

A stages approach to banking development in transition economies

Abstract: *Credit shortages are widely thought to explain the output contraction in former Soviet Union (FSU) countries during the 1990s. It is argued here that these shortages were the result of an ahistorical approach to policymaking which ignored the time needed for the establishment and further development of money, banking, and nonbanking financial institutions. Starting from Chick's stages-of-banking-development framework, we examine the experience of the FSU economies in transition from central planning. We then develop a five-phase framework to characterize the process of banking development required for them to reach stage two of Chick's framework, where bank liabilities are accepted as money.*

Key words: *banking development, FSU countries, money, trust.*

Implementation of the reform packages designed within the mainstream framework for Eastern and Central European countries led to considerable contraction of output in the early years of transition; cumulative annual output loss during the first three to four years of transition ranged between 20 percent and 30 percent of the pretransition output level in these countries. This was particularly the case for the former Soviet Union (FSU) countries,¹ on which this paper focuses. Output in these

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¹ The 15 FSU countries are Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. All of these countries had more than 70 years of experience with central planning except for Estonia, Latvia, Lithuania, and Moldova, which joined the union in 1940 but effectively started their central planning experience after World War II.

countries declined for more than five consecutive years; by 1999, the cumulative annual output decline in the FSU was close to 50 percent of its pretransition output level (European Bank for Reconstruction and Development [EBRD], 1999; 2006). Although persistent output growth was recorded in most of the FSU countries by the late 1990s, almost half of these countries had still not reached their pretransition output levels by 2005 (EBRD, 2003; 2006). It is now accepted that credit shortages played a large part in this output contraction (Calvo and Coricelli, 1993; Glaz'ev, 1998).

The argument will be developed here that these credit shortages were the result of an ahistorical approach to policymaking that ignored the time needed for the establishment and further development of market institutions. In particular, the process of economic transition from a planned economy to a market economy required major changes in the nature, characteristics and role of money, and banking and nonbanking financial institutions. Neglect of the necessary time for the evolution of market institutions proved costly. The newly created banking sector failed to fill the gap left by the monobank system, resulting in a credit crunch, payments crisis, development of inefficient money surrogates, and massive output loss. The reform programs had been formulated by Western experts using the same theoretical framework as for market economies, without proper recognition of more than 70 years of central planning experience. The naive expectation that market institutions would spring up as soon as central planning was abolished was shared by leading Soviet academics (see Aslund, 1995, for a discussion of the infamous Abalkin report).

The purpose of this paper is to examine the complex and necessarily slow-paced nature of banking system evolution that the transition economies of the FSU needed to accomplish. This discussion continues to have policy relevance in that many of the FSU countries have still only partially completed this process.²

² The peculiarity of transition experience as reflected in the widening variation of institutional quality across transition economies was termed the *Great Divide* by Berglof and Bolton (2002). In terms of general financial deepening, all transition economies are still behind the standards of advanced market economies. However, in terms of institutional quality, the advanced transition economies of Central and Eastern Europe and Baltic States are not far from their market economy counterparts (EBRD, 2006). In stark contrast, the poorer and slower-reformer economies of the FSU such as Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan are financially underdeveloped even by the standards of transition economies (de Nicolò et al., 2003).

The Post Keynesian approach to economics takes seriously the significance of irreversible time for the economic process (Davidson, 2002) and is therefore particularly suited to our purpose. Within this approach, Chick (1986; 1993) provides a framework that focuses on the temporal sequence of the stages of development necessary for the evolution of an efficient and well-functioning banking system in a market economy.³

Let us start with a brief look at the essential character of the stages in Chick's framework. In Stage 1, cash is widely used as a means of payment. Deposits at this point represent a part of accumulated savings but not of transaction balances. In Stage 2, once banks demonstrate their viability and win the public's confidence, bank liabilities become a convenient means of payment. However, because confidence in banks still tends to rest on local knowledge, the use of titles to deposits as a means of payment is limited to the local geographical area. In Stage 3, banks realize that it is in their interest to develop a system of interbank lending. The resulting increased availability of finance facilitates the economic growth process. Stage 4 is a turning point in terms of the role of the central bank when it assumes full responsibility for promoting confidence in the banking system, primarily by providing the lender-of-last resort facility.

In Stage 5, banks enter the new phase of liability management; non-bank financial intermediaries (NBFIs) use the liabilities of banks as their reserve base and banks find themselves facing strong competition from the NBFIs. Rather than just waiting for new loan requests, as they would have done in the past, banks now aggressively seek new lending opportunities. As a result, at the outset of Stage 6, banks have an increasing proportion of bad loans because the excessive credit expansion in Stage 5 was not supported by real economic activity. In response, the authorities tighten regulations and introduce capital adequacy requirements to maintain confidence in the entire banking system, thus making credit creation more costly for the banks. This, in turn, encourages banks to develop new instruments, technology, and business services as an alternative source of profit. But this, combined with deregulation, causes the distinctiveness of banks among other financial institutions to appear to fade in Stage 7. Nevertheless, banks continue to play their fundamental role in providing the money base upon which the entire financial sector is built (Dow, 1999). The successful working of modern

³ The framework was applied in Chick and Dow (1988) and developed further by Dow (1999).

capitalist economies requires the existence of a liquid asset, which is a good store of value and whose unit serves as denominator of contracts; this, by definition, is money (Davidson, 1994).

The essential feature of Chick's framework is the gradual building up of confidence in a range of institutional arrangements in a market economy. Although the framework was based on English banking history, it is readily adaptable to other market economies. But the experience of the formerly planned economies has been so different from that of market economies that they merit particular consideration in terms of the process of confidence building. Further, the analysis needs to reflect the fact that their experience in transition has included importation of practices and technology developed by Western banks at later stages of development.

We now proceed to examine the actual experience of transition economies, focusing on the FSU countries, by adding a five-phase process of achieving the second stage of banking development in a country where the starting point is a centrally planned economy. The new framework provided by this paper attempts both to account for changes that have already taken place in some transition countries and to suggest a strategy for financial development in others.

Money and banking during transition

We start our discussion by looking at the organization, role, and importance of money and banks under central planning in the FSU, as the base from which transition must build. Money and banks were designed to play only an accommodative role under central planning. Marx and Lenin, whose views were fundamental in building a centrally planned economy, were aware of the fact that money was nonneutral in a capitalist economy. For instance, using his famous circuit "C-M-C," where C stands for commodity and M for money, Marx argued that when money is used in an exchange transaction, acts of sale and purchase do not necessarily have to be simultaneous. In Marx's words, "[t]he purchaser has the commodity, the seller has the money. . . . No one can sell unless someone purchases. But no one is forthwith bound to purchase because he has just sold" (quoted in de Brunhoff, 1976, p. 42). He further argued that in a capitalist economy, where the driving force of production is profit, the dominant form of circulation is in the form of M-C-M'. After the completion of a production cycle, capitalists convert newly produced commodities back into money (M'). If capitalists think that the rate of profit is not high enough to encourage them to throw their capital into

circulation, they may decide to hoard. Hoarded money holds effective demand back and thus creates the possibility for general overproduction and thus crisis (de Brunhoff, 1976; Sardoni, 1987; Sweezy, 1970).

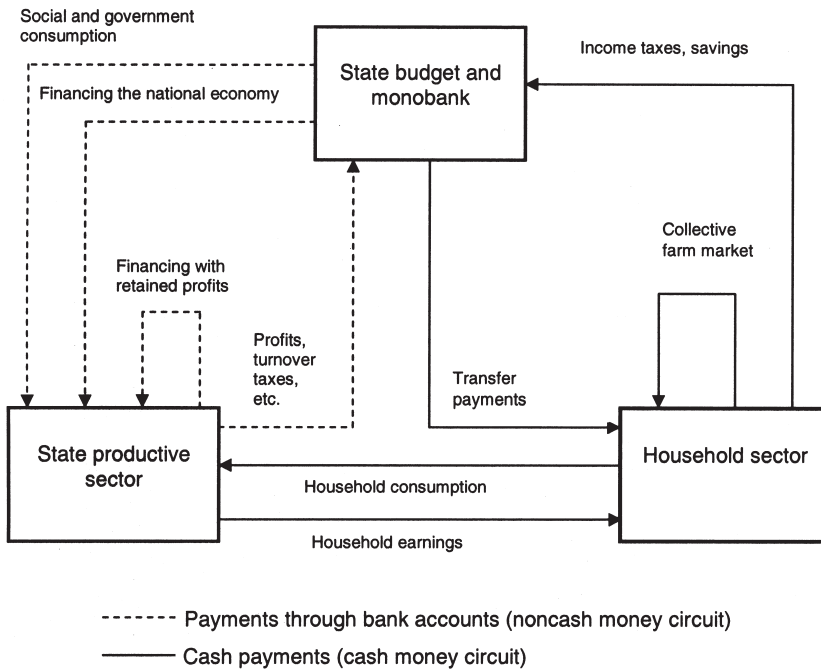
To prevent cyclical crises, communist theorists advocated replacing decentralized markets with central planning and abolishing money from the system altogether (Ellman, 1989, p. 10; Temkin, 1994, pp. 197–198). The idea of abolishing money was so popular that it was treated as an unquestionable attribute of a socialist economy. In the early 1920s, there were, therefore, deliberate attempts to eliminate money from the economic process. Toward the end of 1920, steps were taken to abolish monetary charges for the use of a number of services—postal, telegraph, and telephone facilities; water and electricity supply; housing accommodation in municipal dwellings; railway travel; supply of basic food rations; and so on (Dobb, 1966, p. 106). It is also reported that in cities at the beginning of 1921, 93 percent of all wages were paid in-kind against 7 percent in money (Kuschpeta, 1978, p. 28; see further Yurovsky, 1994).

There was little room for banks in a moneyless society. Banks' new functions were seen to be limited mainly to accounting and control of enterprise activities. Within a few months of the 1917 revolution, all major banks were either liquidated or merged with People's Bank, now a state monopoly. At one point, there was no single bank left in the economy: in 1920, even People's Bank "was liquidated and its assets and liabilities were transferred to the Central Budgeting and Accounting Department of the Commissariat of Finance" (Baykov, 1946, p. 35).

However, practical difficulties proved that the idea of establishing a moneyless voucher exchange system was unimaginably difficult and thus infeasible. As a result, following Lenin's later encouragement regarding the use of money during the first stage of communism, money and banks were soon reintroduced to the system (Dobb, 1966). However, the traditional soviet economic theory of money and banking remained (Gregory and Tikhonov, 2000). The very idea of economic planning and its related neglect of the role of money in the economic process became a dogma of soviet ideology and, as such, remained as a constraint on economic thinking, accounting for the role of money and banks in the FSU from the 1930s to the late 1980s.

The socialist money circulation was composed of two separate and semi-independent circuits, each with its own characteristics and peculiarities. The term *cash money* implied currency outside the banking sector such as coins and notes, and the term *noncash money* referred to bank deposits (Garvy, 1977; Zwass, 1979). Cash money and noncash money were not freely interchangeable. Figure 1 illustrates the semi-independent

Figure 1 Semi-independent nature of cash money and noncash money circuits in the traditional Soviet economy



Source: Green and Petrick (2002, p. 3).

nature of the cash money and noncash money circuits. By law, enterprises and organizations were required to use exclusively noncash money, which was kept in their single current accounts with banks, in their everyday economic activity. The scope for the use of noncash money was limited to organized markets where enterprises exchanged goods and services with each other in accordance with the production plans set by the central planners. Noncash money was exchanged for cash money only through payroll withdrawals and sundry transfer payments, such as pensions and social security benefits to the household sector. Households spent their cash money earnings in organized markets to buy consumer goods from retail trade organizations, as well as in nonorganized markets (often called the *second economy*) to purchase consumer goods and services.

Noncash spending by enterprises was under the direct control of the authorities. In addition to being only partially convertible into cash money, noncash money was *not* freely convertible into goods and services (Zwass, 1979). If enterprises were entitled to buy goods according to their input

plans but were short of noncash money, this would be supplied by the banking sector. On the other hand, enterprises could not spend their extra noncash money holdings if they did not have an authorization to buy. Nevertheless, because some maneuvering was possible within administratively set plan targets, enterprises would convert their redundant noncash balances into inventory (Garvy, 1977, p. 42). Taking these characteristics of soviet money into account, Heinsohn and Steiger (2000, p. 70) rightly referred to it as “ration cards.” Hence, though financial accounting of the firm’s trade transactions did take place, it was monetized only in appearance (Kornai, 1982, p. 9). In short, the role of money was reduced to the function of a *numeraire* so that money and liquidity preference ceased to be constraints on the economic process.

As for the banks, they were designed to facilitate the process of planning and production. The monobank system did not distinguish between central banking and commercial banking, and its role was limited to the organization of the payments system for the enterprise sector, and pumping short-term credits to this sector to facilitate interenterprise trade as well as to smooth out any imperfections unforeseen in planning. Because all enterprises held their accounts with banks, banks controlled their financial flows, monitored their performance, and supplied all necessary information to the authorities. Notions such as market-determined interest rates, liquidity preference, cost of funds, collateral, and creditworthiness were irrelevant to soviet banking practice. Although the enterprise sector depended heavily on bank credit to finance their working capital, the start-up capital of new enterprises, or new investment in existing ones, was financed from the state budget as nonrepayable grants and subsidies. The banking sector was used as an effective but neutral conduit in the government’s resource allocation policy. An inevitable feature of this system was that, as argued by Kornai on numerous occasions, the enterprise sector did not face market-type financial constraints (Szego, 1991).

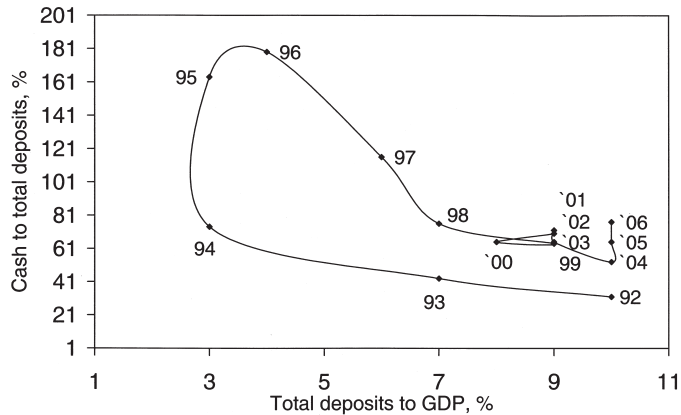
Unfortunately, these peculiarities of the soviet system were not properly taken into account in designing reform packages in the early 1990s. Decentralization of the economic process, price liberalization, privatization, and restructuring of the banking sector in transition countries (copying the blueprint of the banking sector in advanced countries) were seen as a sufficient condition to guarantee the success of the process of transition.⁴ However, because the transformation would require a complete

⁴ The view of Jeffrey Sachs, one of the designers of the Polish economic reforms, represents one extreme example of this “time and institution free” approach. He argued that “markets spring up as soon as central planning bureaucrats vacate the field” (quoted in Green and Petrick, 2002, p. 205). See also Lipton and Sachs (1990).

change from one mode of resource allocation to another—that is, from a barter-like semimonetized economy into a monetary one—these imposed changes would not suffice. Rather, the evolution and gradual maturity of vital market institutions such as money, banks, and other financial institutions would be required.

To transform a supply constrained centrally planned economy into a demand-constrained monetary economy, it was essential that wealth formation and thus the saving habit had to shift from goods to money, that the banking sector had to be reorganized and restructured, and that banking habits had to evolve. To achieve these objectives, first, money had to be a universalized title to all tradable goods and services, so that it became a generally acceptable standard of denominating and discharging debt contracts. That meant that the legal and practical separation between cash money and noncash money circuits had to be abolished altogether. Enterprises were to be given the right to spend their financial resources freely. In addition, it was vital that the existing trust in banks had to be preserved and further enhanced. The banking sector had to abandon certain functions relevant only under central planning, such as granting soft loans, collecting taxes on behalf of the government, and revealing information on customers' accounts to the authorities. Instead, they needed to win the general public's trust and persuade them to switch from cash to demand deposits, learn to assess customer creditworthiness as well as the commercial viability of projects when considering loan applications, and become skillful at credit creation under market conditions. As will be shown below, the only aspect of banking under central planning that could be relevant under the new regime would be the system of payments clearing.

By learning from the banking sector in advanced market economies, the banking sector of the transition economies would be equipped with the following: (1) acceptability of bank liabilities as payment instruments, (2) fractional reserve banking, (3) the interbank market for liquidity, and (4) the lender-of-last-resort facility. However, the logic of Chick's stages-of-banking-development framework suggests that banks in transition economies could not proceed directly to Stage 4 without the buildup of confidence in bank liabilities and the gradual development of banking habits by the household sector in Stage 2. In transition economies, banking development had to start almost from scratch. In the next section, therefore, we examine the experience of the FSU countries during transition in order to break down the process by which Stage 2 was approached in practice. This will allow us to formulate an amplified

Figure 2 Armenia: rebuilding trust, 1992–2006

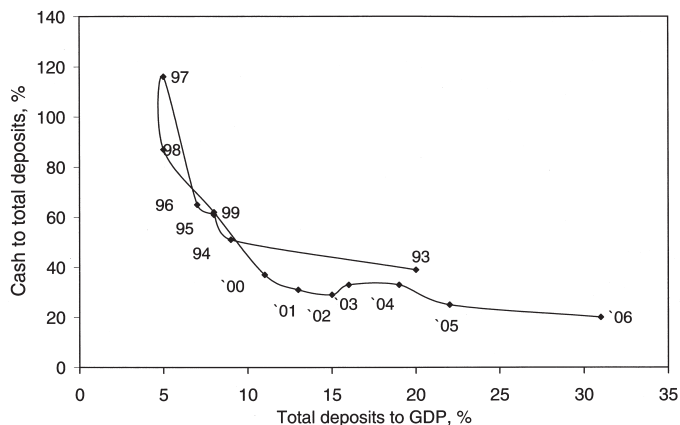
Source: IMF International Financial Statistics (2007).

version of the process by which Stage 2 of Chick's framework can be, and in some cases has been, achieved by transition economies.

The experience of transition to stage 2 in FSU countries

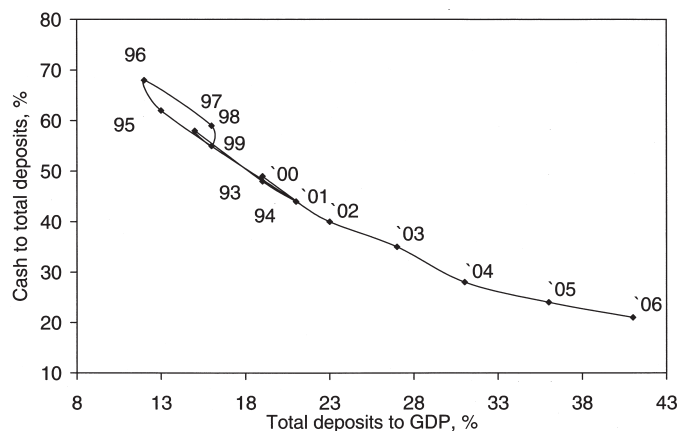
In this section, we examine the actual monetary experience of the FSU countries in transition. Figures 2 to 9 show, for eight FSU countries during transition, the ratio of cash money to total deposits (a measure of the economy's reliance on cash), combined with the ratio of total deposits to gross domestic product (GDP) (a measure of the importance of banking) over the 1992–2006 period. Banking development would be associated with a negatively sloped relation over time. Pretransition ratios of cash to total deposits and total deposits to GDP were about 20 percent and 70 percent, respectively, in the FSU (Peachey and Roe, 2001). The pattern of change during the transition for all members of the FSU was that, as one would expect, reliance on cash transactions increased at the initial stage of transition, and the importance of banking comparatively decreased. This trend continued until 1996–97. Since then, reliance on cash has been decreasing, and the importance of banking has gradually been picking up. Despite this general pattern, however, the level of success achieved since the mid-1990s has been substantially different across countries. In countries such as Georgia, the Kyrgyz Republic, and Tajikistan, the ratio of cash to total deposits was more than 200 percent; in countries such as

Figure 3 Kazakhstan: rebuilding trust, 1993–2006



Source: IMF International Financial Statistics (2007).

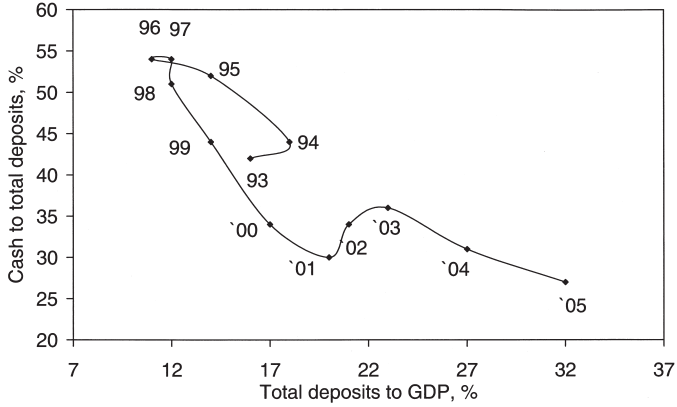
Figure 4 Latvia: rebuilding trust, 1993–2006



Source: IMF International Financial Statistics (2007).

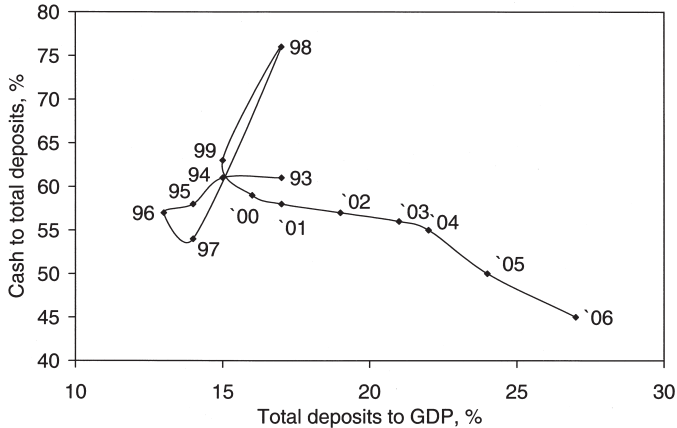
Armenia, Azerbaijan, Kazakhstan, Moldova, Ukraine, and Uzbekistan, the ratio was over 100 percent; in Russia it was around 80 percent; and in the Baltic States, the ratio was less than 70 percent at its peak. Arguably, wars associated with border disputes (Armenia and Azerbaijan), civil strife (Tajikistan), and territorial unity (Georgia and Moldova) also contributed to extreme conditions in some countries.

Figure 5 Lithuania: rebuilding trust, 1993–2005



Source: IMF International Financial Statistics (2007).

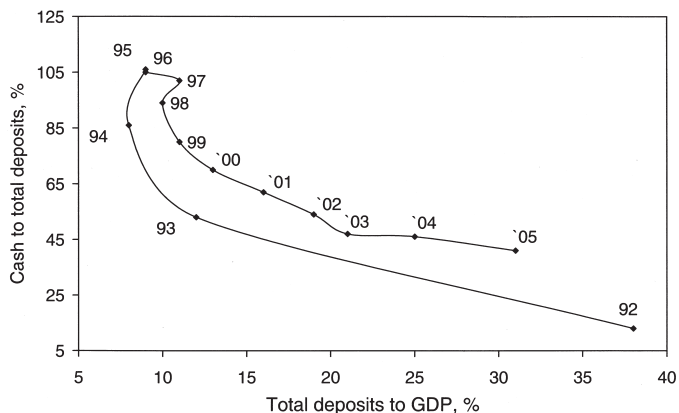
Figure 6 Russia: rebuilding trust, 1993–2006



Source: IMF International Financial Statistics (2007).

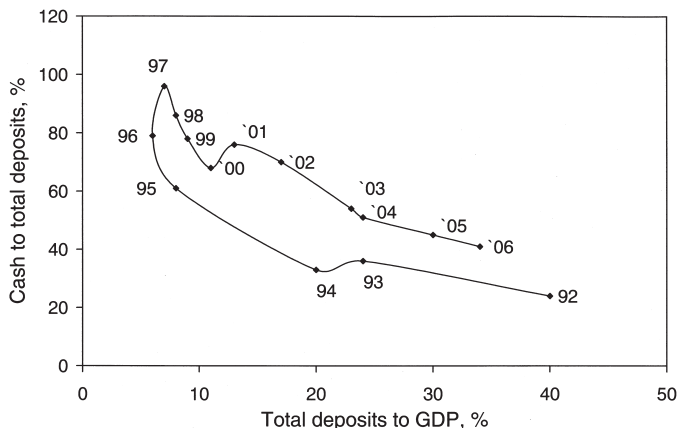
Figure 10 compares the progress achieved by 2005 in the FSU countries in rebuilding trust in their banking sectors with that achieved in more advanced transition economies of Eastern Europe. The size of each country’s bubble measures per capita gross national income in 2005 (ranging from \$330 in Tajikistan to \$10,710 in the Czech Republic); shaded bubbles refer to Eastern European transition economies. Although all FSU countries are still far off their pretransition ratio of

Figure 7 Moldova: rebuilding trust, 1992–2005



Source: IMF International Financial Statistics (2007).

Figure 8 Ukraine: rebuilding trust, 1992–2006

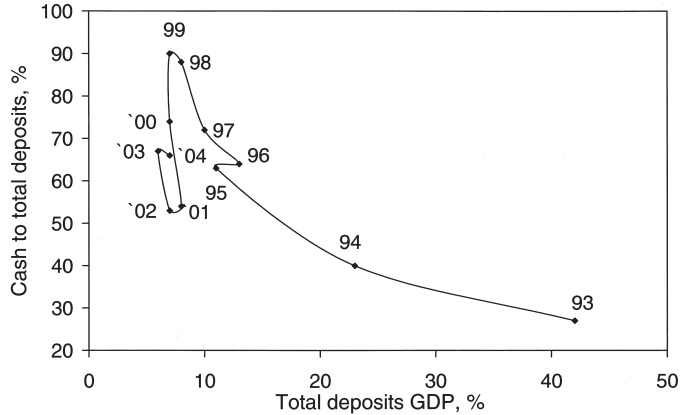


Source: IMF International Financial Statistics (2007).

bank deposits to GDP of around 70 percent, progress made in Estonia, Latvia, and Lithuania is comparable to that in the advanced transition economies of Eastern Europe.

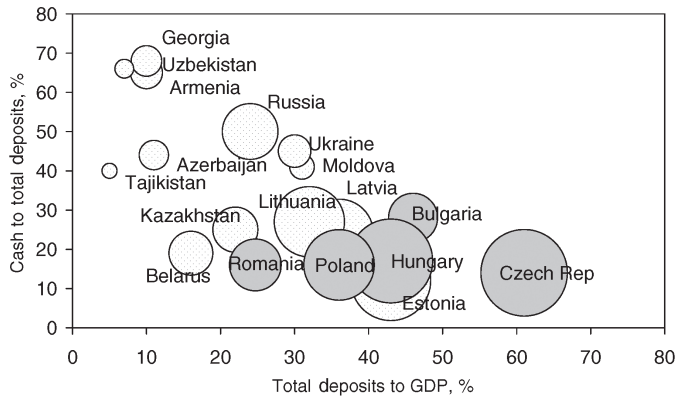
Hyperinflation in the early 1990s wiped out the real value of financial wealth and thus severely shattered the general public’s trust in money and banks in all countries of the FSU. Individual countries reacted differently to this shock and this partly explains the differences in their

Figure 9 Uzbekistan: rebuilding trust, 1993–2004



Source: IMF International Financial Statistics (2007).

Figure 10 Rebuilding trust: selected transition economies, 2005



Sources: IMF International Financial Statistics (2007) and Asian Development Bank (2007).

performance during the recovery period. It is beyond the scope of this paper to survey the experience of individual countries. However, before starting our discussion on whether the initial collapse of confidence could have been prevented, we would like to touch briefly upon three contrastingly different episodes in the example of the Baltic States (a comparative success story), Russia (a complex experience full of recurring crises), and Uzbekistan (an example of retaining full control over the banking sector and preventing output loss but failing to regain the public's trust).

As in any other member of the FSU, the hyperinflation of the early 1990s in the Baltic States hit the general public's trust in the banking sector hard. They responded to this shock by setting their sights firmly on macrostabilization policies. The possibility of joining the European Union provided an extra incentive for carrying out fast and consistent institutional reforms. After the introduction of their national currencies in 1992–93, they arranged currency board–type institutions to combat inflation; Estonia pegged its currency to the deutsche mark, Latvia to a basket of currencies, and Lithuania to the U.S. dollar. As a result, inflation had already been reduced to two-digit figures by 1994 and to single-digit figures by 1998. In addition, they attempted to restructure their banking sector by offering their state-owned banks to strategic foreign investors. Because the Baltic States had the highest per capita income in the FSU and were located nearest to the market economies of the European Union, they were very attractive for foreign bank entry, which made institutional spillovers easier and quicker. By 2000, more than 60 percent of the banking sector capital in these countries was in foreign hands, the bulk coming from the neighboring Scandinavian countries. Arguably, foreign banks brought market expertise and efficient corporate governance, assisted with the payments system modernization, and increased competition and efficiency. Undoubtedly, these policies facilitated the process of regaining the general public's trust.

Russia's experience with reforms and how this affected development of the banking sector is quite remarkable (see Figure 6). The household sector's confidence in the domestic currency as well as domestic financial institutions was hit hard several times between 1991 and 2000.⁵ Unprompted decentralization of the economic process by ad hoc mass privatization and price liberalization was followed by an annual rate of

⁵ The first of these shocks came before the political meltdown of the FSU in early 1991 and therefore was common to all other members of the FSU. During *perestroika* (and *glasnost*—freedom of information), it became public knowledge that corruption and bribery were deeply rooted in society. Because owning private property was banned in the FSU and keeping substantial amounts in bank accounts was not desirable, again for political reasons, it was believed that the bulk of wealth generated by individuals through various “dubious” activities was hoarded in high-denomination banknotes. Therefore, in early 1991, the decision was taken to confiscate part of cash hoards of “unjustifiably” wealthy individuals by withdrawing high-denomination banknotes from circulation. As a result, individuals who either did not bother about financial return offered on bank deposits or did not trust the political system and thus kept their wealth in cash hoards suffered heavily.

inflation of over 1,500 percent in 1992 and almost 900 percent in 1993.⁶ It was during this period that the general public's trust in banks was hit the hardest. During this period, the economy experienced a shortage of cash money in circulation, which also led to a temporary freeze on deposit withdrawals from the state-owned banks. Because no measure was taken to protect the real value of financial assets, hyperinflation ate up the real value of the household sector's bank deposits very quickly. As a result, confidence in banks hit a record low; households attempted to protect their purchasing power in nonruble and nondeposit forms. Hyperinflation quickly eroded the working capital of the enterprise sector, too, and made it extremely reliant on external financing, specifically by bank credit. With their deposit base shrinking, commercial banks were not in a position to meet the enterprise sector's demand for credit. As a result, enterprises started having difficulties in financing their working capital. In order to prevent the looming payment crisis, the authorities were forced to grant centralized and directed credit to banks. Nonetheless, with the banks' role in the payments system steadily declining, these policies did not prove entirely successful and could not prevent rising interenterprise indebtedness. It has been noted that by the end of 1994, only 3 percent of working capital was financed through own capital, 7 percent through credits and loans, and 90 percent through accounts payable and other liabilities (Glaz'ev, 1998, p. 75).

As a result of liberal entry rules and weak regulation, NBFIs entered the banking market in the early 1990s. Unfortunately, most of these NBFIs were fraudulent Ponzi-pyramid schemes, which could stay in business as long as their contractual outflows did not exceed contractual inflows. They offered unrealistically high rates of interest on deposits, thus facing dramatically large and potentially unsustainable financing costs. However, by engaging in speculative activities, especially in the foreign exchange market, they were able to extend their life cycle. In mid-1995, the monetary authorities formally replaced the floating exchange rate regime with a managed regime, as an anchor to curb inflation. These policies seriously limited the ability of Ponzi-pyramid schemes to fund their contractual outflows in the foreign exchange market, and this accelerated their downfall. Because they stayed afloat longer than expected, even cautious households were caught up in these schemes (Rock and Solodkov, 2001).

⁶ All references to inflation figures here and hereafter are from the EBRD (1995; 2001; 2006).

Ironically, although the authorities' attempt to curb inflation brought an end to the unhealthy NBFIs, it also contributed to the creation of another type of Ponzi-pyramid scheme, this time initiated by the fiscal authorities. To coordinate anti-inflationary policies, the fiscal authorities decided to issue short-term government bonds (GKO) and borrow from the private sector to finance the continuing fiscal deficit. By 1997, total short-term and long-term debt issue had reached 296 trillion rubles (\$51.3 billion), of which 25 percent was held by foreign investors. The growing fiscal deficit financed in this way meant that the resulting obligations were financed in Ponzi fashion by sales of new GKOs (Poirot, 2001). The only way out of this situation was to either return to printing huge amounts of money or to cut government spending and improve tax collection. As the consequence of the former option was clear from the hyperinflation of the early 1990s, successive governments decided to choose the latter option (Gros and Steinherr, 2004, pp. 252–253). Unfortunately, however, with the economy still contracting, and with record low world prices for oil, tax revenues did not increase (tax avoidance and evasion were particularly widespread during this period), and this resulted in the government's inability to meet its obligations. As a result, the government defaulted on its obligations on August 17, 1998. Because GKOs paid a high positive real return, in the environment of increased uncertainty and high risk associated with lending to businesses, they proved to be very popular among banks. The moratorium on the government's debt obligations shook the banking sector severely; hundreds of banks collapsed again, and as a result, the general public's trust hit a new low.

Another drawback of the stabilization policies introduced in 1995 was that the low-risk, high-return GKOs "crowded out" bank credit from the enterprise sector (whose access to credit was already limited) and further worsened the problem of interenterprise indebtedness, resulting in a payments crisis. At its peak in 1998, nonmonetary transactions such as mutual write-offs, promissory notes, and pure barter transactions constituted more than 50 percent of industrial transactions in Russia (Ould-Ahmed, 2003). After the crisis of 1998, the annual rate of inflation was finally controlled and was reduced to about 20 percent. The steady rise of oil prices also contributed to macroeconomic stabilization. As a result, since 1999, the economy's reliance on cash money has steadily been declining and the importance of banking has slowly been increasing.

At the other extreme is Uzbekistan, whose banking sector has never truly recovered from the initial shock of hyperinflation, albeit for different reasons (see Figure 9). Although reforms in the small-scale enterprise and retail sectors were fast and successful, the centralized control over

large-scale enterprises in the industrial and energy sectors, and cotton and wheat production in the agricultural sector, were never truly abolished. By maintaining soviet-style macroeconomic management, Uzbekistan managed the lowest output contraction and was the first in the FSU to reach pretransition level output during transition (Ruziev et al., 2007). To finance ambitious new investment projects in the industrial sector by simultaneously maintaining production in the ailing enterprises, the government needed considerable financial resources. To meet this demand, instead of developing its own banking sector, the government resorted to considerable external borrowing and, since independence, it borrowed well over \$5 billion from international financial institutions and multinational banks, equivalent to more than 55 percent of GDP. Government-guaranteed loans attracted from abroad in this way have been estimated to account for more than two-thirds of banking sector assets (World Bank, 2003). The banking sector is still being used as a neutral conduit for channeling soft credits, budget subsidies, and on-lending government-guaranteed foreign loans to enterprises in the priority sectors of the economy. As a result, in spite of some positive changes undertaken during transition, such as replacement of the monobank sector with the market-oriented two-tier banking sector, modernization of the payments system, maintenance of moderate inflation, and the establishment of the deposit insurance fund, the banking sector in Uzbekistan is still struggling to proceed along the transition path.

In short, all FSU countries pursued the initial reforms almost in the same manner and faced similar consequences—hyperinflation, collapse of confidence in banks, a credit crunch, and a payments crisis. The important questions that arise are what could have been done differently to prevent the collapse of confidence in banks from which some countries still struggle to recover, and what can be done to facilitate progress under the current situation?

The hyperinflation of the early 1990s played the most damaging role in destroying the public's trust in banks. It had several causes: price liberalization, monetary overhang, uncoordinated monetary policy within the ruble-zone, and lax fiscal and monetary policies pursued by individual countries. It was logical to expect that liberalization of repressed prices combined with monetary overhang⁷ would lead to a higher overall price level. In the absence of government measures to protect the real value of

⁷ The monetary overhang refers to the inability of the household sector to convert their financial holdings into goods and services simply because these are scarce in supply. Kim (1999, p. 605) gives a detailed account of monetary overhang in the FSU.

deposits, households tried to convert their financial holdings into goods and services, leading to hyperinflation.

This spiraling effect, however, could easily have been prevented, and more importantly, the general public's trust in financial institutions could have been preserved had the real value of household savings held with state savings banks been protected by indexing to inflation. In addition, although administratively set prices did not reflect relative scarcities and needed to be liberalized, there was no reason to liberalize them immediately (Marangos, 2000–1). Finally, the monetary overhang was explained as a result of a higher rate of growth in household financial assets compared to that of goods and services. Household-sector financial assets, cash hoards, and other savings held with state savings banks, accumulated over the years in this way under central planning were estimated to be no less than half of household wealth. Because the monetary overhang was seen as financial assets not backed up with goods and services, it was thought to represent suppressed inflation, waiting to be unleashed sooner or later. However, the monetary overhang did not need to cause any inflationary pressure if it was perceived as title to private property (which was banned almost in all forms under central planning), not simply to goods and services alone. In other words, by allowing private ownership of property and the gradual transfer of public assets to the private sector through step-by-step privatization, any possible inflationary consequences of the monetary overhang could have been prevented.

The national central banks of 15 independent republics that emerged from local branches of *Gosbank* (State Bank) were allowed to pursue a semi-independent monetary policy in early 1991 before the political meltdown of the FSU. When these countries were still under the common currency ruble-zone until late 1993, their central banks continued with uncoordinated independent monetary policies and created excessive credits to finance their national economies; and this was also blamed for the hyperinflation of the period. Allowing this to happen was a mistake, because although the FSU disintegrated politically, the economies of the member countries remained intertwined through the legacy of 70 years of central planning and business practices. Therefore, to guarantee a smoother transition, reformers should have discussed policy coordination to deal with the beginning of transition; they should also have discussed collaborating in the design of a coherent package for monetary, tariff, and taxation policies (Rock and Solodkov, 2001). However, given the political popularity of setting independent national institutions in every aspect of life, including the financial sector, and euphoric expectations about huge aid and investment from the West, this would have been one of the most difficult tasks for the reformers to undertake.

Hyperinflation did not subside immediately after countries launched their national currencies. The first ex-soviet country to introduce its national currency in June 1992 was Estonia, and Ukraine followed suit in November 1992. By the end of 1993, the ruble-zone disintegrated, and by 1994 almost all of the 15 countries had their national currencies in place. Although Estonia, Latvia, and Lithuania managed to reduce the rate of inflation to two-digit figures by 1994, most of the remaining FSU countries suffered from a high rate of inflation until 1997. It was argued that the fact that inflation did not subside immediately, despite the launch of national currencies, showed that the main causes of continued inflation were lax monetary and fiscal policies (Gros and Steinherr, 2004, p. 85). However, a careful investigation of the development of events suggests that these policies were the natural response to macroeconomic chaos created in the first few years of transition. In other words, had the hyperinflation and the collapse of confidence in the banking sector been prevented, there would have been no need to pursue inflationary policies.

During transition, all transition economies abolished the distinction between cash money and noncash money and gradually modernized their payments systems, starting with corporate banking and then extending to retail banking. Under normal circumstances, these policies would have improved the general public's trust in banks and facilitated banking-sector development. However, the impact of these developments was overshadowed by the uncoordinated and ill-thought-out policies pursued in the early 1990s. Moreover, the experience of Russia and the Baltic States indicates that stricter entry rules, a strong regulatory environment, consistent reform policies, and attraction of foreign strategic investors could have had a positive impact on promoting confidence in the banking sector.

Additional stages of banking development for transition economies

We can see from this experience that, given the initial reforms carried out in the early years of transition, such as establishment of the two-tier banking sector, spontaneous price liberalization, and subsequent hyperinflation, banks in transition economies had to go through at least five notional phases in order to reach Chick's Stage 2. Table 1 briefly summarizes the main points of this process. Bearing in mind the distinctions made between cash money and noncash money, as well as between corporate and retail banking services under central planning, we will look at the following issues in turn: (1) why cash-based transactions tend to increase during the early years of transition, (2) how the modernization

Table 1
Gradual rise of confidence in bank liabilities during transition

Household deposits	Corporate deposits	Money outside the banking sector
Phase 1: period under central planning		
Deposits are exchanged for currency at a one-to-one ratio but no clearing system exists. Bank deposits are accumulated savings but not money.	Well-defined but slow and ineffective payments-clearing system. Corporate deposits are noncash money by design. Noncash money is used by the enterprise sector alone.	The household sector's transactions are almost exclusively carried out in cash money.
Phase 2: transition begins—hyperinflation and complete loss of confidence in banks		
Trust in banks erodes and banks cannot attract cash from the general public.	Weak trust in banks, payment delays associated with inefficient payment system, incentives to underreport business dealings, and abolition of distinction between cash money and noncash money result in lower demand for noncash money. In the end, this leads to relative illiquidity of noncash money.	Confidence in domestic currency is lost. Savings are kept in foreign hard currencies. Because it is legal tender, cash money is demanded mostly for transaction purposes. In short, cash-based transactions have dominant power.

Phase 3: achieving moderate inflation and modernizing the payments system

Due to moderate inflation and positive deposit rate offered by banks, deposit base slowly increases. However, trust is still weak and deposits are not money.

Payments system is modernized. Trust in banks, and thus in bank liabilities, slowly increases. Nonetheless, no significant increase in deposit-based transactions yet. Noncash money is not as desirable as cash money.

Trust in national currency gradually picks up. Households start using domestic currency as a store of value. Cash-based transactions still dominate.

Phase 4: maintaining stability of national currency and extending payments system reforms to the retail banking sector

Payment-clearing mechanism is being introduced slowly. Banks' ability to reabsorb cash increases significantly. However, deposits are not money.

Confidence in banks is high. Effective payments system. Noncash money and cash money are equally liquid. Noncash money transactions are on the rise.

Stability of national currency is achieved. Wealth formation takes monetary form. Some cash transactions are replaced with noncash ones.

Phase 5: banks finally regain full public confidence

Effective payment clearing system. Deposit-based transactions are on the rise. Finally, deposits are money.

Banks fully regain confidence. Deposit-based transactions now have dominant power. Now banks can create credit ahead of saving.

As banks regain confidence, and efficiency of noncash transactions is realized, cash-based transactions start declining considerably. Cash money is used only for small transactions.

of the payments system and the gradual rise of confidence in banks can lead to internal convertibility between cash money and noncash money, (3) how bank liabilities can gradually be accepted as money by the household sector, and (4) how all these changes can facilitate banks' ability to create credit. We distinguish between "household deposits," "corporate deposits," and "money outside the banking sector" in Table 1. By considering the relative liquidity of household deposits, noncash money and cash money, respectively, this exercise will show how internal convertibility between these components of broad money can gradually be achieved and how these developments can allow banks to create credit ahead of saving. The first two phases refer to the historical development of events in the FSU and the rest reflect plausible further logical developments, suggested by this paper, expected to take transition banks into Chick's Stage 2.

Phase 1: period under central planning

One of the particularities of banking under central planning was the separation of corporate banking from retail (or household) banking. As a rule, big specialized banks provided only corporate banking services. Although enterprises' current account deposits were seen as a source of funds for individual banks, the issue of trust was not relevant in attracting these deposits simply because, by law, enterprises had no choice but to carry out their payment transactions almost exclusively in noncash (deposit) money through the banking sector.

Provision of retail banking services to households was the primary function of the state savings banks. Although they provided consumer credit services to households, these banks remained underdeveloped mostly due to a shortage of consumer goods. No mechanism similar to that of check clearing was put in place, and therefore titles to these deposits were not used to effect transactions. Despite this, however, the general public's confidence in state savings banks was high because they were the only financial institution that offered depositors financial return and readily exchanged deposits for cash money at a one-to-one ratio on demand.

Phase 2: transition begins—hyperinflation and complete loss of confidence in banks

The monetary overhang generated in the economy over the years under the previous regime represented suppressed inflation, which was contained by administered prices, and the centralized and administrative nature of the process of production, distribution, and resource allocation. With the decentralization of the economic process, liberalization of prices, and

falling output, the monetary overhang (combined with loose monetary policy during this period) translated into hyperinflation. This quickly wiped out the purchasing power of bank deposits, eroding the general public's trust in the banking sector. As a result, household savings were held predominantly in foreign currencies and in-kind. Cash money was held mostly for transaction purposes. The sudden upsurge of demand for cash money during this period is explained by the expansion of the retail trade sector during transition, which was suppressed and was entirely under the control of central planners. After the liberalization of retail trade, the privatized retail sector expanded massively with new entrants, such as private retail outlets and "shuttle traders."⁸ Consequently, the need for cash money for transaction purposes became much higher compared to what it was during the prereform period.

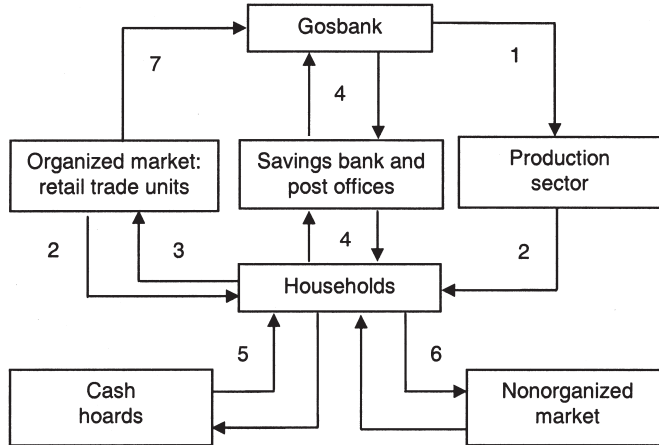
Figure 11 shows the circulation of cash money under central planning, and Figure 12 depicts cash money circulation after reforms. The difference between Figure 11 and Figure 12 is that the latter reflects fundamental institutional reforms and does not distinguish between cash money and noncash money circuits as in Figure 1. First, the monobank sector is replaced by the two-tier banking sector. Second, the abolition of the distinction between cash money and noncash money implies that now not only the household sector but also the enterprise sector can use cash money to effect payments in the retail as well as wholesale markets. Third, the household sector can hoard their monetary savings or hold them with commercial banks. These two figures help explain why demand for cash money goes up and why cash-based transactions increase subsequently during transition.

In short, the collapse of confidence in banks, the higher liquidity preference associated with increased uncertainty during transition, the sluggish and ineffective nature of deposit-based transactions,⁹ and the incentives to underreport business dealings to avoid taxes all put upward pressure on the use of cash money. New supplies of cash money, injected by the central bank into the system by debiting correspondent accounts of commercial

⁸ "Shuttle traders" are individual entrepreneurs who, by law, are allowed to travel to foreign countries to bring back consumer goods and sell them in the home market.

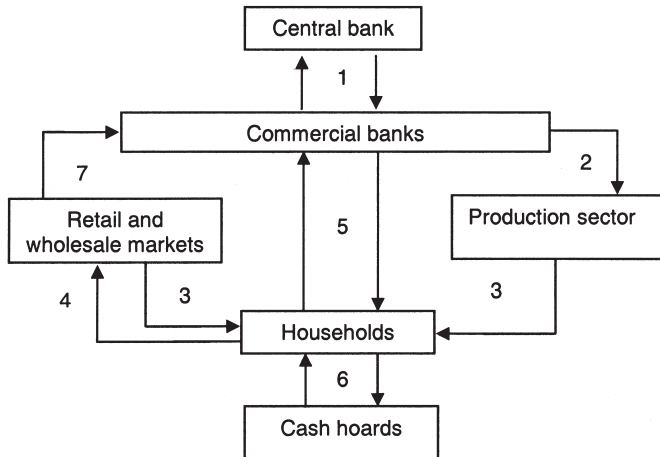
⁹ The payment system inherited from the past was ineffective and extremely sluggish because payment clearing required the physical transport of paper documents. Differences in timing between crediting and debiting of accounts caused by delays in the transmission of payment information and in the subsequent registration of accounting entries increased significantly from 1991 to 1993 in the FSU (Balino et al., 1994; 1996).

Figure 11 Circulation of cash money under central planning



Notes: 1 = injection of cash from the Gosbank; 2 = payment of wages; 3 = consumption expenditure in organized market; 4 = flow of savings, pensions, and other cash transfers; 5 = hoarding (disharding); 6 = income and expenditure in nonorganized market; 7 = return of cash to the Gosbank.

Figure 12 Circulation of cash money during transition



Notes: 1 = injection of cash from the central bank; 2 = receipt of cash from commercial banks; 3 = payment of wages (and dividends); 4 = consumption expenditure; 5 = saving (dissaving) with formal credit institutions; 6 = hoarding; 7 = return of cash to commercial banks.

banks, and which was mainly used by enterprises to pay wages and wage-related expenses, did not flow back to the banking sector. Rather, it increasingly flowed back and forth between the retail and wholesale markets, households, and cash hoards as shown in Figure 12.

In the meantime, excess noncash money that had been accumulating in the banking sector (due to the centralized and directed credits created by the authorities on soft conditions to prevent payment crisis and sharp output loss) and a complete collapse of trust in banks meant that achieving immediate convertibility between cash money and noncash money could come only at the cost of an undesirably high rate of inflation. In an attempt to restrain this excessive inflationary pressure, restrictions were imposed on commercial banks' access to their correspondent accounts with the central bank. This, combined with the banks' inability to persuade the general public to switch from cash to demand deposits, automatically translated into restrictions on the free convertibility of bank liabilities into cash money. Household depositors lost immediate access to their deposits. Enterprises were able to carry out noncash transactions without restrictions. However, they faced difficulties in converting their deposits into cash money even for such basic needs as paying wages.¹⁰ In terms of confidence building, the inability of banks to perform the most basic but fundamental responsibility—that is, guaranteeing the convertibility of their liabilities to cash money upon demand—implies that this phase was a step backward, not forward. In fact, the general public's trust was completely washed out in this phase.

As the economy's reliance on cash money increased and the liabilities of banks became a less popular means of saving and payment, banks could not attract cash from the general public. As a result, the size of bank credits shrank considerably. Under these circumstances, centralized soft credits extended by the central bank were the main source of bank loans. Credit shortages affected not only the working capital needs of enterprises but also the liquidity of the system as a whole. The inability of banks to meet the enterprise sector's demand for credit resulted in a payment crisis, also contributing to wage arrears in the enterprise sector.

¹⁰ Cash shortages were reported to be a common problem throughout the FSU in the first half of the 1990s, which resulted in the relative illiquidity of noncash money. It is a well-documented fact that noncash money was widely traded for cash money at a discount during this time (Conway, 1997; Hardy and Lahiri, 1996). Interestingly enough, this practice continues in some countries. Ruziev (2006) discusses this issue in the case of Uzbekistan.

In response to this liquidity shortage, enterprises started using monetary surrogates, known as barter transactions (Ould-Ahmed, 2003). The rise of barter transactions, which included pure barter transactions, transactions in promissory notes, and mutual debt write-offs, was observed in almost all of the 20-plus transition economies in the 1990s (Carlin et al., 2000). However, it was most severe in Russia and Ukraine where, at their peak in 1998, these transactions accounted for more than 50 percent of all industrial transactions.

In the next three phases, which we would expect to follow the completion of Stage 2, discussed above, we look at how banks can plausibly turn things around from this rock-bottom phase in their evolutionary path and reach the necessary maturity to be able to create credit and fill the gap left by the monobank sector.

Phase 3: achieving moderate inflation and modernizing the payments system

To start the real progress from phase 2, a sound national currency must be established, usually through currency reform and the maintenance of moderate inflation. Modernization of the payments system should follow suit, starting from the corporate banking sector.

Achieving moderate inflation and introducing an efficient payment clearing system will gradually promote confidence in bank liabilities (noncash money) as a safe and liquid asset. As a result, there will be an increasing tendency in the corporate sector to use bank liabilities along with cash money for payment purposes. However, because confidence builds up only slowly, entrepreneurs will not increase their deposit-based transactions dramatically; household deposits will not increase considerably either. Therefore, in this phase, the economy will remain heavily reliant on cash money, reflected in the relatively high ratio of cash money to demand deposits (noncash money). Although the gradual increase in trust in the banking sector will facilitate bank intermediation, banks' ability to create credit depends heavily upon improving the payments system and reabsorbing household sector's cash holdings.

Phase 4: maintaining stability of national currency and extending payments system reforms to the retail banking sector

Financial development presupposes the existence of sound outside money (central bank money) on the basis of which the inside-money system (bank liabilities) can develop. Confidence in outside money facilitates

monetization of wealth formation, which, combined with confidence in bank liabilities, facilitates financial development.

As confidence in outside money gradually picks up and the household sector's banking habit gradually develops, banks' ability to reabsorb cash from the general public will increase significantly. To facilitate this process, banks need to start offering better personal banking services and also introduce a payment-clearing mechanism in the retail banking sector. However, because the start-up fixed costs of equipping this completely new system are considerable, banks can only gradually start introducing debit and credit cards, which are accepted as payment instruments by retail outlets.¹¹

As a result of better-quality services being offered to corporate clients as well as technical developments initiated in phase 3, public confidence in banks as an integral part of a new market economy will strengthen further. This, combined with the stability of the national currency and the modernized effective payments system, will induce entrepreneurs to reduce their reliance on cash money as a medium of exchange and increase their deposit-based transactions; some cash-based transactions will be replaced with noncash ones. As a result, deposit-based transactions will experience a steep rise. As the willingness of the general public to use bank liabilities as money increases, banks' ability to create credit will strengthen further.

Phase 5: banks finally regain full public confidence

The establishment of a payment-clearing mechanism in retail banking (such as an electronic clearing mechanism for debit and credit cards, check clearing, direct debit/credit instruments, etc.) and the growing confidence of the general public in banks imply that household deposits can now be used to effect transactions so that they are money. As banks regain public confidence and the efficiency of deposit-based transactions is recognized, cash-based transactions will start declining considerably in the corporate banking services sector, too. As acceptability of bank liabilities as money increases in the economy, agents will minimize their cash-based transactions and will increase their deposit-based ones. Hence, by this phase, household demand deposits, enterprise demand deposits, and cash money will become equally liquid.

¹¹ This process is gradual because purchasing and installing payment terminals and automated teller machines require time and substantial financial resources.

In short, by phase 5, trust in banks will be firmly established, modernized payments system will cover both the corporate banking services and the retail banking services, and the public will start using bank deposits not only as a store of value but also as a means of payment. In other words, bank liabilities and cash money are now perfect substitutes. Finally, deposit-based transactions will dominate. Bank liabilities will be accepted as fully-fledged money by both the corporate sector and the household sector. Banks will now be able to create credit endogenously.

In summary, as a result of inappropriate policies pursued in the early years of transition, banking-sector development in FSU countries started from an initial period of deterioration. The complete collapse of confidence in the banking sector during the early days of transition meant that transition countries had to start the institution-building process in the banking sector as predominantly cash-based economies. Increasing reliance on cash and the subsequent decline in the importance of banking had resulted in a credit crunch, payments system crises, and output contraction. Following the discussion of these historical developments, in the first two phases, it was suggested here that to evolve into creators of new credit, transition banks need to regain public confidence and reabsorb the general public's cash holdings. Maintaining stability of national currency and modernizing the payments system play a paramount role in facilitating the confidence-building process and lead to the gradual acceptance of bank liabilities as money, by both enterprises and households alike.

Concluding remarks

We approached the problem of inadequate financial development in the transition of the FSU economies by drawing on Chick's stages of banking development framework. This framework suggests that developing confidence in bank liabilities is critical. But how this can be achieved depends on the particular experience of the FSU economies emerging from their central planning history. We have therefore examined the experience of evolution of the monetary and banking system from its origins in the central planning system in order to formulate a five-phase version of the transition to Chick's Stage 2 of banking development.

We argued that the shock therapy-type of policies pursued in the FSU economies in the early 1990s resulted in hyperinflation, macroeconomic chaos, and the general public's loss of trust in money and banks, which had clear implications for credit creation, and thus for production and output. As a result, transition economies had to start the institution-building

process as heavily cash-based economies. Because of the peculiarity of the role and importance of money and banks under central planning and the time-consuming nature of the institution-building process, gradual policies would have been more suitable for guaranteeing a smoother transition from the monobank system to the market-based two-tier system. Policies could have been designed to build upon the preexisting trust in money and banks. Without such policies, the transition has proved to be much more difficult.

We suggested here an amplification of Chick's framework to articulate the additional stages required for banking systems in transition economies to embark on the process of development. Despite achieving stability of their national currencies and modernizing their payments systems in the corporate banking sector, in most FSU countries, the household sector's trust in banks remains weak, and thus most of these countries remain highly cash-based economies. The implication of this evidence is that the banking sector's capacity to create credit is still limited. It has been observed that retail banking services are still considered too expensive and most banks still look for funds "from the same sources as in 1991—corporate accounts" (Rock and Solodkov, 2001, p. 454). Most of the reform work in FSU countries so far has been directed to strengthening of the regulatory regime under which banks operate and improving their risk management and other banking skills with the assistance of institutions such as the International Monetary Fund, World Bank, and the Bank for International Settlements. However, although these reforms are important, they neither guarantee a stable and growing banking system nor predict the relative speed at which transition countries can regain the general public's confidence.

Our discussion shows that institutional change is required to ensure acceptability of bank liabilities in payments, which is required for credit creation and further financial development. To facilitate the process of evolution to phase 5, there is an urgent need to carry out policies that promote banking habits among the general population, which should include extending the payments system reforms to the retail banking sector.

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