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Eastern Europe's experience with banking reform: Is there a role for banks in the transition?

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How have Eastern European countries dealt with their banking system problems? Are there any lessons to be learnt? What role have countries assigned to banks in the transition and in dealing with the enterprise problem? This paper addresses some of these questions by analyzing the experiences of Hungary, Poland, the former CSFR, Bulgaria and Romania. While most countries have made substantial progress in restructuring their banking systems, few have used their banking system as an instrument to stimulate their supply response by ensuring an efficient allocation of credit. Countries that have encouraged the establishment of new private banks, introduced new regulation and supervision, and enhanced bank competition show an improvement in the allocation of credit and greater control of loss-making enterprises.

1. Introduction

In 1989, most Eastern European countries started transforming from centrally planned to market-oriented economies. These countries undertook very comprehensive macro-economic reform programs aimed at stabilizing their economies and introducing market forces. Programs typically consisted of liberalizing product markets, starting the reform of the labor and financial markets, and integrating their economies to the World Economy by removing trade restrictions. In addition, most countries privatized their small-scale state-owned enterprises (SOEs) through public auctions, and a few countries also started designing schemes for restructuring and privatizing their medium and large-scale state-owned enterprises.

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Although the experience with macro-economic reform differs across countries, the most successful countries managed to overcome the fears of hyperinflation and prolonged periods of macro-economic instability. Successful countries managed to stabilize prices, overcome the scarcity of goods that prevailed during the centrally planned period and initiate the development of the private sector.[1] But few have managed to restructure and privatize the SOEs or the banking system. Yet both the SOEs' and the banking system's restructuring and privatization have very important consequences on the macro-economy stability since their postponement could undermine the Governments' ability to balance the budget deficit, undertake a non-inflationary monetary policy and magnify the social effects. Therefore, failure to deal with these problems can make the macro-economic accomplishments unsustainable.

In most Eastern European countries, the introduction of market forces made apparent the large number of loss-making SOEs needing restructuring and privatization. The magnitude of the problem was not fully apparent before because centrally planned economies relied on relative price controls and direct and indirect subsidies. Moreover, after the introduction of market forces these loss-making SOEs have managed to continue financing their losses from the banking system because they constitute a large proportion of total SOEs and thus their closure could result in social implications that could halt the reform effort and because few of these countries have in place a scheme to restructure, liquidate, or privatize these enterprises. This, however, is undermining macro-economic stability and is endangering the future of the well-managed profitable enterprises and the development of the private sector. In fact, it is resulting in a perverse allocation of resources, while loss-making enterprises are accessing additional resources, the new emerging private sector is being crowded out.

Although most studies have analyzed the problems in restructuring and privatizing the SOEs, they have done it by focusing on the enterprises. These studies have started from the enterprise problems and established their link to the other sectors of the economy, such as the banking, public and social sectors. This paper is an attempt to analyze the problem from the perspective of the banking system. It seeks to understand the role that the banking system can and is playing in the transition, that is, during the period when the enterprise restructuring and privatization is taking place. It attempts to understand the starting conditions faced and the Government strategies for reforming the banking system. The focus is on the institutional aspects of financial sector reform. The important lessons will be drawn by focusing on the experience of the five more advanced former centrally planned Eastern

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

European countries: Hungary, Poland, the former CSFR,[2] Bulgaria and Romania.

The paper argues that while Eastern European Governments have made substantial progress in reforming their banking systems, in most countries the banking system still plays a passive role. Few countries have designed the reform of their banking systems as an instrument to stimulate the supply response, for instance, by ensuring an efficient credit allocation, or by using banks to exert control on loss-making SOEs. Most banking systems are still dominated by large state-owned banks which hold a large proportion of non-performing loans. These large banks by lending to loss-making enterprises have contributed to the lack of control of these SOEs and, through it, to the misallocation of credit. While in some countries it is too early to make a definitive assessment since they are still restructuring their banking systems, empirical evidence of countries that have (a) encouraged the establishment of new private banks; (b) introduced new regulation and supervision; and (c) enhanced bank competition shows an improvement in the allocation of credit and greater control of loss-making SOEs.

The organization of the paper is as follows. Section 2 opens the discussion with the analysis of the legacies of the past. Section 3 compares the policies adopted by each Government for restructuring the banking system. Section 4 compares the efficiency of the five banking systems in an attempt to assess the consequences of the Government policies undertaken. Finally in section 5 the conclusions highlights the lessons that can be learnt from these reforms and underlines the problems that remain.

2. Past legacies: The starting conditions

Until the early 1980s, the socialist banking system that prevailed in most Eastern European countries consisted, in addition to the Savings Bank, of a monobank that performed the roles of central bank and commercial bank. As a central bank it was responsible for issuing currency and ensuring that banks granted the resources to the enterprises undertaking the investment. Moreover, it performed the role of commercial bank for the enterprises by keeping and granting short term deposits and loans. In addition, there was a Foreign Trade Bank specialized in enterprises' foreign exchange transactions and in managing the foreign debt and assets; and a group of banks specialized in providing long-term finance to enterprises, which were specialized by area of economic activity. However, unlike banks in western countries which grant credit based on their credit risk analysis, banks in former socialist countries grant credit based on central plan decisions. Banks,

[2]To avoid confusions and since the analysis ends at end-1992, throughout I have referred to the former CSFR as 'the CSFR.'

therefore, allocate credit passively and performed the role of government agencies.

2.a. Abandoning the basic socialist banking system

Although in the five countries the political opening – signaling the starting of the reform towards a market economy – took place in 1989, each country started the process of reform of their banking systems at different periods and using different methods (see table 1). This reform was signaled by the break-up of the monobank, the establishment of a two-tier banking system and the abolishment of the central plan targets.

Hungary was the first country to introduce changes in its banking system. Although these changes started in the early 1980s, they started in earnest in the late 1980s. In early 1987 the authorities established a two-tier banking system and broke up the monobank into a central bank and two state-owned commercial banks. Hungary, however, is rather unique in the opening up process, both because it started very early on and because it followed a very gradual process. Unlike the other countries, the change in economic policies was not marked by a single date when a big bang stabilization program was undertaken. In the early 1970s, with the New Economic Mechanism and with the abolishment of centrally determined targets, the Government started introducing changes in economic policy and allowing enterprise managers greater freedom. Since the 1970s, enterprise managers were granted a greater role in decision-making and in the management of enterprises, thus starting the experience in enterprise self-management under socialism.

In *Poland* the authorities started introducing changes in the banking system in the early 1980s. While in early 1982 the authorities granted more autonomy to the monobank, allowed banks more flexibility in meeting the centrally determined targets and provided for the establishment of new banks, not much changed since the authorities kept tight control on the banking system through the monobank until the late 1980s. Changes started in the late 1980s. First, in late 1987 the authorities carved out the Savings Bank from the monobank and, second, in January 1989, the authorities broke up the monobank into nine state-owned commercial banks and established a two-tier banking system. Moreover, the authorities also granted banks a greater role in management and in the credit allocation.

In the *CSFR*, *Bulgaria* and *Romania*, the process was different than in Hungary and Poland. The break up of the monobank and the establishment of the two-tier banking system, which coincided with the abolishment of the central plan targets and the greater role to enterprise managers, followed the

Table 1

Banking systems' starting conditions.

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

Source: World Bank (1989, 1990 and 1991b) and Thorne (1992). [a]Estimated at the date of the break-up of the monobank.

political opening (see table 1). In the CSFR and Bulgaria the changes in the banking system took place in January 1990, one month after the political opening, while in Romania these changes took place in December 1990, one year after the political opening. Moreover, and unlike Hungary and Poland where enterprises' managers were granted greater freedom before the banks', in the CSFR, Bulgaria and Romania both enterprise and bank managers were granted more freedom at the same time, when the authorities abolished the centrally planned targets. In these three countries, there was no tradition of enterprise self-management as in Poland and Hungary.

However, these three countries' banking system's differed in the method the authorities used for breaking up the monobank and establishing a two-tier banking system. In the *CSFR*, the authorities broke up the monobank by establishing three new banks, two state-owned commercial banks (one for the Czech and one for the Slovak Republic) and one bank specialized in long term finance, which served both republics. In contrast, *Bulgaria* established a large number of commercial and specialized banks. The monobank was broken into 59 commercial banks, and in early 1990 there were also 8 banks specialized in long-term lending by economic sector, one bank specialized in foreign exchange transactions and one Savings Bank. Moreover, in Bulgaria the Government and the central bank who owned these banks decided to sell their shares to the state-owned enterprises as a way of reducing direct state ownership and thus giving up control. In *Romania* the banking system that emerged consisted of a few banks, as in the case of the CSFR. The monobank's commercial banking activities were transferred into a recently established state-owned bank.

2.b. The starting banking system's conditions

The banking systems' of the five countries were similar both in terms of the banks that formed the banking system and in terms of the institutional problems confronted. Typically, these five countries' banking systems had a group of commercial banks, a group of specialized banks and a Savings bank. In addition, the most important institutional problems were:

(a) an inefficient payment system resulting in banks holding a large volume of assets and liabilities with each other – i.e, the float – thus leading to a financial de-intermediation as it becomes unattractive for banks' customers to use banks for making payments;
(b) a lack of a regulatory and supervisory framework adapted to the needs of a market economy, and supervisors ill-prepared to supervise banks operating in a market economy;
(c) a large proportion of bank non-performing loans, especially held by the large state-owned (SO) banks, which resulted from the lending practices during the central plan period;

(d) an inexperienced group of bankers appointed by Government officials and ill-trained for managing banks in a market economy and for assessing risk of potential customers;
(e) a large number of joint-stock banks owned by state-owned enterprises and other semi-public institutions, which prevented banks from taking independent credit decisions regarding their main customers.

Although differences were minor, they resulted from the methods followed by each Government for breaking up the monobank and from the period when the authorities started introducing changes in the banking system. As we shall see in sections 3 and 4, these differences explained the differences in speed in reform and roles for the banking system during the economic restructuring process in each of the five countries.

The first difference consisted on the relative importance of the commercial and specialized banks (see table 2). Hungary and the CSFR's emerging banking systems relied more on the commercial banks than on the specialized banks. In both countries the commercial banks held most of the banking systems' assets after the authorities broke up the monobanks. In contrast, in Poland, Bulgaria and Romania the specialized banks were more important than the commercial banks. This is even true in the cases of Poland and Bulgaria which established the largest number of state-owned commercial banks as a result of the break-up of the monobank in an attempt to enhance bank competition.

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

Hungary and Poland were the countries where this segmentation was less sharp as indicated by the high ratio of Savings Bank loans to deposits indicating that the Savings Bank was not a source of funds for commercial and specialized banks. In fact, both countries Savings Bank's used their resources to grant mortgage and other loans to the household sector. Moreover, in these two countries the ratio of Savings Banks deposits to total deposits were the lowest, suggesting that commercial and specialized banks had their own sources of funds.

In contrast, in the CSFR, Bulgaria and Romania, the Savings Banks were net lenders to the specialized and commercial banks. In 1990, when the Bulgarian authorities broke up the monobank, the Bulgarian Savings Bank was granting close to 70% of its deposits to fund the commercial and specialized banks, while in the cases of the CSFR and Romania, these proportions were 83% and 95%, respectively. Moreover, Bulgaria, the CSFR

Table 2

Structure of the banking system.

	Hungary	Poland	CSFR	Bulgaria	Romania
Ratio of all specialized banks' assets to total assets[a,b]	47.7	79.1	32.2	54.0	52.3
Ratio of commercial banks' assets to total assets[a,b]	35.0	8.5	67.8	25.5	18.2
Ratio of total savings bank deposits to total deposits[a]	52.5	12.1	52.3	46.2	80.8
Savings Bank's households' deposits as ratio of total household deposits[a]	81.3	70.5	100.0	100.0	100.0
Ratio of Savings Bank loans to deposits[a]	100.0	61.3	16.9	33.5	4.9

Source: World Bank (1989, 1990, 1991b and 1991c) and Thorne (1992). [a]Estimated at the date of the break-up of the monobank. Because in Hungary the central bank holds a large portion of the banking systems' total assets the sum of the ratios of commercial and specialized banks' assets to total assets is low relative to the other countries. [b]In the case of CSFR, these ratios are calculated using total loans instead of total assets, as assets by group of banks were not available.

and Romania's Savings Banks accounted for larger proportions of total and households deposits.

3. Restructuring banking systems: The government policies

Starting in 1990, the five Eastern European countries' banking system started to change fast as a result of the political opening and the introduction of market forces. Between 1987 and 1989, the Governments relaxed restrictions for the establishment of new banks and some Governments also encouraged the establishment of new banks as a way of enhancing bank competition. But very little was done to overcome the other structural and institutional problems. This, however, resulted in a very rapid increase in the number of banks. In Hungary the number of banks increased from 19 in late 1987 to 37 in late 1991; in Poland from 18 in early 1989 to about 86 in late 1991; in the CSFR from 7 in early 1990 to 27 in late 1991; in Bulgaria from 69 in early 1990 to 75 in late 1991; and in Romania from 10 in late 1990 to 16 in early 1992.

However, in most countries the banking system restructuring effort only started in late 1990, when most Governments started introducing schemes for restructuring their banking systems. Initially, Governments introduced changes in monetary and credit policies in the context of their macroeconomic adjustment programs, and later, they proceeded with the banking system restructuring schemes. The banking system restructuring scheme typically consisted of: (i) the introduction of a new regulatory and supervisory framework; (ii) the institutional policies for dealing with banks' large non-performing loans and their link with the enterprise restructuring; and (iii) the bank privatization plans. We now turn to the discussion of these three aspects of the restructuring schemes as a way to understand the policy measures adopted by each Government and the way Governments linked the banking and enterprise restructuring.

3.a. Introducing a new regulatory and supervisory framework

Although between 1991 and 1992 all five countries introduced a new regulatory and supervisory framework, some countries kept important aspects of their old legislation. Until mid-1992 only Hungary, the CSFR and Bulgaria introduced a complete new central bank and banking laws, which were mirrored in the western economies legislation. Although Poland and Romania introduced a new central bank law, they only introduced amendments to their exiting banking laws and some key elements of western banking legislation needed for market-based banking systems were still missing in late 1992. In a very recent attempt, however, both countries are planning to introduce a complete new law. Moreover, of the five countries only Hungary has introduced a new bankruptcy law defining the role of banks in restructuring and privatizing enterprises.

In their new legislation the five Eastern European countries have followed two very different banking models (see table 3). On the one hand Hungary, has opted for the Anglo-Saxon model of separation between the commercial and investment banking functions; on the other hand the other four countries have opted for the German-Japanese model of universal banking. This has therefore defined the role of banks in the transition. In Hungary the commercial bank is limited to attracting deposits and granting loans and is restricted on the volume of investments it can make. In contrast, the investment bank is prevented from attracting deposits but is given the possibility of engaging in enterprise restructuring and other types of investment activities by allowing it to make as many investments as it has of capital and reserves to cover. In the other four countries, however, banks are empowered to performed both the commercial and investment bank functions and the legislation is very liberal in allowing banks to make long-term investments, such as in real estate and securities.

However, of the five countries the Hungarian, Bulgarian and Romanian legislation is the most liberal, since it allows banks to invest up to 100% of their capital and reserves. In contrast, the Polish and the CSFR bank legislation limits long-term investments to 25% of the bank capital and reserves. Moreover, only in Hungary, CSFR and Bulgaria the legislation excludes temporarily from long-term investments any collateral or pledge that banks might have taken possession of as a result of foreclosing on guarantees provided by their borrowers.

While all five countries have opted for similar monetary and credit instruments by subjecting initially banks to reserve requirements, credit ceilings and interest rates, some small differences prevail. Hungary is the only country that has retained interest rate ceilings and has the highest reserve requirement. However, only in Hungary and Poland[3] is the level of reserve requirements a relevant indicator because in the other three countries most of the deposits are held by the savings bank, and commercial banks are funded through the inter-bank market or directly through the central bank (see table 2).

Although all five countries have opted for a capital adequacy of 8% of risk-adjusted assets in line with the Basle Agreement, they differ in the method used for calculating the risk-adjusted assets and in the transitional period. Of the five countries only Hungary has a method for calculating the risk-adjusted assets, the CSFR and Bulgaria are in the process of drafting the

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

Table 3

Regulatory frameworks.

	Hungary	Poland	CSFR	Bulgaria	Romania
Date of enactment by Parliament of new banking regulation	November 1991	April 1992 (amendments to existing law)	December 1991	March 1992	March 1991 (amendments being considered)
Separation between commercial and banking investment activities?	Yes	No, universal banking	No, universal banking	No, universal banking	No, universal banking
Limits on the volume of equity banks can hold	Commercial and specialized banks are allowed to hold 15% and 100% of adjusted capital in long term investments, respectively; and excludes collaterals taken possession by banks which must be sold within 3 years	Up to 25% of total capital and reserves and is planning to increase it to 50%	Up to 25% of total capital and reserves and excludes collaterals taken possession by banks which must be sold within 2 years	Up to 100% of total capital in long-term investments and excludes collaterals taken possession by banks which must be sold within 3 years	Up to 20% of total capital and reserves and NBR plans to increase it to 100%
Capital adequacy	8% of risk-weighted assets to be met in January 1993	8% of risk-weighted assets	8% of risk-weighted assets to be met end-1995	8% of risk-weighted assets, transitional period to be determined	Proposed to be 8% of risk-weighted assets by end-1994
Limits on lending to a single customer	Up to 25% of adjusted capital	Up to 15% of assets.	Up to 25% of capital	Up to 25% of capital	Up to 20% of capital
Limits on lending to shareholders	Up to 5% of adjusted capital	Up to 15% of capital.	Determined by the bank statutory body	Up to 1% of paid-in capital	Up to 15% of the bank's capital and reserves

Table 3 (continued)

	Hungary	Poland	CSFR	Bulgaria	Romania
Deposit insurance	Banks should have a mandatory deposit protection by end-1992	Only state-owned banks and Government deposits; will be replaced by a deposit insurance scheme in March 1993	State-owned banks and Government's deposits	By law banks should offer deposit insurance up to an amount to be specified	Only state savings bank's deposits
Minimum capital for new banks	US$ 13.3 m for commercial and US$ 6.6 m for specialized bank	No explicit limit except that it should be proportional to the size of anticipated activities	Determined by the central bank	US$ 10.0 m	US$ 3.5 m
Limits on ownership	State and a single individual may hold more than 25% of equity; no restriction on foreign banks	Maximum ownership is 50% by a single individual or firm	No limits	Authorization from central bank	No limits
Institution responsible for supervision	State Banking Supervision Agency (SBA) and NBH	National Bank of Poland	State Bank of Czechoslovakia	National Bank of Bulgaria	National Bank of Romania
Standards for loan classification and provisioning	No, in preparation	No, in preparation	No, in preparation	No, in preparation	No, in preparation

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

regulation, and in Poland and Romania the 8% capital requirement has not been enforced. In addition, only Hungary and the CSFR defined a transitional period for compliance. While in Hungary banks are supposed to comply with a 7.25% risk-weighted capital by January 1992, and 8% by 1993, in the CSFR banks should comply with 6.25% by end-1993, and with the 8% by end-1995. Bulgaria is in the process of defining the transitional period; in Romania banks will be required to comply with the 8% by end-1994; and in Poland the 8% will soon be enforced.

All five countries have introduced very strict limits on exposures to a single borrower and to shareholders as a way of limiting banks' large exposures and preventing shareholders from benefiting from bank ownership. While most of the countries limit the exposure to a single borrower to about 25% of capital, Poland imposes the lowest limit, 15% of capital. In terms of lending to shareholders, the Bulgarian and Hungarian legislation is the strictest with a limit of 1% and 5%, respectively, while CSFR and Poland have a limit of 15%.

The legislation is different in other important respects as well. First, few countries have a deposit insurance scheme. In Hungary and Bulgaria the banking law requires that banks offer deposit insurance to their depositors, but the deposit insurance schemes have not been introduced. The CSFR, Poland and Romania have the old deposit protection whereby only state-owned banks and Government deposits benefited from protection. A key problem faced by all countries in introducing a deposit insurance scheme has been the presence of banks with a large proportion of non-performing loans. These banks' having a higher probability of default and holding a large proportion of all banking system loans increases the overall cost of the deposit insurance and, in particular, imposes a tax on well-managed banks with low non-performing loans.

Second, countries differ in terms of restrictions for the establishment of new banks. For instance, the Hungarian and Bulgarian bank legislation have the highest minimum capital requirements. Moreover, in Hungary there is a limit on the share of the state in the bank ownership (to be complied for by 1997), and together with Poland, Hungary has limits on the proportion of shares that a single individual and/or institution can hold. In contrast, the bank legislation of CSFR and Romania are more liberal concerning the entry of new banks. In the cases of the CSFR and Romania, entry of new banks is limited only by the minimum capital requirements, while in Poland new banks only need the National Bank of Poland's approval.

Third, although all bank legislation enable banks to initiate foreclosure procedures, in practice few countries have introduced a bankruptcy law and defined property rights. Yet this is key for the development of the banking system, as it defines both the instruments for banks and other creditors for exerting pressure on borrowers and defines the protection that enterprises can get in such cases. Not clearly defining property rights by preventing banks from using SOEs' assets as collateral on loans has limited the supply of credit and the development of the banking system. In most cases banks are demanding mortgages, bank deposits or cross-guarantees as a condition for granting a loan, which has increased the borrowers' risk. But because most bank loans have been granted to SOEs and banks cannot foreclose on state-owned assets, banks have been inhibited from using foreclosure and liquidation as instruments to impose financial discipline on loss-making SOEs and force their restructuring.

Hungary and CSFR are the only two countries that have introduced such legislation, while Poland, Bulgaria and Romania are planning to introduce this legislation very soon.[4] However, only in Hungary is the bankruptcy law effective. In the case of the CSFR, the authorities have granted enterprises a one-year transitional period to adjust as a way of preventing a massive failure. Moreover, no country has defined a scheme for restructuring enterprises before they fall into bankruptcy as a way of dealing with the large number of enterprises in weak financial situations. In fact, the large number of financially weak enterprises in most countries can overload the courts proceedings and thus postpone the liquidation of enterprises. An example is the case of Hungary, where the authorities introduced a type of Chapter 11 clause in their bankruptcy law and by end-March 1992 more than 2,000 enterprises had filed for bankruptcy as a way of protecting themselves from their creditors.[5] Moreover, this has resulted in large losses for banks and has postponed enterprise restructuring and liquidations because it has overloaded the court proceedings.

A key problem common to all countries has been the delay in the introduction of banking supervision capable of enforcing the banking legislation. However, bank supervision and supervisors' ability to carry out on- and off-site bank examinations are key for developing the banking system since it reassures depositors' trust on the banking system by enhancing banks' corporate governance and by assuring that problem banks will be corrected on time or removed from the system. Although countries such as Hungary and Poland started very early on to introduce changes in bank supervision, only Hungary had partial success in: retraining existing supervisors, bringing new qualified supervisors acquainted with western practices, introducing new accounting standards for banks, and providing the institutional strength needed for conducting bank supervision. Hungary is the

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

[5]See Business International (1992).

only country that has established a completely new bank supervision institution (e.g., SBS), while in the other four countries the old central banks' departments in charge of bank supervision are still responsible (see table 3).

In addition and related to banking supervision, neither of the five countries have introduced standards for loan classification and provisioning. As a temporary arrangement however most countries had relied on bank audits. Yet loan classification standards are a key instrument for bank supervision and thus for limiting banks' risk and ensuring a stable banking system. Moreover, disclosure and classification of loans by banks should enable depositors to decide in which banks to deposit their savings. Hungary and CSFR are close to introduce such a regulation and Poland, Bulgaria and Romania are planning to do it at a later date.

3.b. Institutional measures

A crucial aspect of the restructuring strategies of the five countries' banking systems consisted of the institutional measures taken to deal with the inefficiencies of the payment system and the banks' large non-performing loans. In all cases the pressure for restructuring the banking system and, in particular, for dealing with banks' non-performing loans arise from the enterprise sector.

Few countries, however, have undertaken measures to overcome the problems with the structure of the banking system. Perhaps the only country is Bulgaria, which is considering merging the large number of small banks into eight or nine medium-size banks. The most important problems with the structure of the banking system were: (i) the segmentation of the banking system between a circuit of banks serving the enterprises and another serving the households; and (ii) the bias in the competition introduced by the coexistence of a few large banks holding most of the assets, liabilities and capital and of a large number of small banks accounting for a small proportion of the banking system. Most countries decided to deal with these problems by enhancing bank competition and removing the bank specialization by allowing banks to undertake most banking activities.

3.b.1. Overcoming the payment system's inefficiencies

Because the payment system is a fundamental instrument for enhancing bank competition and making monetary policy effective, most countries started their institutional reform with the introduction of a payment system (see table 4). Moreover, most countries had to establish a payment system from scratch because centrally planned economies did not rely on such a system. Unlike a market-based banking system, in a centrally planned economy there was not need to link all banks; it was desirable to segment the banking system.

Table 4
Institutional measures.

	Hungary	Poland	CSFR	Bulgaria	Romania
Date of introduction of the payment system and average delay in settling a bank cheque	1988 and takes 10 days	1990 and takes between 10 and 20 days	1991 and takes about 3 days	1991 and takes between 15 and 20 days	1992 and takes between 15 and 21 days
Removal of banks' bad loans and/or recapitalization of banks using fiscal resources	Yes, 50% of three largest banks non-performing loans inherited in 1987, which accounted for 1.7% of total SOEs by end-1987	Yes, banks' foreign exchange losses were covered in 1991 and a new bank recapitalization is being considered in 1993	Yes, 30% of all outstanding loans to the enterprise sector in January 1991	Yes, 100% of enterprises loans outstanding at end-1990 were guaranteed by the state	Yes, 90% of all enterprise non-performing loans outstanding in December 1990
Audits were used to determined amount of recapitalizations	Yes	Yes	No, based on banks' own assessment	No, based on total loans granted in end-1990	No
Instrument for removing banks' bad loans and/or recapitalizing banks	Government guarantees callable upon the initiation of liquidation procedures	Government bonds denominated in foreign currency; and for the new recapitalization 15-years Government bonds including 5 years of grace	Non-performing loans were transferred to the Consolidation Bank and Government bonds were issued for recapitalizing banks	Government guarantees and bonds	Proposed to be 4-year Government bonds

Amount of non-performing loans covered by the budget	Ft 10.5 bn in Government guarantees or 1.7% of total banks' loans outstanding with enterprises by end-1987	US$ 5.5 bn in dollar-denominated Government bonds issued to finance the foreign exchange losses; and an undetermined amount for the new bank recapitalization scheme	Kcs 120 bn of banks non-performing loans were transferred to the Consolidation Bank and, in addition, a transfer of Kcs 50 bn was made for covering enterprises' non-performing loans and for recapitalizing banks	Lev 4.1 bn in Government bonds and the Government provided guaranteed on the Lev 46 bn bank outstanding in end-1990	Lei 150 bn in banks non-performing loans, Lei 50 bn for bank recapitalization
Link bank recapitalization to enterprise privatization	Yes, indirectly	Yes, directly	Yes, indirectly	Yes, directly	No
Link bank recapitalization to bank privatization	No	No	No	No	No
Do banks have to approve enterprises in arrears restructuring plans?	Yes	Yes, in the new scheme	Yes	No	No
Enterprise privatization involved a give-away scheme	Subsidized loans have been offered to nationals purchasing shares	Yes, the Mass Privatization	Yes, the Voucher Scheme	It is being considered	Yes, similar to Poland and CSFR's schemes using private investment funds

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

While the five countries have followed a similar approach, progress in all countries was very slow. In all countries establishing a payment system proved to be a very cumbersome and complicated undertaking. It involved establishing a national electronic network for settling and clearing payments and introducing a regulatory and a policy framework for the operation of the system.

Most countries, however, took a long time before starting to operate the payment system, and until now countries are still experiencing delays in their bank transfers. These delays, however, are magnified in the cases of Bulgaria and Romania, which have started much later (see table 4). Moreover, most central banks end assuming the liability in case banks have insufficient funds in their accounts since this verification would further delay bank transfers and settlements.

The inefficiencies of the payment system, however, have hindered competition among banks. The largest banks with more developed branch networks have an advantage over the small ones, as they can offer better payment services to their customers. More important, the inefficiencies of the payment system also has impeded the efficient management of monetary policy because the central bank has kept large outstanding balances with most banks, and when the authorities made monetary policy restrictive it has usually resulted in banks experiencing liquidity shortages rather than in an increase in the inter-bank interest rate. Therefore, central banks' management of reserve money became difficult and magnified banks' liquidity problems.

3.b.2. Macroeconomic conditions and schemes for dealing with banks' non-performing loans

In 1991, the SOEs in most countries started experiencing difficulties. The introduction of market forces, the trade shock from the collapse of the CMEA, the economic recession resulting from the macro-economic adjustment and the introduction of new accounting standards made the fragile financial situation of most of SOEs apparent. Moreover, the enterprise crisis resulted in a very sharp fall in the overall production and undermined the Government's ability to balance the budget, even though most Governments had undertaken very drastic cuts in their expenditures and introduced new tax systems.

The crisis of the enterprise sector became particularly apparent in the banking system. Banks in Hungary and Poland which showed large profits until 1990, started showing large non-performing loans in 1991. In Poland, CSFR and Bulgaria, banks started to allow SOEs to capitalize the interest on their loans as a way of helping them to cope with the crisis. For instance, in Poland the capitalization of interest accounted for 100% of the credit expansion in 1991, and in Bulgaria banks, on average, capitalized about 50%

Table 5
Macroeconomic indicators, nonperforming loans and fiscal costs.

	Hungary	Poland	CSFR	Bulgaria	Romania
Ratio of enterprises' bank credit to GDP (%)					
In end of 1990	25.8	15.6	60.5	78.8	38.6
In June 1991	24	18.4	62.4	47.8	44.6
Real interest rates					
In end of 1990[a]	1.9	−44.4	−32.6	−35.5	−96.8
In 3rd quarter of 1991	8.1	15.6	2.3	−71.9	−31.7
Annual rate of inflation (%)					
In end of 1990	33.4	250	16.6	64	150.1
In June 1991	36	79.9	71.3	554.6	224.9
Memo items					
Estimated ratio of nonperforming to total loans in 1991 (%)	50	40	55	44.2	36.6
Estimated fiscal cost of removing all bank nonperforming loans (in % of GDP)[b]	5.4	6.5	5.6	17.7	22.9

Source: Countries' official statistics and author's estimates.

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

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

of the interest on loans in 1991. In addition, in Hungary, Poland, CSFR, Bulgaria and Romania, SOEs' resorted to inter-firm credit as a way of coping with their illiquidity. At one point, in Romania the inter-firm credit problem became so acute that it trapped both good and bad SOEs and threatened to collapse the enterprise sector had the Government not stepped in.

Initial macroeconomic conditions. Countries' ability to overcome the bad debt problem and to introduce a banking reform was influenced by the initial macroeconomic conditions and, in particular, by the fiscal costs. Yet, in all countries' the proportion of nonperforming loans in total loans was much alike (see table 5). Countries such as Hungary, Poland and the CSFR faced more favorable initial macroeconomic conditions. First, the size of total bank loans (and thus of bad loans) as a ratio of GDP was relatively low and, second, the macroeconomic adjustment programs were more successful. Both of these conditions implied that dealing with banks' bad debts was less costly in fiscal terms. While in Hungary and Poland the total enterprises' loans as a share of GDP was less than 20%, in Bulgaria and Romania these were about 50%. This might be explained by the fact that Hungary and Poland started the banking reform several years before the political opening took place. In particular, the size of the monetary overhang in these two countries was relatively small in early 1990, while in Bulgaria and Romania it was very high. Furthermore, Hungary, Poland and the CSFR were very effective in stabilizing their economies and in subsidising the inflation rates.

The low ratio of total loans to GDP and the successful macroeconomic conditions had two very important consequences. First, the lower inflation rate by lowering the nominal interest rate would reduce the fiscal cost of overcoming the enterprises' bad debt problems. For instance, had governments assumed all bank bad loans, the fiscal cost would have been about 6% of GDP in Hungary, Poland and the CSFR, while it would have been about 20% of GDP in Bulgaria and Romania. While assuming all bad loans would not be advisable, it illustrates the likely effect on the macroeconomic performance. Therefore, the authorities in Bulgaria and Romania were less inclined to provide a bold solution to the bad debt problem and more willing to let the high inflation rates and negative real interest rates reduce the real value of the bad debts. However, this undermined the economic stabilization effort.

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

Schemes for dealing with enterprises' bad loans. Although all the countries introduced schemes for dealing with enterprises' bad debts and for reforming their banking systems, some important differences prevailed. These are summarized in table 4 and what follows is a brief description and their shortcomings.

Hungary followed a gradual approach to the problem of the non-performing loans and tried to differentiate the solution of banks' non-performing loans from the solutions for overcoming the enterprise problem. Until end-1989 the authorities argued that banks were in good financial condition. But this situation started to change in late 1989 when the auditors applied stricter standards in auditing banks and the size of the non-performing loans in the three large banks became apparent.[6]

In December 1991, the Government decided to recognized the problem of non-performing loans in the three large state-owned commercial banks that were carved out from the former monobank. The Government took the

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

following measures: (i) provided Government guarantees on 50% of the three banks' non-performing loans outstanding by end-1987. (Guarantees amounted to Ft 10.5 bn or 1.7% of total bank loans outstanding with enterprises by end-1987.) These guarantees are for five years and callable only upon initiation of liquidation proceedings on the debtors; (ii) exempted from income tax any additional provisions that banks might need to do for writing off the non-performing loans; (iii) limited banks' ability to distribute dividends until the problem of non-performing loans has been overcome; (iv) allowed the large commercial banks to swap its inherited stock of non-performing loans for equity;[7] and (v) accelerated the privatization of banks as a way of attracting new fresh capital into these three banks.

There are two important aspects of the Hungarian scheme. First, the scheme might fail to take full account of the total non-performing loans in these three banks, which according to independent bank audits hovered between Ft 50 bn and Ft 100 bn by end-1991 depending on the criteria used for assessing the collateral of these loans.[8] Second, the scheme links the recapitalization of banks to the effectiveness of the bank managers in dealing with the bad debtors. This has been done by limiting the use of the guarantees to the initiation of liquidation proceeding on the debtors and by forcing the debtors to seek approval of their restructuring schemes from the banks. However as with other countries' schemes, this relies on the effectiveness of the bank managers assessment of enterprises' ability to overcome their difficulties. It is quite possible, as preliminary evidence indicates, that bank managers responded by requesting additional guarantees and granting additional loans to their debtors as a way of improving their portfolio and limiting the required provisions.

In addition and aware that the real problem lies in the enterprise sector, the authorities have decided to accelerate the privatization of enterprises through the appointment of a Minister without portfolio. Although the authorities are committed to their gradual approach and would like to refrain from give-away schemes as a way of accelerating the enterprise privatization, they are increasing the number of enterprises for sale and are providing financial facilities to nationals willing to buy shares of these enterprises. In particular, the National Bank of Hungary (NBH) has introduced a series of refinance credit lines offering a subsidized interest rate (subsidy amounts to 25% of the base rate) as a way of encouraging the purchase of enterprises and the starting of new ones. Moreover, the NBH argues

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

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

that this subsidy will not result in a loss for the NBH because the proceeds will be used to retire Government Debt at 6% interest held by NBH.[9]

Poland in a recent attempt is linking the recapitalization of the nine commercial banks to the restructuring of the SOEs. Although Poland started confronting the problem of banks in 1990, at that time both banks' and enterprises' financial statements showed a very good financial situation and the authorities only dealt with the problem of the foreign exchange losses held by two specialized banks, and amended the regulatory and supervisory framework.[10] In addition, the authorities enhanced the management of the commercial state-owned banks and prepared three banks for privatization. The authorities improved the management through the twining arrangements with western banks and by establishing supervisory boards. But not much was accomplished in terms of the regulatory and supervisory framework.

In 1991, the situation of the enterprises and banks started to deteriorate very fast and, as a result, the economy experienced its second year of recession. Moreover, in mid-1991 the first audits on commercial banks already started showing a rapid accumulation of non-performing loans in some banks. Evidence from bank audits indicated that the proportion of non-performing loans increased from about 15% of total loans in end-1990 to 40% in June 1992. Because this coincided with the enterprise crisis, it prompted the Government to design a new scheme for dealing with both the banks' and enterprises' problems.

Initially, the Government plans to enhance the nine banks' governance by: (i) recapitalizing the nine commercial banks to a 12% of capital adequacy level using 15-years and 5-years of grace Government bonds; (ii) providing the supervisory boards greater influence in controlling and overseeing the bank management; and (iii) introducing a new regulatory and supervisory framework. These nine banks will then participate in the restructuring and privatization of enterprises by offering enterprises a wide range of debt-relief schemes for reducing enterprises financial costs, such as partial debt write-downs and debt–equity swaps. While banks are anticipated to play a key role in enterprise restructuring and privatization, current legislation prevents banks from granting new loans to theses enterprises and limits the maximum volume of enterprises shares that banks can hold to 50% of bank capital. Moreover, banks will provide these debt relief to enterprises that submit restructuring proposals acceptable to them and to an ad-hoc agency (IDA) in representation of the Council of Ministers. Enterprises that become non-

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

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

viable even after debt-relief or whose managers fail to provide a restructuring plan acceptable to the banks, will be forced into liquidation.

However, since the success of the scheme depends on both the ability to limit the social consequences of massive lays off and the speed to privatize the SOEs, the Government has decided to establish a special fund for enterprises whose liquidation might have important social consequences and to accelerate the enterprise privatization. The Government will establish a *limited* fund, sanctioned in the 1993 budget law, for restructuring and/or paying the costs of the enterprises that are considered socially important. These can be enterprises whose liquidation will result in very important social effects, or enterprises that the Government might decide to retain.

Although it is too early to assess the scheme since it has not yet been implemented, a key problem is the ability of bank managers to take independent decision from its debtors. This is the key to success because bank managers are responsible for determining which enterprise is viable and which is not and the amount of financial subsidy that each enterprise will be eligible for. This requires of a very strong corporate governance, like the one that prevails in Japan and Germany. While this is provided through the recapitalization of the banks, it might fail to introduce the 'reward and risk' features that are so common in all market economies' corporate governance structures. In this scheme it is clear that the efficient manager will be able to take advantage of the reward because this will become apparent to all, but in the case of inefficient managers it is not clear that the system is designed to identify him on time or make him subject to paying a penalty for his mistakes. While in a private economy this is provided by the risk for the owner of loosing its capital and of loosing its depositors, in a state-managed bank the manager faces no risk, that is, in addition to the risk of being removed. But even this might be doubtful because there are not enough trained bankers to replace him. Perhaps for this reason the authorities have found necessary to establish a unit in the Ministry of Finance for monitoring the state-owned bank-led enterprise restructurings.

CSFR has set rapid privatization of banks and enterprises as the way to overcome both banks' and enterprises' problems. In May 1992, the Government started the first wave of the Privatization Voucher Scheme by offering 1,491 enterprises for privatization, among which are about 50% of the shares of the two state-owned commercial banks. Moreover, it has put about 50% of the shares of the other state-owned banks in the second wave. The Government plans to use the other 50% of the banks' shares for restitution purposes and for attracting a controlling partner. In the mean time, however, the National Property Fund is retaining these shares.

However, before going ahead with the privatization the Government adopted some measures to deal with the banks' non-performing loans. In some respects the CSFR scheme resembles that of Hungary and Poland. It has provided for a partial bank recapitalization as in Hungary, while relying on banks to identify the viable enterprises as in Poland. Yet unlike Hungary and Poland, has accelerated the privatization as a way of imposing control on both state-owned enterprises and banks. The Government proceeded in two steps.

First, in January 1991, under pressure from banks which complained about the large non-performing loans inherited from the former monobank, the Government decided to remove a portion of the so-called TOZ loans. These were perpetual loans yielding six percent interest and had no amortization schedule. SOEs were compelled to take these loans to relend to the Government, which was experiencing a cash shortage by the early 1970s. To decide the amount of the re-capitalization, the Government asked the banks to determine the TOZ loans that they wanted to be removed from their balance sheets.

In February 1991, of the total Kcs 170 bn of TOZ loans held by the two state-owned commercial banks, the Government transferred Kcs 120 bn in loans and liabilities out of the commercial banks and into to a newly established Consolidation Bank (KON), which had the only function of holding and collecting these non-performing loans. The liabilities transferred were deposits from the central bank, the state-owned insurance companies, and the Savings Bank held by the two commercial banks. Moreover, the transferred loans were retained as claims on the enterprises and the conditions were renegotiated by increasing the interest rate to 13% and fixing the maturity to 8 years. Similarly, the commercial banks also renegotiated the TOZ loans they kept by increasing the interest rate to 22% and fixing the maturity to 5 years.

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

Although the Government had provided the banks with Kcs 170 bn for bank recapitalization purposes (amounting to about 30% of all enterprises' loans outstanding by end-1991), anecdotal evidence and preliminary estimates indicates that state-banks might hold about Kcs 145 bn more of non-performing loans (or about 25% of all enterprises' loans outstanding by end-1991). The Government, however, has indicated its commitment to avoiding further recapitalization of banks because of fiscal constraints. On the contrary, the Government is committed to go ahead with its privatization plans.

But the presence of banks with large non-performing loans inclined to take greater risks together with very liberal restrictions for establishing investment funds for participation in the Voucher Scheme, has established yet a new link between banks and enterprises. As a way of growing out of their difficulties, the former state-owned banks decided to establish their own investment funds and bid for enterprises. But because they have used a separate institution, such as the investment fund, this has limited the negative consequences on banks' portfolios. Evidence indicates that the former state-owned banks' investment funds accounted for a large number of the more than 400 registered investment funds, banks' investment funds made the highest redemption offers and thus banks' funds were the most popular.[11] While it is not yet clear what the state-owned banks' strategy is, it seems that by making high redemption offers they intend to attract a large volume of the vouchers and bid for their client enterprises. This will enable banks to influence their client enterprises market value in the bidding process and have full control of the enterprises' management. Moreover, to overcome the 20% limit established by the investment law that an investment fund can hold of a single enterprise, banks have established several funds. Therefore, bank investment funds mirror the role of investment bank in the pre-1930s US and/or in the pre-1980s Japan.

There are three important aspects of the CSFR scheme. First, it illustrates the complexities of designing a strategy for dealing with banks and enterprises and relying on the efficiency of bank and enterprise managers which are operating in an environment subject to moral hazards. It is difficult to conceive that bank managers in charge of state-owned banks with large non-performing loans will behave as western countries' managers do. Bank managers in these circumstances will always be willing to take more risk. In particular, it illustrates the difficulty of relying on weak financial institutions for imposing control on enterprises, while limiting the role of the state in controlling both banks and enterprises.

Second, the voucher privatization scheme by determining the market value of enterprises will, in turn, determine the true size of banks' non-performing loans and thus, the true value of banks. Moreover, demand for enterprises in the bidding process will determine which enterprises should be liquidated and which should be restructured by their new private owners. This however will have direct impact on banks, since it could become apparent that they are empty shells. However, it is possible that the privatization scheme leads

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

to the selection of an excessive number of enterprises for liquidation and only the real good ones are chosen for restructuring by their new private owners. This might result from biases in the enterprise selection process by investors giving more weight to short-term viability considerations rather than longer-term ones. This could, therefore, determine the failure of most former state-owned banks and in magnifying the social costs of the transition.

Third, banks by resorting to investment funds for imposing control on enterprises banks have, in fact, limited the risk of enterprise ownership and thus the risk on bank depositors. Although the effectiveness of investment funds in controlling enterprises and improving banks' financial condition depends on investment funds' corporate governance, there is evidence that banks have moved in this direction. In fact, former state-owned banks that were privatized have seek technical assistance and establish joint ventures with foreign banks. Moreover, the voucher privatization has facilitated banks' investment funds selection by allowing the market to value enterprises. This presumable provided bank managers an assessment of their own portfolio and thus enabled them to focus on viable enterprises. In this respect, the CSFR scheme is different from the Polish one where bank themselves will establish control on enterprises.[12]

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

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

Concerning the strategy for dealing with banks' non-performing loans, the Government has decided to assume responsibility for *all* bank loans granted by end-1991 by providing Government guarantees on these loans, which amounted to about Lev 46 bn (or 37% of 1991 GDP). The Government will make available these guarantees gradually by fixing ceilings for each year and by linking them to the restructuring and privatization of enterprises. If the amount needed for enterprise liquidation and privatization is less than the ceiling, then the bonds can be used for bank recapitalization based on portfolio reviews. However, since the privatization law is still expected to be passed by Parliament and the progress in privatizing and restructuring enterprises is slow, the Government is allowing the different Government agencies and sectorial Ministries to use the bonds for granting debt-relief based on sectorial priorities. In future, it is expected that the Privatization Agency will be responsible for the coordination.

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

Moreover, since banks' non-performing loans (which were estimated in Lev 17 bn by mid-1991) might lead to bank liquidity problems because of bad debtors not paying interest on the loans, the Government has allowed banks to capitalize the interest on the central bank deposits held by banks (which are distributed among banks in the same way as the non-performing loans). In addition, to prevent debtors from taking advantage of the Government guarantee and to force banks to collect on these loans, the Government has prevented banks from lending to enterprises that fall into arrears with banks.

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

In *Romania*, the Government has focused on overcoming the banks' non-performing loans as a precondition for bank privatization, and, as in Bulgaria, the enterprise privatization is still in a very early stage. The Government has taken three types of measures for overcoming the problem of banks' non-performing loans. First, in July 1991 the Government provided a guarantee on 90% (or Lei 150 bn) on all bank non-performing loans outstanding in end-1990 and demanded that banks take responsibility for the other 10% over a period of several years by building up their provisions.

Second, in December 1991 the Government introduced a scheme for clearing up the accumulation of inter-firm arrears. By end-1991 the magnitude of the inter-firm credits had reached about Lei 500 bn or 40% of total bank loans outstanding to enterprises, which threatened the collapse of the whole enterprise sector since good and bad enterprises were linked to each other through the inter-firm credits. Enterprises which had outstanding bills with other enterprises had until January 1991 to discount them with the commercial banks, which, in turn, should convert them into global compensation bank loans (GCBL) at market interest rates. Bank could get a Government guarantee only for enterprises' loans that become due in September 1992 and provided the creditor bank initiated foreclosure proceeding leading to the liquidation of the debtor enterprise. To accelerate enterprise foreclosure the Government passed the so-called Law 76. While there is no case of enterprise liquidation (because most of GCBL have been repaid), anecdotal evidence suggest that banks refinanced most of the overdue GCBL to avoid foreclosing on debtor enterprises.

Third, in 1993 the Government provided Lei 50 bn in additional funds for bank recapitalization.

Although the measures taken by the Bulgarian and Romanian authorities for dealing with banks' institutional problems have important differences, they are common in their emphasis on re-capitalization of banks as the way of enhancing banks corporate governance. In this sense they resemble some aspects of the Polish scheme and thus, are subject to similar comments. However, unlike the Polish scheme, the link between the bank recapitalization, on the one hand, and bank restructuring and enterprise privatization, on the other, was not clearly defined. In this sense both the Bulgarian and Romanian schemes can lead to an across-the-board debt forgiveness. For instance, in Romania available evidence indicates that because the debt write-off was neither linked to enterprise and/or bank restructuring enterprises, banks granted new loans to these same enterprises. In fact, the end-1990 bank audits suggest that these same enterprises accounted for a large proportion of the post-1990 bank bad loans and for the global compensation overdue loans. The post-1990 bad loans accounted for about two-thirds of the total bad loans outstanding in September 1992 which reached close to 30% of total bank loans.

Differences between Bulgaria and Romania consist: (i) of the differences in the guarantees provided; and (ii) of the measures taken by Bulgaria aimed at reestablishing state ownership of banks.

Concerning the guarantees and compared to the other four countries, Bulgaria stands as the only country that has made an open recognition of all enterprises loans. All other countries have been reluctant to make such acknowledgements because of the fiscal implications that it has. Instead, most other countries have opted for guaranteeing only the proven non-performing loans. For instance, in Bulgaria the total guarantees amounted to Lev 46 bn or 44% of total bank loans outstanding with enterprises by end-1991, while in Romania the Government assistance for bank recapitalization amounted to Lei 200 bn or 10% of total bank loans outstanding with enterprises by end-1991. In Hungary, Poland and the CSFR the Government has agreed to guarantee a smaller proportion of total enterprises loans. While it might be important that the Government recognizes the old bad debts, it is important to link it to the overall objective of enterprise privatization and restructuring since this is the true source of the accumulation of non-performing loans.

3.c. Bank privatization

The five countries have indicated that their final objective with bank restructuring is the privatization of banks. But because of the difficulties faced, few countries have managed to privatize banks. Of the five countries the CSFR has privatized the largest number of banks. One bank was completely privatized through direct sales, while the others were partially privatized through the voucher scheme. Poland however might be close to privatizing two banks. However and except for CSFR, neither of the five countries has conditioned bank recapitalization or any other type of investment in banks to the privatization of banks to a controlling investor as a way of assuring a strong bank governance. Despite this, all five countries see bank privatization as the only way of enhancing banks' corporate governance.

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

Second, for a banking system to behave efficiently in the sense that the good bankers will prevail and that the bad banks will be taken out of competition, a sufficient number of banks with an adequate corporate governance structure is required. This, however, can only be accomplished by having a sufficient number of private banks, that is, bankers whose reward for lending is linked to their ability to minimize risk, and who pay dearly for assuming high risks. When this does not happen, the bad bankers will set the rules of the game and the good bankers will be pushed out of competition.[13]

Third, bank privatization should influence the design of the bank restructuring strategy. Because the objective of any privatization strategy is to maximize the present discount value of the assets subject to being privatized, the authorities should ensure that any investment should be in line with this principle. However, this is difficult in the case of banks because the quality of the bank portfolio, which is the most important asset in a bank, can be subject to different assessments depending on the criteria used. It is very likely that bankers' opinions differ in assessing bank loans. Because the value of a banks' assets is maximized at the time of recapitalization, it is argued that this should only happen immediately upon bank privatization. Moreover, recapitalizing a state-owned bank only has the benefit of making explicit something that was implicit by its condition of being state-owned: that the state is responsible for the banks non-performing loans and the income loses that might be generated.

Although the five countries have not been very successful in privatizing banks, some have followed alternative strategies for enhancing the banking system corporate governance. Interesting examples are the cases of Hungary and the CSFR. Both countries have tried to introduce market discipline in the banking system by encouraging the establishment of banks with a stricter

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

corporate structure. Hungary did this by encouraging the entry of foreign-owned banks and the CSFR by encouraging both foreign and domestic-owned banks. For instance, in Hungary the number of joint ventures increased from 2 in 1987 to 15 in 1991, and the number of commercial non-state-owned banks increased from 2 in 1987 to 11 in 1991. In the CSFR between January 1990 and March 1992, 34 new banks were established.

Although the strategy had the expected effect of enhancing competition, two problems have arisen. First, the new banks and, in particular, the foreign-owned banks, as expected, took advantage of their better position and focused on the less risky activities such as the foreign trade financing activities. Second, while a large number of new banks were established in both Hungary and the CSFR, they accounted only for a small share of the market and could not swing the rules of the game in favor of the good banks and impose market discipline on the bad banks. The large banks holding most of the non-performing loans have dominated bank competition. In addition, while this option has been available to Hungary, Poland and the CSFR, it might not be an option for Bulgaria and Romania not to mention some of the CIS countries since they have received less international attention and have received less foreign investment flows.

4. Efficiency of banking systems: an assessment attempt

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

Because the available information is limited, the conclusions should be taken as preliminary and subject to further analysis when more detailed evidence becomes available on banks' credit allocation between loss-making and profitable enterprises, and to interest rates charged by banks to each of these borrowers. But the fact that this data is not yet available should not inhibit us from making a preliminary assessment of banks' performance. On the contrary, this evidence should enable us to assess the role of banks in the transition and to extract the most important lessons. To limit the data quality problems, I have decided to analyze trends in these variables and to focus on Hungary, Poland and the CSFR, the countries which are more advanced in restructuring their banking system.

4.a. Credit allocation

Using the available information on bank net domestic credit, we can assess the role of banks in the allocation of credit. If banks behave efficiently, they will try to diversify their loan portfolio by lending to new good customers and limiting their lending to the old borrowers that have accumulated arrears with banks and account for most of banks' non-performing loans. Moreover, it is possible to associate this diversification with the allocation of credit between private and SOEs. An increasing trend in bank lending to private sector enterprises should indicate that banks are trying to diversify, in particular, because SOEs account for most of the stock of non-performing loans. This does not mean that all SOEs are nonviable enterprises, but rather that as the private sector develops, banks should be encouraged to lend to and respond to the private sector development by allocating them a greater proportion of their loans.

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

Evidence for Hungary, Poland and the CSFR indicates that banks, on average, have increased their loans to the private sector very fast (see fig. 1). However, this growth in credit to the private sector was less rapid than the growth in private sector activity. In Hungary, the proportion of net domestic credit allocated to private sector enterprises increased from 0.6% of net domestic credit and 2.2% of total enterprise credit in December 1988 to 3.3% and 8.3%, respectively, in December 1991. In Poland, bank credit to the private sector (which includes households) increased from 8.1% of net domestic credit and 9.7% of total enterprise sector in March 1989 to 20% and 23%, respectively, in November 1991. In the CSFR, these ratios increased from 0% in December 1988 to 5.6% and 6.1%, respectively, in November 1991.

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

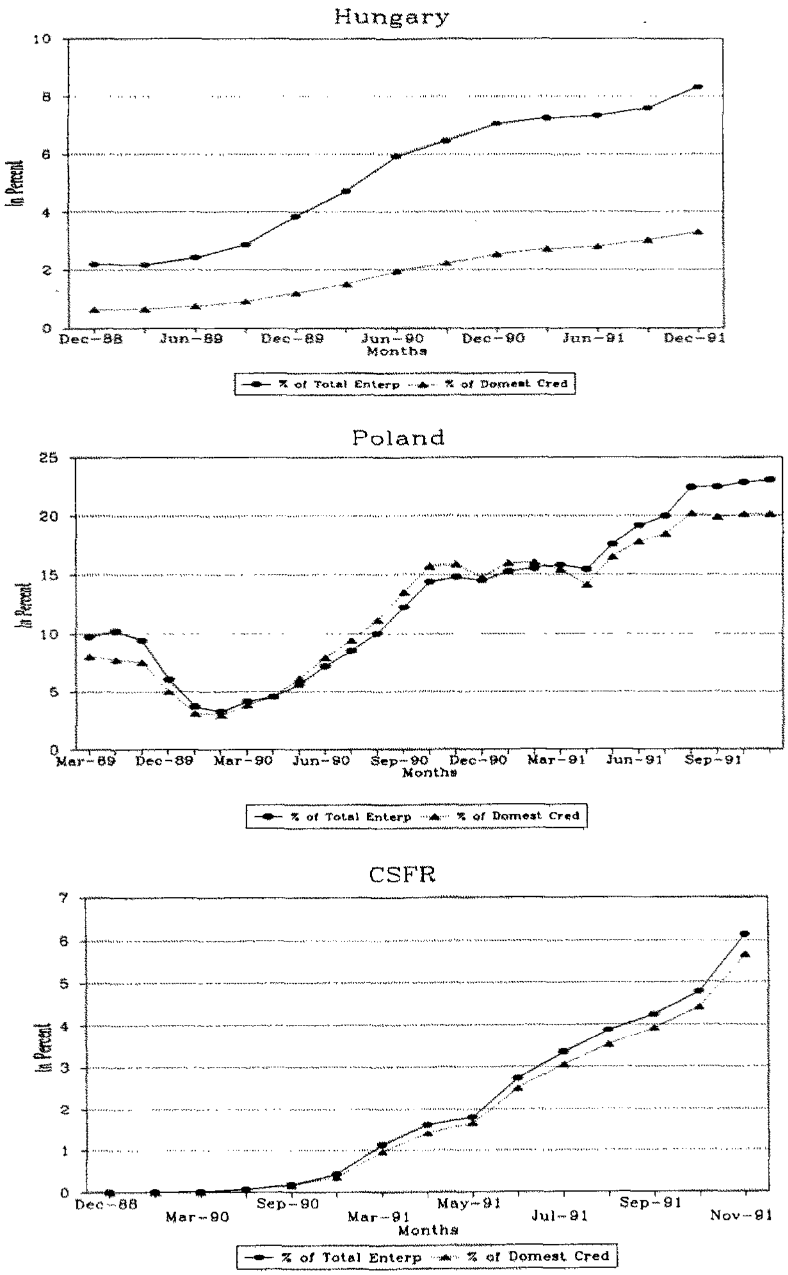


Fig. 1. Credit allocation to the private sector.

Both in Poland and the CSFR, private banks have increased their credit to the private sector faster than the state-owned banks have. For instance, in Poland the private banks have increased their share of loans allocated to the private sector from less than 5% in December 1989, to about 40% in December 1991. In contrast, the state-owned banks (commercial and former specialized) allocated less than 10% of their total loans in December 1991. Similar conclusions are arrived at from the evidence of CSFR's banks. While in December 1991 the non-state-owned banks allocated more than 25% of their loans to the private sector, the large state-owned banks allocated about 5%.

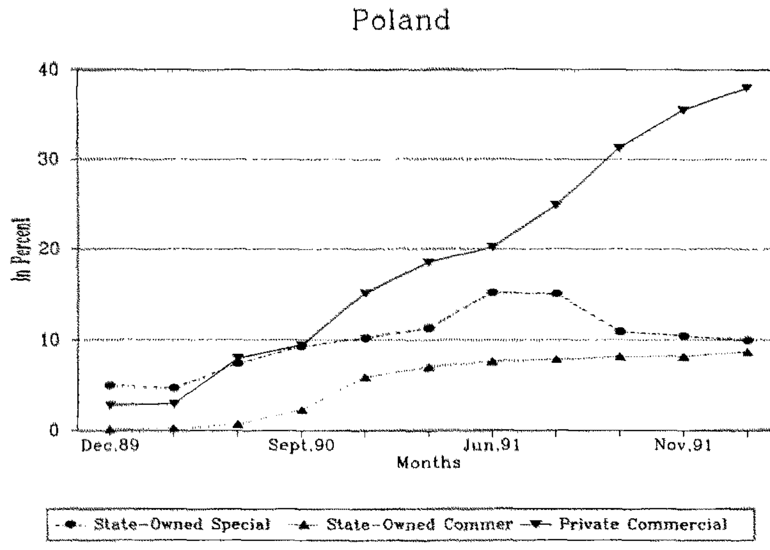
4.b. Real lending rates and interest rate spreads

Comparing Eastern European Banks' real lending rates to those of German and US banks is another way of assessing Eastern European banks' efficiency. If efficient banks dominate in the market, their average real lending will be comparable to that of the German and US banks adjusted for devaluation and risk factors. Moreover, trends in this variable will be very revealing. Efficient domestic banks will charge a lending rate to their prime customers more or less in line with the alternative cost of finance, that is, the international lending rate. This will enable efficient domestic banks to attract low-risk customers. However, differences in the lending rate might prevail if the cost of attracting deposits is higher in Eastern Europe than in Germany and the US.

However, if domestic banks are inefficient because they have a larger proportion of non-performing loans and are subject to high reserve requirements, they will have to charge a high lending rate and/or a large spread to compensate the income foregone as a result of the large non-performing loans and/or the costs of holding high reserve requirements. Moreover, since reserve requirements on commercial banks are relatively low (except for the cases of the Savings Banks and banks in Hungary) the costs of non-performing loans might be the most important cost driving the lending rates and/or the interest rate spreads. These costs, however, will result in high average lending rates (and/or low deposit rates) and interest rate spreads, only if most of the banks or the larger banks hold large non-performing loans.

The comparison of the average real lending interest rates for each of the three Eastern European countries with those prevailing in Germany and the US, are shown in fig. 3. Differences in the real lending rates of each of the three Eastern European countries and those of Germany and the US consist of changes in real lending rates and in real exchange rates.[14] While the

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



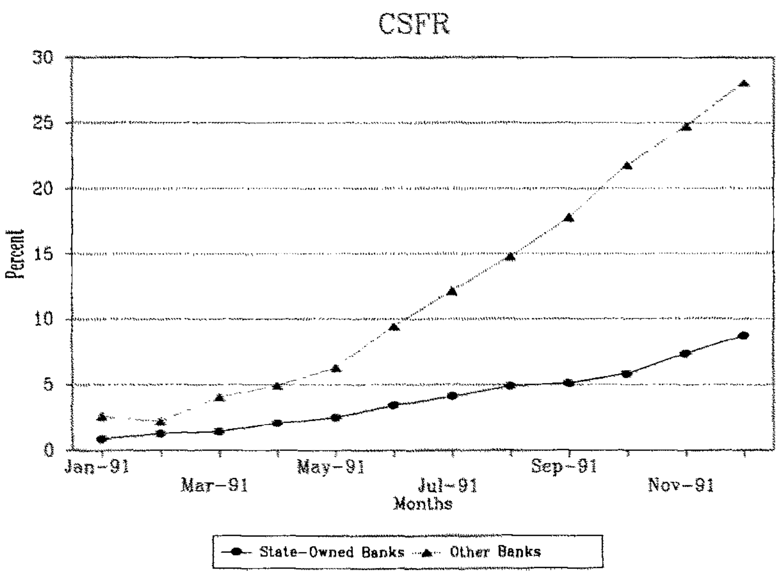


Fig. 2. Allocation of credit to the private sector by type of bank.

evidence is not clear in indicating whether the level of the real lending for these three countries were high or low relative to international standards, the trends are illustrative of banks' policies.

There is a common trend in all three countries for real lending rates to increase relative to international levels. In all three countries the real lending rates increased very fast starting in 1991 and by end-1991 they were higher than those of Germany and the US. This change in the real lending coincides in most countries with particular events. In the case of Hungary the increase in the lending rate in 1991 coincided with the introduction of new bank legislation and the requirement for provisions on banks' non-performing loans. Notice the large difference between Hungarian banks' and German banks' real lending rates in 1991, which was between 5 and 10 percentage points.

In Poland the increase in real lending rates coincided with the SOEs' crisis and the surge in banks' non-performing loans. Polish banks' real lending rates were more than 15 percentage points higher than those of US banks in 1991. This therefore suggests that Polish banks needed to increase their marginal revenue in order to compensate for the revenue forgone as a result of the accumulation of non-performing loans.

In the CSFR, the trends in banks' real lending rates only come close to that of German and US banks by mid-1991. Like in Hungary, it coincided with the introduction of bank legislation and the requirement for provisions on banks' non-performing loans. However, unlike Hungary and Poland, real lending rates in the case of CSFR's banks were very similar to those of Germany and the US.

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

The decomposition of banks' spread by type of bank is also very revealing. In fig. 4 the average bank spread is broken down into the proportion of the average spread taken by a deposit-taking bank, such as the Savings Bank, which lends its resources in the inter-bank market, and the portion of the average spread taken by a non-deposit-taking bank, which borrows from the inter-bank market. This illustrates the situation of the CSFR's banking system, since most of the non-state banks raise their funds by borrowing from the inter-bank market because they don't have a deposit base. This evidence, therefore, indicates that the high spread in the CSFR is explained by the large state-owned banks which need to generate extra income to subsidize their other loans. This is the case of the Savings Bank that has to subsidize the old low-interest loans to the household sector and the low-

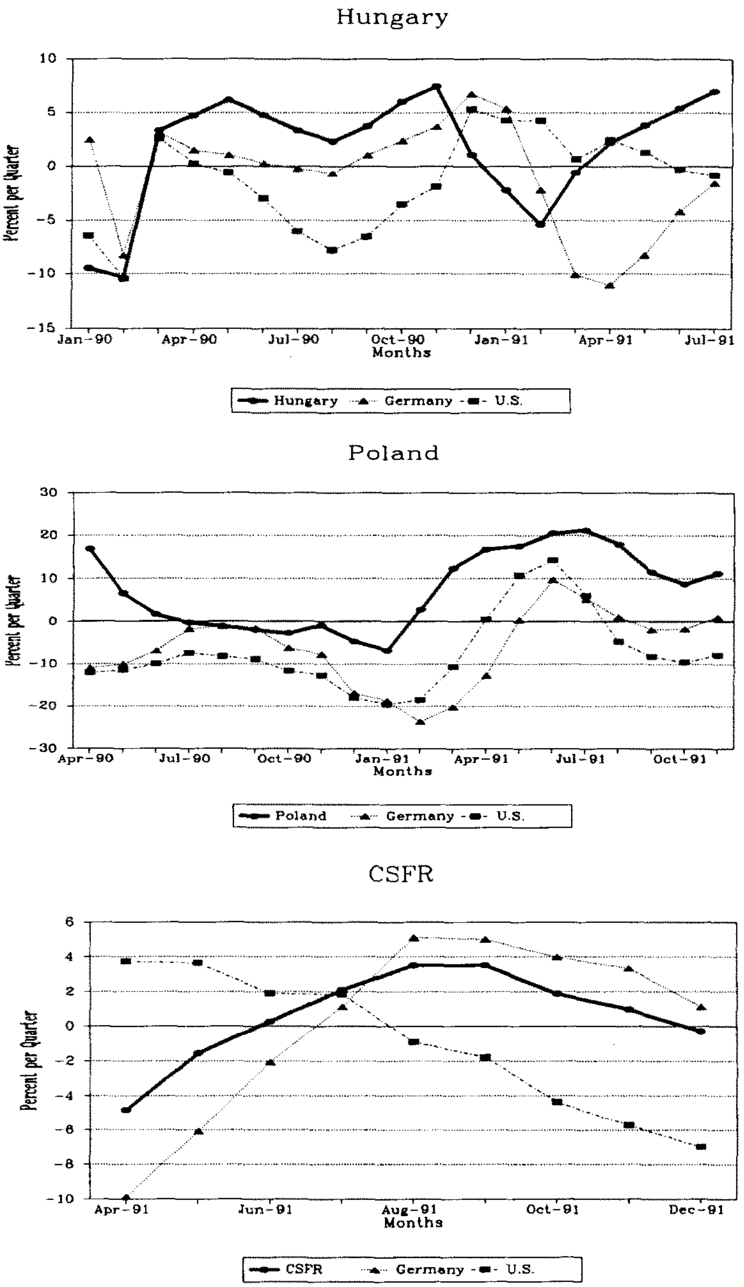
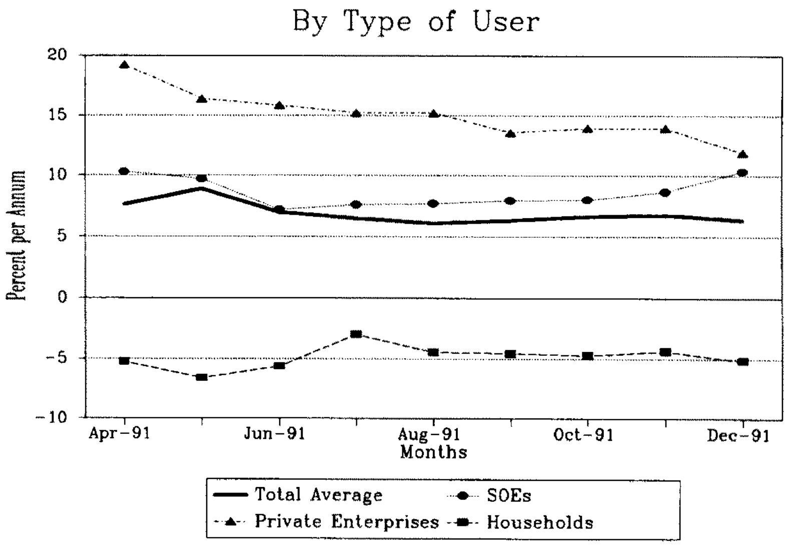


Fig. 3. Real lending rates of Eastern European countries, Germany and the US (in percent per quarter).



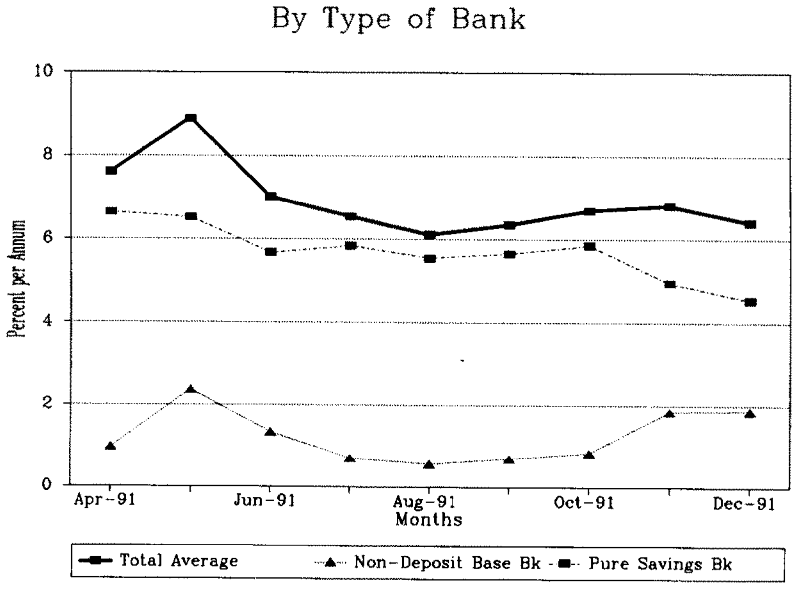


Fig. 4. Decomposition of CSFR's nominal interest rate spreads.

interest funds granted to the other state-owned banks. Although the non-state-owned banks' spread is low, because they have no deposit base and they have to borrow their funds from the inefficient banks, they transfer the inefficiencies of the state-owned banks to their own customers.

5. Conclusions: Are there any lessons?

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

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

First is the relation between the problem of banks and those of the enterprises. It is difficult to pretend to solve the banks' problems without confronting simultaneously the problems of enterprises. In the final analysis, the true problem is not whether banks hold non-performing loans or not, but rather how to prevent further accumulation of non-performing loans. This, in turn, implies that the real problem lies in how to extinguish the loss-making and nonviable enterprises. Moreover, because the past Government experience of subsidizing some enterprises at the expense of some others have led to the present economic crisis a transparent and market-oriented scheme for extinguishing loss-makings is desirable, such as the mass or voucher privatization schemes.

Second is the role of banks in dealing with the loss-making and nonviable enterprises. This is difficult because while the problem of the banks are not unrelated with the problems of the enterprises, it is necessary to grant bank managers enough independence from their customers, the loss-making enterprises. The key question is how fast can the authorities introduce a new bank governance structure which will grant bank managers independence in their credit decisions. It is crucial that banks focus on what banks know best: assessing risk. Here the roles of capital, private ownership and an adequate regulation and supervision are crucial. In fact, the role assigned to banks in the transition should depend on the authorities' ability to provide banks with adequate governance structure. In this regard, few of the five countries have been successful.

Third is the role and timing of bank recapitalization. This is related to the problem of corporate governance and, therefore, to the previous point. The only role of bank recapitalization is to remove the moral hazard problem posed by the presence of non-performing loans. In practice it consists of an *explicit* acknowledgment by the Government of the old non-performing loans. However, this cannot be the true role of bank recapitalization because the Government guarantee on these non-performing loans is *implicit* and recognized in banks' state-owned nature. On the contrary, the objectives of a bank recapitalization should be: (i) to prevent banks from accumulating more non-performing loans, that is, dealing with the enterprise problems; and (ii) to provide banks with a new corporate governance that will prevent them from incurring in new non-performing loans. The most efficient way to introduce the system of risk and reward present in the corporate governance structure of developed countries' banking systems is by making banks comply with the capital adequacy requirements, by privatizing a critical number of banks and by introducing a strong regulation and supervision.

Fourth are the other roles of banks. The complexity in untangling the relation between banks' and enterprises' problems has led some Governments to overlook the other important roles that banks should perform, which are the role of providing an efficient payment systems and the role in the allocation of credit. Banks can become very important in the transition if they become efficient in the payment system and in allocating credit. The innumerable institutional problems that the Governments have confronted in introducing an efficient payment system underlines the need to put greater emphasis on this task, since it is the basis for the development of trust in the banking system. While the role of banks in the allocation of credit is closely associated with the enterprise problem and the Government's ability to provide banks with an adequate governance structure, it also depends on the Government's ability to attract skilled bankers and introduce the necessary procedures for bankers to make risk assessments.

Fifth is the role of regulation and supervision in enhancing banks' governance structure. This is of critical importance. While it appears to be an easy task, in practice it has proven to be extremely difficult. On the one hand is the problem of sequence. Deciding which regulation and supervision to adopt implies knowing what the role of banks should be. The regulation should provide banks the instruments to be able to perform this role. But more importantly, a precondition for introducing the regulation is the decision on bank recapitalization. It is of no practical use for the authorities to enact a new banking law which most of the banks will not be able to comply with.

On the other hand is the problem of upgrading the skills of bank supervisors. This requires complicated technical assistance and strong collaboration from western countries. While most of the five countries have benefited from this strong collaboration, in practice, countries have found it to be a difficult task. It requires time to retrain bank supervisors capable of efficient on-site and off-site bank supervision.

Sixth is the presence of banks with a large proportion of non-performing loans and which account for a large portion of the market. When these are not controlled, credit resources are misallocated. It is common for these banks to grant more credit to borrowers that have accumulated non-performing loans and to increase the average bank lending rate and bank average spread. This usually has negative consequences on the economy because the good borrowers which need credit for increasing their production are either crowded out from the financial system or have to pay a very high interest rate. Preliminary evidence on some of the five countries analyzed confirm this assertion. Moreover, while some countries have tried to limit the extent of credit misallocation by encouraging the entry of new banks, because the banks with non-performing loans dominate in the market the new banks have been unable to change the large banks' behavior. However, preliminary evidence suggests that the new banks are more efficient both in terms of credit allocation and in terms interest rate spreads charged.

This evidence strongly supports the need to recapitalize and privatize a critical number of banks. Moreover, it would be desirable to privatized banks by selling a controlling stake to a group of private investors as a way of attracting new capital (foreign and domestic) into the financial system and establishing a strong bank governance. In fact, the combination of both recapitalization and privatization of banks is optimal because it assures a strong bank governance. The exact number of banks to be recapitalized and privatized will depend on the number of banks needed for reestablishing market discipline and enhancing bank competition. While shrinking (by canceling both non-performing and household deposits[15]) or removing banks with large non-performing loans from the market will be optimal, in the case it is not feasible a strong domestic competition by a critical number of private banks with adequate levels of capital should reestablish the market discipline and prevent large banks with non-performing loans to dominating in the market.

The most important conclusion from the analysis of the five Eastern European experience is that banks play a very important role in the transition. However, all five countries have found difficult to rely on banks because of the difficulty of providing them with an adequate corporate governance. In fact, banks have proved to be weak institutions and that time is needed for the authorities to provide banks with an adequate governance structure. This leads to a key conclusion, that the authorities cannot rely at the early period of the transition on banks to exert direct or indirect control on enterprises. Direct by participating in enterprises supervisory boards and indirect by allocating credit. In the early period and while the authorities provide banks with the needed corporate governance, the control over SOEs should be exerted through a semi-public institution like the Treuhandanstalt

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

in East Germany, the State Privatization Agency in Hungary or the National Property Fund in the CSFR.

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

As the Government provides banks with an adequate corporate governance through their recapitalization, privatization and by introducing new regulation and supervision, the Government will be able to rely on banks to exert control over enterprises. Initially, banks' control over enterprises has to be indirect through credit allocation and in close collaboration with the semi-public institution in charge of enterprises restructuring and privatization. Only when banks are provided with a strong corporate governance will they be able to participate directly in controlling enterprises. Whether banks direct control over enterprises should be performed by special investment banks, like in Hungary and CSFR, or universal banks, like in Poland, Bulgaria and Romania, should depend on the Government's decision and on the best way the Government can provide banks with a strong corporate governance that will assure bank's independence in their credit decisions.

My personal preference would be that during the transition only investment banks should specialized in controlling enterprises. This should limit the effect of bank failure on the rest of the financial system and on depositors, while allowing banks to contribute to the development of the enterprise sector by allowing them to take greater risks. In a way this is the option taken by CSFR. However, to be effective this would need a scheme for valuing enterprises and their loans, such as the voucher privatization or by auctioning the bad loans as I have proposed elsewhere.[16]

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

[16]See Coricelli and Thorne (1992).

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