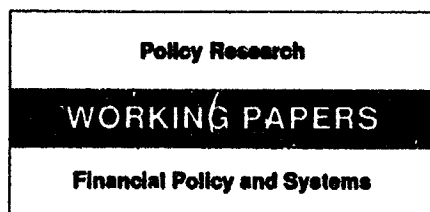


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# **Reforming Finance in Transitional Socialist Economies**

## **Avoiding the Path from Shell Money to Shell Games**

**Gerard Caprio, Jr.  
and  
Ross Levine**

**In several transitional socialist economies the financial system is in danger of becoming part of a shell game to hide the losses of the "real" economy. Rapid, successful economic reform requires putting the shell game to an end.**

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This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in the department to study financial reform in transitional socialist economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37664 (April 1992, 37 pages).

In the late 1980s, transitional socialist economies (TSEs) in Central and Eastern Europe were only somewhat more sophisticated than shell money systems: savings books or currency had to be used for most transactions and there was no risk assessment, information monitoring and acquisition, or portfolio management. The TSEs have moved toward a two-tiered banking system (at different speeds), but they lag in the development of competitive, market-based financial systems. In several TSEs the financial system seems to be part of a shell game to hide the losses of the “real” economy.

Caprio and Levine argue that rapid, successful economic reform requires putting the shell game to an end. They review several contentious issues of financial reform in the TSEs, especially issues involving macrofinance, corporate finance, the internal debt problem, and the need to build efficient banks.

Key problems in the financial sector are achieving some flexibility with interest rates, making the financial system competitive and

efficient, helping in the retooling of existing firms and the construction of new ones, building the banks' institutional capability for commercial lending (including improving the banks' monitoring capability and skills in assessing risk and credit), and cleaning up the heavy arrears in debts between enterprises.

Caprio and Levine contend that the banks should be “cleaned up” when they are privatized, to prevent the quick reemergence of debt problems. They believe that either of the proposed alternatives for shaping financial systems in the TSEs — very highly capitalized banking or narrow banking — would minimize the need for future support. The other alternative would reduce leverage in the TSEs and provide more financial stability.

But taking concerns about moral hazard to an extreme — prohibiting debt finance — could starve new firms for credit and limit economic growth. And without healthy growth, the reform-oriented resolve of TSEs resolve may wane.

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This paper has benefitted from comments with Farid Dhanji, Alan Gelb, Millard Long, Diana McNaughton, Dan Mozes, Robert Pardy, David Scott, Andrew Sheng, Larry Summers, Samuel Talley, and Dimitri Vittas. Mmes/Messrs McNaughton, Mozes and Vittas also contributed to the Appendix.

## I. Introduction

At present the Transitional Socialist Economies (TSEs) in Eastern Europe are at various stages in the evolution toward becoming market-based economies. In the late 1980s, financial systems in TSEs were only somewhat more sophisticated than shell money systems: savings books or currency had to be used for most transactions, and other features of and skills associated with modern financial systems -- such as risk assessment, monitoring, information acquisition, and portfolio management -- were absent. Now, the TSEs generally have moved to a two-tiered banking system, but they have not yet developed competitive, market-based financial systems and are reforming at different speeds.<sup>1</sup> Since countries are at different stages of financial sector reform and economic development, reforming at different speeds, and ultimately may be seeking different financial structures, there is not one "solution to" or "sequence for" reforming the financial sector. Moreover, internal and external advisers remain divided over how to encourage the development of a financial system that effectively mobilizes and allocates resources, so that the financial system can (1) contribute to the transformation of inefficient enterprises to internationally competitive companies and (2) foster the development of new, privately owned firms. Indeed, in several TSEs the financial system appears as part of a shell game to hide the losses of the "real" economy. This paper reviews briefly several contentious issues for financial sector reform in the TSEs, and argues that putting the shell game to an end is necessary for more rapid and successful economic reform.

Before listing the issues analyzed in this paper, it is important to mention three assumptions inherent in our study. First, we take as given that the TSEs in Central and Eastern Europe have decided to move toward a privately-owned, free market system based on existing economic structures in Western Europe and the United States, in part due to a reaction against government interference. Second, we assume that the countries have already adopted significant price and trade liberalization policies, so that, notwithstanding monopoly problems, reasonable price signals exist or are appearing to guide resource allocation.<sup>2</sup> Third, we believe that the financial and enterprise sectors are

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<sup>1</sup>Albania is expected to move to a two-tiered system in the spring of 1992. In Czechoslovakia, Romania, and Bulgaria over 98% of the banking sector is state-controlled (measured by bank assets, admittedly a tenuous indicator), while in Hungary, where reforms began in the mid-1980s, the comparable figure is less than 70%. In terms of privatizing existing banks, Czechoslovakia is planning to move quickly and privatize much of the banking sector early in 1992, while many other countries are still formulating plans to privatize existing banks.

<sup>2</sup>If prices are still grossly different from world prices, financial sector reforms may intensify the financing of sectors not viable in the long-run.

inextricably linked and that, therefore, appropriate reforms in the financial sector are inseparable from reform in the enterprise sector, which is in turn inseparable from price and trade liberalization. For example, the form and speed of enterprise privatization importantly affects the appropriate types and sequencing of financial sector reforms, while the speed and scope of trade and price liberalization may influence enterprise restructuring and privatization.

The issues that we address fall under four broad headings: macro-finance, corporate finance, the internal debt problem, and building efficient banks. By "macro-finance," we refer to both the role of the financial sector and the implications of financial sector reforms in maintaining and promoting macroeconomic stability. The section on "corporate finance" covers policies toward financial markets that have direct implications for financing the re-tooling of existing firms and the construction of new ones, including the breadth of activities in which the government permits banks to engage. "The internal debt problem" refers to the current situation in many TSEs where enterprises are unable to satisfy debt obligations incurred under socialism, thereby creating a variety of problems for the financial and enterprise sectors. We address various financial sector policies that may be used to mitigate the internal debt problem and minimize the probability of future such problems. Finally, we discuss a wide assortment of issues dealing with "building more efficient banks." Here we focus on changes in the structure of bank ownership, managerial incentives, bank restructuring, the role of foreign banks, and creating an enabling environment for new financial intermediaries to arise and function effectively. Some of this section deals with coping with the "heritage problem," i.e., policy makers must design reforms that fully recognize that existing institutions have inherited a stock of old debts, old managers, old institutional capital, and old business and political relationships.<sup>3</sup>

To limit the length and scope of this paper, we only briefly mention some of the most important and fundamental issues associated with reforming the financial sector. Thus, we take as given - or address only cursorily - some institutional pre-requisites for a well-functioning financial system that in many cases are not fully satisfied. We do this to focus on what we believe are the most contentious issues. For example, we do not study in depth the:

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<sup>3</sup>The paper broaches a fifth issue - human resource development - not because of a lack of agreement on its role but rather because outsiders seem to be underestimating the scope of the problem and the magnitude and type of technical assistance needed.

- i) Development of
  - Accounting and auditing systems,
  - Payment systems,
  - Human resources,
  - Prudential regulations,
  - Legal institutions, or
- ii) Provision of "specialized" finance to sectors such as agriculture and housing.

Although each of these issues is important in financial sector development, substantial agreement exists on the "first-order" aspects of these issues, even though differences persist at the implementation level. Nonetheless, it must be emphasized that financial sector reform in TSEs must involve the strengthening of legal and regulatory institutions, improvements in the accounting and payments systems, and enhancements in the financial skills of the work force.

Parts II - VI lay out some key issues in reforming the financial sectors of TSEs, concluding notes are made in part VII, and the appendix briefly reviews where the TSEs in Eastern Europe stand in financial sector reform. The analysis raises some cautionary flags regarding certain strategies while giving qualified green lights for other approaches. We argue that there are two potentially fruitful approaches to financial sector reform, taking account of the exceedingly risky environments in which TSE financial institutions will operate for several years to come. The first alternative would be to allow private banks with broad powers, but, recognizing that the government may find it difficult not to rescue depositors, calls for high capital ratios well above those recommended by the BIS.<sup>4</sup> A second possibility -- the so-called narrow bank approach -- would allow any institution to call itself a bank if it took deposits and invested funds only in short-term and secure instruments.<sup>5</sup> Other institutions could take deposits, make loans or take equity positions, acting like universal banks in fact, but would be explicitly excluded from government provided deposit insurance. A combination of the two approaches, in which capital requirements and portfolio choices would be tiered according to the proximity to the payments system, could be attempted, where the supervisory system has attained some

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<sup>4</sup>The issue of privatizing existing banks is left to Levine-Scott (1992).

<sup>5</sup>For more on narrow banks, see Lawrence (1985), Lawrence and Talley (1978), and Litan (1987).

sophistication. Any of these options would limit the supply of debt finance, compared with a "wildcat banking" extreme, perhaps leading to more stable firms.

Furthermore, we argue that the two extreme approaches to bank privatization -- either privatize all of the state banks or none of them -- are strategically and economically unwise. We deem it important to start the privatization process, as incentives matter as much in this sector as in any other. Privatization of the financial sector does not have to be "all-or-nothing," especially if the all-or-nothing condition delays privatization. Moreover, a "big-bang" privatization of banks could be disastrous; in countries with explicit or implicit government deposit insurance, rapid large scale privatization could overburden existing regulatory and supervisory capabilities and lead to a financial crisis that impedes the entire reform program. Thus, we recommend that countries begin the privatization process as soon as possible and coordinate this process with the establishment of regulatory capabilities and imposition of sensible capital requirements (in line with the powers granted to banks). Also, we would advise against attempts to privatize banks before cleaning up pre-existing losses. Economic efficiency, government credibility, and social fairness -- especially if domestic residents are willing purchasers -- suggest a portfolio clean up on the eve of privatization.

We believe that it is both important and useful to consider the consolidated balance sheet of the government, i.e., the balance sheet that includes state-owned enterprises and state-owned banks. Not only is it misleading to consider the government fiscal budget independently of state-owned banks and enterprise, but this isolated view can lead to misguided and counterproductive policies. Specifically, loss-making firms that remain open must cover their losses through credit from the banking system, budget subsidies or arrears on taxes, or interfirm credits/arrears. In any of these cases, the government (defined appropriately broadly) is incurring losses, and these losses should be explicitly recognized, not "hidden" in bank or inter-enterprise accounts. Allowing either the banks or firms to make loans that cannot be repaid merely defers a government obligation. Since deferral likely raises the cost of dealing with problem firms, a program to cut losses now, through explicit provision of budget support both to keep some firms open and to close others down immediately is preferred. Explicit recognition of these costs may call into question other aspects of reform programs, such as the pace of trade and price liberalization and/or the appropriateness of the exchange rate. We realize that it is exceedingly difficult to value accurately the assets of the consolidated budget and that "truth in budgeting" will be difficult to

sell, particularly given the political costs to ending the shell game. We stress, however, that exposing and explicitly addressing the losses will increase the odds of real sector gains.

Lastly, we argue that the scope for technical assistance that will have a high payoff is immense. Long term secondment of skilled professionals should form the focal point in this effort, on a scale unprecedented in financial sector work. The current supply-driven provision of technical assistance in TSEs risks producing a hodgepodge of approaches to financial sector development and regulation, and we expect that only the on-site presence of advisers can help sort out consistent recommendations for individual countries.

## **II. Macro-Financial Policy**

The state of the financial sector is important to the implementation of macroeconomic policy, and financial sector reforms can importantly influence the macroeconomic environment. This section discusses three aspects of the linkages between financial structure and financial sector reforms on the one hand and macroeconomic developments and macroeconomic policy implementation on the other. We first discuss fiscal policy. Current and future government budgetary requirements are mounting in many TSEs as governments confront financial sector problems by explicitly assuming responsibility for some bank loans, guaranteeing new loans both to bolster bank balance sheets and aid state enterprises, and promising to satisfy unfunded pension liabilities. We next discuss the implementation of monetary policy and analyze mechanisms for developing better methods than the rigid bank-by-bank credit ceilings used in most TSEs. Finally, we analyze the ties between policies toward interest rate determination and the macroeconomy. Although we assume that the objective is market-determined interest rates, experience suggests that during the transition to a market-based economy some interest rate controls may be beneficial in terms of macroeconomic stability and microeconomic efficiency.



### A. Fiscal and Quasi-Fiscal Deficits

Macroeconomic stability in TSEs will depend a great deal on how governments respond to fiscal pressures from a variety of sources. In addition to traditional expenditure and taxation pressures, TSE governments also are confronted by substantial uncovered actual or contingent liabilities of the public sector, which often are discussed under the heading of "quasi-fiscal" activities. Prominent examples include large foreign exchange debts (Yugoslavia, Poland, and Hungary), bad debts of commercial banks (too numerous to be delineated), unfunded pension liabilities, and government guarantees for loans to large state enterprises. Whenever the government makes a "promise to pay" and does not fund this position, it adds to pressures eventually to default, seek budgetary savings elsewhere, or monetize the debt. When the activities are on-budget, or in a separate fund, the situation is transparent: interest payments will have to be financed, and eventually principal repaid. However, when these items -- most often foreign debt and bad commercial loans -- are on the central bank's balance sheet, problems may be disguised, especially when inflation and high interest rates help produce nominal profits for the central bank, even though foreign exchange losses or bad domestic currency loans may leave its net worth negative.<sup>6</sup>

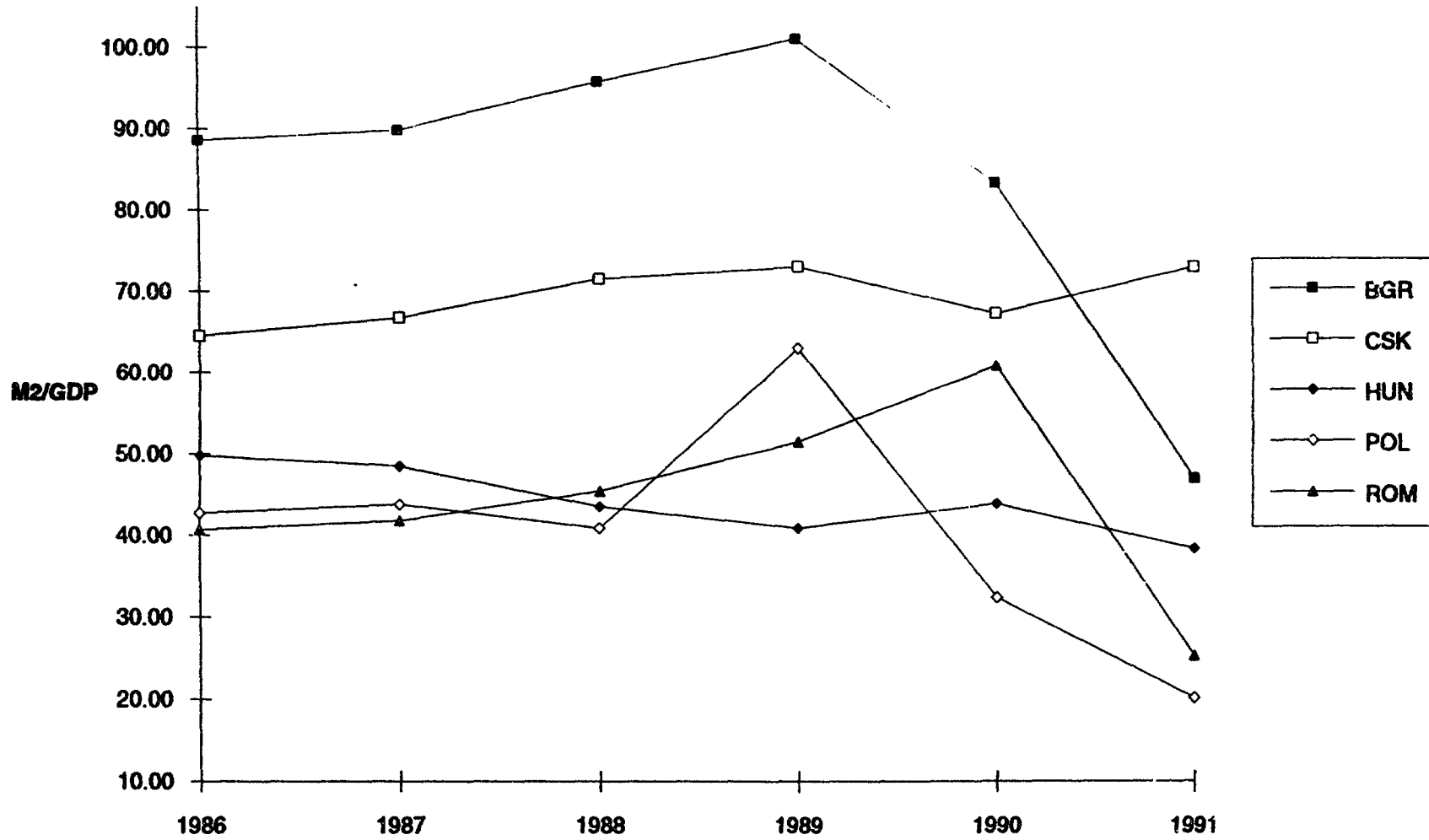
As explicit or quasi-fiscal revenue requirements rise, there will be important implications for the financial system. While a well-functioning government securities market could help smooth the time-path of marginal taxes, inflationary finance combined with rigid interest rate policy could create distortions that adversely affect financial sector development. Thus, financial sector policies must be aligned with fiscal financing decisions. Furthermore, revenue requirements may encourage explicit or implicit taxes on financial market activities that impede financial market development. While all sectors will have to bear the costs of adjustment, the financial sector is a ready target for revenue raising. These taxes should be explicitly compared with alternative revenue options since restrictions on financial sector development may slow structural adjustment and stymie economic growth. Driving residents out of the financial system may entail costs in the future, as it often proves difficult to win back public confidence. As seen in Figure 1, the decline in broad money, relative to GDP, in Bulgaria, Poland, and Romania already has been quite large, and there is no clear evidence of any remaining monetary overhang, as

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<sup>6</sup>As Rocha (1991) notes, notwithstanding negative net worth, the central bank may still pay part of its nominal profits over to the budget.

Figure 1

Monetary Depth in TSEs



monetary depth is about at or below what would be expected for countries of equivalent per capita incomes. Thus the authorities might want to look elsewhere for tax revenue.

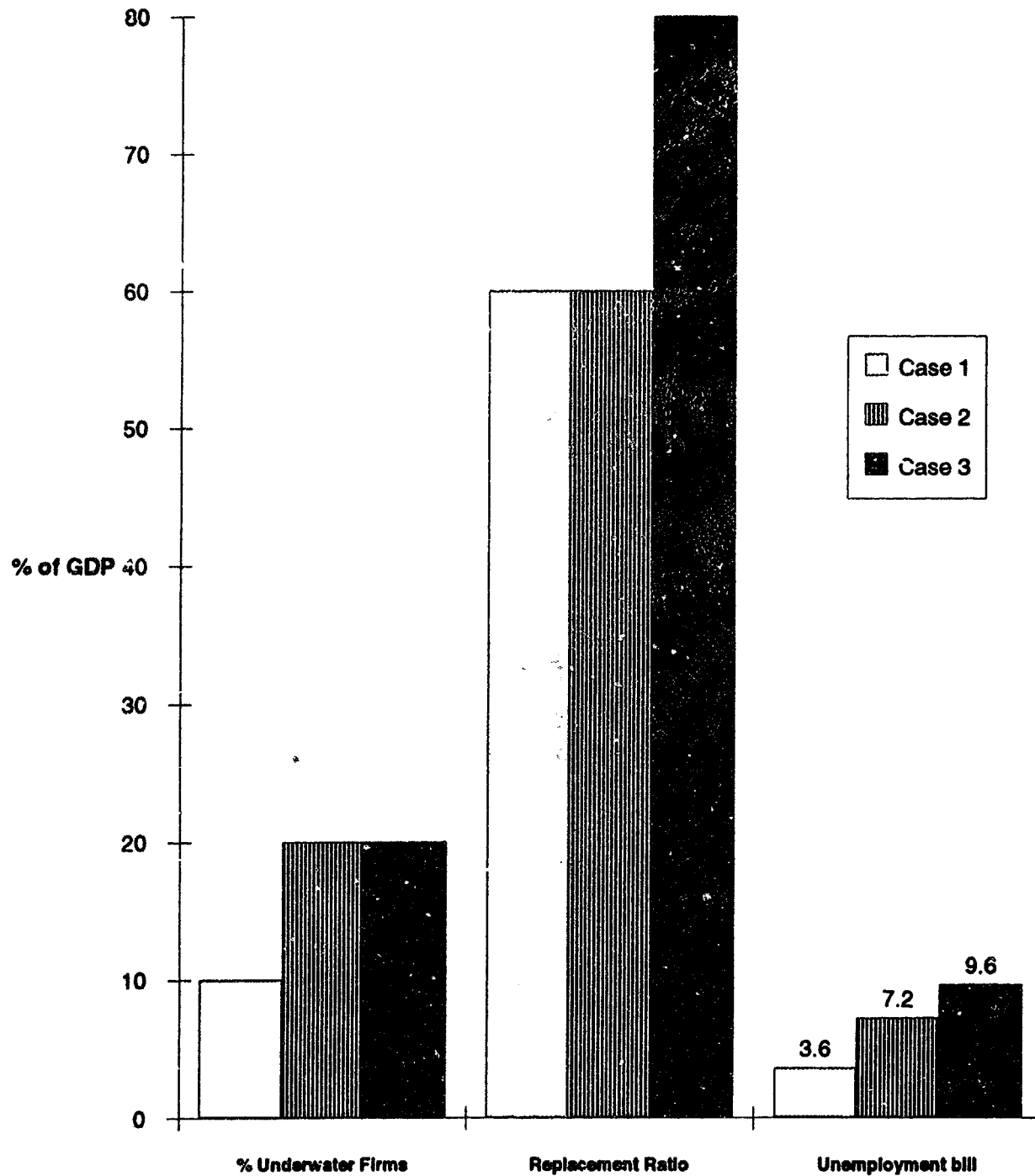
Recognition of the liabilities associated with enterprise and financial reform and avoidance of attempts to bury them in the central banks' balance sheets is important; equally crucial, governments should not issue an excessive quantity of loan guarantees to state enterprises. Additionally, large unfunded pension liabilities demand a reexamination of both eligibility and contribution rates, and suggest added impetus to stimulate the development of contractual savings institutions. Simply put, ending the shell game (moving losses around in an effort to hide them) may help focus attention on the causes of the losses and a re-examination of government commitments.

At some stage in the reform process, most TSEs face large interfirm arrears that sooner or later have to be addressed by government. These arrears typically reflect a combination of restraint on bank credit and outright budget subsidies, combined with an unwillingness to close or scale back loss-making firms. Arrears are likely in most TSEs because of the absence of any ownership control at the firm level, together with poorly defined, if any, bankruptcy proceedings. Arrears are often the least efficient form of credit, as they represent loans created at will by borrowers, and can only be prevented by suppliers demanding payment (in cash or kind) at delivery. And the arrears typically do not net to zero: firms with negative value added -- those using resources to produce output that is virtually unsalable -- use arrears to cover their losses, with little hope of ever repaying. As in Romania in 1991, the arrears can cumulate to the point that they threaten to wipe out the better firms, and then necessitate their assumption by the government. Ending arrears, without disciplining firms that cannot cover their variable costs, will lead to some other manifestation of the losses: the shell game will continue, with the only uncertainty being the next location of the losses. To avoid the shell game and improve the efficient operation of banks and enterprises, governments should explicitly finance loss making state-owned firms that the government has chosen to keep afloat and not force banks or other enterprises to finance the losses.

Shutting down firms will force authorities to cover unemployment and any retraining costs, while open loss-making firms will require subsidies to remain afloat. Figure 2 shows some scenarios for explicitly covering these transition costs under simple assumptions about the percentage of "underwater firms" (those not covering variable costs under rational prices), the wage bill, and the

Figure 2

**Fiscal Consistency in Reforming Economies: Some Alternatives**



replacement rate (fraction of wages replaced by unemployment benefits). Specifically, we assume that the wage bill equals 60% of GDP, a rough figure for many industrial economies and that replacement ratios are high (60% - 80% of average wages, as is presently the case in Eastern Europe). Three cases are considered: in case 1, "only" 10% of workers are laid off (or subsidies are paid equal to what would have been paid had the plant in question been closed<sup>7</sup>) and the replacement ratio is 60%, presently at the low end of the range in TSEs. Case two assumes a higher fraction of underwater firms, but with the same replacement ratio, while the final case pairs this higher fraction with a high replacement rate. The resulting budget deficits (4% to 10% of GDP) would occur if all other budget commitments are covered by revenues and if governments continue to offer generous replacement ratios for unemployment compensation. Deficits of this order of magnitude may be difficult to sustain for long, and any program would have to involve explicit sunset limits for subsidies and unemployment benefits. If the resulting deficit still is too high, it suggests that the government:

- must rapidly find other budget savings, including a reconsideration of replacement ratios;
- has opened too large a part of the economy to import competition and may need to consider import surcharges (again with firm sunset limits) both to raise revenue and reduce the fraction of the labor force in uncompetitive firms.
- should reconsider exchange rate policy, especially if a "dirty" float is sustaining the currency.

Note that in addition to adding realism to budget and credit programs, explicit recognition of the budget costs, together with credible schedules for their elimination, would put more pressure on workers and firms to adjust. Budget targets that merely call for restraint, without addressing these transition costs, act to delay reform and insure the creation of involuntary credit somewhere in the system.

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<sup>7</sup>Admittedly this appears extreme, but may not be. Many firms may be able to cover some fraction of their labor costs. However, since high unemployment will be difficult for many TSE societies to tolerate, authorities may well keep open plants for which it would be cheaper to pay unemployment compensation instead of subsidies.

## B. Credit Control

Achieving control over credit growth is of paramount importance, especially in the early stabilization stage of the reform process. Countries further along (Hungary) in financial sector development can use reserve requirements, central bank refinancing, and eventually various indirect methods for injecting and draining liquidity. However, at the other end of the spectrum are economies with less developed financial systems and with evident inflation concerns (Romania and the Soviet Republics); here, implementation of an aggregate credit target will require temporary bank-by-bank credit ceilings to ensure no loss of monetary control. Needless to say, even successful achievement of an (official) credit target will be meaningless if firms are free to create credit on their own.

A real danger of bank-by-bank ceilings is that monetary authorities tend to enjoy the extent of their apparent control and are concerned about giving up such influence. Moreover, they have seen the difficulties in industrial economies, where fickle changes in velocity have posed problems for central banks relying on indirect targeting methods. And, as is well known, bank-by-bank ceilings impede competition even when they are based on an individual bank's success at deposit mobilization.<sup>8</sup>

However, in practice, prolonged reliance on direct methods of implementing monetary policy has revealed this control to be illusory, as financial institutions find ways around the ceilings, such as by the disintermediation of the banking system. Thus, TSEs using bank-by-bank ceilings should put in place plans for a switch to less direct methods of implementation. As the macro environment stabilizes, authorities could use a system of (low and remunerated) reserve requirements with auctions of refinancing rights at the central bank (to inject liquidity) and of various certificates (deposit rights, central bank certificates, or Treasury bills) at the central bank (to absorb liquidity). Alternatively, some type of repurchase system could be employed.<sup>9</sup> It is widely thought that deep secondary markets in

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<sup>8</sup>Basing quotas on deposit mobilization rarely stimulates much competition, as banks often appear unwilling to mobilize deposits today for the ability to lend in the future. Instead, or in addition, participating institutions could be allowed to trade their unused quotas, since the authorities' real concern is that the aggregate ceiling be respected. Alternatively, a system of escalating penalties (marginal reserve requirements) could be levied when banks exceed their limits, making the individual ceilings more like targets.

<sup>9</sup>Repurchase agreements (Repos) are convenient because of the lack of any restriction between the underlying instrument and the term of the repo itself (see Chapter 1, Caprio and Honohan, 1991). These instruments can be used regardless of whether the authorities attempt to target money or credit, or to adopt the eclectic approach to policy in force in several industrial economies. Alternatively, the authorities could open the capital account and peg the exchange rate, and thereby

government paper are needed to abandon direct controls, but in fact most industrial economies rely not on open market operations but on repurchase agreements between the central bank and commercial banks to effect policy. This type of intervention merely requires that banks have some assets on their balance sheets that can be securitized.<sup>10</sup> The central bank can do much to spur the development of markets and skills needed to support less direct methods of monetary policy. As these developments take hold, the direct controls can be phased out.

### C. Interest Rate Policy.

In most markets the argument for rapid liberalization of prices is clear cut. However, experience argues that one price that should be dealt with carefully is the intertemporal price of money. Premature attempts to liberalize interest rates fully have resulted in a number of problems. The key risk is that, in the absence of ceilings on interest rates, banks with little capital would bid up deposit rates in order to attract deposits to fund continued loans to risky borrowers, to the detriment of more worthy, prudent ventures, and can lead to a spread of bankruptcies and a collapse of the banking system.<sup>11</sup> It should also be noted that high real rates may serve little purpose in TSEs: until state-owned enterprises (often monopolies) respond to competitive market signals, they will either pass-on such costs or not pay.

In general, full liberalization of interest rates should be considered when:

- macroeconomic conditions are reasonably stable;
- the financial condition of banks and their borrowers is sound;
- financial markets are reasonably sophisticated; and

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attempt to import the policy credibility of another central bank.

<sup>10</sup>Although most industrial economies use some government paper as the underlying asset, others use central bank paper or even an approved list of performing loans.

<sup>11</sup>The Chilean reforms of the mid-70s and Turkey's liberalization in the early 1980s, often cited as examples, entailed reported (ex post) real interest rates of 20% to 50% (and at times higher!) that were sustained for long periods of time. Bankruptcies also soared, particularly in Chile. Similarly, in a highly concentrated environment, banks might charge high spreads.

- financial markets are sufficiently competitive or contestable.

In some of the TSEs, none of the above criteria is met, suggesting caution in freeing interest rates. Wherever there is no control or market incentive system at the firm level (as then risky or loss making firms will not be eliminated from bidding for credit no matter what the interest rate), interest rate controls should be maintained (as argued by Dooley-Isard, 1991). In Hungary (and Egypt, also in effect a TSE) indirect methods of implementation (through treasury bills) are in use and appear to be working well, and many rates (those not associated with directed credit) are essentially market driven.

For countries not yet ready to liberalize interest rates, authorities can strive to rationalize their structure -- that is, eliminate the largest interest subsidies -- and aim for positive real rates. With the difficulty in estimating expected inflation, attaining positive real rates will not be straightforward. Since monetary policy in most cases is being determined by aggregate credit targets, the authorities' main goal is to ascertain that deposit rates are high enough to mobilize sufficient resources and that banks are allowed a sufficient spread. Unless a deliberate attempt is being made to erase a monetary overhang by inflation or by a large wave of privatizations, authorities should at the very least raise interest rates on very short term deposits when overall deposits cease to grow in nominal terms or (preferably) in line with some estimate of inflation. The banks should then be allowed to set remaining deposit rates themselves. Minimum deposit rates could be linked to a central bank discount rate, adjusting automatically whenever the latter varied.<sup>12</sup> A rigid structure of interest rates should be avoided: if the authorities are putting a floor on short-term deposit rates, and are using current inflation to determine real rates, they should be prepared to adjust it on (say) a 3-month, moving-average basis.

In some TSEs competition is limited, with most borrowers in practice able to borrow only from a limited number (1 or 2) of banks. In these countries a cap should also be considered for the average spread between deposit and lending rates. However, if imposed, the limit should be kept well above the average deposit rate (at least 5 to 10 percentage points, higher if capital requirements are raised above BIS standards) to allow for the financing of projects with a high rate of return, as well as to provide for adequate remuneration for banks, who will surely need to be taking liberal provisions on new

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<sup>12</sup>In some of the TSEs, banks with large numbers of accounts find it difficult to adjust interest rates often, as accounts are maintained without the use of computers or calculators.



loans in a risky environment.<sup>13</sup> A limit on spreads between average lending rates and average borrowing rates would provide the greatest amount of flexibility for banks (in lending to somewhat riskier projects), compared with an absolute limit on lending rates. However, it should be realized that banks can evade interest rate ceilings (for example, by charging commissions or requiring compensating balances) especially if the limits are allowed to persist.<sup>14</sup>

### **III. Corporate Finance: Intermediaries, Securities Markets, and Directed Credit**

The major issue facing TSEs is the financing of new plant and equipment in both existing industries and emerging firms.<sup>15</sup> Indeed, this paper's analysis of Macro-Finance, "Old" Loans, Bank Efficiency, and Human Capital Development can all be viewed as issues associated with encouraging the development of a financial system that mobilizes and allocates resources efficiently. The present section discusses the channels through which savings make their way to productive endeavors. Within the special context of TSEs, we describe the problems with relying on each of these channels to intermediate between savers and investors. Besides creating an enabling environment by promoting a sound legal system and effective supervision, we also describe more activist government involvement in channelling resources to worthy projects.

**Banks.** Although loan-issuing banks are typically major conduits of external resources to promising enterprises, there are two elements of the existing environment in reforming central and eastern

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<sup>13</sup>This assumes that the banks' portfolios have already been cleaned. It is not recommended to allow banks with a large amount of non-performing loans to cover their losses with high spreads on new loans, the consequences of which are elaborated in the World Development Report, 1989.

<sup>14</sup>In China this type of administered interest rate policy has been followed with mixed results. The main success had been in the field of deposit mobilization, attributable in part to the maintenance of realistic deposit rates. Average real deposit rates were, with one exception, slightly positive in real (ex post) terms between 1970 and 1984, and have returned to positive levels following their drop in 1988-9. The absence of substantially negative real interest rates likely played a role in maintaining China's high savings rate. On the other hand, the authorities allowed only a very narrow spread (sometimes negative) between deposit and lending rates, and continue to allocate credit, thus contributing to a mis-allocation of resources, albeit one that is difficult to measure.

<sup>15</sup> Finance of working capital and trade is less of a problem, especially in the more advanced TSEs. However, when there is a large arrears problem, even short-term, relatively secure credit can suffer.

European countries that suggest that other sources of finance may have to play a larger than expected role: (1) the huge structural shocks that have hit these economies would have damaged and made tentative any banking system; and (2) the environment is characterized by great uncertainty. Even (especially!) if these countries had the "best" banks, bankers, legal structures, and regulators, banks probably would be reluctant to be major financiers of emerging firms, and may even hesitate to lend to all but the very best credit risks. Thus, retained earnings and non-loan making financial intermediaries may play a particularly important role, and there are some debatable arguments for specific public policy actions to prod the dominant existing financial institutions - banks - to finance more aggressively emerging firms during the transition.

In a very uncertain environment, replete with informational asymmetries, retained earnings may be an especially important and efficient form of corporate finance. A crucial complicating factor for some enterprises, however, is that they are burdened with debts incurred under socialism. Consequently, these firms are paying interest and principal to banks instead of having more retained earnings available for investment. While financial commitments should be enforced, it is not clear whether state-owned firms that were issued credit as part of the previous regime have a commitment in a market based system to satisfy those debts or whether the government should explicitly assume them. In terms of promoting efficient corporate finance, explicit assumption of past debts by the government would increase retained earnings and thereby enhance the resources directly available to firms for investment. Of course even with debt relief, many existing firms are not viable in the current environment.

Universal Banks, Other Intermediaries, and Securities Markets. In a highly risky environment where loan issuing banks are reluctant to finance emerging firms, the decision by most TSEs to allow banks to purchase equity in firms increases the potential return (and risk) from financing risky ventures without the adverse selection problems associated with raising interest rates on loan contracts. Nonetheless, policy makers should be cautious and particularly aggressive in establishing appropriate supervisory and regulatory agencies, since close ties between banking and industry has often had disastrous consequences in developing countries. Most TSE banks are still learning the basics of commercial banking and may merely acquire bad debt and bad equity, instead of just the former. Moreover, the economic environment is fraught with risk, especially associated with economic policies, and supervisory capacity is limited.

Non-bank financial intermediaries such as mutual funds, investment banks, and venture capital funds may play an increasingly important role in financing growing enterprises. Policy makers should anticipate these developments and adopt (1) legal codes and institutions to enforce contracts and (2) regulatory guidelines and enforcement mechanisms to oversee the spectrum of financial market activities likely to evolve.

Many TSEs in central and eastern Europe are moving quickly to establish securities markets. In addition to facilitating corporate capital financing through public offerings, these markets provide financial services that complement banks by increasing the liquidity associated with holding equity, facilitating the ability of individuals to hold diversified portfolios, and allowing individuals to adjust their portfolios more easily after large-scale privatization occurs. In addition, there may be positive dynamic interactions between securities markets and the evolution of mutual funds, investment banks, and venture capital firms.<sup>16</sup> Thus, the financial services provided by equity markets and the financial institutions assisted by the existence of equity markets should importantly complement banks and retained earnings in financing investment.<sup>17</sup> Still, firms need to be monitored, and it is plausible that banks can better perform this role (by regulating the supply of external funds) than can large shareholders (by using the blunt instrument of removing managers).<sup>18</sup>

More Activist Policies. In terms of corporate finance, policy makers face a common problem: is the optimal policy to simply provide an enabling environment, or is there a role or obligation on the part of the government to participate actively by providing finance to specific industries or by setting credit guidelines for financial intermediaries?

Given the problems involved in restructuring large state enterprises, governments will have to be involved, perhaps through an interministerial council or a state ownership fund. Smaller firms, the restructuring of which will be politically sensitive, can be left to the banks to handle. Where the government has decided to funnel credit to state-owned enterprises, it should consider: i) explicitly

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<sup>16</sup>Robert Pardy (1992) develops this point.

<sup>17</sup>It is worth noting that direct foreign investment, trade credits, and foreign loans may help fund corporate capital formation. This paper, however, only discusses international finance in the context of foreign financial intermediaries establishing or undertaking cooperative ventures with domestic financial institutions in TSEs.

<sup>18</sup>Scharfstein (1992) cites this arguments as a lesson from the Japanese experience.

providing credit, or ii) using specialized institutions to lend to these firms, instead of directing state-owned banks or private banks on where to loan funds.<sup>19</sup> This not only improves accountability, it keeps state-owned bank balance sheets from deteriorating further because of political considerations. Thus, explicitly separating government credit decisions from sound banking practices should enhance banking skills, financial discipline, and the ability to privatize banks. Loans made by banks under socialism to large enterprises that are currently making losses should perhaps be assumed by the government to promote sound banking practices and curtail the political nature of credit decisions made by banks. Banks should not be called upon to enforce hard budget constraints on large, state-owned enterprises where political considerations play an overriding role. Indeed, private banks may have a tendency to loan money to state-owned enterprises regardless of enterprise profitability, to the extent of implicit or explicit government guarantees. This behavior could reduce the availability of credit for emerging enterprises, especially if the government guarantees a substantial amount of credit for state-owned enterprises.

Financing emerging enterprises raises another set of policy issues. There are good reasons to suspect that formal financial institutions may be reluctant or slow to finance emerging enterprises. As noted above, banks may retrench over the next few years, especially from providing long-term capital, just when emerging private sector firms need financing. Thus Hungary, the farthest along in the transition process, has seen a lack of long term finance (Vittas and Neal, 1992). In addition, current loan decisions may be strongly influenced by past loans and government guarantees, rather than by future profitability. Since TSE governments are attempting to move away from excessive involvement in economic activity, imposing directed credit guidelines on financial intermediaries may not be attractive. However, governments may wish to spell out a schedule for the decline of the proportion of total credit that is extended to state enterprises. This might free resources for new private sector firms and of course would put a deadline on restructuring/privatization decisions. If directed credit schemes are used for new firms, government interference in credit decisions should be broad based, allow banks discretion in choosing customers, and transparent. Governments, with World Bank assistance, could support the emergence of accounting and auditing firms to improve the transparency and accuracy of the financial statements of local firms, thereby mitigating some of the informational problems impeding the provision of bank credit to emerging enterprises. Lastly, it is worthwhile noting that in the case of Hungary, state-

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<sup>19</sup>If specialized institutions are used, they should be funded either directly from the budget or by bonds, but not by deposits. These institutions could have an advantage in monitoring loans to the extent that they were able to hire professionals with banking skills.

owned banks are trying to establish business relationships with emerging firms, but resolving and restructuring old debts interferes with the ability of banks to make loans to new customers. Thus, in the case of Hungary, the government determining where to direct credit is not the major issue; the problem is the large inherited stock of debts from under socialism.

#### A. The Shape of the Financial System

One extreme view on corporate finance (McKinnon, 1992) is that, because of problems of moral hazard, inherent risk, and insufficient supervision, in the early stages of transition all finance should be through retained earnings and equity. He would also leave the privatization of banking until the completion of the reform process. We agree that the environment is risky, and would argue that a narrow banking model, in which "banks" are only permitted to collect deposits and invest funds in short-term, low risk instruments, has some merit as a solution to problems facing TSEs. Other firms -- "nonbanks" -- would be permitted to take deposits or equity shares (like money market mutual funds) and make loans or hold equity positions in nonfinancial firms. These firms would still need to hold capital and to be supervised, with capital ratios and supervision increasing in accordance with the "nearness" of instruments to the payments system. That is, if these nonbanks are permitted to offer fixed rate, checkable deposits, then capital and supervision should be higher than if they only offer equity-like claims, such as money market mutual funds (checkable) or non-checkable mutual funds. With banks essentially risk free, the government should not rescue the "nonbanks" that get into difficulties. Indeed, these nonbanks could be restricted from calling themselves banks. Only banks would be part of the clearing system, so that this alternative has the advantage of safeguarding the payments mechanism. A difficulty with this option concerns the risk faced by banks if they are allowed to hold even very short term paper of either supposedly safe "nonbanks" or enterprises. Clearly the greater the holdings of such paper, the greater the need for capital. Early on in the reform process only government paper might qualify as a potential asset for narrow banks. However, if residents are quite risk averse -- have a high demand for guaranteed narrow bank deposits -- then small and medium scale firms in the private sector will be starved for funds.<sup>20</sup>

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<sup>20</sup> If residents are quite risk averse, the interest rate on government paper might fall to zero, or below. For a discussion of narrow banks in a U.S. context, see Lawrence (1985, Lawrence and Talley (1987), and Litan (1986).

We would eschew McKinnon's extreme position of banning debt finance, in part because of the dearth of examples of financial systems relying solely on self-finance and equity.<sup>21</sup> The absence of debt finance likely would limit investment and restrain growth, but without more rapid growth the entire reform process is in jeopardy. Moreover, TSE governments seem determined to try to emulate a view of the German/European universal banking model, and may well be averse to not having "real" banks. Thus a narrow bank model may well prove unacceptable.

A second alternative would be to establish high risk-asset ratios -- perhaps on the order of 10% - 15% -- to allow for the riskiness of the environment. A high capital ratio would automatically limit the number of commercial banks to be supervised, an important consideration with nascent supervisory systems. Such a ratio also would achieve the goal of a low leverage rate for nonfinancial firms. Banks should be allowed to earn spreads commensurate with the capital ratio in effect, as suggested above. If well capitalized banks still fail, the cost to the government should be minimized by allowing depositors to experience losses.<sup>22</sup> As banks, supervisors, and policy makers acquire greater experience and the macro environment stabilizes, these capital ratios could be lowered, and indeed we view it as urgent to devote more resources to institution building and training. Lastly, a hybrid of these two alternatives -- whereby capital and the list of allowed activities would be tiered according to the proximity to the payments system -- may work, but may require more supervisory skills than many TSEs possess at present.

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<sup>21</sup>McKinnon cites rural China in the 1980s and the Soviet Union during the 1920s.

<sup>22</sup> Many observers argue that higher capital ratios may induce greater risk taking or that capital can disappear quickly when a bank gets into trouble. Even so, we believe a capital ratio of say 15% will lead to a lower failure rate among banks in TSEs than a capital ratio of 5%.

## IV. Inheritance of Old Loans: Current and Future Problems

### A. The Size of the Bad Loan Problem.

Many enterprises in transitional socialist economies are unable to service their debts to banks.<sup>23</sup> The size of the "bad" loan problem is very difficult to estimate. Enormous changes in relative prices, poor information and uncertainty regarding enterprise profitability and viability, the absence of accurate enterprise accounts and reliable bank audits, macroeconomic instability, and the unsure pace and durability of privatization and liberalization make it impossible to assess accurately the magnitude of the bad loan problem. These same complicating factors make it difficult to determine the ability of any one enterprise to satisfy debt obligations. Although subject to error and change, the bad loan situation is "large" in many countries. Estimates from selected audits suggest that 20% to 25% of total bank loans may have a good probability of being repaid. This low figure reflects "original sins" at the time the reform process began, the decline of CMEA trade, and often sharp falls in output.

### B. Implications of the Bad Loan Problem.

Capital Allocation. As argued in Levine-Scott and Dooley-Isard, the inherited stock of bad loans is directly distorting the allocation of credit and indirectly impeding improvements in allocative efficiency. Banks are issuing credit to troubled firms to help them pay wages and service old debts and are not establishing business relations with emerging private firms as aggressively as might occur in the absence of a large stock of bad loans. Furthermore, the unresolved state of old debts, their potential seniority to new debts, and the difficulty old debts introduce in attaching secure collateral claims for new loans hinder efficient capital allocation. Finally, the large stock of bad loans retards improvements in capital allocation by slowing the pace of bank privatization, thereby delaying enhancements in incentives and the importation of foreign expertise through joint ventures. Indeed the inability of banks to make sound credit decisions could impede transition and contribute to a decline in economic activity.

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<sup>23</sup> In addition, banks in some countries are losing funds because they provided loans at subsidized interest rates. For example, interest rate subsidies on housing loans in Hungary amounted to 2.3% of GDP in 1989, and the government is directly compensating the banks for these losses.

**Operational Efficiency.** Bank insolvency impedes the reorientation of management and staff toward more profitable banking operations, so that limited human resources are focused on resolving old debts rather than on acquiring new skills and implementing new operational procedures. Moreover, it is argued that the current ineffective organizational structure (with the centralized design of the banking system) facilitates substantial interactions among the banks, governments, and enterprises that are required to workout the old debts. Thus, the overhang of inherited debts impedes improvements in the operational efficiency of banks. It must be emphasized, however, that the debt overhang impedes but does not prevent improvements. In many countries, banks have invested in training their staffs and have initiated business ties with new enterprises, but inherited loans are slowing these advances.

**Supervision and Regulation.** Establishing sound bank supervision and regulation in TSEs is a complicated task for a number of reasons. In terms of bank credit, the banking system is highly concentrated and insolvent, where losses typically exceed capital by several multiples. This makes it very difficult to supervise and regulate banks in a consistent and effective manner because (1) supervisors and regulators are unable to close down non-viable banks because of their size; (2) political pressures on the large state-owned banks to lend to specific enterprises may conflict with sound bank regulations; and (3) since the net worth of many banks is negative, standard capital adequacy requirements cannot be applied to major banks. These factors hinder the provision sound regulatory oversight of the major banks and make it virtually impossible to establish consistent guidelines for financial institutions.

At the same time that bank concentration stymies effective bank oversight, the rapid emergence of new banks can overwhelm efforts to train adequate staff and prepare effective guidelines for licensing, supervising, and regulating new banks. Changes are occurring quickly in the financial sectors of many TSEs and authorities are having difficulties providing sound oversight of financial sector developments, which may set the stage for future financial instability. These factors may impede the application of clear supervisory and regulatory guidelines to emerging financial intermediaries.

**Privatization. It is difficult and even irresponsible to privatize highly insolvent state-owned banks in transitional socialist economies.** Not only are there high costs and great uncertainties associated with evaluating the market value of bank assets, the negative net worth of banks implies that (1) many banks might be quickly liquidated if privatized and (2) new owners with little capital at risk might engage in extremely risky ventures that could magnify losses. Since existing state owned banks compose the bulk



of the financial system in these countries, privatizing banks in their current state could jeopardize the stability of the monetary and payments system.<sup>24</sup> Furthermore, the likely negative consequences of privatizing insolvent banks would damage policy maker credibility.

### C. Resolving the Bad Debt Problem

There are no attractive policies for coping with large, insolvent, state-owned banks because they all involve the recognition and assumption of losses. Furthermore, even if the bad debt problem disappeared, losses in the enterprise sector, an insufficient number of well-trained bank managers, bank staffs, regulators, supervisors, lawyers, and the lack of firmly established legal, accounting, regulatory institutions suggest that the bad debt problem may quickly reappear. Nonetheless, the existing bad debt problem must be confronted, and resolving the bad debt problem in a cost effective way should assist the formulation of forward looking financial sector reforms focussed on creating a healthy and secure domestic financial system over the next years. In the remainder of this section, we briefly discuss approaches that have been widely used - often in various combinations - and other approaches that are being suggested for TSEs. Of course, unless fundamental changes are instituted, the bad loan problem is likely to quickly reappear (as seems to be the case in Poland, Romania, and Bulgaria), and countries will be left only with the costs of higher inflation.

Deposits. One option is to "tax" deposits. This could take many forms from simple expropriation to inflation. In Poland, Yugoslavia, Bulgaria and Romania (where government deposits in banks temporarily played an important role in restoring bank solvency), inflation has lowered the value of deposits (recall Figure 1, above). Since most TSEs have already reduced the tax base, ever higher inflation rates will be needed to utilize this revenue source, to the long term determinant of the economy.

A variant of the "taxing" deposits approach is a deposit-equity swap, which entails the transformation of a large fraction of deposits into equity claims. As a potential benefit, this approach

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<sup>24</sup> Besides lowering the price of enterprises, the large stock of bad loans may also complicate and politicize the process of privatizing enterprises. Domestic and foreign investors will have incentives to lobby the government to assume responsibility of past debts, which may produce case-by-case government involvement in enterprise debt management and introduce delays and uncertainty into the privatization process.

would encourage the privatization and efficient operation of banks. But, a forced deposit-for-equity swap may raise fairness questions, reduce confidence in the financial system, and induce a large drop in the money supply without improving bank performance.

A second variant, the debt-equity swap, replaces bad bank assets with equities in the enterprises. Although this could be part of the resolution process, the bad loan situation seems sufficiently large that a debt-equity swap would yield banks that own very large shares of the enterprise sector. Thus, banks would be in a position of managing a substantial portion of the real-sector, which is an area in which they have no experience. It may be better for the banking system and the economy to have banks focus on building capabilities in banking, not enterprise management. Also, acquiring equity in non-viable firms does not resolve bank insolvency; put succinctly bad debt equals bad equity.

Debt-Bond Swap. The most common approach to resolving the bad debt problem is to replace loans with government-backed assets. These could be government bonds, government guaranteed mortgages, or claims on privatization funds. Although the debt-for-bond swap is likely to be an important component of the solution, this approach also has problems: it is very difficult in the current environment to distinguish bad loans from good loans; case-by-case debt-bond swaps are likely to politicize the process and create expectations of future government involvement; and if all enterprise debts are substituted for government bonds in a once-and-for-all attempt to break with the past, tax raising requirements may rise significantly unless the government is able to identify other revenue sources such as selling more publicly held assets (the housing stock, real estate, etc.) or maintaining some shares of "privatized" firms.<sup>25</sup> Any of these solutions may help both banks and the enterprises, but a healthy financial sector will not be achieved until the financial institutions themselves and their incentive systems are reformed, the subject of the next section.

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<sup>25</sup> Levine and Scott (1992) suggest that the effect on the fiscal situation depends on the privatization process. If firms are sold to the public, a grand debt-bond swap is unlikely to importantly raise tax raising requirements. On the other hand, if shares in firms are simply distributed to the public, more revenues will have to be raised through traditional fiscal channels to satisfy the larger stock of government obligations.

## V. Building More Efficient Banks

It is not possible to construct a step-by-step financial reform program applicable to all TSEs that will quickly establish efficient financial sectors, and even for a single country there is not a unique road or sequencing path. The unbreakable - though malleable - ties between financial and economic development suggest that appropriate reforms in the financial and enterprise sectors, as well as in the areas of price and trade liberalization are interrelated. Although at some level these linkages are too complicated to be confidently disentangled, we can formulate some strategies based on the presumption that the TSEs have decided to become market-based, free-market economies based on a "European" model of economic organization. In particular, certain steps can be taken to promote competition and improve the incentives of managers.

Ownership and Concentration. In central and eastern european countries that have decided to make the transition to market economies, the banking system is typically highly concentrated and ultimately owned by the government. For example, two state-owned commercial banks in Czechoslovakia account for 80% of commercial lending and almost all of the remaining 20% is by other state-owned banks. Similarly, the two major state-owned savings banks receive the vast majority of household deposits. In Hungary, large state controlled banks - but with minority private participation - currently account for about 35% of commercial lending compared with about 8% in 1987, and privately owned banks are becoming increasingly competitive.

The state's ownership of banks can be direct or circuitous. In Bulgaria, the state-owned Central Bank, the Foreign Trade Bank (which is primarily owned by the Central Bank), and major state-owned enterprises own the commercial banks. In Hungary, the state directly owns about 42% of the major banks, with approximately 35% held by state-owned enterprises and cooperatives, and 15% held by other state-owned financial institutions.

State ownership of the vast majority of the banking system and the generally very high concentration of bank activity create a number of problems. First, the highly concentrated banking sector may reduce competition among existing banks, discourage the emergence of some new banks, and slow

improvements in bank efficiency.<sup>26</sup> Second, when a few large enterprises control the bulk of the banking sector, bank lending may be skewed toward enterprises that own banks, and enterprise control of bank credit may be used to discourage competitors. Third, central bank ownership of banks can conflict with responsible monetary policy and prudential regulation. Finally, when the state still owns the vast majority of the banking sector, political priorities can easily come to influence capital allocation decisions and managerial incentives, as is most clearly evident in China.

Reform: Issues and Complications. Policy makers can stimulate improvements in bank efficiency by encouraging competition in and contestability of the market for financial services, once financial soundness is achieved. Whether existing banks are privatized or not, some restructuring of the highly concentrated banking sector seems necessary to foster competition and contestability.

Bank restructuring to promote competition and privatization could take many forms depending on the country's particular circumstances. For example, a few major commercial and savings banks could be broken-up into smaller banks to encourage competition in the retail and commercial banking market. The savings banks could be permitted - some might argue prodded - to enter the commercial loan market, while commercial banks could be allowed - or even urged - to take household deposits, provide mortgages, and make other household loans. Where savings banks have a large branch network that holds almost all household deposits and commercial banks have only a few branches and obtain most of their funds from savings banks, the central bank, and the government, the merging of components of the large savings banks with components of the large commercial banks could be considered. The speed and scope of restructuring, however, should be consistent with the acute shortage of managers and staff adequately trained to operate in a market based economic system. Furthermore, "breaking-up" banks can create its own set of problems: breaking-up banks along regional or operational lines may produce institutions that are functionally and financially specialized without stimulating competition; and experience in other countries suggests that bank reorganizations typically require above normal managerial oversight for several years after the reorganization to be successful. Thus, while bank restructuring appears to be a prerequisite for increased competition, effectively carving out smaller financial institutions from the existing system will require great care.

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<sup>26</sup> Again, the key words are "reduce," "discourage," and "slow." Competition among banks is on the rise, new banks are entering the market, and efficiency is improving, but these positive developments would probably occur more rapidly in the absence of a highly concentrated, state-owned banking system.

Governments can facilitate competition in and contestability of the banking market by quickly adopting legal codes, legal institutions, anti-trust guidelines, licensing procedures, efficient payments mechanisms, and regulatory agencies necessary to support new banks. Indeed, some strategists suggest letting new private sector enterprises and financial intermediaries bloom and grow until they overwhelm large state-owned institutions without necessarily "fixing" the problems with the state-owned institutions. While encouraging "new flowers to bloom" is undeniably crucial, pruning, and rehabilitating existing structures may create a more fruitful and prosperous country while also creating a more hospitable environment for new entrants.

New entrants have some significant advantages over the remnants of the mono-bank system. Existing banks are burdened with a large stock of non-performing loans that are a result of loans made under socialism and the large changes produced by economic liberalization including the break-up of the CMEA trading arrangements. Furthermore, if the authorities direct state-owned banks to issue credit to large enterprises for political reasons, this further impedes the ability of existing banks to compete with emerging banks not required to support public policies. On the other hand, state-owned banks do not face a hard budget constraint, may confront easier tax requirements than private banks, and may enjoy greater confidence on the part of depositors. Thus, until existing banks are privatized and debts inherited from socialism are extinguished, the playing field is unlikely to be level.

Ownership/Privatization. Having restructured banks to promote competition, bank efficiency and stability could be encouraged by privatizing some state-owned banks or by improving their ownership structure. Authorities should disassemble ownership structures in which large enterprises (often state-owned and insolvent) own the major, often insolvent banks, because of the inherent and potentially dangerous distortion of incentives. Although less problematic than enterprise ownership of banks, central bank ownership of commercial and savings banks could interfere with optimal monetary policy and bank regulation. Until banks are privatized, investment trusts or independent bank boards of directors could be constructed where financial performance targets and managerial incentives mimic those of privately owned banks except for explicitly stated exceptions.

The privatization of some of the existing banks should improve managerial incentives, enhance foreign participation, expedite the retraining of personnel, reduce direct government involvement, and augment the ability to institute comprehensive and effective regulation and supervision. As

mentioned above, highly centralized banking systems will have to be broken down before privatization to avoid the creation of private monopolies. In addition, the early stage of development of supervisory, regulatory, and licensing procedures and institutions suggest that privatization of existing banks should proceed with caution. It is worth suggesting here that authorities begin the privatization of the banking sector early even if this process proceeds slowly. For example, some banks could be restructured, so that a few small state-owned banks are relatively unburdened with bad loans. These banks could be privatized early to establish the governments commitment to supporting a private, market oriented financial system. Governments should initiate this process even while considering more comprehensive approaches to coping with the inherited "bad" loan problem. With such a strategy, the emerging private sector could be served by new banks and some privatized state banks.

Although this paper does not evaluate the different methods that can be used to privatize banks [see McNaughton (1992) forthcoming], it is worth mentioning some of the mechanisms here. Banks can be sold to domestic entrepreneurs, and foreign financial institutions; sales to domestic nonfinancial institutions risks connected lending. Similarly, banks can be privatized using vouchers or bank shares can be distributed to mutual funds that are in turn owned by the public. We only mention here that the process is important because the method of privatization will strongly influence who will own the country's major financial institutions: enterprises ownership of banks has proven problematic in other countries, and experience teaches that careful attention should be paid to the qualifications of entrepreneurs purchasing banks.

Role of Foreign Banks. Foreign banks and other financial institutions can play a key role in assisting TSEs in the transition process. At one level, the issue of how much foreign bank penetration a government should allow would seem to revolve around the same issues as in many developing countries. As benefits, foreign banks bring skills and experience that can be used to upgrade quickly the quality of financial services available to domestic firms (and households), and can serve as an important input in training local bankers. On the cost side are three concerns: first, the potential political liability in the event that foreign institutions earn substantial profits or gain "excessive" market share; second, the weakening of domestic banks' portfolios to the extent that foreign banks attract the best credit risks in the country; and third, a fear that foreign banks will be more likely, in comparison with domestic banks, to retrench in bad times. Most governments resolve these issues in favor of some foreign participation in banking, either as branches, subsidiaries, or joint ventures.

In TSEs, however, a few additional factors appear to make a substantial foreign bank presence an important issue for policy makers. At the very least, the proximity of Western European banks to TSEs in Eastern Europe, as well as historical ties between Eastern and Western European financial systems suggest that significant penetration by foreign banks may be a real possibility in several TSEs. Indeed, by the end of 1991, there were already 21 joint venture banks in Hungary with some foreign participation. Also, the population in Eastern European TSEs have a high degree of literacy and strong quantitative training, in comparison with many developing countries, and may be better able to make quick use of the training provided by foreign banks. Moreover, and perhaps most importantly, TSEs are contemplating a massive wave of privatization, which will require support from financial institutions, not only in the form of credit but advisory services as well. Allowing an important role for foreign or joint venture banks may be necessary if privatization is to advance rapidly.

In view of these considerations, governments might best be advised as to how to get favorable terms for foreign bank entry. One lesson from experience in developing countries is that high taxation of foreign banks will encourage them to under invest in training and local skills development, precisely what the TSEs want most from these banks. Instead, authorities in TSEs might want to consider trading market access for a commitment to training by foreign banks, both through "twinning" foreign and local banks' staffs, as well as active participation in -- including perhaps monetary support of -- a bankers association (or institute) that sponsors training courses. Top-rated foreign institutions usually are more attracted to wholly-owned branches and subsidiaries rather than joint venture banks, but may well find attractive an arrangement whereby they would provide management and training for a number of years, such as is found in a "build-own-operate" transaction.

## **VI. Human Capital Development in the Financial Sector**

Although many observers agree on the importance of human capital in the financial sector, a key problem is that this has not yet been developed on anywhere near the scale needed to effect change rapidly. In fact, there may be a lack of appreciation in many quarters of the low level of awareness of market and legal processes in TSEs. Even when, for example, government officials can agree on a program of reform for specific sectors, on legal changes needed, or on the development of

a bank supervision department, implementation of reforms often is difficult even when specific advice is left behind by visiting experts. In many TSEs there is but a thin layer of expertise in the finance ministry, the central bank, or in any of the commercial banks, and the technical assistance supplied has been sporadic and mostly short term.

In order to improve TSEs ability to adjust, a far greater emphasis should be given to technical assistance and training. Both the finance ministry and central bank need experts on long term assignments to provide advice on policy design and implementation, and to assist in the "in-house" training of staff. In the central bank this is especially crucial in the areas of research and statistics, monetary policy implementation, and bank supervision. Long term assignments would both give added credibility to the advice provided as well as raise its relevance to specific country situations. Advice from experts visiting for one to three week intervals can get "lost," given the sheer numbers of advisers from various countries and organizations. Even when certain recommendations are accepted, TSE officials often need assistance on implementing the policy changes. Thus, long-term advisers would be able to assist and educate officials on a day-by-basis, sort through recommendations from foreign experts, guide policy changes through the implementation stage, and help train staff. For banks and other financial sector institutions, only a small fraction of individuals are being trained in what are very short-term courses; a substantial expansion of training programs would appear warranted, and would turn out under various scenarios to have been a worthwhile use of resources. Thorough asset quality reviews of commercial banks, though expensive, should be undertaken not so much for the data uncovered as for the on-the-job training and forced reexamination of institutional priorities and incentives. Although investments in human capital might not offer high visibility, it may well be the area in which the World Bank can have its greatest impact and also yield high returns.

## **VII. Concluding Notes**

Many of the arguments in this paper are based on the notions that finance is important for economic development, that banks are needed to help with the transition process, and that private incentives are important for financial sector performance. To be sure, finance is risky, and it is understandable that there is an aversion to "cleaning up" the banks if another round of support will be



required in the future. Consequently, we believe that banks should be "cleaned up" when they are privatized to avoid the quick reemergence of bad debt problems. Furthermore, we believe that either of the proposed alternatives for the future shape of the financial system in TSEs -- (very) highly-capitalized banking or narrow banking -- would minimize the need for future support. Either alternative will lead to lower leverage in TSEs and should provide more financial stability. However, taking concerns about moral hazard to an extreme and arguing that debt finance should be prohibited (McKinnon's proposal) runs the risk of starving new firms for credit and limiting economic growth. Without a healthy growth rate, the reform oriented resolve of TSE governments may wane.

Institution building in the financial sector is of paramount importance, and should be pursued as rapidly as possible through training, technical assistance, and foreign bank entry, and should be complemented by privatizing some part of the state banking system. Some or many of the state banks in each TSE may well remain in government control for several years or be permanently closed, but we view it as urgent to increase the part of the financial sector that will respond to market incentives as rapidly as is prudent, a pace that undoubtedly will vary among TSEs.

## Appendix

### Financial Sector Reform in the TSEs: a progress report

Table 1 summarizes some general and financial indicators for European TSEs for which current data were readily available. The GDP data are for 1990, while data relating to bank assets are end-90 or for some time in 1991. Note that bank assets reflect whatever bad loans remain on the books of the commercial banks, which is significant in many TSEs. Thus the importance of state banks may be overstated. TSE financial systems usually are even more concentrated on the deposit side, given the uneven distribution of bank branches, a key variable in the ability to mobilize funds. In short-term funding of private enterprises, the market in some TSEs is notably more competitive than the numbers here indicate. The paragraphs following Table 1 provide thumbnail descriptions of the financial sectors in five European TSEs.

Table 1: Indicators for TSEs

	Population (Millions)	GDP (\$ billions)	Bank Assets (% of GDP)	Private Banks (% of Bank Assets)	Bank Concentration (Share of 5 Largest banks)	Real Interest Rates*	Credit Ceilings?
Bulgaria	9	20	130	N.A.	40	negative	Yes
Hungary	10	33	70	8	90	dispersed**	No
Czechoslovakia	16	43	90-120	1	98	3% to ?	Yes
Poland	38	69	45	5	58	negative***	Yes
Romania	23	30	60	1 to 2	98	-170	Yes

\* Estimates difficult due to sharp changes in inflation.

\*\* Deposit rates range from -5% to -30%; lending rates from -25% to +10%

\*\*\* In 1990, minus 23% to minus 38% on deposits, minus 8% on loans.

**Bulgaria.** Bulgaria moved to two-tiered banking in stages. The household sector was traditionally served by a State Saving Bank. Foreign financial transactions were carried out by the Bulgarian Foreign Trade Bank, but all other transactions were handled by branches of the Bulgarian National Bank (BNB). In 1981 Mineral Bank was created, and in 1987 seven new sectoral banks were established to provide credit to the large state enterprises. The move to two-tiered banking was completed in 1990, when the 59 branches of BNB were turned into independent banks. Since then three private banks started operating.

The banks, especially the previous branches of BNB, are small in size, under capitalized, and lack expertise and experience in commercial banking. A large part of loans are non-performing or uncollectible. The World Bank SAL reform program includes the clean up of loan portfolios through guaranteeing of nonperforming loans, the replacement of uncollectible loans by government bonds, and the creation of a bank holding company to implement

- a merger scheme to decrease the number of banks to a small number of larger banks with branch networks;
- an institutional strengthening program; and
- the privatization of state banks.

A banking law is near passage in parliament, and a modern accounting system is in the process of being introduced. Interest rates were raised in 1991 from single digit annual rates to 60-70% for loans, but the adjustment from price liberalization resulted in an inflation rate of 334% in 1991.

The financial sector needs a major restructuring, including resolution of the non-performing loan portfolio problem, the build-up of expertise and staff, and a working clearing system to provide essential financial services.

**Czech and Slovak Federal Republic.** Early in 1990, Czechoslovakia moved to a two-tiered banking system when the mono-bank, Statni Banka, was split into a central bank of the same name, and two commercial banks: Kommercni Banka in the Czech Republic, and General Credit Bank in the Slovak Republic. There is little inter-republic business and these two banks account for approximately 80% of total lending. Even this underestimates the concentration of market power since the next two largest commercial banks Investicni Banka and Obchodni Banka are more seriously encumbered with non-performing (and under-

performing) domestic and foreign loans. There are two major savings institutions - one in each Republic - that (1) make highly subsidized loans to households (about 10-15% of their portfolios), for which they receive Government subsidy payments, and (2) redeposit their remaining assets with the major commercial bank in their Republic. While still a very small part of the banking system, private banks and joint ventures with foreign banks are emerging. Citibank opened a full branch in Prague with \$15 million of capital and Societe Generale Kommercni Bank is a joint venture between Societe Generale (75%) and Kommercni Banka (25%) with a capital base of about \$12 million.

The margin between lending and deposit rates in the commercial banks is currently about 10%, which the banks argue is needed to finance bad loans. In addition, the "credit crunch" has been severe. Real credit in 1991 is 30% lower than in 1990 and total bank lending is about 5% less than ceilings imposed by Statni Banka. With the liberalization of prices in January of 1991, interest rates were also largely liberalized. Real short-term deposit rates are hovering around 3%. In terms of monetary policy, the authorities intend to seek the gradual phase-out of administered credit controls by moving to an auction process designed to simulate a true open market.

The problem of non-performing or under-performing debts in Czechoslovakia is very difficult to determine with estimates ranging from 25-45% of total bank assets. Nonetheless, the Government is planning to privatize some of the banking sector early in large enterprise privatization program.

Key problems are high concentration, a large stock of under-performing loans, a lack of institutional support (legal, regulatory, supervisory, licensing, accounting, etc.), and a shortage of well-trained bank staff.

**Hungary.** Hungary is well ahead of other Eastern European countries in reforming its financial system. It established a two-tier banking system in 1987. There were 30 banks in operation in 1990. Of these, 4 are large state-owned commercial banks, 3 savings banks, 14 small and medium size banks and 9 specialized finance institutes. Hungary has made considerable progress in introducing a sound regulatory framework, although its robustness remains to be tested. Implementation of many legal and regulatory reforms is rather slow. The authorities have adopted a tight monetary and fiscal stance. Interest rates

are freely determined and there is no recourse to credit ceilings. There is an active market for treasury bills and an auctioning system for some refinancing facilities. However, various heavily subsidized directed credit facilities are also available. Some of these encourage the development of the private sector, though take up of most subsidized facilities is low. The securities market has been reopened, a new securities market law has been passed and various international investment banks have established local offices. These are playing an increasing role in privatization and joint ventures.

The big five banks have substantial state participation, both direct and indirect through other state-owned companies. Of these, the National Savings Bank still dominates the household banking sector, although it has recently expanded into corporate banking. It accounted for 36% of total bank assets in 1990. The four state-owned large commercial banks accounted for 48% of bank assets, while the small and medium-size banks represented 14% of bank assets. However, the small and medium size banks provided 28% of short-term credit to the enterprise sector. They include a number of quite successful joint venture banks as well as a number of less active Hungarian banks that used to operate as specialized finance institutes but acquired a universal banking license. Despite the increase in the number of banks, there is insufficient competition and innovation and considerable market segmentation. The competition is strongest in providing working capital, trade finance and related services. Long-term lending has been stagnant. This reflects both reticent supply and weak demand. Nominal spreads are quite high, penalizing good borrowers. On the other hand, after allowing for potential loan losses as well as the high level of inflation, spreads may be inadequate to prevent an erosion of bank capital adequacy ratios.

The main problem facing the Hungarian financial system relates to the burden of contingent liabilities emanating from three sources: the high level of bad loans to state-owned enterprises (this has been adversely affected by the collapse of the CMEA trade); the central bank exposure to foreign exchange losses; and the unfunded liabilities of the social security (pension) system. Improving the effectiveness of supervision and the institutional capability of banks remain pressing issues, although considerable progress has already been made on both fronts.

Poland. Until January of 1989, the mono-bank system passively financed state enterprises as part of the Government's plan. Then, the mono-bank was split into the National Bank of Poland, which assumed central banking functions, and nine regionally based commercial banks. The Government intends to

develop a predominantly private banking sector, and toward this goal has, as of late 1991, issued over 100 banking licenses, initiated plans to ready the state-owned banks for privatization, and established a banking school in Katowice. Nonetheless, competition in the financial system remains limited: private banks account for a very small share of loans, commercial banks are heavily specialized, both geographically and sectorally. Only one bank issues international trade credits, another bank issues almost all housing loans, one bank receives more than half of domestic time and savings deposits, while a different bank accounts for sixty percent of foreign currency deposits. The 1989 Banking Law permits universal banking, although the precise boundaries of intermediary behavior and the regulatory and licensing infrastructure will only be resolved over time.

The Government's large borrowing requirement restrains the expansion of credit to the productive sector. Moreover, about one-third of non-government credit is flowing to directed/subsidized sectors and state-owned enterprises absorb over sixty percent of the stock of nongovernment credit. Housing finance represents the bulk of directed credit. Furthermore, the Government imposed a grace period for amortization, and subsidizes 40% of interest capitalization. This budgetary expense should reach US\$ 1.2 billion in 1992. Since the public is unlikely to satisfy fully these debts, the housing finance program may ultimately contribute to the large non-performing loan problem. The Government also has credit programs for agriculture and has established other specialized lending institutions to direct credit allocation.

A substantial fraction of loans to state-owned enterprises cannot be paid, and these losses exceed the net worth of banks. While difficult to estimate, few expect more than a small fraction of bank loans to be paid in full. The bad loan problem in combination with limited prudential regulation has induced some bank managers either to restrict credit excessively or allocate credit based on past business ties.

In monetary policy, Poland has implemented indirect control mechanisms such as NBP refinancing, reserve requirements and open market operations, although the market for NBP bills is still thin. The Government plans to remove bank-by-bank credit ceilings. The NBP has used the refinancing rate to keep the interest rate positive in real terms, and has often provided "guidance" to banks in setting loan and deposit rates. It is felt that improved competition and banking skills will promote complete interest rate liberalization.

The major problems include (i) the distortion of credit produced by the government deficit, large specialized credit programs, and the weak state of bank portfolios; (ii) the combination of reserve requirement policy, interest rate controls, and high inflation, which imposes a high tax on banks; and (iii) inadequate policies on foreign exchange deposits that produce a mismatch between foreign exchange assets and liabilities.

Romania. Romania only moved to a two-tiered banking system in December 1990, and its structure remains close to that of the pre-reform period. There are five state-owned commercial banks that account for most banking activity: one savings bank that collects 70% of all deposits and has lent only a fraction of that amount for low-interest mortgages; and four "lending banks" formerly exclusively concentrated on foreign trade finance, long-term investment in agriculture and industry, or short-term finance. Several new private banks have opened in the last year, with one constituted out of several hundred small cooperatives. Still, these institutions thus far have remained tiny. As of mid-91, banks were lending only to private firms and to commercial companies -- state firms cut off from budget support; the large state enterprises, still tied to the budget, were getting loans only with the provision of a government guarantee. All of the banks are endowed with "universal" banking powers, but thus far have concentrated on slowly building up their branch network (the four state-owned lending banks plus the private banks' have less than 5% of the number of branches of the savings bank).

In contrast to many TSEs, the bank losses appear to be minute now, as the government: first, used government deposits (40% of GDP in 1988) to wipe out a large share of losses during the 1988-90 period; and second, removed 90% of remaining estimated losses as of July 1991, to be replaced by government bonds paying a yet-to-be announced interest rate. The system's other main advantage, aside from the absence of any significant foreign debt, is in the form of banking laws, which give the central bank more statutory independence than in most countries and considerable leeway in crafting supervisory regulations. Although the central bank has deregulated interest rates (except for (during much of 1991) setting a 3 percentage point limit between the average cost of funds and the average lending rate of each bank), rates in fact are controlled by the savings bank, which is the main provider of funds to the lending banks and whose management has decided -- in part, it maintains, because of a physical inability to adjust rates more than once a year -- to hold down the interbank cost of funds to levels far below the rate of inflation.

Key problems of the financial sector are: achieving some flexibility of interest rates, creating competition in finance, building institutional capacity within the banks to conduct commercial lending (credit assessment skills, monitoring capacity, etc.), and cleaning up a large inter-enterprise arrears problem. The latter process began in early 1992 and may entail a sharp increase in credit to the extent that net arrears are covered by central bank credit. Also, the non-bank market, primarily insurance, is small but growing.



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