

WPS 1565

POLICY RESEARCH WORKING PAPER

1565

Housing Finance in Transition Economies

The Early Years in Eastern Europe and the Former Soviet Union

Bertrand M. Renaud

The evidence from the past five years suggests that the transition economies that achieved low inflation, adopted radical banking reforms, and seriously reformed laws and institutions in the real estate sector should be among the first to develop a modern system of housing finance.



Summary findings

The transition to markets dominates the development agenda of the 1990s. Financial sector reforms are central to a successful transition to a market economy. Renaud focuses on one dimension of these reforms: the development of housing finance institutions and services.

He presents a progress report for the years since 1989, when the road to change opened with the collapse of communist regimes in most countries. Rather than a detailed account of reform in 25 countries, he offers a general framework for analyzing change and evaluating the prospects for rapid development of market-based housing finance systems.

To understand why sound housing finance systems have not yet developed, one must consider factors in four key reform areas:

- The macroeconomic policies adopted to liberalize the economy and stabilize prices.
- Privatization policies, in particular in housing and real estate.
- The strategies adopted — whether by design or by default — to reform the financial sector.
- The nature of the financial priorities and institutional constraints affecting housing finance reform strategies followed in different countries.

Housing finance policy development has been somewhat haphazard in many countries. But the evidence suggests that the transition economies that have achieved low inflation, have adopted radical banking reforms, and seriously reformed and liberalized their real estate sector should be among the first to develop a modern system of housing finance.

This paper — a product of the Financial Sector Development Department — is part of a larger effort in the department to monitor financial development in transition economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Rozzy Garner, room G8-010, telephone 202-473-7670, fax 202-522-3198, Internet address rgarner@worldbank.org. January 1996. (19 pages)

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**HOUSING FINANCE IN TRANSITION ECONOMIES:
The Early Years in Eastern Europe and the Former Soviet Union**

by

Bertrand M. RENAUD

HOUSING FINANCE IN TRANSITION ECONOMIES:

The Early Years in Eastern Europe and the Former Soviet Union¹

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The World Bank

I. INTRODUCTION

The transition to markets dominates the development agenda of the 1990's for several reasons. First, about 35 percent of the world's population lives in socialist economies that were centrally planned until recently. Second, most of these countries have been undertaking profound reforms of their institutions and economic structure since 1989. This reform process has been absorbing a very large share of the resources available for technical assistance from the European Union, the United States, Japan, Canada and other countries. In addition to the large share of the world's population affected by the transition to market, strong international efforts are also justified by the fact that world stability will greatly benefit from a successful and rapid transition. This paper focuses on one dimension of reform, housing finance, and presents a progress report for the early years of this transition to market since 1989 when the road to change opened up with the collapse of communist regimes in most countries.

A detail account of the on-going housing and housing finance reforms their progress and temporary setbacks across 25 or so countries could be overwhelming. Instead, what is offered here is a general framework which will help us interpret the changes that have been taking place. Concisely speaking, what are the necessary and sufficient conditions for the rapid emergence of market-based housing finance in this very distinct group of countries? This is the central question. It bears repeating that the transition to markets is a process and not an event. Therefore the choice of evaluation criteria is important if we are to properly identify constraints on the development of commercial housing finance and gauge progress. How long the transition might take

¹ The author is Housing Finance Advisor, Financial Sector Development Department, the World Bank, Washington DC. This paper is based on the plenary presentation made to the XXIst World Congress of Housing Finance Institutions, London, September 13, 1995. However, the views presented here are the sole responsibility of the author. They should not be attributed to the World Bank and its affiliates.

cannot be foretold if we do not inventory properly the multiple reforms that are in progress. The housing systems of these former socialist countries share many systemic features. Yet, in spite of these important common features, the transition differs very much across countries. To evaluate the prospects for a rapid development of the housing finance system we will consider the pace and scope of reforms in four key policy areas. First, we consider the macroeconomic policies adopted toward economic liberalization and price stabilization. Second, we review privatization conditions in the key sectors of the economy, including housing and the real estate sector. Then we proceed to the financial sector reform strategies adopted by the authorities, by design or by default, toward the old finance system. Finally, we can provide an account of the nature of the housing finance strategies followed by different countries.

II. LIBERALIZATION AND STABILIZATION

2.1 A Typology of Socialist Countries Along the Path to Market²

The process of economic reform was not new to socialist economies prior to the communist collapse of 1989. In fact, these countries' post-war history is marked by successive attempts at reviving the economy and remedying the secular decline in growth that gradually set in after the switch to central planning. After 1989, however, the objectives of reform are very different with full democracy and the move to markets. The early years have been marked by international debate about the relative efficiency and social costs of gradual versus radical reforms.³ The latter being colorfully described but somewhat misrepresented by the press as "shock therapy" or "big bang" with the suggestion that the social costs of change would necessarily be greater under radical than under gradual reforms. In practice, different governments have made different choices, and these former communist countries are moving along the path to market at various speeds. To order and interpret this diversity of experience across some 25 countries, a country typology can be helpful. It must reflect the extent to which governments have so far been willing and able to take public action in three major areas of economic liberalization:

- the liberalization of the *internal market* through price liberalization and the abolition of the state trading monopolies;

² This typology has been developed by Martha DE MELO, Cevdet DENIZER, and Alan GELB in their paper "From Plan to Market: Pattern of Transition", Transition Economics Division, The World Bank, May 1995, unpublished.

³ See Leczek BALCEROWICZ "Economic Transition in Central and Eastern Europe: Comparisons and Lessons" IFC Second Annual Lecture, Washington DC, December 1, 1993; Leczek BALCEROWICZ and Alan GELB "Macro-policies In Transition To A Market Economy: A Three-Year Perspective", World Bank *Annual Conference on Development Economics*, April 1994, Washington DC.

- the liberalization of international trade of *external markets* with extensive changes in the external trade regime and moves toward internal and external currency convertibility;
- support to the *private sector and competition* with freedom of entry into all sectors with the privatization of state enterprises and the development of banking reforms moving in parallel.

It is possible to develop cumulative indices measuring change over the last five or six years in these three policy areas and to reflect reasonably well the relative quality of the overall reform environments across countries. The result is a very suggestive clustering of countries into five groups of countries strung along the long road to a full market economy. The clustering of these 25 or so countries is as follows:

Group 1 - Advanced Reformers: *Czech Republic, Hungary, Poland, Slovakia, and Slovenia.* The Czech Republic and Slovenia are often considered to be leading members of this first group in terms of speed and quality of change.

Group 2 - High Intermediate Reformers: *Estonia, Latvia, Lithuania, Albania, Bulgaria, Romania.* In this group, Estonia is the former Soviet republics that has moved the most energetically and successfully toward market.

Group 3 - Low Intermediate Reformers: *Russia, Moldova, Kazakhastan, Kyrgyzstan.* The Dominant member of this group is Russia where there remains considerable scope for progress in the macroeconomic, legal, and financial areas before the emergence of market based housing finance can develop on a significant scale.

Group 4 - Slow Reformers: *Belarus, Ukraine, Uzbekistan, Turkmenistan.* These are the countries that tried to continue with central planning. They have been the most reluctant to make needed macroeconomic reforms during the first years of the transition. Because of its resources, size and significance for Western Europe, Ukraine's case is best known.

Group 5 - Countries at War: *Republics of the former Yugoslavia, Armenia, Georgia, Azerbaijan, Tajikistan.* Unfortunately, these are countries where age-old ethnic conflicts instead of being resolved in the socialist era were merely buried and have resurfaced under the social, political, and economic stresses that the transition would have generated in any case.

To round out this international typology, a sixth group of Asian socialist economies could be added. This group would include China, Vietnam, North Korea, and possibly Burma as cases that differ significantly from the countries of Eastern Europe and the former Soviet Union. While Asian, Mongolia would be better treated analytically as a former Soviet republic. It is also important to reiterate that the present clustering reflects the early years of change. With decisive leadership and some good fortune, one or more countries might well speed ahead of their present group. Others could fall behind.

2.2 Initial Impact of the Transition on Economic Performance

The initial moves from plan to market have led to four economic outcomes that we find repeated in country after country, across Central and Eastern Europe and Soviet countries:

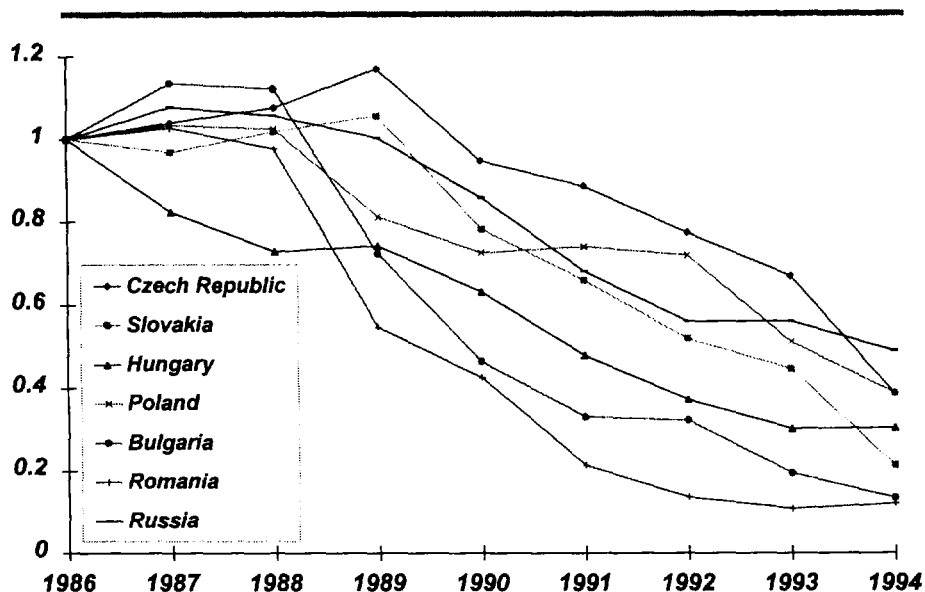
- A *significant decline in output* linked to the disruption of the old system of economic coordination by the state. This output decline was accentuated by the disruption of trade patterns among these countries that were traditionally dictated by governments under the old CMEA trade arrangements, popularly known as the Comecon.
- A *sharp increase in open inflation* following the initial price liberalization after decades of price controls. The impact on consumers is not entirely negative given trade-offs between this open inflation and the end of the shortages and queues which had become increasingly long prior to the communist collapse.
- An important *movement of resources across sectors* of the economy. These shifts are the consequence of the move from state-planned decisions to market-driven decisions, both on the internal and external markets. Resource transfers also reflect the important distortions that existed between socialist domestic prices and actual prices on the world markets. These distortions were especially important in the energy sector and have had a large impact on housing construction and operation.
- Important *gains in private sector output* with the new encouragement of private sector activities and the shifts to private ownership. However, these gains are usually not well recorded by official statistics since the information network of the old statistical bureaus focused on state enterprises and public activities. A significant source of these private sector gains has been the rapid emergence of private regional trade flows with Western Europe and of new links with the rest of the world.

Output decline has been particularly severe in the housing sector. Housing is a sector where the state had achieved almost total dominance through monopoly control of access to land, financing, and the supply and price of materials, especially in the larger cities. With the disruption of state controls, very high inflation and falling wages, the initial years of the transition have been marked by a massive collapse of housing output. Figure 1 shows the decline in the number of *completed* new housing units in seven countries representative of Group 1 (Czech Republic, Poland, Hungary, and Slovakia), Group 2 (Bulgaria, Romania), and Group 3 (Russia). To facilitate comparisons, annual housing production in these seven countries is standardized on the national production level in year 1986, the last year of economic stability in many of these countries.⁴

⁴ I am grateful to Dr. Margarete Czerny of the Austrian Institute of Economic Research (WIFO) for providing me with the latest data on Eastern Europe and her own evaluations "Trends in Eastern Europe: 1995/96" prepared for the annual Euroconstruct Outlook Conference, London, June 1995.

Figure 1 shows that housing output usually remained level until 1988 and entered a period of precipitous decline after 1989. Hungary is a notable exception. It has been the first country to experiment with “market socialism” and moved away from direct state housing production after 1981. Since that year, Hungarian housing output has been in a phase of continuing decline from which it had not yet recovered in 1994. Even if we take into account the statistical reporting problems for private activities mentioned earlier and for investment in housing rehabilitation that is mostly unreported, it is undeniable that the withdrawal of the state from direct housing production has led to a precipitous fall in annual output. In most countries, during these early years of transition the volume of *unfinished* housing under construction was several times the old annual volume of *completed* output. The housing contraction has been particularly severe in Bulgaria and Romania where the number of units completed in 1984 was reported as less than 20 percent of what it was in 1986.

FIGURE 1: Collapsing Output of Completed Dwellings

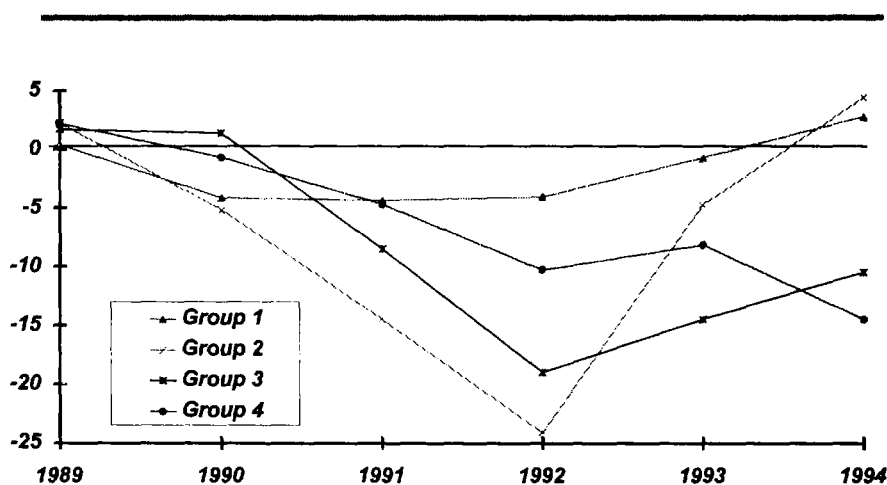


The contraction of housing output raises two obvious questions. Why this calamitous housing contraction? Why is the private sector so slow to take the relay of public sector production? In reply, the central claim of this review -- and its *leitmotiv* -- is that during the early years of the transition neither the necessary nor the sufficient conditions for the revival of the housing sector and for the development of a market-based housing finance system were in place yet.

2.3 Necessary Conditions for Market-Based Housing Finance

From a macroeconomic viewpoint, three necessary conditions for the revival of the housing sector are the resumption of economic growth, the lowering of inflation to at least a moderate level, the recovery of real wages and a return to a perception of employment stability for the greatest majority of the population. These conditions were beginning to be met among the “advanced reformers” of Group 1, especially the Czech Republic and some of the “high intermediate reformers” of Group 2, Estonia in particular. Figure 2 shows that these two groups of countries were experiencing a positive rate of GDP growth again by 1984, while the countries of ‘low intermediate reformers’ of Group 3 and the “slow reformers” of Group 4 were enduring economic contraction.

FIGURE 2: GDP Growth Path Across the Four Country Groups

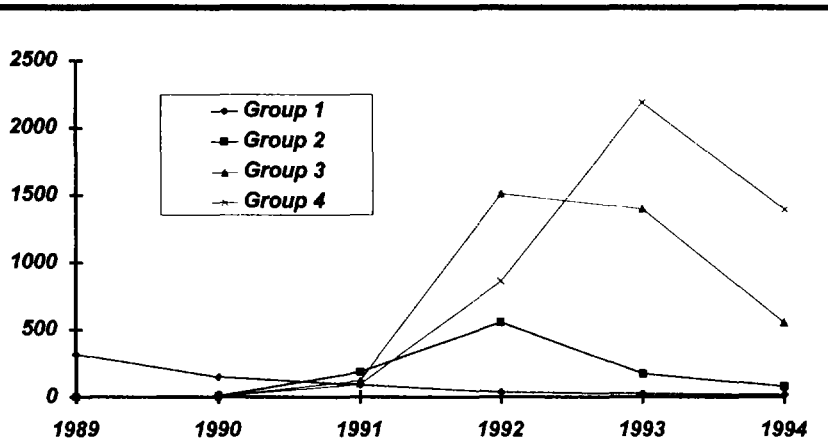


Source: EBRD: Transition Report

Macroeconomic stabilization and the return to some degree of price stability has been extremely difficult to achieve in most transition economies, partly because of the deep but hidden macroeconomic disequilibria that had accumulated during the 1980s. The Czech Republic is a rare exception. As Figure 3 shows, the scale of inflation has been massive by the standards of market economies across the four country groups. However, each group has followed a significantly different path with Group 4 still experiencing annual average inflation rates well above 1500 percent per year in 1983 and 1984. Even the inflation experience of the best reformers has prevented the emergence of market-based long-term finance needed for housing until 1994. Figure 4 shows the improving performance of the members of Group 1 between 1989 and 1994. Yet, if we zoom further onto the years 1992 to 1994 (Figure 5) we see how difficult it remains even for these leading countries to achieve what Latin American economists used to call a “moderate inflation” around 20 percent (Figure 5). Such an inflation rate would be seen

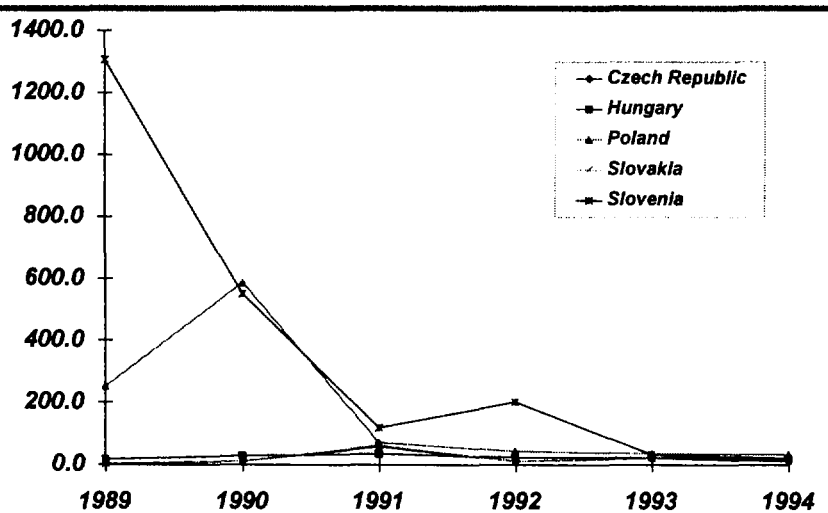
as disastrous by Western or North American countries and remains a major impediment to housing finance.⁵

FIGURE 3: CPI Inflation Across the Four Country Groups



Source: IMF

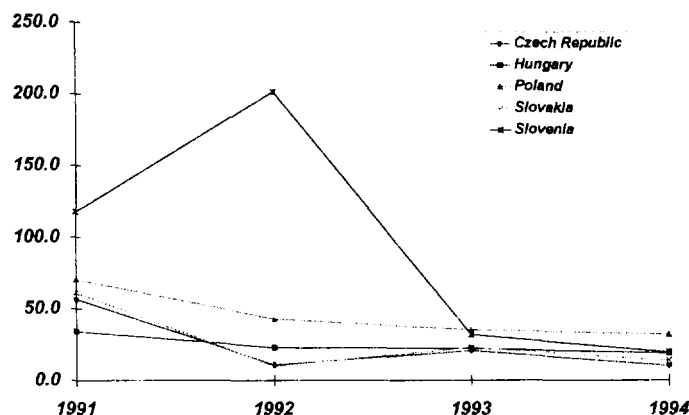
FIGURE 4: Inflation Experience of Advanced Reformers



Source: IMF

⁵ See Rudiger DORNBUSCH and Stanley FISHER "Moderate Inflation, *The World Bank Economic Review*, January 1993, Vol. 7, No. 1.

FIGURE 5: Advanced Reformers: New “Moderate” Inflation

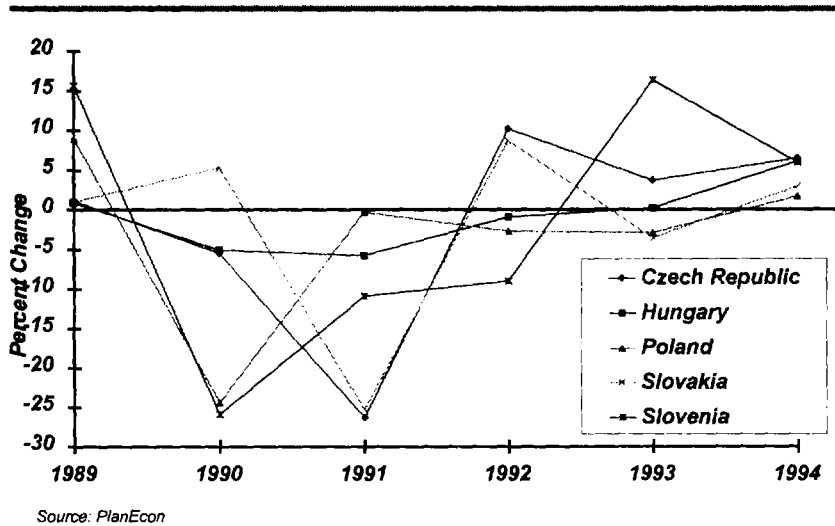


Source: IMF

The third necessary condition of an improving wage situation was met by the group of “advanced reformers” in all five countries by 1994. Originally, all four groups of countries have experienced a very sharp real wage decline when they initiated market reforms. Even the countries of Group 1 experienced overall real wage declines of the range of 25 percent for two successive years in 1990 and 1991 (see Figure 6). These sharp initial losses were only partially made up in the following years. Once again, we can see that Hungary which pioneered “market socialism” experienced less pronounced wage fluctuations and smaller year-to-year real wage losses. Yet, even the reported Hungarian wage losses were of the order of 5 percent annually. Such losses would create major political tensions in Western economies.

The demand for market mortgage finance has been minuscule due to the combination of three negative factors: job insecurity that results from a sharp contraction in output; high inflation with the higher risk, higher real interest rates, and its front loading of real repayments on long-term loans; falling real wages that cut back on the ability to save. Each one of these three factors would have been individually enough to curtail the demand for mortgage finance in well-established markets economies. In addition, housing finance in transition economies is facing other obstacles in the initial years. The development of long-term mortgage lending is also shaped by the speed and quality of privatization in the real estate sector and by the sustained quality of the financial reforms pursued by the government. These two other key policy areas must also be taken into account if we want to properly gauge the potential speed of development of the new housing finance system. We now turn to privatization.

FIGURE 6: Advanced Reformers: Wage Decline and Recovery



III. HOUSING PRIVATIZATION

3.1 Housing as One of the "Four Privatizations"

The Hungarian economist Janos Kornai has been the leading analyst of the structure, behavior, and performance of socialist economies. He has pointed out the affinity that exists between forms of ownership on one hand and economic control mechanisms and modes of financing on the other.⁶ In socialist economies we have state ownership, state financing, an atrophied financial system (as we shall discuss in the next section) and widespread state monopolies over the production and distribution of goods and services. By contrast, in market economies private forms of ownership dominate and financing is provided by the banking system and the capital markets. Competition and contestable markets form the cornerstone of public policy in these economies. Even when and where public activities are significant, they are also evaluated with reference to that analytical and policy yardstick. Housing privatization is a very much a precondition to market-based housing finance: where there is no housing sold to private individuals there will be no demand for private mortgage finance, because there is no need for it.

⁶ See in particular Kornai's grand synthesis, *The Socialist System, The Political Economy of Communism*, Princeton University Press, 1992.

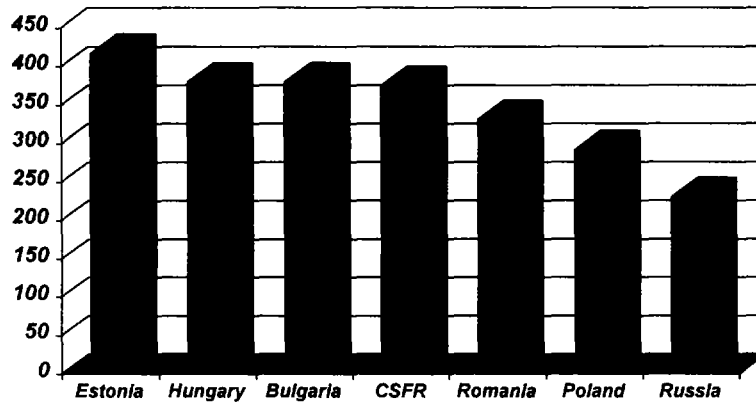
Socialist countries made the goal of universal access to housing and its provision by the state at trivial prices an important claim of the superiority of socialism over capitalism. Yet, by the end of the 1980s there was no other sector of their economy where the system of state production and allocation met with such universal dissatisfaction as housing. The economic and institutional reasons why the *direct* provision of housing by the state is usually a failure and cannot be expected to meet popular expectations -- especially as incomes rise -- are well understood and known.⁷ Housing is not a very complex *technical* good to produce in industrial societies. On the other hand, housing is perhaps the most complex *economic* good to analyze and manage properly because of its durability, heterogeneity, spatial fixity and sensitivity to the specific financial and regulatory environment in which it is provided.⁸

After decades of provision by the state, housing is now one of the “four privatizations” in transition economies together with the privatization and restructuring of large state enterprises, the privatization of medium and small scale urban enterprises, and that of agriculture. Because Central and Eastern Europe as well as Russia are fully urbanized economies the value of the housing stock in national wealth is quite important and of the order of 20 to 25 percent of reproducible assets. The potential transfer of wealth to households is therefore massive. In the very early months of the transition there was some confusion about the extent of an absolute housing shortage in these countries. It is generally understood that these highly urbanized countries have more of a quality than a quantity problems and, as Figure 1 vividly shows, pressures on the sector have intensified. As Figure 7 shows, the nearer geographically a country is to Western Europe, the closer is its housing stock to the Western European ratio of about 440 units per 1000 people. Figure 7 also shows that Poland and Russia have a more significant quantitative shortage. The quality problem however is serious everywhere. A very large proportion of the socialist housing stock consists of very large, mass-produced industrial housing estates, with small uniform units of about 55m². These units are energy inefficient, costly to maintain, and frequently loathed by their occupants. A significant contributor to the long waiting lists everywhere was that the demand for housing was artificially stimulated by absurdly low rents. In most socialist countries, total housing expenditures (i.e. rents plus utilities) were much less than 3 percent of total household expenditures. In market economies of comparable per capita GDP, this ratio is well above 15 percent and often above 20 percent. It is well known that in Russia total monthly rent for a standard apartment was equal to the price of a pack of cigarettes at the start of the reforms.

⁷ See B. Renaud, *Housing Reforms in Socialist Economies*, World Bank, Discussion Paper 125, June 1990, and *Russia: Housing Reform and Privatization*, World Bank Report No. 14929-RU, 1995.

⁸ Contractual and regulatory arrangements are at the core of housing reforms, not technology which is easily transferable from Western to Eastern Europe, when it is not already available locally. This crucial policy perspective is missed by construction engineers or bureaucrat holdovers of construction ministries with no professional knowledge of the real estate sector.

FIGURE 7: Housing Stock Level in Selected Countries, 1991



Source: UN-ECE, Annual Bulletin of Housing & Building Statistics, November 1994

3.2 Housing is Caught Between Plan and Market

Today, housing in socialist economies is caught between plan and market. Managing the transition toward markets requires the simultaneous pursuit of two very distinct set of policies which should match the dualistic structure of the housing system. One set of policies is needed to privatize the large inefficient stock of public housing, and the other to encourage the rapid growth of the very small new private sector.

So far, the privatization of the public stock has been slowed by several factors. *First*, privatization has been complicated by land property restitution policies and inadequate or unclear administrative processes. There was a contradiction between the profound desire for a return to a legally based civil society and the use of rough-and-ready procedures to return property to former owners. *Second*, technical problems are also serious. Socialist housing systems have uniformly poor land registration and cadastre. The concept of real estate property combining land and buildings has to be recreated -- or, in Russia, understood for the first time. Much of housing privatization, especially as it is practiced in many republics of the former Soviet Union is merely the privatization of apartments units to their occupants without clear rules about the ownership and maintenance of the public spaces, and no delineation nor registration of land boundaries. Hence, the ubiquitous preoccupation with condominium laws and their practical implementation. A *third* impediment to rapid privatization is the inability of the various public owners of housing to achieve full cost recovery of housing maintenance costs -- without speaking of capital costs which are typically ignored and treated as sunk costs. Under such conditions, *why would occupants want to buy their units when it is so much cheaper to rent than to own?* The implicit rent windfall is used for the purchase of

newly available capital goods such as home appliances and cars. *Fourth*, there is a circular causation problem: the absence of loans lowers the prospect for trading units which in turns weakens mortgage loan demand. The frequent mismatch between unit size and household needs -- young couples have too little space, retirees have excess space-- then becomes another impediment to privatization to the occupants of the unit.

Contrasting with the old state system , there is a small but rapidly growing private housing supply which is the forerunner of the future market system. However, this sector serves mostly the high income groups who have been the first to achieve full and substantial market wages. They reject mass housing and demand new types of housing units.

So far, governments are experiencing significant difficulties in articulating and implementing the needed two-pronged housing policy. Winding down the state sector typically requires them to restructure their municipal housing and to truly privatize their socialist cooperative housing stock which had been run by state-controlled organizations in the past. Supporting the rapid expansion of a diversified supply of private housing requires reforms in four areas where the new transition administrations lack experience: the implementation of market-oriented urban planning; the development of real estate codes and the training of the new real estate professions; the reform of what remains almost everywhere arbitrary and capricious taxation; and, finally the development of financial services which is our main concern, but for which existing construction ministries have neither the appropriate powers nor skills.

IV. FINANCIAL SECTOR REFORMS

The transformation of the old state financing mechanisms into a modern, competitive financial system is a critical task that occupies reformers since the beginning of the transition. The overall financial sector strategy followed by governments -- whether this strategy has been adopted by design or by default -- inevitably shapes the provision of specialized financial services such as housing finance.

The legacy of central planning and socialist administration is a burdensome one. In market economies, financial systems play a critical role in the decentralized process of deposit mobilization, information processing and resources allocation across the full spectrum of activities in the economy. In contrast, the fundamental goal of a centrally planned economy was to transfer this critical resource mobilization and allocation functions to the state. *As a result, banks were no really banks.* Resource allocation decisions were made by the central planning authorities and therefore a very small number of these banks were needed. At the peak of central planning, socialist economies ended up with a “monobank system”. This banking system was structured as an integral part of the central allocation system managed with a ‘credit plan’ for investments and a much smaller “cash plan” for regular operations, and wages. There was essentially one “state bank” such as Gosbank in the Soviet Union. A

monopoly savings bank was also present to collect household deposits to finance the plan but it did not lend to anyone else. Because this monobank system did not have any autonomous resource allocation function it was merely an accounting and auditing arm of the government for which it acted as a treasury. Similarly, in terms of its functions, organization and staffing, the ministry of finance of the day would be better described as the “accounting and auditing” ministry.

There were constant problems with the slow and frequently inappropriate decisions made by this centralized bureaucracy. As secular decline set in, country after country experimented with various types of administrative reforms affecting state enterprises and banks. However, these reforms did not challenge the central concept of state control; they just aimed to make it work better. In banking, the monobank was thus segmented into a few sector-oriented banks such as a bank for heavy industry, a bank for international trade, a construction and industry bank, and a bank for social and municipal investments. This shift away from total centralization to the financing of investment by sectoral banks did not really change the system for three fundamental reasons. One reason is that the new banks still did not make independent decisions and continued to wait for state instructions. Another is that these banks did not face any financial risk as problem loans were refinanced by the state. Finally, neither the behavior of enterprise borrowers nor that of the banks did improve because they continued to operate under a “soft budget constraint”. That is to say, if a state-controlled institution ran into financial difficulty because of wrong decisions it knew that it could rely on the state to bail it out.

The dynamics of banking and financial sector reforms in a given country can be evaluated with reference to two basic models. One model is the *gradual conversion* of the existing state bank system. The other is the *radical transformation* of financial policies and financial institutions with the aim of creating rapidly an entirely new banking system where the surviving pieces of the old systems would become very different institutions. A very important distinguishing factor shaping the dynamics of these financial reforms is that they have been taking place under two very different macroeconomic environments: in some cases *moderate inflation*, in others *very high inflation*. As was already mentioned, financial reform strategies were adopted sometime by design such as in Estonia or the Czech republic and sometime by default such as in Russia where very high inflation and erratic decisions during the *perestroika* period often forced the hand of reformers. These two criteria leads us to a simple matrix reflecting the actual diversity of country experiences across and within the four groups (Figure 8).⁹

⁹ The distinction between gradual and radical reform was first made by Ronald I. MCKINNON in particular in his monograph *Gradual Versus Rapid Liberalization in Socialist Economies: Financial Policies in China and Russia Compared*, San Francisco, International center for Economic Growth, 1994. However, McKinnon emphasizes the macroeconomic management perspective. The characterization of banking and capital reforms presented here extends work done by Gerhard POHL and Constantijn CLAESSENS of the World Bank in “Privatization and Banking Reform in Russia,” March 1994.

FIGURE 8: GRADUAL VS. RADICAL FINANCIAL REFORMS, A MATRIX

	GRADUAL REFORM	RADICAL REFORM
Low Inflation	Hungary (group 1) Poland (group 1) Slovakia (group 1)	Estonia (group 1) Czech Republic (group 1)
High Inflation	Bulgaria (group 2) Romania (group 2) Ukraine (group 4) Belarus (group 4)	Russia (group 3)

Under *gradual reform*, the basic approach is the modification of the existing institutional structure and the conversion of financial administrations into genuine banks. The process starts with the creation of a two-tier system with on one level a genuine central bank, and operating below it commercial banks. Reform activities include the introduction of new charts of accounts and new accounting standards based on international practice for both banks and their client enterprises. The necessity to open the economy and the desire to converge quickly with the norms of the European Union have facilitated the widespread acceptance of these difficult internal accounting changes. The development of new prudential regulations for banks and the organization and training of supervisory staff to manage a more competitive environment is also needed. Because the banks carved out of the old system have inherited a substantial amount of non-performing loans from the socialist era, the transition process usually requires a large amount of work on balance-sheet restructuring and recapitalization.

The success of this gradual strategy depends to a significant extent on measures taken outside the banking system, in particular enterprise reform and privatization. It became rapidly obvious to many that success in privatization and in banking reform go hand in hand. Privatization creates the proper incentives and introduces the essential ingredient of a hard budget constraint into the management process. Without privatization of both enterprises and banks there will be little change in behavior. If the privatization process is held up by political forces, the danger of total failure of banking reforms cannot be overlooked as many banks will be making new rounds of post-1989 bad loans to weak clients. A fresh portfolio of new problem loans

often concentrated in a small number of powerful state enterprises may require repeated rounds of interventions, as has been the case in Hungary for instance.¹⁰

A smaller number of countries have chosen the path of more *radical reform*. The new financial authorities recognized that the old banks were not really banks. These reformers were also deeply concerned by the difficulty of changing the old bureaucratic culture of existing financial organizations. Radical reformers were therefore willing to lower barriers to entry into the sector and to issue banking licenses to new commercial banks relatively easily. Because it was difficult to develop immediately a strong bank supervisory function, the authorities placed less emphasis on regulation and supervision. Instead, they placed more reliance on market mechanisms, including bank failure, to induce banks to manage their risks properly. The decision of a government and its central bank not bail out a failed commercial bank is a critical departure from the past. It sends an important message to banks and enterprises with very beneficial long-term effects, as happened in countries like Estonia.

V. HOUSING FINANCE

5.1 *The Lack of Coherent Housing Finance Strategies*

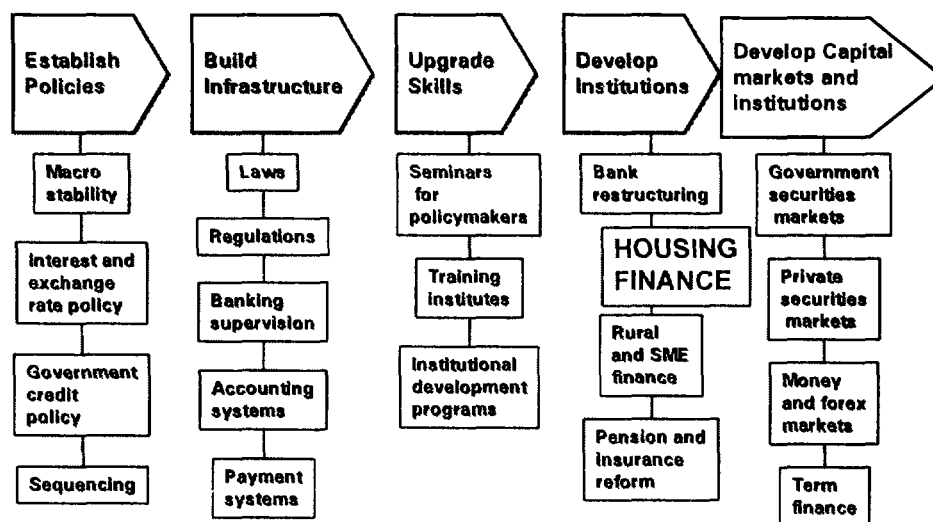
A striking aspect of the early banking transition in most countries is the recurrence of three strategic gaps in domestic financial reform policies, and also in international advisory work. Typically, retail banking, small and medium enterprise (SME) finance, and housing finance have taken back seats in the reform process. The absence of a well articulated framework for housing finance reform as part of overall banking reform is a cause for concern. So far, only piecemeal actions have been taken and they may be inconsistent with the desirable features of financial markets in the late 1990s and beyond. One of the reasons for this policy gap lies in the sequencing of financial reform. Initially, the attention of the new financial authorities had to concentrate on the core systemic components of the transition. They had to create an autonomous central bank and implement new macroeconomic, monetary and financial policies as the earlier discussion of macroeconomic liberalization made clear. The authorities were concerned with building the core financial infrastructure of the new system: laws, regulations, bank supervision, accounting systems, and payment systems. They also had to focus in priority on the thorny problems of bank restructuring, and what to do with bad loan portfolios and how to finance these bank restructuring activities.

By default, the leadership of the housing finance reforms usually fell into the lap of construction or even social affairs ministries that were even less well equipped that

¹⁰ For views on these banking issues from the perspective of various multilateral institutions see Steven Fried (editor), *Transition: Private Sector Development and the Role of Financial Institutions*, London: EBRD Working Paper No. 13, July 1994.

their Western European counterparts to address this financial task. Under central planning, construction ministries were line agencies with limited responsibility for policy work. Their main focus was on the implementation of projects funded by the plan. Inevitably, these agencies were more aware of the needs of the construction industry as their primary client than of other stakeholders in the housing system, be they final consumers or banks. They had little reason to develop expertise in finance and banking. It is therefore not surprising to see them adopting existing housing finance instruments such as loan-linked saving instruments, mortgage instruments, and any public tool that had succeeded in markets economies. Yet their staff were ill-equipped to carry out the “reverse financial engineering” needed to understand why these instruments worked elsewhere.

FIGURE 9: A Framework for Sustainable Financial Development



The Central Question for a Housing Finance Strategy

The central question in the design of a housing finance strategy is: “*Why is it that banks do not lend for housing?*” This question requires sector policy makers to change their focus and to look beyond short-term expedients to revive the construction sector and to think about the overall design of a sound housing finance. After all, the volume of loans made every year will depend on the financial processes to mobilize funds and on the management of the variety of financial and operational risks that are inherent to long-term housing finance and should not be borne by the state. Admittedly, this question requires a drastic change of perspective for officials who could not and did not even distinguish between housing finance and housing subsidies under central planning. One of the lessons of the developing countries is that there is nothing romantic about the informal sector that is encountered in too many places. We have learned that the informal sector results mostly from inappropriate regulatory frameworks that prevent banks from

voluntarily financing the sector because it is not financially sustainable. There is no conspiracy there: why would private developers and bankers deliberately price themselves away from the bulk of the potential market? The real issue then is to identify and remedy the risks that make it impossible for a lender to lend in a sustainable and profitable way for a broad clientele. During the early transition, the risks of mortgage lending were substantial.

Credit risk is the first issue. The tried and tested ways of managing this risk that are in use in market economies have had to be rebuilt or adapted in transition economies. Initially, property laws had to be rewritten to recreate the concept of real estate. Privately managing the bundle of land and building rights that constitute real estate property in market economy is still a new way of operating. The requirements of residential and business real estate development often remain poorly understood or accepted by central and city administrations. In Russia, in particular, it is proving politically very difficult to develop the concept of private land ownership and to accept the trading of land and the emergence of land markets.¹¹ Another problem is that the privatization of the housing stock originally had gaping holes in many countries. Apartments units were privatized, but in the absence of condominium laws and the creation of condominium associations the financing and maintenance by residents of the public space and the networks within the buildings by could not be done adequately. Another frequent problem was, and still is, that land property boundaries were not drawn up and recorded at the time of construction under the state system. They now need to be defined and accepted by parties often suspicious of each other.

Collateralized lending is a problem everywhere for long term lending because of the legacy of poor land titling from both legal and purely technical point of views. Even in countries with a tradition of high quality registration, like east Germany, "land books" were no longer properly maintained during the socialist era. The legacy of the old state urban planning is still being felt everywhere. Stable and sound land use systems are emerging in a painfully slow way. Old urban plans and old urban cadres constrain the entire property sector and therefore all forms of physical investment. From a direct mortgage lending point of view, inadequate credit and collateral laws still create large credit risks for lenders. New foreclosure laws have had to be written and generally remain untested to this day. Alternative forms of collateral lending that differ from the usual Western foreclosure practices may therefore be useful.

In terms of bank management, long-term housing lending creates significant liquidity risks, interest rate risks, and market risks. The instruments and financial markets to manage these risks are now beginning to function properly in the group of advanced reformers. In particular, money markets are now beginning to function for

¹¹ See, Alain BERTAUD and Bertrand RENAUD, *Cities Without Land Markets, Lessons of the Failed Socialist Experiment*, World Bank Staff Discussion Paper 227, 1994.

liquidity management in support of commercial loans. However secondary market facilities specifically supporting long-term housing lending can play a central role but do not exist in any of these countries. Volatile inflation and political pressures to control interest rates are another problem for mortgage lenders. The development of contractual savings institutions such as pension funds and life insurance offers the promise of improvement for the management of interest risk and market risks by developing institutions with the capacity to bear such risks. The lack of credit skills and inadequate capital are other constraints to mortgage lending that are slowly being met.

Given the institutional and political context of the transition, the lack of coherent housing finance strategies can be lamented, but it is perfectly understandable. Fragmented ownership rights, insular and competing bureaucracies, scarce financial skills and information systems that are not geared to market monitoring readily explain the pattern of piecemeal policy decisions that is usually observed. Major efforts are now being made to overcome this socialist legacy on the real estate side. In parallel, the development of coherent housing finance policies as a vehicle to bring together line construction ministries, the ministry of finance and the central bank could speed up change considerably. A large amount of public education on appropriate housing and housing finance policies, beginning with parliaments, would also make a great difference.

What Housing Finance System in Transition Economies?

A housing finance strategy should be well integrated with the development of the rest of the financial sector. The initial question raised by reformers is what kind of Western model should be followed. A typical reflex of Western consultants is to promote their own national model of housing finance because it works, and because that is the system that they understand the best. However, these existing systems are fifty to seventy years old and they are now evolving significantly with the revolution in information technology and in financial engineering in a context of extremely rapid globalization of financial markets. In particular, should these *latecomer countries* aim at the development of special housing finance circuits in favor of which construction ministries are strongly predisposed by the legacy of the past and the poor state of the sector for which they are directly responsible?

There are good reasons to argue that the transition economies of Eastern Europe should aim at housing finance systems that deliver *specialized services* to the sector within fully integrated and competitive financial markets. Latecomers should and can avoid *special housing finance circuits* that consist of narrowly *specialized institutions* whose housing finance activities benefit from special fiscal and regulatory privileges at the cost of important regulatory restrictions on their lines of business and their products. There are presently strong forces at work in favor of open housing finance systems. Trade barriers continue to decline and all economies are opening up to the world economy. This trend is supported by the rapid growth of global financial markets. In Eastern Europe, this means convergence with the rapidly integrating financial systems of the European Union.

Around the world the decline of special housing finance circuits coexists with the overall expansion of the total housing finance system.¹² The forces at work behind financial liberalization and innovations are associated with the new approach to macroeconomic management of most countries.¹³ Financial liberalization has led to many decisions including: the lifting of credit ceilings; changes in bank supervision in direct support of active risk management by financial institutions; the freeing of interest rates that permits the trading of fixed income securities, among which mortgage-backed securities of various kinds play a dominant role; asset powers deregulation in parallel with better financial markets for risk management; competitive deposits and savings market in which mutual funds play an influential role. Last but not least, the rapid emergence of private long-term investors such as pension funds and life insurance companies is expected to play a large and very positive role for the growth of efficient and effective housing finance systems.

If one had to venture a guess about the future, one would expect that the transition economies that have achieved low inflation and have adopted radical banking reforms will be the first to develop a modern housing finance system. Within this system we should find: full service deposit institutions that have chosen housing as one line of business, mortgage banking firms, secondary market facilities and an integrated, efficient and resilient overall financial system. Complementary to these private financial institutions, there will be public arrangements for the delivery of targeted public subsidies to special groups that should be transparent, distinct from, but often complementary to commercial housing finance. Knowing where they want to go will help these transition countries find the shortest path and avoid blind alleys.

¹² See, Douglas B. DIAMOND, Jr. and Michael J. LEA "The Decline of Special Circuits in Developed Country Housing Finance", *Housing Policy Debate*, Vol.3 , Issue 3, 1992, Washington DC.

¹³ In his opening address to the XXIst World Congress of Housing Finance Institutions, Governor Eddie GEORGE of the Bank of England clearly outlined the implications of the goal of a stable medium- and long-term macro-economic environment for the housing sector and housing finance.

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