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The end of the Czech miracle? Currency crisis reveals need for institutional reforms

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The End of the Czech Miracle?

Currency Crisis Reveals Need for Institutional Reforms

by Claudia M. Buch and Ralph P. Heinrich

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- After years of high growth, low unemployment and low inflation, the Czech economy has suffered a sudden setback. Speculative attacks on the currency have forced the Central Bank to abandon its fixed exchange rate. The government has now announced austerity measures to reduce the massive current account deficit. In the short run, these measures will lead to lower growth and higher unemployment. Moreover, the devaluation of the Czech Koruna will make it more difficult to further reduce inflation.
- The crisis is due in part to the previous boom in domestic absorption. The expansion of absorption has been fuelled by massive capital inflows which helped to maintain the fixed exchange rate. At the same time, productivity growth has been sluggish despite high investment-to-GDP ratios, and wages have increased substantially despite sluggish productivity growth. These developments have contributed to the overvaluation of the exchange rate. As a result, the competitiveness of the tradables sector has been weakened, and the current account deficit has widened dramatically. The policy measures now announced aim at reducing domestic demand by cutting fiscal expenditure, raising taxes, devaluing the currency, and containing wage growth in the public sector.
- However, the government has so far failed to address the microeconomic issues that are at the heart of these supply-side problems. These include inefficiencies in financial intermediation, ineffective bankruptcy procedures, and weaknesses in the corporate governance of enterprises resulting from mass privatization.
- Solutions to the problems in the banking and financial sector should comprise tax incentives for banks to provision for loan losses, decentralized debt restructuring, the streamlining of bankruptcy proceedings, upgrading of the court system's resources, and a greater political will to enforce the existing bankruptcy legislation. Opening up for foreign banks more decisively and in particular allowing foreign banks to participate in the privatization of the large commercial banks can help to improve the efficiency of the banking system and the corporate governance role of banks. In order to encourage funds to manage their portfolios for the benefit of investors, funds should be encouraged to register as open-end unit trusts rather than as joint stock companies.
- On the macroeconomic level, the government is moving in the right direction. As regards the medium term outlook, fundamentals of the Czech economy remain strong. However, decisive and timely action to improve the institutional framework is needed if the economy is to overcome the present crisis and to reach a new, sustainable growth path.

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I. Introduction

Until recently, economic reformers in other transition economies have been envious of the Czech Republic. Unemployment rates remained by far the lowest in the region, reaching 3.5 percent as of December 1996 (Table 1). Inflation, which has stubbornly hovered above 20 percent in most reform countries, has not exceeded single digits since 1994 in the Czech Republic. The economy grew at a 5 percent rate in both 1995 and 1996 on the basis of fixed investment rates almost comparable to those of the fast-growing economies in South-East Asia. These achievements have appeared to be soundly based on a macroeconomic policy package involving balanced budgets, a tight monetary policy, and a nominal exchange rate that had been fixed relative to a currency basket since 1991.

The spectacular performance of the Czech economy seems now to have come to a sudden end. The current account deficit has been wide-

ning since 1994. Net capital inflows, which had soared in 1994 and 1995, started to dwindle in 1996. Several policy measures designed to reduce the current account imbalance, such as the announcement of reduced government spending and the introduction of deposit requirements for importers, remained ineffective. International investors attacked the fixed exchange rate. Within only a few days, the Central Bank suffered a massive loss of foreign currency reserves. On May 27, the Bank was forced to abolish the exchange rate target and to let the exchange rate float. The government has since plunged into disarray over austerity measures needed to correct the external imbalance. Several government officials have been replaced. As a result of the devaluation and the austerity measures, economic growth must be expected to slow down markedly, while inflationary pressure and unemployment will rise.

Table 1 – Key Macroeconomic Variables for the Czech Republic, 1992–1997

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 (Q1) |
|---|------|-------|------|------|-------------------|-----------|
| GDP growth (percent) | -6.4 | -0.9 | 2.6 | 4.8 | 5.1 | ... |
| Budget balance (percent of GDP) | -0.2 | 0.1 | 1.0 | 0.6 | -0.1 | ... |
| Unemployment rate (percent) | 2.6 | 3.5 | 3.2 | 2.9 | 3.5 | 3.9 |
| Consumer price inflation (percent) ^a | 12.7 | 18.2 | 9.7 | 7.9 | 8.6 | 6.8 |
| Producer price inflation (percent) ^a | 9.3 | 11.4 | 5.6 | 7.2 | 4.4 | 4.3 |
| Growth rate of M2 (percent) ^a | 19.6 | 17.5 | 17.2 | 7.5 | 4.9 | 7.3 |
| Official reserves (bn US-\$) | 0.8 | 3.9 | 6.2 | 14.0 | 12.4 | ... |
| Current account balance (percent of GDP) | 2.1 | 0.3 | -0.3 | -4.2 | -9.2 | ... |
| Trade balance (bn US-\$) | -1.6 | 0.3 | -0.7 | -3.9 | -5.9 ^b | -1.4 |
| Export growth (percent) | ... | 50.0 | 8.3 | 20.7 | 1.4 ^b | -3.7 |
| Import growth (percent) | ... | 24.0 | 16.3 | 39.8 | 9.9 ^b | 3.4 |
| <i>Memorandum items:</i> | | | | | | |
| <i>Poland</i> | | | | | | |
| Trade balance (bn US-\$) | 0.5 | -2.3 | -0.8 | -1.8 | -8.2 | ... |
| Export growth (percent) | 9.7 | -3.0 | 24.8 | 35.0 | 6.7 | ... |
| Import growth (percent) | 6.1 | 17.7 | 12.0 | 38.9 | 31.6 | ... |
| <i>Hungary</i> | | | | | | |
| Trade balance (bn US-\$) | -0.4 | -3.6 | -3.8 | -2.4 | -2.6 | ... |
| Export growth (percent) | 5.1 | -16.8 | 20.1 | 19.7 | 10.7 | ... |
| Import growth (percent) | -6.7 | 13.1 | 16.2 | 4.8 | 10.3 | ... |

^aDecember over December of the previous year. 1997: same period of the previous year. — ^bNot exactly comparable to previous years due to a change in methodology.

Source: CNB (1997a, 1997b), EBRD (1996), PlanEcon (1997a, 1997b, 1997c).

Balance of payments crises have plagued emerging market economies, most notably in Latin America, on and off. In Central and Eastern Europe, Hungary suffered a similar crisis episode in 1995. These crises are usually explained by a combination of adverse external shocks, inconsistent macroeconomic policies and a lack of microeconomic reforms. Understanding why the Czech Republic, which until recently has been considered a model reformer, has now suffered the same fate holds crucial lessons for emerging market economies elsewhere. In what follows we argue that while ex-

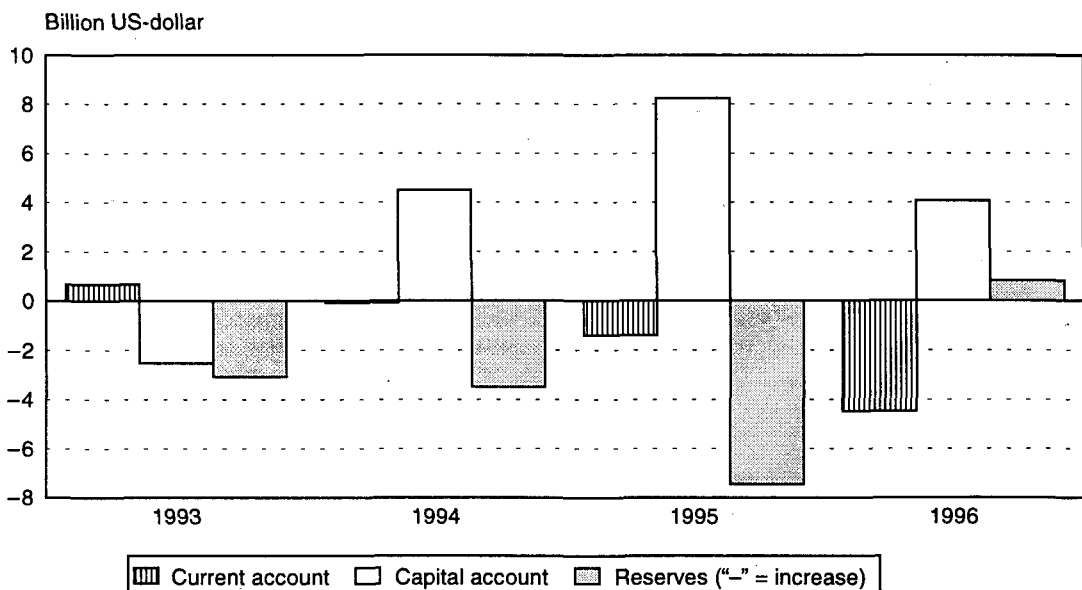
ternal shocks and macroeconomic policy errors have contributed to the present crisis in the Czech Republic, the failure to push forward key institutional and microeconomic reforms is one of the main reasons for the deteriorating performance. Other transition economies such as Hungary and Poland have arguably made greater progress in these areas, have used the exchange rate more flexibly in order to reduce real exchange rate appreciation, and have reacted to balance of payments problems more timely.

II. The Czech Economy in Spring 1997

Prior to the currency crisis of May 1997, the performance of the Czech economy had already started to deteriorate. The current account balance worsened significantly (Figure 1), growth forecasts had to be revised downward, tax revenue declined, and the fiscal deficit increased in the first months of 1997. Behind the widening current account deficit in 1996 were both a modest increase in merchandise exports (1.4 percent) and a relatively rapid increase in im-

ports (9.9 percent) which pushed the trade deficit to \$5.9 billion (Table 1). This stands against a surplus in the balance of services (\$1.8 billion) and a deficit in the balance of transfer payments (-\$0.8 billion). In the first quarter of 1997, the growth of merchandise exports even turned negative (-3.7 percent) while imports continued to grow (3.4 percent) as compared to the same period of the previous year.

Figure 1 – Balance of Payments of the Czech Republic, 1993–1996



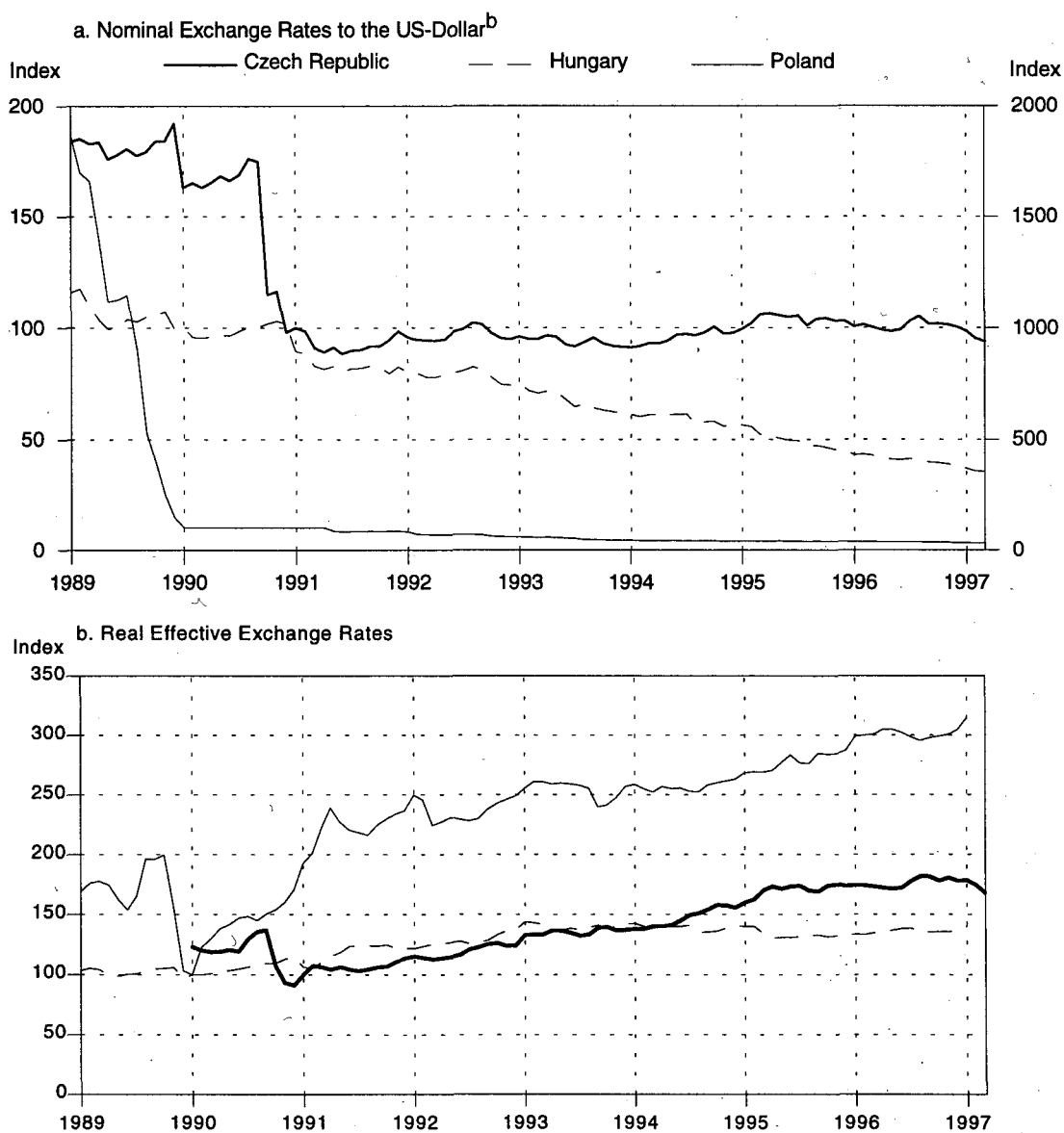
Source: IMF (1996), CNB (1997a).

Apart from a deteriorating cost competitiveness of Czech exporters, demand factors explain these developments as well. Slower growth in the main exports markets of Western Europe, coupled with a rapid growth of aggregate domestic demand by 9.4 percent in 1996, mainly driven by fixed investment (12.4 percent) and personal consumption (6 percent) (PlanEcon 1997a: 12), let imports grow faster than exports. In 1996, as in previous years, im-

ports of investment goods accounted for a relatively high share of about 40 percent of total imports (CNB 1997a). These imports of machinery and equipment are mainly used for infrastructure projects and thus improve investment conditions in the medium to long run.

In May 1997, the current account deficit, which had reached more than \$1.4 billion in the first quarter of 1997 (CSU 1997), finally became unsustainable. As capital imports were in-

Figure 2 – Nominal and Real Exchange Rates, 1989–1997^a



^aFor Poland and Hungary Jan 1990=100; for the Czech Republic Jan 1991=100. A depreciation is shown as a decline of the curve. — ^bFor Poland see the right scale.

Source: IMF (1997), PlanEcon (1997a, 1997b, 1997c).

sufficient to finance excess expenditure abroad, foreign reserves of the Central Bank declined from \$12.4 billion at the end of 1996 to slightly above \$10 billion as of late May. An attempt of the Bank to stop the decline in reserves by raising its Lombardrate from 14 to 50 percent, hereby pushing the overnight rate on the Czech money market to almost 500 percent, remained rather ineffective.

Finally, the Central Bank was decided to abandon the exchange rate band and to let the currency float since May 27. After the Czech Koruna had already been allowed to float within a margin of ± 7.5 percent vis-à-vis a basket of D-mark and US-dollar since February 1996, a six-year period of nominal exchange rate stability has thus come to an end. Eventually, a

renewed currency peg to the D-mark is envisaged, but no details have been announced as yet. Following the abandoning of the exchange rate target, the Koruna devalued by 12 percent against the D-mark and 10 percent against the US-dollar (Figure 2a); compared to the end of 1996, the devaluation against the dollar amounted to 21 percent.

In the following, we will first analyze the integration of the Czech Republic into the international capital market during the past years and outline the policy responses to increased capital inflows. We will then discuss the developments in the Czech banking and financial sector in more detail in order to show how these insights help to improve our understanding of the present situation.

III. A Victim of External Shocks?

In view of the Czech Republic's apparently sound macroeconomic situation during the first years of the transformation process, one might be tempted to argue that the attack on the Czech currency had fairly little to do with fundamentals, and that it has been the (random) decision of large international institutional investors to withdraw their funds which has put the Czech Republic on the verge of a currency crisis. If this were true, little could be done domestically to shield the economy from volatile international capital flows, and restrictions on capital controls might have to be introduced. A recent empirical study has indeed found that currency crises are contagious to some extent (Eichengreen et al. 1996). However, the authors still concluded that it is fundamentals which explain the overwhelming share of the probability that a currency crisis occurs. In their study, contagion is explained as "an increase in the probability of a speculative attack on the domestic currency which stems *not* from domestic "fundamentals" [...] but from the existence of a [...] speculative attack elsewhere in the world" (p. 474) (emphasis added).

If defined in this *pure* sense, contagion would occur completely randomly, and inves-

tors would entirely disregard fundamentals. If one assumes that information about economic fundamentals is scarce, and if the collection of information implies substantial costs, it may indeed be rational to update information only occasionally. Actions of some investors or events elsewhere in the world may then induce investors to withdraw funds from seemingly similar economies but, at the same time, to improve their information about fundamentals. This suggests a *wider* definition of the contagion effect, according to which fundamentals are taken into account.¹ The fact that the Czech crisis coincided with attacks on foreign exchange reserves elsewhere in the world (e.g. in Thailand) suggests that such an adjustment mechanism may have taken place. Because these events occurred in response to similar evolutions of fundamentals (widening current account deficits, declining growth prospects), the pure contagion hypothesis would not hold. Rather, we need to explain developments in fundamentals in order to understand why international investors lost confidence in the Czech Republic.

IV. Integration into the International Capital Market

Since 1993, the transition economies in Central and Eastern Europe have successfully accessed the international financial market, and the Czech Republic has been one of the main beneficiaries. Net capital inflows into the transition economies grew constantly² from a negligible \$0.5 billion in 1989 to \$42.2 billion in 1995 (Table 2).³ Capital inflows particularly surged in 1995, putting them at 5.8 percent relative to GDP in the region as a whole.⁴ Not burdened by a large amount of foreign debt like Poland or

Hungary, the Czech Republic has been able to attract sizable capital inflows, which peaked at 18.3 percent of GDP in 1995 (Table 3). Long-term capital inflows have been likewise impressive, reaching 7.5 percent of GDP between 1992 and 1996.⁵ These values substantially exceed those observed during other capital inflow episodes (Schadler et al. 1993). Since they reflect to a large extent the adjustment to a new equilibrium, they are unlikely to be sustained at this high level of the past.⁶

Table 2 – Net Capital Flows to Transition Economies, 1989–1996 (billion dollar)^a

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996b |
|---|------|------|------|------|------|------|------|-------------------|
| Czech Republic ^c | -0.3 | 0.6 | 0.3 | 0.0 | 2.5 | 3.4 | 8.2 | 4.1 |
| Hungary | 0.7 | -0.9 | 2.4 | 0.4 | 6.1 | 3.2 | 5.9 | -1.8 ^d |
| Poland | 1.8 | -0.8 | 2.1 | 3.9 | 5.7 | 4.4 | 12.9 | 4.8 |
| European transition economies ^e | | | | | | | | |
| In absolute terms | 0.5 | 2.1 | 5.2 | 10.8 | 18.5 | 4.5 | 42.2 | ... |
| In percent of total capital flows to developing countries | 1.1 | 3.5 | 3.1 | 7.3 | 9.2 | 2.9 | 18.2 | ... |

^aNet capital flows = capital account (credit – debit) plus financial account (liabilities – assets) of the balance of payments, excluding changes in official reserves; positive numbers indicate net inflows. — ^bData for 1996 were drawn from national statistics and may not be entirely comparable to earlier data. — ^cFormer Czechoslovakia prior to 1993. — ^dIn 1996, the government and the Central Bank repaid foreign debt by the amount of \$2.8 billion. During the same period, net foreign debt of the business sector and net foreign direct investment in Hungary increased. — ^eEuropean developing countries as defined by the IMF minus Cyprus, Malta, and Turkey and non-specified countries.

Source: CNB (1997a: 83), NBP (1996b: 35), NBH (1997: 99), IMF (1996), own calculations.

Table 3 – Capital Flow and Debt Indicators, 1989–1996

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1989–1995 | 1996 |
|----------------------|--|------|------|-------|------|------|------|-------------------|-------------------|
| | <i>FDI in percent of gross capital inflows</i> | | | | | | | | |
| Czech Republic | 32.7 | 15.1 | 28.0 | 112.2 | 10.5 | 14.4 | 23.2 | 21.9 | 34.1 ^a |
| Hungary | ... | ... | 61.1 | 178.2 | 44.8 | 39.6 | 78.6 | 61.7 | ... |
| Poland | 0.7 | 2.4 | 10.8 | 27.9 | 15.1 | 74.6 | 80.7 | 39.8 | 57.3 |
| Transition economies | 0.3 | -5.8 | 31.9 | 40.9 | 34.2 | 23.8 | 42.4 | 31.7 | ... |
| | <i>Short-term debt in percent of GDP</i> | | | | | | | | |
| Czech Republic | ... | 6.7 | 7.7 | 6.8 | 7.2 | 8.7 | ... | ... | ... |
| Hungary | 11.4 | 9.5 | 7.4 | 7.0 | 5.6 | 6.2 | ... | ... | ... |
| Poland | 11.3 | 14.1 | 10.8 | 6.1 | 3.1 | 0.1 | ... | ... | ... |
| | <i>(Net) capital inflows in percent of GDP</i> | | | | | | | | |
| Czech Republic | ... | ... | ... | ... | 7.9 | 9.4 | 18.3 | 12.6 ^b | 7.8 |
| Hungary | 2.6 | -2.9 | 7.1 | 1.1 | 15.8 | 7.7 | 13.4 | 6.9 | ... ^c |
| Poland | 2.2 | -1.3 | 2.6 | 4.6 | 6.6 | 4.7 | 10.7 | 4.9 | 3.4 |

^aNet inflows. — ^b1993–1995. — ^cIn 1996, Hungary reported net capital exports of \$1.6 billion because of the repayment of foreign loans through the National Bank and the government. Net capital inflows in the form of FDI and portfolio investment were positive (\$1.1 billion).

Source: IMF (1996), NBH (1997), NBP (1996b), World Bank (1997).

The integration of the Czech Republic into the international capital market has been promoted by a gradual move towards greater current and capital account convertibility.⁷ Generally, the country has followed a sequence of liberalization measures which is common to almost all transition economies: parallel to the liberalization of domestic prices, the foreign trade monopoly was abolished in 1990, and the domestic currency was made internally convertible for current account transactions. Quantitative restrictions on foreign trade flows were fully abolished in January 1991. Yet, Article VIII of the IMF has been signed only in October 1995. Capital account transactions are subject to tighter restrictions than those of the current account: while capital inflows were liberalized fairly soon, in particular in connection with foreign direct investments (FDI), restrictions on capital outflows are being maintained. The substantial liberalization of current account transactions, however, has weakened the ability of the authorities to enforce capital controls. Uncertainty surrounding the start of economic reforms in 1990 and the separation from the Slovak Republic in 1992/93 precipitated outflows of private capital — despite relatively rigid restrictions on capital flows (Hrncir 1997b: 7–8). Also in 1995 did the CNB fail to contain total capital inflows by restricting short-term capital imports because banks simply raised the maturity of contracts slightly above the threshold level of one year.

Although inward FDI is generally unrestricted, some important sectors, notably the banking sector, have been excluded. Foreign banks have been allowed to establish subsidiaries and to buy stakes in domestic banks since 1990. However, branches can only be opened since the beginning of 1992. A permission of the Czech National Bank is needed for the acquisition of a domestic bank (CNB 1995). Yet, after the Czech banking sector came into distress in late 1993 and in the first months of 1994, the issuance of new licenses for domestic as well as for foreign banks was stopped in mid-1994. Even during this period, foreign banks could acquire stakes in existing domestic banks (CNB 1994a). Reportedly, however, de-

mand has been fairly low. In early 1996, the National Bank started to grant new licenses to foreign banks, but future market access will remain regulated. A similar moratorium on foreign bank licenses as in the Czech Republic had been imposed in Poland while market entry of foreign banks was handled quite liberally in Hungary.

Capital account convertibility has been pushed forward in 1994 in all Visegrad countries. This move towards greater capital account convertibility has been prompted by increased capital inflows and thus by market forces on the one hand and by the intention to join the OECD and to accept the convertibility requirements of the IMF on the other hand (Backé 1996). In the Czech Republic, the needed regulatory changes came into force with the new foreign exchange law of October 1995 (CNB 1995). In the context of OECD membership, it is envisaged to abolish remaining capital controls within the coming five years. Inward portfolio investment in bonds and equity is generally permitted but the placement of securities on the domestic market by foreigners usually requires a permission. Medium and long-term financial credits have been liberalized in most of the advanced reform states; Czech residents can also borrow short-term funds from abroad. As regards capital outflows, the Czech regime is the most liberal with regard to real estate investment for residents, which is largely restricted in Hungary or Poland.

Generally, the major restrictions that are being retained are repatriation requirements for foreign currency obtained abroad by residents, portfolio investment abroad, the opening of accounts with foreign banks abroad, outward financial credits, guarantees and the like, and the sale and purchase of domestic currency abroad. A safeguard clause is included in the Czech foreign exchange legislation, allowing the authorities to impose deposit requirements on capital inflows for a maximum period of three months.

A far-reaching liberalization of capital flows as in the Czech Republic may lead to unsustainable current account deficits, excessive real exchange rate appreciation, and an increased

exposure to a sudden withdrawal of funds (Cho and Khatkate 1989; Edwards 1987; Schadler et al. 1993). This volatility of financial flows is crucially affected by the share of foreign direct investment and other long-term investments in total capital (in)flows. Developing countries in Asia where inflows of FDI have dominated, for example, are usually considered to have a more stable external balance than Latin American countries where portfolio investment has been more important. Because foreign direct investment typically occurs in the form of machinery and fixed assets, it can less easily be withdrawn than liquid portfolio investment.

Generally, the transition economies in Central and Eastern Europe have not attracted sizable amounts of portfolio investment until very recently. Foreign direct investment and other long-term investments, primarily through large international finance institutions, have dominated. This reduces the exposure of the region as a whole to a sudden withdrawal of funds. The stylized facts can be summarized as follows:

- In the years 1989 through 1995, flows of foreign direct investment into the transition economies reached in the aggregate almost 32 percent of total capital inflows (Table 3). They thus substantially exceeded the world's average of 17.9 percent. Generally, FDI was about as important as in the average developing country. At the same time, differences between transition economies are striking. FDI inflows have been much more important in Hungary (61.7 percent of inflows) and Poland (39.8 percent) than in the Czech Republic (21.9 percent).

- The smaller share of FDI in the Czech Republic is compensated by the fact that Czech firms borrowed more funds from abroad than their Hungarian and Polish counterparts. Since 1993, Czech enterprises have increasingly raised loans on the international capital market (CNB 1994b). Between 1993 and 1995, loans received from abroad by the non-financial corporate sector have been much greater in the Czech Republic (\$3.8 billion) than in Hungary (\$2.1 billion) or in Poland (\$0.9 billion). Net inflows of loans to enterprises and FDI had ap-

proximately the same volume in the Czech Republic during this period. In 1996, net borrowing of Czech firms in the international capital market exceeded (net) FDI inflows by 50 percent and reached approximately \$2 billion (55.6 billion CSK) (CNB 1997a: 30).

- With regard to the structure of inflows of portfolio capital, the Czech Republic and Hungary also differ substantially.⁸ While portfolio capital has been attracted into the Hungarian economy mainly to finance the budget deficits in 1993 and 1994, portfolio capital inflows into the Czech Republic have been used to purchase equity of the non-financial corporate sector only.

- In the Czech Republic (between 1993 and 1995) and in Poland, the bulk of "other capital" inflows comprised short-term loans to the government which reached a share of 56 and 75 percent of other capital inflows, respectively. In contrast to the Polish government, however, the Czech authorities have also increased their short-term foreign assets, hence the *net* contribution of short-term government liabilities to other investment inflows is very small.

- Although the Czech Republic entered the transformation process with a much lower level of foreign debt as compared to Hungary, at the end of 1994 short-term debt over GDP was even higher in the Czech Republic (8.7 percent) than in Hungary (6.2 percent). Short-term debt relative to GDP was almost negligible in Poland (Table 3).

The structure of capital flows into the Czech economy thus reveals both potentially destabilizing and stabilizing elements. On the one hand, the small share of foreign direct investment and the importance of short-term liabilities in gross capital inflows may increase the vulnerability to external shocks. Also, the fact that Czech enterprises have quite substantially borrowed from abroad raises their exposure to foreign exchange rate risks. This holds in particular as the long-sustained fixed exchange rate regime may have reduced the firms' sensitivity to these risks (Hrncir 1997b). On the other hand, the increase in short-term foreign liabilities of the government has been compensated

by an increase in short-term assets. The maturity structure of foreign loans also has a potentially stabilizing impact. Between 1993 and 1995, the vast majority (94 percent) of all loans raised abroad by firms were long-term funds (IMF 1996). Hence, the fact that the Czech Republic has liberalized not only medium and long-term financial credits (like Hungary and Poland) but also short-term loans has not raised

the exposure to short-term borrowing risks. Finally, the fact that portfolio investment has been concentrated on equity investments is generally welcome because, unlike debt, it does not generate a fixed interest burden independent of the performance of the economy. Under otherwise identical conditions, this type of capital inflow can therefore be sustained for longer periods than inflows into securitized debt.

V. Real Exchange Rate and Competitiveness

The sustainability of capital inflows not only depends on their structure but also on the underlying competitiveness of the recipient economy. This, in turn, is reflected in its real exchange rate. Generally, transition countries initially face the twin challenges of stabilizing the internal value of their currencies and at the same time opening up their economies to the world market. The former requires a credible restrictive monetary policy, while the latter necessitates an appreciation of the real exchange rate towards its open economy equilibrium. Experience from developing countries suggests that these two goals may conflict with each other as the transition unfolds.

Like almost all other transition economies, the Czech Republic has used the nominal exchange rate as an anchor for its stabilization program. Since the beginning of the reform process in 1991, the Czech National Bank had been able to defend a fixed exchange rate which allowed the value of the Czech Koruna to fluctuate around a basket of currencies only by a narrow margin of ± 0.5 percent, although the commitment to defend this rate was never binding (Hrncir 1997a). The basket has comprised the D-mark (65 percent) and the US-dollar (35 percent) since May 1993. The rationale behind this policy was that the fixed rate, coupled with a liberalization of the current account, would immediately reduce inflation by tying the domestic prices of tradable goods to their world market levels. By immediately reducing the inflation in tradable goods prices, the relative price of non-tradables would rise,

and demand would shift out of non-tradables into tradables. As a result, prices would start to come down in the non-tradables sector as well, eventually leading domestic inflation to converge to inflation in the anchor currency country. Thus, a nominal exchange rate target would reduce inflationary expectations and would contain the real cost of weaning the economy away from inflationary habits.

Since the relative (shadow) prices of non-tradables were artificially low in transition economies prior to their opening up to the world market, a real appreciation has been desirable from the point of view of structural adjustment as well. A real appreciation serves to integrate the economy into the international division of labor by allowing it to import some of the tradables it used to produce at home and to free resources for the production of additional non-tradables. Such an appreciation is all the more necessary if part of the investment needed to finance economic development is to come from net capital imports. Moreover, as economic development progresses, productivity growth in the tradables sector usually tends to outpace productivity growth in the non-tradables sector. This further raises the equilibrium real exchange rate in small economies and warrants a further real appreciation.

However, numerous stabilization programs based on nominal exchange rate anchors ran into problems when an excessive real appreciation eroded the cost competitiveness of domestic exporting and import competing industries and thus created unsustainable current ac-

count deficits.⁹ Under such circumstances, the dependency of the economy on net foreign capital inflows rises. Once foreign investors start to question the sustainability of the country's balance of payments position, the nominal exchange rate comes under pressure. The appropriate policy response would be to reduce domestic absorption by tightening fiscal policy and to facilitate a switch of expenditure towards exports by devaluing the currency (Schadler et al. 1993). By contrast, attempts to defend the nominal exchange rate by raising interest rates without fiscal tightening are self-defeating since they encourage additional inflows of short-term speculative capital. This serves to delay the necessary correction of the external imbalance at the cost of exacerbating the real overvaluation and widening the current account deficit. When capital flows reverse, the squeeze on domestic absorption will have to be all the more sudden and severe. The policy lesson from numerous attempts at exchange-rate-based stabilization therefore is that once signs of a real overvaluation appear, trying to defend the nominal exchange rate risks making matters worse, at least unless accompanied by significant fiscal tightening. A more flexible exchange rate regime such as a crawling peg with wide bands is needed.

How fast a currency becomes overvalued, though, depends crucially on two factors. First, real appreciation under a nominal anchor will be the faster the more slowly domestic inflation converges to the international level. The speed of inflation convergence in turn depends on the degree of inflation inertia which can be due to explicit wage and price indexation schemes and, not least, to policy inconsistencies which reduce the credibility of the anti-inflation stance.¹⁰ But, secondly, domestic price and wage inflation will not erode the competitiveness of the tradables sector if they are accompanied by corresponding gains in factor and particularly labor productivity. In this case, the *equilibrium* real exchange rate appreciates. It is therefore absolutely crucial for economic policy to provide conditions conducive for investment to increase along with capital inflows and for funds to be invested efficiently.

In keeping with the lesson that a rather flexible approach to the nominal exchange rate can reduce the risk of balance of payment crises, Poland abandoned its nominal anchor in early 1991 and has since followed a crawling peg. Hungary at first devalued in periodic discretionary steps. Starting in the spring of 1995, a crawling peg was introduced there as well. By contrast, the Czech authorities have not allowed greater exchange rate flexibility for a prolonged period of time, after it had devalued its currency in 1990/91. It was only in late February 1996 that the Czech monetary authorities decided to widen the band to ± 7.5 percent relative to the currency basket in response to the massive capital inflows of 1995. This move precipitated an outflow of short-term capital and a loss of foreign exchange reserves of the National Bank, mainly in the first half of 1996 (CNB 1997a: 30).

Real exchange rates have risen substantially in all transition countries. However, the degree of real overvaluation, if any, is difficult to gauge. Most countries initially devalued their nominal and in their wake their real exchange rates. An exception to this is Hungary where the nominal devaluation was insufficient to depreciate the real exchange rate. According to estimates by Halpern and Wyplosz (1995), the degree of initial real undervaluation was particularly pronounced in former Czechoslovakia. Hence, the scope for equilibrium real exchange rate appreciation would appear to have been greater in the Czech Republic than for instance in Hungary or in Poland. In fact, real appreciation as measured by the consumer price index has actually been less over the 1990–1996 period (Figure 2b). However, starting in 1993, real appreciation has been fastest in the Czech Republic.

An indicator for the movement of the equilibrium real exchange rate is unit labor costs in the tradables sector as measured in foreign currency (Table 4). On this measure, the competitiveness of the tradables sector suffered an unabated and significant deterioration in the Czech Republic throughout the 1991–1996 period. This is in marked contrast to developments particularly in Hungary where, after a

sharp initial rise, unit labor costs have been declining since 1992. That competitiveness in the Czech tradables sector has been deteriorating is suggested also by a look at its trade balance (Table 1). Export growth has been slower in the Czech Republic than in Hungary or Poland in the 1994–1996 period and has turned negative in early 1997.

Table 4 – Unit Labor Costs, Labor Productivity, and Real Producer Wages in Dollar Terms, 1990–1996 (percentage changes)

| | Czech Republic | Hungary | Poland |
|-----------|----------------------------|---------|--------|
| | <i>Unit labor costs</i> | | |
| 1990 | -17.3 | 14.4 | -8.9 |
| 1991 | -14.8 | 29.4 | 66.5 |
| 1992 | 32.8 | 7.6 | -8.7 |
| 1993 | 25.8 | -9.6 | -8.8 |
| 1994 | 13.2 | -1.0 | -7.3 |
| 1995 | 6.9 | -8.7 | 15.1 |
| 1996 | 6.9 | -10.3 | 10.8 |
| 1990–1996 | 52.3 | 16.7 | 49.3 |
| | <i>Labor productivity</i> | | |
| 1990 | -0.4 | 0.4 | -21.1 |
| 1991 | -16.6 | -17.9 | -11.9 |
| 1992 | -7.6 | 10.7 | 17.1 |
| 1993 | -3.5 | 18.5 | 14.5 |
| 1994 | 4.0 | 7.3 | 19.2 |
| 1995 | 20.5 | 11.2 | 9.6 |
| 1996 | 10.3 | 7.2 | 9.7 |
| 1990–1996 | 2.4 | 38.3 | 33.6 |
| | <i>Real producer wages</i> | | |
| 1990 | -5.8 | 0.9 | -34.4 |
| 1991 | -33.1 | -5.4 | 10.3 |
| 1992 | 7.0 | 13.7 | 7.2 |
| 1993 | 10.7 | 12.3 | 5.1 |
| 1994 | 10.4 | 9.2 | 6.4 |
| 1995 | 10.3 | -5.9 | 7.2 |
| 1996 | 7.7 | 2.2 | 19.2 |
| 1990–1996 | -2.1 | 28.0 | 10.8 |

Source: EBRD (1996), IMF (1997).

Three factors are behind the large increase in unit labor costs in the Czech Republic (Table 4). First, labor productivity growth has been relatively flat compared to Hungary or Poland.¹¹ This indicates that the equilibrium level of the real exchange rate has likely risen more slowly in the Czech Republic than in some other transition economies. By implication, the same rate of real appreciation would cause an overvaluation more quickly in the Czech Republic than in other economies. Second, real wages have risen by 45 percent since 1992 and have thus

outpaced real wages in Poland and Hungary.¹² These problems are particularly acute in the government sector and in state-owned firms, where productivity growth has been below-average while nominal wage increases tended to be above-average (PlanEcon 1997a). And third, the Czech currency has remained stable in nominal terms while Hungary and Poland have allowed some of the real wage gains to be offset by nominal exchange rate depreciation. Hence, in view of the actual development of the real exchange rate in the Czech Republic, the attempt to give more flexibility to the exchange rate by widening the exchange rate band in early 1996 may have been too little too late.

In light of the experience with earlier balance of payments crises, the questions arise why has productivity growth not been faster and why have wages risen so much ahead of productivity? The former problem may appear particularly puzzling in light of the high rate of fixed capital formation in the Czech Republic.¹³ It has stood at around 30 percent of GDP. The Czech Republic is the only transition economy which comes close to the fast growing Asian economies in this regard. In contrast, investment ratios in most other countries have been closer to 20 percent of GDP. This finding points to a problem in the efficient allocation of domestic and foreign savings as a possible cause of sluggish productivity growth.

The failure of wages to rise by no more than productivity growth can hardly be ascribed to implicit indexation or excessive inflationary expectations in the Czech case, since both the initial correction of the price level and subsequent inflation have been moderate by comparison with other transition countries or emerging market economies in Latin America. Instead, it reflects weaknesses in the corporate governance of enterprises. Hence microeconomic inefficiencies play a key role in explaining the present Czech crisis. Thus far, however, economic policy has responded to the crisis mainly on the macroeconomic level, notably monetary policy, while fiscal and institutional reforms have lagged behind.

VI. Macroeconomic Policy Responses

The CNB struggled to sterilize capital inflows in order to prevent them from fueling inflation, but this became increasingly difficult. Generally, sterilization can be defined in a *narrow* sense, implying that increases in the monetary base due to inflows of foreign reserves are compensated by reductions in domestic credit (Hrncir 1997b). Sterilization in a *broader* sense mainly comprises adjustments in the money multiplier through changes in minimum reserve requirements and shifts of government deposits to the Central Bank, but also diminished re-financing facilities. In the years 1993–1995, the increase in net foreign assets of the CNB exceeded the increase in the total monetary base by 26 percent. Hence, net domestic assets were reduced in an effort to sterilize capital inflows. In 1996, in contrast, net foreign assets declined by less than the monetary base, reflecting an increase in net domestic assets. The decline in foreign exchange reserves mainly occurred in the first half of the year as short-term capital was exported in response to the widening of the exchange rate band in February (CNB 1997a: 30). The CNB has furthermore raised minimum reserve requirements successively from 1994 onwards¹⁴ and induced banks to shift government deposits to the Central Bank mainly in 1995. Overall, however, open market operations have been more important as a tool to reduce the domestic money stock.

In 1994 and 1995, sterilization policies have been relatively effective and have imposed relatively small costs on the Czech economy (Hrncir 1997b). Estimates indicate that the CNB through its open market operations and reserve policies has indeed been able to affect total money supply;¹⁵ the quasi-fiscal costs¹⁶ of the sterilization measures have been put at 0.3–0.5 percent of GDP in these years. Yet, sterilization became increasingly expensive and ineffective, as the turnaround in monetary and exchange rate policies in 1996 and in the first months of 1997 illustrates. It must be borne in mind that sterilized intervention in response to capital inflows tends to raise the level of do-

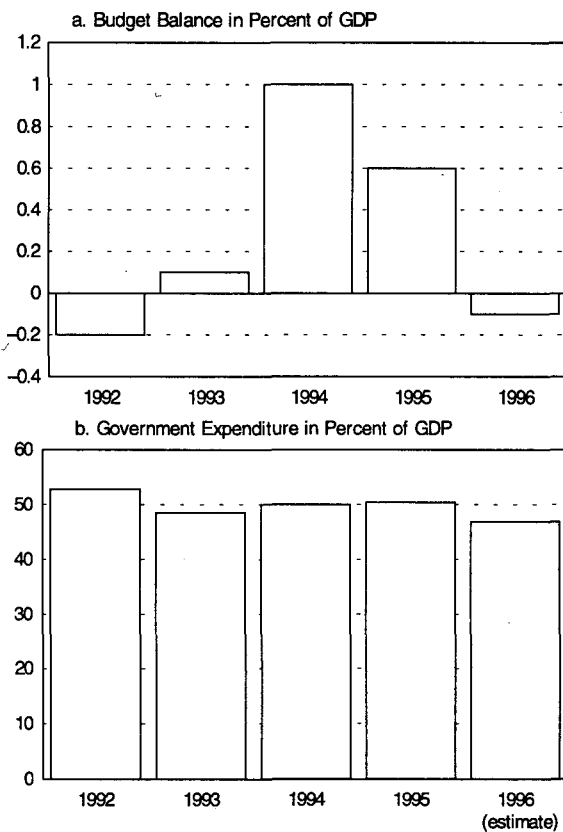
mestic interest rates and thus triggers additional capital inflows. Besides, raising minimum reserve requirements is a fairly distortionary instrument of monetary policy since it distorts the asset management of commercial banks and imposes a tax on the banking system.

Adjustments of monetary and exchange rate policies alone are insufficient responses to increased capital inflows and widening current account deficits. The interesting point about the Czech case is that the attack on the Koruna in May 1997 was not a response to inconsistent fiscal and monetary policies in the conventional sense. Typically, speculative attacks on fixed exchange rate regimes are encountered when central banks finance large budget deficits through excessive money creation (Agénor et al. 1992). Although the Czech government did not run fiscal deficits, fiscal policy failed to counteract the strong demand expansion in the private sector (Figures 3a and 3b). Domestic absorption has been fueled by substantial real wage growth and strong investment demand. In order to reduce it, a comprehensive policy package, including fiscal adjustment, wage moderation, and structural reforms is called for. In view of the large capital inflows, in particular in 1995, a fiscal surplus might have been more appropriate (Hrncir 1997b).

Since April 1997, the government has started to respond to the widening current account deficit and the loss of foreign currency reserves of the Central Bank by implementing some emergency measures (PlanEcon 1997a; CNB 1997b; NZZ of 30.5.1997):¹⁷

- In early April, the government decided to reduce planned spending for the year, to put a cap on public sector wages, and to impose restrictions on the purchase of certain consumer goods. More specifically, 20 percent of the value of imports must be deposited at an interest-free account for 180 days.
- In late May 1997, after the abolition of the fixed exchange rate, it was decided to lower

Figure 3 – Budget and Government Expenditure in the Czech Republic, 1992–1996



Source: CNB (1997a), EBRD (1996).

government expenditure to achieve a balanced budget in 1997 and a small surplus in 1998.

Imports financed through the budget shall be reduced significantly. A wage freeze on public sector wages is to be imposed; wage moderation in the private sector shall be negotiated.

The above measures are appropriate to reduce domestic absorption and to correct the real overvaluation of the exchange rate. To some extent, the Czechs follow the Hungarian example. To correct its external disequilibrium, Hungary was forced to introduce an austerity program in March 1995. The government cut budget expenditures, raised taxes, instituted an import tax surcharge and devalued the currency by 9 percent. Subsequently, it shifted from a policy of discretionary devaluations to a pre-announced crawling peg in an attempt to preserve the competitiveness of the Forint without foregoing its role as a nominal anchor. This austerity package cost Hungary some output growth in 1995 and 1996, but helped the country to successfully avert a full-fledged crisis along Mexican lines. In the Czech Republic, such macroeconomic adjustment may be insufficient to solve the underlying microeconomic causes of the crisis. Although the intention to tackle institutional reforms was stated, concrete proposals are lacking as yet.¹⁸ Solving the problems in the banking and financial sector seems particularly important in order to improve the corporate governance and the restructuring of firms.

VII. Banking and Balance of Payments Problems: Another Twin Crisis?

Kaminsky and Reinhard (1996) have recently provided evidence that banking and balance of payments crises are closely linked. They analyze crisis episodes in 20 developed and developing countries for the 1970s through the 1990s and find some common features. In contrast to the 1970s, banking and balance of payments crises have become increasingly common lately in response to the increasing globalization of financial markets. While the causality between the two types of crises is not clear-cut from a theoretical point of view, the empirical evi-

dence suggests that — if anything — banking crises help to predict balance of payments crises, and not vice versa. At the same time, similar domestic and external shocks help to predict both types of crises. Among the domestic shocks are a weakening of the export sector, high real interest rates, a decline in the stock market, or an increase in the money multiplier. Finally, most of the banking crises studied were preceded by domestic financial liberalization policies.

The situation of the transition economies in Central and Eastern Europe quite closely resembles some of the common features of financial crises. Quite encompassing programs of internal and external financial liberalization were launched at the beginning of the reform process, and the reforms of the domestic banking sectors have at first not been accompanied by appropriate regulatory reforms.¹⁹ As concerns the crises indicators, no clear picture emerges in the Czech Republic. On the one hand, export growth slowed down considerably in 1996 (Table 1). Also, the stock index declined prior to the crisis. On the other hand, neither an increase in the money multiplier nor an increase in real lending rates (starting from relatively high levels) could be observed.

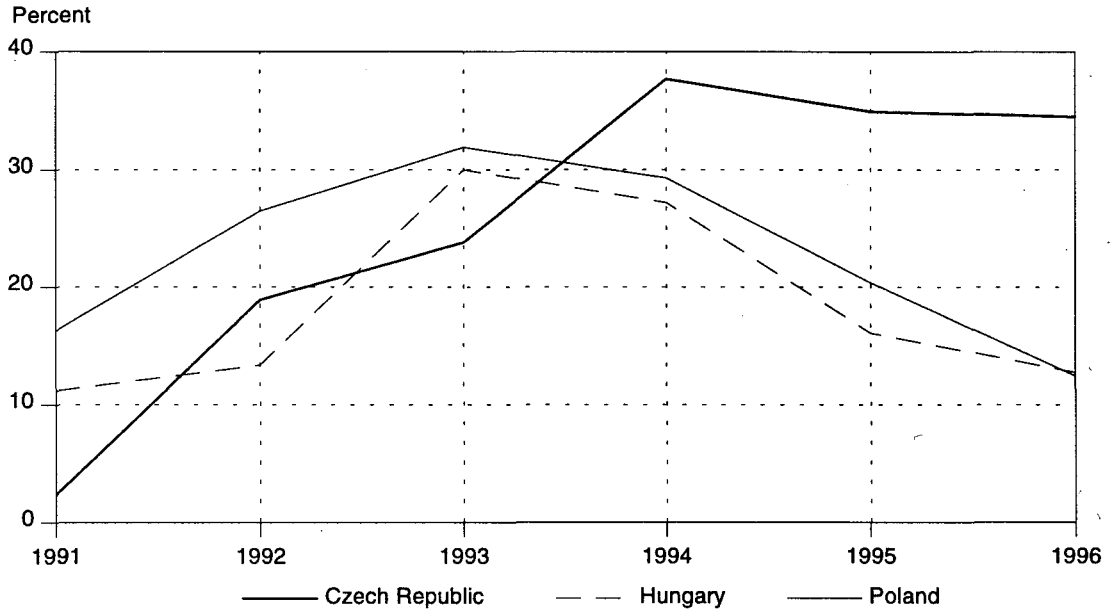
Yet, the developments in the banking sector are of particular interest. In the Czech Republic, banking reform got ahead of comparable countries such as Hungary and Poland at the beginning of the reform process but slowed down considerably later on. Both with regard to the solution to the stock problem of non-performing loans and to the privatization of state-owned banks did the Czechs act relatively quickly. After a two-tier banking system was established in 1990, inherited low-interest loans, which had been granted under central planning to finance inventories, were taken off the balance sheets of the successor banks of the monobank, and the banks were recapitalized by government bonds (Consolidation Program I). The loans in question were taken over by the newly founded, state-owned Consolidation Bank; the costs of recapitalization were covered through privatization revenues. Further recapitalizations followed later on, but the authorities made sure that only inherited bad loans were covered. Bank privatization started in 1992 as the state-owned banks were included in the voucher privatization scheme.

Yet, other important reforms of the banking sector were not pushed forward decisively enough. Bank privatization remained incomplete because only about 50 percent of the banks' shares were included in the voucher privatization; the remaining shares are being retained by the government, mainly through its

National Property Fund. After a new banking law had been passed in 1991, further measures to improve the supervision of the banking system and banking legislation were substantially delayed. At first, the creation of loan loss provisions was not based on a case-by-case assessment of the loan portfolio. Banks established a general provision instead. New reporting systems for asset quality and loan loss provisioning became mandatory only in the second half of 1994. These reporting systems require banks to base loan classification on indicators such as the duration of the payments delay and the quality of the borrower. These regulatory changes had partly come in response to mounting solvency problems in the Czech banking industry. They brought the true scale of the non-performing loans problem to the surface and induced the Central Bank to impose a moratorium on new banking licenses. Because also foreign banks have been affected, new entry of foreign banks into the Czech banking sector was prevented for more than two years between 1994 and 1996, and foreign participation in the large Czech banks has not actively been sought. As a consequence, concentration ratios in the Czech banking system remain comparatively high, the large successor banks of the monobank dominate the market, and efficiency gains through foreign competition and full privatization have eventually been foregone.²⁰

In contrast to Hungary and Poland, total classified loans in the Czech banking sector have remained stubbornly high (Figure 4). At the end of 1996, they still accounted for more than 37 percent of total bank loans while their share had been reduced to less than 20 percent in the other two economies. These non-performing loans are not only a legacy from the past. As of May 1996, about 41 percent of all classified loans were short-term loans that had been granted within the past 12 months (CNB 1996). Generally, a high share of non-performing assets hampers the efficiency of the banking system for various reasons (Buch 1996). Banks burdened with risky assets are likely to raise interest rate spreads, to reduce their overall lending, to invest into safe assets, and to potentially bias lending towards their existing clients. By

Figure 4 – Classified Loans in Percent of Total Loans, 1991–1996



Source: CNB (1997a), SBS (1997), NBP (1996a), Buch (1996).

not writing off non-performing loans, the banks realize an option value of waiting as they hope to eventually recover some of their classified loans. As a consequence, savings and investment are suppressed and new private enterprises may be rationed out of the market. Recently, some positive developments seem to have taken place in the Czech banking sector with regard to the issue of non-performing loans (CNB 1997a). Commercial banks have written off some of their non-performing assets, which has so far largely been discouraged by tax legislation.²¹ The quality of new lending seems to have improved, and loan loss provisions reach 34 percent of classified loans, the remainder being backed by collateral. Yet, it must be taken into account that the value and the liquidity of assets which might serve as collateral are highly uncertain in transition economies. In fact, Czech banks have thus far hardly collected any collateral from their debtors. According to foreign auditors, non-performing loans still threaten the solvency of Czech banks to a substantial degree (Kapoor 1997) and thus potentially distort lending decisions.

As a reflection of the problems in the banking sector, an open banking crisis could not be averted anymore in 1995 and especially in

1996. At this point, a new bank consolidation program (Consolidation Program II) was launched which comprised the evaluation of banks' loan portfolios, the restructuring of banks, and the eventual extension of a deposit insurance to depositors of insolvent banks. Until mid-1996, the licenses of two banks had been withdrawn, conservatorship had been imposed on three banks, four banks had been merged with others, and seven banks were recapitalized through existing shareholders or new investors (Matousek 1997). While liquidity assistance had primarily been geared towards the large successor banks of the monobank in the Consolidation Program I, the new consolidation program thus mainly targeted small and medium-sized banks, accounting for roughly 10 percent of the banking system's assets (Hrncir 1997b: 24). In autumn 1996, the CNB and the Czech government created a special financing unit which is under the administration of the Consolidation Bank, which takes over non-performing loans from the banks in question, and which undertakes the loan work out. The banks have to repurchase the assets after 5–7 years and are under special supervision by the CNB throughout the duration of the scheme.

In summary, early progress in banking sector reform in the Czech Republic could not be exploited to effectively contain the emergence of new bad loans. While gradualism in banking reform has been a common feature of all transition economies, reformers in Hungary and Poland have at least in some areas produced better results. In Hungary, for example, market entry of foreign banks has been handled quite liberally, thus improving the competitive situation in the banking system. Hence, the procrastination of bank recapitalization and privatization may have been less harmful than in the Czech Republic. Polish reformers have, as in the Czech Republic, substantially delayed bank privatization and the opening up for foreign banks. In 1993, a loan consolidation program was implemented in Poland which seems to yield some positive results (Gray and Holle 1996). By relying on decentralized debt restructuring in special loan work-out departments of the commercial banks, the program has tried to utilize the learning potential of the banks. While loan work-out departments have also been established in Czech banks, government-initiated debt restructuring has mainly relied on centralized solutions. Also, the Polish program has strengthened the incentives of banks to restructure bad loans by effectively changing the seniority of claims.

In the Czech Republic, restricted market access of foreign banks, coupled with a liberal regime towards foreign borrowing, has potentially increased the foreign exchange exposure of the commercial banks that have intermediated foreign loans of Czech firms.²² Although the final jury is still out, there are indications that efficiency gains in the partly state-owned banks through full privatization and foreign ownership may have been sacrificed in favor of a politically motivated behavior of banks. Although the state as an owner of the large commercial banks does not interfere with the daily business decisions of the banks, it does influence long-term strategic decisions to a certain degree. Empirical evidence from a case study of the largest commercial bank, Komerční Banka, at least does not lead to reject the hypothesis that an implicit contract between the government and the bank exists (Snyder and Kormendi 1996). This "contract" may explain why the large banks have been relatively reluctant to restructure firms or to force them into bankruptcy and why foreign competition has not been encouraged. Yet, in order to understand the role of banks in corporate governance and in the restructuring of firms, a closer look at the specifics of the Czech privatization process and capital markets is warranted.

VIII. Banks, Capital Markets, and the Restructuring of Firms

Commercial banks in the Czech Republic have full-fledged universal banking licenses. They can operate as commercial and investment banks at the same time, and they can hold limited amounts of equity in non-financial firms. With regard to their role in corporate governance, Czech banks also have an influence on firms through their involvement in the investment fund structure. The leading Czech banks founded most of the investment privatization funds, which collected the bulk of voucher points issued to the population during mass privatization. The funds invested these vouchers into shares of the firms to be privatized.

Although over 300 investment companies were originally founded, only about 50 of them have played a significant role in the corporate governance of firms through their board membership in privatized firms. Contrary to earlier fears, mass privatization in the Czech Republic has thus not led to widespread dispersed ownership structures. Instead, in the first privatization round, investment funds acquired 66.2 percent of the total book value of Czech enterprises, and 75 percent of the privatized firms were characterized by concentrated ownership of investment funds of at least 30 percent (Matesova and Seda 1994: 39–40). Because bank-con-

trolled investment funds have collected about 60 percent of the voucher points of all funds in the first privatization wave — this share having gone down somewhat in the second wave (Mejstrik 1994: 21) —, banks potentially play an important role in corporate governance.

In the first privatization wave the funds had to be incorporated by law as joint stock companies. The original voucher owners became owners of the privatization funds.²³ However, ownership in the funds has been so dispersed that investors have in fact had little control over how the funds have been run. Instead, control has rested with the funds management companies. These are usually owned by the banks who founded the funds in the first place. Hence, while the funds are expected to control firms, mechanisms to encourage the fund managers to maximize shareholder value have remained weak. Given the absence of an effective voice at shareholder meetings, the main mechanism to influence funds managers should have been exit. And indeed, hefty discounts on the funds' share prices of up to 80 percent on the market value of the underlying portfolios as well as a considerable dispersion in the secondary market prices of different funds indicate that many investors have taken that avenue.²⁴

At the same time, persistently large discounts suggest that some funds have been largely aloof of the message sent by deserting shareholders. They appear to be run more for the benefit of the lending business of the banks owning the respective fund management companies than for the benefit of investors. This lack of interest in keeping shareholders satisfied can be traced to two factors. First, the funds are organized as joint stock companies which are not required to redeem the shares of investors at the market value of the underlying portfolio. Second, the funds' connections to banks allow them to stay afloat without attracting new outside capital.

Roughly half the funds established for the second privatization wave (1993) have been founded as unit trusts rather than joint stock companies (Egerer 1995). They are required to redeem their shares on demand at the market price of the underlying portfolio. Setting up funds as unit trusts rather than joint stock com-

panies has been motivated on the one hand by the high costs of convening shareholder meetings, but on the other hand also by the disappointment of investors with the high discounts at which the shares of the original joint-stock investment funds have been trading. The bulk of the new funds has been set up as open-end funds which means they can attract additional capital from outside. This can be expected to provide incentives to fund managers to generate profits for shareholders in order to attract more capital and to maximize proceeds from management fees.

While the emergence of unit trust funds tends to strengthen the role of the stock market in providing corporate control via movements in share prices, some funds established in the first privatization wave, most notably some non-bank-controlled funds, have moved the opposite way. They have transformed into holding companies. Thereby, they are avoiding a 20 percent limit on stakes in any one company and can consolidate their portfolios for active management.

To what extent banks use their power to improve the performance of Czech enterprises and thus to contribute to the success of the privatization process cannot be evaluated definitively. In principle, bank-owned investment funds are less likely to be liquidity-constrained than independent investment funds and thus should be able to take a long-term view of the enterprise's affairs rather than maximizing short-run cash flow (Brom and Orenstein 1994). However, compared to non-bank-controlled investment funds, bank-controlled funds tend to have rather dispersed portfolios (Coffee 1994), indicating that their strategy may be to manage portfolios rather than to actively get involved in the management of any enterprises.

Because the bank-controlled funds typically hold rather diversified portfolios, their role in the effective control of firms is limited by the sheer lack of qualified personnel to fill board seats. As a result, the bank-controlled funds send representatives to the executive and supervisory boards of firms less frequently than non-bank-controlled funds do (Egerer 1995). Despite their presence on company boards, most

funds have remained largely passive shareholders (Pistor and Spicer 1996). Moreover, conflicts of interest can arise between the investment fund management and the commercial banking operations. Often, bank managers are sent to fill board seats. These managers have incentives to recover as much as possible for their loan business rather than to opt for high dividends or for profits to be reinvested (Matesova and Seda 1994: 19). Coffee (1994: 32) provides mixed evidence with regard to the exchange of information between the commercial and investment banking activities. While some banks actively exchange information between these departments, others have established fire walls, trying to evade possible conflicts of interest. Banks can in principle be required also by law to establish Chinese walls between their investment and commercial banking activities, but the implementation of such requirements appears to be difficult. These problems can be exacerbated by the degree of cross-ownership in the banking system through investment funds.

Market-based evidence on the impact of investment funds in general and bank-controlled funds in particular on the firms that they own seems to suggest few problems, though. A recent study by Claessens et al. (1997) finds that firms in which bank-controlled funds own large stakes actually exhibit a higher market value than firms with either dispersed ownership or with large stakes owned by non-bank-controlled funds. However, the study covers only firms actively traded on the Prague exchange where trading is mostly between or through the major banks. By contrast, the bulk of stock trading is taking place outside the exchange at undisclosed prices (Triska 1995; Pistor and Spicer 1996). The information content of the prices quoted on the Prague exchange may therefore be quite low.

Because the success of the Czech voucher privatization ultimately depends on the incentives for the investment funds (and the banks) to perform effective corporate governance, financial market legislation is crucial. Yet, the authorities have only hesitantly moved to improve the relevant laws and to implement

Western standards. Although the number of listed companies on the Czech stock market (1,635 in 1995) and market capitalization (33 percent of GDP) are higher than in many mature market economies, market turnover (23 percent), i.e., the trading value relative to market capitalization, is lower than in e.g. Hungary or Poland (IFC 1996; World Bank 1996). One reason for the low turnover is the poor quality of financial information, the intransparency of the financial system, and the weak protection of minority interests. New stock market legislation, which came into effect in July 1996, tried to address these problems, but the reforms are generally perceived not to be far-reaching enough.

Apart from problems with owner control over firms, there have been problems with the enforcement of creditor claims as well. The Czech Republic has been notorious for the hesitant enforcement of bankruptcy legislation. Effective bankruptcy legislation is crucial to enable creditors to intervene in firms failing to service their debt. Otherwise, creditors may become excessively cautious in their lending because of the risk of not being able to recover their loans if the enterprise gets into trouble. Moreover, poorly designed bankruptcy laws may give creditors incentives to refinance ailing firms in the hope of keeping them afloat so that they may eventually be rescued, and at least some of the loans may be recovered. As a result, promising new firms may be starved of credit.

In order to provide the right incentives for creditors, several points are important. First, seniority of claims should rest with (secured) creditors, rather than with the government, the workers or the owners. Else, creditors cannot hope to recover a sufficiently large portion of their loans to make an initiation of bankruptcy proceedings worthwhile. Second, asset markets in transition economies are often depressed. Therefore, creditors may be reluctant to press for liquidating the assets of a firm due to the rather low expected returns. Hence, short of liquidation, the legislation should include a possibility for creditors to work out an agreement with the debtor firm in which debts are written

down or restructured in return for restructuring the firm. In order for this kind of work-outs to be feasible, agreement should require the assent of a qualified majority of creditors, rather than unanimity. Third, a firm deadline should be set before which an agreement must be reached, and after which liquidation becomes mandatory. Otherwise, work-out negotiations may drag on forever while the firm is allowed to struggle on and to waste the remainder of its capital stock. Finally, in case of liquidation, the court-appointed liquidators should be afforded financial incentives to wind up the firm quickly.

In the Czech Republic, it is only since April 1993 that creditors are legally allowed to take bankruptcy cases to court (Brom and Orenstein 1994: 898). The bankruptcy law has been amended twice in order to simplify the process and to make it more difficult for debtors to shield themselves from creditor claims. Creditors enjoy seniority over other claims. On paper, the Czech bankruptcy law does not look worse than for instance the Polish law. And yet, the number of bankruptcies has remained small. Through mid-1996, less than 500 bankruptcy cases had been opened, none of which involved a major enterprise, and none of which had been completed. The major obstacles to the effectiveness of bankruptcy legislation appear to be excessively cumbersome procedures and inadequate resources devoted to the court system, leading to substantial backlogs in unprocessed filings and pending cases (Zemanovicova and Zitnanska 1996). In addition, some creditors are protected by government guarantees.

This is in marked contrast to Hungary and Poland where bankruptcies have been used liberally to weed out enterprises which are not viable. Hungary introduced one of the most stringent bankruptcy laws in the region in 1991, forcing firms to self-declare bankruptcy if and when they were more than 90 days in arrears on

their debts.²⁵ The number of bankruptcy cases has vastly exceeded those in the Czech Republic.²⁶ The strictness of the law led to disruptive bankruptcy proceedings even in enterprises merely facing liquidity crises rather than being insolvent; hence the requirement to self-declare bankruptcy in case of payment arrears was removed in 1993. Nonetheless, bankruptcy legislation in Hungary has contributed to hardening the budget constraints of Hungarian firms and to improve financial discipline in both firms and banks. Even in Poland, where bankruptcy legislation exhibits significant weaknesses in terms of the priority of creditors, several thousand cases have been filed and several hundred have been completed (Gray and Holle 1996).

In summary, this section has lend support to the hypothesis that problems in the corporate governance of firms are one main reason behind the increase in wages in excess of productivity and the resulting loss of competitiveness of Czech firms. It is hardly conceivable how these corporate governance problems could be solved without improving the situation in the banking sector and the functioning of capital markets at the same time. Simply forcing banks to divest the shares in enterprises that they hold (either directly or through investment funds) is not feasible in the current situation. In view of the complementarity between efficient banks and efficient stock markets, reducing the governance role of banks may also be suboptimal from a theoretical point of view.²⁷ However, if banks are supposed to perform corporate governance functions and to restructure firms, the banks themselves must be run efficiently. In view of the relatively large ownership stakes that the government still holds in the dominant banks, speeding up bank privatization while closely involving foreign investors is unavoidable.²⁸

IX. What Are the Lessons?

After capital inflows into the transition economies in Central and Eastern Europe surged in 1993 and 1995, the Czech Republic has witnessed a reversal of (short-term) capital flows and, in response to increasing current account deficits, had to abandon its fixed exchange rate regime. External factors, in particular the recent increase in international interest rates, have *ceteris paribus* made the transition economies less attractive for foreign investors. Yet, our analysis also suggests that domestic fundamentals can explain the current situation in the Czech Republic to a great extent.

There are a number of lessons that other transition economies can take from the Czech experience. To be sure, increased capital inflows have beneficial effects for the process of economic transformation. They allow higher domestic investment and provide for a transfer of know how and new technology. However, in order to avoid excessive real exchange rate appreciation and unsustainable current account deficits, appropriate policy responses must be taken as well. While exchange rate targets may be used, the authorities must stand ready to flexibly adjust them to new conditions. Emergency measures such as (temporary) capital controls and deposit requirements on imports can hardly be an effective substitute for a sufficient degree of exchange rate flexibility. Monetary sterilization of capital inflows may be partially feasible in the very short run but overall proves to be a rather costly, inefficient, and counterproductive instrument. Apart from monetary policy, fiscal and wage policies must adjust in order to moderate domestic demand. Hence, the need to reduce government spending may not only be given in a situation of high budget deficits.

One of the most important lessons from the Czech experience is that macroeconomic factors alone are an imprecise and perhaps misleading indicator of the underlying strength of an economy. Rather, institutional and micro-economic conditions must be taken into account as well. In the Czech Republic, weak fi-

ancial market regulation has reduced the transparency of ownership relations and has prevented the emergence of effective corporate governance structures conducive to the restructuring of firms. The role of banks is particularly important. On the one hand, banks have been assigned an influential role in the corporate governance of firms. On the other hand, (partial) state-ownership of the banks, the relatively high share of non-performing loans on their balance sheets, and weak regulations have reduced the incentives of banks to efficiently monitor enterprises. As a result, productivity growth was disappointing and was outstripped by wage growth.

In order to improve the incentive system and to allow for a better corporate governance role of banks, the following reforms are particularly indicative:

(1) Because Czech banks have already been recapitalized for a substantial part of their truly inherited non-performing loans, additional recapitalizations would entail moral hazard problems. Rather, the issue should be addressed by giving banks more leeway to provision against their bad loans, i.e., to allow more generous pre-tax provisions and loan writeoffs. Under the current practice, which allows only a partial deductibility of required provisions, paper profits are *de facto* being taxed. Furthermore, by focusing on decentralized loan restructuring and by creating appropriate incentives for the banks, banks can be induced to engage in the restructuring of firms and possibly to recover some of their classified loans. The results of the Polish restructuring law show that banks made use of the enhanced role that was assigned to them. Incidentally, decentralized debt restructuring utilizes the learning potential of banks and may lay the basis for a more solid loan assessment in the future.

(2) The hesitant enforcement of the bankruptcy law has prevented market-based adjustment in the corporate sector. To speed up the resolution of bankruptcy cases presently pending and thereby to encourage the use of bankruptcy to

work out debt problems, bankruptcy proceedings should be streamlined and the court system's resources to deal with bankruptcy cases should be upgraded. Above all, the political will to enforce the existing bankruptcy legislation is crucial.

(3) The restricted market access of foreign banks for at least two years and a substantial slow-down in bank privatization have contributed to a preservation of inherited market structures. Opening up for foreign banks more decisively and in particular allowing foreign banks to participate in the privatization of the large commercial banks can help to improve the efficiency of the banking system and the corporate governance role of banks.

(4) Abandoning universal banking entirely and switching to a system of specialized banks is hardly feasible and unlikely to solve the problems in the Czech corporate sector. Rather, regulation of the investment fund industry should be improved. In order to encourage funds to manage their portfolios for the benefit of investors, funds should be encouraged to register as open-end unit trusts rather than as joint stock companies.

Because weak incentives of banks have eventually contributed to the poor performance of the Czech economy, the problems in the banking sector and the recent balance of payment crisis are merely two sides of the same coin. Hence, the interaction between these areas should not be overlooked. The above lessons are thus particularly important for Russia where, similar to the situation in the Czech Republic, banks stand at the core of so-called financial-industrial groups and are closely linked to industry.

In order to solve their current problems, the Czech reformers should continue to follow their liberal-minded reform strategy but complement it by appropriate institutional reforms. In fact, the envisaged EU membership and the needed adjustment of regulations to common market legislation can provide useful guidance. In this sense, the current crisis episode has not moved the Czech Republic farther away from Europe, but rather has shown the need to implement a sound (financial) market infrastructure along Western lines.

Clearly, reducing domestic absorption and forcing firms to restructure will impose short-run adjustment costs on the Czech economy. Unemployment rates will have to go up as the restructuring of firms takes momentum, reducing the inflation rate will become increasingly difficult after the devaluation of the Koruna, and the needed reduction of domestic absorption will not only serve to reduce imports but also negatively affect demand for domestically produced goods. As regards the future outlook for the Czech economy, however, medium to long-run prospects certainly remain favorable as the fundamentals in the Czech Republic are still relatively strong. Potentially stabilizing factors are a high share of investment in GDP, high shares of machinery and equipment in total imports, a relatively sound fiscal situation, and the low unemployment which should ease lay offs. While the dream of a Czech miracle may indeed be over, decisive action taken now to improve the institutional framework can serve to turn the situation around and to set the economy on a new, sustainable growth path.

Endnotes

- 1 Essentially, this would be the definition of contagion employed by Sachs et al. (1996: 10) who claim that “[...] in 1995 contagion did not occur randomly across emerging markets. The Mexican crisis spread to countries with weak fundamentals and low reserve ratios, but not to countries with strong fundamentals or high reserve ratios.”
- 2 The decline in net capital inflows in 1994 as compared to the previous year is due to a substantial capital outflow of \$17.1 billion from Russia. Hence, capital inflows into transition economies excluding Russia have increased. This section mainly draws on the data provided in the IMF *Balance of Payments Statistics Yearbook* (IMF 1996). These data may divert from other sources. In order to ensure comparability of the data across countries, a common source of information was used nevertheless.
- 3 Other sources put the net inflow of foreign capital into Central Europe and the Baltic’s (excl. Russia) only at about \$31 billion for 1995 (UNECE 1996: 143).
- 4 These numbers were calculated on information given in PlanEcon (1996a).
- 5 This figure was calculated on the basis of data on capital inflows taken from CNB (1997a) and GDP as given by the EBRD (1996).
- 6 Indeed, no country can forever sustain an increase in the ratio of foreign debt to GDP. Hence, capital inflows as percent of GDP will eventually have to come down to the growth rate of GDP if they are to be sustainable. For a number of structural reasons, the Czech Republic may be unable to replicate the impressive growth performance of the Asian tiger economies (Sachs and Warner 1996). Thus, capital inflows to the Czech Republic would have to remain in the range of no more than 5 percent of GDP in the long run.
- 7 The following section draws heavily on Backé (1996) who provides an excellent survey of the current and capital account restrictions in the Visegrad countries and in Slovenia.
- 8 For Poland, portfolio capital has not been a separate statistical item until very recently.
- 9 See, for example, Dornbusch et al. (1995), Edwards (1995), Bruno (1995), Langhammer and Schweickert (1995) for discussions of recent episodes of balance of payments crises in Latin America and Finland.
- 10 Macroeconomic policy inconsistencies such as excessive fiscal deficits, often financed through money creation, have been prominent in many Latin American crises. The experience of Mexico at the end of 1994 and of Chile in 1982 show that indexation of wages and prices can derail an exchange-rate based reform program even in the absence of fiscal laxitude.
- 11 The figures for labor productivity growth are based on output rather than value-added and on constant prices. They may understate true productivity growth because they fail to capture quality improvements as well as savings in material inputs. These caveats in principle apply to all transition economies. However, a recent study based on enterprise-level data argues that variable factor productivity through 1994 actually grew fastest in the Czech Republic (Pohl et al. 1996).
- 12 Over the entire 1990–1996 period, real wage growth have remained somewhat below productivity growth in the Czech Republic, but in Hungary and Poland, productivity has risen significantly faster than real wages (Table 4).
- 13 Infrastructure projects account for a large part of these investments. Hence, these investments may not have an immediate impact on the short-run productivity of firms while contributing to improved investment conditions in the medium to long term.
- 14 Reserve requirements were reduced again on May 8, 1997 (CNB 1997b).
- 15 That is, sterilization policies have not been completely ineffective. To be sure, capital inflows have, among other factors, been responsible for the fact that the CNB missed its M2-targets in the years 1992 through 1995.
- 16 These costs arise because a central bank which sterilizes net capital inflows gives up domestic assets which yield high interest rates (including a risk premium on domestic assets) in exchange for relatively low-interest foreign assets.
- 17 In 1995, the CNB had also introduced a fee on foreign exchange transactions of commercial banks and limited the open foreign exchange position of the banks.
- 18 Details on the stabilization and recovery program of the government coalition adopted on May 28, 1997, are given on the Internet page of the Czech news agency CTK: <http://www.ctknews.com/special/docu.htm>
- 19 For a more detailed analysis of banking system reform in the Czech Republic and in other transition economies see Buch (1996).
- 20 See Buch (1997b) on the role of foreign banks for the transition economies.
- 21 In 1995, new legislation became effective that allows banks to create some of their mandatory loan loss provisions out of pre-tax profits but not the full amount.
- 22 To some extent, banks have covered their increased foreign exchange exposure through off-balance sheet activities. However, detailed data about the volume of these off-balance sheet items is not available.
- 23 In the second wave open-end and closed-end unit trusts were also permitted.

- 24 In mid-1994 for instance, the discount on shares of the top ten investment privatization funds ranged from 28 to 78 percent (Egerer 1995).
- 25 For discussions of Hungary's experience with bankruptcies see Borish and Noël (1996), Gray et al. (1995) and Szanyi (1995).
- 26 There have been more than 38,000 cases under the Bankruptcy Law in Hungary through the first quarter of 1996 (EBRD 1996; Gray et al. 1995). This number includes both bankruptcy proper and liquidation cases, the difference being that bankruptcy proceedings are intended to work out debt problems, while liquidation is intended to close down unviable enterprises.
- 27 See also Buch (1997a). Demirgüç-Kunt and Levine (1995) provide empirical evidence for the complementarity between banking and financial market development.
- 28 Recently, the Czech Ministry of Finance has announced plans to privatize also the large state-owned banks, but no details have been released as yet.

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