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ECONOMIC TRANSFORMATION AND THE REFORM OF THE FINANCIAL SYSTEM IN CENTRAL AND EASTERN EUROPE

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ABSTRACT

Economic Transformation and the Reform of the Financial System in Central and Eastern Europe*

The paper investigates those aspects of economic transformation and long-term economic development where financial institutions can and should make a contribution. It also investigates the financial services industry as a sector and tries to point out the conditions which can enable financial firms to perform these tasks properly. Banks, or any other financial firms, will become competitive and innovative only if the market conditions force them to do so. On the other hand, they will be unable to compete if they themselves do not have proper access to resources, production technologies and the appropriate infrastructure, and a supportive legal environment to carry out the necessary product and technology innovation.

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NON-TECHNICAL SUMMARY

The reform of the financial system is one of the most frequently discussed issues of economic transformation in Central and Eastern Europe. Papers touching upon this issue agree almost uniformly that the lack of a properly-designed and well-functioning financial system is one of the major obstacles to relatively fast economic transformation in the region. On the other hand, by creating a competitive and innovative financial system, the reform of the financial system is expected to make a substantial contribution to the solutions to a large number of difficult problems.

The banking sector is expected to deal with the bad loans inherited from the past, and eventually to find a relatively painless solution for writing off these debts. Banks are also expected to take part actively in the process of enterprise restructuring and privatization, and eventually to become the most important institutions exercising control over (private or public) enterprise management. Naturally, banks are also expected to be able to increase the efficiency of credit allocation by improving their abilities to evaluate credit applications. The financial system, in particular banks, is supposed to play a crucial role in providing the financial services for small and medium-sized firms in order to improve their market positions on domestic and foreign markets, thus decreasing the extremely high level of concentration inherited from central planning.

On the other hand, the financial system, and again in particular banks, is charged with the task of collecting the saving necessary to finance restructuring from financial investors. To this end, they have to create a modern retail sector and create the necessary financial instruments which meet both the financial investors' and borrowers' preferences. This involves a massive overhaul of high street banking which was present only in a very primitive form in centrally-planned economies, and a fast expansion of branching networks.

In a nutshell, the financial services industry in Central and Eastern Europe is expected to increase its supply of financial services at an unprecented pace and eventually become one of the dynamic sectors creating economic recovery in the region. In fact, a rapid increase in the share of this industry in GDP and employment can be expected. The question is whether this expansion will be rapid enough, and whether this sector can fulfil the high expectations. This requires an investigation of the necessary conditions under which such a rapid development can take place, and which ensure that the outcome of this process will be a truly competitive and innovative financial system.

This paper investigates those aspects of economic transformation and long-term economic development where financial institutions can and should make a contribution. It tries to identify the problems for which financial institutions can

play an active role in seeking solutions. It also investigates the financial services industry as a sector, and tries to point out the conditions which make financial firms able to perform these tasks properly. Banks, or any other financial firms will become competitive and innovative only if the market conditions force them to do so. On the other hand, they will not be able to compete if they themselves have not got a proper access to resources, production technologies and the appropriate infrastructure, and a supportive legal environment to carry out the necessary product and technology innovation.

Economic transformation in Central and Eastern Europe entails several steps, not necessarily separated by time. Financial institutions have important roles in each of them. This paper follows a possible grouping of these steps: (a) dealing with the legacies of the past; (b) establishing and maintaining a stable macroeconomic environment; (c) laying down the foundations of a market economy and a competitive economic environment; (d) restructuring and expanding production; (e) reorientation of foreign trade and (re)integration of these economies into the European and world economy.

0 Introduction

The reform of the financial system is one of the most frequently discussed issues of economic transformation in Central and Eastern Europe (see, e.g., Kessides et al., 1989, Brainard, 1991a, 1991b, McKinnon, 1991, Kemme and Rudka, 1992, Mullineux, 1992). Papers touching upon this issue agree almost uniformly that the lack of a properly designed and well functioning financial system is one of the major obstacles to a relatively fast economic transformation in the region (e.g., Calvo and Fenkel, 1991a, 1991b, Long and Sagari, 1991, Balassa, 1992, Jindra, 1992, Mladenov, 1992, Rudka, 1992, Várhegyi, 1993). On the other hand, by creating a competitive and innovative financial system, the reform of the financial system is expected to make a substantial contribution to the solutions to a large number of difficult problems. The banking sector is expected to deal with the bad loans inherited from the past, and eventually to find a relatively painless solution for writing off these debts. Banks are also expected to take part actively in the process of enterprise restructuring and privatization, and eventually to become the most important institutions exercising control over (private or public) enterprise management. Naturally, banks are also expected to be able to increase the efficiency of credit allocation by improving their abilities to evaluate credit applications. The financial system, in particular banks, is supposed to play a crucial role in providing the financial services for small and medium size firms in order to improve their market positions on domestic and foreign markets, thus decreasing the extremely high level of concentration inherited from central planning.

On the other hand, the financial system, and again in particular banks, is charged with the task of collecting the saving necessary to finance restructuring from financial investors. To this end, they have to create a modern retail sector and create the necessary financial instruments which meet both the financial

investors' and borrowers' preferences. This involves a massive overhauling of high street banking which was present only in a very primitive form in centrally planned economies, and a fast expansion of branching networks.

To sum up, the financial services industry in Central and Eastern Europe is expected to increase its supply of financial services at an unprecedented pace and eventually become the engine of economic recovery in the region. In fact what one can expect in the region is a rapid increase in the share of this industry in GDP and employment. The question is whether this expansion will be rapid enough, and whether this sector can fulfil the high expectations. Put differently, one has to investigate the necessary conditions under which such a rapid development can take place, and which ensure that the outcome of this process will be a truly competitive and innovative financial system.

The present paper concentrates on the role of the financial system in the process of economic transformation and in long term economic development. It investigates those aspects of economic transformation and long term economic development where financial institutions can and should make a contribution. It tries to identify the problems for which financial institutions can play an active role in seeking solutions. It also investigates the financial services industry as a sector, and tries to point out the conditions which make financial firms able to perform these tasks properly. Banks, or any other financial firms will become competitive and innovative only if the market conditions force them to do so. On the other hand, they will not be able to compete if they themselves have not got a proper access to resources, production technologies and appropriate infrastructure, and a supportive legal environment to carry out the necessary product and technology innovation.

There are several issues not touched upon by the present paper. Though these are very important and interesting issues in themselves, their natures are somewhat different from those of the problems discussed here. In addition, in the early phase of economic reforms they attracted somewhat more attention by researchers and policy makers; there is therefore a fairly large body of literature dealing with them. Thus, the present paper does not explicitly deal with issues related to central banking (see, e.g., Corrigan, 1990, Kemme, 1991, Kemme and Rudka, 1992), monetary and exchange rate policies (see, e.g., Tarafás and Szabó, 1985, Ábel and Szalkai, 1987, Hagelmayer, 1987, Oblath, 1988, Halpern, 1989, Szentgyörgyvári, 1991, Estrin et al., 1992, Riecke, 1993, Kemme and Rudka, 1992), convertibility (see, e.g., Portes, 1991), political pressure on financial institutions, in particular on banks (see, e.g., Várhegyi, 1993), involuntary inter-enterprise, involuntary trade credit and arrears (see. e.g., Ábel and Bonin, 1991, Begg and Portes, 1992, Caprio and Levine, 1992), foreign indebtedness and international finance (see, e.g., Oblath, 1993, Riecke, 1993). Though the legacies of the past is a central issue of the paper, it does not discuss in detail the way financial systems developed under central planning and in the pre-transition period. In this respect too, the reader is referred to a rich literature (see, e.g., Podolski, 1973, Zwass, 1979, Portes, 1970, 1983, Tardos, 1987, Kessides et al., 1989, Székely, 1990a, Blejer and Sagari, 1991, Boote and Somogyi, 1991, Corbett and Mayer, 1991, Fischer and Gelb, 1991, Kemme, 1991, Estrin et al., 1992, Kemme and Rudka, 1992)

Economic transformation in Central and Eastern Europe entails several steps, not necessarily separated in time. Financial institutions have important roles in each of them. A possible grouping of these steps is the following. (1) Dealing with the legacies of the past; (2) establishing and maintaining a stable macroeconomic environment; (3) laying down the foundations of a market economy and a competitive economic environment; (4)

restructuring and expanding production; (5) reorientation of foreign trade and (re-)integration of the Central and Eastern European economies into the European and world economy.

1 Dealing with the legacies

From the viewpoint of our discussion, the main legacy of the past is the large amount and share of low quality assets and the irrational ways[1] of bundling these assets. As a result, financial institutions, mainly commercial banks, have low quality asset portfolios. The low quality of the portfolios stems from the low quality of individual assets and also from the very high risk concentration. Due to the ways commercial banks were created in Central and Eastern European economies (see, e.g., Bácskai, 1989, Székely, 1990a, Blejer and Sagari, 1991, Balassa, 1992, Estrin et al., 1992, Jindra, 1992, Mladenov, 1992, Rudka, 1992, Várhegyi, 1993) they would have had low market values even without the bad loan problem discussed in detail below. High exposure to a small number of industries, to borrowers whose abilities to service their loans are highly positively correlated, makes a bank's market value low even if those industries where its borrowers are concentrated are crisis free. Naturally, during a reorientation of economies at an unprecedented scale such banks are bound to experience serious problems in collecting due receivables.

Another form of low quality assets accumulated in large amounts in many Central and Eastern European countries is the concessional mortgage loans. The precise nature of the problem is different depending on the way the problem was approached in different countries[2], but the origin of the problem is the same, financial repression (stipulated interest rates) and segmentation (of retail and wholesale banking).

In the second part of this section, we discuss in detail two aspects of low quality assets and improper asset bundling, the problems of bad loans and concessional mortgage loans.

The other main legacy of the previous economic system is the highly segmented and over-concentrated nature of financial systems. Central planning, due to its very nature, led to financial repression, over-concentration and segmentation[3] of financial markets. Due to the importance of the latter issues in creating a competitive economic environment, and within this a competitive financial system, and to the fact that financial repression, and the consequences of it mentioned above are not exclusively confined to central planning, we leave the discussion of these issues to Section 2.3 dealing with the foundation of a competitive environment.

The overwhelming amount of public debts in many Central and Eastern European economies is also an important part of the legacies, being of high relevance to the reform of the financial system. If the public debt is monetized, the resulting inflation and rather hectic macroeconomic environment have devastating repercussions on the financial system. If it is financed from domestic capital markets, the crowding-out effect becomes the main issue. The crowding-out effect can emerge even when the public debt is financed from foreign capital markets, but the loan or security is not directly issued by the government, but rather by the central bank.[4] The origin of the problem in this case is that the state does not pay market rates on its liabilities (which are the assets of the central bank), thus the central bank is forced to either over-price its other assets, that is basically tax the business sector, or under price its liabilities and through financial repression force retail and/or commercial banks to hold these under-priced instruments (for them, assets). This in turn forces these banks to under-price their liabilities, that is the assets of financial investors. In the latter case financial savings are

drying up, or are forced outside of the official system.

1.1 The problem of bad loans

The most tangible legacy of central planning in the financial sector is the problem of **bad loans.** Central allocation of financial resources naturally led to the accumulation of low quality assets. Moreover, due to the asymmetric distribution of information resulting from the functioning of the system, central planners were never really in a position to be able to accurately asses the quality of these assets. Not surprisingly, the quality of enterprise loans, and consequently, the precise extent of the bad debt problem[5] were thus largely unknown until the commercial banks inheriting these loans started to operate in a somewhat more market-like manner and the emerging competition due to the opening up of the economies started to reveal vital price information on the products of those industries where substandard loans were concentrated.

Though it is not clear why central planners chose debt finance versus equity finance for their firms, the actual outcome is that the financial system is stuffed with substandard, dubious and bad loans. Though it is again not clear why the same central planners decided to transfer these loans into the portfolios of the newly created commercial banks, the problem we face in many Central and Eastern European countries is that commercial banks desperately need to restructure their loan portfolios.

Naturally, the bad debt problem exists irrespective of whether these loans have been transferred to the newly created commercial banks (as in Bulgaria, Hungary, Poland, Romania, and in the first place in the former Czechoslovakia[6]), or they have been put into a consolidation bank (as in the case of the perpetual loans in Czechoslovakia after the vehement protest of the enterprises concerned, see Vojtisek, 1992).[7]

However, this choice had a profound implication for the functioning of the whole banking system. The large state owned banks which had these loans in their portfolios dominated the corporate loan market and were thus the price leaders in these markets, establishing a practice of loan pricing which naturally reflected their large holding of substandard assets. Consequently, the whole corporate sector was implicitly taxed to recover the losses on these loans and pricing in corporate lending became highly distorted.

The losers are clearly the emerging small and medium size private enterprises for which the cost of debt finance became unbearably high (Caprio and Levine, 1992, Begg and Portes, 1992). Put differently, the crowding out effect already pretty strong due to the soaring budget deficit was further amplified by this way of financing the write down of bad loans. That is, there is another example which shows that the way in which the legacy is dealt with in Central and Eastern Europe has profound implications for the success of economic transformation and for longer term economic development.

Moreover, mid-size banks not holding substandard assets could to some extent capitalize on the high lending rates. Evidence on interest rate spreads shows that these banks quickly caught up with the large banks in this respect. That is, instead of trying to increase their market shares by offering better terms, they cashed in on the situation.

Who should be charged with the task of solving the bad loan problem? Are the large (directly or indirectly) state-owned commercial banks well placed to deal with the issue? What should be the form and extent of state involvement, and how much of taxpayers' money should be devoted to such an operation? How should one allocate the public finance made available to the operation and minimize costs?

The literature mentions several possible technical solutions to the problem (see, e.g., Caprio and Levine, 1992), but few complete packages have been worked out so far. Begg and Portes (1992) offer a well designed and sequenced policy package to deal with the issue. Their answers, in our interpretation, are that (a) the banks are not to be given the job (because of the management control problem), but it should rather be undertaken by the state[8]; (b) the loans should be transferred back at face value and any recovery of the losses should be attempted by the state in a later phase when these firms are privatized; (c) there is no allocation problem at this stage, as loans are 'bought back' at face value, that is banks are fully compensated. From our viewpoint, it does not really matter how the finance is raised, or whether the banks are given cash or bonds[9], though, it is worth mentioning that when these loans were transferred banks were also provided with refinance credit, which should also be withdrawn at this stage.

The above package is probably an optimal (least costly) solution in countries where (a) the first wave of financial reforms was carried out not long ago, and thus commercial banks have gathered hardly any insider information about the firms involved; (b) banks were not forced to asses the quality of their assets and to provision accordingly; (c) banks are really poorly managed and bank managers have no personal stake in their ventures. However, countries where the situation concerning the above issues is markedly different may want to pursue other policies. The development in Central and Eastern Europe so far clearly showed that the same problems can and should be addressed in different ways in different countries, and alternative solutions should always be considered.

We put forward a proposal[10] which might be thought to suit countries (namely Hungary and perhaps Poland) where (a) reforms started much earlier; (b) the financial system is more developed

and banks have already gathered a great deal of insider information about the firms with substandard loans; (c) banks have been obliged to assess the quality of their assets and provision accordingly; (d) privatization is a clear (and very likely to be the fastest and thus the most attractive) career path for management.[11]

Though the way the large commercial banks holding these assets were created contradicts any principle of asset bundling (concerning, e.g., risk and liquidity management), it had one clear logic. Loans were transferred to banks where the loan officer who had dealt with that industry was assigned to.[12] This insider knowledge about firms - partly inherited, partly accumulated during the last couple of years, an information which due to several reasons is very costly to gather and not readily available to anybody else outside the firms concerned - may make these banks an able candidate for this job.

A large state factoring body is an option in these countries as well. Administrative bodies, however, very rarely possess the insider information mentioned above. The most likely thing a state factoring firm would do is to contract out to consulting firms the job[13] of evaluating the market values of the loans (or the liquidation values of the firms involved) transferred into its portfolio. For these firms, it would take a considerable time and would be rather costly to gather this information.[14] Naturally, the moral hazard such a procedure is thought to tackle is a serious issue, but it is somewhat questionable whether eliminating it is worth any price.

That is, in these countries, commercial banks are well placed (some of them perhaps even the best placed) institutions to try to tackle the issue. This is however not meant to suggest that there should be no competitive pressure on them and a mechanism to eliminate moral hazard to the extent possible, but there is perhaps an alternative mechanism to ensure these. There are basically three

problems involved: (a) How to force banks to reveal the information they have on the market values of these loans (on the liquidation values of the firms involved)?; (b) How to force banks to reveal the extent to which they are willing to contribute to the losses incurred? (c) How to design a mechanism which enforces the participants to minimize the costs of the operation?

Besides public money, banks previously holding these loans should, and for several reasons are willing to, contribute to the costs of write-offs. First, because these are frozen assets, that is, there is an enormous opportunity cost involved. In a period when markets are vigorously contested by new entrants this can be really very high. In addition, there is an enormous opportunity cost due to the fact that these banks, because of the bad loans, are seriously inhibited in building up business contact with newly emerging private firms[15] ('the partners of the future'). Second, these banks are not always fully directly owned by the state. The cleaning up of the portfolios would most likely substantially increase the market values of the equity holdings of the other owners. Third, these banks have already accumulated substantial general and risk reserves (partly at the expense of profit tax and dividends due to the state, that is, implicitly from public money). Finally, bank managements have also got large personal (though not equity) stakes in the future of these banks (which could be further increased by transferring equity to them as bonus).

These circumstances make possible other alternative solutions. The skeleton structure of one possible alternative mechanism is as follows. The Treasury (or any other state body) would determine the amount of public money devoted to this purpose. This money would be used to make a secondary market for the loans eligible to participate in the process (a junk loan market). The essence of the mechanism would be extremely simple. The banks presently holding the loans would put a price tag on each eligible loan contract they want to sell under the scheme[16], as would any participating firm

willing to buy eligible loans. If the smallest gap[17] between the asking and the offers for a given eligible loan is smaller than the rate implicitly determined by the amount made available by the Treasury the loan would be given to the best offer.[18] Both sides would be required to make sealed bids. Loans where the gap is too wide remain with the bank. If the money offered by the Treasury is not fully exhausted, unsuccessful bids would be satisfied in increasing order of proportional losses. Credibility would be ensured by making banks understand that this is a once-and-for-all offer by the state, that is, no other money outside liquidation processes of banks will be made available for this purpose. Any firm would be allowed to participate[19], and participating firms could spread the risk by issuing high risk, high yield securities. Making these available for foreign investors could increase the finance available for the operation.

The merit of the procedure is that it utilizes the information banks posses about the firms, the financial expertise (human capital) available in bank managements and elsewhere in the economy, the personal motivation of bank managements, and exposes the procedure to the market. Since the privatization of the banks involved is already on the agenda, the process could be part of the privatization package[20], and in fact could speed up the privatization (or the exit) of the firms involved.

1.2 Concessional mortgage loans

Another important decision of central planners in some of the Central and Eastern European countries was to create a substantial amount of concessional mortgage loans concentrated into the loan portfolios of the saving banks (see, e.g., Sagari and Chiquier, 1992). This was a conscious decision of central planners between equity and debt finance[21], which in fact constituted a part of the central plans.[22] Since the mortgage market as well as the housing market, in particular the supply of new housing, were tightly

controlled and regulated by the state, families were on the one hand forced to resort to equity holding in housing, resulting in highly distorted household portfolios (see Ábel and Székely, 1993), and, on the other hand, were provided with the necessary debt finance at a cost which reflected their capacity to pay and the prevailing targets of central planners on the level of consumption.

It is again far from clear why these debts were issued with fixed interest rates. Whatever the reason was, it created a situation in which the loan portfolios of saving banks were stuffed with long-term fixed rate loans. Naturally, this made it necessary to preserve the deposit basis of these banks, which consisted of household time and saving deposits. Consequently, this problem constituted a major stumbling block in the process of financial reforms (integrating saving and lending markets) and liberalization (removing interest rate ceilings). Similarly to bad loans, the solution to this problem had a profound repercussion on the financial system, as it preserved financial repression and segmentation of financial markets, distorted the pricing of deposit instruments, and, by implicitly taxing savers, discouraged private saving.

The lack of wholesale financial markets and financial product innovation clearly shows up in the way this issue was tackled in Hungary, so far the only country which embarked upon some solution to the problem. In the presence of these, no economic policy maker, nor any politician in his or her right mind would have attempted to resort to the nightmare scenario of aiming at changing each individual mortgage loan contract (more than half a million of them). The credit risk involved is minimal[23], the essence of the problem is the low fixed yield of the asset and the consequent low market value of the asset (well below face value).

Fixed rate instruments are however widely present in market economies. Though these are fairly risky assets in the period of

volatile inflation, they may still suit the preferences of financial investors. The problem is simply the capital loss, which formally occurred to the state owned saving bank (NSB), but eventually to the state. More precisely, the problem is how to divide up this capital loss.

Technically, the problem is very simple. On the one hand, there is an exogenously given stream of income[24], which has a market value, naturally different from the face value of the contracts. The state could do basically two things, either make an outright payment covering the capital loss, or alternatively, if it thinks that it has a better assessment of future inflation and variable interest rates than other market participants[25], the state itself could undertake the swap and cash in on its 'insider' knowledge. In both cases, the operation could be backed up by an issue of a debt or security instrument (either with fixed or variable rate, though in the latter case this would naturally be a variable rate instrument) by the state spreading the costs of the operation over time.

Again, making the issued instruments available to foreign investors would lower the costs. The income stream from the untouched original mortgage loans could be made a collateral to lower risk premium, or alternatively, as the saving bank is fully state owned, the state could issue a guarantee, or buy one for the saving bank.

The Hungarian solution was to offer two options for each household with concessional mortgage loan: (a) 50 per cent write down of the still outstanding principal and variable market rate on the rest, with an option for an early full repayment of the outstanding principal at any time; (b) a subsidized but variable rate on the whole outstanding loan with an early repayment option as in case (a). Is this solution a good one? Clearly not for many reasons. First, its legal basis is very shaky and was not tested in

court.[26] Second, it offered a uniform write off scheme (50 per cent of the remaining principal) without any market test, making the costs of the operation most likely unnecessarily high.

An efficient mortgage market is an important factor of economic transformation and long term economic development for several reasons. First, the lack of this is one of the reasons why the residential building industry collapsed, further amplifying the general decline in these economies. Second, the picking up of this industry is an important factor of any recovery. Without proper finance this will come about later and more slowly than with it. Third, for small entrepreneurs, remortgaging is a natural source of finance. Of course, residential real estate could be used as a collateral to other loan contracts, but for saving banks (or building societies, though these are non-existent in Central and Eastern Europe), due to their experience in this field, the procedure of repossessing and reselling is much less costly than for commercial banks.

In general, the mortgage market is one of the most neglected issues in the region. The investigation of the market structure in Section 2.3 reveals part of the explanation to this. In addition, one should not forget about the welfare aspect of the problem. If one of the aims (and indicators of the success) of policy makers in devising economic transformation is to minimize welfare loss, this situation is hardly acceptable.

2 Establishing and maintaining a stable macroeconomic environment

The soundness of the financial system during economic transformation is of utmost importance in Central and Eastern European economies. Any major disruption here will undoubtedly have serious repercussions on the whole economy, and thus jeopardize

economic transformation itself. However, soundness and financial liberalization (deregulation) are not necessarily antagonistic ideas. It can be rather costly and thus very damaging to sacrifice any deregulation on the altar of soundness. After all, over-regulation and financial repression are also rather costly options, though costs are not up front, they rather tend to appear in the medium to long run.

Financial deregulation is widely associated with excess volatility in the developed countries currently undergoing this process, the last thing Central and Eastern European economies need at the moment. However, due to the perverse nature of the inherited economic system, financial deregulation (reforms) can be a stabilizing factor in these economies, if carried out in a proper manner. Though this may sound at first a rather odd proposition, one should take into account several factors. One of the major problems is how to increase the information content of economic decisions. The financial system, financial markets are very important transmission mechanisms, conveying information to economic agents. If they are imperfect and distorted, they cannot fulfil this function. Naturally, as in any other parts of these economies, the actual dose one should apply of this remedy depends to a large extent on the actual situation, and thus, it is certainly different in different countries. A firm commitment to a steady (though not necessarily immediate or too fast) course of financial deregulation is however a major component of the credibility of reforms inside and outside the financial system.

In a liberalized environment, where financial institutions enjoy an increased degree of independence in making their decisions on pricing products and allocating (financial and non-financial) investments, prudential regulations and their enforcement (supervision) are of course of great importance. It is however questionable whether this is the proper instrument to deal with the moral hazard issue, or whether it can be a substitute for control

over management in the financial services industry.

Wholesale financial markets are important components of the institutional setup of a stable macroeconomic environment. They have several important functions which have bearing on the stability of the economy. They are the major mechanisms conveying the signals of monetary policy, and at the same time smoothing out the impacts of monetary policy on the business sector. Wholesale markets provide mechanisms to (re)allocate liquidity in the system and (through markets for derivative instruments) to share risks assumed by financial investors. They have additional very important functions in Central and Eastern European economies, originating from the segmented nature of financial systems and from the limited ability of banks to carry out maturity conversion.

While banking reforms are being implemented relatively fast throughout the whole region, wholesale financial markets are in their infancy even in the economies with the most sophisticated financial systems (see, e.g., Király, 1993, Rudka, 1992). Thus, in the future, policy makers should pay much more attention to this issue.

Perhaps the most important prerequisite of a sound and stable financial system is a proper legal environment, including legislation on (central, commercial and retail) banking, bankruptcy procedures, and accounting. As far as banking legislation is concerned, the process is advancing fairly fast, countries are preparing and passing laws and other forms of legal regulations in line with European legislation (see, e.g., SBSA, 1991, Ghizari, 1992, Jindra, 1992, Mladenov, 1992, Rudka, 1992, Sárközy, 1993). The other elements of the necessary legal environment are however not yet in place in many Central and Eastern European economies. The advantage Hungary has in this respect (see Sárközy, 1993 and Stadler, 1993), which is due to the fact that reforms there started much earlier, seems to be a major factor of the success of the

Hungarian economy in attracting foreign capital, and in devising economic transformation in a much smoother manner than some other countries in the region.

Finally, an important element of a stable macroeconomic environment, in particular during economic transformation, is the mechanism which ensures that the necessary finance for the state budget is available, and at the same time, it does not cause unnecessary disruption to the financial system and, through this, to the economy. Wholesale financial markets are important in this respect as well, as they provide the mechanisms to smooth out the impact of tapping markets by the budget. As many papers on the subject point out, there are several factors increasing the pressure on both sides of the state budget, leading to massive budget deficits in almost every country in the region. As the abilities of Central and Eastern European governments to tap foreign private capital markets are severely limited[27], even for relatively successful countries, and the available finance from public sources (international financial institutions, European Communities (EC), and national governments in the west), though substantial, is also rather limited (as compared to the needs of these countries, and in any case, these loans not meant to be entirely devoted to finance budget deficits), governments are bound to resort to tapping domestic capital markets to a great extent.

3 Laying down the foundations of a market economy and a competitive economic environment

As pointed out in several places above, the initial conditions for financial reforms were rather poor in almost every country in the region.[28] Central and Eastern European countries embarked upon economic transformation, in many cases implementing rather ambitious packages, either still having the financial system of a centrally planned economy, or being through just the very first

steps of financial reforms and having very fragile banks (and practically no other financial institutions). Financial markets were highly segmented, over-concentrated and imperfect, banks had very low quality loan portfolios (see Section 2.1), legal and institutional structures were underdeveloped, and more than anywhere else in the economy, state ownership was overwhelming in the financial sector. As a result, entry and exit barriers to competition were prohibitive.

A competitive financial system is a key ingredient of a competitive and thus successful economy. The costs and availability of (short term and long term, production and export) finance and financial services for exporters (and for any other business unit) is a factor which to a large extent determines the degree of international competitiveness of producers. Though the price competitiveness of Central and Eastern European producers at present largely stems from the low unit labor costs in these countries, it is already to a large extent offset by high costs of capital and financial services, and by the low quality (or sometimes even the lack of proper) financial services. On the other hand, their competitors in the west greatly benefit from the rapid changes in finance and banking which took place in the eighties and resulted in a large number of new innovative financial instruments and eventually in a sizeable decrease of the relative costs of capital and financial services for industry and trade.

The most important, and perhaps the longest lasting task in this respect is institution building. As pointed out above, with the only exception of Hungary, Central and Eastern European countries inherited institutional structures geared towards the needs of a centrally planned system. Thus, they have to start this process from scratch. The institution building includes the regulatory institutions (banking, securities issue and trade, and insurance supervision), the institutions of direct finance (stock exchanges) and the financial firms themselves.

While the first is clearly to be created by the state, the role of the state in creating the remaining two other types of institutions is somewhat less clear. In a normal market economy, financial firms and institutions of market places are naturally best (though not always) created and managed by private entrepreneurs. However, in Central and Eastern European countries, the situation is somewhat more complicated for various reasons. First, though central planning tried to eliminate money (financial instruments and markets) as a vehicle for conveying market signals to firms, and for allowing them to react to these, technically it did rely on such instruments. That is, it did accumulate a substantial portfolio of financial assets and liabilities, and it did build up capacities, in its monobank system, to provide financial services. These were then transferred to the (state owned) banks where they are at the moment. That is, in one way or another, the state had to create financial firms.

Though market values of these firms as firms[29] are rather questionable, it does not change the fact that they do exist and cannot be dismantled in an abrupt manner. In fact, their dismantling is closely linked to the process of privatization, again conducted to a large extent by the state itself. To sum up, the specific situation in Central and Eastern Europe makes it almost inevitable, in many aspects in fact even desirable, that the state be involved in creating financial institutions. The extent of this in different countries will again depend on their specific circumstances. What is of importance in this respect is that market mechanisms and emerging new or entering foreign entrepreneurs should be allowed to correct for the inevitable mistakes made during this initial phase. That is, barriers to entry and exit should be made as low as possible, and legal and institutional reforms should ensure that entries and exits take place as fast as possible.

Financial markets will for quite some time to come be highly concentrated by western standards (see the section on market structures below). The incentive to abuse market power and impose the high costs of a sleepy monopoly (Seabright, 1993) on customers will most probably be there. Thus, legislation and supervision of competition rules in the financial system are of great importance, in fact, due to the lack of full convertibility and the presence of some remaining restrictions on providing financial services, they are even more important than in the other parts of the economy, where import liberalization, already in place in most countries, is a powerful mechanism to put certain limits to such practices. Financial reforms in Central and Eastern Europe are rather slow in this respect, and even in Hungary, where legislation and supervision of competition rules are already in place and producing some tangible results, the financial system is outside of the scope of this institutional structure (see Stadler, 1993).

Privatization is undoubtedly one of the most important ways of establishing a competitive environment and providing mechanisms for control over management. Privatization in a broader sense entails two processes of different natures and dynamics. Privatization in a narrower sense means the turning over of previously (partly or fully) state owned firms to private investors, while the broader definition includes the encouragement and support to new (domestic, foreign, or joint) private ventures entering the domestic economy. In practice, both processes entail the heavy involvement of the state, which, as pointed out earlier, is to some extent inevitable. Privatization in the broader sense is of great importance in the financial system for several reasons, partly already pointed out. Financial markets, as we shall document it later in this section, are bound to be highly concentrated, simply due to the way financial firms were created.

While turning over of the existing large commercial banks to the private sector is high on the agenda of policy makers in the

region (see Balassa, 1992, Jindra, 1992, Rudka, 1992, Ghizari, 1992, Székely, 1993, Várhegyi, 1993), this in itself is far from being enough to achieve true competition. What is needed is the credible threat of contestability of each segment of the market, which is best achieved by new entries and exits. Though, as we shall argue in Section 2.5 in relation to foreign participation, the new banks will most likely concentrate on market segments where they have competitive or other advantages, and where they can capitalize on the extra profit generated from this, some of them can grow astonishingly fast, and can take over larger but less efficient units after a while.[30]

The forms and extent of the involvement of the banking sector in corporate activities is an important aspect of economic transformation, which we discuss in some detail below.

3.1 The model issue

The control over enterprise management is widely recognized to be a major issue of economic transformation and long term economic development. Privatization and the encouragement of private capital are thought to be the remedies. However, many researchers (e.g., Corbett and Mayer, 1991, Mayhew and Seabright, 1992) emphasize the point that private ownership in itself is not a sufficient remedy, for a lot depends on the actual form of it. From the viewpoint of our discussion this debate boils down to the issue of German vs. Anglo-Saxon models. But is it a real issue? Is the Anglo-Saxon model a viable option for Central and Eastern European countries? Can the stock exchange, or the equity market be the major mechanism through which the control over enterprise management is exercised? Put differently, is the equity market and direct finance the proper vehicle for putting competitive pressure on enterprise management? Though these are very exciting questions in general, we will restrict our discussion to the present context, that is to the present situation in Central and Eastern Europe.

The Anglo-Saxon model is not a feasible option for these economies for a number of reasons. First of all, any widespread holding of equities assumes a large number of actors having the will and the capacity to hold these assets. At present, these agents simply do not exist, and it will take a rather long time until they emerge. There are hardly any institutional investors other than banks, and direct holding of equities is simply not reasonable for other than a handful of private investors. After all, even in countries with a long tradition in direct equity holding, the extent to which private investors hold equity is rather limited. In a period of high volatility and in an environment where information on public firms is very costly to gather and markets are extremely thin and thus not less volatile, it is simply not reasonable for households to have too much of equity in their portfolios.

Second, the vast majority of firms seeking equity finance lack any proper track record. This makes them a risky investment even for banks. Western accounting standards have been introduced very recently in few of the countries and the others are expected to follow suit in the future. Thus, even for foreign investors it was (and partly is) very difficult and costly to evaluate the performance of a firm and to mark firms for investment. The number of credit analysts is very small, in many countries practically nil.

Thus, it is of no surprise that the market capitalizations of the newly created stock exchanges are very low by international standard, and so are the traded volumes. Also not unexpectedly, thin markets create volatile prices. On the Budapest stock exchange, which is perhaps the most developed one in the region, there were 7 listed and 13 traded shares (the total market capitalization of these enterprises at the end of the year was USD 517 mn), and the average daily turnover was USD 30.000 in 1991 (Járai, 1993). Though the over the phone trade adds some additional

turnover to this, nobody would expect this market to provide equity finance for firms, or to perform the task of management control in the economy. The stock exchange cannot even be expected to be a suitable vehicle for privatization in the foreseeable future, for the same reasons mentioned above.

Specialized investment banks are also practically non-existent as yet. The few banks which to some extent are specialized in equity investment are created by the large commercial banks, mainly to deal with their bad and dubious loans.

Third, stabilization packages inevitably result in high nominal and real interest rates, discouraging equity holding on the income side. The high exchange rate risk and remaining restrictions on capital movements in some of the countries further discourage foreign investors.

Finally, the massive budget deficit, also an almost inevitable phenomenon of economic transformation, crowds out private firms from the capital market, thus demand for additional equity finance is rather sluggish.

The model issue thus was in fact not a real issue from the very beginning. On the other hand, it is not an issue any more, as the so far introduced legal regulations in each country in the region opted basically for universal banking, following EC regulations, and the intentions in the remaining countries point to the same direction.

3.2 Market structures in banking

As many researchers point out (e.g., Kessides et al, 1989, Corbett and Mayer, 1991, Kemme, 1991, Caprio and Levine, 1992, Estrin et al., 1992, Kemme and Rudka, 1992, Székely, 1993,

Várhegyi, 1993), it is of vital importance to increase the degree of competitiveness in the financial system, in particular in banking. The initial conditions in this respect were rather poor in Central and Eastern European countries (Bácskai, 1989, Székely, 1990a, Corbett and Mayer, 1991, Kemme, 1991, Jindra, 1992). As we shall discuss in detail below, the reforms creating the two-(or three-)tier banking systems in the region left behind highly concentrated and segmented markets, undercapitalized units, substantial (in many countries dominating) direct and indirect (through state owned enterprises) state ownership, poor management, obsolete infrastructure and production technology in banking. Though the development since then tackled many of these deficiencies to some extent, banking in the region is still far from being so highly competitive as it is in the developed west, irrespective of whether it is within an insider or outsider system.

Corbett and Mayer (1991) emphasize that competition in product markets is a prerequisite for a competitive economic system. This applies not only to manufacturers but also to producers of financial products, that is, to firms in the financial services industry. A major element of competition is import competition. However, this element due to the remaining restrictions (on cross-border capital movements and branching and the provision of financial services) is almost entirely missing in this industry. Though (partly or fully) foreign owned financial firms could somewhat increase the competitive pressure from outside (see also Section 2.5), as we already pointed out, foreign investors are rather cautious in moving in. Thus, when stabilization is successfully accomplished and a relatively stable macroeconomic environment is established, policy makers should reconsider the merits of these restrictions and work out a package to relax them as much as possible.

Corporate loan and deposit markets

Markets in banking are still highly concentrated in Central and Eastern Europe. Corporate lending, in particular, long term lending is dominated by few directly or indirectly state owned large commercial banks, created in the course of the first banking reforms. On the other hand, due to the still typical segmentation of markets and the lack of wholesale markets, the central bank is the major source of finance to back up these loans. Refinance credit, especially for long term investment loans is the major source for banks. In Czechoslovakia, though the number of commercial banks is above 30, the corporate loan market is dominated by two large state owned banks (Commercial Bank Prague and the General Credit Bank Bratislava having market shares of 54 and 22 per cent respectively, for details see Jindra, 1992). In Hungary, though there are 37 loan-issuing financial institutions (31 commercial banks and 5 SFIs), the four large directly and indirectly state owned commercial banks still provide 63 per cent of corporate loans, and collect 54.9 per cent of enterprise deposits (there is no separate figure on the deposits of small entrepreneurs, though it is very likely that if one disregards from this segment which is part of the retail market, the degree of concentration would turn out be significantly higher).

The more competitive mid-size banks (many of them partly or fully foreign owned) are very cautious in entering this market. They are more active in deposit collection (in Hungary, for example, they increased their market share from 6.1 per cent in 1987 to 29.7 per cent in 1991), in particular in hard currency denominated deposits (where it is allowed) than in providing loans. They instead channel their liquidity surplus to other banks through interbank markets. The lack of branch network, the policy of avoiding too rapid an expansion of the asset portfolio, the inherently high risk due to economic transformation, the lack of instruments to share risk, the lack of proper accounting standards,

and uncertainties concerning privatization are the factors explaining this behaviour. Whatever the reasons are, the fact is that these markets are very far from being competitive. Product pricing in these markets is in accordance with this character.

Retail loan and deposit markets

Retail markets are even more concentrated. Though in principal commercial banks are licensed to collect retail deposits, the lack of proper branch networks severely limits them in this business. In Czechoslovakia, the retail market is practically fully confined to one fully state owned saving bank in each land (The Czech Saving Bank and the Slovak Saving Bank, for details see Jindra, 1992), and in Bulgaria and Romania to one, also fully state owned, saving bank (State Saving Bank, for details see Mladenov, 1992 and Ghizari, 1992). In Hungary, the situation is somewhat different as there are already some signs of a moderate competition on this market. First, the fully state owned saving banks (NSB), since the very early phase of central planning, coexisted with saving cooperatives (at present, there are 259 of them, and their number was rather stable during the last two decades), though until very recently their business activities were geographically separated. Commercial banks were from their establishment onwards formally licensed to conduct retail business, and they started to penetrate this market in 1988 in a rather cautious manner. The first credible threat for the NSB was the foundation of the Post Bank in 1989, which relies on the postal branch network (at least as widespread as that of the NSB). The latest development was the foundation of the IBUSZ bank, which utilizes the rather well developed and technically sophisticated branch network (the only one supported with a computer network) of IBUSZ, previously the state travel agency. Meanwhile, in the process of privatization, IBUSZ was sold to one of the large commercial banks (NCCB), which makes this threat rather credible. Some of the mid-size banks started to penetrate the upper end of the market, providing quality services (e.g., charge (debit) and

credit cards in domestic and foreign currencies).

4 Restructuring and expanding production

The ultimate success of economic restructuring and the long term growth potential of Central and Eastern European economies depend to a large extent on how fast they can restructure their industrial production, and, through new investments, enhance their export capacities and international competitiveness. This in turn needs substantial finance, which should first be collected and then allocated to the most efficient investment projects. Though there is undoubtedly a large growth potential in privatization (in the narrower sense), this will soon diminish for two reasons. It will either be used up, that is firms earmarked for privatization will rapidly be sold off and reorganized, or it will simply disappear, as the firms not privatized or not reorganized within the state sector will simply become bankrupt and eventually liquidated.

Moreover, reorganization is hardly possible, and in fact very rarely carried out in a way which does not entail new investments. New ventures on the other hand by nature rely on new investments. That is, whichever way turns out to be characteristic, the need for massive investment finance will be there. The opening up of these economies also means that in the medium and long run, firms in the region can only preserve their competitiveness if they adopt modern production technologies and marketing methods, again needing (long term) investment finance.

As in any other economy, firms will have basically two ways to get this finance, direct or debt finance. In the remaining part of this section we shall investigate problems related to these two forms of finance.

4.1 The commercial banks' role

Corbett and Mayer (1991) suggest that banks in Central and Eastern Europe should play a central role in this respect, as they have the capacity and the financial strength to fulfil this function. The major advantage of banks' involvement (an insider system) is thought to be their willingness to provide finance on a longer term basis. They are also thought to be the major institutions carrying out enterprise restructuring. But is this true in reality? Start with the issue of longer term finance. The reality is that the main element of banks' lending policies is the restructuring of the maturity compositions of their loan portfolios by reducing the shares of longer term loans (with maturity longer than a year) and substituting short term loans, or securities issued by the state. That is, the 'narrow' banking found by McKinnon (1991) to be the only feasible way to deal with the problems of moral hazard, inherent risk, and insufficient supervision during transition and advocated by others (see, e.g., Caprio and Levine, 1992) is taking place in practice without any regulation.

Large state owned commercial banks created during the first wave of banking reforms and dominating the banking sector are themselves poorly managed and laden with substandard, dubious and bad loans. As the detailed discussion above suggests, the banking market is highly concentrated, there is no real competition in banking, and banks are owned by the state and by (state owned) enterprises. More competitive, partly truly privately or foreign owned medium size banks, though rapidly increasing their market share as a group, individually are simply not strong enough to fulfil this function. Moreover, as the experience so far shows, they rather focus their activities on the bottlenecks of the financial system, that is on highly profitable activities where they can make new, previously non-existing markets, and thus rapidly capture substantial market shares. Investment finance is

definitely not among these activities. The enterprise lending market, especially longer term lending belongs almost exclusively to a small group of large banks. This situation is strikingly different from what one can observe in any developed market economy in the west. Thus, in the foreseeable future, banks cannot be expected to live up to these expectations.

4.2 Direct finance for firms

As we argued in Section 2.3, the availability of equity finance for enterprises will be rather limited and confined to a small well definable group of private ventures. Moreover, similarly to bond finance, it will not come in large amounts until macroeconomic stabilization is achieved, the adoption of new relative prices and trade reorientation are completed, and new legislation on bankruptcy procedures and accounting standards are firmly in place and effectively enforced. Even after this, the problem of lack of proper track record, also mentioned above, will remain a major obstacle.

A special form of direct finance is foreign direct investment. As the case of Hungary clearly shows, the degree to which the extent of foreign direct investment depends on the success of macroeconomic stabilization, legal and institutional reforms is not lesser than for any other direct investment. What is perhaps more different is the capacity and will of foreign investors to hold equity in their portfolios. But one should remember that the competition for foreign direct investment Central and Eastern European economies will face in the very near future, if not already, will be extremely tough for various reasons. First, due the present state of the world economy, foreign direct investment is slowing down in general. Second, a number of developing countries have already undertaken major reforms, or will do so in the near future, increasing their attractiveness in the eyes of foreign investors. Finally, some of the advantages these economies enjoy (e.g., low unit labour costs or tax incentives) will soon to

a considerable extent diminish. On the other hand, the necessary investments to improve infrastructure (including financial infrastructure), a very important element of attractiveness, will take considerable time. All this means, that if Central and Eastern European economies want to keep up, or increase the present level of foreign direct investment, they have to improve their domestic economic environment. An important element of this is the improvement of the financial system.

5 Reorientation of foreign trade and (re-)integration of the economies into the world economy

Nobody doubts that any recovery in Central and Eastern Europe will be an export led growth. Increasing export activities increases the demand for very special financial services related to financing exports and facilitating foreign payments. There is already an excess demand for such services in the economies which have been successful in trade reorientation. As we shall argue below, this is a market segment where small and mid-size (mainly foreign) banks can capture sizeable part of the market. In fact, in the early phase they practically do not face any competition[31], simply because of the limited capacities in the system (a classical case of excess demand in a market economy). Surprisingly, in this market segment, competitive pressure may come from the large state owned banks, after they manage to set up and efficiently operate their corresponding departments.

A special aspect of reintegration is the association with and the membership in OECD and EC. Both have important consequences on financial reforms and financial deregulation. The Revised OECD Codes of Liberalization of Capital Movements and that of Current Invisible Operations and the EC's second banking directive have clear implications on the financial system of an economy undergoing preparations for membership, though the pace with which and the

manner in which these two legislations have to be implemented are rather different. A government can lodge reservations to the OECD codes, and in fact governments do so quite frequently, but it still necessitates a firm commitment to financial liberalization. EC legislation is binding on member states and, thus, has more immediate impact, but both point to the same direction, the opening up of the financial system. In other industries, Central and Eastern European countries have already experienced the impact vigorous which foreign competition can have on domestic firms. It is safe to say that this will not be different in the case of the financial services industry. That is, if OECD and EC memberships are serious targets, the need for improving the competitiveness of financial firms in the region must have high priority. It takes time - a long time - to catch up with the leaders in any industry, including the financial services industry.

5.1 Foreign firms in the financial system

Policy makers and researchers alike inside and outside the region almost uniformly support the view that foreign participation in the financial services industry is highly desirable and thus should be encouraged, because foreign financial institutions can greatly contribute to the successful restructuring of the financial system, and through this, to that of the whole economy (e.g., Calvo and Fenkel, 1991a, Long and Sagari, 1991, Balassa, 1992, Járai, 1993, Rudka, 1992, Mladenov, 1992, Ghizari, 1992, Várhegyi, 1993).[32]

Though regulations in Central and Eastern European countries are in general rather permissive[33] in this respect, foreign investors are rather cautious in moving into the region. A sizeable presence is observable in Hungary, where most of the foreign direct investment into the region is concentrated. Beside the lack of full liberalization of capital movements, the rather volatile economic situation, in particular the very high rate of inflation and the

massive exchange rate risk, is an obstacle in this respect. In Hungary, where foreign investors have an overall 13.3 per cent equity stake in the banking sector (amounting to appr. USD 0.2 bn) there are 16 partly or fully foreign owned banks, with total market share of 15.6 per cent (in the balance sheet total of banks).

However, as the experience of some other countries outside the EC also shows (see, e.g., Savela and Herrala, 1992), one should be more precise as to where exactly to expect foreign banks to impose competitive pressure on domestic banks. Foreign owned banks tend to operate from a single outlet located in the capital and concentrate on markets and instruments where they are much more competitive than their domestic counterparts. Put differently, they tend to concentrate on the bottlenecks of the system, where their special expertise can be utilized most profitably, and where they can most benefit from their links to the international parent banks. Retail corporate lending, especially long term investment finance, and retail businesses in general, which need extensive branching network, close link to and detailed information about clients are typically outside of their scopes of business. That is, they can be expected to capture substantial market shares in derivative instruments accommodating risk sharing, in foreign exchange instruments, in services related to investments, restructuring, foreign issues and foreign trade payment. They can also be expected to introduce new forms of instruments, and be in general innovative. However, they cannot really be expected to help making retail markets more competitive and thus force domestic banks to price their products and services more competitively in these markets.

6 Conclusions

The paper investigated the reform of the financial system during economic transformation in Central and Eastern European economies and the interrelationships between reforms in the

financial system and in other parts of the economy. It found that there is hardly any aspect of economic transformation where the financial system would not have an important role, and thus, where the success of reforms in other parts of the economy would not to a great extent depend on the outcome of financial reforms. In particular, a properly designed financial reform was found to have paramount importance in establishing a competitive economic environment which is a prerequisite for a successful economic transformation and economic growth in the long run.

In investigating the factors hindering financial reforms, the paper put forward an alternative policy package to deal with bad and dubious corporate loans thought to suit the situation of countries with more developed financial systems and longer experience with economic (financial) reforms. The major characteristic of this package is its reliance on the market to determine the current values of the loans, and to reallocate the ones with positive market values to financial firms that are able to restructure the enterprises involved. Another important feature of the package is that it tries to minimize the amount of public money needed for the operation and allocates the amount available in a competitive way.

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NOTES:

1. Irrational in the sense that the principles which were followed in asset bundling in CEE economies are very different from those prevailing in competitive economic environments. This a rather general problem which concerns the whole economy, but in the present discussion the focus is on financial institutions, mainly on commercial banks.

2. Originally these were very long term (sometimes with maturities of 20-30 years) mortgage loans to first time buyers or purchasers of newly built dwellings bearing low interest rates. When these low rates were left unchanged, the loans turned out to be very low yield assets, not covering the costs of deposits or other liabilities. When the rates were adjusted to prevailing very high nominal market rates, they turned out to be dubious or bad loans.

3. This is again a general problem present everywhere in the economy, not only the financial system.

4. In some countries, it was not even the central bank which issued these instruments, but rather a separate bank (normally the foreign trade bank). We do not however regard this as a different case, for this bank was under the direct control of the central bank, which in turn was under the direct control of the government (or central planning office).

5. Asymmetric distribution of information in this respect and a consequent underestimation of the extent of the problem are problems not exclusively confined to economies in transition (see Marrese, 1992). In general, the same is true for many of the problems raised in the present paper, though the extent to which these problems emerge are not necessarily similar. What makes the present situation in CEE unique is the extent of problems and their simultaneity.

6. In what follows, Czechoslovakia refers to the former Czechoslovakia which was split into two independent states on 1 January 1993.

7. As Begg and Portes (1992) point out, so does the capital loss incurred by the owner (the state) of the underlying real assets (the enterprise), or in the case of negative liquidation value, the owner(s) of the banks (again the state and partly the troubled firms themselves). If the banks involved themselves have negative liquidation values, part of the loss is passed over to the owners of the banks' liabilities, which in turn are the troubled state owned firms (deposits), the central bank (refinance credits) and certain bodies of the administration (deposits). Due to the explicit guarantee on the deposits of private (non-corporate) financial investors, they are not among the potential losers, at

least not in this phase. However, private firms, as it clearly turned out recently in the case of the collapse of Ybl bank in Hungary, may very well be made to pay for the losses. The point is that the loss which has already occurred is mainly borne by the state, even if it is not always readily visible. Caprio and Levine (1992) advances an argument similar in nature, though they base it on the 'consolidated balance sheet' approach.

8. This in fact amounts to saying that the original decision of transferring these loans to the commercial banks was a mistake which should be corrected by transferring back these loans to where they originally were, that is, to the state as soon as possible.

9. For, unless these bonds are not tradeable, banks can immediately sell them if they have better investment opportunities. Conversely, if they are given cash and have no better investment opportunity, they can buy the liability (debt or security) issued by the state to cover the costs of the operation.

10. In writing up this part, I greatly benefited from an extensive discussion of the topic with Kálmán Mizsei, for which I am grateful to him.

11. It should also be mentioned, that some of these managements were recently replaced, and consist of young capable bankers, with rather good training and previous experience in key positions in administration and business, that is with credible personal track record and commitment to personal success.

12. The importance of this link between loan officers and enterprises in Hungary is emphasized by Spéder (1991). He points out that though after a while enterprises in Hungary were free to switch bank, they very rarely did so, and when they did switch bank, they followed the loan officer who moved to another bank. Given the very high cost of gathering information and the long time needed to build up confidence in a firm (management), this was a reasonable reaction on the part of these firms.

13. One can for example refer to the experience of the SPA in Hungary to support this argument.

14. Of course, they could in turn hire the corresponding loan officers from the banks which previously held these loans, but if so, the merits of such a procedure are not quite clear.

15. The importance of this aspect is emphasized by Caprio and Levine (1992).

16. The rules of the procedure should however make sure that the fact that a firm is involved in the process does not further damage its market position. This point was raised by Kálmán Mizsei. In general, the details of such a procedure needs further very

thorough work, including the participation of business lawyers, for many of the details depend to a great extent on the prevailing legal regulations.

17. By nature, there is such a gap, for otherwise a factoring firm would have already bought the loan.

18. If no offer is made, the offer price is zero. This still allows for a transaction, as the asking price can be smaller than the proportional coverage by the Treasury.

19. In principle, the state could set up its own factoring body to make competitive bids in the process. If the state is better informed about the liquidation value of a firm, or about its future performance, it could cash in on it this way.

20. The new owners of the banks would have a strong incentive to pick out the firms which can be restructured successfully, for several reasons. First, because of the loss (the accumulated reserves can be used for better purposes). Second, because they lose their clients, that is future business. Third, in the restructuring process they can realize capital gain. Hungarian banks, for example, have already produced successful debt/equity swap cases, where the equity was quickly and under relatively good conditions resold (e.g., the HCB-TUNGSRAM case).

21. In a traditional CPE, for well defined social groups, there was a full state provision of housing, that is, a pure equity finance by the state. Later on, for various reasons this was relaxed in several CEE countries, and a mixture of state equity finance, equity holding in own housing by households, capital transfer from the state to first time buyers, and subsidized debt finance was created.

22. Most precisely, it was a chapter of the so-called credit plan. Though plan targets were very frequently missed in CPEs, these particular targets were regularly met with a high degree of precision.

23. Naturally, this does not apply to regions hardly hit by the recession, as there the market values of mortgaged dwellings are fast diminishing, in many cases leaving the families with negative net wealth. This is however a general problem as in vulnerable regions, incomes of families with mortgage loans and the market values of their estates are strongly positively correlated. An additional problem in CEE countries is the lack of clear legal regulations on repossessing.

24. Assuming that the individual mortgage contracts remain in force.

25. This is not an absurd assumption as one of the main characteristics of CEE economies is that financial markets are imperfect.

26. It is now in a dozen of cases, as many individuals decided to challenge the decision of the government filing cases at several courts, the outcomes of these court cases are anything but clear.

27. In 1991, the total share of CEE countries on international private capital markets was 0.3 per cent, out of which Hungary had a 0.225, Czechoslovakia a 0.056 per cent market shares respectively, and the rest went to the other countries (see OECD, 1992).

28. As in many other places in the paper, we have to emphasize the rather different position of Hungary in this respect as well. This however does not mean that the problems discussed here were not present to some extent in Hungary (see, Székely, 1990a, Estrin et al., 1992).

29. The difference between the sum of the market values of their assets individually and the market values of the entire firms, that is the extra values originating from the specific bundling of assets.

30. There are some examples for such developments in Hungary, though the large commercial banks have not yet been touched by the process of privatization. The Post Bank (Postabank) established in 1989 is already on the verge of becoming a large bank and being able to compete with the other large state owned banks created during the first wave of bank reforms in 1987. In fact, due to its relatively well developed retail branch network, it has a better growth potential than the others. Many mid-size (some of them partly or fully foreign owned) banks are also growing very rapidly, capturing substantial market shares in certain special market segments (e.g., foreign payments) (see, e.g., SBSH, 1992).

31. This is well shown by the soaring prices of such products and services (e.g., futures, see Estrin et al., 1992, p. 23).

32. Jindra (1992) is a rare exception. He expresses a serious concern about a possible 'massive invasion of German banks' (p. 58). Corbett and Mayer (1991) warns that transfer of managerial knowledge should not be achieved through ownership (p. 3). Though this statement concerned the enterprise sphere in general, naturally, it applies to banking as well. Especially, because they expect banks to be the main institution to perform control over management.

33. At least as far as subsidiaries and representative offices are concerned. Cross-border branching is allowed in none of the countries in the region, but this policy is rather typical

internationally at this stage of economic development.