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# Financial regulation and financial system architecture in Central Europe

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## Abstract

At the beginning of the transition, advice to Central European countries with respect to how to set up their financial systems was based on models used in western economies. This paper analyzes the experiences to set up a financial system in Central Europe. The experience in the first transition years (1990–1996) with financial system architecture shows that changes are slow but that the Central European countries tend to catch up more quickly with the western ones in the case of their banking systems than with respect to their stock markets. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

This paper aims at analyzing the efforts to develop the financial system in Central Europe. Has advice from academics and multilateral institutions on financial system architecture been followed and what have been the results? How does the financial system of countries in Central and Eastern Europe compare to those of Western European ones? We focus on the structure of the financial system as the issue of financial sector reform is already dealt with to a

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great extent elsewhere in the literature (see Calvo and Kumar, 1993; Thorne, 1993; Caprio et al., 1994; Griffith-Jones and Drábek, 1995). The structure of the paper is as follows: As the frame of reference in the transition economies in general has been the situation in Western Europe and North America, we first review the practices and principles of financial system architecture in these economies. The purpose is to come to a basic conceptual framework of institutional arrangements in financial systems. Then, in Section 3, we investigate the arguments to construct a particular system. Section 4 gathers evidence on the experience in Central Europe during the early transition years (1990–1996). We focus on bank credit and the stock market as these are regarded as both crucial determinants and indicators in discussions about financial system architecture. A conclusion is in Section 5.

## **2. Financial system architecture**

Financial intermediaries have emerged to help firms, consumer households and governments to finance their expenditure and to save or invest their liquid funds in a world that is full of market imperfections. Two main types of financial intermediation can be distinguished if it comes to the transformation of funds within the economy. Bank or indirect finance is the intermediation between surplus and deficit spending households. The financial intermediary is permanently in a position between the ultimate borrower and the ultimate lender. The intermediary issues (contingent) claims on himself and sells these to the borrower. At the same time, it holds (contingent) claims on lenders in return for (access to) funds. In market or direct finance, the financial intermediary takes no position at all between borrower and lender, or only for a very brief period. The claims issued by the deficit spending unit are bought by the ultimate borrowers. The financial intermediary brings together supply and demand for these claims and passes through or underwrites the securities. With bank finance, the intermediary acts as a delegated monitor. This is an efficient solution to free riding problems that arise in financial markets where the incentive structure to monitor the issuer of debt or equity is weak (Diamond, 1984). Fixed costs in monitoring are crucial to achieve economies of scale in gathering and processing information. It is much more efficient for one information specialist to screen and monitor a large number of firms than for a large number of individual lenders. The intermediary collects funds from the depositors/investors, promises them a fixed return and diversifies these funds along various projects. Thereby it reduces risk (as project returns are imperfectly correlated) and offers diversification to those from which it lends.

Hellwig (1991) argues that, from a pure theoretical perspective, it appears that bank finance is a superior means of financing. This results from the

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