive economic environment in these countries. At the same time as banks have been diversifying and re-defining their business, a wide range of new type of firms have begun to supply traditional banking services: transactions deposits, savings accounts and a range of loans. Such firms include supermarkets, utility companies, insurance companies, mutual funds and even a car manufacturer (BMW in Germany).

Figure 2



Contrary to this, in the Republic of Macedonia banks still retain their traditional monopoly advantages because of the lack of other firms (financial or non-financial) - suppliers of banking services. The previous fact, together with concentration and uncompetitive environment in the Macedonian banking industry, determine supply of very poor banking services. Traditional banking activities (lending) take the major part of banking business. Retail banking services, such as credit cards etc, are still in initial stage. Also, off-balance sheet activities of Macedonian banks consist of traditional off-balance sheet instruments - guarantees, letters of credit etc. Derivative products are at the very beginning of their existence.

Although in the past few years some foreign banking capital has entered in The Republic of Macedonia, still there is absence of well-known foreign banks, which determines low level of



competition in the banking industry. Also, uncompetitive environment in Macedonian banking, caused very comfortable behavior of the banks and postponement of the process of mergers and acquisitions. The previous situation is possible due to the fact that in the uncompetitive environment, high costs of business can be transferred to the final users of banking services.

However, The Republic of Macedonia has started to feel the winds of consolidation and mergers, which have long blown on the world's financial markets. Namely, at the end of the last year there was a merger of two Macedonian banks. The process continues during this year and the result of entry of some foreign banks from European Union, which is expected in the near future after the ending of on-going negotiations, will be a relevant improvement of competition and efficiency of Macedonian banking industry. But, the miles left on the road of banking rehabilitation are still ahead of us. The sooner the banks will operationally be restructured, The Republic of Macedonia sooner will renew and accelerate its economic development.



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