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## STATE DESERTION AND CREDIT MARKET FAILURE IN THE HUNGARIAN TRANSITION

I. ÁBEL—J. P. BONIN

State desertion is a rapid and continual decrease in the involvement of the state in the aggregate economy. An abrupt withdrawal of the state from the economic infrastructure that supports the allocational mechanisms is a contributing factor to the deep recessions observed in all CEE countries. Credit market failure is caused by state desertion of the financial sector leaving commercial banks burdened with bad loans. The paper describes the causes of and evaluates the proposed solutions for bad loan problems.

### 1. Introduction: The role of the state in the transition

For the first two to three years of the transition, all of the Central East European (CEE) countries in transition experienced deep recessions. The austerity programs pursued to stabilize these economies reduced private sector demand significantly. Liberalization of both prices and external trade added an inflationary shock to which the policy response was increased austerity. As the recession deepened, the tax base was eroded and transfer payments increased plunging the fiscal budget into serious deficit. The budget deficit soaked up private savings that would have been better channelled into financing the business expansion necessary to initiate and nurture the supply response to price liberalization. Given this vicious cycle, determining the proper role for the state to play during the transition in the CEE countries is crucial.

Due to its predominant, almost all-embracing, past role in the socialist bureaucratically managed economy, the state obviously must reduce substantially its economic activity in order to facilitate a successful transition to a mixed market economy. At the same time, the state must orchestrate the evolution and development of the environmental infrastructure necessary to support the growth of the market economy. According to *Chang and Rowthorn* (1994), the state must be involved whenever a new economic coordination structure is established. As it withdraws from micro-managing the economic sphere in the CEE countries, the state must accept responsibility for nurturing, but not smothering, the maturing market economy.

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That the state should be involved in developing the appropriate legislative support for the market economy is self-evident. It is equally important for the state to be an institution builder, i.e., an economic enabler as well as a legal enabler. In the CEE countries, system-specific legacies work against state intervention. The perception is strong that a continuing planner's mentality will perpetuate the petty tutelage of the earlier period. Such an attitude is a natural response to the over-centralization of the planning period. However, preventing state intervention may lead to state desertion and impede the transition to the market economy.

To conceptualize state desertion, we define two types. Type 1 state desertion is a rapid and continual decrease in the state's involvement in the aggregate economy. Such state withdrawal from macroeconomic activity could well be a contributing factor to the deep recessions observed in all CEE countries. Type 2 state desertion is an abrupt and discontinuous withdrawal of the state from the economic infrastructure that supports the allocational mechanisms. Since the institutional and behavioral preconditions for a well-functioning market are underdeveloped in CEE countries, state intervention (not state desertion) is required to fill the void. The state must create and nurture the economic institutions necessary to support the fledgling market economy. In this context, the major policy issue facing CEE governments is a lack of any historical precedence for such a radical restructuring of the state's role in so short a period of time. Hence the appropriate mix of state withdrawal and state support is difficult to ascertain.

The transition to a market economy requires the state to withdraw from directing the allocation of resources and leave this task to markets. At the same time, financial support is necessary if state-owned enterprises are to be restructured so that they can perform efficiently in the new market setting. Financing is also required to allow new ventures to become strong enough to introduce much needed competition to nascent domestic markets. While relinquishing its role in the direct allocation of capital, the state must support the creation of a market-based alternative, i.e., a healthy independent banking sector. Commercial banks should take over the intermediation of savings and investment. However, CEE governments did not grant the newly created commercial banks sufficient autonomy nor did they provide them with a strong enough capital base to carry out intermediation efficiently. Rather, the CEE states left a financial black hole in which a credit market crunch threatens the macroeconomic stability attained at an already high cost.

Our paper uses Hungary's experiences to illustrate the problems and issues to be dealt with sooner or later in all transforming countries. In the next section, we identify type 1 state desertion in Hungary even though the macroeconomic data turn out to be potentially misleading. In *Section 3*, we characterize type 2 state desertion of the Hungarian financial sector and conclude that the state acted irresponsibly in creating semi-independent commercial banks burdened with distorted loan portfolios of dubious quality. In *Section 4*, we analyze the severely dysfunctional financial distress resulting from credit market failure in Hungary.

In *Section 5*, we evaluate several proposals for resolving the bad loans problem in CEE countries. *Section 6* is a concluding one in which we recommend strong and decisive state intervention to strengthen commercial banks so that they may play their crucial intermediary role in the emerging financial markets in the CEE countries.

## 2. State desertion in Hungary: myth or reality?

**Table 1**  
*Summary of general government operations: international comparison*  
*(as percentage of GDP)*

Country	Revenues	Expenditures	Deficit (–) or Surplus (+)
<b>Hungary (1987)</b>	<b>61.0</b>	<b>63.0</b>	<b>–2.0</b>
<b>Hungary (1989)</b>	<b>58.7</b>	<b>61.4</b>	<b>–2.7</b>
<b>Hungary (1991)</b>	<b>57.7</b>	<b>59.7</b>	<b>–2.0</b>
<b>Hungary (1992)<sup>1</sup></b>	<b>56.5</b>	<b>63.6</b>	<b>–7.1</b>
<b>Hungary (1993)<sup>2</sup></b>	<b>55.9</b>	<b>62.6</b>	<b>–6.7</b>
The Netherlands (1989)	51.1	56.6	–5.5
Sweden (1988)	59.1	56.9	2.2
Denmark (1989)	59.6	59.4	0.2
Belgium (1987)	47.8	54.7	–6.9
Austria (1989)	46.9	49.7	–2.8
France (1989)	46.2	47.8	–1.6
Germany (1987)	46.0	47.9	–1.9
Poland (1987)	47.4	47.6	–0.3
Romania (1987)	52.8	45.5	7.3
Canada (1987)	40.3	44.7	–4.4
U.K. (1987)	42.7	44.0	–1.3
Finland (1987)	42.7	43.9	–1.2
Spain (1987)	35.0	38.6	–3.6
U.S.A. (1987)	34.9	36.9	–2.0

<sup>1</sup>Expected for 1992 as of February 1993.  
<sup>2</sup>Planned for 1993.  
*Source:* Kornai (1992, p. 5) and Murakōzi (1992, pp. 1051 and 1053) for the data for countries other than Hungary. For Hungary data are revised and corrected by László Borbély of the Ministry of Finance.

János Kornai (1992) measures the predominance of the state in economic activity in Hungary by the ratio of general government budget operations to GDP. As *Table 1* indicates, the Hungarian government is directly involved in about 60 percent of Gross Domestic Product (GDP). The typical proportion in mar-

ket economies is between 40 and 50 percent (in the U.S. economy it is significantly below 40 percent). In *Table 2* consolidated general government expenditures and revenues as a percent of GDP are recorded for Hungary from 1985 to 1993 (target). Both ratios are inordinately high by international comparison. Moreover, expenditures as a percent of GDP have been increasing since 1990 in Hungary. In 1992, this ratio was higher than it had been in all but one of the pre-transition years. Does the data indicate that type 1 state desertion is a myth in Hungary? A satisfactory answer requires consideration of the economic situation at the beginning of the transition.

**Table 2**  
*Summary table of consolidated general government  
Hungary, 1985–1993 In percentage of GDP*

Year	Total expend- itures	Total reve- nues	Enter- prise subsidi- es <sup>1</sup>	Consumer price subsidy	Health and education	Unemploy- ment com- pensation	Total expend- itures for households <sup>2</sup>
1985	60.9	60.3	13.2	4.8	10.2	—	28.3
1986	64.6	61.5	14.0	5.5	9.9	—	29.6
1987	63.0	61.0	13.5	5.4	9.5	—	28.5
1988	61.6	61.5	11.3	3.1	8.6	—	31.1
1989	61.4	58.7	7.7	2.6	10.1	—	34.9
1990 (adj)	(54.4)	(55.6)	(5.9)	(1.7)	(11.3)	(0.1)	(34.6)
1991	59.7	57.7	4.8	1.8	13.2	0.8	40.6
1991 (adj)	(50.8)	(48.1)	(4.0)	(1.6)	(11.2)	(0.7)	(34.5)
1992 <sup>3</sup>	63.6	56.5	4.4	0.7	12.8	3.1	39.9
1992 (adj)	(51.4)	(45.6)	(3.6)	(0.6)	(10.3)	(2.5)	(32.2)
1993 <sup>4</sup>	62.6	55.9	3.9	0.7	11.6	4.9	39.2

<sup>1</sup>Includes subsidies received from Central Government, Extra-budgetary Funds and Municipalities.

<sup>2</sup>In addition to the categories mentioned in the table includes expenditures on culture, sports, pensions, dependent care benefits and sick benefits.

<sup>3</sup>Expected for 1992 as of February 1993.

<sup>4</sup>Target for 1993 in the budget plan.

*Source:* Ministry of Finance; Hungary. Consolidated data are revised and corrected by László Borbély.

*Note:* For the years 1990–1992 we adjusted the data for the effect of the recession. Data in parantheses are ratios calculated by assuming no change in GDP from 1989 to 1992.

After having stagnated with low real growth in the second half of the eighties, the Hungarian economy slid into a recession in 1990 with real GDP falling by 3.5 percent. The recession deepened in 1991 and continued in 1992 as real GDP declined by 12 percent and 5 percent respectively so that the cumulative drop over the three-year period exceeded 20 percent. Might this recession explain why the

ratio of government expenditures to GDP in Hungary rose while the state was withdrawing from macroeconomic activity? To adjust the data for the effect of the Hungarian recession, we calculate the expenditure and revenue ratios for 1990, 1991 and 1992 as if GDP had remained constant at its 1989 level.<sup>1</sup> Then, a starkly different picture emerges. As *Table 2* records, expenditures as a percent of 1989 GDP are 54.4, 50.8 and 51.4 for 1990, 1991 and 1992 respectively. For the same years, the ratio of revenues to 1989 GDP becomes 55.6, 48.1 and 45.6. Therefore, after adjusting for the recession, the aggregate figures do indicate type 1 state desertion. The adjusted ratio of expenditures to non-recessionary GDP fell by ten points (or almost 18 percent) from 1989 to 1992. Currently at about 51 percent, this ratio places Hungary in the upper tier of Western market economies.

Even if GDP is not adjusted for the recession, the state's withdrawal from micro-managing the aggregate economy is evident. From *Table 2*, subsidies to enterprises declined from 13.5 percent of GDP in 1987 to 4.4 percent of GDP in 1992. Consumer price subsidies as a percent of GDP fell from 2.57 in 1989 to 0.73 in 1992. *Table 2* also provides information on the changing composition of support for households. Support for health and education remain almost constant if GDP is adjusted. Unemployment compensation, which was nonexistent in 1989, grew to 2.5 percent of adjusted GDP in 1992 (and was forecast to reach almost 5 percent of actual GDP in 1993). Nonetheless, total support to households adjusted for the recession decreased from 34.87 in 1989 to 32.21 in 1992 for a decline of 2.66 percentage points. Consequently, aggregate state support of households was smaller by the end of the period due mainly to the decrease in direct subsidies. The composition of state support changed to reflect the new and growing social safety net.

Reducing the state's interference with markets by decreasing direct subsidies to consumers and firms is a necessary condition for the emergence of markets. However, reductions in overall government expenditures decrease aggregate demand and exacerbate the decline in GDP. When adjusted for the effect of the recession, the ratio of aggregate government expenditure to GDP fell by ten points over a three-year period in Hungary. Thus, type 1 state desertion is discernible in the Hungarian macroeconomic data and it has the potential to hinder and postpone the economic recovery. In what follows, we argue that irresponsible state withdrawal from the financial sector is definitely impeding the progress of the transition in all CEE countries.

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<sup>1</sup>In market economies, recessions are accompanied by fiscal budget deterioration due to increased transfer payments and decreased taxable income. Although similar effects must be occurring in Hungary, we do not adjust the data to try to separate out cyclical from structural aspects of the fiscal budget.

### 3. State desertion of the financial sector

The severe decline in real output experienced in the CEE countries since 1990 has its roots in a credit market failure caused by state desertion of the financial sector. During the planning period, household and business money circuits were institutionally separate. The fiscal budget provided the necessary intermediation by transferring liquidity from the household or external sector to the production sector. Institutionally, the Central Bank extended the credit for business expansion designated by the plan and administered company accounts. Interenterprise transactions were recorded as debits or credits at the Central Bank; no separate payments clearing system outside of the monobank system existed. Credit policy was subordinated to planning as enterprise officials negotiated with bureaucrats to obtain funds for investment. Monetary policy as practised in a market economy using indirect instruments did not exist.

Hungary moved in the direction of market reform earlier than other CEE countries by dismantling the institutions of annual physical planning in 1968. However, the dominant role of the state in financial intermediation persisted. *Ábel and Székely* (1992) show that government money was the only causal explanation for liquidity in the business sector from 1974 to 1986. Monetized fiscal deficits provided overall liquidity to the economy prior to the restructuring of the banking system in 1987. Subservient to the state bureaucracy, the Hungarian National Bank played no major role in intermediating savings and investment. Until the banking reform in 1987, changes in the fiscal budget position and changes in interenterprise credit were inversely related (*Ábel and Bonin* 1992a). The business sector responded to any decrease in fiscal liquidity by increasing the length of the credit queue. Hence, the fiscal budget position drove credit market behaviour up to the time when the banking system was demonopolized.

As a precursor to (or as an essential first step in) the transition, all CEE countries created two-tier decentralized commercial banking systems from their central (monopoly) banks by breaking off entire credit divisions. In Hungary, the separation occurred in 1987 along sectoral lines.<sup>2</sup> The four newly created commercial banks, in descending order of assets, are Hungarian Credit Bank, Commercial and Credit Bank, Budapest Bank, and Hungarian Foreign Trade Bank. The largest Hungarian bank in terms of assets is the National Savings Bank which is the Primary collector of household deposits.

In all CEE countries, commercial banks are primarily state-owned (directly and also indirectly through ownership participation by state-owned client compan-

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<sup>2</sup>In Czechoslovakia (separation in 1990) and Poland (separation in 1989), regional divisions were maintained.



ies).<sup>3</sup> Their initial portfolios were saddled with nonperforming (bad) debt. As newly created commercial banks, they held virtually no loan-loss reserves. The CEE states accepted no responsibility for the distorted portfolios inherited from discredited political regimes. For example, the three largest Hungarian commercial banks were insolvent according to international accounting standards from their conception. Consequently, CEE banks were bequeathed weak loan portfolios without any compensation government support. As such, they are all victims of type 2 state desertion.

The loan portfolios of these banks continued to deteriorate with the recessions. Such financial distress is not without precedence; financial systems all over the world have experienced problems in the last fifteen years (World Development Report 1989). However, CEE banks have particular characteristics that demand special attention when designing financial policy. The abrupt withdrawal of the state from the process of credit allocation left the newly created commercial banks as the primary conduits of credit in the economy. In particular, banks were expected to provide new capital to promising projects and ventures. However, by leaving them financially weak, the state abdicated its responsibility for the obligations that were incurred under the old regime. Type 2 state desertion makes it impossible for the banks to intermediate savings and investment efficiently.

In Hungary, the dilemma for the newly created banks was exacerbated by the New Banking Act, which became effective on December 1, 1991. This act introduced specific categories for rating the loan portfolios of the banks, mandated the accumulation of provisions (loan-loss reserves) against the qualified loans in the portfolio, and specified a schedule for meeting international capital adequacy targets. Although this legislation was designed to make Hungarian banking standards more consistent with international ones, the provisions required against bad loans severely impacted the banks' ability to make new loans. The cost of services and interest spreads were maintained at levels high enough to allow banks to generate sufficient cash flow to accumulate the required loan-loss provisions. In essence, the New Banking Act imposed a flow solution on the (bad debt) stock problem.

The bad loans left on the books when the commercial banks were created became a burden on the healthy segment of the commercial sector. Companies that serviced their loan obligations did so at unusually high interest rates. High financing costs discouraged small entrepreneurial activity, inhibited entry of new firms, and precluded the capital injections necessary to restructure potential profitable state-owned enterprises to prepare them properly for privatization. By pricing investors

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<sup>3</sup>The direct ownership share of the state in the four large commercial banks varies between 35 percent to 50 percent but the residual in all cases consists almost entirely of ownership shares held by state-owned companies. This arrangement creates the curious situation that company privatization increases the state's ownership share in the commercial banks because the company's share reverts to the state when it is privatized.



out of the market, the commercial banks promoted further stagnation. By refusing to accept responsibility for the legacies of the past, the state left the banks with no alternative. Type 2 state desertion of the financial sector seriously impaired the ability of the newly created commercial banks to carry out their primary function, namely to allocate credit on economically rational grounds.

In leaving commercial banks burdened with bad (inherited) loans, the state substituted its earlier transparent support of ailing companies through direct fiscal subsidies with nontransparent financial redistribution. Companies with nonperforming loans had their interest arrears capitalized by the banks. Furthermore, the banks continued to do business with their old clients, many of whom held ownership shares in the banks, even when these clients' did not meet interest obligations. Consequently, the stock of bad debt increased. The healthy segment of the commercial sector supported ailing companies by paying high fees for financial services and high rates for loans. These financial transfers were less transparent than the earlier direct subsidies from the fiscal budget; moreover, as we develop in the next section, they were severely damaging to the health of the emerging market economy.

#### 4. Credit market failure: the consequence of state desertion

Although the three largest Hungarian commercial banks were insolvent by international standards from inception, the banking system generated large cash flows from the beginning of the transition.<sup>4</sup> In 1991 and 1992, household deposits grew rapidly in Hungary. An interbank market transferred these deposits from the National Savings Bank to the commercial banks. Unsterilized injections of foreign exchange in accounts opened by foreign companies doing business in Hungary added further liquidity to the banking system. Although the supply of loanable funds increased substantially, interest rate spreads remained large. Even when inflation declined in 1992, nominal lending rates remained high.<sup>5</sup> The commercial banks used this increased liquidity to attend to solvency problems by accumulating the provisions required by the new banking legislation rather than to take an active role in providing credit to the emerging private sector.

<sup>4</sup>In 1990, profit margins were high enough for taxes and dividends from the financial sector to constitute 7.6 percent of fiscal receipts (Ábel and Bonin 1992b).

<sup>5</sup>The spread in real interest rates was even greater due to the difference (about 9 percent in 1992) between CPI and PPI inflation. Historically, margins in the retail sector had average about 10 percent. As retail trade became increasingly privatized, margins increased to approach those in Western market sectors which average 30 percent to 40 percent. The difference between the ratio of tradeables to nontradeables also explains gaps in CPI and PPI inflation. Since real household deposit rates should be calculated using CPI while real commercial lending rates should use PPI, the spread of real rates was even larger than the spread of nominal rates.

The high spreads maintained throughout this period made borrowing from domestic banks unattractive to high-quality commercial costumers and led to credit market failure in Hungary.<sup>6</sup> On the demand side of the loanable funds market, the Hungarian production sector can be divided into three tiers consisting of good, struggling, and bad companies. The first tier consists of currently profitable companies that tend to operate either in export-oriented activities or in retail trade. These companies either generate sufficient internal funds to finance investment or, if they are joint ventures, they obtain credit from the mother company. Moreover, domestic companies exporting to Western markets have access to international capital markets at rates that cannot be matched by Hungarian banks. Hence, good companies tend to avoid the domestic credit market and the Hungarian banks are left with lending opportunities mainly in the second two tiers.

The third tier consists of companies that are already heavily indebted and, due to the nature of their markets, cannot continue to exist in their present form (e.g., many Hungarian SOEs in heavy industry and the energy sector). These companies will ultimately either be forced to enter bankruptcy proceedings or become chronically dependent on subsidies from the state budget. In the former case, liquidation or reorganization will occur. Obviously, these are not good credit risks for a bank attempting to improve the quality of its portfolio. Hence, unless they are forced to do so by the state for political reasons, banks are no longer extending new credit to this tier.

The middle tier consists of companies that are currently struggling, due primarily to the deterioration in the domestic economy, even though they are potentially profitable under normal conditions. To become profitable, a company in this tier may need to change both its market outlook and its management and to introduce new products and new technology. An injection of new capital, financed either by a strategic partner (equity) or by long term bank credit, will be required to transform such a company into a profitable venture. The only strategic partner with sufficient equity and know-how to accomplish the task in the near future is a foreign company. Until the nondiversifiable (macroeconomic and systemic) risk is reduced, foreign equity cannot be attracted in sufficient quantities. However, the commercial banks are equally reluctant to take the risk involved with restructuring companies that have yet to prove their creditworthiness. Hence, the stagnation and the "wait and see" attitude of creditors and potential equity holders.

Consequently, the Hungarian credit market exhibits an undesirable separating self-selection equilibrium in which the creditworthy borrowers are not interested in borrowing from the domestic banks and the riskier borrowers remain as the only available clients for these very banks. As a result, the increased supply of household savings observed in Hungary during the first three years of the transition is not directed toward the production sector because the commercial banks that were

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<sup>6</sup>See *Thorne* (1992) for a discussion of financial de-intermediation in Eastern Europe.

created to perform this intermediation are concerned about the quality of their portfolios. Instead of providing credit to the business sector, Hungarian banks have chosen to purchase government securities and channel domestic savings to financing a fiscal budget deficit which was above 7 percent of GDP in 1992 (*Table 1*). Hence, business investment is crowded out by fiscal expenditures because the banks find the risk-return bundle on government securities more attractive.

The brunt of the Hungarian credit crunch is born by potentially profitable but risky ventures (both creating new companies and restructuring middle-tier companies). Yet even though they are financially risky, new businesses must be encouraged to lead the country out of its recession and provide jobs for the workers being laid off as SOEs restructure. Due to the provisioning requirements against bad loans, Hungarian banks are currently unable (and prudently unwilling) to intermediate savings and investment effectively. Hence, the production sector does not receive the new capital it requires and the end to the recession is brutally slow in coming. Neoclassical economic theory argues in favour of government intervention to redress market failure. The Hungarian state should take this lesson to heart and assume its responsibility for creating an undesirable outcome in the credit market when it dealt the banks a weak hand, i.e., the bad loans problem.

### 5. The bad loans legacy: an evaluation of proposed solutions

At the time that the commercial banks were created, the bad debt in CEE countries could have been recognized as inherited from the previous regime and removed from the balance sheets of the banks. The consolidated balance sheet of the state would be unaffected since the state (either directly or indirectly) owned both the banks and the companies. Any decrease in state assets (loans on the banks' balance sheets) would be matched by an equal decrease in state liabilities (the companies' debts). If it had sufficient information to evaluate the loan portfolios when the banks were created, the state could have designed a credible once-and-for-all bad debt cancellation program.<sup>7</sup> Then the newly created commercial banks would have started their life with cleansed balance sheets and had not been burdened with the bad-debt albatross.

Although this argument is compelling, it would not have resolved the problem of inherited weak portfolios. Even if all the bad debt in the original portfolios had been removed, the situation of the commercial banks would still be financially fragile today. The deep recession and the loss of the Soviet market added significantly to the stock of nonperforming company debt in CEE banks. Long term loans made and long term obligations taken with clients during the previous regime turned

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<sup>7</sup>To avoid any incentive for banks to continue making bad loans because they expect subsequent bailouts, *Caprio and Levine* (1992) recommend linking debt forgiveness to bank privatization.

bad because of these macroeconomic shocks. Hence, the portion of current bad loans that was actually inherited from the previous regime is difficult to identify. Furthermore, a forward-looking classification of the loan portfolios is difficult to accomplish. In some cases, debtor companies are antiquated with obsolete capital and no competitive market position. Evaluating such assets is a relatively simple task as it amounts to estimating scrap values. For most companies, the uncertainty of future profit streams makes a realistic "market" value of the assets difficult to establish.<sup>8</sup> In the intermediate stage of the transition, portfolio evaluation is still a difficult task.

To avoid the issue of identifying bad debt, *Beggs and Portes* (1992) recommend removing all inherited loans from bank balance sheets. The state is then charged with the responsibility of "marking these loans to their market values" and, thus, making transparent the actual condition of its consolidated balance sheet. Although such a proposal forces the state to take responsibility for decisions made by previous regimes, the removal of the entire stock of inherited debt from bank balance sheets would have undesirable consequences. From the bank's perspective, the balance sheet must balance so someone has to pay for debt cancellation. One possibility would be to reduce bank liabilities sufficiently to offset exactly the reduction in bank assets. Then debt removal would be financed by writing down the deposits of healthy profit-making companies and private households. Given the magnitude of the stock of inherited debt, the confiscation of such a significant portion of deposits would surely destroy confidence in commercial banks.

Recognizing this fact, *Beggs and Portes* (1992) recommend issuing government bonds equal in face value to the loans removed.<sup>9</sup> They stress that the securities should earn a market rate of return and be sufficiently liquid to avoid having their value eroded by inflation. If all inherited debt is replaced in this fashion, the asset side of banks' balance sheets would consist mainly of liquid government securities. If the banks are sufficiently independent of state control, they can expand their loans and investments subject to a fractional reserve requirement on deposit liabilities. The additional liquid bank reserves created by this exchange is potentially inflationary. To reduce commercial banks' free reserves, the central bank could increase the reserve requirement (temporarily) to attenuate the inflationary impact of the government issue.

When amended to recognize its potential inflationary consequence, the *Beggs-Portes* proposal leaves the relationship between the central bank and the commercial banks in a rather primitive state. The central bank retains control over the

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<sup>8</sup>To avoid having to evaluate entire bank portfolios to determine how much debt should be removed, *Scott and Levine* (1992) have suggested forgiving bad debts only when the enterprise is privatized.

<sup>9</sup>For Poland, *Beggs and Portes* estimate the financing implications of this policy to be between 2 percent and 3 percent of GDP. Whether or not such an addition to the fiscal deficit is feasible or warranted can be argued.

aggregate level of credit while commercial banks are encouraged to take independent allocational decisions. However, reserve requirements are likely to be quite high. The banks would be making loans for which they would be held fully responsible. Yet with high reserve requirements, the cost of funds is likely to be high. As a result, the cost of credit would be high. Consequently, an infusion of liquid government securities accompanied with high reserve requirements to offset its inflationary potential is not likely to jump-start lending to businesses and unblock credit markets.

The proposal also presumes that the state has the resources and capabilities to manage the entire portfolio of inherited debt as effectively as the banks. However, the individual commercial banks are the best sources of information about their clients. As such, they are able to monitor better managerial (e.g., asset stripping) and to work out the problem parts of their portfolios more successfully than a centralized government agency. *Bonin and Mitchell* (1992) develop a model in which the value of the state's assets will be higher if banks rather than a state agency work out the problem loans. Both moral hazard considerations and informational asymmetries make the centralized work out of bad loans suboptimal from the perspective of state wealth maximization.

More than likely, the government authorities in the CEE countries have understood that removing all inherited debt was infeasible.<sup>10</sup> Each state opted for some form of decentralized policy in which the banks were given the responsibility to work out their bad debt. At the same time, banks were required to accumulate reserves against the qualified part of the portfolio. However, this policy of bank self-reliance with its accompanying provisioning requirements is the primary cause of credit market failure in Hungary (as we argue above). The proper policy is for the state to avoid type 2 desertion of the financial sector and resolve the bad debt problem.

Since Hungarian commercial banks are required to evaluate their portfolios according to the requirements of the Banking Act, it would be possible for the state to remove only bad loans from bank balance sheets. Unless properly designed, this approach would penalize banks that have already accumulated significant provisions. To remove only the bad loans against which sufficient loan-loss reserves are held amounts to confiscating funds from healthier financial institutions. Thus, proper bank governance would be discouraged. An attractive alternative would be

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<sup>10</sup>In 1991, Czechoslovakia adopted a program in which 20 percent of the existing commercial loans were transferred from the banks' balance sheets to the newly formed Consolidation Bank. Although this program was the most adventurous among CEE countries with respect to debt removal, it still left Komerční Banka, the largest commercial bank in the Czech Republic, with a shortfall in loan loss reserves of 9 billion koruna (or about 5 percent of its remaining loan portfolio) for 1991. The Hungarian government negotiated with the banks to guarantee about 10 billion forints of doubtful loans purported to represent about half of the existing bad debt at the time that the commercial banks were created in 1987.

recapitalization of the banks using subordinated debt, either government-issued or government-guaranteed (private) debt. Bank net worth would increase and loan work out would be left in the hands of the commercial banks. These banks are in the best position to handle this task because of the information they have on their clients. This combination of decentralized bank work out (self-reliance) and government-assisted recapitalization is preferable to centralized schemes based on debt forgiveness alone.

## 7. Conclusion: state withdrawal vs. state desertion

The transition to a market economy requires state withdrawal in the aggregate sense of decreasing the role played by the state in overall economic activity and in the petty tutelage sense of eliminating direct interference with market activities. However, the state must not abdicate responsibility for the burdens that past decisions impose on evolving institutions. Rather, the state must become an economic enabler; it must build and strengthen the environmental underpinnings on the emerging market economy. In Hungary from 1990 on, the aggregate data on subsidies clearly indicate a rapid decline in the state's direct interference with production and distribution. By adjusting government expenditure to GDP ratios for the recession, we demonstrate a rapid and continual decline in the state's involvement in aggregate economic activity (type 1 state desertion). The level of support to the household sector is also declining even as unemployment compensation transfers increase rapidly. State desertion of this type has the potential to lengthen and deepen the recession in Hungary.

The Hungarian state's abrupt and discontinuous withdrawal from the process of credit allocation (type 2 state desertion of the financial sector) is unambiguously deleterious to the health of the nascent market economy. Inherited bad loans inhibit the newly formed commercial banks from performing effectively their intermediation function. Credit markets exhibit a separating self-selection equilibrium in which good risk clients are driven away from domestic banks by the high cost of funds and services. As a result, the commercial banks assist in the crowding out of private investment as they attempt to improve the quality of their portfolios. Hence, companies attempting to restructure and newly emerging entrepreneurs face a severe credit crunch. The state must intervene to break the gridlock and jump-start investment in the productive sector.

Why should the state be held responsible for the quality of the banks' portfolios? By reducing subsidies to companies, the state withdrew its direct fiscal support leaving these companies in a precarious financial condition. These loss-making companies were heavily indebted to the commercial banks. Furthermore, the recession and a more stringent bankruptcy act in Hungary combined to make



more client's loans bad according to the classifications in the banking act. As a result, Hungarian commercial banks continue to support unhealthy companies with non-transparent subsidies (e.g., interest capitalization). The state not only deserted the financial sector; it continues to contribute to its distress.

How should the state walk the tightrope between helpful assistance and meddling interference? The objective is to provide the support necessary to nurture the development of credit markets. As a precondition, the state must assume responsibility for the bad loans problem. In doing so, it must not interfere directly with the lending activities of the commercial banks. Therefore, the Hungarian government should continue its self-reliance program but at the same time it must inject fresh capital into the banking system. By using subordinate debt to recapitalize the banks, the state would both accept responsibility for the legacies of the past and maintain the necessary arms-length relationship with the commercial banks.

State desertion (type 2) of the fledgling financial sector imposes too great a cost on the economy. The peculiar type of credit market failure that evolved in the CEE countries requires government intervention to assure the healthy development of market institutions. On the road to the mixed market economy, the state should withdraw from economic activity but not abdicate its responsibility to address market failures. State desertion has the potential to stall the transition indefinitely.

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