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Financial intermediation and the rule of law in the transitional economies of Central and Eastern Europe

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Abstract

We explore the level of intermediation in the 17 (out of 29) transitional economies of the former Soviet Union and Central and Eastern Europe for which data are available. We find that, ceteris paribus, the levels of financial intermediation relative to GDP are between 21 and 28 percentage points below our sample of developing countries. In addition, we find that the former Soviet countries have lower levels of intermediation than the non-Soviet Eastern European transitional economies. We document that rule of law and legal enforcement increase intermediation and conclude that economic growth in these countries will be more constrained because such growth is more difficult to achieve without a developed banking system.
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1. Introduction

A number of the 29 transitional economies of the former Soviet Union and Central and Eastern Europe (henceforth referred to as Eastern Europe) are attempting to become market economies without the infrastructure of a developed banking system. In an extensive review of the literature on the transition, Campos and Coricelli (2002, p. 831) suggest that much more research is needed about the development of financial institutions in these former communist countries. Their comment is appropriate because no rigorous analysis comparing the level of intermediation in these

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29 countries with other countries exists in the literature. This paper provides such an analysis for the transitional economies and strives to fill this gap in the literature by providing estimates of how the level of financial intermediation in these countries compares with other developing countries.

Using panel data techniques with four different measures of intermediation as dependent variables, we find that the former Soviet countries have significantly less financial intermediation than a large sample of developing countries in three of the four measures. Relative to GDP, the levels of financial intermediation are between 21 and 28 percentage points below the developing country sample. The magnitudes of these differences are economically significant. The non-Soviet transitional economies also exhibit lower levels of financial intermediation than developing countries, although not to the same extent. Only one measure of financial intermediation, namely *Claims on the Private Sector/GDP* (the level at which the banking system transforms claims on itself into loans granted to productive enterprises and households), is statistically significantly lower than developing countries. Furthermore, we find that transitional economies, as a whole, have lower levels of intermediation than the sample of developing economies.

The measure of law enforcement and legal protection, *Law*, as measured by Political Risk Services' (PRS) Law and Order index is a significant and positive determinant for two of the four measures of financial intermediation, namely *Domestic Credit/GDP* and *Claims on the Private Sector/GDP*. This supports the notion that countries with legal systems that provide good protection to investors have greater financial development and is consistent with findings of previous studies.

The remainder of the paper is organized as follows: Section 2 describes the relevant literature. We describe the data and develop the hypotheses and methodology in Section 3, and present the empirical results in Section 4. Section 5 concludes.

2. Literature review

King and Levine (1993a, 1993b) use cross-country regressions to show that the level of intermediation at the start of the period is positively related to the rate of economic growth during the period. King and Levine's work is part of a rapidly developing literature on intermediation and growth which includes Saint-Paul (1992), Pagano (1993), Cetorelli (1997), Levine and Zervos (1998), Rajan and Zingales (1998), and Cetorelli and Gambera (1999), among others. Our research differs from King and Levine because many of these newly formed transitional economies could not be considered separately in their research since the data did not exist at that time. It also differs from King and Levine because we consider the *determinants* of intermediation. This is important because intermediation facilitates development and growth in a number of different but interrelated ways. We base the following discussion on Levine's (1997) excellent summary of approximately 150 studies on intermediation and on Entrepreneurship (1997). Advanced financial systems: (1) allow firms access to better technology; (2) permit more efficient mobilization of savings; (3) allow greater investment in human capital; (4) facilitate risk amelioration; (5) reduce information costs; (6) permit better monitoring of managers and improved systems of corporate control; (7) facilitate the specialization and division of labor by allowing larger scale operations; and (8) facilitate financing of small firms, an important engine of growth. As Pagano (1993) comments, in the process of financial and economic development, bank lending to firms generally appears first, stock and bond markets develop later and consumer credit and insurance markets develop last. Thus, it is appropriate to focus on the development of the banking system in this research.

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