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By GIEL A. W. VERBEECK

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Phone: (36-1) 266-6640 Fax: (36-1) 266-8858

The Financial Sector in Central and Eastern Europe: Three Question and Three Answers

by

Giel A. W. Verbeeck

The author is free lance financial researcher in Budapest and student from the University of Amsterdam, writing his thesis work on the Hungarian financial sector reforms. Correspondence to Giel A.W. Verbeeck c/o BUES/ISC, Fővám tér 8, H-1093 Budapest. E-mail: Verbeeck@Hermes.BKE.HU or Harmonielaan 7, NL-3704 HG Zeist, the Netherlands.

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I. Introduction

This paper wants to arrive at a strategy for the development of the financial sector in the countries of Central and Eastern Europe.[1] In order to have a clear idea of the significance of this, the paper's first question will be: Why should the financial sector develop? With financial (sector) development is meant a balanced growth of financial institutions and markets, their balance sheet totals and turnovers, the availability of financial instruments and services and also the development of the financial sector's. institutional and legislative framework. The next section will formulate the financial sector's function in the economy. A conclusion is drawn with respect to the importance of financial sector development in a policy aimed at economic development.

One can recognize the importance of financial development, the way in which this is to be achieved is still an open question. The third section will analyse how the financial sector can best develop. It will introduce the concept of financial liberalization as a way to develop the financial sector. Then this argument is confronted with different analysis, research and criticism. A conclusion is drawn with respect to financial liberalization in a policy aimed at by financial development.

The final section will end up with a strategy for the policy in the countries of Central and Eastern Europe. It will answer the question of how to apply a policy aimed at financial development in the countries of this region. To come to a policy for one of the particular countries would require specific research. This paper presents the common characteristics and the possible differences of what in the author's view should be transformed to specific policies for these countries.

1 The term 'financial sector' refers to all markets and institutions that enable financial transactions to take place. With financial institutions is meant all those organizations which have rather financial than real, tangible assets on their balance sheets. Financial markets are theoe on which the object of trade is not a tangible asset but an indirect or financial claim such as money, stocks, bonds and financial derivatives such as options, swap arrangements etc.

II. The Financial Sector and Economic Development

II.1. The Financial Sector's Economic Functions

Value Added

As a first step one can explain the meaning of the financial sector by its "value added". This can roughly be estimated as the sum of the production factors allocated to it (labour, capital), plus the profits made. Financial institutions trade in financial assets. A transformation of financial titles takes place with respect to risk (for instance insurance companies), time (for instance savings accounts), scale (for instance investment funds) and also place (for instance international finance). Usually the financial institution's value added consists of a mixture of these transformational activities. The financial institutions transform financial claims in such a way that they are more useful for it's buyers andso the financial sector increases the country's wealth as a whole. The financial claims held by its residents are more adjusted to their risk/return preference.

Administering the Economic Process

Though a financial institution produces and trades just as any other business entity, one should notice that financial institutions are of special importance. They enable economic transactions which otherwise might not have taken place. For example a payment system, provided by commercial banks reduces costs by clearing transactions against eachother and it reduces risks by its settlement facilities (checks, commercial bills). In this way trade becomes cheaper and safer as one need not to pay in cash money or barter goods and services. If transaction costs are lower output will be permanently at a higher level.

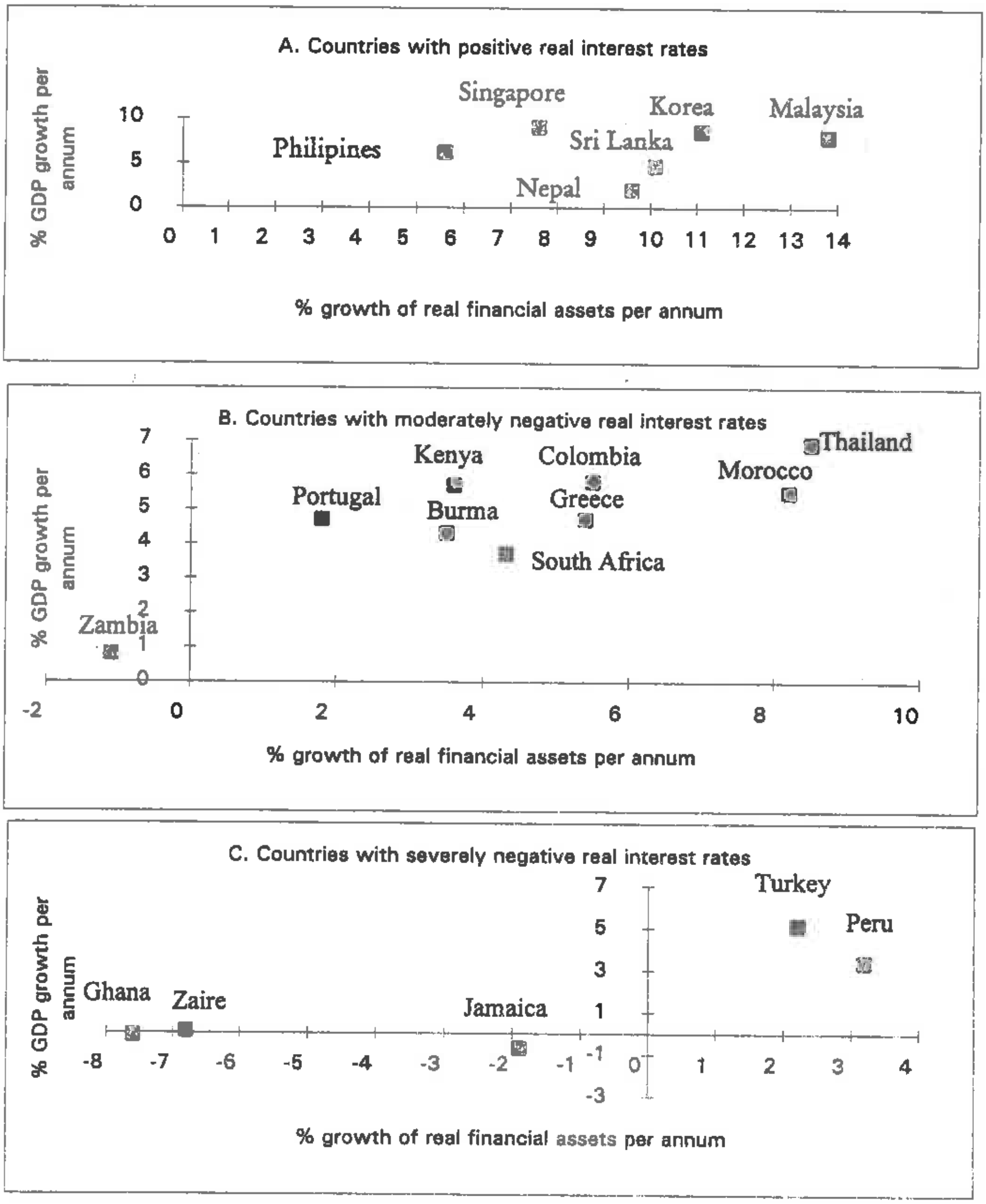
Furthermore, by allocating financial resources to the most profitable sectors and persons, the financial sector stimulates economic efficiency (it's selecting-function). It protects the market against unfair players (it's screening-function) and accelerating losses (it's monitoring-function). Whether stock prices go down, or banks are (not) ready to give additional credit or insurance companies deny guarantees, each event gives clear signals to the market. In this way the financial sector makes dispersed economic information publicly available. As one can rely on financial institutions to perform their screening, selecting and monitoring functions the rest of the participants in the market can concentrate more on their primary business. In this sense the financial sector fulfills a crucial role in the economic process.

Acceleration

Finally, the financial sector is important in a dynamic sense. Financial institutions make their decisions with an open eye to the future (picking the winners). Without such institutions economic growth might come to a halt. According to Gurley and Shaw (1955) financial intermediation becomes increasingly important during the process of economic development. Gerschenkron (1962) on the other hand stresses the importance of financial institutions (especially banks) in backward cq less developed countries. To a certain extent large banks are able to conduct industrial policy and manage economic development. Financial markets and institutions can stimulate saving and so the available amount of capital which can be invested. If one accepts the idea that economic growth stems from the quality as well as the quantity of investments, financial institutions are the key to economic development. One can formulate the hypothesis that the development of the financial sector accelerates economic development.

Figure 1.

Growth of Real Financial Assets and GDP Growth (1971-1980)[2]



Source: McKinnon, 1988 [based on I.M.F.-research].

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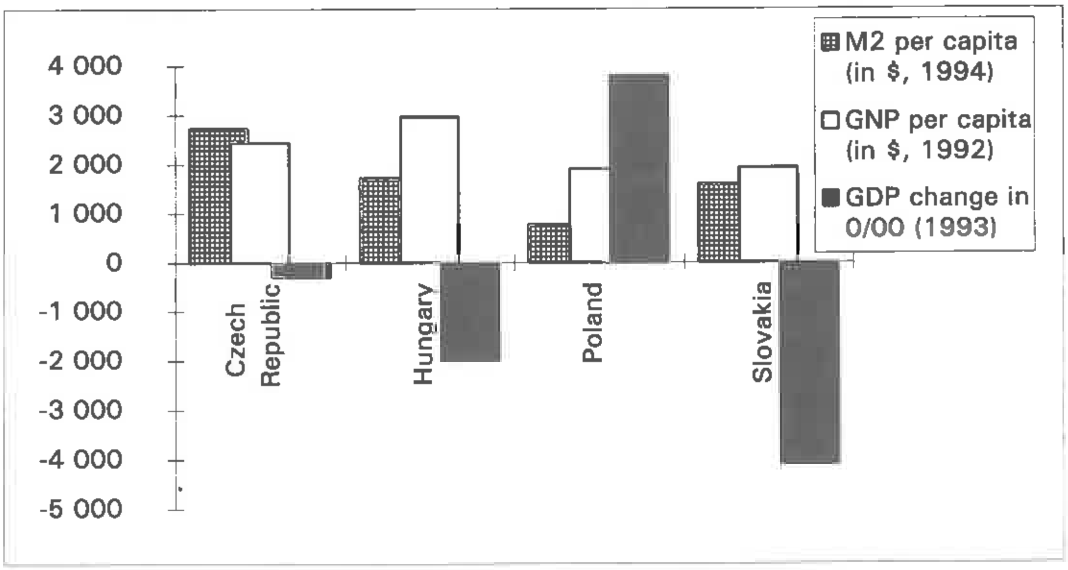
2 Real financial assets were measured as the sum of monetary and quasi monetary units with the banking sector, corrected for changes in the consumer price index.

Figure 2.

Real Money Supply per capita, GDP and GDP-change in the Visegrad-countries



Source: Központi Statisztikai Hivatal (1995)

II.2 Evidence

To test the acceleration hypothesis just mentioned argument one has to look for evidence for the influence of the financial sector on economic development. One has to compare the financial conditions of a country with its economic growth and other measures of economic development. Goldsmith's (1969) classical economic historical study finds several correlations between indicators of the stage of development of the financial sector and that of the of the economy. One of the outcomes was that developing countries have a lower financial intermediation ratio than developed countries.[3] This and other findings of his research are consistent with the acceleration hypothesis. However, a problem arises if one questions the causality of the relationship. Does financial development follow from economic development or is it just the other way

3 Financial intermediation ratio is the aggregated balance sheet total of financial institutions divided by the countries national income.

round? Except Goldsmith's correlations there is some econometric evidence on more specific relationships in the field of financial intermediation and economic development. This research is consistent with the idea that financial intermediation stimulates economic development.[4] The problem with these econometric studies is that they are too specific to answer the general question. And the causality-question remains there. For instance, neither fig. 1 nor fig. 2 does allow to draw any conclusions on the causality of the correlations one may observe. Recently however, King and Levine have given convincing econometric evidence on the causal relationship from financial development to economic development (King and Levine, 1993). They compared economic growth with several indicators of financial conditions. The time factor is included in their study to avoid the causality problem. King and Levine show that part of the development of the financial sector is prior to economic development. Though it cannot be proved, it is likely that financial sector induces economic development.

One may say that the financial sector plays a major role in resource allocation and mobilization in most countries. As these are the keys to investment, economic growth and development, the financial sector deserves special concern from policy makers. Financial sector development can be a condition for economic development and it might also stimulate economic development. As there is evidence that part of the financial development is prior to economic development the financial sector should be among of the first priorities of a policy aimed at economic development.

4 For instance there is evidence (Fry, 1988. pp421-423):
- on a positive effect of the proximity of rural bank branches on the domestic savings rate, provided that these branches are profitable.
- that negative real interest rates prevents domestic resource mobilization.
- that higher real deposit rates influence the savings rate, but this relationship is both weak and small.
- that negative real interest rates lead to financial disintermediation.
- that substituting negative real interest rates by positive ones increases the savings rate directly.
- that increasing real deposit rates of interest raise the productivity of investment.

III. Financial Development by Financial Liberalization

III.1 The McKinnon-Shaw-School

Prior to 1973 there was little attention for the environment in which financial sector development best could take place. In the works of Marx, Keynes and Tobin, which have influenced financial and monetary policies throughout the world, the objective of low interest rates and the financing of priority sectors was of more importance (Fry, 1988, p6). The government had to assure these objectives by restricting the freedom of banks and set institutional, low interest rates.

In the publications of McKinnon (1973) and Shaw (1973) this policy is christened as financial repression. McKinnon and Shaw stress the detrimental effects of government intervention in the financial system. According to them it is better to remove the obstacles that prevent financial development rather than to try to stimulate saving and investment from above. The McKinnon-Shaw-model has had an enormous follow-up in the academic world. One can even speak of the McKinnon-Shaw school in development economics. Their approach also influenced (and partly determined) the policy programs which were advocated by the IMF and World Bank in the 1970's and early 1980's.

III.2 Financial Repression and Liberalization

McKinnon and Shaw's starting point is an economy which is financially repressed. The concept of financial repression involves several characteristics. First of all it is associated with interest rate ceilings enforced by the government.

As interest functions asa the price of using capital and it is administratively fixed below its market clearing level, saving is disencouraged and credit rationing is necessary as demand for credit is too high. Because the loan rate is fixed banks do not have an incentive to select the most profitable debtors who can afford to pay the highest interest rates. Rather they look for the ones which are the least likely to default. In general these are the ones that are backed by the government. Project risk and demanded return are correlated with eachother. Banks cannot require a risk-premium and so they will select those projects and clients which have a low default chance. In general these projects have a return slightly above the interest rate which the banks may charge. In a free market the real interest rate would have been higher and these projects would not have had received any credit at all. They would have been ruled out because of having a negative net present value.

Social considerations, such as stimulating investment and an equal income distribution, are often used as an argument in favour of loan rate ceilings. But one easily neglects that loan rate ceilings also protect the government from competing for loanable funds with the public. The government can obtain its funding cheaply and with the consent of the banking system. Because under the current conditions banks have not got other and more profitable alternatives at their disposal. This might be another reason that interest rate ceilings exist.[5]

Besides the institutional fixed interest rates there are often additional selective credit policies or directed credit programs which discriminate specific projects against others.[6] These take additional responsibilities away from the financial sector. Banks cannot decide in freedom whom to grant and whom to deny creditand on the conditions of the loans. Therefore they cannot be held responsible for the results either. The governmental policy induces moral hazard. Banks are likely to be bailed out in times of trouble. A growing portfolio of bad

5 Loan interest rate ceilings are often accompanied with deposit interest rate ceilings. This can be explained as additional protection for the government as the government then only has to bid slightly above the deposit interest rate ceiling to ensure complete funding of it's financial needs.

6 Selective credit policies and directed credit programs can occur in the following forms (Fry, 1988, pp398-418):
- subsidized loan rates for priority sectors
- differential rediscount rates with the central bank
- direct budgetary subsidies
- credit floors to priority sectors
- credit ceilings to non-priority sectors
- profileration of privileged specialized financial institutions (financial layering).

loans and non performing assets will occur on the balance sheet. Though losses can be hided for some time by so called creative accounting, the attractiveness of deposits is again reduced when the solvency of the banking system comes into danger. Then the final costs will be even bigger. Nevertheless private and social returns may differ from eachother and a case can be made for selective credit policy and directed credit programs on social grounds. But this presupposes that planners know best which projects should be undertaken and credit allocation is able to select these and only these projects. Several studies show that these assumptions are not valid (Fry, 1988, p417). Rather the opposite of which was intended is the result.[7] Though selective credit policy and directed credit programs are often defended on social grounds it is more likely that their existence is in favour of vested interests. The ones that are able to get the credit, are the more influential and wealthier, rather than the ones that really need it in terms of social justice.

Finally, selective credit policy and directed programs have a distortionary effect on factor prices. If the privileged few receive cheap loans, they will probably prefer more capital intensive projects above others as their cost of capital is artificially low. This mechanism can be strengthened by financial layering. For instance, the management of a development bank which is not responsible for the obtainance of funds has got no incentive either to take the real opportunity cost of capital into account. In this way employment is reduced. The ones that do not have access to credit will use less capital than would have been desirable on socially rational grounds. A dual economy comes into existence with an overcapitalized privileged sector on the one hand and a relatively low yielding overemployed private or informal sector on the other.

The McKinnon-Shaw school associates financial repression with more than only interest rate ceilings, selective credit policy and directed credit programs. High reserve requirements with the central bank are also part of it. As a consequence of this the government can postpone inflation and enjoy cheap funding. Furthermore a panoply of institutional restrictions of the financial

7 There is no evidence of any positive effect on income redistribution. There is even some evidence of a negative effect on an equal distribution of income. Neither is there any evidence of an increased productivity of capital following from selected credit policy (Fry, 1988, p417).

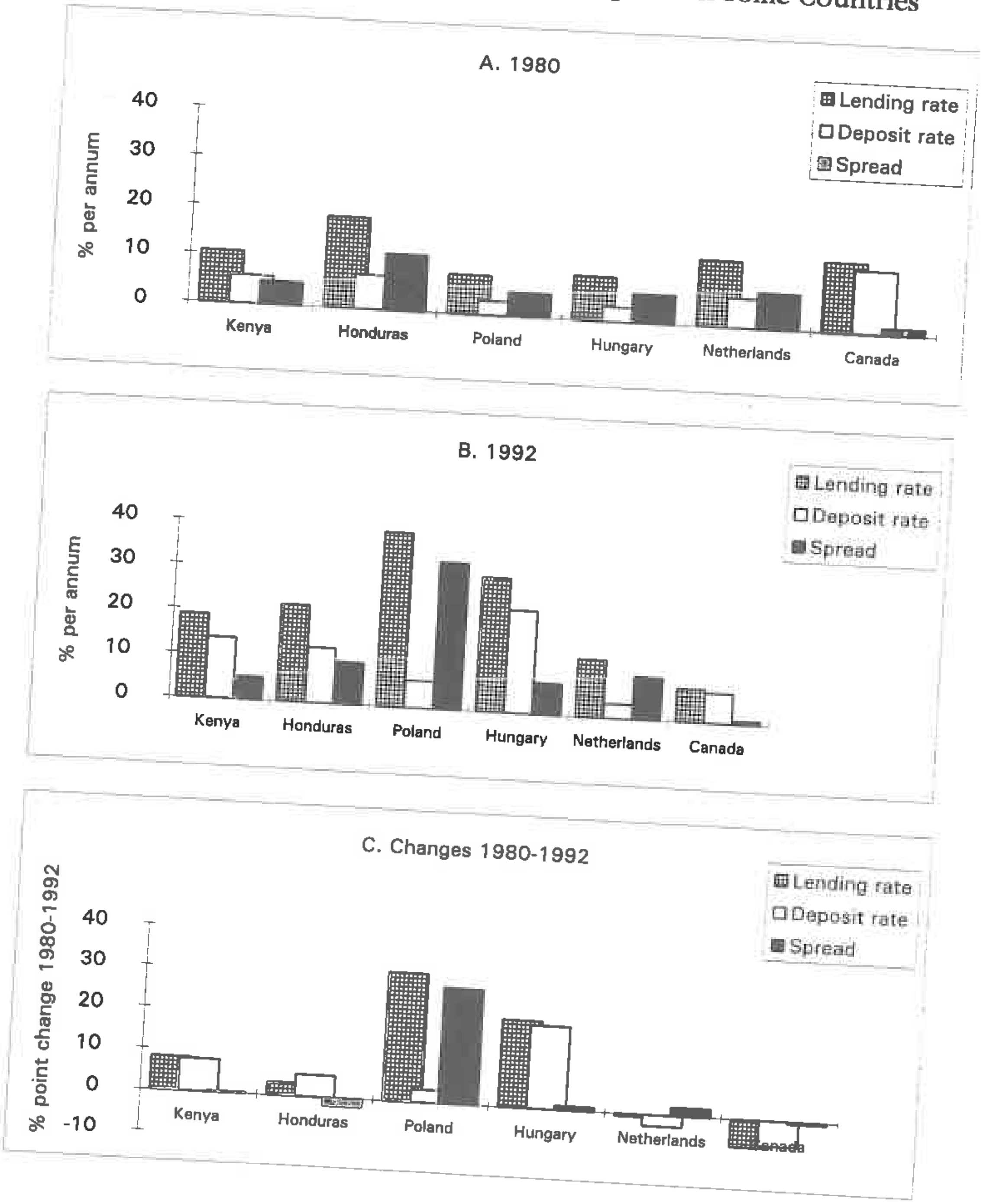
sector's freedom of movement. Transaction taxes, such as stamp duties, excessive taxation of capital income and an unconducive legal framework are also part of a regime which prevents the financial sector to develop.[8]

McKinnon and Shaw's analysis concludes that the key to financial development is financial liberalization. The growth maximizing interest rate is the free market interest rate. Demand equals supply only in this point. The McKinnon-Shaw-school strongly advocates the abolishment of institutional interest rates, selected credit policies and directed credit programs. It stresses the importance of the elimination of the larger part of the reserve requirement ratio. However, financial liberalization is not an aim in itself. The perceived positive effects such as higher savings and social returns can only be obtained in an environment which is competitive and where there is free entry to the financial market. Competition should therefore be encouraged while it should be possible to enter the market relatively easy, both as a buyer and a seller of financial services. From fig. 3. one may conclude that in terms of spread there are not a lot of competitive banking markets.

8 As the effects of them on the economic development are more clearly detrimental an analysis is not necessary for the purpose of this paper. One can find an analysis of the effects of these phenomena in Fry (1988, pp300-322).

Figure 3.

Deposit Rate, Lending Rate and Spread in Some Countries



Source: World Bank (1994a)

III.3. Financial Development

While the concept of financial liberalization is relatively straightforward, questions arise on the concept of financial development that the McKinnon-Shaw-school has in mind and which should be the result of financial liberalization. In the eyes of the McKinnon-Shaw-school financial development consists mainly of better financial conditions such as a growing financial intermediation ratio, a higher bank branch proximity per population, a variety of products, risk taking, yield and liquidity of indirect claims and the real deposit rate of interest. It does not speak out a clear preference for one or another kind of financial structure which should serve economic development better or worse. It advocates universal banking implicitly by advocating freedom of contract, exploiting economies of scale and scope and the monitoring function of the financial sector.[9] On the other hand it stresses the importance of arm's length dealing and it speaks out against oligopolistic structures. The latter is more in line with the Anglosaxan model of capital market oriented development.[10] The concept of financial liberalization does not speak out for specific financial structures. Financial liberalization makes a process possible in which either banks or capital markets can become the driving force behind economic development.

III.4 Criticism and Comment

The McKinnon-Shaw-school has been criticized from various persons and people. A common denominator of this criticism was the underestimation of the

9 Universal or continental European banking involves close ties between firms and banks, share holding of financial institutions and long term lending.

10 Therefore it is difficult to compare this with the approaches such as Gurley and Shaw (1955), Gerschenkron (1962), Goldsmith (1969) and Zysman (1983). In these works one can find descriptions of different development models. Zysman for instance distinguishes three models of modernization. In each model the financial sector or one of its components (like the capital market or the banking sector) plays a different role. Gurley and Shaw find different functions for components of the financial sector, as well as the financial sector as a whole during stages of economic development. Gerschenkron introduces the concept of path dependency, which leaves little alternatives to choose from for countries as they are caught on a deterministic path. These kinds of studies do not serve the object of developing statements which are relevant to policy makers, because they do not present viable policy alternatives. Their object is to describe and to explain. Therefore one cannot say that the ideas of the McKinnon-Shaw-school are opposite or in line with those of one of these authors. One can only say that the McKinnon-Shaw-school leaves the decision on the political-economic-financial structure -if there is any to make- to the market. In this sense it clearly rules out the socialist model as well as state led modernization such as took place in postwar France.

significance of institutional aspects in developing countries. Popular criticism often does not specifically address the McKinnon-Shaw-school, but rather the bureaucracy of the I.M.F. and World Bank. In addition two other forms of criticism can be distinguished. One is from those institutional economists who do not agree with the basic assumptions of the model or disagree with the approach on methodological grounds. A drawback of this kind of criticism is that it does not have well formulated alternative policy proposals ready. One only should 'take into account the institutions. The other source of criticism stems from the so called Neo-Structuralists. Van Wijnbergen (1983) and Taylor (1983) introduce microeconomic structural aspects into their models of financial development and reach in this sense a synthesis between the McKinnon-Shaw-school and the institutional economists. The neostructuralist criticism has been adopted in the models used nowadays as well as in the policy proposals made by the McKinnon-Shaw-school-economists. Still, the School's dominance as well as the stress on eventual financial liberalization remains.

One may conclude that financial liberalization can be used as an overall guideline to indicate the direction of financial sector policy. In the longer run financial liberalization is nowadays maybe the only viable alternative for developing countries.[11] However, one should take institutional aspects into consideration as well as country specific features and lessons from the past.[12] These three should be given special attention with respect to the shorter run whereas the aim of financial liberalization is relevant for the longer run.[13] Financial liberalization remains the objective, but it's speed and order should depend heavily on the peculiar circumstances of a country.

11 The protectionistic, non market oriented development path from specific countries of postwar Europe and Japan is a problematic counterargument, because the nowadays developing countries have to operate in a much more internationalized, open climate, in which is less space for individual countries to conduct their own independent policy.

12 For instance the case of Chile provides valuable insight on how detrimental acute financial liberalization can be within a context that lacks macroeconomic stability (Fry, 1988, 255).

13 Short, medium and long run are rather associated with stages following eachother than with time. Approximately with short run is meant the immediate future (0-2 years), with medium run the period after some stabilization has taken place (3-5 years) and with long run the period in which the final objectives of the policy should be reached (5 years and more).

IV. Financial Liberalization in a Transitional Economy

IV.1 Introduction

Having demonstrated the importance of financial development and the need of financial liberalization, the second half of this paper will confine itself to the financial sector in Central and Eastern Europe. How should the policy of financial liberalization be applied in this region?[14] As outlined in the previous paragraph it is necessary to take into account the institutional aspects in advance. First is given a short analysis of the relevant institutional characteristics of transitional economies in Central and Eastern Europe. Second, the precondition for a policy of financial liberalization will be mentioned. Then the strategy towards the development of the financial sector is presented.

IV.2 The Common Starting Point: the Financial System under Classical Socialism

Nearly all socialist economies started the reform process from a situation which can be characterized as classical socialism.[15] [16] [17] Analyzing the economic

14 To formulate a policy strategy for one of the former socialist countries would require additional considerations with respect to country specific features such as it's indebtedness, prospects for European Union-membership, stage of economic development, social structure and others. However, it is the objective of this paper to shed only a light on the general issues of all transitional economies in Eastern Europe. It does not a priori advocates a common recipe for all these countries.

15 Before 1989 the financial sector largely functioned in the same way as it did under classical socialism, even in the reform socialist countries. In countries where there was a reformed financial sector the changes were largely virtual and small in effective terms. Comprehensive financial sector reform started after 1989 (Catte & Mastropasqua, 1993, p785). See Kornai (1992, part II and III) for a description of classical socialism and reform socialism.

16 Characteristics of classical socialism given by Kornai (1992, ch6) and Ellman (1989, ch2) include state ownership of the means of production, political dictatorship, a mono-hierarchical system, imperative planning (bureaucratic rather than market coordination), physical planning (the system was only semi-monetized) and restricted consumer sovereignty.

17 Next to the traditional dichotomy between forward and backward or developed and underdeveloped a new dichotomy between capitalism and socialism is introduced here. Former socialist countries were typically more

transmission mechanisms of this system, some typical characteristics come into the picture (McKinnon, 1993a, pp233-228):

1. The tax system is largely implicit because of central price setting, which makes sales taxes pro forma. Agricultural products are held cheap and are subsidized by the revenues from relatively heavy 'taxed' industrial products produced in the large state owned enterprises. The system of money and credit is passive and subordinated to planning and political decisions. There is a monobank-system with one mammoth bank who issues the currency, oversees the transactions, handles the government budgetary transactions, collects savings, allocates credits, allocates investments from the state budget to the enterprises and monitors cash payments from enterprises to the population.[18]
2. The centralized method of mobilizing capital and allocating credit has an important effect on the real capital structure of firms. All enterprise finance can be in a certain sense classified as 'internal'.[19] Consequently all financial transactions are more or less administrative. For the state bank, who had only an executive function, there was no direct incentive to get any money back from granted loans. Therefore the budget constraint of all sectors in the economy was soft.
3. In such a system money has lost part of it's meaning: It is not a universal means of exchange (it is neither internal nor external convertible), it measures value only to a certain extent and it also looses it's function as a store of value.[20] People were forced to save,

developed than the underdeveloped economies and typically less advanced than Western economies. They had different system characteristics as described in the previous footnote and formed a category of their own.

18 As the system was semi-monetized there was a difference between cash-money and money on accounts. As money on accounts was earmarked (money with a specific purpose, which was only available for that purpose) and couldn't be transformed into direct purchasing power, cash payments to the population could cause open inflation (either official or hidden) much earlier to arise.

19 There are three different forms of finance: Direct internal finance is funding from retained earnings. Direct external finance is provided by equity and bond-finance, or accounts payable. Indirect external finance is provided through intermediaries, such as banks. As we can see a socialist economy as one large factory there is no external source of finance. An exception is external finnance from foreign countires. However this source came mostly from other socialist countries.

20 In a shortage economy with rationing prices mean much less than in a market economy. Except the money one needs to be licensed by the bureaucracy in order to be able to obtain a certain good. A common 'licensing' procedure for consumerables was simply queuing. For non-consumerables, which in general had a higher priority, it depended on belonging to a priority sector, following procedures, lobbying, using connections and even bribing.

but still the financial intermediation ratio was small compared to the countries' estimated GDP's (Peebles, 1991, ch3, Caprio & Levine, p3). [21]

IV.3 The Process of Systemic Change: Transition

Except the common characteristics of the socialist financial system, the transitional economies share a common objective with respect to their reform processes: the transition to a mixed market economy.[22] For the purpose of this paper the process of systemic change -the transition- will be narrowed to that of privatization.[23] This in order to make a clear separation between economic development and transition.[24]

As the countries have celebrated the fifth anniversary of the liberalizing events one can expect some progress in the reform of the financial sector. The typical changes that took place were the creation of a two tier banking system: the mono-bank has been split up in a formally independent central bank, a foreign trade bank, a savings bank and some commercial banks. The commercial banks often have a regional, agricultural, industrial or other sectoral character. Many new private owned banks have emerged. The stock and corporate bond-market are in their initial stage. An interbank money market is functioning as well as a market for government bonds.

The situation is indeed slightly different than it was five years ago, but the financial sector in most transitional economies has some serious problems and deficiencies. First of all a high float and an unreliable payment-system. Second the lack of a regulatory framework and supervision. Third the problem of the bad

21 Forced saving could be induced by agressive campaigns to buy government bonds, but mostly people were forced to save because there was nothing to buy in the shops.

22 All the countries define their transition as the process of increasing market coordination and reducing bureaucratic coordination. They want to privatize and restructure their enterprises, decentralize economic decisionmaking and open their economies to the world market.

23 With privatization is meant not only to make the enterprises separate legal entities, but also to bring their shares into private, non state owned hands. This concept of privatization entails financial sector reform. The change in ownership structure cannot happen without banks and other financial institutions and markets.

24 To some extent the problems of postsocialist transition are also those of a developing country. One can even argue that increasing marketization is the essential aspect of modernization in general. However, there are too much specific socialist inheritances that it is worth separating transition and economic development from eachother.

loans which accelerated during the early years of reform (Blommenstein & Lange, 1993, p17).[25] Fourth, the managers lack the skills to operate in the present environment.[26] And fifth, an unclear ownership structure has arisen (Thorne, 1993, p964). Some banks are kept in the hands of (former) state owned enterprises who commit insider lending and keep potential competitors from the credit market. Sixth, the new governments still borrow heavily from the banking system. Except crowding out the newly emerging private sector, the loss making state owned enterprises still can obtain additional credit by governmental intervention in the banks' credit decisions. The banks 'fund' themselves with deposits from households. The situation of disequilibrium is illustrated in fig. 4. Negative real deposit rates of interest are not an uncommon phenomenon and an increasing part of the population now wants to avoid the inflation-tax. As a consequence foreign currency or commodities are substituting money and financial disintermediation drives the banking system out of the economy. There are virtually no banks with a solvency ratio which is in conformity with the international (BIS-)standard (8% capital against risk weighted assets). Some banks even have a negative solvency ratio.[27]

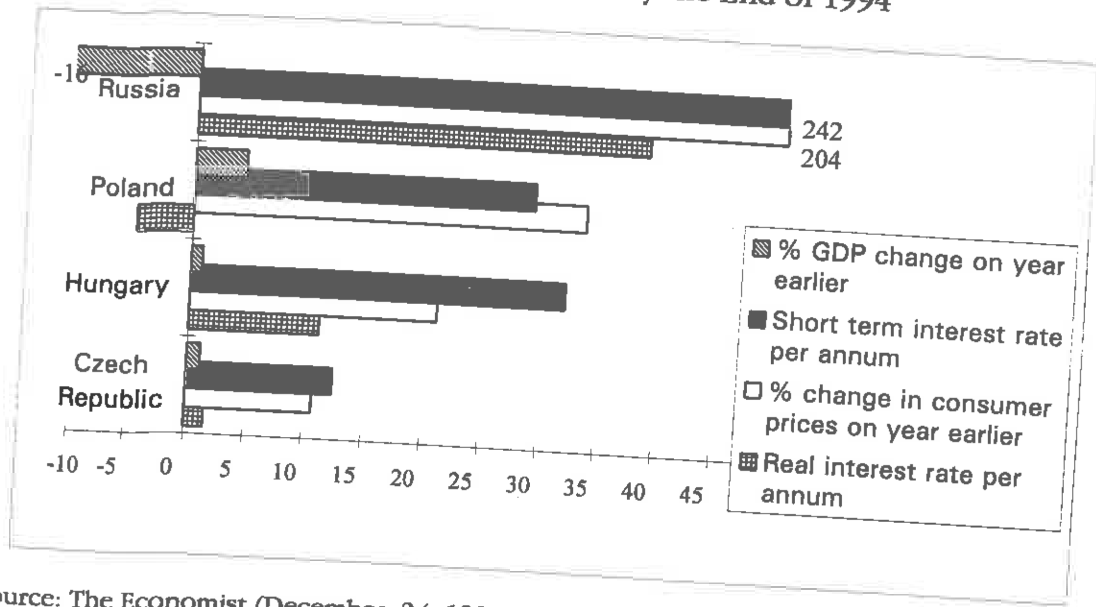
25 Financial control under socialism served the state. In a market economy it serves the market process. During the period of transition there can be a vacuum in which the incentive framework is even more detrimental than under classical socialism. This explains the increase of bad loans after the fall of socialism, together with the economic recession.

26 One can assume that Western managers would not either be able to cope with the problems, but at least there would be more understanding of the problems.

27 If this is to find in the annual reports it will rather be a positive sign. The bank has started to make provisions according to the international accounting standards. Some banks still keep on hiding their losses.

Figure 4.

GDP-Growth, Interest Rates, Inflation and Real Interest Rates in some Postsocialist Economies by the End of 1994



Source: The Economist (December, 24, 1994)

IV.4 Financial Reform Should Precede Full Financial Liberalization

Financial liberalization should accompany the transition process. It is even part of it. However, fast and radical financial liberalization can seriously endanger the countries' stability, given the economic structure and the present situation of the financial sector (McKinnon, 1993b). Also the World Bank warns against radical liberalization as it can cause destabilizing capital flows, large differences between the loan and deposit rate of interest and corporate distress (World Bank, 1989, p127). Therefore the process of financial liberalization will have to take its time. During this, financial reform must precede full liberalization.

If gradual financial liberalization is the only viable alternative, a program should be spelled out which steps are to be taken. In the medium run there are two issues with which the government will have to deal first. In their order of priority these are the building up of a sound financial infrastructure and the privatization of the remaining state owned banks. The former can be divided in five separate issues. These are described below. The privatization of the remaining state owned banks includes a solution for the problem of the bad loans.[28] The way in which a country is able to deal with these subjects will determine the speed of financial liberalization. Finally it is necessary to choose the right order of financial liberalization. The last paragraph of this paper will pay attention to this problem.

IV.4a. The Building up a Sound Financial Infrastructure

1. *The Governance Framework*

The reform of the financial sector is not carried by one organization. Lots of organizations, institutions, private and public corporations may be involved. They should all share a part of the responsibility. On the one hand there should indeed be a division of responsibilities in the governing of the financial sector.[29] In the case of the countries of Central and Eastern Europe one can distinguish several roles. Among others these are those of owner, supervisor, regulator, lender of last resort and privatizer. Separation of these roles has advantages as well as drawbacks. Separation bears the risk that the reform process will be politicized. In this case separate bodies do not have separate responsibilities and start to represent certain vested interest or political views. In the longer run however democratic control and the avoidance of double functions is as important for the modernization of the financial sector. But currently one should create an institutional framework which is able to carry the reform consistently. A first thing is to make clear which organization is responsible for which aspect of the governing of the financial sector, which role should be played by whom.

2. *Stop Hiding Losses*

Though price liberalization has largely taken place there is still a mixture of commercial and non commercial decisions present. Losses of state owned

28 Though the issues are to a certain extent interrelated with eachother they will be treated here separately for analytical purposes.

29 In modern market economies this can develop even in a high extent of self regulation, by bodies of professionals from a specific sector or occupation.

enterprises are not as clearly revealed as they should be. In order to bring the social costs of maintaining these 'white elephants' in the picture, the government should separate subsidies from loans. The best way to do this is too end directive credit programs and selective credit allocation and replace them by subsidies or credit out of the governmental budget. The most drastic way is simply to prohibit everyone but the government to grant loans to the state owned enterprises. If it is not possible to cut the informal connections between banks and state owned enterprises one could do this. These measures to stop the hiding of losses will decrease the crowding out effect and give an incentive to governments not to postpone the restructuring and privatization of state owned enterprises.

3. *A Sound Legal System*

If a country wants to rely more on private decisionmaking, it has to increase confidence in the real value of financial contracts. This means to secure and spell out property rights and enforce them if necessary. A bankruptcy law that is legally effective is a major step forward.

Transparent accounting and reporting standards should be introduced as well as modern auditing methods. This will also make possible to evaluate the firms' and banks' profitability. The regulatory framework of the financial sector should be transformed to the needs of a market economy, while new organizations should keep prudential supervision on it. It is necessary to train a new generation of financial professionals.

4. *The Payment System*

If banks want to gain trust of their clients they should first provide a quick and reliable payment system. An explosion of private trade and financial transactions is taking place and if substandard payment systems reduce the confidence in the financial institutions, this encourages barter and cash trade. A national clearings and settlement system produces high social returns. However, effective cooperation and agreement between all the participants might be too difficult to accomplish. Then a subgroup of well organized private banks can be expected to provide a payment system for their customers. This will only be available to a limited amount of people but might be the only alternative.

5. A Level Playing Field

While a sound legal system provides the very basic needs of a market economy, the creation of the conditions for fair competition in the financial sector requires additional measures. Among others one can think of anti trust guidelines and clear licensing procedures. These will prove to be necessary support for new banks. On the other hand one should avoid the old state owned banks to exercise political power. For instance they then may obtain easier tax treatments than the newcomers. Competition and contestability of the financial market are an essential part of the change in the incentive framework, which should lead to financial development. In order to achieve this one can first split up the state bank. But regional or operational split ups do not alter the monopolistic structure. If it had happened one could allow savings banks to perform commercial banking activities and vice versa. Foreign banks can bring in skills and experience and quickly upgrade the amount of financial services available. It has the disadvantage that they might take away the better clients, but it will stimulate the domestic banking system undoubtedly. Allowing foreign banks to establish joint ventures may accelerate the privatization process. To enforce a turnaround in the financial sector it is necessary that a critical number of banks becomes private owned quickly. Otherwise it will be difficult to reduce the power of the state owned part.

In addition to the banking system the legal and regulatory environment in which capital markets can develop needs to be established. The auctioning of treasury bills is a good starting point. Capital markets are to a certain extent complementary to the banking system. But they can compete with it as well. This will stimulate both to develop. A variety of institutions creates the best conditions for competition: mutual funds, pension funds, insurance companies, venture capitalists etc. However, these institutions cannot be simply established by the government. But if the institutional conditions of the market are better they are more likely to be founded.

IV.4b. The Privatization of Financial Institutions

The remains of the state financial sector that are to be privatized in the medium run are the commercial banks, the savings bank and the country's foreign trade bank.[30] The problem with the privatization of sometimes even the best managed banks is that they run operational losses. Furthermore they are in serious need of fresh capital. Under these conditions it won't be possible to privatize most of the state owned banks. It will be necessary to restructure them first.[31] Simply turning banks into joint stock companies and divide the shares among third parties will lead to new problems. It will lead to unclear ownership structures. If the privatization is not convincing, there is a risk of moral hazard. The bail out process will start again eventually.[32] [33] During the process of restructuring investment trusts and an independent directory board mag take care of the bank.

The restructuring of the banks consists of economic and financial restructuring. With economic restructuring is meant the modernization of the bank, it's adjustment to it's new role, a change in management, improvement of the staff and the set up of a debt work out department. Financial restructuring refers to the banks balance sheet. It involves the introduction of international accepted accounting procedures and adequate provisioning, as well as a capital injection in order to enable the bank to perform it's functions as a reorganized bank. The capital injection can be best given in connection with the bad debt work out. The bad debt problem is too comprehensive for a government to oversee in detail.[34] The banks will only effectively deal with the bad debt problem if the ex ante incentive framework promises them appropriate rewards for their efforts (Van Wijnbergen, 1994, p19). The decentralized, Polish approach towards the debt workout is in this way to be preferred above the centralized Hungarian

30 The privatization of the savings bank in the medium run may seem premature as in many Western countries the privatization of the State savings bank is of very recent history. However, the State is in urgent need of liquidity and maybe needs to finance the restructuring. Then the privatization of certain banks with the revenues of others such as the State Savings Bank and maybe the Foreign Trade Bank might be an option. The state insurance company is likely to remain a budgetary organization. Insurance and pensions services from private companies are only available for the wealthier people. In the longer run there might be more effective competition and should the state insurance company be privatized.

31 Only if there is a foreign investor you can try to do it the other way round, but it is quiet unlikely that you will find one.

32 This is not necessarily the case with non-financial firms as the mass privatization in Czechoslovakia showed.

33 This is probably the most important one of the Chilean lessons (McKinnon, 1993b).

34 The problems of the banks have to do with those of the enterprises, but because of the interenterprise arrears the problems of enterprises are closely connected to eachother as well.

approach (Institute for EastWest Studies, 1994, p11).[35] Banks can best deal themselves with their bad loan portfolio and probably better than governmental agencies who take over the debt after a debt-bond-swap with the government. This even holds for non privatized banks.[36] Banks can choose between a debt-equity swap with the firm or renegotiate and reschedule the amount of debt and write off the rest. They can also resale part of the debt. The advantage of the debt-equity swap is that they enable banks to perform a role both as owner and as creditor. In this way they can harmonize conflicting interest and prevent unnecessary bankruptcies (Bokros, 1993, p6). If banks are going to be allowed to be the main agents of change and perform financial and non financial reorganizations within firms this would give them a major task in the transition process. This can only be possible if they are successfully privatized. If this is not possible in the medium run the state should perform these tasks on its own. It remains the question whether it is capable to do this.

IV.5 The Order of the Financial Liberalization

Financial liberalization is a process. Some measures can be taken as quickly as politically possible. For instance the reduction of the reserve requirement ratio's and the abandoning of the directive credit programs. Others liberalizing measures may have to wait. For example the control over the interest rate should be maintained as long as there is not a minimum of a competitive market, distortionary prices and taxes still exist and the government is not ready to compete with the market for funding its deficit. Interest rates can be set at the perceived market equilibrium rate.

The building up of a sound financial infrastructure and the privatization of banks will already result in a much more liberalized financial sector. While this is taking place the financial sector should be kept under control. The state cannot be entrusted to act as a good manager. It will be better to keep control

35 In the centralized approach banks can exchange their bad loans for government bonds against certain discounts. A governmental agency will try to deal with the loans afterwards. In the decentralized approach banks have to deal with the bad loans themselves. Governmental support depends on the bank's proceedings with bad debt work out.

36 For instance by giving managers profit related payments, or options on shares in the future as proposed by Van Wijnbergen (1994).

administratively. This by means of simple and clear rules on what is allowed and what is not. Gradually one can lift the regulations in conformity with the proceedings of financial reform. One can divide this process in two stages before full liberalization takes place. McKinnon (1993a, pp243-249) proposes to give only but very limited space for either privatized or non privatized banks to take risks in the first stage. In his 'near worst case scenario' the government initially continues to borrow heavily from the banks, giving a permanent inflationary pressure. Due to the fiscal deficit there is no room for non inflationary bank lending to the private sector and this should be prohibited. Furthermore banks cannot be expected to act as responsible lenders in the short run, which would lead to new bad loans problems and eventually governmental bail outs. Stage one is about encouraging firms to use monetary assets as a store of value. The price for this is that even sound companies won't have access to credit. On the other hand, reliance on self finance is 'the simplest technique for imposing financial restraint on liberalized enterprises while simultaneously increasing the productivity of physical capital' (McKinnon, 1993a). If the confidence in the financial system is restored, limited and fully collateralized lending to liberalized enterprises from commercial banks can take place, according to real bills doctrine: Only credits for productive short term assets, such as accounts receivable and inventories. In the mean time the non bank capital market had come to a development which will provide useful experience and personnel for the banks to take over.

McKinnon's proposal has been criticized by Caprio & Levine (1994, p12) for being too strict and unfeasible. They propose a commercial banking system which has to keep high ratios of risks to assets to allow for risks. This will also limit the number of banks that has to be supervised. In addition rural credit cooperatives and an urban commercial bills market should provide funding to private enterprises.

Van Wijnbergen (1994, p1) criticizes McKinnon for depending too much on the state as an agent of change. In his view a selected and limited group of banks should receive extra attention from the supervisory agencies and should be allowed to perform investment bank-like functions.

The final alternative mentioned here is the so called narrow banking model. The commercial banking system is allowed to take deposits, but obliged to invest in short term low risk instruments, such as government bonds. These banks are in the national clearing system and administer the payment system. In addition there is a group of non banks which performs the other transformation functions of the financial sector. However, 'non bank-banks' are not rescued by the central banks if they get into trouble. They do not belong to the national clearing system, but are allowed to hold equity positions in non financial firms.

It is not possible to say which order of financial liberalization is the best one. Each method has it's advantages and drawbacks. Accordingly the optimal solution will differ from country to country. In general one can observe in Central and Eastern Europe a too enthusiastic embracement of the universal banking model. Most of the banks have already severe problems with the basics of commercial banking. A large number of universal banks with a weak supervisory system endangers the stability of the financial system. Reinforcing financial control rather than financial liberalization should be the short run objective in most of the countries.

V. Summary

The financial sector plays a major role in resource allocation and mobilization. As savings and the quality and quantity of investment are the key to economic growth and development, the financial sector deserves the special attention of policy makers.

Financial development will in the long run best be achieved by financial liberalization. Financial repression, consisting of institutionally fixed interest rates, selective credit policy, directed credit programs and institutional restrictions and a heavy tax burden on the financial sector, prevents financial development. Financial development has been defined as the improvement of the financial conditions. Criticism and experience in practice have shown the necessity of taking into account the institutional aspects in the countries that carry a financial sector reform. In the longer run financial liberalization remains the objective.

The starting points of the financial sector in the transitional economies from Central and Eastern Europe are to a certain extent similar. So are the ultimate objects of the economic reforms. The most important preconditions for financial liberalization are twofold. First a financial infrastructure has to be built up. This consists of a halt to hiding losses, the creation of a sound legal system, an effective payment system and the creation of a level playing field. Second there is the privatization of the state owned banks. This includes a way to deal with the problem of bad loans as well as recapitalization. With respect to the bad debt work out the decentralized, Polish approach is to be preferred. Banks have to deal with the bad debt themselves, because they have the best information and know how of the firms involved. The State should set the right ex ante incentive framework to let them do so.

Towards the process of financial reform a policy strategy has been formulated. The right order of financial liberalization depends heavily on the individual countries' characteristics. Several methods of gradual liberalization are at the disposal of the transitional economies. It is not possible to give a common recipe for the order and speed of financial liberalization. Much will depend on the countries' individual characteristics, including their risk/return preference. The fundamental dilemma is to stimulate economic growth and liberalization on the one hand, while maintaining control and stability on the other hand.

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