Public and Financial Institutions in Transition Economies: An Overview and Recent Evidences from Central and Eastern Europe

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This article is a survey of economic literature about the public and financial institutions in countries with transition economies. It also presents some particularities within the countries from Central and Eastern Europe. We investigate the factors that influence a certain institutional architecture and the impact of those institutions on several economic aspects such as growth, trade, corruption, stock markets, inflation, unemployment, etc. For the financial sector we investigate some specific problems: stock markets, deposit insurance, central bank and credit market, consolidation, globalization and international investment in financial services.

Key Words: institutions, transition, economic reform, Central and Eastern Europe
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Introduction

In the 1990's the countries from Central and Eastern Europe embraced democracy and capitalism, which led to numerous radical socioeconomic transformations over a short period of time. However, the degree to which each country has changed is extremely variable. Obviously, these changes have affected the institutional framework as well, which in turn had a significant impact on the development of the society in general and on the economic development in particular. The aim of this article is to overview the literature on the institutions, especially financial institutions, with specific reference to the transition countries.

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In the first part of the article we survey the economic literature, which describes the institutions in transitions with case studies regarding the countries from Central and Eastern Europe. We make a succinct description and a comparison of the main results of the empirical and theoretical studies concerning this subject. We consider (a) the factors that influence a certain institutional architecture; (b) the impact of institutions on several economic aspects, such as growth, trade, stock markets, inflation, unemployment, etc.

In the second part of the article, we analyze some of the main aspects that characterize the current financial systems in the transition economies. We discuss the most important issues related to the creation of a financial system similar to the ones in the developed economies. More precisely, we have studied some aspects about the functioning of the financial system in general and of the banking systems in particular, namely the role of the stock market in the economic development, the introduction of deposit insurance, the degree of bank intermediation, nonperforming loans, the use of collateralization in offering credits, and the soft budget constraints. We have also shown the position of the central bank within the financial system, particularly in connection with its independence and the monetary policy strategy based on inflation targeting. Concerning the global economy, in the last two decades we have witnessed a rapid consolidation of the financial system due to mergers and acquisitions, as well as to globalization and foreign investment in the financial system. Taking into account that this trend will occur in the transition countries, we consider the causes that led to consolidation and its multiple effects and the factors that influence foreign direct investment.

Public Institutions

Starting with the 1990s, after the fall of the communist regimes, the Central and East European countries had to establish new institutional regimes. The transition towards a democratic system was made in different ways and at different speeds from one country to another. It is important to understand which of the social or economical factors have determined the different behaviour of the nations in the process of adopting the new structures. Some authors consider that the economical factors predominate in the building of new regimes; others imply that the social factors, especially the social capital, decide the sustainment degree of the institutional reforms by the citizens.

NATURAL RESOURCES AND SOCIAL VALUES

The traditional economic reasoning and common sense suggests that a country's increasing resources promotes the economic growth. But this reasoning is contradicted by a substantial amount of empirical evidence that demonstrates that the abundance of resources breaks the economic growth.

Leite and Weidmann (2002) showed that resource abundance is a major factor which influences the role of institutional variables in the economic growth. They demonstrated an important indirect effect of resource wealth on economic performance: resources affect the level of corruption, which in turn determines growth. Isham et al. (2003) find a negative relation between resource abundance and economic growth when the control of the institutional quality is not appropriate. The analysis of Bulte, Damania, and Deacon (2005) indicates a significant association between development and resource intensity. They found that the resources have a robust negative impact on institutions, an idea that may lead to the conclusion that for countries rich on resources, but with poorer institutions, the policy improvements are less effective.

Based on empirical regional studies (in Italy), Putnam (1993) considers the social capital the most important aspect of the economical modernization. The social capital is a very general notion. In order to be able to quantify its development degree in a community we have to study its components. Putnam (1993) considers that the social capital of a society is described by: (a) involvement in the public field; (b) political equality based on cooperation not on dependency (addiction) regarding the relationships with the public authorities; (c) solidarity, trust and tolerance; (d) extensive participation in voluntary associations. Kunioka and Woller (1999) consider Central and Eastern Europe a favourable context for correlating the social capital with the democratically controlled procedures. The main motivation is the total extinction, during the communist period, of the institutions of civil society: private business, churches, press, voluntary associations. Using a logit model on a set of 8 countries (Belarus, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Ukraine) Kunioka and Woller (1999) try to determine which of the aspects of the social structure influence the citizens' preferences for a parliamentary or for an authoritarian government. They use exogenous variables regarding the social capital: institutional trust, ethnic groups and minorities as a threat, immigrants and refugees as a threat, patience vs. quick results, order vs. freedom, town size; and also economic exogenous variables: current/future macro economy, current/ future household economic conditions, evaluations of the communist regime. The results show that the variables linked with the social capital are more representative than the economical ones. The control variables: education, age and gender have also significance. The author concludes that the probability that the citizens of the countries from the sample prefer a parliamentary regime over an authoritarian one is great, 'given higher levels of institutional trust, higher levels of political patience, and lower levels of intolerance for ethnic groups, minorities, immigrants and refugees. These findings are consistent with our hypotheses that each constitutes a statistically significant stock of social capital in support of parliamentary government' (Kunioka and Woller 1999, 593). Also, the parliamentary regime is preferred to the authoritarian one by the more educated, more aged and male persons.

DEMOCRACY AND ECONOMIC REFORM

In the countries from Central and Eastern Europe (CEE) the transition after the falling of the communist regime is characterized by the simultaneous evolution of the economic reform and of democracy. This behaviour was not similar to that of certain countries from the Southern America and Asia where the political liberalization followed the success of the economic transformations.

A government's ability to accomplish radical economic reforms is placed in difficulty by the development of the democratic regime (Roland 2000). In a democratic system the citizens can refuse some economical reforms, which would not happen in the case of a benevolent dictator (eg. China). Cheung (1998) considers that the introduction of democracy in an unstable stage of transition may lead to a decline of the national output.

Fidrmuc (2003) believes that in the CEE the 'democracy reinforces progress in economic liberalization, which in turn, improves growth' (p. 583). He investigates this connection using a sample of 25 transition countries. The results show that the impact of liberalization on growth is positive and strongly significant. The outside environment also has an effect on the development for the transition period. The variable 'government expenditure' is not statistically significant even if the sign is the expected (positive) one. For the initial GDP per capita Fidrmuc (2003) obtains a negative and significant coefficient. The economical growth of a country is more rapid when the initial GDP per capita is lower.

In some CEE countries the political transformations have gone before the economic reforms. But in some other countries a regress of the democracy was seen even though initially there have been taken measures in a good direction – especially in countries of the former Soviet Union. Even if the relationship between the creation of a democratic regime and the economic development is often discussed in the economic literature, this effect has hardly ever been clearly estimated. Dethier, Ghanem, and Zoli (1999) remark a positive correlation between the degree of democratization and the evolution in economic liberalization. Nonetheless, they do not consider the direct effect of democracy on growth. Fidrmuc (2003) estimates this direct effect. He concludes (p. 602) that 'democratization alone is not the key to growth; it is through its positive impact on economic liberalization that it improves growth performance. A centrally planned democracy would be even less conducive to growth than an autocratic market economy.'

PRIVATISATION

In the 1990's, the former communist countries considered the privatization of public enterprises an instrument for economic development by increasing its efficiency. The privatization process was very different from country to country and from one period to another.

Fisher and Sahay (2000) consider that the velocity and the level of privatization have essential economic repercussions for competition and development. Generally, it is considered that privatization depends on three groups of factors: economic conditions, government policies and exogenous factors (Goel and Budak 2006; Parker and Saal 2003; Djankov and Murrell 2002).

Goel and Budak (2006) examine the determinants of privatization in 25 transition countries and also the differences between large scale and small scale privatization between 1997 and 2001. They consider (p. 99) that the 'large-scale privatization involves privatization of major industries, including those involved in providing infrastructure services. Small-scale privatization deals with private ownership of small enterprises like shops and service units.' Goel and Budak (2006) use the following variables: index of large-scale/small-scale privatisation, a human development index, unemployment rate, inflation rate, general government expenditure, the index of foreign exchange and trade liberalization, general government balance, population, population density, land area (p. 103). The results show that a high level of economic success (GDP, education, longevity), influence positively the privatisation. Greater unemployment and lower inflation stimulates small scale privatisation but the influence on large scale privatization is not statistically significant. Foreign exchange liberalization encourages both types of privatisation but bigger government deficits stimulate only the large-scale privatisation. The country size and the population have an important positive effect, especially in the last years of transition. Strangely, a greater population density appears to slow down the process.

CORRUPTION

Due to massive privatization in the 1990s there were disproportionate opportunities for corruption in the Central and East European countries, with a negative impact on society and the economy. Corruption in this European area has turned out to be more brutal as these countries amplify their openness and participation in international communities and organizations.

Based on empirical evidence (in Czech Republic), Lizal and Kocenda (2001) consider that a significant transform of approach to the institutional structure is required in order to prevent and battle against corruption effectively. They think that the best way to avoid corruption is not only to make all procedures completely transparent but also to create such a background that minimizes the incentives to go around the rules even in the absence of penalty.

Another aspect of corruption is the negative impact on foreign direct investment (FDI). Even if transition economies show high levels of corruption and high levels of FDI, Cuervo-Cazurra (2008) believes that it is not the level but rather the type of corruption that influences FDI in transition economies. There are two main types of corruption: (a) persistent corruption, or corruption that is generally present and acts as a limit to FDI because it increases the known costs of investing; (b) arbitrary corruption, or corruption that is unsure and does not have such a limiting influence because it becomes part of the ambiguity of operating in such economies. The second type is preferred by the foreign investors because they prefer to deal with an unknown evil.

Several empirical studies support the main hypothesis that competition and corruption are connected (Mauro 1995; Bliss and Di Tella 1997; Ades and Di Tella 1999; Treisman 2000). Emerson (2006) has built a model of the interaction between corrupt government officials and industrial firms to prove that corruption is adverse to competition. He suggests that the quantity of industrial competition is a function of the quantity of corruption (the level of the bribe). The level of competitiveness (or economic freedom) in a country is explained by the following variables: the degree of corruption, the gross national product, GNP per capita, the amount of foreign direct investment and the size of the country. A second regression explains the degree of corruption by the level of civil liberties, the amount of expenditures on education and the net enrollment ratios for primary and secondary schools. The estimations show that competition and corruption are negatively correlated. Higher education and democracy have a depressing effect on corruption in a country.

INFLUENCE OF INSTITUTIONS ON ECONOMIC DEVELOPMENT

In recent time, in the economic literature, there has been a revitalization of interest concerning the influence of institutions on economic development. Nelson and Sampat (2001) argue what are the factors which merge the diverse definitions of institutions and expand a concept of institutions in order to analyse the economic performance and growth. Knack and Keefer (1995) create a measure of property rights security and confirm a positive and statistically significant correlation between this measure, investment and growth. In another study Knack and Keefer (1997) conclude that better institutions stimulate the level of investment. A particularity for the transition countries is the existence of an institutional vacuum. Schmieding (1993) explains this emptiness by the destruction of the old institutions without an adequate replacement by new ones. Brunetti, Kisunko, and Weder (1997b) and Havrylyshyn and van Rooden (2000) were focused to transition countries in growth empirics with institutional measures. On a sample formed by 18 transition countries, Brunetti, Kisunko, and Weder (1997a) found a positive relationship between institutional credibility and growth.

Using a sample of 25 countries from Central and Eastern Europe (CEE) over the 1990–1998 period, Grogan and Moers (2001) explore the connection between institutions, foreign direct investment (FDI) and growth. They establish some new institutional measures and make extensive sensitivity tests. The endogenous variables are: GDP growth per person and net FDI inflow share. To explain the investment and growth the authors use two groups of exogenous variables: (a) concerning the institutions: rule of law, investment law, property rights, civil society; (b) control variables: GNP per person, share of value added in industry, gross secondary/tertiary school enrolment rate, export share, import share, liberalization index, private sector share, government consumption share and inflation rate. The results of the estimations for the transition countries show a strong mutual connection between the quality of institutions and foreign direct investments (FDI). The institutional quality is more probable to be a source of growth, because the correlation is less mutually relevant. The significant statistical results obtained by Grogan and Moers (2001) show that an adequate institutional frame is more important than some 'classical' economic variables when explaining the growth and investment. Amongst the control variables, only the inflation rate and the liberalization index are robust and influence the growth rate in the expected direction. Multicollinearity problems complicate the estimation of the relative importance of macroeconomic stabilization and liberalization on institutions.

Another point of interest regarding the institutional frame of the transition countries is represented by its effect on the economic development throughout trade. Some studies explore the regression of GDP per capita on measures of institutional quality and market dimension by using the historical and geographical component of institutions and trade. In long term, these regressions can quantify the effects of trade and institutions on growth. The effect of property rights and rule of law on the investment and innovation predilection was explained by Frankel and Romer (1999). This predilection and implicitly the economic growth are also affected by the market size, which can be evaluated either by population or by access to foreign trade.

The partial effects of the institutions on trade and growth have been studied by Dollar and Kraay (2003), using cross-country regressions. They measure the institutional quality using an index of rule of law and protection of property rights created by Kaufmann, Kraay, and Zoido-Lobation (2002), covering 168 countries. The market size was quantified by the logarithm of population and the logarithm of trade as a fraction of GDP. The results obtained by Dollar and Kraay (2003) from the sample of the countries show that in the long run high-quality institutions and a higher trade share (% in GDP) determine a rapid economic growth. Because the quality of institutions and the participation in international trade are coming from historical and geographical factors, it is difficult to differentiate the effect of each one of them. The sample of countries used does not offer a sufficient variation for appreciating the relative importance of trade and institutional quality. In the short run the influence of trade on growth has a significant role, but the influence of the institutions is not confirmed. Table 1 provides several studies regarding subjects related to public institutions, mainly for the CEE countries.

TABLE 1 Overview on topics related to public institutions

Problem topics/authors	Related problem issues
Natural resources and social values	
Leite and Weidmann (2002)	• Connection between resource abundance – institutional variables – economic growth
Isham et al. (2003)	• Negative relation between resource abundance and economic growth
Bulte, Damania, and Deacon (2005)	• The resources – a robust negative impact on institutions
Putnam (1993)	• The social capital is the most important aspect of the economical modernization
Kunioka and Woller (1999)	• The social structure influences the citizens' preferences for a parliamentary or authoritarian government
Democracy and economic reform	
Roland (2000)	• Negative correlation between radical economic reforms vs. the development of the democratic regime
Cheung (1998)	• The introduction of democracy in an unstable stage of transition involves decline of the national output
Fidrmuc (2003)	• Democracy reinforces progress in economic liberalization, which in turn improves growth
Dethier, Ghanem, and Zoli (1999)	• Positive correlation between democratization and the evolution of economic liberalization

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Financial Institutions

SIGNIFICANT ISSUES REGARDING THE FINANCIAL SYSTEMS IN TRANSITION

When transition countries began the process of political and economic liberalization at the beginning of the 1990s, they had to conceive their national financial systems. Several studies, such as those by King and Levine (1993a; 1993b), and Pagano (1993), show the existence of a strong positive relation between the characteristics of the financial system and economic growth. That is why the development of the financial system has become a top priority issue of the reforms that have taken place in transition economies.

The process of economic development depends on how the financial system is constructed. Generally, there are two main alternatives for the creation of the financial system: the market-oriented financial system and the bank-oriented system. Most transition economies from Central

TABLE 1 *Continued from the previous page*

Privatisation	
Fisher and Sahay (2000)	• Velocity and level of privatization: economic repercussions for competition and development
Goel and Budak (2006)	• The differences between large scale and small scale privatization between 1997 and 2001
Parker and Saal (2003)	• The factors of the level of privatization: economic conditions, government policies, exogenous factors
Djankov and Murrell (2002)	• A quantitative approach to enterprise restructuring in transition
Corruption	
Lizal and Kocenda (2001)	• A survey of the corruption problems in the Czech Republic
Cuervo-Cazurra (2008)	• Correlation between the type of corruption and FDI in transition economies
Emerson (2006)	• Models the quantity of industrial competition as a function of the quantity of corruption
Mauro (1995), Ades and Di Tella (1999), Treisman (2000)	• Empirical studies which support the main hypothesis that competition and corruption are connected
Influence of institutions on economic development	
Nelson and Sampat (2001)	• Expand the concept of institutions in order to analyse the economic performance and growth
Knack and Keefer (1995)	• Positive correlation between the measure of property security rights, investment and growth
Knack and Keefer (1997)	• Better institutions stimulate the level of investment
Brunetti, Kisunko, and Weder (1997a)	• Positive connection between institutional credibility and growth (sample of 18 transition countries)
Grogan and Moers (2001)	• Relation between institutions, foreign direct investment and growth (sample of 25 CEE countries)
Frankel and Romer (1999)	• The effect of property rights and rule of law on the investment and innovation predilection
Dollar and Kraay (2003)	• Long run high-quality institutions and higher trade share determine rapid economic growth
Kaufmann, Kraay, and Zoido-Lobation (2002)	• Measure the institutional quality using an index of rule of law and protection of property rights

and Eastern Europe opted for a bank-based system. Regarding the development of the financial system in transition countries, some specific issues must be taken into account, such as the role of stock markets in the financial system, the importance of deposit insurance in securing financial system stability and the position of the central bank within the financial system (Hermes and Lensink 2000).

Stock Markets

A significant factor in the development of the financial system in transition economies is the regulation of stock markets, which can increase its efficiency. Some empirical studies (Levine and Zervos 1998a), proved that a strong financial system, with well performing stock markets, has a positive effect on economic development. The role of stock markets in promoting economic growth consists in the allocation of funds to investment projects that offer the maximum profit. Since stock markets supply liquidity insurance, they may help out more profitable long-term investments (Hermes and Lensink 2000).

The liberalization of capital control is significantly related to the stock markets issue in transition economies. Many transition countries maintained control over capital movements for a long time. Levine and Zervos (1998b) argue that the liberalization of capital flows may contribute to the expansion of stock markets, facilitating more liquid, more volatile and bigger stock markets. Their study indicates a positive relationship between liquid and bigger stock markets and durable economic development. The transition economies from Central and Eastern Europe have proceeded to a gradual liberalization of capital flows, and as of today they have managed to abolish capital control. As a consequence, the stock markets in these countries have expanded considerably and become more efficient.

Deposit Insurance

The role of the deposit insurance system consists in securing the protection of deposit holders against the risk of losing their financial savings and the protection of banks against the negative effect of runs on their liabilities. When depositors have some doubts regarding the safety of their bank, they may withdraw their deposits. The failure of a bank can be interpreted by the public as a signal of the weak financial situation of other banks and this may cause liquidity problems even for solvent banks. Deposit insurance aims to diminish the risk of strong banks being affected by the bad reputation of weak banks. When contagious bank runs becomes serious, it results in incredibly unsound financial markets and financial crises. The confidence of the public in banks can increase through this mechanism because the entire or limited value of the deposit held at banks is guaranteed in the situation where the bank could not respect its payment obligations. Thus, deposit insurance may make a positive contribution to the safety of the financial system (Hermes and Lensink 2000).

The deposit insurance was not introduced in transition economies in Central and Eastern Europe from the beginning of the reform process. Given the fact that in the first years of transition some banks recorded financial crises and became insolvent, a lot of deposit holders lost their savings partially or entirely. Therefore, the public lost its confidence in the bank system in particular and in the financial system, in general. It became therefore necessary to implement the deposit insurance mechanism, although this was not an easy process. At the initial stage of the deposit insurance functioning, the guarantee value of deposits remained at a low level. At present, the extent of depositors' protection in these transition countries is similar to that of the countries of the EU.

Central Bank

Essentially, the main task of the central bank is to implement monetary policy. Moshirian and Szego (2003) consider that price stability represents the vital issue for an effective monetary policy. Price stability can be achieved by central banks through two different strategies: monetary targeting and inflation targeting. Recently, some transition countries from Central and Eastern Europe have adopted inflation targeting, namely the Czech Republic (1997), Hungary (2001), Poland (1998), Romania (2005) and Bulgaria (2006). Several studies have found that inflation targeting has a positive impact on the performance of inflation and output by reducing the anticipated level of inflation. Other studies argue that there is no clear proof to sustain the benefits of inflation targeting, despite the fact that their results do not offer arguments against inflation targeting either (Yifan 2003). Still, in all these countries, the inflation rate decreased after the implementation of this new strategy.

Central bank independence is another very important issue for transition countries, since an independent central bank can reduce inflationary pressures. Granting real independence to central banks in transition countries represents a complex process and requires the existence of a consistent legal and political infrastructure (Hermes and Lensink 2000). Concerning the meaning of central bank independence, we can distinguish different components. Grilli, Masciandaro, and Tabellini (1991) make a basic distinction between political independence (central bank's ability to pursue price stability free from government's influence), and economic independence (central bank's ability to determine its policies towards the achievement of its objectives). Debelle and Fischer (1994) highlight the distinction between goal independence (central bank's ability to determine freely the goal of monetary policy), and instrument independence (central bank's freedom of choice and adjustment of instruments to achieve the goals set). Cukierman, Miller, and Neyapti (1992) distinguish between legal independence (various stipulations in the law of central bank), and actual independence (annual turnover rate of central bank's governor).

Another essential aspect is the role of central bank independence in reducing inflation. Some empirical research has provided evidence for the negative relation between central bank independence and inflation in developed countries. Other studies could not find evidence for such a relationship in the case of developing countries. Yet, there are some studies that reveal a negative correlation between central bank independence and inflation both in developing countries (Jacome and Vaszquez 2005) and in transition countries (Cukierman, Miller, and Neyapti 2000; Maliszewski 2000).

CREDIT MARKET

In the process of the development of the market economy, transition countries have chosen to create a bank-based financial system. Their bank system has been confronted with several problems, among which we notice a substantial utilization of collateralization in granting credits and a low degree of bank intermediation, measured as the share of domestic enterprise credit to GDP.

The bank intermediation recorded a low degree because of two important factors: banking sector concentration (Rother 1999) and deficient legal system (McNulty and Harper 2001). In the case of a flawed legal environment in transition economies, banks utilize collateral not only to resolve the issue of moral hazard but also to take out rents based on their market share. Collateralization may solve the problem of moral hazard since it diminishes the payoff in the situation of collapse and, consequently, determines the company to make effort (Bester 1994).

Empirical studies reveal that the likelihood of obtaining credit rises depending on the quantity of collateral offered by the company that requires a loan. The perfection of institutional environment may have as effect the decrease of collateral requisite, and, thus, the increase of bank intermediation. A perfection of the legal environment implies that more credits are mortgaged than collateralized. Thus, the banks have less possibility to take out rents as the liquidation values of houses and flats are higher than those of other types of assets and vary much less. Therefore, the general requisite of collateral is reducing (Hainz 2003).

Even if almost all contract credits are collateralized, in transition countries banks have a large part of nonperforming loan in their portfolio, because of some problems, such as the difficulty of the collateralized assets evaluation, the possible disappearance of movable assets, and the imperfect functioning of secondary markets in the situation where the liquidation of collateral is necessary. Hainz (2003) finds some solutions to solve these problems. First, the accumulation of information provided by the balance sheet can simplify the assessment of collateralized assets. Furthermore, all people involved in the collateralization process need to be well qualified and the property rights to be clearly set. Second, the existence of collateral registers should supply information concerning the collateral assets and set priority of claims. Third, the formalities for seizing the collateral should be simpler and the laws related to collateral should be set clearly.

The high bank concentration in transition countries determines a lower bank intermediation, not because of a lower demand for credit due to the high interest rate, but rather because of the credit rationing (Rother (1999)). Banks apply credit rationing to avoid the adverse selection arising from asymmetric information concerning the company's assets attributable to the incomplete information provided by the companies' balance sheets. Therefore, the companies may hide assets by announcing less collateralized assets than they own in order to keep more rent. Thus, a low degree of a bank competition has two effects: (1) a large quantity of collateral required by banks, which leads to a considerable loss in the case of liquidation; (2) an increase in credit rationing, which has imposed in transition economies a constraint on successful corporate restructuring. This constraint can be reduced by the stimulation of competition between banks and the improvement of the institutional and legal environment (Hainz 2003).

CONSOLIDATION AND INTERNATIONAL INVESTMENT IN FINANCIAL SERVICES

In the last two decades, at the global level, some important progress has been made in the development of the financial system, e. g. the consolidation of the financial system due to the mergers and acquisitions, the expansion of foreign investments in the financial system, and the globalization of the financial system. Despite the fact that these phenomena are just recent manifestations in the transition countries, they will affect the future development of the financial system in these economies.

Mergers and Acquisitions in the Financial System

Recently, there is a worldwide tendency for the consolidation of the financial system. In the developed countries, mergers and acquisitions have developed at a sustained pace, which may constitute an answer to the financial crises in other countries, including the transition countries.

Berger, Demsetz, and Strahan (1999) think that consolidation has as a major incentive the maximization of shareholder value through mergers and acquisitions mainly by increasing the participating company's market power in establishing prices or by becoming more efficient. In some cases, the institutions implied in mergers and acquisitions may be interested in heightening their possibility to benefit from the government's financial safety network (deposit insurance, discount window access, payments system guarantees).

The stakeholders other than shareholders, particularly managers and governments, may also be motivated in the consolidation. First, managers can be concerned about their own financial advantages in consolidation decisions since executive compensation is proportional to the size of the financial organization. Nevertheless, Hadlock, Houston, and Ryngaert (1999) indicate that management with large ownership stakes could obstruct exterior acquisitions, especially when managers of the banks quit following an acquisition. Secondly, the position of a government in consolidated decisions consists in its possibility to restrict the type of mergers and acquisitions allowed (by imposing different limits and by approving or rejecting decisions for individual mergers and acquisitions) or to support mergers and acquisitions (especially in times of financial crisis, when it may offer financial support in the consolidation of financial institutions threatened by bankruptcy (Berger, Demsetz, and Strahan 1999).

The pace of consolidation is influenced by the changes in economic environments that modify the constraints, which the financial institutions must deal with. A study by Berger, Demsetz, and Strahan (1999) provides five relevant issues, which explain the current pace of mergers and acquisitions:

1. Technological progress can facilitate the appearance of innovative

instruments of financial engineering, new delivery modalities for depositor services or development in payments technology, which small financial institutions can benefit from at a low cost.

2. Improvements in financial conditions may increase the activity of mergers and acquisitions in the banking sector through low interest rate and high stock price environment.
3. Excess capacity or financial distress in the industry or market can be solved with the support of consolidation more efficiently than by bankruptcy or other means.
4. International consolidation of markets can generate demands for currency, credit, deposit and other services by international financial services providers, and therefore may favour the creation of cross-border mergers and acquisitions.
5. Deregulation of geographical or product restrictions can lead to a rise in the number of mergers and acquisitions after the countries permit interstate branching in most states.

Consolidation has several effects on multiple planes. As direct effects of consolidation we notice the increase in market power or the improvement of institution efficiency implied in mergers and acquisitions. As a potential indirect effect of mergers and acquisitions we mention the decrease in the accessibility of financial services to small clients, as the powerful institutions created by consolidation are able to offer wholesale financial services or they might close some of their branch offices.

Berger, Demsetz, and Strahan (1999) consider that mergers and acquisitions may determine as potential systemic consequences an increase in the payment system efficiency, due to the decrease in the quantity of payment information and instruments, which must be processed and transferred among the financial services providers, since the payments are internal and do not need inter-bank transfers. Moreover, the financial service industry could accelerate the implementation of electronic payments technologies. Countries with a more consolidated banking sector utilize the electronic payment system to a larger extent, given the greater easiness in agreeing on payment standards and common technology and the utilization of centralized account information (Humphrey, Pulley, and Vesala 1996).

Consolidation may also affect the safety and soundness of the financial system owing to the decrease of costs demanded by a heightened systemic risk (through risks diversification and the supervision of a smaller number of financial institutions) or by an improved financial safety network. Finally, external effects of mergers and acquisitions are likely to appear, given the reaction of other rival institutions that may be tempted to develop their activities in the sectors abandoned by the consolidating institutions (Berger, Demsetz, and Strahan 1999).

Similar benefits and costs could be forthcoming from mergers and acquisitions that will occur in transition economies, especially those from Central and Eastern Europe. The enlargement of the European Union and, in future, of the Monetary Union with the transition countries can stimulate more cross-border mergers and acquisitions to appear, given the expansion of trade, the reduction of currency exchange costs supported by the financial institutions which activate in multiple states, and the reduction of costs paid by customers for the services of foreign-owned institutions.

Foreign Investments in the Financial System

Another global tendency manifested even in transition countries is represented by international investment in financial services in general and in the banking sector in particular. The worldwide movements towards financial deregulation, the progress in information technology and telecommunications, and the capital market globalization have stimulated foreign direct investment (FDI) in the banking system. Moshirian (2001) divides foreign investors in overseas banking, including transition countries, into at least three important groups:

1. Banks that set their branches, agencies, and subsidiaries in a foreign country.
2. Banks that do not open any physical office in a foreign country but are shareholders of foreign banks.
3. Non-bank corporations, institutions, and individuals who invest in foreign banks.

Some studies (Lizondo 1990; Moshirian 2001) show that FDI in banking is influenced by several factors, such as:

1. *Bank's foreign assets.* Empirical results of Moshirian (2001) indicate a positive relationship between the bank's foreign assets and foreign direct investment in banking. It is supposed that FDI in banking grows with the expansion of the international lending activities of banks.

2. FDI *in non-finance industry.* Gray and Gray (1981) suggest that FDI in banking is positively related to FDI in other industries. So, there is complementarity between FDI in banking and FDI in other manufacturing sectors.
3. *Bilateral trade.* Agarwal (1980) reveals a positive relationship between FDI in banking and bilateral trade. This means that FDI in banking increases with the expansion of bilateral trade.
4. *The size of the market in the host country.* O'Sullivan (1985) claims that the size of the host country's market represents one of the major factors of FDI. This implies that the number of potential new customers increases with the enlargement of the foreign banking market.
5. *Relative economic growth.* Sabi (1988) finds a positive relationship between economic growth and FDI in banking. The strong economic development in a host country is contributing to the expansion of FDI in banking in that country.
6. *Cost of capital differential.* Moshirian (2001) demonstrates that the cost of capital differential for banks between investors' countries and host countries is negatively correlated with the FDI in banking abroad. A bank with an effective and competitive cost of capital structure may be more successful when it enters into the foreign banking markets.
7. *Exchange rates.* Froot and Stein (1991) show a negative correlation between the value of host countries' currency and FDI in banking in these countries. The host countries' currency depreciation relative to foreign investors' currencies is likely to amplify the FDI since it becomes cheaper for foreign investors to invest in host countries.
8. *Tax regime.* Moshirian (2001) argues that the tax regime applied in a country may or may not attract foreign investors. To attract more FDI in banking, the host countries' governments can take initiative for deregulating the domestic financial market.

Taking into consideration the more facile access of foreign investors to the transition countries' market and its big potential, the relative economic growth, the low cost of capital, the fast expansion of the domestic banking market and the deregulation of the financial market recorded recently in transition economies, we can expect that foreign investors may increase their investments in the financial system in these countries, especially in banking.

Globalization in the Financial System

The government-led system design after the second war was replaced by a much more powerful system – the market-led system – due to the growth in the movement of private capital in the developed countries and to the emerging markets, the gradual deregulation of the financial markets, the increased importance of the private sector and multinational corporations in development of the economy. The innovations in the financial instruments and the deregulation of the financial system that have occurred in the latest decades have stimulated the process of globalization and the integration of the financial markets. The globalization of financial markets has resulted in the expansion of multinational banks abroad, which compete with the source countries' banks and therefore promote the process of financial markets integration (Moshirian and Szego 2003). Even in the transition countries we can notice the expansion of multinational banks that have managed to gain an important position in these countries' markets.

Since the bank system cannot be fully globalized, given the fact that national banks could basically offer some services to host companies all the time, an important question that arises with respect to globalization in the financial system is to what extent the banking sector will be globalized. An empirical study (Berger, Demsetz, and Strahan 1999) on this issue makes a distinction between two dimensions of globalization – bank nationality and bank reach. This study shows that the affiliates of multinational companies prefer host nations' banks for cash management services more frequently than home nation or third country banks. It also indicates that bank nationality and bank reach are considerably correlated and both differ to a large extent depending on the legal and financial development of the respective country. The conclusion is that globalization of the banking system may be limited in the future since a lot of companies would rather resort to local or regional banks for some of their services.

Conclusions

The topic of institutions in transition countries has become a significant research domain within economics. Over the last two decades, numerous academic studies have been dedicated to this theme particularly for Central and Eastern Europe.

The conversion towards a democratic system and an efficient economy was made in different ways and with different speeds from one country to another. Several studies have revealed that the social and economic factors jointly have determined the behaviour of the nations in this process. There is negative relation between resource abundance and economic growth especially when the control of the institutional quality is not appropriate. The policy improvements are less effective within the countries with poorer institutions but rich on resources. Some authors consider the social capital the most significant aspect of the economic reconstruction. The results based on empirical studies show that the variables linked with the social capital are more representative than the economic ones.

In the countries from Central and Eastern Europe the transition is characterized by the synchronized evolution of democracy and the economic reform. Using a sample of transition countries it was proved that there is a robust positive relationship between democracy, economic liberalization and growth. The velocity and the level of privatization have essential economic consequences for competition and economic development. In the economic literature, there has been in the last decade a renaissance of interest regarding the influence of institutions on growth. From a sample of countries it was shown that in the long run, high-class institutions and a higher trade share decide a rapid economic growth. The transition countries represent an attractive market for foreign direct investments. In order to take advantage of this situation the governments must create a better institutional framework by trying to reduce the corruption, because of its negative impact to FDIs and economic growth.

The bank-oriented system adopted by the transition economies must be completed by the liberalization of the stock markets, due to their positive influence on durable economic development. The ex-communist European countries had gradually liberalized the capital flows and now the capital control was eliminated. The liberalization led to significantly larger, more efficient and liquid stock markets.

The deposit insurance was not introduced in transition economies from the beginning of the reform process. At present, the extent of depositors' protection in these countries is similar to that of the old members of the European Union.

In transition countries, there is a high degree of bank concentration, which determines a lower degree of bank intermediation. A low degree of bank competition has two effects: a large quantity of collateral required by banks and an increase in credit rationing which imposes a constraint on successful corporate restructuring. This constraint can be reduced by the encouragement of competition on the banking market and the upgrading of the institutional environment.

The supporting of mergers and acquisitions may represent for the governments the answer to the financial crisis, bringing benefits such as: consolidation of financial institutions threatened by bankruptcy, increase in the efficiency of the payment system and expansion of trade.

The international investment in financial services in general and in the banking sector in particular is a global tendency manifested even in transition countries. We can expect that foreign investors may increase their investments in the financial system, especially in banking, in countries from Central and Eastern Europe.

Future researches may be focused on the theoretical modelling and estimation of the relations between: (a) the costs implied by better institutions, lower levels of corruption, better social values, on one side, and (b) the amount of foreign direct investments, the rhythm of the economic growth, on the other side.

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