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Working Paper

Better banks for Eastern Europe

Kieler Diskussionsbeiträge, No. 197

Provided in cooperation with:
Institut für Weltwirtschaft (IfW)

Suggested citation: Schmieding, Holger; Buch, Claudia (1992) : Better banks for Eastern Europe, Kieler Diskussionsbeiträge, No. 197, http://hdl.handle.net/10419/48017

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KIEL DISCUSSION PAPERS

197

Better Banks for Eastern Europe

Weltwirtschaft Kiel
Ag 214/93

by Holger Schmieding and Claudia Buch

CONTENTS

- Grossly inefficient banking systems are one of the major impediments to a rapid and sustained upswing in Europe's emerging market economies (EMEs for short). Although the transition from plan to market necessitates a large-scale re-allocation of domestic capital and easy access to foreign capital, the EMEs have adopted slow and inefficient approaches to the transformation of their banking systems.
- The EMEs can create optimal conditions for financial intermediation and a substantial import of capital and skills if they immediately import an efficient banking system and enter into an East-West Banking Union with the EC. A Banking Union goes far beyond the adoption of some relevant EC regulations for local banks; it gives all financial intermediaries licensed in one EC country free access to the EMEs subject to the same rules that apply in the EC internal market.
- At present, non-performing loans still tie state banks to insolvent state enterprises; the precarious portfolio positions of domestic banks serve as a convenient excuse for not allowing efficient and experienced Western banks to enter the market in the EMEs. To resolve the portfolio problem at one stroke, all loans that state banks had granted to state firms prior to a certain date should be written off; tight ceilings on the amount of new credits each state firm can receive from state banks would prevent a recurrence of the problem. The ceilings should not apply to private banks, which are controlled by self-interested owners.
- State banks should be recapitalized using government bonds that are indexed to inflation. Since a programme of debt write-off and recapitalization raises the value of state firms and state banks and thus the potential proceeds of privatization, it need not constitute a drain on the state budget. A clean sweep, which eases the privatization of firms and banks, is preferable to a time-consuming and arbitrary case-by-case approach.
- Even if it is no longer politically possible to fully discard the present gradualist policies, the EMEs should at least upgrade their piecemeal debt-reduction and recapitalization programmes. Thereafter, the residual portfolio problems should no longer pose an obstacle to immediate and free market access for foreign banks within an East-West Banking Union.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · DEZEMBER 1992

ISSN 0455-0420

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Schmieding, Holger:
Better banks for Eastern Europe / by Holger Schmieding and Claudia Buch. Institut für Weltwirtschaft, Kiel. — Kiel: Inst. für Weltwirtschaft, 1992
(Kiel discussion papers; 197)
ISBN 3-89456-038-X
NE: Buch, Claudia:; Kieler Diskussionsbeiträge

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Printed in Germany
ISSN 0455 - 0420

I. Introduction

During the transformation process from plan to market, the emerging market economies (EMEs) need efficient financial intermediation even more than mature market economies do; the large-scale privatization of state property, the need for substantial restructuring of firms, and the important role that new firms play in the transformation process put above-average strains on the financial system. But despite the importance of efficient financial intermediation, capital markets and banking systems in Eastern Europe are still suffering from a number of severe shortcomings. These shortcomings include non-performing loans on the balance sheets of banks, excessive expansion of interenterprise credit, insufficient supply of finance for private enterprises, state-ownership of most banks, lack of competition, and the lack of adequate and adequately enforced regulations.

The purpose of this paper is to assess potential remedies for these shortcomings. The proposals that emerge from the discussion presented here comprise: (i) a radical write-off of loans that state firms owe to state banks, (ii) a recapitalization of state banks by government bonds, (iii) transitional caps on credits from state banks to state enterprises, and (iv) a thorough institutional reform in the form of a Banking Union with the EC and a privatization of banks. There is no need to sequence the reforms. Quite the contrary holds true: there are positive externalities among the proposed measures that should be tapped by using an encompassing approach.

The paper is organized as follows: the second part reviews the major deficiencies of post-communist financial markets. The third part addresses the major problems that the EMEs will have to solve at home. Particular attention is paid to the problem of non-performing loans. The fourth part assesses the recent reform experience of Eastern Europe. Building on these parts, the fifth part presents a proposal on how the EMEs could rapidly improve their financial system by entering into a Banking Union with the EC. The last part summarizes the major findings.

II. Major Deficiencies of Post-Communist Financial Markets

In developed market economies, banks and other financial intermediaries perform a variety of vital tasks:

- they mobilize savings and allocate funds to optimal uses,
- they pool investment risks,
- they exploit scale economies in the evaluation and monitoring of borrowers, and
- they reconcile the different preferences of lenders and borrowers for liquidity as well as for specific currency structures and term structures of portfolios.

Financial support from the Volkswagen-Stiftung is gratefully acknowledged. Parts II, III.1, and V build on Schmieding [1991b; 1992]. The authors wish to thank Ralph Heinrich, Norbert Funke, Ernst-Jürgen Horn, and Martin Raiser for valuable comments on an earlier draft.

Driven by self-interested owners whose own capital is at risk and by equally self-interested top managers who care about their reputation on the market for top executives, the banks exert financial discipline on their customers.[1]

On paper, the EMEs have made substantial progress towards a modern financial system:[2] the old, one-tier system of state banks was already transformed into a two-tier system with a central bank and a variety of commercial banks at an early stage of the transformation process; new commercial banks have been established; and significant financial funds are flowing between banks and enterprises as well as between enterprises. However, actual progress has not been very impressive. Commercial banking operations still depend on the state as well as on central bank directives and financial support [Langhammer, 1992; Sundarajan, 1991]. As stock exchanges and security markets are in their infancy, banks must play the pivotal role in financial intermediation for the time being. Unfortunately, the banks are not up to the task. In the turbulent phase after the abolition of central planning, little is known about the future prospects and hence the creditworthiness of enterprises. This pervasive uncertainty concerns the potential viability of an individual firm relative to others under given circumstances (specific risk) as well as the course of economic policy and the path of economic development under any given policy (systemic risk). Furthermore, many potential borrowers have little equity and can offer little collateral, or only collateral of dubious legal status, to signal their creditworthiness.

In addition, a variety of institutional deficiencies are still impeding proper financial intermediation [see also Winiecki, 1991b; 1991c]:[3]

(1) As the banks are almost exclusively *state-owned*, the bank managers have little incentive to act as prudent advocates of capital, be it their own capital or that of their depositors. Furthermore, the market for managers is underdeveloped. Many bank managers have little reason to care about their professional reputation because they justly assume that they will be replaced sooner or later by younger and politically untainted newcomers. State banks are continuing to operate as if they *could not go bankrupt*; the expectation that the government would have to bail out the banks anyhow is well entrenched because bank failures on a substantial scale could undermine whatever confidence the public already has in the nascent financial market [Hinds, 1990, p. 99].

(2) In some EMEs — and notably in the successor states of the Soviet Union — small financial institutes have mushroomed after the collapse of the old economic regime. Many of these barely regulated and largely undercapitalized institutes are not banks in the usual sense of the word. Although often counted as private commercial banks, many have in fact been founded by state firms as instruments to channel cheap credit towards the state enterprises.

(3) Bankers often do not possess the necessary *skills and expertise*. Even simple tasks such as the clearing of payments between branches of a bank (let alone the clearing between different banks) often take long time.

(4) The EMEs lack a well-established and well-tested system of *prudential regulation* and supervision. Accounting procedures do not yet conform to the basic requirements of a market economy.

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1 On the importance of the financial liberalization for economic development, see McKinnon [1988], Balassa [1990/91], and King and Levine [1992].

2 In Hungary, banking reform started in the 1970s but the new banking law was passed in 1987 (amended in December 1991). In Poland, the early reforms in 1982 were drastically amended in early 1989 and March 1992. In Czechoslovakia, the new banking law was enacted in early 1990 (amendments effective in February 1992). Bulgaria and Romania started reforms in 1991. For the legislative changes, see Glismann and Schrader [1991].

3 The following description is of course highly stylized. It abstracts from country-specific peculiarities. Some post-communist countries such as Poland, Hungary, and Czechoslovakia have already made some progress towards resolving the problems of financial intermediation after the abolition of the old economic order (see Part IV below). Other countries such as most successor states of the Soviet Union have barely started to tackle the task.

(5) Specific banks and firms are tied to each other in various ways that impede competition between banks and grossly distort financial flows. To facilitate financial control under central planning, firms were forced in the past to deal almost exclusively with a specific bank, and banks were specialized in serving enterprises in a specific branch or region. The *portfolios* of many commercial banks *are highly concentrated*. These banks tend to channel fresh money to their main customers, on whose willingness or ability to pay the fate of the individual bank depends [Hinds, 1990, pp. 133, 147]; they are refinancing existing obligations and providing new credits to cover the interest due [see, e.g., Brainard, 1991, p. 97]. At the same time, more promising potential borrowers suffer from a dearth of funds. As a consequence, banks carry a heavy burden of *non-performing loans* granted to state enterprises. Some of these bad loans are a legacy from the days of socialism, although the value of these loans has been largely eroded by inflation in some countries such as Poland. A major portion of the bad loans was accumulated when the banks expanded their lending to state enterprises in the aftermath of the collapse of tight central control.

(6) The portfolio problem not only results from loans not being serviced; it is also unclear which further loans will eventually turn out to be unrecoverable. Furthermore, in socialist times banks were compelled to grant sizeable amounts of *long-term credits at extremely low interest rates* that were fixed in nominal terms. Due to inflation and some financial liberalization, the banks' present nominal costs of refunding are far above these old lending rates. Hence, banks in some countries are losing sizeable amounts of money even on loans that are fully serviced [see, e.g., Hinds, 1990, Annex 2]. To stay solvent nonetheless, banks would have to charge new customers excessive interest rates. The likely result would be a slow process of adverse selection, with borrowers increasingly turning to new banks or to those old banks that by chance have inherited a comparatively healthy portfolio.

(7) Apart from portfolio concentration and bad loans, the *personal contacts* established in the days when there was little or no choice of partners forms a third factor that links banks to specific firms [see Winiecki, 1991b]. To some extent, this systematic favouritism reflects a perverse system of mutual insurance. Trusting each other and trying to keep their cushy old jobs for as long as possible, bankers and firm managers try to bail each other out to avoid bankruptcy proceedings and other kinds of outside scrutiny; they collaborate to cook the books and to channel financial flows so that both the bank and the firms look sufficiently healthy on paper for the time being. By the end of January 1991 (i.e. 13 months after the implementation of Poland's stabilization programme), no Polish commercial bank had initiated bankruptcy proceedings against any of its debtors [Winiecki, 1991a, p. 1].

(8) The *financial links among firms* are similar to those between firms and their banks. Personal contacts, dependence on a dominant supplier or outlet, neglect of the long-term capital value of the state-owned firms, and a reluctance to initiate bankruptcy proceedings against other firms are the major factors prompting many of the more liquid firms to extend interenterprise credit to less liquid ones almost regardless of the ultimate creditworthiness of the borrower [see Dabrowski et al., 1991]. Hence, a pattern of cross-subsidization within the state sector emerges. Furthermore, the network of *interenterprise credits* of dubious quality complicates the task of assessing the solvency of firms even more. Note that, to some extent, the growth of interenterprise debt reflects delays in the processing and clearing of payments between banks rather than a conscious decision by the enterprises concerned.

(9) The expansion of bank and interenterprise credit counteracts the attempts at macroeconomic stabilization in the EMEs. Although the beneficiaries of these credits may no longer be subsidized directly by the state purse, they de facto still enjoy *soft budget constraints*. In some countries such as the successor states of the Soviet Union, negative real interest rates increase the incentives for firms to obtain credits and — in the absence of any noticeable penalty — to delay payments.

(10) Similarly, the *segmentation of the credit market* complicates the task of macroeconomic stabilization. Attempts at reducing the growth rate of the overall volume of credit may squeeze credits to the emerging private sector more than credits to the major established state enterprises, who — by courtesy of their old links to the state banks — enjoy preferential access to funds [Winiecki, 1991b, pp. 14–16; Walters, 1991, pp. 8–9]. In other words, as long as the disbursement of credits is severely biased, macroeconomic restriction tends to conserve the predominance of inflexible and inefficient state-owned enterprises.

All in all, the haphazard pattern of credit disbursement entails substantial losses in efficiency for the economy as a whole: scarce investible funds are wasted and viable ventures that by pure chance suffer from a lack of credit go bankrupt, while their less promising competitors have sufficient funds to survive for the time being. The restructuring of the economy is thus deferred. The inefficient enterprises that stay afloat crowd out the more efficient ones on the market for other factors of production and for intermediate inputs [Hinds, 1990, p. 150]. The uncertainty about the amount and the future fate of dubious loans also impede the privatization of banks. In addition, the legacy of old loans makes it much more difficult politically to open the national financial system to foreign banks. Because they could start from the beginning in the EMEs, outsiders would enjoy a competitive advantage over the local banks with troubled portfolios [World Bank, 1991, Annex 4, p. 6]. This would provide the local banks with a convenient argument to lobby against unrestricted market access for foreign financial intermediaries.

III. Internal Policies for Efficient Financial Intermediation

This part deals with the major problems that presently affect financial intermediation in the EMEs. For the purpose of this analysis, the solution to the problem of existing bad debt (the stock problem, Section 1) will be separated from the issue of how to stop a renewed accumulation of non-performing loans (the flow problem, Section 2). The issue of interenterprise debt is taken up in Section 3.

1. Cleaning the Balance Sheets for a Fresh Start

a. A Radical Solution to the Problem of Bad Loans

In the literature, a virtual consensus has evolved on three aspects of a solution to the bad debt problem:[4] the old-debt link between firms and banks has to be cut, at least part of the old debt has to be removed from the books of the banks, and the banks need to be recapitalized by means of an infusion of funds from the state budget in the form of long-term bonds with positive real rates of interest, preferably in the form of indexed bonds. It is necessary to recapitalize the banks because debt relief could easily consume the small capital base of the banks. Two major questions remain:

(i) Should all loans incurred before a specific date or only the supposedly bad ones be affected?
(ii) Should the respective loans be written off, i.e. removed from the balance sheets of the state firms as well, or does it suffice to let only the banks off the hook? If enterprises have to repay their debts, the

[4] See Calvo and Frenkel [1991], Hinds [1990], Brainard [1991], Hrncir and Klacek [1991], Saunders and Walter [1991], World Bank [1991], Manasian [1991], Buch and Monti [1991], Begg and Portes [1992].

liabilities of state firms need not be cancelled. Instead, they could be transferred from the banks to some other institution and be dealt with on a case-by-case basis.

In his seminal paper, Hinds [1990] proposed a solution that many other authors have in principle endorsed. After the books of state firms and state banks have been audited, the government, according to this proposal, should purchase the problem loans from the banks. These loans should not be cancelled; instead, some institution should try to recover the outstanding amount as best as it can from the debtor firms. The institution, which would be paid by the government for the task, could be the respective bank itself [Hinds, 1990, p. 75] or a special fund [Brainard, 1991]. Building on Hinds, Brainard advocates a comparatively restrictive approach. He proposes in-depth audits using Western accounting methods as a precondition for cleaner balance sheets. These audits would permit the government to rank enterprises and bank loans from best to worst. Furthermore, the access of state firms to new credits should be tied to their ability to serve old loans [ibid., p. 106].

The radical alternative would be to completely write off all old debt[5] that was incurred before a specific date. Unlike this clean sweep, the more restrictive approach of dealing only with the supposedly bad loans necessitates case-by-case audits. This restrictive case-by-case approach has a number of disadvantages:

(1) Given the uncertainty about the future viability of individual firms and the pervasive linkages between firms, the audits may yield *little hard data* on the ability of firms to serve and repay their inherited debt; the current classification of loans into "good" and "dubious" ones may mean little in the future.

(2) Thorough audits of the balance sheets of firms take *considerable time*. As the banks have to carry the old loans until the respective audit has identified the dubious ones, the process of restructuring the bank portfolios and hence of making the banks better equipped for their tasks in a market economy is delayed.

(3) The initial audits and the case-by-case assessments of dubious loans necessitate considerable human capital input and *administrative capacities and capabilities*. This runs directly counter to one of the most urgent priorities for the design of a rational policy strategy in the EMEs, namely to economize on the ultra-scarce financial and administrative skills.

(4) A case-by-case approach necessitates considerable *administrative discretion* in treating the huge financial assets and liabilities involved. It thus begets a vast scope for lobbying and outright corruption.

For these reasons, the case for the restrictive "bad loans only" approach advocated by Brainard and others is not convincing. The radical alternative of writing-off all old loans on the balance sheets of banks is preferable. Note that this radical approach resembles some features of a currency reform for non-cash monetary aggregates: some assets and liabilities are cancelled and banks are recapitalized with bonds that roughly correspond to the "equalization claims" granted, for instance, after West Germany's currency reform of June 1948.

The above discussion has addressed the situation of state banks. The additional question as to whether state firms should also be relieved from the burden of the arbitrarily distributed debt is more complicated. In the days of the socialist command economy, the level of a firm's debt was virtually irrelevant to the managers and workers; over the course of the transition to capitalism, this problem vanishes when the firm is privatized. The moment a state firm is sold, it makes no difference how much old debt is still on the books of the firm. The

[5] Note that, for the purpose of this paper, the term "old debt" refers both to the loans inherited from socialist times and to the loans incurred in the aftermath of the collapse of the old regime.

amount of debt will be fully reflected in the price that the private owners pay for the firm. Time-consuming negotiations about a debt write-off can be a standard ingredient of privatization procedures.

As long as it was widely assumed that state firms would be privatized rapidly, it did not seem to matter whether the books of firms would be cleared of old debt before privatization or not. However, the privatization progress has so far been much slower than expected. In the *interregnum period* between the collapse of the command economy and privatization, the debt burden is of considerable importance for the firms that are still owned by the state. Because the old debt is distributed arbitrarily among state firms, many viable firms carry by pure chance a comparatively heavy debt burden. These state firms may thus go bankrupt although they would be profitable in the absence of the old debt.

Postponing the resolution of the old-debt problem until a firm is privatized may lead to an inefficient management of state-owned assets. Knowing that they have no other way to clean their firms' books, even efficiency-oriented managers of state firms may willingly steer their firms into bankruptcy, if need be by shifting selected assets to newly registered companies and deliberately mismanaging the remaining assets until the old enterprise collapses [Manasian, 1991, p. 24].

An attempt to force state firms to service old loans according to their actual ability to pay at any point in time impairs the incentives for managers and workers of indebted state firms. They would have little reason to try hard to improve the financial situation of their firms if the fruits of their endeavour were largely to accrue to the respective creditors. In this case, an extra effort on the part of workers and managers would not benefit the firm and thus not increase the probability that the state firm will survive and continue to offer employment for its present managers and workers.[6]

Objections to a Clean Sweep

Governments in the EMEs have so far objected to cancelling old debt because they are concerned about (i) the danger of creating an unwarranted precedent and (ii) the supposed cost to the state budget. These objections are considered below in turn.

(i) The objection that general debt relief might create an unwarranted precedent appears quite convincing at first glance. Debt relief, especially if apparently granted at the expense of the state, could foster the expectation that government bail-outs will also be available in the future. This could induce economic agents to lend and borrow carelessly, or rather to continue to do so. Yet, the objection is beside the point. Substantial funds have already been wasted: irrevocable losses have been incurred regardless of whether and how they show up in the more or less unaudited books at present. Hence, major debt write-offs cannot be avoided. The real question is whether debts should be cancelled at one stroke or whether it is preferable to sort out the loans case by case and over the course of time. Regardless of the approach chosen, the state needs to make it clear that debt relief will not happen again. This will be easier in the case of a decisive break with the past, i.e. a highly visible and one-off clean sweep, than in a drawn-out process of financial restructuring. In the latter case, some debt relief will have to be granted for a long time to come.[7] This casts doubt on government announcements of a tough stance on new debt, especially as it may become increasingly difficult to disentangle old and new liabilities. Of course, a clean sweep

6 Many enterprises are so heavily indebted that they suffer from a debt overhang, i.e. they no longer have an incentive to undertake adjustment efforts because all their earnings would go to their creditors. In this situation, a partial reduction of the nominal debt burden may provide incentives to implement measures that increase profitability. Thus, the enterprise could pay out more to its creditors. The implicit assumption is that the enterprise benefits from the debt reduction because otherwise it would not undertake the adjustment effort.

7 Abel and Bonin [1992a] disagree. They claim that drawn out debt relief would not give rise to moral hazard problems because the balance sheets would change only slowly.

does not suffice to prevent a recurrence of the problem in the future. For this purpose, strong safeguards need to be introduced at the time when the old debt is written off (see Section 2). The debt write-off should be linked to the recapitalization and, in the ideal case, also to the privatization of banks. Debt relief can be most easily presented as a non-recurring event if it is indeed closely linked to the non-recurring privatization of banks.

(ii) The need for the state to recapitalize the banks after debt cancellation appears to place a burden on the state budget. This argument is mistaken, however. Debt relief has no direct effect on the net asset position of the state. It merely clarifies the distribution of assets and liabilities within the state sector. The value of state firms rises by the amount of liabilities erased; on the balance sheets of state banks, the claims on state firms are converted into claims on the government. In a proper account of public wealth, the government liabilities to banks would be offset by the increase in the net value of state firms [see also Steinherr and Perée, 1992, Section 3]. Upon selling the state firms, the government recoups the equivalent of the cancelled debt in the form of higher privatization revenues. As to the current state budget, only the time profile of outlays, not their amount, is directly affected by the choice of a debt-settlement method. In the case of a general write-off, the state can sell its firms at a higher price; however, the budget has to bear the annual interest payments on the recapitalization bonds for banks. In the case of a piecemeal and gradual approach, the state receives fewer privatization revenues than otherwise and has to foot the bill of the debt-caused bankruptcies of individual state firms. It is not even clear a priori under which strategy the direct budgetary outlays are more front-loaded.

Note that the two strategies of an immediate clean sweep or a protracted assessment of the balance sheets of state banks and state firms differ substantially in their indirect budgetary effects. This is so for two reasons. First, an immediate debt write-off removes one important aspect of uncertainty about the true value of banks. Hence, risk-averse purchasers of state banks will be willing to pay more than otherwise. While the value of state firms increases by the amount of the cancelled debt, the value of the recapitalized state banks is augmented as well. The overall revenues from the privatization of firms and banks thus rise by more than the value of the loans that have been written off. Secondly, and more importantly, a rapid and wholesale debt write-off facilitates the privatization of state banks, the emergence of an efficient banking system, and a rational allocation of fresh funds. This solution thus contributes to widening the tax base via faster economic growth.

To discriminate old from new debt, a qualifying date needs to be set, which, for instance, could be one year after the date at which most markets were liberalized. To avoid politically disruptive allegations of unfairness, the debt settlement should reflect the differential behaviour of state firms in the meantime. For this purpose, all state firms could be put in a position that would be the same as if their debt had been cancelled at that time.[8] The state firms that serviced or even repaid debt thereafter would be rewarded by a corresponding amount of long-term government bonds (worth the capitalized present value of the interim debt service and the repaid principal). This improvement in the asset position of state firms does not constitute a drain on the state budget because the infusion of capital directly raises the privatization value of these firms.

Modifications to the Radical Approach

The resolution of the old-debt issue is complicated by the fact that the privatization of state enterprises is already under way in most EMEs. The standard approach so far has been to cancel a substantial part of the old

[8] All in all, a comprehensive solution to the old-debt problem becomes more complicated the longer it is delayed. The rationale for a radical write-off of old debt becomes weaker the more time has elapsed since the date that is to serve as the qualifying date to separate old from new debt.

loans upon privatization on a case-by-case basis. Changing tack and cancelling all old debt of the firms that are still state-owned could give rise to allegations of unfairness from the new owners of those firms that have already been privatized and that still have part of the old debt on their books. In principle, the objection is completely invalid. The conditions of previous privatizations reflected what the parties knew about the net value of the firms; if the firm had been privatized with less debt, the state could have demanded correspondingly higher prices or tougher non-price conditions. Hence, the differential treatment of old debt for the already and the not-yet privatized firms does not result in any discrimination.

Nonetheless, a genuine problem arises if some ownership titles have been, and will continue to be, given away to specific groups for next to nothing. In this case, the previous recipients of such a gift, say the employees of already privatized firms that still bear part of their old debt, have indeed obtained less net value than the corresponding beneficiaries of future privatizations will receive after debt relief for their firms. For these cases, special provisions such as a further reduction in the old debt carried by the already privatized firms may be needed for reasons of political expediency.[9] Unfortunately, this would indeed constitute a drag on the state budget.

The above point can be put more comprehensively. If the conditions of privatization are not related to the value of the property, i.e. if ownership titles are given away, the extent to which the value of the gift is increased by debt relief matters for the public purse. The more property values are given away for free, the more the state has to finance its outlays by corresponding increases in taxes.

Levine and Scott [1992] have indeed shown that the financial burden to the budget remains small even if the government assumes all enterprise debt and if enterprises are privatized only by giving away shares, i.e. privatization revenues are zero. Levine and Scott calculate the additional real GDP growth needed to generate the extra tax revenues. These tax revenues are required to pay off the extra costs to the budget which arise from the fact that some "good" debt, i.e. debt to ultimately solvent enterprises, is cancelled at the expense of the state. Assuming an initial ratio of enterprise debt to GDP of 30 per cent, a percentage of good debt of 25 per cent and an amortization period of 10 years, the extra GDP growth needed is 0.46 per cent annually.[10] A correspondingly lower growth would be required if the amortization period were lengthened, if privatization yielded some revenue, or if the debt relief to enterprises created some efficiency gains and increases in tax revenues.

In private discussions, officials from the EMEs have sometimes argued that wholesale debt relief may enhance the opportunities for the least efficient firms to obtain new funds regardless of their solvency. Private banks that take care of their capital would have no rational incentive to provide new funds to the least promising firms. However, as long as banks are mainly state-owned, such an outcome cannot be entirely ruled out. On the one hand, cutting the debt link that used to tie banks to borrowers makes it easier for banks to refuse fresh money to bad customers; on the other hand, a state banker can point to the clean balance sheet of a firm that is managed by an old friend as an excuse to extend a new credit. Thus, a complete cancellation of old debt makes most sense if it is closely linked to the privatization of banks.

As long as major banks are still in the hands of the state, one modification of the radical proposal for debt relief merits some discussion: A widespread presumption among politicians and economists holds that the largest technical units in the EMEs, which are frequently in heavy industry, are among the least viable. To

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[9] Note, however, that the already privatized firms are often among the few obviously promising ones in the EMEs. Even with part of the old debt still on their books, these firms may be worth more than most other firms even after debt relief for the latter. Hence, the case for ex post changes in the conditions of previous privatizations is weaker than it first appears.

[10] In addition, the authors assume a discount rate of 3 per cent, a baseline real GDP growth rate of 3 per cent, and a tax rate of 30 per cent [Levine and Scott, 1992, pp. 25–27].

keep these state firms under strong pressure to adjust or to go bankrupt soon, debt relief could be restricted and biased against the big borrowers: up to a uniform amount per firm, all old debt would be cancelled; above that threshold, a fixed percentage of the additional old debt would remain on the books of the firms. The threshold could be set so high that the majority of firms would still get rid of all their old debt. To clean the books of the banks, the remaining part of the debt of the big firms could be transferred to, and managed by, a special fund. In this case, a clear and uniform rule should specify under which conditions this fund should initiate bankruptcy proceedings against its debtors.

A general debt write-off for enterprises seems to neglect that "good debt" can have a disciplining effect on debtors. The necessity to repay debt may induce debtors to undertake adjustment efforts and to operate profitably if default is costly. Thus, Lane and Folkerts-Landau [1992] propose that debt which can ultimately be serviced should not be written off. Their proposal amounts to a partial debt relief granted to solvent enterprises. However, the discussion on the disciplining effects of good debt and on partial debt reduction neglects one important aspect that is crucial for the post-communist debt problem: The state is debtor and creditor at the same time. A private creditor would try to maximize the market value of the loan to a private debtor and would thus calculate gains from a partial debt reduction. He wants to utilize the disciplining effects of good debt. The state, in contrast, realizes a zero profit irrespective of the change in the market value of the loan because the more the state bank receives the more the state enterprise has to pay. This argument would only need to be modified if a reduced nominal debt burden increased the incentives of the enterprise such that it would make profits in excess of the debt servicing payments. In that case, the state would realize a positive profit from the partial debt reduction. However, the case for these extra profits is very weak if control structures remain unchanged. In addition, the necessity of evaluating the debt claims case by case remains. The state will incur greater gains if the balance sheets of banks as well as of enterprises are cleaned immediately because this will facilitate the privatization of both firms and banks. It will thus promote the economic recovery of the EMEs and the growth of the tax base.

b. Alternatives to a Radical Debt Write-Off

Debt-Equity Swaps

An apparently elegant alternative to a write-off of old debt could be debt-equity swaps. Bank loans to firms would be turned into equity shares in the respective firms. Such swaps even seem to deal with two problems at one stroke: the old debt vanishes upon conversion into equity held by banks, and fewer ownership titles in state firms remain to be disbursed to the public during the privatization of firms. However, in the peculiar circumstances of the EMEs, such debt-equity swaps have serious drawbacks relative to a write-off:

(1) In order to determine the conditions for the swaps, the value of the firm's assets and liabilities needs to be calculated.
(2) The inherited links between state banks and state firms would be strengthened rather than cut. These links are a major source of the capital market deficiencies in the EMEs.
(3) Whereas state firms would indeed be relieved from their old debt, state banks would not be better off. In many cases, they would simply have exchanged non-performing loans for equity stakes in loss-making firms. These losses could easily consume what little equity the banks themselves have.
(4) The state would still need to recapitalize the banks; the state purse would not save money in this way.
(5) The present state banks would be rather unqualified as owners of enterprises. The banks still are mostly state-owned and not equipped with the relevant management expertise. Only if they were

privately owned and had such expertise would they indeed have the incentive and the means to monitor the behaviour of the firms in which they had stakes.

(6) The variety of ownership stakes in firms of dubious quality would further complicate a most vital part of the financial rehabilitation of the EMEs, namely the privatization of the banks.

(7) The privatization of state firms would not be facilitated very much either. Sizeable ownership stakes that are already held by a state bank may deter strategic investors who, upon acquiring a dominant stake in a firm, would like to have a major say in the distribution of the remaining ownership titles as well.

Despite their apparent elegance, debt-equity swaps are thus inferior to a debt write-off in the particular situation of the EMEs.

Gradual Recapitalization of Banks

Abel and Bonin [1992a] propose an alternative solution to the bad debt problem for Hungary. They suggest that because Hungarian banks are presently operating quite profitably and delivering large amounts in excess of their tax payments to the federal budget, the government should set this money aside and use it to gradually relieve banks of their bad debt. Ceteris paribus, this gradual recapitalization would solve the bad debt problem within three years in Hungary. The final outcome would be similar to an instant recapitalization, i.e. an instant swap of enterprise debt for state debt.

The Abel and Bonin proposal is not convincing, though.[11] If implemented, it would impair the efficiency of financial intermediation and delay the emergence of a modern banking system. State banks would be induced to charge excessive interest rates and to make monopolistic profits. The privatization of banks would have to be postponed. Most importantly, Abel and Bonin's proposal provides the government with a reason to delay liberalization of the domestic financial markets even further because the entry of foreign competitors would erode the profits of the established domestic banks, profits that would be needed, however, for the recapitalization of banks.

Despite these criticisms, there is an important lesson to be learnt from Abel and Bonin. Their proposal demonstrates once again that a well-designed debt write-off need not impose a major financial burden on the budget. Hungarian banks relieved of their bad debt will realize high, taxable profits, and will have a correspondingly high privatization value.

Market-Based Debt Reduction

Under market-based approaches, banks are allowed to sell their loan portfolios either to the debtor (debt buy-back) or to some outside investor. Similarly, a securitization strategy can be followed. Existing debt would be transformed into some kind of bond or equity (debt-equity swap) that is more valuable to investors if it is senior to the existing claims or if it offers some other advantages, such as participation rights. In practice, the debtor would sell the new securities and use the cash proceeds to buy back the old debt.

In principle, market-based approaches to debt reduction can promote a more efficient evaluation of enterprises, enhance the experience of banks with the evaluation of assets, and impose market-related incentives on banks. Market-based approaches to debt reduction have two further appealing features. First, market mechanisms are utilized to replace banks' uncertain assets by safe ones: upon the sale of the uncertain debt

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[11] The proposal also contradicts Abel and Bonin's analysis of the underlying problems. In essence, Abel and Bonin seem to claim that Hungary has no major old-debt problem. If the banks were really as profitable as the authors suggest, they would not need to be recapitalized in the first place. They could make provisions for all dubious loans themselves. State intervention would not be required.

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claims, the banks receive cash payments. The risk associated with the debt is not eliminated but borne by its buyer voluntarily. Of course, cash payments may be substantially below the face value of the debt. In this respect, market-based approaches are similar to a partial debt-relief coupled with a partial recapitalization. Secondly, market-based solutions to the debt problem are more in line with the recent policies in the EMEs than a general debt write-off. Some variants of market-based solutions have already been implemented in some countries and may thus be easily widened. In Hungary, for example, a bank has been set up to buy non-performing loans from commercial banks. In Hungary, Poland, and Czechoslovakia, debt-equity swaps are planned [see VWD, b, 28 August 1992, p. 4 and Part IV].

However, market-based approaches to debt reduction are rather inappropriate in the special situation of the EMEs. The problems of debt-equity swaps have already been mentioned above. In addition, market-based approaches entail three serious disadvantages. First, the market structure for secondary securities that is necessary in order to implement market-based debt reduction hardly exists in most EMEs. Secondly, market-based debt reduction schemes relieve debtors of their liabilities only if debt buy-backs are allowed. But under buy-backs, the debtor would face adverse incentive effects. The less adjustment effort he undertakes, the lower the market value of the debt is, and the fewer resources he has to use in order to buy the debt on the market. Finally, market-based debt reduction is not the tool to facilitate the partial debt relief needed to exploit potential disciplining effects of debt: these effects occur only if a reduction of the nominal debt value brings about an increase of the debtor's efficiency. But if the government knew for certain that efficiency would increase after a nominal debt reduction it might simply induce the state banks to write off the debt partially. Market-based debt reduction would yield identical results and would thus not provide new, ex ante information about the gains in efficiency obtained by reducing debt. The real problem is that the government does not possess the information that is required to decide whether partial debt reduction yields efficiency gains.

The arguments against a partial debt relief (see Section 1a) also apply to the market-based approaches. Market-based debt reduction schemes neither solve the problem that banks with problem loans need to be recapitalized nor do they provide superior information over the efficiency gains from a partial debt relief. Instead, some variants of market-based approaches that include debt buy-backs may have adverse incentive effects. Of course, in the case in which a government opts for a — preferably rule-based — partial debt reduction and not for a general debt write-off, banks should be allowed to trade their remaining loans on the market.

2. Transitional Credit Ceilings for State Firms

Experience from Eastern Europe shows that the privatization of banks will not happen overnight. In the meantime, the flow of funds from recapitalized state banks to ailing state enterprises needs to be directed to more profitable uses. Newly founded private enterprises in general, and manufacturing units in particular, will be the foundations of economic progress in the reform states.[12] Private manufacturers have a great need for capital because they need to build up a capital stock before they can start operations. Unlike existing state firms, new private enterprises can neither rely on retained earnings as a source of finance nor produce by simply exhausting their capacities.[13] At the same time, access to international capital markets is virtually

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[12] Schmieding [1991a, p. 103]. In Poland, private enterprises contributed 45 per cent to GDP in 1991. This share is expected to rise to 50 per cent in 1992 [VWD, b, 4 September 1992, p. 6; Milanovic, 1991]. In Czechoslovakia, private enterprises currently have a share of 15 per cent in GDP, and in Hungary of about 30 per cent [DB Research, July 1992].

[13] In addition, strict capital market legislation in Poland effectively prevents new private enterprises from issuing securities [Pietrzak, 1992].

closed off and domestic stock markets are in their infancy. Therefore, domestic capital markets and especially bank credits should be major sources of financial funds.

On domestic markets, however, private enterprises have difficulties obtaining bank credits because state banks prefer to lend to state enterprises. The decisive question is how preferential lending to state enterprises can be stopped in the short run. In the long run, private banks and a well-designed regulatory framework should be sufficient to guarantee proper credit evaluation. Financial subsidies for private enterprises, for instance, in the form of preferential tax treatment, do not address the problem as long as quantitative credit ceilings bind. Besides, they do not constitute an economically warranted substitute for bank credits. Therefore, the biased lending behaviour of state banks needs to be changed. Two forms of quantitative measures can serve this purpose: (1) a credit programme can force state banks to allocate a greater share of their lending to private enterprises until the banks are privatized, or (2) a cap can be put on credits to state enterprises without directly influencing the allocation of credits towards the private sector.

Begg and Portes [1992] prescribe the following *credit programme*: A certain quota of the total credit volume must be given to private enterprises; if the quota is not exhausted, preferential interest rates should apply to private enterprise credits. This proposal has a number of positive features:

(1) It can be implemented quickly by changing banking legislation.
(2) It lessens the preferential treatment given inefficient state enterprises in credit allocation and it redirects funds to private enterprises. The credit programme may also help to solve the flow problem of non-performing loans in the balance sheets of banks if the private enterprises that receive credit are more efficient than state enterprises.
(3) Direct state intervention in credit allocation is not required because the state banks screen the potential borrowers.
(4) State enterprises are forced to obtain credit on the domestic private and on the international capital markets in excess of their allotted quota.[14] This strengthens competition between state-owned and private banks and forces state enterprises to submit themselves to the evaluation of the market.

However, the credit programme proposed by Begg and Portes also has potential drawbacks:

(1) It is not clear whether the most profitable private enterprises will receive credits. One major problem that the state banks have is that they lack experienced personnel who are willing and able to assess the creditworthiness of potential clients. Now, the same people will have to decide about the profitability of private enterprises. Even if private enterprises are on average more efficient than state firms, badly trained personnel may pick the wrong, below-average clients.
(2) If preferentially low interest rates became an effective tool for redirecting credit, implicit subsidies to private enterprises would be introduced. This would counteract the attempts to free the economies of state intervention and of other forms of subsidization.
(3) The problem posed by non-performing loans could even become greater after the credit programme has been implemented. If banks wish to continue lending of the same magnitude to state-owned enterprises and if they are forced to allocate a certain percentage of credit to private firms, they may try to boost total available credit. They may then neglect to screen private borrowers even more.

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[14] Even if the problem of the foreign indebtedness of the Eastern European states is not solved, international capital markets are not necessarily closed for domestic enterprises. Experience in Mexico and other Latin American states has shown that financing instruments like asset-backed receivables can help to bring funds also to indebted countries [West, 1991].

(4) Finally, the question remains as to how the quota of private sector credit is to be set. It could be set either as a percentage of total credit volume or of the growth of credit. If the quota is set as a percentage of total credit volume, banks would have to adjust their existing portfolios instantaneously. Thus, they would have to grant new credit. Hence, a percentage share is preferable that could be oriented towards the share of private sector activity in GDP and dynamically adjusted upwards in order to gradually suppress state activity.

The proposed credit programme could be a way to direct credit to more efficient private enterprises if the credit assessing abilities of the managers of state-owned banks were to be improved. This condition is unlikely to be met. It would thus be preferable to curtail credit to state enterprises without introducing other potential distortions. Hence, credit from state banks to state enterprises should be restricted directly by putting a tight *cap* on it.[15] The cap should be tied to the firm's sales revenues, not to the more or less arbitrary book values of assets. The ceiling should be calculated as a fraction of the sales revenues of a base period well before the respective law or regulation has been discussed and passed so that firms cannot render the ceiling ineffective by indulging in accounting tricks that seem to boost sales; the ceiling should not be fully indexed to inflation.

The above proposal of cutting credit to state enterprises without requiring state banks to grant more credit to private firms would weaken the position of state banks. State banks with excess funds, which they cannot lend to state enterprises, could make these funds available to other financial intermediaries that are better suited to assess the viability of enterprises. The state banks need not do so directly; they could also do it indirectly by depositing their funds with the central bank, which would then be able to relax the refinancing conditions for private banks without jeopardizing macroeconomic stability. With an unchanged pool of credit available, more funds become available which private banks can allocate to private enterprises. This should lower the interest rates on credits to private enterprises. As such a rule favours private banks, it would even give a further impetus to the privatization of the banking system.[16]

McKinnon [1992, pp. 34ff.] goes even further than the above proposal for quantitative credit ceilings for state enterprises. Based on a study of financial liberalization in (ex-)socialist economies of Asia, McKinnon recommends prohibiting all credits from deposit-taking monetary intermediaries to all enterprises that are not subject to tight and traditional central planning. Some fully collateralized bank lending to these enterprises should only be permitted in a second phase of reforms. The logic behind this proposal resembles the analysis of financial market deficiencies presented in Part II above: as soon as the old state-directed system of financial control is weakened, state firms and state banks gain substantial leeway for an excessive growth of credits. This undermines macroeconomic stability and grossly distorts the allocation of investible resources. In three respects, McKinnon's proposal is even more radical than the solution advanced in this paper:

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[15] Even in developed market economies, restrictions on the maximum exposure of banks are nothing unusual. In Germany, for example, so-called large credits, i.e. credits to one single customer, may not exceed 50 per cent of a bank's equity; credits exceeding 15 per cent need to be reported. All large credits, taken together, may not be larger than 8 times the equity capital [Deutsche Bundesbank, a, pp. 35]. For the peculiar situation of the EMEs, these regulations do not suffice to impose financial discipline on state banks and state enterprises. The regulations could be circumvented and state enterprises could receive excessive credit if more than one state bank were to extend the allowable credit to each customer. The proposed cap should thus specify the maximum credit that a state enterprise may receive. This cap can be abandoned when banks are privatized and Western-type regulations on maximum exposure apply.

[16] Both approaches require efficient control mechanisms because they invite corruption and illegal behaviour. The reason for this is that state enterprises might try to circumvent the regulations by founding fictitious private enterprises in order to obtain funds.

(i) the credit ceilings would be set at zero;
(ii) private enterprises would also be subject to the no-credit restriction;
(iii) private banks would also be prohibited to lend to enterprises.

These three points merit a brief discussion:

(i) A *zero-credit rule* would confine enterprises to self-finance and to borrowing from non-bank capital market (equity or bonds). This may be feasible in the comparatively underdeveloped reform countries of Asia. In these countries, a liberalization and de facto privatization of labour-intensive agriculture can yield an immediate surge in output and profits in this dominant sector of the economy. The rapidly growing demand for non-agricultural goods and services makes it possible for non-agricultural firms to earn substantial profits even in the short-long and thus to self-finance substantial investments. At the same time, the surplus of agricultural producers can be channelled into equity stakes in new or existing firms or into bonds issued by these firms. However, the situation is completely different in the overindustrialized countries of Central and Eastern Europe, including the European successor states of the Soviet Union. As agriculture is comparatively small and heavily capital- and fertilizer-intensive, there is little basis for a rapid surge in agricultural goods and services, equity stakes, and bonds. Hence, the potential that non-agricultural enterprises have for self-finance and for non-bank capital is extremely limited, at least in the short run. Some bank credit is thus warranted to avoid an excessive collapse of enterprises and to facilitate the adjustment process.

(ii) Given the weak state of aggregate demand and the lack of a substantial agricultural surplus that could be channelled into non-agricultural activities, the prohibition of bank credits to *private enterprises* would be extremely counterproductive in Central and Eastern Europe. It would obstruct one of the major pillars on which the economic re-emergence of Europe's post-socialist countries need to be based.

(iii) With respect to prohibiting credit from private banks as well, McKinnon can point so some good arguments in favour of his extreme proposal. In post-socialist countries, private financial intermediaries may indeed behave no better than state banks. This may be so for two reasons. (1) Many so-called private financial intermediaries are owned by state enterprises and are used as instruments to circumvent the remaining state regulations of the state banking system (for instance, the continuing non-convertibility of enterprise deposits in Russian state banks into cash). (2) Inadequate prudential regulation and the presumption of an implicit state guarantee for deposits encourage reckless lending. However, the solution to these problems need not and should not be the outright suppression of private banking. The need for efficient financial intermediation by institutions that are driven by self-interested private owners is far too great to warrant such a crude measure. Instead, the underlying problems can be tackled directly: deposit-taking banks that have state firms as a main owner should be treated as state banks and not as private banks; prudential regulation should be strengthened dramatically (see Part V) and a compulsory system of (partial) deposit insurance should be explicitly established as a substitute for implicit state guarantees.

All in all, the McKinnon proposal may be suitable for reforming economies in Asia; it is not the optimal approach to financial control in Europe's emerging market economies. Instead, these countries should opt for ceilings on credits from state enterprises to state firms. The tightness of these ceilings can depend on the stage of transformation. The successor states of the Soviet Union should opt for rather tight ceilings. Poland in 1990 would also have needed much tighter caps than the lax and ineffective credit controls that were actually put in place. By now, the Central European countries where financial reforms have already advanced further and where the behaviour of state banks has started to improve might opt for somewhat laxer ceilings that are already somewhat closer to the credit limitations embodied in standard Western regulations.

Caps on credits from state banks to state enterprises stop the flow problem of non-performing loans. Of course, they can only supplement other measures of financial market reform, notably the debt write-offs, the

privatization of banks, and the establishment of efficient supervision. Together with the unrestricted admission of banks from abroad and adequate regulations, these are the only remedies for the failure of financial markets in the long run.

3. Dealing with Interenterprise Credits

The need for short-term financing of enterprises in the EMEs has increasingly been met by extending supplier credits. In many cases, firms fail to pay bills that are due.[17] In principle, supplier credits are nothing unusual. In developed market economies, supplier credit granted by writing bills of exchange constitutes an important source of short-term financing. In Germany, the ratio of supplier credit to GDP was 20.4 per cent in 1971; it fell to 14.8 per cent in 1989. In Czechoslovakia's emerging market economy, the corresponding ratio increased from only 2.3 per cent in 1982 to 15.8 per cent in the fourth quarter of 1991. The ratio of supplier credit to total bank credit in Germany is about 30 per cent for the whole economy and 60 per cent for manufacturing, construction, and transportation. In Czechoslovakia, the ratio of interenterprise credit to bank debt rose after a contraction of real bank credit in early 1991 to 23 per cent and is now at about 25 per cent (see Appendix). This is still comparatively low considering the underdeveloped banking system, because supplier credit serves as a substitute to bank lending.[18]

From that perspective, an expansion of interenterprise credit does not appear to be alarming. However, Eastern Europe and the successor states of the Soviet Union differ from developed market economies: supplier credit is not granted on the basis of performance-oriented criteria. Enterprises that were used to receiving funds from superior agencies whenever they were under financial distress perceive no need to properly assess the creditworthiness of a customer. As a result, credit allocation is *biased* and may threaten the survival of otherwise viable enterprises. A solvent enterprise can be forced by insolvent enterprises to grant too much trade credit.[19] Enterprises will be even more passive in initiating bankruptcy proceedings against a client than banks if banks are privileged creditors.[20] In this case, the expected benefits for enterprises from bankruptcy proceedings are negligible. And even if an enterprise wants to initiate bankruptcy proceedings against a customer, legal regulations may be too weak. Thus, solvent enterprises are forced into a liquidity crisis.

In the long run, the peculiar problem of interenterprise credit will disappear in the EMEs. Banks will step in and provide liquidity to solvent enterprises when the banking system matures. Also, the clarification of ownership rights increases the incentives for enterprises to initiate bankruptcy proceedings against customers that do not pay. In the short run, some corrective state action against excessive interenterprise credit is warranted. As a first step, existing claims should be netted out on a regular basis. A large share of the measured interenterprise credit is simply due to double-counting: it will disappear when bilateral obligations

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[17] In Hungary, interenterprise trade credit was 14 per cent of short-term credit in 1982 and rose to 34.6 per cent in 1989 [Abel and Bonin, 1992a]. For the end of 1991, gross arrears, i.e. overdue credits, were estimated at 6 per cent of GDP [Lane and Folkerts-Landau, 1992]. In Poland, interenterprise credit reached a stock value of about 45 per cent of GDP at the end of 1989. At the end of 1991, gross arrears amounted to 22 per cent of GDP [Calvo and Coricelli, 1992].

[18] In Germany, after the Second World War, the expansion of output and employment went along with an extraordinary expansion of interenterprise credit. In industrial stock companies, financing through accounts payable was 150 per cent of financing through bank credits. Altogether, external financing contributed to only 40 per cent of total financing. The remainder came from retained earnings [Baumgart et al., 1960; Hartmann, 1964]. Evidence that supplier credit served as a substitute for bank lending in Poland is given in Pinto et al. [1992].

[19] Burda [1992, p. 210] notes that "the real risk seems to be the systemic risk to those long in interenterprise debt", i.e. the undiversifiable risk to net creditors.

[20] The phenomenon of "creditor passivity", which leads to the expansion of credits to enterprises that are actually insolvent, has been described by Begg and Portes [1992].

are netted out by using improved settlement procedures.[21] To deal with the remaining net imbalances, a time limit, say three months, should be set for supplier credits between state firms. A prolongation should be prohibited.[22] The state enterprises should be forced to provide regular information on the amount and the time structure of credits that they owe to each other. All enterprises that are net debtors in interenterprise arrears and that have failed to service and repay their interenterprise debt at a specified time after the expiry of the three-month deadline should be subjected to liquidation proceedings.

If the creditor company does not initiate bankruptcy proceedings against a debtor company itself, an outside agency should step in automatically and do so ex officio. The automatic liquidation procedure could entail the dismissal of the management and the public sale of the enterprise or the liquidation of the enterprise and an auction of the remaining assets. This procedure could also help to speed up the privatization of state assets.[23]

One objection to the automatic initiation of bankruptcy proceedings is that even enterprises that are solvent in the long run might be forced into liquidation because they are too closely tied to some insolvent and thus illiquid customers. If this is the case, however, the prospects are good that potentially solvent enterprises will continue to operate after they have been cleared, over the course of the bankruptcy or conciliation procedures, of most of their debt. Without the automatic initiation of liquidation proceedings, the situation of solvent enterprises will actually worsen because insolvent enterprises will also stay afloat instead of going bankrupt. If insolvent enterprises are forced into bankruptcy, this would be an important step towards the hardening of the soft budget constraints [Kornai, 1992a].

The above discussion has dealt with those EMEs such as Czechoslovakia and Hungary where the inherent bias rather than the *overall amount* of interenterprise credits constitutes the major problem. But in some successor states of the Soviet Union such as Russia and Ukraine, supplier credits have expanded so rapidly as to pose a significant threat to macroeconomic stability. In Russia, interenterprise credits jumped from a mere 39 billion roubles at the beginning of 1992 to roughly 3 trillion roubles in July 1992.[24] If the central bank decides to monetize the debt, as the Russian and the Ukrainian central banks did to some extent in the summer of 1992,[25] hyperinflation will become a real threat.

Under these conditions, additional safeguards are needed to stop the continuing accumulation of interenterprise credit. In order to control the expansion of interenterprise credit in the future, a quantitative cap could be put on the total amount of supplier credit that a particular enterprise can grant. This cap could be set at a fraction of the enterprise's total assets or its sales proceeds, and could be differentiated by branches, as branches typically differ in their need for normal supplier credits. Of course, by setting quantitative caps, some desired economic activity that is facilitated by supplier credits is suppressed. However, the macroeconomic hazards that an unchecked expansion of interenterprise credits entails in countries such as Russia justify this somewhat crude measure. Anyway, a general credit ceiling is preferable to a case-by-case approach that would leave ample scope for detrimental lobbying activities and for outright corruption.

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21 In Czechoslovakia, gross trade credits fell by 20 per cent when the Commercial Bank netted out claims in early 1991 [Begg, 1991].

22 In countries such as Russia where payment may be stuck in the banking system for more than two months, the time limit should be more generous (say four months) to allow for these technical deficiencies.

23 Initially, the state may have to issue long-term bonds to partly recapitalize the enterprises that cannot recover their credits. The state should make clear that this applies only to the existing backlog of arrears and will not be repeated. Otherwise, firms might be encouraged to keep lending carelessly to other firms.

24 This corresponds to a tenfold increase even in real terms.

25 In late spring 1992, Ukraine also reduced the debt between its firms by granting enterprises credits amounting to 352 billion roubles.

4. The Problem of Deposit Insurance

Private banking is no guarantee for efficiency in banking per se. This has been the experience in the Southern Cone of Latin America in general and in Chile in particular [McKinnon, 1988]. Especially if the government provides deposit insurance and neglects banking supervision, private banks will assume unduly high risks because they can expect future bailouts (moral hazard). With respect to the set-up of a deposit insurance system, two designs are possible. Either deposit insurance can function on a voluntary basis like in Germany. Each member bank pays a fee proportional to its deposits and other liabilities into a fund. The fund, in turn, secures deposits and liabilities of up to 30 per cent of the banks' equity capital for each individual depositor. The fund does not provide finance in order to improve the liquidity position of banks. Or a mandatory deposit insurance may be set up like in the United States. Here, the Federal Deposit Insurance Corporation (FDIC) not only secures a fixed amount of each deposit but also performs a regulatory function. For example, the FDIC audits the insured banks and regulates deposit rates in accordance with the central bank. However, state-supported deposit insurance systems entail severe moral hazard problems. The savings-and-loan crisis in the United States serves as an instructive example, because the banks involved engaged in risky ventures, expecting to be bailed out by the government.

In the ideal case, deposit insurance should be free from state intervention. Some of the problems in the Eastern European banking sector today are the result of implicit government guarantees for the security of deposits in the past. In a state-supported system, if banks come under financial pressure in the future they can reasonably expect bailouts financed by the state budget. In order to finance the losses of the banking system, the government may resort to inflation taxes if other tax sources are not available. Also, the renationalization of the banking system may be seen as the means of last resort to protect domestic depositors.[26] However, deposit insurance on a completely voluntarily basis is often not credible. The state typically provides implicit deposit insurance to the extent that it will not easily let savers lose their money at the time of a severe financial crisis. If this is to be the case, the government may make its commitment explicit and provide a mandatory minimum insurance. Banks may then voluntarily decide to set up an additional deposit insurance system. The premia of the insurance can include a fixed-rate as well as a risk-adjusted portion.[27] Apart from providing minimum deposit insurance, the role of state institutions in the banking sector should be restricted to supervising banks and providing legal regulations that can be enforced in courts. Of course, the central bank as a lender-of-last-resort can provide banks with liquidity if its allotments are properly priced.

IV. Reform Experience in Eastern Europe

Apart from the special case of East Germany, the emerging market economies have opted for a slow and cautious approach to the transformation of their financial systems, not for a radical approach along the lines

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[26] This happened in Chile at the time of the major financial crises (1981–1982) although the state never did actually set up an explicit deposit insurance system [McKinnon, 1988, p. 400].

[27] The setting of deposit insurance premia prices constitutes quite a problem. On the one hand, insurance premia that are not risk-adjusted are equivalent to subsidies of low-risk to high-risk insured banks. Hence, low-risk banks may have no incentive to join a voluntary deposit insurance programme unless reputational aspects outweigh the disadvantages of paying the subsidies [Fischer and Grünbichler, 1991]. On the other hand, perfectly risk-adjusted premia are not enforceable in a competitive banking system where some information is private information and moral hazard problems occur [Chan et al., 1992].

discussed above. The following section reviews the recent experience with gradualist banking reforms in Poland, Hungary, Czechoslovakia, and with the radical solution used in eastern Germany. Particular attention is paid to the policies dealing with the problem of bad debt on the balance sheets of banks.

1. Poland

In Poland, the problem of bad debt inherited from the time of central planning virtually disappeared during the hyperinflation of 1989/90 which largely eroded the real value of outstanding debt. Accordingly, the audits for 1990 revealed that the nine largest commercial banks of Poland were financially sound and had operated highly profitable. The situation worsened dramatically in 1991 because the banks had extended a sizeable amount of loans to troubled state enterprises throughout 1990 and 1991. In December 1991, 2,880 enterprises were classified as uncreditworthy compared with only 548 the year before [NBP, a, 1/1992, p. 5]. Of the 4,388 uncreditworthy enterprises at the end of June 1992, more than half were state-owned [NBP, a, 7/1992, p. 5]. The share of bad debt on the balance sheets of banks was estimated at 20–30 per cent in July 1992, and for some banks at even 50 per cent of all assets. There are at least three reasons for this situation. First, the supervisory system is only rudimentary. This was revealed by banking scandals in 1991 and the subsequent collapse of two commercial banks — one of them privately owned [Handelsblatt, 30 July 1992 and 5 January 1992]. Secondly, until recently tax laws discouraged banks from building up reserves because taking reserves for non-performing loans out of pre-tax profits could only be done if the loan had been written off completely.[28] Hence, banks capitalized interest and rolled over credits in order to look financially healthy on paper. Most importantly, however, banks continued to lend to enterprises they knew without due consideration of these enterprises' business prospects.

Until recently, the government showed no intention of recapitalizing banks. Instead, it relied on a so-called "growth strategy" that induced banks to use excessive interest rate margins in order to increase their profits and thus their reserve accounts.[29] In December 1992, the Polish Parliament passed a new law on the financial restructuring of state enterprises[30] and state banks. The law consists of three main measures: First, nine state-owned banks will be recapitalized with Polish government bonds amounting to $2 billion and with $50 million taken from the stabilization fund set up by Western governments in 1990 to support the zloty [Neue Zürcher Zeitung, 28 November 1992]. The Ministry of Finance will decide which banks are to benefit from this recapitalization. The recapitalization aims at raising the capital-asset ratio[31] to 12 per cent. This ratio substantially exceeds the 8 per cent ratio recommended by the Bank for International Settlements in the Basle guidelines for prudential regulation. Thus, recapitalization is intended to guard against future deteriorations of banks' liquidity. Banks are free to decide whether they want to use this leeway to write off non-performing loans. Secondly, the initiation of conciliation and liquidation procedures of state enterprises through banks will

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[28] New tax laws allow banks to take reserves out of pre-tax profits for a maximum of 1 per cent of non-performing loans for each quarter [Kostro, 1992, Art. 96].

[29] OECD [1992a; 1992b], Handelsblatt [5 January 1992]. At the end of February 1992, the average lending rate for a one-year credit in a standard risk class was 46–47 per cent, compared with interest rates on demand deposits of 12 per cent and on certificates of deposit of 36 per cent and 47 per cent for a 3-month and 12-month term, respectively [NBP, a, 1992, 2–3, Table 7]. In July 1992, the National Bank of Poland lowered interest rates by about 3 per cent and is now discounting paper at 32 per cent, refinancing at 38 per cent, and granting lombard credit at 37 per cent [Handelsblatt, 30 July 1992].

[30] This includes commercial law companies in which the Treasury holds the majority of the shares. See Ministry of Finance (Poland) [1992].

[31] The capital-asset ratio is the ratio between the capital base and the balance sheet total, both weighted by risk factors. The greater the weight of risky claims, the larger the balance sheet total and the smaller the capital-asset ratio.

be made easier. With this, a general debt write-off is not envisaged. Instead, the government, banks, and the enterprise will relieve the banking system of the non-performing loans by rescheduling and converting debt or by forcing unviable enterprises into bankruptcy [Neue Zürcher Zeitung, 21 August 1992]. Thirdly, banks will be allowed to trade debt (commercialization) without the permission of the debtor. Alternatively, debt claims exceeding 30 per cent of the debtor's liabilities may be transformed into equity. To the extent that private agents buy the debt and opt to transform it into equity, this measure may speed up privatization.

The Polish banking laws were amended in early 1992. The new law on commercial banks of March 1992 forbids large exposure, which is defined as credits exceeding 15 per cent of the bank's total funds and granted to one single borrower or to a group of connected borrowers. Also, banks cannot grant credit exceeding 10 per cent of their own capital in one single contract. The sum of all credits may not exceed 800 per cent of all funds, which corresponds to a capital-asset ratio of 12.5 per cent. A new deposit insurance system specifies that the state does not insure anything in excess of the maximum credit allowances specified in the new law. However, upon approval of the central bank, the insured limits may be raised to a maximum of 50 per cent of the bank's capital. The new law on the central bank introduced new standards for reserve provisions and interest payments on mandatory reserves [NBP, a, 5/1992, pp. 6–8].

Although the state monopoly in banking has been abolished officially, the state still owns the 14 most important banks. There are 70 fully privately owned banks, whose share in banking operations, however, is only 5 per cent. Two banks were scheduled to be privatized in 1992, the others are to follow within 2–3 years. The government wants to retain a share of 30 per cent, leaving a maximum of 40 per cent of shares for public sale and 10 per cent for the staff [Financial Times, 28 April 1992]. In general, foreign banks can be founded as joint stock companies or as affiliates of foreign banks upon approval of the president of the National Bank. At the end of February 1992, 16 banks with foreign participation between 2 and 100 per cent were operating in Poland.

Since 1990, the National Bank of Poland [NBP] has tried to induce state banks to allocate 50 per cent of new credits to private enterprises. The effective ratio that was realized was only 20 per cent. Aggregate data supports the hypothesis that the allocation of credit is significantly biased against private enterprises. In 1990, the share of private sector credit in total credit (15.8 per cent) was significantly below the share of private sector activity in GDP (35 per cent). In 1991, the share of private sector credit increased to 24.1 per cent but it is still far below the contribution of private sector activity to GDP that some estimates put at 40–50 per cent.[32] Yet, starting from a low basis, credit growth to the private sector and individuals (147 per cent) substantially exceeded the growth of credit to the socialized sector (52 per cent) in 1991. Credit limits are set at Zl 135,500 billion for the 14 main commercial banks [NBP, a, 1/1992, Table 2, and 5/1992, pp. 6–8].

2. Hungary

After the establishment of a two-tier banking system in 1987, the amount of non-performing loans in the banking system grew from Ft 2.8 billion to Ft 43.3 billion in 1990. 89.6 per cent of these loans were accumulated on the balance sheets of the large, state-owned banks. From the end of 1989 until the end of 1990 alone, uncollectible assets grew at a rate of 192 per cent, their share of total assets rising from 1.78 per cent to 2.68 per cent [NBH, a, 6/1991, pp. 5–6]. In July 1992, the amount of the bad debt was officially estimated at

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32 OECD [1992b]. This bias can partly be attributed to the high share of private activity in trade (82 per cent) that is less capital-intensive than, for example, industrial production.

Ft 60 billion; unofficial estimates are more than twice as high.[33] However, until recently, uncollectible loans did not seem to endanger the stability of the Hungarian banking system substantially; most Hungarian banks realized monopolistic profit margins because prudential regulations were weak.

The new Act on Financial Institutions, which became effective in December 1991, finally laid down capital adequacy requirements conforming to Western standards.[34] Prior to this act, banks were discouraged from making provisions for risky assets. The new law requires banks to maintain an 8 per cent capital-asset ratio, which corresponds to the Basle guidelines, by January 1993; a ratio of 7.25 per cent applies for the interim period. Individual exemptions will be given until December 1994. Reserves in cash or liquid assets for risky loans taken out of untaxed earnings must be 20 per cent for "substandard", 50 per cent for "doubtful" and 100 per cent for "bad" loans. Reserves can be taken out of profits. In mid-1992, 40 per cent of all loans were estimated to fall under one of these categories.[35] To some extent, the stricter regulations have already proven effective. The state-run banking inspectorate suspended operations of three banks in the first half of 1992. These banks had extended credit between themselves as well as to the enterprises they were owned by [VWD, b, 14 July 1992].

An improved bankruptcy law that aims at reorganizing and eventually terminating illiquid enterprises went into force in January 1992. According to the new law, an enterprise must initiate bankruptcy proceedings at a court of law if it has not been able to honour all obligations within 90 days from the due date. It then has 60 days to reach an agreement with its creditors. The regulation proved effective after the first quarter of 1992. In April alone, registered bankruptcy declarations, 2,258 in all, were almost three times as high as in the three preceding months taken together. 3,658 enterprises declared bankruptcy during the first eight months of 1992. Although large enterprises are in principle included in this number, the government and the large banks are more reluctant to let important employers go bankrupt. Instead, conciliation procedures are initiated by the banks [VWD, b, 5 November 1992, p. 3]. In July 1992, 573 enterprises were declared insolvent and registered on a so-called rediscounting refusal list. The central bank refuses to rediscount bills of exchange drawn by these enterprises [NBH, b, March 1992, p. 28, and July, 1992, p. 29; FAZ, 22 August 1992]. In addition, a new accounting act was implemented in January 1992 that requires enterprises to hold reserves for doubtful receivable. It is hoped that this act will solve the problem of interenterprise indebtedness [Abel and Bonin, 1992c, p. 4].

With respect to the problem of non-performing loans, the Hungarian government has granted subsidies as well as guarantees to the banking system and it has partially recapitalized banks with bonds. As early as 1987, an initial state subsidy of Ft 30 billion was given to the banking system to cover the discrepancy between book and market values of loans. In January 1989, the Hungarian government founded a Housing Fund, to which low-interest rate housing credits were transferred. On the balance sheets of the banks, these credits were replaced with government-guaranteed securities issued by the Housing Fund at negotiated rates [Sundarajan, 1991, p. 261]. In mid-1991, a state guarantee of Ft 10.3 billion was granted to cover half of the bad debt burden estimated for 1990. Also, the guarantee reduced the commercial banks' reserve requirements. A further

[33] Latest available estimates for end-1990 put capital and reserves of the banking system at only Ft 46 billion [The Banker, 1992, p. 23].

[34] Although the Act allows universal banking activities, investment fund management is excluded from the allowed operations of banks. Besides, export credits can only be given upon licensing. By January 1993, a mandatory deposit insurance system is to be established. For an overview on Hungarian banking legislation, see OECD [1991b], Ministry of Finance (Hungary) [1991a; 1991b]

[35] Substandard loans are performing loans but entail a large economic branch risk; doubtful loans are loans to borrowers who have defaulted on servicing the loan for more than 60 days or who have incurred balance sheet losses within the last 2 years; bad loans are loans to borrowers who have been in default for more than one year or are under liquidation [Abel and Bonin, 1992c, pp. 1–2].

Ft 50 billion have been written off by the banks over the 1991–1992 period [The Banker, July 1992, pp. 24 and 30]. In December 1992, a new guarantee system for credits to small and mid-sized companies was implemented.[36]

The desired shift in the ownership structure of banks away from state banks towards privately owned domestic and foreign banks has only partially been accomplished although the government intends to privatize the major state-owned banks. Foreigners can already found fully owned affiliates. Yet, they cannot acquire more than 25 per cent of the registered capital of a Hungarian bank (approval is needed for foreign share ownership exceeding 10 per cent of the capital). Foreign capital currently accounts for 12–13 per cent of the equity in Hungarian banks [Bundesstelle für Außenhandelsinformation, March 1992, p. 2]. The government intends to allow foreigners to hold majority shares in banks in the future. Four out of the five major Hungarian state banks are to be privatized soon (tenders will be called for under the assistance of foreign investment banks). The state intends to maintain a share of about 25 per cent in the privatized banks. Privatization aims at raising the equity capital of the banks; except for the Foreign Trade Bank, the banks will have to clean up their loan portfolios prior to privatization [VWD, a, 23 October 1992, p. 9]. The large commercial banks are still reluctant to lend to the private sector. At the end of March 1992, the share of loans granted to small businesses (8 per cent) was substantially below the share of small businesses' deposits (14.7 per cent) in the total [NBH, b, March 1992, p. 27]. According to government plans, 90 per cent of Hungarian state enterprises are to be privatized without granting debt relief to the enterprises. For the planned privatization of banks, a special committee was founded in April 1992 [FAZ, 22 August 1992; VWD, b, 28 August 1992].

3. Czechoslovakia

The situation in Czechoslovakia differs from the situations in Poland and Hungary. A two-tier banking system with an appropriate banking law has only been in force there since January 1990. At that time, the State Bank and its deposit and loan portfolios were divided up into two banks, one for commercial and one for long-term investment activities. Banking supervision remained with the State Bank, whose main problem is the undercapitalization of banks (the capital-asset ratio of the commercial banks was only 1.5 per cent in early 1991). This number is not even very meaningful because the international security and accounting guidelines set by the Bank for International Settlements [BIS] in Basle were not fully in force. However, for banks that were founded after January 1, 1991, the capital-asset ratio of 8 per cent recommended by the BIS was to be applied by the end of 1991.[37] The share of credits that are officially in arrears or are of dubious quality seems rather low, amounting to 2.95 per cent of total credits in July 1992. Unfortunately, the classification of bad loans remains unclear. For example, so-called perpetual credits for inventories (PCIs) are not included, although rescue measures had been designed specifically for these loans. If PCIs are included, the share of bad debt in the Czechoslovakian banking system rises to over 15 per cent [SBC, a]. Furthermore, the official figures are probably rather optimistic. The ongoing slump may also exacerbate the problem considerably.

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[36] VWD [b, 9 December 1992]. The credit guarantee company will guarantee up to 80 per cent of the credit sum, 56 per cent of which it will receive back from a guarantee fund. The company is set up as a joint stock company with Ft 2 billion provided by the government in 1992 and an additional Ft 500 million by a fund that supports enterprises. The guarantee fund is also state-owned (capital: Ft 2 billion); the required capital is supposed to come from privatization [VWD, b, 13 July 1992].

[37] Commercial and savings banks founded prior to January 1, 1990, only need to meet a capital-asset requirement of 1.5 per cent [SBC, c, p. 21].

In 1991, the government took three ad hoc steps to resolve the problem of non-performing loans by founding the Consolidation Bank, by granting interest rates subsidies to banks, and by recapitalizing banks with government bonds:

In March 1991, the *Consolidation Bank* was set up in a fashion similar to the United States government fund for solving the savings-and-loan crisis. The new bank took over a total of 110 billion korunas' worth of PCIs from the commercial banks; 80 per cent of such loans to industrial enterprises and 50 per cent of loans to trade organizations were transferred. In March 1990, PCIs had totalled Kcs 180 billion and accounted for 31 per cent of the state-owned banks' assets. These credits had been extended in the 1970s to finance the working capital of enterprises. The credits had no time limit and paid only 6 per cent in interest. Banks received claims on the Consolidation Bank in return for the PCIs with a term of 8 years, carrying interest payments of 13 per cent. The Consolidation Bank itself has been capitalized with a redistribution credit granted by the State Bank (50 per cent) and loans by the Savings Bank.[38] The Consolidation Bank will decide on the PCIs on a case-by-case basis and eventually turn the good ones back to the banks. The PCIs are scheduled for repayment within 8 years but whether this goal will be achieved is highly questionable. In July 1992, the State Bank reported a good payments record that reduced PCIs to Kcs 95 billion, or 12 per cent of total credits [SBC, a].

Interest rate subsidies via negative real interest rates, i.e. low nominal interest rates on loans at times of inflation, were extended to enterprises from mid-1990 until mid-1991.[39] Hrncir [1992b] estimates that subsidies from savers to debtors, which were channelled through the banking system, amounted to a staggering 20 per cent of GDP in 1991. From mid-1991 on, positive real interest rates were established and the banks used high spreads between lending and borrowing rates in order to increase their reserve accounts [Hrncir, 1992a, pp. 21–23].

In October 1991, in order to recapitalize the six largest Czechoslovakian banks, a *Kcs 50 billion bond issue* was issued by the National Privatization Funds of the Czech Republic (30 billion), of the Slovak Republic (15 billion) and of the Federation (5 billion). The commission of the Privatization Fund decided which banks would receive the bonds. Banks could use most of the bonds to write off debt (38 billion), and the remainder served to increase their capital base and to restructure enterprises (12 billion). The banks can select the enterprises that benefit from this fund. However, only loans granted prior to 1989 can be written off and only enterprises that are "potentially healthy" can benefit from the debt relief [SBC, c, p. 10]. In December 1991, three major Czechoslovakian banks indeed cancelled the long-term liabilities of 344 firms amounting to Kcs 22 billion [FAZ, 20 December 1991, p. 9].

Purely state-owned banks are currently holding 50 per cent of the capital of all the banks in Czechoslovakia; fully foreign-owned banks contribute only 6 per cent to the total capital. In July 1992, there were three joint-stock companies with foreign participation below and 11 banks with participation above 50 per cent operating in Czechoslovakia [SBC, a]. The large Czechoslovakian banks collected 92.8 per cent of all deposits and granted 80 per cent of all credits in July 1992 [Hrncir, 1992a, pp. 6–7]. The government planned to privatize the five largest Czechoslovakian banks in the first privatization round, which was completed by the end of December of 1992, and one in the second round while it intends to maintain a certain share in each bank. Two state banks are to remain fully state-owned. Credit limits are set only for the large banks and are fixed on the basis of the monetary programme. Over most of 1991, the limits did not prove effective because of cautious lending practices of the banks [SBC, c, p. 4; d, Annex No. 1]. Credit allocation to the private sector has

[38] These credits carry interest rates of 13 per cent for a 6-month term and 16 per cent for a 12-month term.

[39] OECD [1991a]. On September 30, 1991, there was an interest rate ceiling in effect that did not allow banks to charge more than 7.5 per cent in excess of the 9.5 per cent discount rate. On April 1, 1992, this restriction was cancelled and the discount rate set at 9 per cent [SBC, d, Annex 1].

improved in Czechoslovakia: whereas in December 1990 credits to private enterprises were only 0.6 per cent of total credits, this figure reached 10.2 per cent in December 1991 [SBC, b, Fourth Quarter of 1991, p. 5]. In the first three quarters of 1992, more than the whole increase of total credits went to the private sector as total credits to the state sector even decreased. So far, Czechoslovakia has not experienced major failures of firms. The law on bankruptcy proceedings, which was adopted only in mid-1991, based on an old Czechoslovakian law of 1931, was to have been replaced by a new law in October 1992. However, the introduction of the new law, which would impose much tighter bankruptcy rules on enterprises, was delayed for a further six months. The reason for the delay is the interenterprise indebtedness, which, as it is feared, could trigger chain reactions of bankruptcies once firms have started to declare their insolvency.

The current political situation in Czechoslovakia impairs the transformation of the financial sphere. In the Czech lands, bankruptcy procedures seem to be favoured in order to eliminate the indebtedness of enterprises. Slovak politicians seem to prefer restructuring procedures.

Because of its large share of heavy industry in total production, bad debt constitutes a more severe problem in Slovakia than in the Czech lands [VWD, b, 14 August 1992; Handelsblatt, 21/22 August 1992].

4. Eastern Germany

Prior to the reunification of Germany, East Germany had a banking system of the standard socialist type. Private savings were channelled through the savings bank and allocated by the Staatsbank for investment purposes. In April 1990, the newly founded Deutsche Kreditbank AG took over the loan portfolio of the Staatsbank. With the German monetary union of July 1, 1990, assets and liabilities were transferred into D-marks at different rates. Assets were scaled down by a factor of two, while liabilities were converted at the highly unrealistic rate of one D-mark to one East German mark. Thus, the equity position of the banks deteriorated. As compensation, banks received equalization claims on the government's special fund (*Kreditabwicklungsfonds*). These claims carry money market interest rates and can be used as collateral for refinancing with the Bundesbank. Apart from this, banks received equalization claims (i) for all credit commitments that were signed prior to July 1990 and that had to be written down, and (ii) for the amount needed to increase their equity up to a share of 4 per cent of the total balance.

Although a debt write-off to the enterprises was discussed [DIW, 1990; Schmieding, 1990], the government decided to use the case-by-case approach. In principle, enterprises had to repay all debt. However, banks received a full state guarantee for debt accumulated prior to July 1990. For banks, the problem of old loans was thus solved at the stroke of a pen. The Treuhandanstalt assumed responsibility for interest payments on the debt until the opening balance sheets, in D-marks, of the enterprises were published. After that, enterprises had to meet their debt payment obligations themselves. Over the course of time, the Treuhandanstalt has granted considerable debt relief on a case-by-case basis, usually at the time of privatization. The German Ministry of Finance estimates that by the end of 1994 the Treuhandanstalt will have taken over debt amounting to about 70 per cent of total enterprise indebtedness on July 1, 1990 (DM 103.9 billion).[40] In addition, the Treuhandanstalt has given a number of global credit guarantees to firms seeking access to credit on the market. At the end of May 1992, these guarantees amounted to DM 24 billion, 85 per cent of which had effectively been taken

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[40] Bundesministerium für Finanzen [1992, p. 6], Treuhandanstalt [5/1992, p. 3.2.4.], Boss [1991, p. 12].

advantage of. Almost all bank credit to Treuhandanstalt enterprises was secured by Treuhandanstalt guarantees, which in the final analysis are government guarantees.[41]

With western German help, banking business in eastern Germany has expanded quite rapidly, even if it is still limping behind the west. The Deutsche Kreditbank AG, for example, has been fully taken over by the Deutsche Bank and the Dresdner Bank. In May 1992, there were 47 private banks with 750 branches operating in eastern Germany, which is one branch per every 16,000 inhabitants. In the west, there is approximately one branch per every 10,000 inhabitants [FAZ, 15 May 1992]. In the course of implementing monetary and economic union, East Germany thus entered into a banking union with West Germany and as a result became fully integrated into EC banking legislation.

In spite of the eastern German advantages, the adjustment process from plan to market took fairly long. As a matter of fact, not even the exact amount of equalization claims arising from the opening financial statements of the banks, i.e. from the asymmetric conversion of assets, liabilities, and the equity adjustments, were known with any certainty as of February 1992 [BMF, 1992, p. 1]. In addition, the number of firms that the Treuhandanstalt will eventually have bailed out can only be estimated: in May 1992, there were 4,637 enterprises still waiting to be privatized. But the experience shows that the case-by-case approach will finally lead to an almost complete debt write-off. Lengthy individual decisions could have been avoided by writing off old debt to begin with. This would have increased borrowers creditworthiness and may also have reduced the amount of Treuhandanstalt guarantees. In addition, case-by-case approaches may invite lobbying for more state support in the future and for new credits. In Germany, however, these moral hazard problems may have been less pronounced than elsewhere. Both, the government and the western banks, had a good reputation to lose by granting or demanding government bailouts of ailing companies in the future.

Of course, rapid and efficient transformation of the East German financial system cannot solve all of eastern Germany's problems. The banks are quite reluctant to lend at their own risk to eastern German firms. The reason for this is quite simple. As eastern German labour costs are far above productivity levels, few firms are viable and thus creditworthy. Furthermore, many potential borrowers lack collateral because the property right problems in eastern Germany have not yet been resolved. For these reasons, the government has softened credit market constraints through measures such as interest rate subsidies.[42]

5. Lessons for Future Reforms

(1) In Poland, Hungary, and Czechoslovakia, governments refrained from cancelling the bulk of bad debt on the balance sheets of state banks. As a consequence, the state banks remain undercapitalized and the privatization of banks has become more problematic. The traditional links between state banks and state firms were preserved. In the aftermath of microeconomic liberalization, the amount of bad debt even rose considerably because state bankers continued their inefficient lending practices. The postponement of debt write-offs made the burden of bad debt even heavier and retarded the development of the financial system. With considerable delay, the countries have recently made some progress towards the transformation of their financial systems. State banks have become more cautious lenders, and the amount of credits granted to private firms has risen. While the gradual banking reforms have thus not been a complete and lasting failure,

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[41] In October 1991, only 2–3 per cent of bank credits to Treuhandanstalt enterprises were granted at the banks' own risk [Carlin and Mayer, 1992, p. 47]. In the second half of 1992, the Deutsche Bank still made its loans to Treuhandanstalt enterprises conditional upon Treuhandanstalt guarantees [FAZ, 3 September 1992].

[42] In eastern Germany, over 50 per cent of all loans are supported by interest rate subsidies [Deutsche Bundesbank, b, August 1992, p. 17].

these countries have unfortunately taken a slow and inefficient rather than a fast and easy path towards better banks.

(2) At the early stages of reform, legal banking regulations were not fully adjusted to Western standards and prudential supervision was weak. Therefore, banks were induced to assume unduly high risks. For example, low equity requirements for new banks caused many small banks to be founded on an insufficient capital base. Furthermore, tax regulation discouraged banks from taking reserves for bad debts out of untaxed profits. By now, the first impetus to implement market-oriented reforms is over and it has become easier to organize lobbying activities. Thus, necessary amendments to the banking laws are increasingly difficult to pass. However, a positive approach towards hardening the soft budget constraints of enterprises has recently been taken by Hungary, who drastically amended her bankruptcy legislation. This approach is roughly in line with one major aspect of the radical proposal advanced in this paper.

(3) Differential legislation for state-owned banks on the one hand and newly established banks on the other hand hampers the necessary market entry of banks. Even if explicit barriers to entry in the form of minimum capital requirements are low, implicit barriers remain high. For example, the existing banks inherited an existing branch structure that enables them to collect savings more easily. Government policy makes it difficult for new banks or for foreign banks to acquire parts of this existing branch network. In Poland, the state explicitly intends to maintain a significant ownership share in privatized banks. These significant control rights serve to deter foreign investors. Competition is also hampered because the branch network system has been divided among too few banks. In Hungary and Czechoslovakia, too few banks were founded when the commercial banking activities of the Central Banks were determined. Only in Poland were computer simulations used to assess the number of bank branches needed [Sundarajan, 1991, p. 253].

(4) The situation in Germany after reunification differs sharply from the situations in the Eastern European EMEs. East Germany had the advantage of being able to import an existing legal system, expertise, and, most importantly, credibility from western Germany. The main features that eased adjustment in eastern Germany were the massive financial and technical help, as well as the supply of administrative and managerial skills, supplied by western Germany. However, it is just this alleged ease of transformation that makes the German case interesting for purposes of comparison: negative experiences of the type made in eastern Germany are likely to be worse in Eastern Europe unless different reform measures are taken there. In particular, general debt write-offs are superior to lengthy case-by-case evaluations.

(5) In eastern Germany, western German banks played a major role in the restructuring of the economy: apart from providing finance, banks brought in managerial knowledge and advice, and promoted the development of interfirm relations. This was largely facilitated by the board membership of bankers in industrial enterprises. In fact, eastern Germany has entered into a banking union with the EC and could thus utilize the support and advice from western German banks. Because the old-debt problem of banks was entirely solved by the full state guarantee, new banks could start their operations with clean balance sheets.

V. Importing a Banking System from the West

The eastern German example demonstrates two major points: (i) *Internal reforms* (such as the ones discussed in Part III) are only a partial step towards an efficient banking system; they should be complemented by an immediate *external liberalization* that provides open access for competitors from abroad. (ii) The EMEs could

accelerate this process if they do not design and build their own system from scratch but import essential features from the West.

As many EMEs are striving to become members of the European Community (EC), their future financial systems will ultimately need to be compatible with the EC laws and regulations. The EMEs could save time and avoid needing to adjust their nascent financial systems to EC requirements in the future if they opted for a wholesale institutional transfer in the first place: they could import the basic elements of the financial system of an EC member. Before this issue is explored further in Section 2, a brief look at EC banking systems is warranted (Section 1).

1. Banking Systems in the EC

The present banking systems in the EC are not uniform; they differ in their definition of banks as well as in the regulation and prudential supervision of banking activities. Germany maintains a full-blown system of universal banking with no separation between commercial and investment banking and without legal limits on the equity stakes that banks can hold in firms. The United Kingdom moved from a system of separated banking to a semi-universal one in the mid-1980s. Although commercial and investment banking still have to be carried out by different banks, these institutions can now be subsidiaries of the same holding company. Italy restricts the activities of banks far more than Germany does [see Schneider, 1989; 1990, pp. 8–14, 19–20; Büschgen, 1989].

The completion of the EC internal market is about to change the ground rules for banking in the Community. The cornerstone of the EC banking legislation, the Second Banking Directive, enshrines the three principles of minimum harmonization, mutual recognition, and home country control [European Communities, 1989c]. *Minimum harmonization* covers common criteria for the capital adequacy and solvency ratios of banks (minimum ratio of equity to risky assets) [European Communities, 1989a; 1989b]. Apart from such criteria, the EC members *mutually recognize* their national definitions of banking activities and the national systems of regulation and prudential control. Each bank with a licence to operate in one EC country can automatically extend operations to, and establish branches and subsidiaries in, all other parts of the Community. Apart from a few exceptions such as deposit insurance or compensation fund requirements, the banks are subject to the prudential supervision of their home country, not of their host country (*principle of home country control*). The German laws and regulations will, for instance, apply to the activities of German banks in, say, Italy.

2. An East-West Banking Union

With respect to their own banking systems, the westernmost EMEs have indeed opted for the most straightforward aspect of an institutional transfer from the EC. Some of the local laws and regulations that Hungary, Poland, and Czechoslovakia have passed already conform to EC requirements (see Part IV). In the association agreements that these three countries signed with the EC in mid-December 1991, they explicitly committed themselves to adopt the EC set of common rules and standards for the supervision and regulation of banking, insurance, and other financial services. The EC will provide technical assistance, inter alia, to translate the relevant parts of the EC *acquis communautaire* into the new legislation of the EMEs.

Yet, the institutional transfer is far from complete: it is restricted to the import of some laws and regulations and of some expertise. Within the framework set by the EC rules, the EMEs are erecting their own national systems of regulation and supervision. And although politicians and central bankers from Poland, Hungary, and Czechoslovakia have publicly encouraged Western banks to establish representative offices and

subsidiaries in their countries,[43] the governments of these three EMEs are at the same time trying to protect their local banks against foreign competition. The association treaties with the EC explicitly authorize Poland, Hungary, and Czechoslovakia to restrict competition from EC banks for up to ten years.

For banks in the EMEs, and for their customers, this partial institutional transfer mitigates but does not remove uncertainty about the regulation and supervision of banking in the crucial years of the near future. Furthermore, a legal framework is of limited use without the relevant skills to operate within it: laws and rules can be implemented, policed, and interpreted differently. For a wholesale transfer of an EC-compatible financial system, the EMEs would thus have to go much further and encourage the import of the organizations, the human capital, and the reliability that make Western financial systems work smoothly. The easiest way to do so would be to enter a Banking Union with the EC.

The establishment of a Banking Union with the EC would necessitate the following steps for an EME:

(1) The EME would have to cease discriminating between banks owned by locals and by foreigners.

(2) The EME would have to invite foreign banks to enter the market freely via the acquisition of existing banks or via the establishment of new subsidiaries and branches.

(3) Banks from EC members would remain subject to the national laws, regulatory systems, and prudential supervision of their home country (mutual recognition, home country control). Foreign banks from non-EC members would be treated within the EME as they are in the EC internal market.[44]

(4) All locally owned banks in the EMEs could choose once (or, say, once every five years) between the different regulatory and supervisory systems of the EC members. They would thus become subject to the national laws, regulations, and prudential supervision of the EC country whose system had been chosen.

(5) With regard to those aspects of financial intermediation for which host country control will apply in the EC internal market, the EME would have to adopt the relevant laws and rules of one EC country. It would also have to commission the respective body that is responsible for this aspect of prudential supervision in the respective EC country to set up a local branch and operate in the EME as well.[45]

This East-West Banking Union proposal combines competition between banking systems with a wholesale institutional transfer. It removes the legal uncertainties for Western banks operating in the EMEs. In conjunction with cleaning the balance sheets of the existing banks, it constitutes a radical way of turning the presently underbanked EMEs into an attractive field of activity for foreign banks. Naturally, a banking system comparable to that in developed market economies would not emerge overnight. Even in an optimal institutional framework, foreign banks are likely to be cautious, perhaps initially restricting their branch networks to the major cities. The case for a wholesale institutional transfer is not that this would solve the problems of financial intermediation at the stroke of a pen. Instead, under the given and mostly adverse circumstances, this transfer would make it as easy as possible for Western banks to become active in the EMEs and to transfer and fully utilize their expertise. To make it attractive for Western banks to purchase existing Eastern European institutions, the portfolio problems need to be resolved along the radical lines discussed in Part III.

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[43] In autumn 1992, there were 20 subsidiaries of foreign banks and 80 representative offices operating in Eastern Europe [The Banker, 9/1992, p. 25].

[44] As most major non-EC banks already operate within the EC, this entails virtually no discrimination. The principles of mutual recognition and home country control could easily be extended beyond the EC internal market.

[45] Similarly, the relevant court of appeal of the respective EC country (or the EC Court of Justice) would become the ultimate arbiter in legal disputes in these fields.

3. Possible Objections to an East-West Banking Union

(1) Governments in the EMEs would have to pay a "price" for an East-West Banking Union: by joining such a union, they would voluntarily restrict the sovereignty of their countries. However, restraints on the scope for subsequent sovereign behaviour are standard ingredients of international treaties. The politicians in major EMEs have repeatedly stated their desire to join the EC as soon as possible. This step would also entail a substantial delegation of national sovereignty to common institutions. Even the conditions to which countries voluntarily agree in a standard IMF stabilization programme amount to considerable restraints on national sovereignty.

(2) Ascribing a prominent role to foreign banks could give rise to allegations in the EME of "selling out" to foreigners. The opposite holds true, though. A banking system that is being made more efficient by allowing free access for foreign banks helps to mobilize domestic savings and to enlarge the supply of credits to local entrepreneurs. Hence, foreign banks would actually widen the opportunities for EME citizens to establish their own private business or to purchase state property.

(3) In negotiations with the European Community, the Eastern European EMEs successfully brought forward the infant industry argument in order to protect their domestic banking sector. The Association Treaties of late 1991 discriminate heavily against foreign banks. Whereas foreign banks that have already been founded cannot be subject to differential legislation, the freedom to establish new banks is limited for the next ten years [Langhammer, 1992, p. 17; Kuschel, 1992, p. 99; European Commission, 1991]. With this, these Eastern European countries have effectively erected barriers to the market entry of Western banks. However, the infant-industry argument is not appropriate in this respect. The accumulation of banking skills in Eastern Europe will be faster, not slower, if foreign banks are allowed to enter the market and establish branches immediately. The activities and the expansion of branch networks of Western banks is likely to increase rather than reduce the number of jobs in the financial system. The underdeveloped financial system in Eastern Europe has so far absorbed a far smaller fraction of the labour force than is the case in Western Europe. Furthermore, competition will benefit the countries more than protected domestic banking monopolies. In eastern Germany, the reform of the banking sector succeeded quite rapidly because Westerntype banks stepped in on a massive scale.

(4) A further objection to competition between banking systems in the EMEs may be that a system could prevail which does not suit the requirements of the EMEs. For instance, if locally owned banks were given a choice, they might opt for full-blown universal banking rather than for British-style semi-universal banking or an Italian-style separated banking system. Fortunately, universal banking is more appropriate for the EMEs anyhow than a system with legal barriers between various banking activities. First of all, universal banking is the more liberal approach; the worldwide trend towards a deregulation of financial systems has already lowered the old legal barriers between banking activities in various countries.[46] The laws that Hungary, Poland, and Czechoslovakia have passed so far also point towards some kind of universal banking. Second, universal banking makes it possible for banks to acquire significant stakes in enterprises. By admitting a further group of prospective owners, choosing universal banking could thus speed up and facilitate the privatization process [see also Steinherr and Perée, 1992, Section 3]. Third, universal banking makes it easier for financial intermediaries to finance investments with a mix of credit and equity. Many firms are undercapitalized and have few investible funds of their own. To the extent that a bank provides equity as well as credits, the bank also participates in unexpected gains and not only in unexpected losses as in the case of a

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[46] Examples worth noting are the French Law on Banks of 1984 and the British Building Societies Act of 1986.

credit-only funding of investments. The risk premium that the bank needs to charge per unit of credit disbursed would be correspondingly lower; the bank would have an incentive to provide more funds than otherwise.

Nevertheless, there are two serious objections to universal banking: (i) Ownership links between firms and banks may soften the budget constraint for firms and hence cause inefficiency [Hinds, 1990, p. 132]. This objection holds true in the short term for firms that come to own their banks and can deplete the assets of the banks until such misconduct becomes obvious or is noted by the supervisory body, so that depositors switch to a more prudent institution. It does not apply to the standard case of universal banking in which *private* banks become part owners of private firms. In this case, banks acquire an even greater interest in the profitability of the firm than if they had merely extended a credit. (ii) Banks that own significant stakes in firms may try to exploit their strong position in the local economy for political purposes.[47] However, such misconduct is less likely if foreign banks are involved which — unlike fledgling local banks — would put a well-established reputation in the world capital market at risk. And if the financial market is completely open for potential competition, there is little leeway for any behaviour that is not primarily geared towards economic efficiency. In any case, the objections to universal banking would be largely obsolete in the envisaged East-West Banking Union in which EC standards would be rigorously applied by well-established regulatory bodies from EC countries.

VI. Summary and Conclusions

This study has discussed the major issues in the transformation of the banking systems in Eastern Europe and reviewed the experience gathered so far. The seven major conclusions of the study can be summarized as follows:

(1) To speed up the emergence of efficient banking systems, the EMEs should enter into a Banking Union with the EC. Two major aspects set this proposed Banking Union apart from the present approaches of Poland, Hungary, and Czechoslovakia. First, the EMEs would cease gradually erecting their own national banking systems on top of the EC minimum requirements; instead, they would import existing banking systems from the EC and the EC members in a wholesale fashion. Secondly, the financial markets of the EMEs would be radically opened to foreign competition immediately.

(2) Banking legislation should comprise the permission of universal banking including investment banking activities, partially private and voluntary deposit insurance, and the establishment of efficient banking supervision. The same capital adequacy requirements should apply to all banks irrespective of their ownership structure. Lengthy licensing procedures for foreign banks can be avoided by taking recourse to approval by home country agencies and acknowledged Western rating systems as envisaged in the proposed Banking Union with the EC.

(3) The stock problem of bad loans on the balance sheets of banks should be solved by writing off credits from state banks to state enterprises which were granted prior to a certain date.

(4) Tight caps should be imposed on credits from state banks to state enterprises in order to prevent a renewed squandering of scarce financial resources in the state sector.

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[47] See Frydman and Rapaczynski [1991, p. 30], who nonetheless stress the economic advantages of universal banking for the EMEs.

(5) State banks should be recapitalized with government bonds yielding market rates of interest for all loans to state enterprises. The bonds should have positive real interest rates and may be indexed to inflation.
(6) As soon as banks have been recapitalized with government bonds, the process of privatization should commence, preferably with a substantial involvement of foreign banks within the Banking Union envisaged here.
(7) In countries such as Hungary, Poland, and Czechoslovakia, where gradual banking reforms are finally beginning to show some results, it may be politically difficult to completely abandon the already adopted strategy in favour of the much more radical and efficient proposals for clean balance sheets as advocated in this paper. As lamentable as this may be, however, these countries should at least enlarge and enhance their existing debt and recapitalization programmes considerably. They should do so to such an extent that these problems can no longer pose an obstacle to immediate and free access for foreign banks within an East-West Banking Union.

Because of the interdependence of the proposed measures, there is no particular need to sequence the steps of banking sector and financial market reform. Positive externalities arise from the enhanced credibility that clearly worked out privatization plans and a solution of the flow problem by means of credit caps give to the recapitalization of banks. In addition, the implementation of Western-type banking regulations, the more effective banking supervision provided by the Banking Union envisaged here, and the market entry of foreign banks would enhance the credibility of the reform package.

Appendix

A1. Interenterprise Credits

Table 1 — Supplier Credits in Germany (in per cent)

	supplier credits[a] as a ratio of GNP	supplier credits as a ratio of bank credits in			
		total industry	manufacturing	trade	construction
1971	20.4	59	—	—	—
1981	17.9	36.7	—	—	—
1985	16.1	33.1	82	54.4	68
1988	—	—	58	—	63
1989	14.8	32.3	—	60	—

[a] Accounts payable for goods and services.

Source: Deutsche Bundesbank [b], own calculations.

Table 2 — Interenterprise Credits in Czechoslovakia (in per cent)

	interenterprise credits as a ratio of GDP	interenterprise credits[a] as a ratio of credits to enterprises
1982	2.3	—
1988	3.6	—
1989	1.0	1.2
1990	6.6	10.1
1991 I	30.2	13.6
II	24.7	20.1
III	20.2	22.9
IV	15.9	23.0
1992 I	—	25.8

[a] Payments not honoured in due time.

Sources: Begg [1991], Begg and Portes [1992], and Hrncir [1992a, 1992b], IMF [var. issues], SBC [b].

Table 3 — Interenterprise Credits in Relation to Bank Credits to Enterprises in Hungary (in per cent)

1983	19.82	1989	23.96
1985	12.77	1991 (May)	19.46 [a]
1987	5.12	1992 (April)	21.14 [a]
1988	17.95	1992 (May)	21.14 [a]

[a] Involuntary interenterprise lending caused by enterprises on rediscounting refusal list / debt of enterprise sector with banks.

Sources: Abel and Bonin [1992a], NBH [a, 10–11/1991; b, April–May 1992], own calculations.

A2. Financial Indicators

Table 4 — Development of Financial Indicators

	1985	1990	1991	Change 1990–91
	in billions of domestic currency			per cent
	Hungary (forint)			
GDP	1033.7	2080.9	NA	NA
Broad money	498.3	912.9	735	–19.5
Money	239.7	449.1	530	18.0
Quasi money	258.6	463.8	580	25.1
Bonds	30.6	93.3	NA	NA
Dom. credit	992.5	1703.6	1853	8.8
Savings dep.	230.8	368.6	484	31.3
	Poland (zloty)			
GDP	10367	606726	NA	NA
Money	2449	101670	127006	24.9
Quasi money	1917	96334	160175	66.3
Dom. credit	6079	116462	230025	97.5
Demand dep.	1435	59014	70110	18.8
Deposits	1917	90225	153057	69.6
	Czechoslovakia (koruna)			
GDP	677	759.49	977	28.6
Money	261	291.15	371	27.4
Quasi money	171	259.5	326	25.6
Dom. credit	449	640.20	750	17.2

Source: IMF [var. issues]; PlanEcon [var. issues].

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