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Building Market Economies in Europe: Lessons and Challenges after 25 Years of Transition

Joint NBP-IMF conference

Panel III: The plumbing: financial sector development

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General remarks on financial sector development and on the role of foreign banks in transition

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- The development of efficient financial sector has been a major challenge but also indispensable for countries in transition from centrally planned to market economy.
- Developed and integrated financial sector opens broad channel for the intermediation of funds, but also for the transmission of – domestic and foreign – financial shocks.

- The entry of foreign financial intermediaries has not only changed the ownership, but also the governance practices in the domestic part of the financial sector.
- It is of key importance that foreign banks originate in well-functioning jurisdictions and operate on economic terms, in order to prevent abuse.

A) What is the optimal size of financial sector?

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- Size does not necessarily indicate quality =>

  Economy with a large "developed" financial system that misallocates funds may be worse off than an economy with a smaller, but well-managed financial system.

- If underdeveloped, financial sector may hamper growth potential.

- If over complex, financial sector may increase vulnerabilities to shocks.

- In the recent crisis, the capacity of plumbing installed in the financial system has come under a heavy strain. The speed of financial deepening has proven unsustainable in many cases.

B) Is there a decoupling of financial and real cycles?

- If the idea of decoupling is valid, the effectiveness of monetary policy transmission is significantly reduced.
- Domestic banks have behaved differently than foreign banks prior to the crisis.
- During the crisis, the behaviour continues to diverge.
- Decoupled capital flows, given their size, may themselves become a source of shocks.
- Have foreign banks contributed to the post-crisis divergence between the cycles?

C) What should be further changes in the institutional framework of the financial sector?

- Cross-border co-ordination in the field of banks' deleveraging and in terms of macroprudential policies.

- Further financial deepening: bank-domination or greater recourse to other forms of financing.
  - Role for capital markets to widen alternatives to bank financing
  - Strong institutional framework needed for direct finance to become a viable alternative to financial intermediaries

- How to deal with shadow banking?

- What is the optimal size of financial sector?

- Is there a decoupling of financial and real cycles?

- What should be further changes in the institutional framework of the financial sector?