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The impact of banking sector reform in a transition economy: Evidence from Kyrgyzstan

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ABSTRACT

We examine the impact of financial sector reform on interest rate levels and spreads using Kyrgyz bank-level data from 1998 to 2005. We find that, in addition to macroeconomic stabilization, structural reforms to the banking sector significantly contributed to lower interest rates. In particular, our results suggest that foreign bank entry and regulatory efforts to increase average bank size were important in reducing deposit rates. In contrast, we find little evidence that banking sector reform or macroeconomic stabilization has impacted interest rate spreads.

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1. Introduction

Over the past decade, most transition countries in Eastern Europe and the former Soviet Union have pursued reforms aimed at increasing the size, stability and efficiency of their financial sectors. Banking supervision has been tightened with the aim of restoring confidence in the banking sector (Berglof and Bolton, 2002). The financial sector has been liberalized with the goal of inducing stronger competition, more efficient intermediation and greater financial stability (Bonin and Wachtel, 2003; De Haas and Van Lelyveld, 2006). Moreover, in order to reduce credit risk, company and bankruptcy laws have been reformed to facilitate transparency and contract enforcement (Pistor et al., 2000). In addition to these structural reforms, the stabilization of monetary and fiscal policy has created a macroeconomic environment that is more conducive to financial intermediation.

Recent data suggest that the macroeconomic and structural reforms pursued by transition countries have been successful in fostering financial sector development. Between 1998 and 2005, the ratio of private credit to GDP increased from 31% to 46% in central and Eastern Europe, from 18% to 28% in Southeast Europe and from 8% to 19% in CIS countries.[1] This substantial deepening of the financial sector in transition countries has been accompanied by a marked reduction in banks' interest rates. Between 1998 and 2005, average nominal lending rates over all countries fell from 32.9% to 12.9%, while deposit rates dropped from 16.4% to 5.4%. The intermediation spread of banks (the lending rate minus the deposit rate) has thus, on average, been more than halved (from 16.5% to just 7.5%).

Are these welcome developments in the banking sector simply a result of widespread macroeconomic stabilization? Or have they been fueled by structural reforms to the financial sector? In this paper, we examine how banking sector reform has affected interest rates in one transition country: Kyrgyzstan. We analyze deposit rates and interest rate spreads at the bank level on a quarterly basis from 1998 to 2005. Our primary interest is to examine whether financial sector reform has increased public confidence in the

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[1] The figures reported in this paragraph are unweighted averages across countries, based on IFS statistics. Regional definitions are taken from the 2006 EBRD transition report: Southeast Europe (SEE) includes Albania, Bulgaria, Bosnia & Herzegovina, Macedonia and Romania. Central Eastern Europe (CEE) includes Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia. Commonwealth of Independent States (CIS) includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, and Ukraine. We exclude Turkmenistan and Uzbekistan due to a lack of data.

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banking sector, allowing banks to pay lower deposit rates. We further examine how financial sector reform has affected the interest rate spreads earned by banks.

Our empirical analysis suggests that banking sector reform has substantially contributed to reduced deposit rates in Kyrgyzstan. We find that macroeconomic stabilization accounts for only half of the fall in nominal deposit rates observed in our data. By boosting public confidence in the banking sector, foreign bank entry and regulatory attempts to increase bank size seem also to have significantly reduced banks' deposit rates. In contrast, our results suggest that neither structural nor macroeconomic reforms have had a strong effect on banks' interest rate spreads.

Existing research on transition countries suggests that structural reforms to the banking sector may have been instrumental in improving the efficiency of financial intermediation. Examining the performance of 477 banks in 15 transition countries for the period 1995–2004, Fries et al. (2006) find that financial liberalization, i.e., privatization and foreign bank entry, lowers banks' costs and encourages demand for their services. Bonin et al. (2005), Fries and Taci (2005), Grigorian and Manole (2006) and Havrylchyk (2006) also find that foreign bank entry increases efficiency in Eastern European banking sectors. Recent evidence suggests that financial liberalization also increases bank efficiency in China, the world's largest transition country (Berger et al., 2009). Studies on Latin America and Sub-Saharan Africa, however, only partly confirm these findings. Evidence by Martinez Peria and Mody (2004) on Latin America suggests that foreign bank entry reduces intermediation spreads throughout the banking system by raising pressure on all banks to reduce costs. Barajas et al. (2000) confirm this finding in an analysis of Columbian banking data. In contrast, Beck and Hesse (2009), who study Ugandan bank-level data, find no significant relationship between foreign bank entry and interest rate spreads. Examining data from Malawi, Chirwa and Mlachila (2004) find that broad financial sector reform resulted in higher spreads due to macroeconomic instability and market power in the banking sector.

We contribute to this recent literature on financial sector reform and interest rates in two ways. First, we examine the impact of financial sector reform on interest rate levels as well as on intermediation spreads. De Nicolo et al. (2003) suggest that a key reason for high interest rate levels in transition countries is the lack of public confidence in banks. By analyzing the differences in deposit rates across banks and the development of deposit rates over time, we can establish whether financial sector reform has increased public confidence and reduced deposit interest rates. Second, we examine data from a low-income transition country for which there is scarce evidence regarding the determinants of financial sector development. Relying on income statement data of banks, existing studies (Bonin et al., 2005; Fries and Taci, 2005; Grigorian and Manole, 2006; Fries et al., 2006) study more advanced European transition countries, for which this type of data is publicly available. The little evidence available for low-income transition countries suggests that, as in the studies on Sub-Saharan Africa, banking sector reform may be less effective in reducing spreads. De Nicolo et al. (2003) examine aggregate intermediation spreads for CIS-7 countries[2] for the period 1995–2002. They find that intermediation spreads are closely linked to credit risk and regulatory requirements, while improvements in bank efficiency and competition have had negligible effects. In a more recent paper, Dabla-Norris and Floerkemeier (2007) suggest that interest rate spreads in Armenia are strongly correlated with bank size and market power, but are not correlated with foreign bank presence or macroeconomic reforms.

Our data allows us to examine the relationship between banking sector developments and interest rates in a more precise way than can previous studies. First, as we observe the actual interest rates set quarterly by banks on new loans and deposits, we have much more precise information on interest rates than that generated from the income statement data of previous studies. Second, as we observe banks' interest rates for both local currency and foreign currency funds, we can compare interest developments that should depend strongly on domestic macroeconomic conditions (local currency interest rates) with those that should depend less on domestic macroeconomic conditions (foreign currency interest rates).

The paper is organized as follows. Section 2 provides an overview of banking sector developments in Kyrgyzstan. Section 3 derives predictions for interest rates in a strongly dollarized banking sector like that of Kyrgyzstan. Section 4 describes the data. Section 5 presents our empirical results, and Section 6 concludes.

2. Banking sector development in Kyrgyzstan

In 1991, Kyrgyzstan inherited a two-tier banking system from the former Soviet Union. The state bank (Gosbank) acted as the central bank, while the second tier consisted of four specialized state-owned banks and three smaller non-specialized private banks. In February 1992, Gosbank was renamed the National Bank of the Kyrgyz Republic (NBKR), which inherited its predecessor's responsibilities for licensing and supervising second-tier banks. As in many other transition countries, licensing and supervision of banks in Kyrgyzstan were initially lax, allowing many small private banks to emerge. At the end of 1995, there were 19 commercial banks in the country; five were state-owned and 14 were private. The introduction of on-site inspections and provisioning requirements by the NBKR in 1995 caused half of all banks to report a negative net worth and initiated a first wave of banking sector restructuring. In 1996 and 1997, with the support of the World Bank, two specialized state banks and four private banks were closed and liquidated. In addition, the two remaining specialized banks were restructured. During this restructuring process, a state agency ("Debt Equity and Banks Restructuring Agency" – DEBRA) was founded in order to ensure the recovery of assets of liquidated banks.[3] NBKR records suggest that very few customers actually lost deposits during this first restructuring phase. The closed private banks were small at the time and had a limited customer base. Moreover, while the former savings bank "Sberbank" was restructured, all private customers had their deposits transferred to the newly founded and NBKR-owned "Savings and Settlement Company". Nevertheless, the collapse of several financial institutions did undermine public confidence in the banking sector, particularly because many of the customers of restructured institutions did not receive their deposits until up to five years later.

Between 1998 and 2000, the Kyrgyz banking sector suffered greatly due to the Russian financial crisis and consequent domestic macroeconomic turbulence. Since the banks had underestimated credit and currency risks, non-performing loans rose to nearly 30% of the banks' total loan portfolios in 1999. During this period, six banks were closed and two were restructured. The assets of the two restructured banks were transferred to DEBRA, while their liabilities were transferred to the newly founded, state-owned "Kairat Bank". This second restructuring phase undermined public confidence in the Kyrgyz banking sector. As in 1996 and 1997, the actual losses incurred by depositors due to bank failures were quite low, at roughly 1.6% of total bank

[2] CIS-7 countries are Armenia, Azerbaijan, Georgia, Kyrgyzstan, Moldova, Tajikistan, and Uzbekistan.

[3] At the beginning of 1997, the total amount of given debt was 1.3 billion Som.

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