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Part A: Establishment of an effective financial intermediation mechanism

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Financial sector development[1]

In the shortage economy the absorption of the excessive liquidity of households and the provision of financing for a production sector controlled by the central planning allocation mechanism were very critical problems. Only later, in the reformed economies of Eastern Europe and in China and Vietnam, were banks used as core institutions through which governments might try to impose hard budget constraints on state-owned and private enterprises.

A banking system which serves business and household economies efficiently is essential everywhere, and the structure of the banking system is very important. Sound commercial banks are a prerequisite in the effort to guarantee competition. Privatization cannot succeed if it is not backed by a supportive competitive climate, which is not feasible as long as there is no solid banking system.

The successful overhaul of the banking system calls for the privatization of state banks. The saleoff of assets to strategic domestic and foreign investors and deregulation permitting the operations of foreign banks may help, but they do not respond to the pressing need for bank recapitalization. Because of the contraction, banks were being stripped of their assets; and, as the economy shrank, there was no way to avoid severe losses in the banking sector. The process of consolidation and recapitalization is always costly for the budget; hence it ought to be initiated together with the reforms in the fiscal system. When these steps must be undertaken, output is still declining or has only recently begun to recover. Savings are scant; the adequacy ratio is too low, and capital is insufficient and ‘deconcentrated’. The need

[1] Excerpts from Grzegorz W. Kolodko, “From Shock to Therapy. The Political Economy of Postsocialist Transformation”, Oxford University Press 2000, Chapter 8.4, pp. 187-191.

to recapitalize in a situation in which capital is insufficient is another vicious circle which must be broken during transition.

In Russia in the mid-1990s there were about 2,500 banks, only a small portion of which could be considered reliable. Since then bank consolidation has been advancing speedily, particularly among the larger Moscow-based banks. A special bankruptcy law has been adopted by parliament, and many banks qualify for restructuring under this law. Since then, the process of bank restructuring has apparently been gaining momentum.[2] However, this occurred too late to avert the spectacular crisis in the summer of 1998.

In Poland, due to a special government bank consolidation programme initiated in 1993, less reliable banks, of which there were many, began to disappear, and the relative number of more dependable banks grew. The quality of banking services for businesses and households rose as well. Gradual privatization and an orderly process of increasing openness toward foreign banks facilitated further enhancements and improved the corporate governance of banks and of companies to which banks were lending.

In the Czech Republic, the banking sector became caught up in crisis owing to the mismanagement of a mass privatization programme and the lack of proper banking regulations. Banks had been more involved in speculative acquisitions and mergers than in commercial lending or financial consultancy for the restructuring of privatized companies. Efficiency and output were not being raised, and the economy was losing momentum and was stagnating. Only in 1998 was an appropriate law adopted for the regulation of the financial sector.

In Bulgaria in 1996-7 the banking crisis was so severe that the whole course of transition policy had to be detoured. At the insistence of the IMF, several banks were closed, and a currency board was introduced. In January 1998, for the sake of transparency, a list of bad debtors was published.

The restructuring of portfolios of outstanding debt is important, too. These debt portfolios were not a legacy of the centrally planned economy, but appeared as a by-product of transition. Contraction and the attempts to stabilize the economy through austere monetary measures led to an increase in non-performing debt. Given that restrictive interest rates were imposed not only on new credit, but on old credit as well, it should hardly come as a surprise

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[2] See Bernstam, Michael S. and A. Rabushka. 1998. Fixing Russia's Banks: A Proposal for Growth. Stanford, CA: Hoover Institution Press. The OECD 1997 survey on Russia is excellent on the then current Russian banking system (see 'Russia 1997'. OECD Economic Surveys. Paris: Organization for Economic Cooperation and Development).

that many debt-ridden companies soon became insolvent. Later, they tried to save themselves by taking advantage of mounting inter-enterprise arrears[3]. Many companies experienced a sudden switch from excessive liquidity to insufficient liquidity, and this had negative consequences for capacity utilization, employment, and output.

Recapitalization has been carried out in various ways. In Poland banks have been obliged to forgive, restructure, lend to, or bankrupt their debtors. In the Czech Republic loss-making enterprises have been assigned to an agency which then attempts to recover some of the bad loans. The Czech currency crisis of mid-1997 and its harmful influence on growth suggest that the Polish approach may have been more effective. Although in Poland the banking sector was far from perfect, it recovered. In contrast, in the Czech Republic not only the banking sector, but the entire capital market was driven back onto the ropes.

Meanwhile, in Albania, Bulgaria, and Romania the situation has been still more difficult. In Hungary there has been progress, though numerous major banks have become entirely dependent on foreign capital. Such dependency highlights the danger of excessive injections of foreign capital, which, however, may relieve the problem of recapitalization. This sort of dependency is a more sensitive issue in the banking sector than it is in non-financial sectors.

The road leading to the liquidity of the entire banking system and to healthy individual banks without a resurgence of inflation is very bumpy and not always very direct. Gradual privatizations, the upgrading of corporate governance, the injection of fresh capital, and Treasury-assisted debt-to-equity swaps between banks and companies do help, but the difficulties remain quite serious. One dilemma is the fact that bank recapitalization and the elimination of inter-enterprise arrears are only possible if there is sufficient capital. Unless it becomes available because the economy is already growing, such capital must be supplied from elsewhere. So far, foreign assistance – despite all the statements to the contrary – has been minor, although the banking sector (along with energy and telecommunications) is a favorite target of big foreign investors in transition economies.[4]

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[3] Selowsky, Marcelo and Matthew Vogel, "Enterprise Credit and Stabilization in Transition Economies: Present Experiences and Stabilization in Transition Economies". Conference paper presented at 'First Dubrovnik Conference on Transition Economies', Dubrovnik, 8-9 June 1995.

[4] One needs only compare the total lending provided to transition economies by the Bretton Woods institutions and the EBRD (and the relatively small engagement of private capital in bank restructuring and recapitalization) with the remarkable sums invested in the attempt to bail out the Asian countries. The $10 billion provided gradually under tough conditionality by the IMF and the World Bank to Russia between 1991 and mid-1998 is dwarfed by the rescue

As bank consolidation advances and the economy begins to expand, commercial and investment banks are able to absorb growing savings. By borrowing for profitable ventures and investing in other financial intermediaries, these banks contribute to the efficient allocation of savings, and the savings add to capital formation.

Yet, the overhaul of the banking system is only part of the story of the development of the financial sector. Another important chapter is the establishment of capital markets.

Postsocialist nations have opted for a course whereby the core of the financial sector is being taken over by the banks. The stock exchange is of relatively minor significance. Even in the most advanced economies the capitalization of the stock exchange is rather limited. For example, in Hungary and Poland it does not exceed 10 per cent of GDP, although about three-quarters of the output of these two countries is being produced by the private sector. In the countries considered advanced in the transition process by the EBRD, that is, in Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia, the share of foreign capital in the stock exchanges is 20 to 30 per cent (during a bull market, of course), in contrast to the situation in the whole economy, where the share of foreign capital is very small.

In Croatia and Estonia there is a structural bias on the stock exchange since the financial sector is 'overbanked', meaning that the banks listed on the stock exchange account for about one-third of overall capitalization. The activities of financial intermediaries are still limited in Georgia. In Russia banking regulations and bank supervision were enhanced in response to the East Asian crisis, but this came too late, and the banking sector went into severe crisis. In Bulgaria the first major bank was privatized only in 1997, and the stock exchange started to operate in October of that year. In Hungary over 80 percent of the banking sector is in foreign hands, and the stock exchange has been flourishing for several years already. In Poland the major banks are profitable and well capitalized and close to 70 percent of the banks is already also owned by foreign investors. In Turkmenistan the banking sector is still burdened with non-performing loans. In Moldova higher minimum capital requirements for banking have been enforced since 1997. In Tajikistan asset liquidity continues to deteriorate. Thus, the health and regulatory environment of the banking sector in postsocialist economies are not like those in Ethiopia, nor are they like those in Switzerland. They remain in transition.

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package of almost \$20 billion for Thailand, about \$43 billion for Indonesia, and over \$58 billion for South Korea.

The stock exchange also functions as a useful vehicle for privatization schemes. In this role, it has significance for technical purposes, such as the saleoff of state assets through public offers, but also as a substantial means of demonstrating to people how capital and the market work. Yet, perhaps the cost of some of this educational process has been too dear, and perhaps not enough people are learning the lessons well. The huge price fluctuations – greater than any in developed market economies – have beguiled many individual investors and then ruined them, and the speculative manoeuvres of big investors, mainly the institutional ones, have sometimes rendered these markets too vulnerable.