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Eastern Europe's Experience with Banking Reform

Is There a Role for Banks in the Transition?

Alfredo Thorne

The effectiveness of banks in the transition depends on how soon authorities begin to restructure the banking system and how that restructuring fits into the sequence with enterprise restructuring and privatization.

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Europe and Central Asia, and Middle East
and North Africa Regions Technical Department
Private Sector and Finance Team
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Summary findings

Are there lessons to be learned about how Eastern European countries have dealt with problems in their banking systems? What role have these countries assigned to banks during the transition? How have they used banks in dealing with the enterprise problem?

Thorne addresses these questions by analyzing experiences in Bulgaria, Hungary, Poland, Romania, and the former Czech and Slovak Federal Republic. Most of these countries have made substantial progress in restructuring their banking systems, but few have used their banking systems to improve the allocation of credit and hence stimulate the supply response.

Among other things, Thorne finds that:

- The problem is not whether banks hold nonperforming loans but how banks can avoid accumulating more nonperforming loans. The underlying problem is how to close loss-making and nonviable enterprises.
- The countries that have encouraged the establishment of new private banks, that have introduced regulation and supervision, and that have tried to make banks more competitive have been more successful at improving the allocation of credit and achieving more control over loss-making enterprises.
- Banks must focus on assessing risk — and for this, capital, private ownership, and adequate regulation are crucial. How quickly banks achieve independence in credit decisions depends on how fast new governance structures can be introduced. In this, the five countries have been less successful.
- The objectives of bank recapitalization should be to prevent banks from accumulating more nonperforming loans (that is, dealing with the enterprise problem) and to give them the governance structure that would prevent them from incurring new nonperforming loans. This requires introducing a system of risk and reward — by making banks comply with capital adequacy requirements, by privatizing a critical number of banks, and by introducing strong regulation and supervision.
- Governments should see that banks provide efficient payment systems, the basis for trust in banking systems.
- Introducing adequate regulation and supervision has been difficult as it requires knowing what the banks' role should be.
- Evidence strongly supports the need to recapitalize and privatize a critical number of banks.
- Authorities cannot rely on banks to exert control on enterprises early in the transition. In the early stages, control over state-owned enterprises should be exercised by a semipublic institution.

This paper — a product of the Private Sector and Finance Team, Europe and Central Asia, and Middle East and North Africa Regions Technical Department — is part of a larger effort in the Bank to extract lessons from the reform of Eastern European economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Noni Jose, room I8-168, extension 33688 (38 pages). December 1993.

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EASTERN EUROPE'S EXPERIENCE WITH BANKING REFORM:

Is there a Role for Banks in the Transition?

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TABLE OF CONTENTS

A. INTRODUCTION 1
B. PAST LEGACIES: THE STARTING CONDITIONS 3
1. Abandoning the Basic Socialist Banking System 3
2. The Starting Conditions 5
C. RESTRUCTURING BANKING SYSTEMS: THE GOVERNMENT POLICIES 6
1. Introducing a New Regulatory and Supervisory Framework 7
2. Institutional Measures 12
Overcoming the Payment System's Inefficiencies 12
Macroeconomic Conditions and Schemes for Dealing with Banks' Bad Loans 14
3. Bank Privatization 26
D. EFFICIENCY OF BANKING SYSTEMS: AN ASSESSMENT ATTEMPT 29
1. Credit Allocation 29
2. Real Lending Rates and Interest Rate Spreads 31
E. CONCLUSIONS: ARE THERE ANY LESSONS? 33
REFERENCES 37

A. INTRODUCTION

In 1989, most Eastern European countries began changing from centrally-planned to market-oriented economies. Some countries undertook comprehensive macroeconomic reform programs aimed at stabilizing their economies and introducing market forces. Programs typically consisted of liberalizing product markets, reforming labor and financial markets, and integrating their economies to the world economy by removing trade restrictions. In addition, most countries privatized their small-scale state-owned enterprises (SOEs) through public auctions and a few countries also introduced schemes for restructuring and privatizing large state-owned enterprises.

Although the experience with macroeconomic reform differs across countries, the most successful countries managed to stabilize their economies, to liberalize prices and introduce competition, ending the goods shortages of centrally planned economies.[2] But few managed to restructure and privatize the SOEs or the banking system. Yet both the SOEs' and the banking system's restructuring and privatization will have important effects on macroeconomic stability. Their postponement could undermine the governments' ability to balance the budget and to pursue non-inflationary monetary policies.

The introduction of market forces made apparent the large number of SOEs needing restructuring and privatization. The magnitude of the problem was not fully apparent before because centrally-planned economies relied on price controls and subsidies. Loss-making SOEs continued to have access to finance from the banking system because their closure would have had a substantial impact on employment and could have halted the reform effort. Also policies to restructure, liquidate, or privatize these enterprises are not yet in place. This is undermining macroeconomic stability and is endangering the future of the well-managed enterprises. It is resulting in a perverse allocation of

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[2] See Bruno (1992) for a recent critical macroeconomic assessment of the five more advanced Eastern European countries (Hungary, Poland, CSFR, Bulgaria and Romania).

resources: loss-making enterprises are accessing credit while the new emerging private sector is being crowded out.

A number of studies have analyzed the problems in restructuring and privatizing the SOEs by focusing on the enterprises' problems. This paper attempts to analyze the problem from the perspective of the banking system. It seeks to understand the role that the banking system is playing in the transition. It attempts to understand the starting conditions and the governments' reform strategies. The focus is on the institutional aspects of financial sector reform, drawing on the experience of the five more advanced former centrally planned Eastern European countries: Hungary, Poland, the former CSFR,[3] Bulgaria and Romania.

Although Eastern European governments made substantial progress in reforming their banking systems, it still plays a passive role. Few countries have successfully used their banking systems as an instrument to accelerate the supply response, for instance, by ensuring an efficient credit allocation, or by using banks to exert control on loss-making SOEs. Most banking systems are still dominated by large state-owned banks which hold a large proportion of nonperforming loans. Countries that have established new private banks, introduced new regulation and supervision, and enhanced bank competition show an improvement in the allocation of credit and greater control of loss-making SOEs.

The organization of the paper is as follows. Section B opens the discussion with the analysis of the legacies of the past. Section C compares the policies adopted by each government for restructuring the banking system. Section D compares the efficiency of the five banking systems in an attempt to assess the consequences of the government policies undertaken. Finally in Section E the conclusions highlight the lessons that can be learnt from these reforms and underlines the problems that remain.

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[3] To avoid confusions and since the analysis ends in end-1992, throughout I have referred to the former CSFR as "the CSFR."

B. PAST LEGACIES: THE STARTING CONDITIONS

Until the early-1980s, the socialist banking system that prevailed in most eastern European countries consisted of a mono-bank that performed the roles of central bank and commercial bank, and a savings bank that provided services to households. The mono-bank was responsible for issuing currency and granting short-term credit to enterprises. In addition, the specialized banks provided long-term finance for investment. Unlike banks in western countries which granted credit based on credit risk analysis, banks in former socialist countries granted credit based on central plan decisions. Banks, therefore, allocated credit passively and performed the role of government agencies.

1. Abandoning the Basic Socialist Banking System

The five countries began the reform towards a market economy in 1989. Each country differs from the others in their timing and methods of reform (see table 1). The breakup of the mono-bank, the establishment of a two-tier banking system and the abolishment of the central plan targets signaled that reform was underway.

Table 1. Banking Systems Starting Conditions

	Hungary	*Poland*	*CSFR*	*Bulgaria*	*Romania*
Date of political opening.	1989	April 1989	November 1989	November 1989	December 1989
Date of breakup of the mono-bank and start of the two-tier banking system.	January 1987	January 1989	January 1990	January 1990	December 1990
Number of state-owned commercial banks. 1/	4	9	2	59	4
Number of private or foreign owned commercial banks. 1/	2	5	0	0	2
Number of specialized banks (excluding foreign exchange banks). 1/	10	1	1	8	2
Number of banks specialized in foreign exchange transactions. 1/	1	3	2	1	1
Number of Savings Banks. 1/	1	1	2	1	1
Date of last revision of last legislation. 1/	January 1987	January 1989	January 1990	May 1990	April 1991

Source: World Bank (1989,1990 and 1991b) and Thorne (1992).

1/ Estimated at the date of the breakup of the mono-bank.

Hungary was the first country to introduce changes in its banking system. It started very early on and followed a gradual process. Unlike the other countries, the change in economic policies was not marked by a single date when a big bang stabilization program was undertaken. In the early 1970s, with the New Economic Mechanism, it abolished the centrally-determined targets and allowed enterprise managers greater freedom. Managers were granted a greater role in decision-making and in the management of enterprises, thus starting the experience in enterprise self-management under socialism. In 1987 the authorities established a two-tier banking system and broke up the mono-bank into a central bank and two state-owned banks.

In *Poland* the authorities started introducing changes in the banking system in the early 1980s. In early 1982 the authorities granted more autonomy to the mono-bank, allowed banks more flexibility in meeting the centrally-determined targets and provided for the establishment of new banks. Significant changes started in the late 1980s. In 1987 the government separated the savings bank from the mono-bank and, in January 1989, the government broke up the mono-bank into nine state-owned commercial banks and established a two-tier banking system. The authorities also granted bank management a greater role in credit allocation.

In the *CSFR*, *Bulgaria* and *Romania*, the break up of the mono-bank and the establishment of a two-tier banking system followed the political opening of 1989 (see table 1). Enterprise and bank managers were granted more freedom simultaneous with the authorities' abolition of the central plan targets. In these three countries, there was no tradition of enterprise self-management as there was in Poland and Hungary.

In the *CSFR*, the authorities broke up the mono-bank by establishing three new banks, two state-owned commercial banks (one for the Czech and one for the Slovak Republic) and one bank specializing in long term finance, which served both republics. In Bulgaria the government broke up the mono-bank into 59 commercial banks and established 8 specialized banks. Moreover, the

government decided to transfer ownership of banks to the state-owned enterprises. In *Romania* the mono-bank's commercial banking activities were transferred to a recently established state-owned bank and the emerging banking system consisted of few banks.

2. Starting Conditions

The banking systems of the five countries were similar in terms of the institutional problems confronted. These were:

(a) slow progress in introducing market-oriented payment mechanisms with long delays in payment and lack of contract enforcement, leading to a large "float" in the banking system;

(b) a lack of a regulatory and supervisory framework adapted to the needs of a market-economy, and supervisors ill-prepared to supervise banks operating in a market economy;

(c) a large proportion of bank nonperforming loans, especially held by the large state-owned (SO) banks, which resulted from the lending practices during the central plan period;

(d) an inexperienced group of bankers appointed by government officials and ill-trained for managing banks in a market-economy and for assessing risk of potential customers; and

(e) close ownership links between state enterprises and banks which prevented banks from taking independent credit decisions with respect to their main customers.

There are, however, a number of differences that distinguish these five countries. The first difference is the relative importance of the commercial and specialized banks (see Table 2). Hungary and the CSFR relied more on commercial banks than on specialized banks. In both countries, once the authorities broke up the mono-banks, commercial banks held most of the banking systems' assets. In Poland, Bulgaria and Romania, the opposite was true, the specialized banks account for the bulk of bank assets and were more important than the commercial banks. The importance of specialized banks was particularly true in Poland and Bulgaria, nations that established the largest number of state-owned commercial banks.

The second difference is the importance of the savings bank. This indicated the segmentation between a group of banks that were net borrowers and lent to the enterprise sector (e.g., the commercial and specialized banks) and a group of banks that were net lenders and captured most of the deposits. This is also an indicator of bank competition, since net borrower banks depended on funding by net lender banks.

Table 2. Structure of the Banking System

	Hungary	Poland	CSFR	Bulgaria	Romania
Ratio of all specialized banks' assets to total assets. 1,2/	47.7	79.1	32.2	54.0	52.3
Ratio of commercial banks' assets to total assets. 1,2/	35.0	8.5	67.8	25.5	18.2
Ratio of total savings bank deposits to total deposits. 1/	[illegible]2.5	12.1	52.3	46.2	80.8
Savings Bank's households' deposits as ratio of total household deposits. 1/	81.3	70.5	100.0	100.0	100.0
Ratio of Savings Bank loans to deposits. 1/	100.0	61.3	16.9	33.5	4.9

Source: World Bank (1989,1990 1991b and 1991c) and Thorne (1992).

1/ Estimated at the date of the breakup of the mono-bank. Because in Hungary the central bank held a large portion of the banking systems' total assets the sum of the ratios of commercial and specialized banks' assets to total assets is low relative to the other countries.
2/ In the case of CSFR, these ratios are calculated using total loans instead of total assets, as assets by group of banks were not available.

In Hungary and Poland this segmentation was less sharp. The high ratio of savings bank loans to deposits indicates that they were not a source of funds for commercial and specialized banks. Instead, savings banks used their resources to grant mortgage and other types of loans to households.

In the CSFR, Bulgaria and Romania, the savings banks were net lenders to the specialized and commercial banks. When the Bulgarian authorities broke up the mono-bank in 1990 the Bulgarian Savings Bank was using nearly 70 percent of its deposits to fund the commercial and specialized banks. In the CSFR and Romania, it was 83 and 95 percent respectively. Savings bank deposits in these countries accounted for larger proportions of total and households deposits.

C. RESTRUCTURING BANKING SYSTEMS: THE GOVERNMENT POLICIES

Starting in 1990, the five Eastern European countries' banking system started to change as a result of the political opening and the introduction of market forces. Between 1987 and 1989, some governments relaxed restrictions on the establishment of new banks to encourage bank competition. This resulted in an increase in the number of banks. In Hungary, the number of banks increased from 19 in late 1987 to 37 in late 1991; in Poland, from 18 in early 1989 to about 86 in late 1991; in the CSFR from 7 in early 1990 to 27 in late 1991; in Bulgaria from 69 in early 1990 to 75 in late 1991; and in Romania from 10 in late 1990 to 16 in early 1992.

In most countries, though, the major restructuring began in 1990. Some governments introduced changes in their monetary and credit policies as part of their macroeconomic adjustment programs. Usually the bank restructuring scheme consisted of a new regulatory and supervisory framework, a policy framework for dealing with bank nonperforming loans as part of the enterprise restructuring, and bank privatization plans. We now turn to the discussion of these three aspects of the restructuring schemes as a way to understand the policy measures adopted by each government and the way governments linked bank and enterprise restructuring.

1. Introducing a New Regulatory and Supervisory Framework

Between 1991 and 1992 the five countries introduced a new regulatory and supervisory framework. But some countries kept important aspects of the old legislation. By mid-1992 Hungary, the CSFR and Bulgaria had introduced a new central bank and banking laws, modeled on western economies legislation. Although Poland and Romania introduced a new central bank law, they amended the existing banking laws and key elements of market-economies banking legislation were still missing by late 1992. By contrast, Hungary is the only country of the five to have introduced a new bankruptcy law that defined the legal role of banks in restructuring and privatizing SOEs.

These five countries have followed two very different banking models (see Table 3). Hungary has opted for the Anglo-Saxon model of separating commercial and investment banking functions. The

Table 3. Regulatory Frameworks

	Hungary	Poland	CSFR	Bulgaria	Romania
Date of enactment by Parliament of new banking regulation	November 1991	April 1992 (Amendments to existing L[illegible])	December 1991	March 1992	March 1991 (Amendments being considered)
Separation between commercial and banking investment activities?	Yes	No, universal banking	No, universal banking	No, universal banking	No, universal banking
Limits on the volume of equity banks can hold	Commercial and specialized banks are allowed to hold 15% and 100% of adjusted capital in long term investments, respectively; and excludes collaterals taken possession by banks which must be sold within 3 years.	Up to 25% of total capital and reserves and is planning to increase it to 50 %.	Up to 25% of total capital and reserves and excludes collaterals taken possession by banks which must be sold within 2 years.	Up to 100% of total capital in long-term investments and excludes collaterals taken possession by banks which must be sold within 3 years.	Up to 20% of total capital and reserves and NBR plans to increase it to 100%
Capital adequacy	8 percent of risk-weighted assets to be met in January 1993	8 percent of risk-weighted assets	8 percent of risk-weighted assets to be met end-1995	8 percent of risk-weighted assets, transitional period to be determined	Proposed to be 8 percent of risk-weighted assets by end-1994
Limits on lending to a single customer	Up to 25% of adjusted capital	Up to 15% of assets.	Up to 25% of capital	Up to 25% of capital	Up to 20% of capital
Limits on lending to shareholders	Up to 5% of adjusted capital	Up to 15% of capital.	Determined by the bank statutory body	Up to 1% of paid-in capital	Up to 15% of the bank's capital and reserves
Deposit insurance	Banks should have a mandatory deposit protection by end-1992	A new deposit insurance should be in effect since March 1993.	State-owned banks and government's deposits	By law banks should offer deposit insurance up to an amount to be specified	Only state savings bank's deposits
Minimum capital for new banks	US$ 13.3m for commercial and US $ 6.6m for specialized bank	No explicit limit except that it should be proportional to the size of anticipated activities.	Determined by the central bank	US$ 10.0m	US$ 3.5m
Limits on ownership	State and a single individual may hold more than 25% of equity. No restriction on foreign banks	Maximum ownership is 50% by a single individual or firm.	No limits	Authorization from central bank	No limits
Institution responsible for supervision	State Banking Supervision Agency (SBA) and NBH	National Bank of Poland	State Bank of Czechoslovakia	National Bank of Bulgaria	National Bank of Romania
Standards for loan classification and provisioning	No, in preparation	No, in preparation	No, in preparation	No, in preparation	No, in preparation

Source: Countries' central bank and banking law acts and World Bank (1992).

other four countries have opted for the German model of universal banking. This has defined the role of banks in the transition. In Hungary commercial banks can attract deposits and grant loans but are restricted on the volume of investments they may hold. Investment banks cannot attract deposits but can engage in enterprise restructuring and other types of investment activities. Their investments are only limited by their capital and reserves. In the other four countries, however, banks are empowered to performed both the commercial and investment bank functions and the legislation is very liberal in allowing banks to make long-term investments in areas such as real estate and securities.

The Bulgarian and Romanian legislation is the most liberal, since it allows banks to invest up to 100 percent of their capital and reserves. By contrast, the Polish and the CSFR bank legislation limits long-term investments to 25 percent of the bank capital and reserves.[4]

Although all five countries introduced similar monetary and credit instruments, by imposing bank reserve requirements, credit ceilings and interest rates, some small differences remain. Hungary alone has retained interest rate ceilings and it also has the highest reserve requirement. The level of reserve requirement is only a relevant indicator in Hungary and Poland.[5] In the other three countries most deposits are held by savings banks, and commercial banks are funded by the interbank market or the central bank (see table 2).

All five countries have opted in principle for a capital adequacy of 8 percent of risk-adjusted assets, a choice that conforms with the Basle Agreement. In practice they use different methods to calculate risk-adjusted assets. To date, Hungary has a method for calculating the risk-adjusted assets, but the CSFR and Bulgaria are still drafting regulations, and Poland and Romania have not drafted the 8 percent capital requirement. In addition, Hungary and the CSFR have defined a transitional period

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[4] In Hungary, CSFR and Bulgaria the law excludes from long-term investments any collateral or pledge that banks might have taken possession of as a result of foreclosing on guarantees provided by their borrowers.

[5] In Hungary reserve requirement were 16 percent and remunerated in end-1992, in Poland it was 30 and 10 percent for short and long term deposits, respectively, and remunerated. In the former CSFR, Bulgaria and Romania, reserve requirements were 8, 7 and 10 percent respectively, and also remunerated.

for compliance. Hungarian banks should have complied with a 7.25 percent risk-weighted capital by January 1992 and 8 percent by 1993. CSFR banks should comply with 6.25 percent by end-1993, and 8 percent by end-1995. Bulgaria is in the process of defining the transitional period; in Romania banks will be required to comply with the 8 percent ratio by end-1994; and Poland will soon enforce this requirement.

All five limit exposures to a single borrower and shareholders. The banking law limits the risk of losses and prevents shareholders from benefiting from bank ownership. Limits on exposure to a single borrower range from a high of 25 percent of capital in four of the five countries, to a low limit of 15 percent of capital for Poland. The Bulgarian and Hungarian legislation is the strictest limiting lending to shareholders to 1 and 5 percent, respectively, while CSFR and Poland have a limit of 15 percent.

The legislation is different in other important respects as well. First, few countries have a deposit insurance scheme. In Hungary, Poland and Bulgaria the banking law requires that banks offer deposit insurance, but the schemes have yet to be introduced. The CSFR and Romania have the old deposit protection whereby only state-owned banks and government deposits are protected. Providing a deposit insurance scheme for banks with a large proportion of nonperforming loans is problematic. Such banks have a higher probability of default, and hold a large proportion of all banking system loans, which increases the overall cost of the deposit insurance and imposes a high burden on well-managed banks with low nonperforming loans.

Second, countries impose different restrictions on establishing new banks and on bank ownership. The Hungarian and Bulgarian bank legislation have the highest minimum capital requirements. In Hungary the government's share is limited, and together with Poland, limits the proportion of shares held by a single individual and/or institution. The CSFR and Romania are more

liberal concerning the entry of new banks. Entry of new banks is only limited by the minimum capital requirements, while in Poland new banks only need the National Bank of Poland's approval.

Third, in practice, bank's ability to initiate foreclosure procedures is weak because few countries have a well-functioning bankruptcy law and/or have defined property rights. Yet this is key for the development of the banking system. Such statutes define the instruments banks use to exert pressure on borrowers and it defines the protection provided for insolvent enterprises. Because most bank loans have been granted to SOEs and banks cannot foreclose on state-owned assets, banks have been inhibited from using foreclosure and liquidation as instruments to impose discipline on loss-making SOEs and force their restructuring. Without clearly defined property rights banks cannot use SOEs' assets as collateral on loans and therefore their absence limits the supply of credit. In most cases banks are demanding personal mortgages, bank deposits or cross-guarantees as a condition for granting a loan, all factors which have increased the borrowers' risk.

Hungary and CSFR have introduced bankruptcy legislation, and Poland, Bulgaria and Romania plan to introduce it soon.[6] However, only Hungary has a market-oriented bankruptcy law. To forestall the massive failure, the CSFR granted enterprises a one-year transition period. Aside from Poland, there is no scheme for restructuring enterprises before they fall into bankruptcy. There are a large number of enterprises in weak financial situation. In fact, the large number of financially weak enterprises in most countries will overload the courts and postpone liquidation. An example is the case of Hungary which introduced a type of Chapter 11 clause in their bankruptcy law. But to protect themselves by the end of March 1992 more than 2,000 enterprises filed for bankruptcy.[7] This flood of cases resulted in large losses for banks and postponed enterprise restructuring and liquidations.

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[6] In Romania the authorities introduced the so-called Law 76 which allowed banks to foreclose only on enterprises that failed to repay their global compensation bank loans in 1992. However, anecdotal evidence indicates that banks refrained from foreclosing on enterprises because of property rights issues and because the legal procedure would have been too long. Instead, some anecdotal and empirical evidence indicates that banks refinanced enterprises' overdue global compensation bank loans .

[7] See Business Eastern Europe (1992)

A key problem common to all countries has been delay in instilling market-oriented banking supervision capable of enforcing the banking law. Bank supervisors must be able to carryout on- and off-site bank examinations. These are key for developing the banking system because it assures depositors' trust on the soundness of the banking system, ensures strong bank governance. It assures that bank problems will be corrected on time and/or banks will be removed from the system. Hungary is the only to have made progress in: retraining existing supervisors, bringing [illegible] qualified supervisors acquainted with western practices, introducing new accounting standards for banks and providing the institutional strength needed for conducting bank supervision. It was the only country that established a new bank supervision institution (e.g., SBS), while the other four countries left the old central banks' departments responsible for bank supervision (see table 3).

None of the five countries have introduced standards for loan classification and provisioning. As a temporary arrangement most countries had relied on external bank audits. Yet loan classification standards are central for bank supervision. Disclosure and classification of loans by banks should enable depositors to select a bank to deposit their savings. Hungary and CSFR are close to introducing such a regulation, Poland, Bulgaria and Romania are planning to do it at a later date.

2. Institutional Measures

Institutional measures were taken to deal with the inefficiencies of the payment system and to address the banks' nonperforming loans. Few countries have undertaken measures to overcome problems with the structure of the banking system. Problems with the structure include: the segmentation of the banking system between a circuit of banks serving enterprises and another serving households, and the oligopolistic competition resulting from the coexistence of a few large banks holding most of the bad assets and of a large number of small banks. Most countries decided to deal with these problems by enhancing bank competition and removing the bank specialization by allowing banks to undertake most banking activities.

Overcoming the Payment System's Inefficiencies

Because of its importance for enhancing bank competition and making monetary policy effective, most countries started their institutional reform with the reform of the payment system (see table 4). Most countries began from scratch because centrally planned economies did not rely on such a system. Unlike a market-based banking system, in a centrally planned economy there was no need to link all banks; it was desirable to segment the banking system.

The five countries followed a similar approach; in all progress was slow. Establishing a payment system was a cumbersome and complicated undertaking. It required creating a national electronic network for settling and clearing payments. It also required introducing a regulatory and a policy framework to guide the operation of the system.

Most countries took a long time before starting to operate the payment system and some are still experiencing delays in bank transfers. The delays are worst in Bulgaria and Romania, which got a late start. Moreover, delays in verification of transfers and settlements led some central banks to assume the liability of banks with insufficient funds in their correspondent accounts.

The inefficiencies of the payment system have hindered bank competition. The largest banks with more developed branch networks can offer better payment services to their customers and therefore have obvious advantages over the small ones. The inefficiencies also has impeded the efficient management of monetary policy. The central bank had to keep large outstanding balances to ensure their liquidity and when the authorities made monetary policy restrictive it resulted in bank illiquidity rather than in an increase in the inter-bank interest rate.

Table 4. Institutional Measures

	Hungary	Poland	CSFR	Bulgaria	Romania
Date of Introduction of the payment system and average delay in settling a bank cheque	1988 and takes 10 days	1990 and takes between 10 and 20 days	1991 and takes about 3 days	1991 and takes between 15 and 20 days	1992 and takes between 15 and 21 days
Removal of banks' bad loans and/or recapitalization of banks using fiscal resources.	Yes, 50 percent of three largest banks nonperforming loans inherited in 1987, which accounted for 1.7 percent of total SOEs loans by end-1987.	Yes, banks' foreign exchange losses were covered in 1991 and a new bank recapitalization is being considered in 1993.	Yes, 30 percent of all outstanding loans to the enterprise sector in January 1991.	Yes, 100 percent of enterprises loans outstanding at end-1990 were guaranteed by the state.	Yes, 90 percent of all enterprise nonperforming loans outstanding in December 1990.
Audits were used to determined amount of recapitalizations	Yes	Yes	No, based on banks' own assessment	No, based on total loans granted in end-1990	No
Instrument for removing banks' bad loans and/or recapitalizing banks	government guarantees callable upon the initiation of liquidation procedures.	government bonds denominated in foreign currency; and for the new recapitalization 15-years government bonds including 5 years of grace.	Nonperforming loans were transferred to the Consolidation Bank and government bonds were issued for recapitalizing banks	government guarantees and bonds	Proposed to be 4-year government bonds.
Amount of nonperfroming loans covered by the budget	Ft 10.5 bn in government guarantees or 1.7 percent of total banks' loans outstanding with enterprises by end-1987	US$ 5.5 bn in dollar-denominated government bonds issued to finance the foreign exchange losses; and an undetermined amount for the new bank recapitalization scheme.	Kcs 120 bn of banks nonperforming loans were transferred to the Consolidation Bank and ,in addition, a transfer of Kcs 50 bn was made for covering enterprises' nonperforming loans and for recapitalizing banks.	Lev 4.1 bn in government bonds and the government provided guaranteed on the Lev 46 bn bank outstanding in end-1990.	Lei 150 bn in banks nonperforming loans, Lei 50 bn for bank recapitalization .
Link bank recapitalization to enterprise privatization	Yes, indirectly	Yes, directly	Yes, indirectly	Yes, directly	No
Link bank recapitalization to bank privatization	No	No	No	No	No
Do banks have to approve enterprises in arrears restructuring plans?	Yes	Yes, in the new scheme	Yes	No	No
Enterprise privatization involved a giveaway scheme.	Subsidized loans have been offered to nationals purchasing shares	Yes, the Mass Privatization	Yes, the Voucher Scheme	It is being considered	Yes, similar to Poland and CSFR's schemes using private investment funds.

Source: World Bank (1992), Demekas and Khan (1991) , OECD (1991), The National Bank of Hungary (1991) and Thorne (1992).

Macroeconomic Conditions and Schemes for Dealing with Banks' Bad Loans

In 1991, the SOEs in most countries started experiencing difficulties. The causes of the problem were multiple: the introduction of market forces, the trade shock from the collapse of the CMEA, the economic recession resulting from the macroeconomic adjustment and the introduction of new accounting standards. All these factors, in combination, made the fragile financial situation of most enterprises apparent. The enterprise crisis led to a sharp fall in overall production. Moreover, even though most governments had undertaken very drastic cuts in their expenditures and introduced new tax systems, the SOEs crisis undermined the government's ability to balance the budget.

The crisis of the enterprise sector showed up in the banking system. Banks in Hungary and Poland, which posted large profits until 1990, started showing large nonperforming loans by 1991. In Poland, CSFR and Bulgaria, banks started to allow SOEs to capitalize the interest on their loans as a way of helping them to cope with the crisis. In Poland the capitalization of interest accounted for 100 percent of the credit expansion in 1991; and in Bulgaria banks, on average, capitalized about 50 percent of the interest on loans in 1991. In Hungary, Poland, CSFR, Bulgaria and Romania, SOEs' resorted to inter-firm credit as a way of coping with their illiquidity. At one point, in Romania the inter-firm credit problem became so acute that it trapped both creditworthy and noncreditworthy SOEs and threatened the collapse of the entire enterprise sector had the government not stepped in.

INITIAL MACROECONOMIC CONDITIONS. It seems straightforward that the countries' ability to overcome the bad debt problem and to introduced bank reform would be influenced by the initial macroeconomic conditions, in particular, by the fiscal costs. Yet. in all countries the proportion of nonperfroming loans to total loans was quite similar despite different macroeconomic conditions (see table 5). Countries such as Hungary, Poland and the CSFR faced more favorable initial macroeconomic conditions: first, the size of total bank loans (and thus of bad loans) as a ratio of GDP was relatively low and, second, the macroeconomic adjustment programs were most successful. Both of these

conditions implied that dealing with banks' bad debts would be less costly in fiscal terms. In Hungary and Poland the total enterprises' loans as a share of GDP was less than 20 percent but in Bulgaria and Romania these were about 50 percent. This might be explained by the fact that Hungary and Poland started the banking reform several years before the political opening took place. In particular, the size of the monetary overhang in these two countries was relatively small in early 1990, while in Bulgaria and Romania it was very high. Furthermore, Hungary, Poland and the CSFR were very effective in stabilizing their economies and in lowering the inflation rates.

Table 5. Macroeconomic Indicators, Nonperforming Loans and Fiscal Costs

	Hungary	*Poland*	*CSFR*	*Bulgaria*	*Romania*
Ratio of Enterprises' Bank Credit to GDP (in percent)					
In end of 1990	25.8	15.6	60.5	78.8	38.6
In June 1991	24	18.4	62.4	47.8	44.6
Real Interest Rates					
In end of 1990[1]	1.9	-44.4	-32.6	-35.5	-96.8
In 3rd Quarter of 1991	8.1	15.6	2.3	-71.9	-31.7
Annual Rate of Inflation (in percent)					
In end of 1990	33.4	250	16.6	64	150.1
In June 1991	36	79.9	71.3	554.6	224.9
Memo Items:					
Estimated Ratio of Nonperforming to Total Loans in 1991 (in percent)	50	40	55	44.2	36.6
Estimated Fiscal Cost of Removing all Bank Nonperforming Loans (in percent of GDP) in June 1991[2]	5.4	6.5	5.6	17.7	22.9

Source: Countries' official statistics and author's estimates

[1] Because the end of 1990 CSFR's real interest rate was not available, I have used the first quarter of 1992 .

[2] It is the interest cost of either swapping government bonds for bank nonperforming loans or of providing a government guarantee on these loans. Since there is no market government bonds in these countries, I have used the average nominal lending rate as a proxy.

The low ratio of total loans to GDP and the successful macroeconomic conditions had two very important consequences. First, the lower inflation rate, by lowering the nominal interest rate, reduced the fiscal cost of overcoming the enterprises' bad debt problems. For instance, had governments assumed all bank bad loans, the fiscal cost would have been about 6 percent of GDP in Hungary, Poland and the CSFR, while it would have been about 20 percent of GDP in Bulgaria and Romania. While assuming all bad loans would not be good economic policy, it illustrates the likely effect of such

a decision on macroeconomic performance. Therefore, the authorities in Bulgaria and Romania were less inclined to provide a bold solution to the bad debt problem and more willing to let the high inflation rates and negative real interest rates reduce the real value of the bad debts even though this undermined the economic stabilization effort.

Second, the shift to positive real interest rates in Hungary, Poland and the CSFR (most likely as a result of the macroeconomic stability and lower inflation rates), by increasing the demand for bank financial assets, enabled banks to expand, to reduce the proportion of bad loans and to increase their cash income. The positive real interest rates, by rationing the demand for loans, also may have encouraged financial discipline among borrowers.

SCHEMES FOR DEALING WITH ENTERPRISES BAD LOANS. Although all the countries introduced schemes for dealing with enterprises' bad debts and for reforming their banking systems, there were important differences among them. These are summarized in Table 4 and are briefly described and evaluated for each country below.

Hungary followed a gradual approach to the problem of the nonperforming loans and tried to distinguish the solution of banks' nonperforming loans from the solution for overcoming SOEs problems. Until end-1989 the authorities argued that banks were in good financial condition. But this situation started to change in late 1989 when the auditors applied stricter standards and the size of the nonperforming loans in the three large banks became apparent (amounting to Ft 10.5 bn or 1.7 percent of total bank loans outstanding with enterprises by end-1987).[8]

In December 1991, the government recognized this problem. The government responded by (a) providing government guarantees on 50 percent of the three banks' nonperforming loans still outstanding by the end of 1987;[9] (b) exempting from income tax additional loan loss provisions on the

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[8] See Nyers and Rosta Lutz (1992) for a discussion of the whole enterprise privatization process.

[9] These five-year guarantees were only callable when liquidation proceedings on the debtors had initiated;

nonperforming loans; (c) limiting distribution of dividends until the nonperforming loans have been fully provided; (d) allowing the large commercial banks to swap its inherited stock of nonperforming loans for equity;[10] and (e) accelerating the privatization of banks in order to attract new capital into these three banks.

There are two important aspects of the Hungarian scheme. First, the scheme might fail to take full account of the total nonperforming loans in these three banks. According to independent bank audits, nonperfroming loans hovered between Ft 50 bn and Ft 100 bn by the end of 1991.[11] Second, the scheme linked the recapitalization of banks to the effectiveness of the bank managers in dealing with bad debtors. This was done by limiting the use of guarantees to the initiation of liquidation proceeding on the debtors and by forcing the debtors to seek approval of restructuring schemes from the banks. This approach relied on the effectiveness of bank managers' assessment of enterprises' future. Preliminary evidence indicates that bank managers requested additional guarantees and granted additional loans to debtors to improve their portfolio, and to limit the required loan loss provisions.

Aware that the true problem originated in the enterprise sector, the authorities decided to accelerate the privatization of enterprises through the appointment of a Minister without portfolio. The authorities, committed to the gradual approach, increased the number of enterprises for sale and provided low interest finance to citizens to purchase shares in these enterprises. The National Bank of Hungary (NBH) introduced a series of refinance credit lines at subsidized interest rates (subsidy amounted to 25 percent of the base rate) to encourage the sale of enterprises and starting up new ones. The NBH argued that the subsidy would not result in NBH losses because the proceeds would be used to retire the 6 percent interest government debt.[12]

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[10] An example is the Hungarian Credit Bank which swapped Ft 6.42 billion of Tungram's bad loans for 91 percent of its equity. A controlling interest of 51 percent was later sold to General Electric. See Radio Free Europe Research Report (1992).

[11] This is a very conservative estimate, some other studies based on estimated arrears calculate the size of nonperfroming loans in as much as Ft 500 bn or 50 percent of total loans in 1991.

[12] See National Bank of Hungary (1991) for a discussion of the refinance schemes available to national willing to buy or start new enterprises.

Poland, in a recent attempt linked the recapitalization of the nine commercial banks to the restructuring of the SOEs. Poland started confronting the problem of banks in 1990, when both the banks' and the enterprises' financial statements showed a very good financial situation. The authorities only dealt with the foreign exchange losses held by two specialized banks and amended the regulatory and supervisory framework.[13] The authorities improved the management of the commercial state-owned banks through twining arrangements with western banks and by establishing supervisory boards. Little was done to establish a regulatory and supervisory framework.

In 1991, the situation of the enterprises and banks deteriorated quickly and, as a result, the economy experienced its second year of recession. By mid-1991, the first audits of some commercial banks already showed a rapid accumulation of nonperforming loans. According to bank audits the proportion of nonperforming loans increased from about 15 percent of total loans in end-1990 to 40 percent in June 1992. This prompted the government to design a scheme for dealing with both the banks' and the enterprises' problems.

The government is improving the nine banks' governance by: (a) recapitalizing the nine commercial banks to a 12 percent of capital adequacy level using 15-years and 5-years of grace government bonds; (b) granting banks' supervisory boards greater control of and oversight over bank management; and (c) introducing a market-oriented regulatory and supervisory framework. The nine banks now, more effectively governed, would participate in the restructuring and privatization of enterprises. Using tools such as partial debt write-downs and debt-equity swaps, the banks are anticipated to play a key role in enterprise restructuring and privatization. Legislation will place limits on banks' activities and thus prevent banks from granting new loans to enterprises and limit the maximum volume of enterprises shares that banks could hold to 50 percent of bank capital. Debt relief would be contingent on enterprises submitting restructuring proposals acceptable to banks. Enterprises

[13] In mid-1991, the government issued US$ 5.5 bn in foreign currency-denominated bonds with a maturity of twelve and a half years for recapitalizing these two banks.

that became nonviable even after debt-relief or whose managers would fail to provide a restructuring plan acceptable to the banks, would be forced into liquidation.

Because the success of the scheme depends on limiting the social consequences of massive lay offs, the government will establish a special fund for enterprises whose liquidation might have important social consequences. This fund will be sanctioned in the 1993 budget law and will be used for restructuring and/or paying the costs of enterprises considered socially important, for example, enterprises whose liquidation would have important social effects or enterprises the government wants to retain.

For the successful implementation of this scheme the competence and independence of bank managers is critical. Bank managers are responsible for determining the viability of enterprises and the size of the financial subsidy. This, however, requires very strong bank governance like that that prevails in Japan and Germany. To some extent, the authorities have provided this through the recapitalization of banks and through bank regulation and supervision. And the scheme as it stands seems to have been well designed to reward managers for good credit decisions, but not necessarily to penalize them in case of bad credit decisions. A good governance structure must include an incentive structure with "reward and risk" features that are a common feature of corporations in market economies. In a market economy private ownership means that the losses resulting from bad loans are paid directly out of the owner's capital and the managers face the risk of being removed. These penalties are difficult to introduce as long as banks are state-owned. In a state-managed bank the manager faces no risk in addition to the risk of being removed and even this threat is somewhat doubtful because there are not enough trained replacements. Perhaps for these reasons the authorities have found it necessary to establish a unit in the Ministry of Finance to monitor the state-owned bank-led enterprise restructurings.

CSFR chose rapid privatization of banks and enterprises. In May 1992, the government started the first wave of voucher privatization by offering 1,491 enterprises for sale, among which were offered about 50 percent of the shares of the two state-owned commercial banks. It also put about 50 percent of the shares of the other state-owned banks in the second wave. The government plans to use the other 50 percent of the banks' shares for restitution and to attract a controlling partner.

Prior to the privatization the government adopted measures to manage the banks' nonperforming loans. As in Hungary, it provided for a partial bank recapitalization while relying on banks, as Poland had done, to identify the viable enterprises. Yet unlike Hungary and Poland, CSFR has accelerated privatization to impose control on both state-owned enterprises and banks. The government proceeded in two steps.

In January 1991, under pressure from banks, the government decided to remove a portion of the nonperfroming loans. These perpetual loans, the TOZ loans, were yielding six percent interest and had no amortization schedule. SOEs were compelled to take these loans to re-lend to the government, which was, by the early 1970s, experiencing a cash shortage. To decide the amount of the recapitalization, the government asked the banks to select the TOZ loans they wanted removed from their balance sheets.

In February 1991, of the total Kcs 170 bn of TOZ loans held by the two state-owned commercial banks, the government transferred Kcs 120 bn in loans and liabilities out of the commercial banks and into to a newly established Consolidation Bank (KON), which had the sole function of holding and collecting these nonperforming loans. The liabilities transferred were deposits from the central bank, the state-owned insurance companies and the Savings Bank held by the two commercial banks. Moreover, the transferred loans were retained as claims on the enterprises and the conditions were renegotiated by increasing the interest rate to 13 percent and fixing the maturity at 8

years. Similarly, the commercial banks also renegotiated the TOZ loans they kept by increasing the interest rate to 22 percent and fixing the maturity at 5 years.

Second, in late 1991, the government concerned with the over-indebtedness of enterprises that otherwise could be viable and with the low capital adequacy of some of the banks, decided to make Kcs 50 bn available for these two purposes. It provided banks with Kcs 38 bn for overindebted viable enterprises, and Kcs 12 bn for recapitalizing the four commercial banks and the two savings banks. While banks were responsible for identifying the enterprises eligible for the debt-relief (provided that enterprises incurred this debt before 1990), a specially designed commission was responsible for reviewing the banks' selection. In addition, the government used the Kcs 12 bn to recapitalize the four commercial banks to a 4.2 percent level of capital adequacy and the two savings banks to 3.2 percent level. In doing this the government assumed that the banks held no more nonperforming loans.

But although the government had provided the banks with Kcs 170 bn for bank recapitalization purposes (amounting to about 30 percent of all enterprises' loans outstanding by end-1991), anecdotal evidence and preliminary estimates indicated that state-banks held about Kcs 145 bn more in nonperforming loans (or about 25 percent of all enterprises' outstanding loans by end-1991). The government indicated its commitment to avoiding further recapitalization of banks because of fiscal constraints.

But the presence of banks with large nonperforming loans inclined to take greater risks together with very liberal restrictions for establishing investment funds for participation in the voucher scheme, established yet another new link between banks and enterprises. As a way of growing out of their difficulties, the former state-owned banks established their own investment funds and bid for enterprises. However because they used a separate institution, such as the investment fund, there have been limited negative consequences on the banks' portfolios. Evidence indicates that the former state-owned banks' investment funds accounted for a large number of the more than 400 registered

investment funds, banks' investment funds made the highest redemption offers and thus banks' funds were the most popular.[14] While the complete investment strategy of the state-owned banks is not yet entirely clear, at least one part of the strategy appears to be making high redemption offers in order to accumulate a large volume of the vouchers and then bid for their client enterprises. This will enable banks to influence their client enterprises' market value through the bidding process and to gain full control of the enterprises' management. The investment law currently limits an investment fund to no more than 20 percent of the holdings of a single enterprise. Banks have circumvented this rule by establishing several funds. Therefore, bank investment funds mirror the role of investment bank in the pre-1930s U.S. and/or in the pre-1980s Japan.

Three important aspects of the CSFR scheme stand out. First, it illustrates the complexities of designing a strategy for dealing with banks and enterprises. While it might be desirable to use banks to enhance enterprises' corporate governance, it is risky to rely on banks subject to moral hazards. Because these banks have large nonperforming loans they might not be the best instruments.

Second, voucher privatization was a key instrument for determining market value and enterprise viability. This, in turn, contributed to financial reform by providing banks information about the financial condition of enterprises. Through voucher privatization bank managers learned the market value of the enterprises in their own portfolios thus enabling them to focus on viable enterprises.

Third, investment funds and privatized banks were the main instrument to impose control on enterprises. There is evidence that investment funds and privatized banks strengthened their corporate governance by getting technical assistance from western banks. For instance, the privatized, formerly state-owned, banks have sought technical assistance and established joint ventures with foreign banks.

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[14] Preliminary information indicates that out of the six funds which are expected to control 30 percent of the assets, four are owned by state-owned banks or insurance companies. Moreover, state-owned banks' funds redemption offers hover between 10 and 15 times, while the other funds made much lower offers.

In this respect, the CSFR scheme is different from the Polish one where state-owned banks will establish control of enterprises.[15]

Bulgaria and *Romania* are still designing their strategies for restructuring their banking systems; in this sense they are behind Hungary, Poland and CSFR. Most of the measures taken were still partial and in some respects responded to the problems faced.

Although *Bulgaria* is designing a program for dealing jointly with the bank and enterprise problems, it has made little progress in enterprise privatization and restructuring. It has started with land and small-scale enterprise privatizations and will soon start a pilot project for the privatization of large-scale enterprises.

Concerning the strategy for dealing with banks' nonperforming loans, the government has guaranteed *all* bank loans granted by end-1991, which amounted to about Lev 46 bn (or 37 percent of 1991 GDP). To limit the effect on the budget deficit, the government plans to make these guarantees available gradually. There will be fixed annual ceilings and requirements regarding the restructuring and privatizing enterprises. If the amount needed for enterprise liquidation and privatization is less than the ceiling, then the bonds can be used for bank recapitalization based on portfolio reviews. However, since the privatization law is still expected to be passed by Parliament and the progress in privatizing and restructuring enterprises is slow, the government is allowing the different government agencies and sectoral Ministries to use the bonds for granting debt-relief based on sectoral priorities. In the future, it is expected that the Privatization Agency will be responsible for the coordination.

Moreover, since banks' nonperforming loans (which were estimated in Lev 17 bn by mid-1991) might lead to bank liquidity problems because of bad debtors not paying interest on the loans, the government has allowed banks to capitalize the interest on the central bank deposits held by banks (which are distributed among banks in the same way as the nonperforming loans). In addition, to

[15] I thank Richard Salzmann for making this point to me at an EBRD conference .

preventing debtors from taking advantage of the government guarantee and to forcing banks to collect on these loans, the government has prevented banks from lending to enterprises that fall into arrears with the banks.

To reestablish control on banks, the government has created a Bank Consolidation Company (BCC). The government has required that all state-owned enterprises or banks holding shares of other banks transfer them to the BCC, and by early-1992 the BCC held about 70 percent of all banks' shares. This was considered a necessary precondition for enabling banks to take independent credit decisions from their borrowers which at the same time were their owners. Once this process and the bank portfolio reviews are completed, the government plans: (a) to merge the large number of small banks into eight medium-sized banks; (b) to recapitalize the banks by substituting government bonds for the nonperforming loans; and (c) to start the process of bank privatization.

In *Romania*, the government focused on dealing with banks' nonperforming loans and, as in Bulgaria, the enterprise privatization is still in an early stage. The government has taken three measures. First, in July 1991 the government guaranteed 90 percent (or Lei 150 bn) of all bank nonperforming loans outstanding at the end of 1990. It also compelled banks to take responsibility for the remaining 10 percent over a period of several years by building up their provisions.

Second, in December 1991 the government introduced a scheme for clearing up the accumulation of inter-firm arrears. By the end of 1991 inter-firm arrears had reached about Lei 500 bn or 40 percent of total bank loans outstanding to enterprises. The inter-enterprise arrears threatened the collapse of the whole enterprise sector since it linked good and bad enterprises. The government netted out and cleaned up these arrears by enabling enterprises with outstanding inter-enterprise credits to discount them with the commercial banks until January 1991. Banks should then grant debtor enterprises a special loan (a global compensation bank loan (GCBL)) at market interest rates. To avoid the deterioration in bank portfolios and force enterprises to repay the bank loans, the government

guaranteed the loans that became due in September 1992 and provided the creditor bank initiated foreclosure proceeding leading to the liquidation of the debtor enterprise. To accelerate enterprise foreclosure, the government passed the so-called Law 76. But until the end of 1992 there was no case of enterprise liquidation and anecdotal evidence suggest that banks refinanced most of the overdue GCBL.

Third, in 1993 the government is planning to provided Lei 50 bn in additional funds for bank recapitalization.

Although the measures taken by the Bulgarian and Romanian authorities for dealing with the banks' institutional problems have important differences, they both emphasize re-capitalization of banks as the way to improve banks' corporate governance. In this sense they resemble some aspects of the Polish scheme and thus, are subject to similar comments. Unlike the Polish scheme, the link between the bank recapitalization, on the one hand, and bank restructuring and enterprise privatization, on the other, was not clearly defined. Both the Bulgarian and Romanian schemes can lead to an across-the-board debt forgiveness. For instance, in Romania available evidence indicates that because the debt write-off was neither linked to enterprise nor to bank restructuring enterprises, banks granted new loans to these same enterprises. By the end of 1990 bank audits suggested that these same enterprises accounted for a large proportion of the post-1990 bank bad loans and for the global compensation overdue loans. The post-1990 bad loans accounted for about two-thirds of the total bad loans outstanding in September 1992, close to 30 percent of total bank loans.

The notable difference about Bulgaria was the guarantees provided. Bulgaria is the only country that has openly recognized *all* enterprises loans. All other countries have been reluctant to make such acknowledgments because of the large fiscal costs involved. Instead, most other countries have opted for guaranteeing only the proven nonperforming loans. In Bulgaria, for instance, the total guarantees amounted to Lev 46 bn or 44 percent of total bank loans outstanding with enterprises by

end-1991, while in Romania the government assistance for bank recapitalization amounted to Lei 200 bn or 10 percent of total bank loans outstanding with enterprises by end-1991. In Hungary, Poland and the CSFR the government has agreed to guarantee a smaller proportion of total enterprises loans. While it is important that the government recognize the old bad debts, it is also important to link that to the overall objective of enterprise privatization and restructuring.

3. Bank Privatization

All five countries have as the final objective of bank restructuring the privatization of banks. Few countries have succeeded in this difficult task. Of the five countries, the CSFR has privatized the largest number of banks. One bank was completely privatized through direct sales, while the others were partially privatized through voucher schemes. Poland might be close to privatizing two banks. Yet except for the CSFR, none of the five countries has conditioned bank recapitalization on the privatization of banks. A controlling investor is needed to ensure a strong bank governance. Despite this, all five countries see bank privatization as the only way of improving banks' corporate governance.

There are three reasons for stressing bank privatization as the final and most important goal in bank restructuring. First, recapitalization of banks and transfer of ownership to the private sector is the only way of assuring an adequate corporate structure, that is, the only way of assuring bankers' credit decisions are made independently of their creditors' interests. This is the key for ensuring banks take an active role in the transition. Private ownership of capital generates a system of risks and rewards that is the basis of the corporate governance structures found in market economies.

Second, a sufficient number of banks with an adequate corporate governance structure are required to guarantee a competitive banking system. This will ensure that bankers reward for lending is linked to their ability to minimize risk, and that they pay dearly for assuming high risks. When this

does not happen, the bad bankers will set the rules of the game and the good bankers will be pushed out of competition.[16]

Third, bank privatization should influence the design of the bank restructuring strategy. Because the objective of any privatization strategy is to maximize the discounted present value of the assets subject to privatization, the authorities should ensure that any investment should be in line with this principle. However, this is difficult in the case of banks because the quality of the bank portfolio, which is the most important asset in a bank, can be subject to different assessments depending on the criteria used. It is likely that bankers' opinions differ in assessing bank loans. Because the value of a banks' assets is maximized at the time of recapitalization, it is argued that the assessment should occur immediately upon privatization.

Although the five countries have not been very successful in privatizing banks, some have followed alternative strategies for enhancing the banking system corporate governance. Interesting examples are the cases of Hungary and the CSFR. Both countries have tried to introduce market discipline in the banking system by encouraging the establishment of banks with a stricter corporate structure. Hungary did this by encouraging the entry of foreign-owned banks and the CSFR by encouraging both foreign and domestic-owned banks. In Hungary the number of joint-ventures increased from 2 in 1987 to 15 in 1991, and the number of commercial non-state-owned banks increased from 2 in 1987 to 11 in 1991. In the CSFR between January 1990 and March 1992, 34 new banks were established.

Although the strategy had the expected effect of enhancing competition, two problems have arisen. First, the new banks and, in particular, the foreign-owned banks, as expected, took advantage of their better position and focused on the less risky activities such as the foreign trade financing activities. Second, while a large number of new banks were established in both Hungary and the

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[16] See de Juan (1987) for a vivid account of how goods banks can turn into bad in an environment subject to moral hazards.

CSFR, they only accounted for a small share of the market and could not swing the rules of the game in favor of the good banks and impose market discipline on the bad banks. The large banks holding most of the nonperforming loans have dominated bank competition. In addition, while this option has been available to Hungary, Poland and the CSFR, it might not be an option for Bulgaria and Romania not to mention some of the CIS countries since they have received less international attention and have received smaller foreign investment flows.

E. EFFICIENCY OF BANKING SYSTEMS: AN ASSESSMENT ATTEMPT

In assessing the banks' performance, I will focus on two types of evidence: (a) trends in domestic credit allocation by sector and, in particular, allocation of credit to private sector enterprises; and (b) trends in domestic banks' real lending rates and interest rate spreads. This evidence should enable us to judge whether domestic banks have been allocating credit efficiently and whether the interest charged for these credits to the productive sector have been competitive. As is well known, if banks misallocate credit and/or charge high interest rates, they could preempt the economic recovery.

Because the available information is limited, the conclusions should be taken as preliminary. The available evidence should enable us to make a preliminary assessment of the role of banks in the transition and to extract some important lessons. To limit the data quality problems, I have decided to analyze trends in these variables and to focus on Hungary, Poland and the CSFR, the countries which are more advanced in restructuring their banking system.

1. Credit Allocation

Using the available information on bank net domestic credit, we can assess the role of banks in the allocation of credit. Efficient banks will try to diversify their loan portfolio by lending to new good customers and limiting their lending to the old borrowers that have accumulated arrears with banks and account for most of banks' nonperforming loans. Moreover, it is possible to associate this

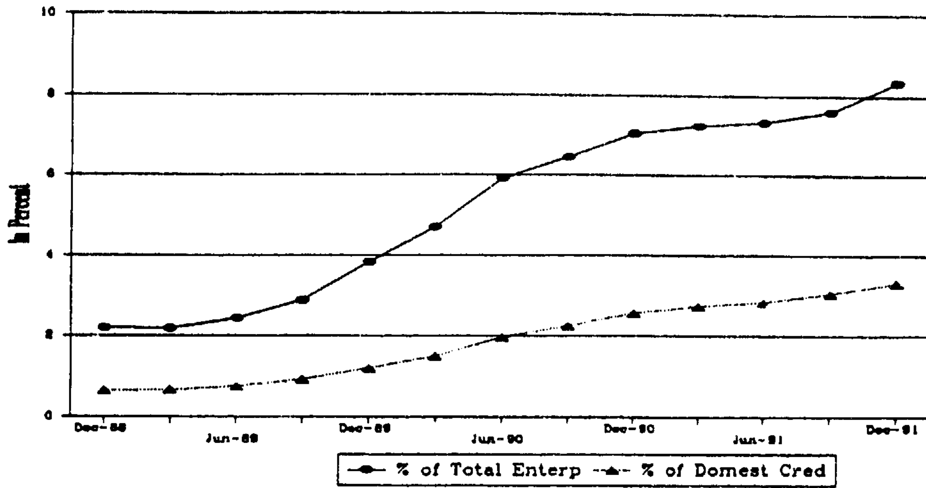
diversification with the allocation of credit between private and SOEs. An increasing trend in bank lending to private sector enterprises should indicate that banks are trying to diversify, in particular, because SOEs account for most of the stock of nonperforming loans. This does not mean that all SOEs are nonviable enterprises, but rather that as the private sector develops, banks should be encouraged to lend to the potentially profitable private sector and therefore should target a larger proportion of their loans to them than to SOEs.

However, banks will respond to this behavior depending on the incentives they face and the ability to minimize their own losses. For instance, if banks with nonperforming loans dominate in the market and they can by-pass regulations on required provisions on nonperforming loans, credit resources will be misallocated. Insolvent banks holding large nonperforming loans might decide to limit their provisions on nonperforming loans by granting new loans to their bad customers as a way of helping them to overcome their difficulties and turning them into good customers. Moreover, it could also happen that bankers behave as in the previous regime and grant credit to the old SOE customers because they have no incentive to diversify, or because the government compels bankers to lend to SOEs. In any case, this will have the consequence of crowding out the good borrowers from the banking system and thus lead to a misallocation of credit.

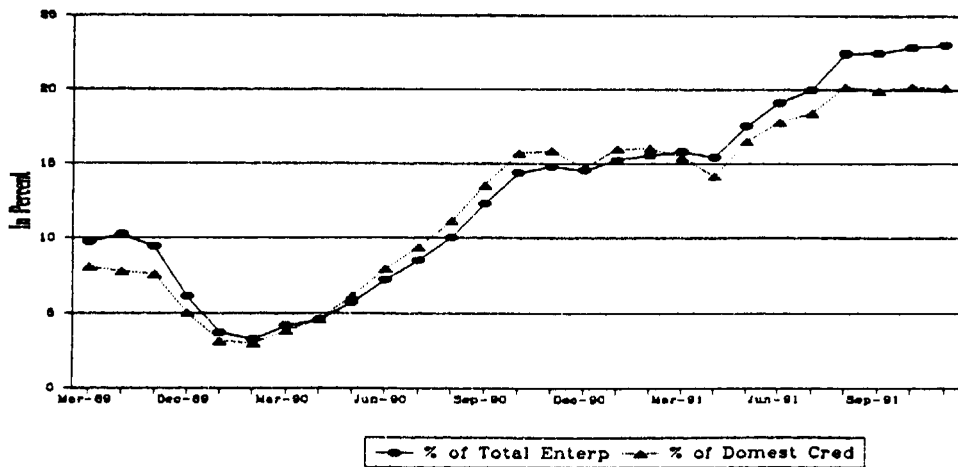
Evidence for Hungary, Poland and the CSFR indicates that banks, on average, have increased their loans to the private sector very quickly (see Graph 1). However, this growth in credit to the private sector was less rapid than the growth in private sector activity. In Hungary, the proportion of net domestic credit allocated to private sector enterprises increased from 0.6 percent of net domestic credit and 2.2 of total enterprise credit in December 1988 to 3.3 and 8.3, respectively, in December 1991. In Poland, bank credit to the private sector (which includes households) increased from 8.1 percent of net domestic credit and 9.7 percent of total enterprise sector in March 1989 to 20 and 23

Graph 1: Credit Allocation to the Private Sector

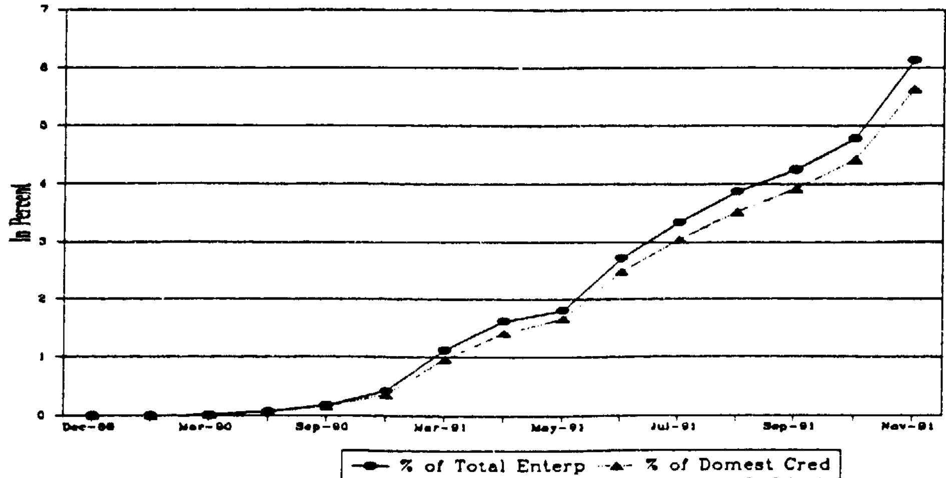
Hungary



Poland



CSFR



percent, respectively, in November 1991. In the CSFR, these ratios increased from 0 percent in December 1988 to 5.6 and 6.1, respectively, in November 1991.

Another source of evidence for assessing the role of banks in the allocation of credit is the proportion of credit allocated to the private sector by type of bank. This information is provided in Graph 2 for Poland and the CSFR. This graph shows the proportion of credit allocated to the private sector by state-owned banks and by private banks. This indicates the extent to which banks holding nonperforming loans, such as the state-owned banks, have diversified their lending.

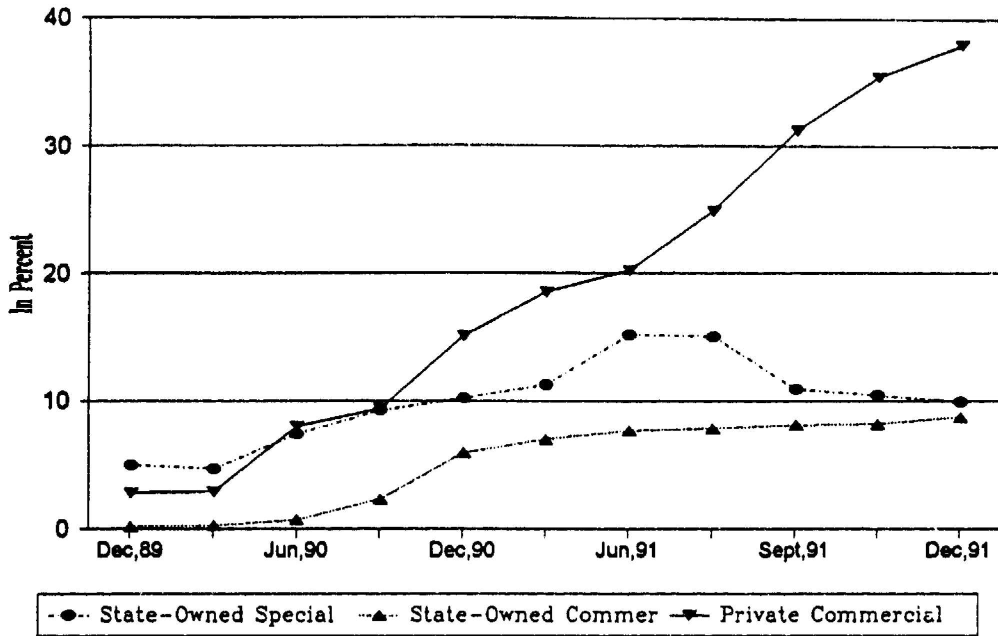
Both in Poland and the CSFR, private banks have increased their credit to the private sector faster than the state-owned banks have. For instance, in Poland the private banks have increased their share of private sector loans from less than 5 percent in December 1989, to about 40 percent in December 1991. In contrast, the state-owned banks allocated less than 10 percent of their total loans to the private sector. Similar conclusions follow from the evidence of CSFR's banks. In December 1991 the non-state-owned banks allocated more than 25 percent of their loans to the private sector, but the large state-owned banks only 5 percent.

2. Real Lending Rates and Interest Rate Spreads

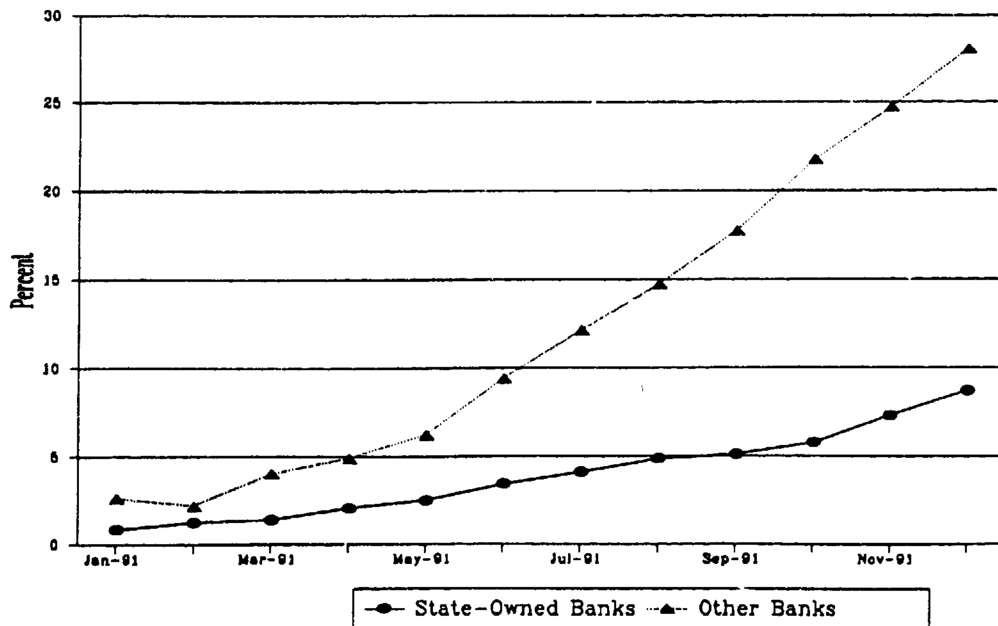
Comparing Eastern European banks' real lending rates to those of German and U.S. banks is another way of assessing Eastern European banks' efficiency. If efficient banks dominate in the market and their commercial risks are similar, their average real lending will be comparable to that of the German and U.S. banks adjusted for devaluation and risk factors. Efficient domestic banks will charge a lending rate to their prime customers more or less in line with the alternative cost of finance, that is, the international lending rate. This will enable efficient domestic banks to attract low-risk customers. Differences in the lending rate might prevail if the cost of attracting deposits is higher in Eastern Europe than in Germany and the U.S.

Graph 2: Allocation of Credit to the Private Sector by Type of Bank

Poland



CSFR



If domestic banks have a larger proportion of nonperforming loans and are subject to high reserve requirements, they will have to charge a high lending rate and/or a large spread to compensate the income foregone. Since reserve requirements on commercial banks are relatively low (except for savings banks and banks in Hungary) the costs of nonperforming loans might be the most important cost driving the lending rates and/or the interest rate spreads. These costs, however, will result in high average lending rates (and/or low deposit rates) and interest rate spreads, only if most banks hold large nonperforming loans.

The comparison of the average real lending interest rates for each of the three Eastern European countries with those prevailing in Germany and the U.S., are shown in Graph 3. Differences in the real lending rates consist of changes in real lending rates and in real exchange rates.[17] The trends are illustrative of banks' policies.

In all three countries real lending rates have increased relative to international levels. Real lending rates increased very fast starting in 1991 and by end-1991 they were higher than those of Germany and the U.S. This change in the real lending coincides in most countries with policy changes. In the case of Hungary the increase in the lending rate in 1991 coincided with the introduction of new bank legislation and the requirement for provisions on banks' nonperforming loans. Notice the large difference between Hungarian banks' and German banks' real lending rates in 1991, which was between 5 and 10 percentage points.

In Poland the increase in real lending rates coincided with the SOEs' crisis and the surge in banks' nonperforming loans. Polish banks' real lending rates were more than 15 percentage points higher than those of U.S. banks in 1991. This suggests that Polish banks needed to increase their revenue in order to compensate for the interest forgone of nonperforming loans.

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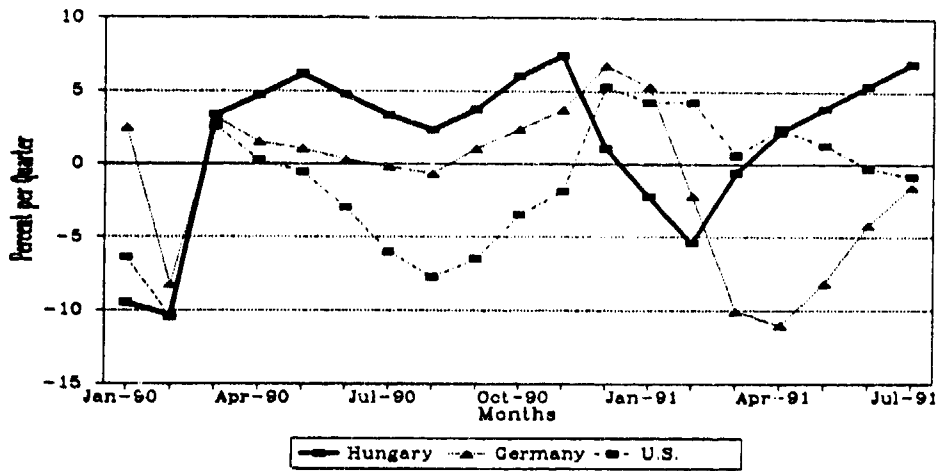
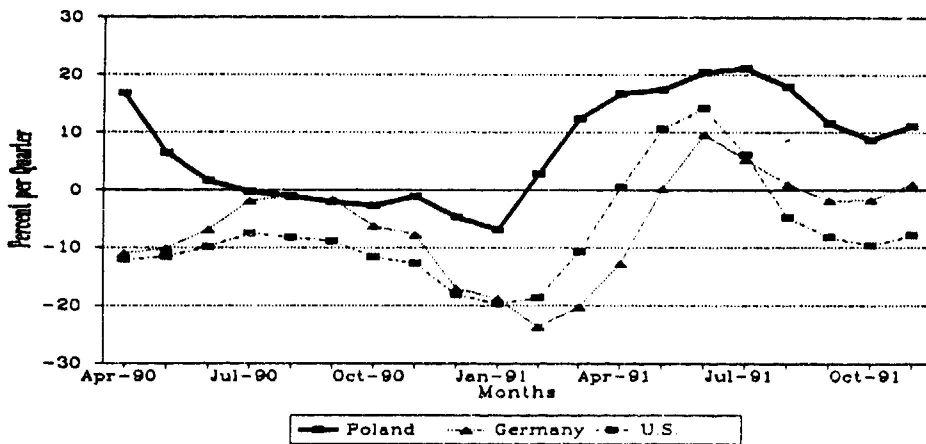
[17] To calculate the real lending rates and the real interest rate spreads I have used the following equation: $\{[(1+i)*(1+E)/(1+p)]-1\}*100$, i is the nominal lending rate or interest rate spread of Germany or the U.S., E is the devaluation of the domestic currency against the DM or the US$ and p is the annual domestic inflation.

Graph 3: Real Lending Rates of East.European Countries, Germany and the U.S. (In Percent per Quarter)

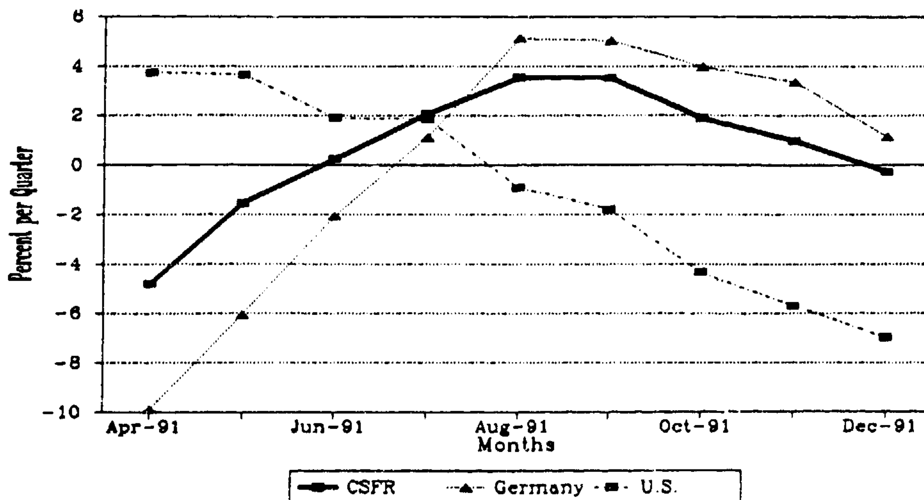
Hungary



Poland



CSFR



In the CSFR the increase in real interest rates coincided with the introduction of bank legislation and the requirement for loan loss provisions. Unlike Hungary and Poland, real lending rates in the case of CSFR's banks remain similar to those of Germany and the U.S.

Information concerning interest rate spreads is provided in Graph 4. This graph shows the decomposition of CSFR's bank spreads by type of borrower and by type of bank. It shows that CSFR's banks charge their highest spread to private enterprises and the lowest to the households and SOE sectors. In fact, it could be argued that CSFR's banks supplemented their income by expanding credit to the private sector and charging, at the margin, the highest spread .

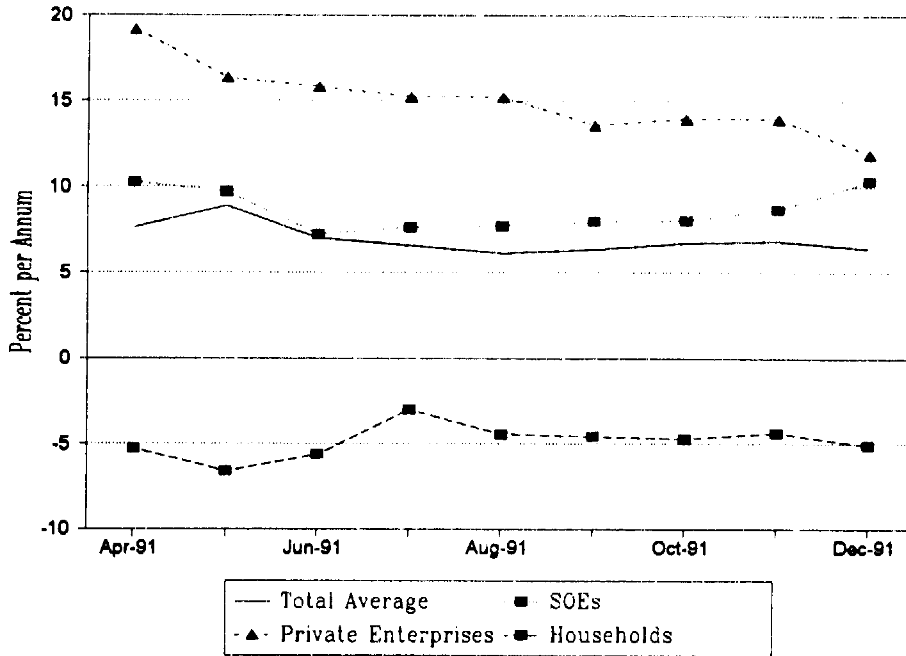
The differences in interest rate spread by type of bank are also very revealing. In Graph 4 the bank spread is broken down into the portion taken by a deposit-taking bank, such as the Savings Bank, which lends its resources in the interbank market, and the portion taken by nondeposit-taking banks, which borrow from the interbank market. Most of the non-state banks raise their funds by borrowing from the interbank market because they don't have a deposit base. This indicates that the high spread is explained by the large state-owned banks which need to generate income to subsidize their other loans.

F. CONCLUSIONS: ARE THERE ANY LESSONS?

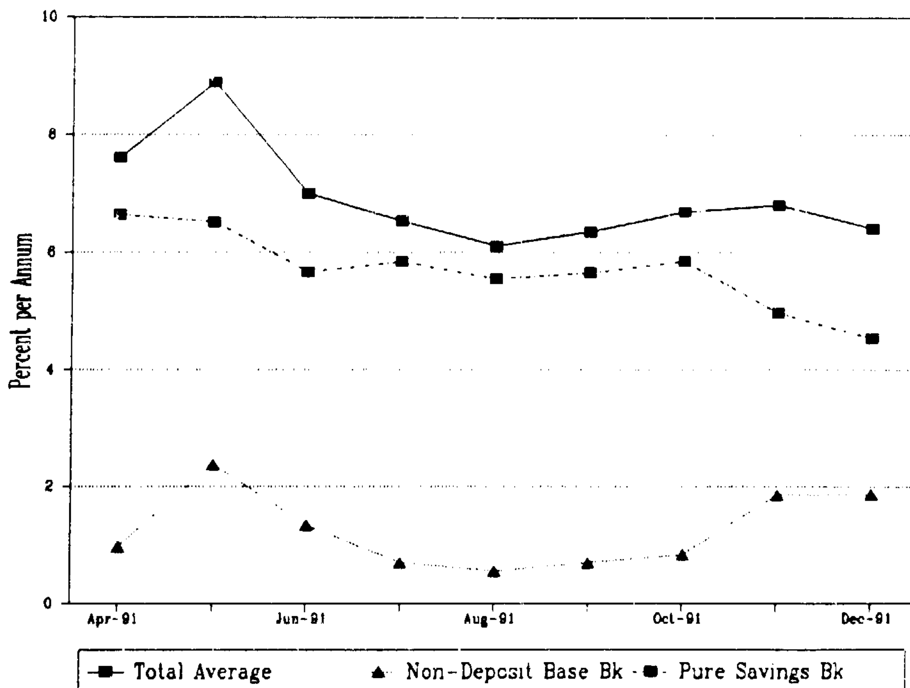
In all five Eastern European countries, the governments have undertaken important measures for restructuring their financial systems. The task was not an easy one, since all five countries inherited a heavy legacy. Banks in a centrally planned economy were designed to play a role very different from the one they have to play in a market economy. In centrally planned economies, banks are passive institutions, and the transition to a market economy requires that governments turn banks into active institutions capable of participating in the economic restructuring effort.

Graph 4: Decomposition of CSFR's Nominal Interest Rates Spreads

By Type of User



By Type of Bank



Although it is too early to assess the relative success of each country, it is possible to suggest a few elements that can serve as lessons from the reform so far.

First is the relation between the problem of banks and those of enterprises. It is difficult to pretend to solve the banks' problems without confronting simultaneously the problems of enterprises. In the final analysis, the true problem is not whether banks hold nonperforming loans or not, but rather how to prevent further accumulation of nonperforming loans. This, in turn, implies that the real problem lies in how to close the loss-making and nonviable enterprises.

Second is the role of banks in dealing with loss-making and nonviable enterprises. This is difficult because it is necessary to grant bank managers enough independence from their customers, loss-making enterprises. The key question is how fast a new bank governance structure can be introduced which will grant bank managers independence in credit decisions. It is crucial that banks focus on what banks know best: assessing risk. Here the roles of capital, private ownership and adequate regulation and supervision are crucial. In fact, the role assigned to banks in the transition will depend on providing banks with adequate governance structures. In this regard, few of the five countries have been successful.

Third is the role and timing of bank recapitalization. This is related to the corporate governance. Bank recapitalization only removes the moral hazard problem posed by the presence of nonperforming loans. In practice it consists of an <u>explicit</u> acknowledgment by the government of the old nonperforming loans. However, this involves an explicit guarantee. The objectives of a bank recapitalization should be: (a) to prevent banks from accumulating more nonperforming loans, that is, dealing with the enterprise problems; and (b) to provide banks with a new corporate governance that will prevent them from incurring in new nonperforming loans. This requires introducing a system of risk and reward by making banks comply with the capital adequacy requirements, privatizing a critical number of banks and introducing strong regulation and supervision.

Fourth are the other roles of banks. The complexity in untangling the relation between banks' and enterprises' problems has led some governments to overlook other important roles that banks should perform, such as providing an efficient payment systems. The institutional problems that the governments have confronted in introducing efficient payment systems underlines the need to put greater emphasis on this task, since it is the basis for the development of trust in the banking system.

Fifth is the role of regulation and supervision in enhancing banks' governance structure. While it appears to be an easy task, in practice it has proven to be difficult. Deciding which regulation and supervision to adopt implies knowing what the role of banks should be. It is of no practical use for the authorities to enact a new banking law with which most of the banks will be unable to comply.

There is also the problem of upgrading the skills of bank supervisors. This requires considerable technical assistance and strong collaboration from western countries. It requires time to retrain bank supervisors capable of efficient on-site and off-site bank supervision.

Sixth is the presence of banks with a large proportion of nonperforming loans and which account for a large portion of the market. When these are not controlled, credit resources are misallocated. It is common for these banks to grant more credit to borrowers that have accumulated nonperforming loans and to increase the interest rate spreads. This usually has negative consequences because good borrowers are either crowded-out from the financial system or have to pay a very high interest rate. Some countries have tried to limit the extent of credit misallocation by encouraging the entry of new banks. But because the banks with nonperforming loans dominated in the market the new banks have been unable to change the large banks' behavior. Preliminary evidence suggests that the new banks are more efficient both in terms of credit allocation and in terms of interest rate spreads.

This evidence strongly supports the need to recapitalize and privatize a critical number of banks. Moreover, it would be desirable to privatize banks by selling a controlling stake to a group of private investors as a way of attracting new capital (foreign and domestic) into the financial system and

establishing strong bank governance. In fact, the combination of both recapitalization and privatization of banks is optimal because it ensures strong bank governance. The number of banks to be recapitalized and privatized will depend on such factors as reestablishing market discipline and enhancing bank competition. Although shrinking (by canceling both nonperforming and household deposits[18]) or removing banks with large nonperforming loans from the market will be optimal, in the case it is not feasible strong domestic competition by a critical number of private banks with adequate levels of capital should reestablish the market discipline and prevent large banks with nonperforming loans from dominating in the market.

The most important conclusion from the analysis of the five Eastern European countries' experience is that banks play a very important role in the transition. However, all five countries have found it difficult to rely on banks without prior change in banks' corporate governance. This leads to a key conclusion, that the authorities cannot rely at the early period of the transition on banks to exert control on enterprises. In the early period the control over SOEs should be exercised through a semipublic institution like the Treuhandanstalt in East Germany, the State Privatization Agency in Hungary or the National Property Fund in the CSFR.

There are three reasons for this: (a) banks are weak and do not posses the needed corporate governance; (b) banks do not posses all the legal instruments to impose control on enterprises; and (c) banks are not in a position to take some key political decisions which only the government can make, such as the proportion of debt write-off that each enterprise should be granted, whether or not to force the liquidation of large enterprises which will result in great social problems, or whether or not banks should grant loans to loss-making enterprises. These are decisions that only the government can make.

As the government provides banks with an adequate corporate governance through recapitalization, privatization and introduction of new regulation and supervision, the government will

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[18] See Frydman et al (1992) for an interesting explanation for shrinking the existent large state-owned banks.

be able to rely on banks to exert control over enterprises. Initially, banks' control over enterprises has to be indirect through credit allocation and in close collaboration with the semipublic institution in charge of enterprise restructuring and privatization. Only when banks are provided with strong corporate governance will they be able to participate directly in controlling enterprises. Whether banks direct control over enterprises should be performed by special investment banks, like in Hungary and CSFR, or by universal banks, like in Poland, Bulgaria and Romania, will depend on whether banks with strong corporate governance will emerge, assuring banks' independence in their credit decisions.

My personal preference would be that during the transition only investment banks should specialize in controlling enterprises. This should limit the effect of bank failure on the rest of the financial system and on depositors, while allowing banks to contribute to the development of the enterprise sector by permitting them to take greater risks. In a way this is the option taken by CSFR. However, to be effective this would need to be a scheme for valuing enterprises and their loans, such as the voucher privatization or by auctioning the bad loans as I have proposed elsewhere.[19]

However, it will be a mistake to postpone the banking system restructuring because it takes time. The key conclusion from the five Eastern European countries' experience is that the role of banks in the transition is of great importance, but its effectiveness will depend on how soon the authorities start with banking restructuring and how they sequence it with the enterprise restructuring and privatization.

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[19] See Coricelli and Thorne (1992)

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