Financial Sector Reform in Transitional Socialist Economies

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Washington, D.C.
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Contents

Foreword v

1. Introduction 1

2. The Preconditions of Financial Reform 3

3. The Supportive Role of Monetary and Other Macroeconomic Policies 11

4. The Institutional Environment for a Sound Financial System 15
   Regulation 16
   Capital Adequacy 16
   Uniform Accounting Guidelines 17
   Limits to Large Exposures 17
   Enforcement Powers of the Central Bank 17
   Supervision 17

5. The Restructuring of Enterprises 19
   Incentives and General Signals 19
   Management 20
   Financial Restructuring 20
   Physical Restructuring 21
   Privatization 22

6. The Restructuring of Banks 25

7. Long-Term Issues: Nonbank Intermediaries and Capital Markets 31

8. Is There One Blueprint for Financial Sector Reform? 35

Annex A: List of Papers Presented at the Seminar 41
Annex B: List of Participants 43
Foreword

EDI's Financial Sector Training Program focuses on the structure, reform, development, and management of financial systems and institutions in developing countries through a systematic review of:

- the policies and mechanisms for reforming the structure of financial systems;
- the policies and regulations necessary to prevent and deal with systemic distress, as well as with insolvency and illiquidity of financial intermediaries;
- the development of markets for short- and long-term financial instruments;
- the role of institutional elements in the development of financial systems;
- the links between the financial sector and the real sectors, particularly in the case of the restructuring of financial institutions and industrial enterprises;
- the dynamics and management of financial systems during periods of stabilization and adjustment; and
- the policies and mechanisms for facilitating access to international financial markets.

EDI's financial sector program covers each of these topics independently or in various combinations, designed to reach specific audiences based on specific needs. The program also offers specialized training activities developed in conjunction with the industrial sector program, which includes topics such as privatization and private sector development.

This report summarizes the discussions that took place at the senior policy seminar held in Paris, September 10-12, 1990, on the subject of Financial Sector Reform in Transitional Socialist Economies. The seminar was organized by the Economic Development Institute of the World Bank, with the support of the Ministry of Foreign Affairs of France. The views expressed herein are entirely those of the author and do not necessarily reflect the views of the French Ministry of Foreign Affairs, of EDI, or of The World Bank.

Amnon Golan
Director
Economic Development Institute
Introduction

This report summarizes the discussions that took place at the senior policy seminar held in Paris, September 10–12, 1990, on the subject of Financial Sector Reform in Transitional Socialist Economies. The seminar was organized by the Economic Development Institute of the World Bank, with the support of the Ministry of Foreign Affairs of France. The meeting brought together ministers and senior officials from six Central and Eastern European economies: Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia, as well as ministers and officials from Algeria. The World Bank staff team was led by the regional vice president of the Europe, Middle East, and North Africa (EMENA) Region, Mr. Willi Wapenhans. Observers were also present from the government of France, the Organization for Economic Cooperation and Development, the International Monetary Fund, and the United States Agency for International Development.

The purpose of the seminar was to exchange ideas and experiences about key issues of financial sector reform that were relevant to the emerging situation of transitional economies, especially in the Central and Eastern European countries. Detailed issues such as the appropriate steps required to restructure banks; the implications that enterprise restructuring, including privatization, might be expected to have for the financial sector; and the appropriate stance of supportive macroeconomic policies constituted the central focus of the seminar. Participants also reflected on the eventual structure of the financial sectors that Eastern European economies might set out to achieve.

Mr. Wapenhans, chairman of the first session, drew attention to the inherent difficulties of the policy reforms now facing seminar participants. These difficulties arose mostly from the lack of historical precedents to guide current developments in Central and Eastern Europe. There are only a few cases where the state has sought to remove itself so dramatically from a formerly all embracing role both as owner and manager. Chile is the prime example. Such a massive and rapid withdrawal has raised numerous questions about the role of the existing and new financial institutions in these countries. Several aspects of that role were already becoming clear.
First, banks that had previously been expected to neither take the risks nor share in the benefits of resource allocation decisions would now need to do both. Second, the process of restructuring productive sector enterprises would certainly need a far greater mobility of resources, and financial sector institutions would need to be at the forefront of efforts to facilitate this mobility. Although some people argue that the key problems now are with the productive enterprises themselves rather than the banks, this is something of a false debate, because a minimum package of financial sector reform is necessary early on in all reform programs to assist with the emergence of a system based on profits and centered on clients. Third, with the banks taking on a more substantial economic role, their functions will become particularly important when they refuse credit to important but nonviable enterprises; no institution in the socialist economies has done this before. Finally, the financial systems in the countries represented at the seminar are largely being redesigned from scratch. Thus, radical thinking and comprehensive approaches are needed involving new policies, new procedures, and, often, new institutions.

Mr. Wapenhans emphasized that training was a vital element in all this, as was exposure to international experience: something that the seminar itself was designed to provide. The World Bank stood ready to further extend the support it had already provided to countries such as Algeria, Hungary, Poland, and Yugoslavia through its structural and sectoral adjustment initiatives and its technical assistance programs. Thus, the seminar was an opportunity not only to exchange experiences but also to communicate ideas and requests for future World Bank support.

This report focuses on the following seven areas. These correspond broadly to the progress of the discussions during the three days: key issues in the financial structure needed to condition the design of reform programs; aspects of the overall monetary policy of an economy that can have important effects on the process of financial sector reform; institutional preconditions for a healthy financial system; the main issues involved in restructuring productive sector enterprises; the restructuring of banks and financial institutions; selected longer term issues in financial reform, especially the possible role of nonbank intermediaries, money, and capital markets; and a synthesis of the different themes of the discussion to establish the extent to which it is possible to specify a blueprint for future actions.

The objective in each section is to integrate the main points made in the nine keynote presentations (by Messrs. Hinds, Long, Calvo, de Juan, Buchi, Sheng, Pohl, Soulard, and Roe) with the main points that emerged from both the panel discussions and the floor discussions.
In introducing the preconditions and structure of financial reform, Manuel Hinds began by considering the major global factors that had stimulated the international trend of the past decade toward more liberal markets both in Central and Eastern Europe and the world in general. The main reason, he argued, was the increasing evidence that the old model of development based on import substitution, state-directed development of heavy industries, and disregard for the role of prices failed. The old model maintained the inherent contradiction of requiring a heavy foreign exchange input to pay for imported raw materials and intermediate goods, while providing little or no real stimulus for the international competitiveness of industry, which is the prerequisite for the successful earning of foreign exchange. Thus, many economies had become more rather than less dependent on primary commodity exports as a result of adhering to this model, a dependence that was problematic given the poor long-term volume and price prospects for major commodities.

A second reason was the rapid international changes of recent years in industrial, transport, and communication technologies resulting in more stringent and changing conditions for international competitiveness. Bureaucratic and centrally planned systems proved quite incapable of organizing the flexible and frequent adjustments of, for example, product mix and technologies required by this more intense competition. As a result a growing realization has emerged that market processes need to be allowed a greater role in making the myriad decisions involved in allocating resources in complex modern economies.

This analysis in turn suggests the following guiding principles for economies aspiring to liberal reforms:

- Allow prices that are both flexible and reasonably reflective of international price movements.
- Eliminate impediments that could abort necessary producer responses to changing prices; in particular, ensure a reasonably liberal basis for both new products and producers to enter markets and for failed products and producers to exist.
• Allow productive agents to emerge who are motivated to change in response to changing conditions. Those who manage capital without ownership involvement may not have the proper incentives to build a sound capital base, resist unaffordable wage demands, and generally champion the needs of corporate profitability and capital.

• Establish a stable macroeconomy; a difficult prospect in many of the reforming socialist economies because of the inherent tendencies toward instability caused by large monetary overhangs, as well as the perceived need to generate the large changes in relative prices required as an essential feature of reform.

• Establish sound and flexible financial systems.

In light of this broad set of requirements, Hinds then moved on to anticipate an issue that reappeared at several stages in the discussion, namely, what kind of financial system the reforming economies should aim to achieve. Choices were between a relatively interventionist system in which the government retains some influence over the allocation of investment resources, and a highly liberal and unrestricted system. He noted that although there were a few clear exceptions, such as South Korea, the interventionist model had normally failed and certainly could not be generally recommended. However, the liberal approach, such as the Chilean model of the early 1980s, could also be dangerous if certain precautionary measures were not also taken. Above all it was vital that as the rules governing financial organizations were reduced in number, those rules that remained, especially those pertaining to banking regulations and supervision, should be applied with greater vigor.

A third possible approach Hinds mentioned related to ownership issues, especially the possible cross-ownership of industrial enterprises by banks. It is true that cross-ownership has worked reasonably well in both the Federal Republic of Germany and Japan, but these cases, he felt, were exceptional. More commonly, this cross-ownership has caused major problems. Thus, in the privatization programs now being defined in Central and Eastern Europe, there were good reasons to deny banks the opportunity to purchase stakes in productive enterprises, and to try in other ways to achieve an arm's-length relationship between lenders and borrowers.

Finally, Hinds introduced a critical theme, which again recurred throughout the seminar, namely, the sequencing of reforms. His remarks focused on three questions. The first was whether it was possible to achieve effective macroeconomic stabilization without first achieving some structural reform at the enterprise level. Hinds' own view was that in the absence of structural reform many of the conventional instruments of stabilization policy would fail to achieve their objectives. The rigidities of the pre-reform system are likely to cause unnecessarily large output losses when stabilization is attempted. The
30 percent real output loss in Poland in 1989 was cited as one example. Furthermore, the rules of a pre-reform system will often contain numerous devices for sidestepping the intended effects of stabilization instruments. Yugoslavia's recent experience was cited; enterprises, faced with tight macroeconomic pressures, have merely ceased to pay salaries and service their debt charges rather than resort to more fundamental adjustments involving, for example, reduced manning levels and closure.

The second question was whether it was preferable to sequence bank restructuring in advance of enterprise restructuring, or vice-versa. Hinds' own position was that although enterprise restructuring was a somewhat longer term task than bank restructuring, action on both fronts needed to move along together. However, successful enterprise restructuring is critically dependent on the financial discipline of well-functioning banks; this implies that some early action to achieve a reasonable degree of efficiency in the banks is going to be necessary.

The third sequencing question focused on restructuring relative to the privatization of enterprises. The United Kingdom proved that it was possible to restructure certain loss-making state enterprises as a first step to privatization. British Airways was a prime example. However, this was only possible because the United Kingdom at the time already had a strong base of market-oriented enterprises into which the newly privatized companies could be embedded quite easily. The situation is fundamentally different in Central and Eastern Europe where there is no tradition of market-oriented activity, and certainly no core of such activity to define the role models and benefits of good performance for restructuring enterprises. Hinds argued for a strong early privatization of enterprises to establish the champions of capital and to ensure that there really was motivation for pursuing restructuring.

The subsequent presentation by Millard Long extended Hinds' analysis by assessing some aspects of the financial sector structures that countries undertaking reform needed to consider. In relation to banks, Long noted that most economies in transition appeared to be opting for universal banks. He felt, however, that this tendency may be based on a misunderstanding of the German model. In Germany, for example, banks have relatively limited (for example, 20 percent) ownership claims on industry, whereas in Central and Eastern Europe the moves under way are likely to create much larger involvements than this. Long also raised serious questions over whether it was prudent to allow banks to offer not only banking services but a full range of other financial services including insurance, brokerage dealings, and security market activities. Critical questions were whether the bankers in these countries, whose experience was limited, should be licensed to move immediately into this broadened and complex range of activities, and whether central bank supervision would be able to maintain control if banks were indeed allowed to extend services in this way.
It is true that in many of the G-10 countries, the recent trends have been to allow banks to offer a broadened range of services. However, this has normally been done through a range of subsidiary companies that could be separately managed and supervised. With this approach subsidiaries are allowed to disappear in the event of their failure without compromising the stability and reputation of the bank. Possibly, this would be a better alternative for Eastern European countries than would full-fledged universal banking.

Many participants took issue with Long over this point. Those from Yugoslavia and Poland argued that universal banking was the only real route that could be followed in their countries, in part because this was the only way to economically use the limited banking skills and resources currently available. However, many participants recognized the need to divide the different activities of the banks. Some but not all participants expressed confidence in their countries' ability to build adequate supervisory systems for controlling complex institutions.

The most controversial issue concerned whether banks should or should not be allowed to acquire ownership stakes in productive enterprises. A few participants felt that this was the only way in which a reasonable amount of equity financing could be quickly established to dilute the preponderance of loan-based financing in the existing systems. It was also pointed out, however, and elaborated in later sessions that no real capital is created in the process of banks' acquiring equity stakes in enterprises. Furthermore, if banks own the enterprises or lend to enterprises in order to enable the purchase of other enterprises, there is little consolidated capital and no real expectation that the banks will seriously oversee the borrowers; nor is there any resilience in the system when things begin to go wrong. In cases where the ownership of commercial banks lies with the central bank, there is a serious danger that the central banking functions of monetary control, credit allocation, and prudential control will become confused and ineffective.

Long also considered the steps required to establish reasonable efficiency in banking and proposed that competition and contestability of markets are not necessary. Arrangements in Central and Eastern Europe and in Algeria before 1984 established specialized financial institutions, which were determined by factors such as region, sector, and type of banking (for example, commercial versus investment). Segmentation meant that although there may have been a large number of banks, serious competition was still lacking. Seventy or more banks in Bulgaria, for example, and seventy to ninety banks in Yugoslavia seemed too high from the viewpoint of system efficiency.

The reform of these financial structures necessarily raises many questions. For example, in countries where the savings bank specializes in savings mobilization but does little lending, would it be better to sell branches of the
savings bank to a large commercial bank, or to establish the savings bank as a major lender? A particular issue is what is to be done about the foreign trade banks in Central and Eastern Europe, which are often quite efficient but have a somewhat ambiguous role in the environment of reform. One approach to introducing competition, which received some support from the floor, was that of inviting investment from foreign banks. It was argued, however, that this should be done only with care and only when some progress had been achieved with the restructuring of domestic banks.

In relation to the nonbanking components of the financial system, Long drew attention to the importance of certain types of nonbank intermediaries and security markets in providing competition for banks and ensuring an adequate supply of term finance and a greater range of risk-to-return configurations to support different types of portfolio preferences and investment needs. Long argued that pension and provident funds, together with life insurance companies, provide an important source of long-term external finance for industry in many countries. In Central and Eastern Europe, the replication of this arrangement would probably require a move from unfunded to funded social security schemes, as well as amended fiscal arrangements to provide more possibilities for retirement funds to be used in the private sector. It was noted from the floor that leaving the responsibility for old age and health provision with productive enterprises, which is the common practice in Central and Eastern Europe, has several negative consequences for financial reform. Because the social safety valve is so closely associated with employment in a particular enterprise, the social costs of enterprise restructuring are obviously raised when social responsibilities are not kept separate from the productive role of enterprises.

The confusion of social responsibilities and productive role is, however, deep-seated and certainly a factor holding back change. Above all it is an impediment to early privatization. A move to shift pension responsibilities from enterprises to individuals would result in a rise in savings. Thus, it was generally felt that early action to lift social responsibilities from enterprises would be beneficial both to the enterprises and to financial sector restructuring, although this would also transfer an increased burden to the government budget.

Transitional issues, Long argued, are of critical importance to the design of reform, as are the associated issues of sequencing, which Hinds had alluded to. The specific areas that needed to be addressed in this context included the following:

- Many of the existing financial institutions within these economies in transition are bankrupt, and there is an obvious question of whether it would help to restructure their clients before resolving the institutions'
problems. It is also unclear whether banks should take on a broadened range of new functions while they are still in financial difficulty.

- It is imperative to determine if any of the micro/restructuring issues should be seriously addressed before taking action on macroeconomic, tax, and price reform issues.
- The elimination of price controls and subsidies will result in converting a repressed economy into an open inflationary economy, which in turn will complicate the problems of macroeconomic stability.
- Higher inflation will continue to force devaluations and exchange-rate losses, as it has in Poland and Yugoslavia. This process, if not controlled, can add to the difficulties for the financial sector.
- At some point banks must move from a soft to a hard lending mode, but it is unclear whether this should be done before or after relative prices and the tax system are reformed.

A final issue that emerged in discussion relating to both the Hinds and the Long papers concerned the methods to be used for privatizing enterprises. Several participants noted that there will be many new demands on total private savings as a consequence of reforms. These include demands to finance increased private housing ownership, to support enterprise restructuring, and to support the restructuring of financial institutions. Large surpluses of savings available to buy the assets of privatizing companies are unlikely. Thus, if banks were also ruled out as purchasers of these assets for the reasons cited above, then the logic of the situation, as presented by some participants, may well be that the assets have to be given away. In any case, a sale to the public would merely shift scarce savings back into the hands of the government, thereby partially aborting the attempts to decentralize. This point worried other participants who perceived a major budgetary problem if the government merely gave away the assets of enterprises and at the same time took over the social welfare obligations formerly handled by the enterprises. While this might result in more micro-level flexibility in the economy, how will the resultant budgetary cost be met?

A related concern was whether the management problem could be handled in an asset give-away scheme. In essence, there is the presumption that even the former managers of enterprises would have better incentives under a private property system, even though it is dispersed. The emergence of a market for the assets leading to an early concentration of their ownership in the hands of those who wished to manage and undertake restructuring could speed up the incentives for good management. Participants generally accepted that the realization of efficiency gains was the main objective of privatization, and if these gains were sufficiently large, then the foregone revenue associated with a give-away rather than a sale could be justified. Hinds suggested a
compromise arrangement that could provide greater prospects for the attainment of the efficiency gains; this involved an 80 percent give-away combined with a 20 percent asset retention by the government. The government would use the last 20 percent to offer management contracts to individuals or organizations that could oversee the restructuring process. Hinds' general point in defense of give-away is that there are no costs involved in an adjustment of this type. The costs are associated with the retention of the old system of enterprises, with all the inefficiencies it entails.
The Supportive Role of Monetary and Other Macroeconomic Policies

The conventional view of the role of inflation control and other macroeconomic policies in the reform process is that these factors should be addressed early on. The basis of this view, as one participant explained, is that in the presence of high inflation and other instabilities of this type, there is too much "noise" to enable the relative price movements, which are fundamental to the mainline reforms, to show up sufficiently to stimulate the desired responses. An extension of this view, which is likely to be applicable in most of the Central and Eastern European economies, is that inflationary pressures emanate mainly from government budgetary deficits, defined broadly to include enterprise deficits that are either a direct or indirect burden on the state.

This conventional view, if correct, results in straightforward prescriptions for policy and provides unambiguous guidance about the sequencing of macroeconomic reforms. Unfortunately, as the introductory discussion already indicated, there are several reasons for doubting whether policymaking in the real world is quite that simple. Several other points that emerged from the subsequent discussion indicated important but problematic feedbacks from the mainline economic reforms to the macroeconomic policies. The following three examples were given:

- The true size of the government deficit, broadly defined, is not known or even knowable until reforms have proceeded to the point of bringing the true losses of both productive sector and financial enterprises into the open. In most of the countries, even the accounting systems need to be reformed before the true scale of the problem of enterprises is revealed.

- The very first element of the blueprint advanced by Heman Buchi for restructuring enterprises (see "Restructuring Enterprises," a subsequent section of this report) is to remove the conflicting objectives, including social objectives, imposed on enterprises. As soon as this is done, however, the burden is necessarily thrown back onto the budget deficit with obvious and adverse consequences for macroeconomic stability.
The behavior of economic agents before mainline reforms are introduced will not be market oriented. Thus, the responses of economic agents to some of the standard instruments of an economic stabilization policy, such as tight credit and higher interest rates, may not be those that conventional models would predict or that the success of the policies require. Indeed, there are good reasons for expecting perverse responses.

It was this last point in particular that Guillermo Calvo’s presentation emphasized and developed, especially in relation to interest rate policy. Calvo noted by way of overview the dissonant themes that emerged during the discussion of credit and interest rates for the reforming economies. On the one hand, there was a willingness to regard freer credit and interest rate policies as an integral part of the process of achieving improved resource allocation—the interest rate being just another relative price to be set right. On the other hand, there was some recognition that the substantial real resource movements now required in Central and Eastern Europe could well be complicated if a credit crunch was imposed prematurely or if interest rates on a transitional basis achieved unsustainably high levels. There might well be a conflict, for example, between the apparent efficiency gains associated with the closure of a sector of inefficient activities caused by tight monetary policies, and the longer term benefits for the economy that might accrue if somewhat more benign monetary policies allowed parts of the sector to survive.

Certain specific issues come from this general line of analysis. For example, available evidence already indicates that the magnitude of the average price rises during reform may be extremely large (300 percent or more), because the starting point is so distorted. The monetary targets introduced as part of a stabilization program obviously need to accommodate this to avoid an unwanted credit crunch. Similarly, the resolution of the problems of large interfirm debts would require an expansion of bank credit, which would also need to be properly reflected in monetary targeting. A major element of the argument in favor of higher interest rates was that the increased rates would enhance the flow of borrowing from external sources. The current indications in Central and Eastern Europe are that this external flow will not happen early on or in large amounts; therefore, higher interest rates may not help to avoid a possible credit crunch.

Calvo’s message was that high real interest rates sustained for any length of time should not be regarded as the cornerstone of stabilization policies in any context, and certainly not in the very difficult circumstances confronting most of the reforming economies of Central and Eastern Europe. In both the open economy and closed economy models, a high and sustained real interest rate would be a sign that the stabilization program lacked credibility. In an open
economy, the high interest rate implies expectations of high future rates of devaluation. In both cases, a successful stabilization program that succeeded in reducing inflationary expectation would be expected to go hand in hand with low real interest rates at an early stage. Thus, the persistence of high rates would indicate failure.

Particular problems arise if real interest rates remain for many months above the real return on capital of a typical enterprise—something that is likely in reforming economies where rates of return are known to be generally low. The initial losses or low profits of the enterprise sector would be intensified by financial charges, thereby increasing the incidence of enterprise bankruptcy. However, this is not what stabilization policy should be aiming for, because the lower price expectations that will result will be of little benefit if they are accompanied by a major decline in the supply-producing capacity of the economy. One intermediate consequence could be the piling up of debts, even in sound enterprises. Calvo concluded that interest rates should invariably be set in a manner that does not contradict the sustainability of a stabilization program. Thus, where inflationary expectations are likely to be difficult to push down, policymakers should not seek to solve the inflation problem in just a few months, and they should certainly not push real interest rates to extremely high levels in an attempt to achieve this.

Participants provided some vivid examples of the dangers anticipated by Calvo. Yugoslav participants noted that the 40 percent real interest rates recently experienced in their country had generated large numbers of both distressed borrowers and distressed lenders. Bankers were trying to cover their high resourcing costs by lending, to some extent, recklessly. Borrowers were mainly concerned about survival and were borrowing suicidally with little regard for even the medium-term future. Both participants at the seminar and agents in the Yugoslav market assumed that this process would have to result in a widespread bailout, with the consequence that losses would fall on the government. Certainly the pernicious expectations now established denied the economy any benefits from the high interest rates in the form of efficient credit rationing, which is the way interest rates are supposed to achieve their stabilizing effects.

Similar problems were noted in the case of Poland. In Bulgaria, however, where inflation had already moved above 50 percent but with still very low nominal deposit rates, participants questioned what policies would be appropriate to pursue. Calvo's advice was to avoid the active use of interest rates for stabilization and other purposes until the reform of the banks and the borrowing enterprises has been achieved at least in part. It was also suggested that if the Bulgarians proceeded in a different way, one consequence could be the eventual need to monetize a larger amount of enterprise debts, which would be the antithesis of stabilization.
The Institutional Environment for a Sound Financial System

In addition to a reasonably stable macroeconomic environment, most economies in transition also need to put in place certain institutional arrangements for a sound financial system. The identification and analysis of these arrangements were the main points of the discussion introduced by Aristobulo de Juan.

Aristobulo de Juan began by noting a fundamental principle of all banking, namely that banks should not mobilize deposits for the banks' sake. On the contrary, deposit funds that are mobilized should be lent out, and those loans should subsequently be repaid. Money that goes out must come back. If it does not, it imposes a burden on the economic system in general through a variety of distortions, and on the government in particular as it arranges various partial or complete rescue packages for failed borrowers and banks. However, in Central and Eastern Europe these principles have not been regarded as important and have certainly not been observed. Instead, there has been an emphasis on the role of banks in helping to keep enterprises alive. Consequently, loans have been made as readily to bad as to good enterprises in order to keep enterprises going. The process has necessarily involved large elements of ad hoc political interference, malpractice, and corruption.

One consequence has been that the portfolios of these countries' banks have often failed to produce a yield: the money has not come back. However, because the principle of keeping enterprises alive has also been applied to the banks, various arrangements have been made to save the banks. Such arrangements included the absence of any on-site supervision of banks and a negligible respect for the importance of off-site supervision; and accounting rules that disguise the poor quality of bank portfolios, allowing some banks to achieve apparent profits and continue to pay taxes as well as dividends in spite of their true situation.

In this climate of self-deception, there has been little or no importance attached to operational efficiency. Consequently, the interest rate margins of the banks have also been generally high. However, this is of little concern to most borrowers who are in no position to service their loans in any event and have no real need to be concerned themselves about high borrowing rates. Furthermore, in some banks the mobilization of deposits has come to be
motivated more by the need to meet the banks' own payroll obligations than to accommodate the financing requirements of clients.

Several of these facts about banking motivation and behavior were confirmed in relation to [the former] East Germany by Michael Altenburg, vice president of Deutsche Bank, and responsible for a joint venture involving 140 bank branches in East Germany, between Deutsche Bank and the Deutsche Creditbank of East Germany. Altenburg noted the enormous cultural differences between the staffs of these two banks. In particular, the Deutsche Bank staff are trained to appraise customers' proposals on their financial merits. Staff from the Deutsche Creditbank, however, regard clients as part of the same system of mutual support and not as clients to be appraised objectively in the manner of Western banks.

Aristobulo de Juan noted that some of the measures for deregulating, introducing more competition, setting up capital markets, and so on, which are often advocated for reforming economies, are both good and bad in this type of situation. In relation to liberalization, for example, de Juan noted that many of the banks forced to close during the banking crisis in Spain and Argentina during the 1980s had been part of a liberalization just a few years earlier. Liberalization per se clearly had not created the conditions for sound banks. Similarly, the energetic promotion of capital markets would be unlikely to achieve significant benefits for financial performance while enterprise insolvency remains the norm rather than the exception. Finally, free interest rates introduced into an environment in which banks do not know how to make sound loans is a recipe for the type of disaster now afflicting Yugoslavia. Therefore, the benefits of general financial sector reforms will be better if they are preceded or accompanied by certain critical institutional reforms. Aristobulo de Juan defined these reforms as regulation and supervision.

Regulation

In relation to regulation, the guiding principle is that the more the system is deregulated overall, the tighter should be the rules governing the banks and the application thereof. Specific rules that most transitional economies need to tighten up include capital adequacy, uniform accounting guidelines, limits to large exposures, and the enforcement powers of the central bank. These are described briefly in the following paragraphs.

Capital Adequacy

In many countries the actual assessment of the capital adequacy of the banks is inflated, because very high proportions of the total apparent capital in accounts is made up of the revaluations of the banks' buildings, while other
elements comprise fictional revenue reserves associated with the booking of interest on nonperforming loans. A sound procedure would be to include only paid in capital and undistributed profits that have genuinely been earned.

**Uniform Accounting Guidelines**

While there are many possible accounting guidelines, the most commonly used is the least reliable. This approach, in which loan quality is assessed on the basis of loan arrears, is inaccurate, because the worst loans are never in arrears. A better alternative, therefore, is to establish a system of loan quality classification based on an objective assessment of the creditworthiness of each borrower. In this way, the bank can discern what proportion of the money lent will come back to the bank. The part that is unlikely to come back should be represented in provisions and in no circumstances should interest be accrued on the loans that are provisioned.

**Limits to Large Exposures**

In de Juan's opinion, it is important to have clear limits on the proportion of a bank's total lending provided to any one borrower. Twenty percent of total unimpaired capital and reserves of the bank is a reasonable limit. It is equally important to strictly limit loans to industries and other parties with whom the banks may have an ownership association. However, because these limits were extremely difficult to enforce in cases where the banks are the actual owners of industrial companies, de Juan personally was not in favor of allowing the banks to be shareholders in industrial companies.

**Enforcement Powers of the Central Bank**

It is extremely important to grant substantial powers to the central bank to deal quickly and effectively with major problems. These powers should include the authority to remove managers, to force the banks to arrange new injections of capital when capital is inadequate, and in extreme cases, to fully take over the management of a bank.

**Supervision**

While bank regulation is concerned with setting the rules, bank supervision is concerned with enforcing compliance with the rules. The two aspects of

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1. In such situations, he said, attempting to enforce loan limits is "rather like trying to stop an avalanche with an umbrella."
control go together, and there is absolutely no merit in a system of regulation unless it is backed up by a good system of supervision.

The basic objective in establishing a supervisory system is for banks to be gradually required to disclose all relevant information to supervisors. Disclosure requirements should be far more demanding than the information disclosures that banks are normally required to make to the public in annual accounts and in other ways, because losses and insolvencies may be extremely hard to detect in standard accounting returns. Thus, de Juan argues for substantial use of on-site supervision, in contrast to the present systems in Central and Eastern Europe, where there is almost no such supervision. The on-site capability is essential, in de Juan's opinion, to ensure that falsehoods are detected early for banks in trouble. A file-by-file audit of accounts, at least of larger borrowers, would be necessary.

However, guidelines concerning which agency should have the bank supervision capacity are less easy to define. If it is located within a Ministry of Finance, its work may get too closely tied to tax collection; thus, the compliance of bankers may be harder to achieve. If the supervisory group is part of a central bank there are less difficulties, although its work may become confused with the application of monetary policy. There are, therefore, good reasons for creating an entirely separate capability.

While the general discussion surrounding de Juan's suggestions generally endorsed separate supervisory boards, several participants noted how comprehensive the reform of institutional arrangements needed to be, and what an enormous burden on scarce human resources these reforms would need to impose.
The Restructuring of Enterprises

Discussion at the seminar turned its focus toward two vital building blocks of any financial sector reform, namely, enterprise and bank restructuring. The first of these topics was introduced by Heman Buchi who, as the minister of finance in Chile, had much of the responsibility for reforms in his country in the mid-1980s.

Buchi noted that in a market system numerous aspects of the environment affecting enterprises change almost daily, and a high degree of flexibility is required to ensure proper responses to these changes. The process of establishing such flexibility and creating an effective market economy is essentially one of defining certain general rules and then allowing the market economy to evolve and the individual enterprises to make the majority of their own decisions. Certainly, the politicians and civil servants in a reforming environment will be told that almost every situation they address is a special case needing special arrangements, but these pressures need to be resisted. One of the greatest pressures will normally come when the needs of both enterprise and bank restructuring merge, namely, when enterprise losses need to be reduced. It will often be argued that these losses represent merely a temporary liquidity problem and can be resolved if only more money is made available on a strictly temporary basis. Such statements are rarely valid, however, and it is a fundamental requirement of successful enterprise reform that they be resisted.

Buchi then focused the discussion on five main aspects of enterprise restructuring: incentives and general signals, management, financial restructuring, physical restructuring, and privatization. Each of these is described below.

Incentives and General Signals

Companies in the economies in transition have traditionally been presented with a whole set of inconsistent objectives. These have included requirements such as the need to create more jobs and help in the development of a region, as well as requirements based on centrally directed output and marketing targets. An important reforming initiative would be to remove all the
peripheral requirements imposed on companies so that they could concentrate on their main objective: the efficient and profitable production and sale of high-quality products. The companies need to maximize their profits and achieve this within a system that is as free as possible. This would certainly include the need to transfer obligations such as social security away from the companies and place them where they properly reside, namely, with the government.

Management

A difficult task in enterprise restructuring is that of introducing competent management. There were two aspects to this. First, privatization of ownership might be expected to improve management by establishing a higher degree of motivation in the typical manager. Buchi referred to the compromise position that Hinds had described, as well as to the importance of opening up ownership to foreign companies in order to achieve the necessary managerial and technological capacity that companies in economies in transition seriously lacked. Buchi believed that the resistance to foreign ownership, evident in Czechoslovakia and some of the other countries, was seriously misplaced. Reforming countries need to recognize that far from being overrun by foreign capital, they will have serious difficulty attracting it in any quantity. This position received considerable support, especially from the participants from Hungary and Yugoslavia.

Second, in the absence of privatization and a change of ownership, the government must try to carry out some of the management tasks that ideally belong to private managers. Although this should be a transitory second-best situation, the disadvantages can be minimized if the government organizes a group that acts with an owner's mentality and within a framework that establishes clear and transparent rules about what managers can and cannot do. The governmental management group must especially avoid ad hoc and arbitrary intervention from politicians.

Financial Restructuring

The managers of enterprises under central control never really thought that their losses would matter. Thus, successful restructuring requires that this view be fundamentally changed, and that enterprises understand the threat to the future of the companies and their managers should they make persistent losses. This is part of the process of creating in the managements of the companies something resembling the mentality of an owner even when private ownership is not formally established.

A reformed banking system can play a very important part in this, because banks have the power to—and should not—loan more funds to badly
performing companies. Consequently, when enterprise restructuring needs to precede the restructuring of banks, the situation is more problematic, and comparable judgments concerning the denial of credit to enterprises are necessary. One possible alternative is to establish a holding company to administer the assets of restructuring companies. Although this could create another center of excessive political power, the danger is not inevitable. If the holding company is well-run on proper business lines, it will be in a better position to make sound business judgments on behalf of the companies than would the sectoral ministries who are likely to be the alternative decisionmaking body in the absence of an early privatization. The critical point is to clearly separate governmental decisions from those that relate more narrowly to the commercial needs of the company.

Another important requirement for the successful financial restructuring of enterprises is that the banks that are the creditors of the enterprises be allowed to make hard decisions, including the writing off of some loans, without threatening their own financial viability. This might be done, for example, by encouraging a restructuring agency or holding company to buy off the bad debts of the banks. However, even if this is done the banks are likely to remain as the most effective organization to administer and attempt to collect some part of the portfolio of bad debts. Because of this, some arrangement should be sought whereby the banks can retain some proportion of any collections they achieve.

**Physical Restructuring**

With thousands of companies in need of restructuring, the task of devising and implementing all the necessary changes cannot possibly be handled on a centralized basis. For smaller companies in particular, it is necessary to create general mechanisms, including various types of financial and technical support, but then allow the companies to do most of the restructuring themselves. For larger companies, and especially conglomerates, it may be necessary to divide the company into smaller elements, which are easier to privatize, manage, and control. In this case, when a subset company of a larger company is deemed to be loss-making even in the medium term, it was generally accepted that they can be neither privatized nor closed down easily because of the high political and economic costs that this would entail. One widely endorsed suggestion from the floor was that these companies might be subjected to a decisionmaking process that could alleviate some of the political pressure surrounding those companies' future. The process might include quantifying and making public the direct and indirect costs of keeping the enterprise alive, establishing court-like hearings to reach decisions about various major aspects (for example, job retrenchment) of the restructuring of the companies, and defining ex ante a limited number of
policy levers and subsidies that the government is empowered to use to support the enterprises. Such support might also be governed by ex ante time limitations.

Privatization

The general proposition that most of the detailed decisions about restructuring should be made by the companies leads to the view that privatization of ownership is itself a critical element in the process. Such a view, Buchi argued, is the most direct way to create the owner mentality in as many enterprises as possible. Privatization, in Buchi's view, has to be implemented on a wide scale even though there are many arguments as to why this is impossible. One such argument is that privatization is difficult when there is no market to which to privatize. Buchi believes, however, that the actual process of widespread privatization will be the major force in creating an active market in company shares. The process is unlikely to start with the sale of many state owned enterprises; thus, Buchi subscribed to the proposition advanced by Manuel Hinds, that initially the majority of shares will need to be given away. While the government may be unwilling to sell profitable companies, because it will need the ongoing revenue from their activities, the government will not be able to sell loss-making companies because no one will buy them. Proceeding on the basis of widespread distribution of property does not preclude the emergence of an active market at a later stage.

A second argument against privatization if it is organized through a give-away is that the allocation of shares is likely to be unfair. Buchi agreed that the initial allocation might be unfair, although this could be mitigated, as it was in Chile, by reserving certain blocks of shares for employees in the privatizing enterprise and other blocks to small shareholders. However, the possible unfairness that may remain is the necessary price for beginning a process that will result in greater enterprise efficiency.

The participants, however, did not universally accept this point of view; participants from Yugoslavia, in particular, argued that their decision to reject share-handouts was reached in part because this approach was regarded as inimical to the achievement of managerial and technical efficiency at an early stage. In detailed comments from the floor both Yugoslav and Hungarian participants accepted the general proposition that enterprise restructuring and privatization needed to go hand in hand. The focus on privatization was seen to be particularly important in the situation faced in the two countries where the human and other resources needed to sustain restructuring were in very short supply.

In the case of Yugoslavia, it was argued that many of the preliminaries for reform had been successfully completed. Inflation appeared to have been brought under control during the past few months; trade liberalization was
The Restructuring of Enterprises

well advanced, as was the liberalization of prices; the financial pressures on companies through monetary policy had been kept tight; and the legal framework for a market system, including new bankruptcy laws, had been strengthened. However, a variety of problems still stood in the way of an early resolution of problems at the enterprise level.

First, like the situations in Poland and Hungary, the ownership status of many enterprises remained ambiguous. Paradoxically, it was necessary in Yugoslavia to first nationalize some of the worker-council companies, including very large companies such as railways, before restructuring could begin. The losses in some of these enterprises, however, were huge, and the government had neither the interest nor the ability to run them. In other countries, too, the current ownership status of enterprises was ambiguous and needed to be resolved before restructuring began. In Bulgaria, for example, property, in effect, had always belonged to the apparatchiks, who had made all the decisions about the companies located on their property.

Second, while it had been recognized that formal bankruptcy was a considerable spur for enterprise restructuring, it was not clear how the situation could and should be handled when as many as 30 percent of the enterprises were formally bankrupt. The legal system does not have the capacity to handle this volume of activity. Thus, it seems that the Ministry of Finance is turning a blind eye to the failure of companies to pay income tax, for example, and is not using this as a pretext for forcing legal proceedings.

Yugoslavia had followed the general advice of setting up separate arrangements for restructuring for small and large companies. A special program had been developed, in collaboration with the World Bank, for the 80 to 100 largest lossmakers. For the smaller companies, a number of small business center initiatives had been set up to provide advice, incubator facilities, and franchising arrangements to encourage the emergence and growth of new and existing small companies. In some regions, such as Ljubljana, these initiatives had been developed with substantial advice and support from larger regional companies. In general, the potential to achieve some restructuring by dividing some large company activities into smaller companies was considerable in most countries. Nonetheless, in spite of these initiatives Yugoslavia, like the other countries represented at the seminar, still faced major problems with the physical aspects of restructuring. Foreign participation was generally welcomed, but international management contract arrangements were perceived to be far too expensive to use on a wide scale.

A further and contentious issue for debate in this area arose over the question of the valuation of the enterprise assets to be privatized. Participants generally agreed that enterprise book values in the countries represented at the seminar were almost meaningless because of the inadequate accounting practices used. Thus, new valuations, often requiring assistance from the large
Western audit companies, were generally required as a prerequisite for privatization. Such assistance was generally thought to be expensive but nonetheless helpful, especially if it succeeded in transferring the valuation skills and related techniques to the client countries.

One participant noted that it was essential to accept low valuations early on in order to begin the process of reallocation and restructuring of assets. Valuations are not critical to the realization of the benefits from restructuring and privatization; thus, all that matters is to get some feel for the appropriate value of the company. Other participants contested this, arguing from a political and equity point of view that it was difficult to sell state assets at a low price if their subsequent valuations after restructuring were going to be much higher. This was thought to be especially problematic when companies were sold to foreign investors who then engineered massive job cuts in order to put the company into better shape before reselling at a substantially higher price.

Others against this pointed out the fundamental difference between a company’s valuation and its price: the latter being determined by the supply and demand for its assets in the market place. The reality of privatization in Central and Eastern Europe was that price was currently more important than objective valuations. More fundamentally, valuation depends on future cash flows, which in turn depend on the skills and effectiveness of those who run the company. Buyers who convert loss-making companies into profitable ones have created their own capital and should certainly be allowed to keep it. It would be quite wrong to have contingent contracts in which buyers are required to pay an increased price if the companies, under their ownership, achieve high profitability. The slogan ought to be “the past belongs to the state, but the future belongs to enterprise.”

Finally, participants correctly pointed out that enterprise restructuring is not merely concerned with the process of turning around existing companies. It should also encompass a whole range of measures to support private sector development more generally, including the emergence of new companies. Judicial and public administration systems need to be reformed and simplified to avoid situations such as that in Czechoslovakia, where it currently requires sixty-four steps to set up a new small business. A variety of initiatives had been tried either in Central and Eastern Europe and elsewhere, and it was generally agreed that there were numerous models from which to take guidance. These included support and promotion programs for small companies initiated by large companies, such as British Steel, in an effort to mitigate the high social costs of their own restructuring; and widespread advisory and support networks of the type increasingly supported by, for example, the European Economic Community.
The Restructuring of Banks

In introducing bank restructuring, both Andrew Sheng and Aristobulo de Juan noted some solutions that need to be applied across-the-board and others that can be handled on a case-by-case basis. However, because the problems in the banks of Central and Eastern Europe are systemic, it is necessary to begin the process of bank restructuring by taking measures that can be helpful to the whole banking system. Generally, the transitional banking systems in these countries suffer both because information is soft—that is, there is no real knowledge of the true size of accumulated losses—and because contracts are soft, so no one really knows who owns what or where responsibility for previous decisions currently lies. In this situation the vacuum of responsibility can only really be occupied by the state, which in many of the countries is merely dealing with the problem by monetizing the losses and therefore creating high inflation.

This calls for solutions that include the development of sound accounting systems and the establishment of proper bank attitudes toward risk, innovation, and the acceptance of responsibility. It was noted in discussion that in East Germany, Yugoslavia, Poland, and other countries, the large Western audit firms were making diagnostic studies and establishing sound accounting practices. This type of external involvement in the problem was unavoidable. In Yugoslavia in particular, the losses in the banks were thought to be enormous. Of total bank assets of some $38 billion, as much as $10 billion could be nonperforming; this compares to bank capital, which, including asset revaluations, is only about $3 billion to $4 billion. The first step in bank restructuring in this and other cases is to get out of the dark and establish the true size and nature of the problem.

de Juan noted several forms of handicap that affect banks, and have contributed in part to the distress now evident in many of the economies in transition. Removing these handicaps is an essential step in the restructuring process. An example of such handicaps is reserve requirements on banks that go beyond the magnitude of prudential requirements, combined with the failure of central banks to pay interest on these reserves. Another example would be the obligations imposed on banks in many countries to make forced investments in government and other specified securities. Argentinian banks,
for example, once had to allocate up to 70 percent of deposits for the use of regional governments.

In addition to removing these handicaps, a participant suggested that a useful approach might be to consider an across-the-board government purchase of the bad loans of the banks to clear the banks' balance sheets and therefore clarify the task of establishing better lending and other bank practices. This approach, which has been adopted in Chile, for example, made the government's support for distressed banks more explicit; otherwise government support often becomes diffused across a variety of interventions and appears generally distorted and inefficient. Participants generally agreed with this example. Furthermore, participants noted that in Yugoslavia and other reforming economies the stabilization stage of reform had already converted the existing insolvency of many enterprises and banks into illiquidity, thereby advancing the need for governmental action to deal with the financial restructuring of banks.

Turning to the case-by-case actions needed to restructure banks, de Juan noted that the discussion on this subject normally started by considering the possible closure of banks. However, in the majority of cases the banks in Central and Eastern Europe and elsewhere were too large to be allowed to fail; therefore, the substantive action related more to rehabilitation than to closure. He advocated that rehabilitation should be addressed in three stages.

First, it is necessary to reconstruct the equity base and the profits of the bank. Although writing-off irrecoverable losses is important, it cannot solve the problem, because these losses might amount to five or six times the capital of the banks. Consequently, new assets with good yields need to be found to help sustain the buildup of profitability. Selling off nonperforming assets, already referred to above, is an important part of the process too, because not only does this show explicitly the government's ultimate responsibility to pay these losses, but it also puts capital back into the banks. However, it is important that these purchases be made at book value and paid for by the issue of government securities or in other ways that can avoid undesirable monetary expansion as a side effect. A concern is that governments in the countries concerned typically face tight budget constraints; however, the costs of such a rescue will typically be lower now than if the problems of the banks are allowed to persist until some future date.

Other actions should also include the halting of dividend payments to shareholders insofar as these are justified by fictional bank profits rather than real earnings. In some situations, too, where the government is injecting new capital into productive sector enterprises, the enterprises ought to be required to directly repay their loans to the banks. In almost all cases it should be recognized that the government and the central bank are likely to be very bad at collecting bad loans. It may be preferable to establish some special
institution to act as the agent for the government in this function. A final point is that banks seeking to rebuild profitability may try to work with high interest margins. However, this is clearly dangerous when so many productive enterprises are in financial distress. Action is needed to lower the spreads, and for Yugoslavia it was again suggested that eliminating excessive reserve requirements is an important way to achieve this result.

Second, it is important to force the restructuring banks to establish new management teams. This indicates that the problems in the banks are, in part at least, the fault of the existing managers. This fact alone will make it difficult for solutions to be identified and implemented if the senior personalities are not changed. The new managers will initially have to take some extremely unpopular measures, which may not be possible if members of the original management team remain in positions of authority.

The establishment of new ownership in the banks is important for its own sake but also because it is a way to find new managers. The existing shareholders of the bank should not have to worry that their investment has been lost; they also should know that they can acquire a right to a further ownership involvement with the banks only if they put up new money. Other potential new owners who are often suggested may complicate the task of restructuring. Employees of the bank, for example, may have a valid interest in an ownership stake in the bank but are unlikely to cooperate easily with the acute cuts the bank would need to make in the process of restructuring. Members of the general public could certainly be involved, but because they are unlikely to bring the requisite management skills their involvement should ideally be preceded by the establishment of good professional management. Institutional investors would probably provide the best type of new ownership and management; de Juan, like other participants, advocated that the reforming countries should be less nervous about involving foreign partners than they currently appeared to be.

de Juan also noted that controversy about the price at which bank shares should be sold was in reality a minor issue, partly because many restructuring banks have a very low market value. Beyond this, however, the objective should be to get rid of the banks and its problems for good. Thus, a sale to a strong investor at a relatively low price could well be a better proposition than a higher-price sale to an investor who might prove incapable of putting the bank on a sound footing.

Another general matter brought into this particular discussion concerned the sequencing of bank versus enterprise restructuring. In a similar vein to Buchi, de Juan argued that setting up banks as sound institutions was an enormously important aid to enterprise restructuring, because the restructured banks would have the ability to say no to the loan requests of distressed enterprises. However, at the practical level de Juan felt it was probably
necessary to undertake banks and enterprise restructuring simultaneously to avoid the danger of putting off the one until the other is successfully completed. This, he felt, was a prescription for indefinite procrastination. Spain, he noted, had tackled the task of financial sector restructuring at a very inauspicious time between 1979 and 1985, during a major recession when the enterprises were in serious difficulty. However, the action taken in relation to the banks had created a role model for other aspects of reform. Furthermore, the process was certainly successful, with only three of the country's banks needing to close. In spite of a $10 billion injection of funds into the financial system, the restructuring process did not fuel inflation; indeed, inflation fell during the period when it was being carried out.

A number of country-specific problems emerged during the open discussion. In the case of Hungary, it was noted that the splitting up of the national bank had created an arbitrariness about where the previously accumulated losses had now settled. Although these losses were large, they probably had not risen much since 1987. Some of the losses were more difficult to face up to and resolve than others. The losses of the national savings bank were a particular problem, because they accounted for as much as 3 percent of gross domestic product, and the loans in question had mainly been allocated to households. The loans were then represented by the deposits of household savers. It was noted too that East Germany had a major advantage over countries such as Hungary, because the large seignorage gains associated with the currency integration with the deutschmark provided funds to pay some of the restructuring bills.

In the case of Czechoslovakia it was suggested that no real reform in the financial sector had begun. Instead it seemed that the working hypothesis was that many of the prevailing problems, such as bad portfolios, and so on, could be resolved simply by creating new banks. However, it was clear that if these new banks were any good, they would quickly wipe out the existing banks, which would likely be a painful process.

Some participants mentioned the strength of the bank lobby in Yugoslavia, and the resistance there to some of the reforms that had been advocated during the course of the seminar. The banks, for example, are resisting the tightening of rules to enforce the systematic classification of nonperforming assets and the ending of arrangements for crediting interest on nonperforming loans to suspense accounts. Notwithstanding the merit of the arguments behind these proposed reforms, the Yugoslav bankers are claiming that the reforms are too tough. The Yugoslav lobby also does not favor the introduction and strengthening of prudential controls on banks. Their argument appears to be based on a misunderstanding that a market system imposes no regulations, or very limited regulations, on banks and other institutions. The more correct position, as advanced by several participants at
the seminar, is that the more the financial system as a whole is deregulated, the greater the control on the bank.

The following points emerged while participants summarized this discussion:

- The problems of deep insolvency in banks are rarely solved by injecting more liquidity to allow them to grow out of their difficulties. However, the plea for more liquidity will invariably be heard in Central and Eastern Europe, as well as it is elsewhere.
- The sooner restructuring actions are taken the better, because the problems will invariably get larger rather than smaller.
- It is important not to be scared of the unpleasant side effects of restructuring, such as enhanced unemployment and accelerated monetary expansion. Whatever happens, the failure to do nothing with the banking problem will create more serious problems in these areas at a later stage.
- While losses are painful, they can also be beneficial because of the positive signals and encouragement that this can give to the restructuring banks, and also because of the synergy that these new positive signals can create.
Long-Term Issues: Nonbank Intermediaries and Capital Markets

The final substantive session of the seminar returned to the topic with which it began, namely, what structure within the financial sector can best support the reform programs and longer term development in the countries concerned. It was recognized that in several countries progress had already been made in breaking up the former monobank systems into a two-tier arrangement, establishing new bank legislation to better define the roles of central and commercial banks, integrating the deposit mobilization and allocation functions that formerly had been segmented, and breaking down other aspects of segmentation. However, so far relatively little progress had been made in developing the nonbank financial institutions and capital markets in the economies in transition, and a whole range of issues needed to be resolved in this area. The most important of these were highlighted in the introduction by Millard Long; they include the following:

- Will special measures be needed to promote the nonbank financial institutions?
- Can government budgets be financed without forcing insurance and pension funds to invest in government securities?
- Should one agency regulate both banks and nonbanks, or should insurance and security market regulation be separated?
- How can regulatory and tax authorities ensure fair competition between banks, nonbanks, and security markets?

Gerhard Pohl noted that, except for life insurance, nonbank institutions are virtually nonexistent in the economies in transition, and even the life and pension funds have a narrowly defined role. Pohl explained the numerous types of nonbank institutions that could be established in these economies, and what their roles, advantages, disadvantages, and existing importance are in the Western market economies. He suggested that three sets of factors will condition the size and importance of the nonbank financial institutions in these countries. First, this will depend on a variety of factors that lie outside the direct influence of the financial sector, including the future role of the private sector, the extent and manner of state enterprise privatizations, the regulatory environment established for nonfinancial companies, the tax
system, retirement and pension arrangements in general, and the nature of inheritance laws. In different ways all these systems can provide either openings or difficulties for the emergence of new financial services, depending on how the institutions are organized.

Second, the size and importance of the nonbank sector will depend on the regulations established for the banking sector. For example, if banks are restricted in their activities or subjected to tight restrictions on interest rates or reserve requirements, then opportunities immediately open up for nonbanks.

Third, it will depend on the specific legal and regulatory framework established for the nonbank sector. Particularly important in this regard is the extent to which the legal and other parts of the enabling structure favors or disfavors nonbank or security market activity relative both to each other and to the banks.

The critical factor in the development of nonbanks, apart from the policies applied specifically to them, is the role and size of the emergent private sector in the socialist economies. It is possible that this could be significant even in the absence of a major privatization program for state enterprises. With free entry and appropriate commercial and company laws, the private sectors in Poland, Hungary, and elsewhere could emerge as an accumulation of a larger number of smaller but effectively managed private firms. However, this would probably be a very lengthy process unless foreign firms entered the economy in large numbers: a development that is unlikely without extensive privatization. Thus, the pace and nature of the privatization programs would be a critical determining factor in most countries during the next few years.

A sound and market-oriented financial system can be seen as an essential part of a sound enterprise sector because the former can provide the latter with specialized financial, information, and advisory services. However, the respective roles of banks and nonbanks in this were less clear. Traditionally banks in other countries have tended to engage in relatively short-term business with lower risk characteristics, whereas the nonbanks have tended toward longer term business, some of which had greater risks. With modern financial technologies and the greater securitization of transactions, however, this distinction is breaking down. Pohl argued that the view that governments needed to intervene to promote long-term financial institutions is probably misplaced in the Central and Eastern European context. In these countries, the primary problem is not one of mobilizing more longer term resources but rather using savings more efficiently and using enhanced competition and managerial independence to achieve this.

Whatever is decided about the nature of the nonbank financial sector that is ultimately required, it must be recognized that this cannot be created overnight. The existing large institutions, such as the pension funds, provide a core on which to build. However, in the absence of substantial foreign
involvement in joint ventures in the financial sector, the pace at which it would be possible to extend this core into a modern, complex system would probably be slow. Several participants remarked that a major constraint was human resources, especially managerial skills and experience. The pace of transformation of the financial sector could be accelerated by the wholesale borrowing of existing and proven regulatory systems. However, even this requires the transfer, on a transitional basis, of a sufficient number of managers and regulators familiar with the day-to-day functioning of financial institutions in a market economy. In the West German joint ventures in banking with East Germany, for example, the West German banks had needed to import managerial and technical personnel equivalent to 10 percent of the existing staff of the East German institutions.

Some of these matters were further developed, especially in relation to capital markets, which Alain Soulard discussed. He examined the progress made in the past twenty years with the development of capital markets in a number of developing countries, and assessed some of the legal, regulatory, fiscal, and other prerequisites for successful securities market development. He noted the potential importance of securities markets as a convenient tool for attracting foreign portfolio investment into a country and focused in particular on the very large flows attracted by the country funds now marketed by a number of middle-income developing countries. The first move of this type in Central and Eastern Europe was the establishment, with help from the International Finance Corporation, of an $80 million fund for Hungary; similar possibilities in other countries are now being assessed. The major constraint on this type of development is recognized to be the severe shortage of domestic firms that can offer attractive returns to purely passive investors without a major restructuring of their operations. The experience with other country funds has indicated that foreign investors can be attracted to countries where political and other investment risks were relatively high but only if these are compensated by high expected rates of return. Few Central and Eastern European companies could offer this at the present time.

Thus, the main requirements for the next few years are the enterprise restructuring programs discussed earlier, associated programs of wholesale privatization, and the involvement within this of active rather than passive foreign investors. Soulard believes that the sheer scale of the privatization envisaged in some of the countries offers very considerable potential for both security market development as well as foreign investor involvement. In Poland, for example, the net worth of the top 500 companies has been tentatively valued at $30 billion, which is equivalent to 40 percent of gross national product. However, the sheer magnitude of these amounts are themselves problematic, because they substantially exceed the accumulated wealth of the private sector in Poland and could not be expected to be funded by the transfer of this wealth from other uses.
In assessing the extent to which securities markets development might be required as an essential vehicle for achieving privatization objectives, there was a general opinion that this is unrealistic for one main reason. Specifically, the time needed for the valuation of individual firms and the problem of pricing individual issues for an offering of securities is probably incompatible with the strong political pressures for early privatization. It could be that some existing institutions, such as pension funds, could be used to support wholesale privatization and, in combination with foreign management skills, this could ensure the parallel pursuit of privatization and restructuring objectives. However, these and other similar arrangements could only work if they can achieve the intended transfer of both ownership and management and can result in a real incentive, in the form of profitable companies, for local investors to want to buy shares.

The obvious solution to this problem would be to ensure that the few local investors with the necessary managerial skills are allowed to acquire majority interests in privatized firms at an early date. If local investors are not available, a very open approach toward foreign direct investment, including majority foreign control in many cases, would be the most effective way to simultaneously achieve the privatization and restructuring objectives. While this might initially put securities market development and portfolio investment into a less important role, they would still be important both as a source of fresh capital after privatization and as vehicles for the divestiture of companies, both by local and foreign majority investors, once restructuring objectives have been successfully achieved.
8

Is There One Blueprint for Financial Sector Reform?

The final session of the seminar was given the title, "Constructing the Blueprint for the Transition to an Efficient Financial Sector." In introducing this session, Alan Roe repeated a point made earlier by several participants that there was unlikely to be a common master plan for financial sector reform that could either be defined unambiguously in advance or be expected to apply equally to all the participating countries. The author suggested instead that the state of our knowledge on this subject, as represented in the seminar papers and discussion, is analogous to a complex multisectonal building. For some sections of this building the necessary design is very well-established and there is little controversy over how these sections should be constructed. However, this is not true for all the sections. More importantly, the design requirements for the connecting passages between the different sections of the building are very poorly understood; yet a failure of design or implementation in these connecting passages could well result in the collapse of the whole structure. Our current knowledge about financial sector reform in the economies in transition, in other words, is a combination of a clear understanding about how to address some sections of reform, and a seriously deficient understanding and considerable disagreement about how these different sections might be fitted together and sequenced.

Bearing these basic ideas in mind, it was noted that reform in the transitional economies comprises three main components:

- Macroeconomic stabilization.
- Structural reforms that are clearly required by the political developments that have indicated the need for reform (for example, moves to establish more private ownership and more realistic price structures).
- Other structural reforms that are essential to ensure the success and sustainability of the politically mandated reforms. Most of the issues of financial sector reform fall under this last item.

The conventional view was that the first of these components, macroeconomic stabilization, should also be sequenced first in time, and in most of the economies represented at the seminar, this had indeed been the
case. However, a great deal of skepticism was expressed at the seminar as to whether a sustainable stabilization could be achieved while certain key elements of structural reform are not in place. This discussion involved, first, the informational problem; in the absence of the diagnostic work necessary for bank and enterprise restructuring it is impossible to assess the scale of the measures in the macroeconomic area that are necessary to stabilize inflation and other key variables. In addition, there are many important feedbacks from enterprise and bank restructuring on the macro level to the scale of the macroeconomic problem, and so detailed prescriptions for how to proceed are difficult to define.

A second example of uncertainty and dispute about the sequencing of reform relates to the establishment of broad-based private ownership in the economy. One view that was strongly articulated during the seminar was that stabilization and other reforms cannot succeed until ownership is placed mainly on a private basis, with an energetic advocate of capital in the system. This supports early action on privatization even if it requires a certain degree of rough justice, a variety of shortcuts on the valuation of the assets being sold, and an overriding dependence on a voucher/give-away system. Simply expressed, if ownership does not change, restructuring may not be soundly based. In reality, most of the economies in transition are proceeding more gradually than this to the transformation of the ownership structure of productive sector assets. This alternative position was justified at the seminar by participants who argued that soundly based restructuring requires active and managerially competent owners, and these are not easy to find. But instead, the passive investors who will be the initial beneficiaries of the quicker-acting give-away approaches to privatization would be. However, it is important to stress that this gradualist approach is of great concern to those who regard the ownership transformation as a matter of preeminence.

A third connecting passage where there is a lack of clarity and some disagreement, relates to the proper sequencing of bank versus enterprise restructuring. Ideally, the establishment of sound banks at the outset would be enormously helpful to the process of enterprise restructuring. However, in a real situation the two reforms have to move parallel to one another, with the result that the relative sluggishness of the one will create major difficulties for the other.

These comments all relate to the connecting passages of the building. Clearly, other elements of the discussion indicated that the design and implementation of reform were well-defined and reasonably noncontentious. These included, above all, Buchi's detailed comments about enterprise restructuring; Sheng and de Juan's corresponding comments about bank restructuring; and de Juan's comments about the regulatory and supervisory structure of the financial system.
The proposals regarding enterprise restructuring contain four main elements. First, the general incentives and signals facing enterprises have to be recast to allow them to focus more on maximizing profit, and to remove the numerous noncommercial objectives that enterprises in centralized economies are expected to pursue. This should be done by establishing the freest possible system, albeit with some remaining regulations, for example, to curtail the possible abuses associated with monopoly positions. Second, it is necessary to establish competent and professional management within enterprises. An ideal way to achieve this is through privatization so that managers act as owners, as many managers as possible. In the absence of privatization, a second best would be to define clear operational objectives for managers and leave them operational freedom, associating these with transparent performance evaluation practices and appropriate rewards. Third, it is necessary to enforce financial restructuring by imposing tight budget constraints on enterprises either directly (for example, when banks are functioning well) or in other, less direct ways. Finally, a variety of approaches were recommended to achieve the required physical restructuring. These would include efforts to attract appropriate foreign investors into joint ventures, safety-net arrangements to lower the political and social costs of job retrenchment, and small business promotion schemes to help, among other things, diversify vulnerable regions away from dependence on single large industries.

It was noted in the case of the large loss-making state enterprises that few of the countries represented would be able to achieve an early divestiture of ownership; therefore, clear arrangements would be necessary to manage and restructure these enterprises. It was generally accepted that these arrangements should seek explicitly to depoliticize as many of the hard decisions as possible. This could be done by publishing the costs of keeping the enterprises alive, establishing clear rules about the specific instruments that the government might use to support the enterprises, and time limits on their use; and maintaining courtlike procedures to make judgments about the actions involved in restructuring.

Restructuring can also be interpreted to include promotional initiatives for small-scale enterprises. This could ultimately expand the number and importance of small businesses, making them a major element in the overall industrial structure. Aside from the simplification of the legal framework for establishing new businesses, a variety of initiatives were proposed to promote their development.

A similarly high degree of consensus was achieved in relation to the proposals to address the restructuring of banks. In brief, the first step would be to look systematically across the board and try to remove all the factors, such as excessive reserve requirements, that might be found to contribute to the low profitability and general insolvency of banks in these economies. Thereafter, the requirement is for certain case-by-case measures, which can be
classified under three main headings. First, it is necessary to define measures to reconstruct the profits and the equity of insolvent banks. This issue involves measures to write off bad loans, end the payment of dividends on fictional profits, and establish better procedures for realizing higher yields. Second, it is important to change the senior management team, thereby eliminating the practices that have contributed to the distress of the bank. Finally, it is necessary to establish new ownership, but in a way that will bring about more competent management. In doing this the original owners of an insolvent bank have to be denied any further role unless they are prepared to put in new money. In addition, the selling price of the bank should not be regarded as a main issue. What is important is to rid the bank of ownership by the state in such a way that further state intervention does not become necessary a few years into the future.

A third well-defined section of the overall reform structure related to the regulatory and supervisory environment necessary to ensure a healthy financial system in the longer term. Participants generally approved of de Juan’s basic proposition that the Central and Eastern European banks have, above all, to move into a mode in which loans are expected to be repaid, and away from the mode provided in an attempt to keep failing enterprises alive or resolve social problems. In the transitional phase of financial sector reform as traditional rules are being relaxed, it is highly probable that the incidence of fraud and mismanagement will be high. Therefore, a regulatory framework is needed to prevent abuse. Several main principles of such a framework include the following:

- In deregulating markets, clearly define a set of rules for the banks and enforce those rules.
- Enforce capital adequacy requirements only on the basis of paid in capital and distributed profits if really earned.
- Introduce accounting guidelines based on real credit worthiness; use loan quality classification (not just arrears).
- Limit large exposures, including those to other banks and related parties.
- Give the bank supervisor strong enforcement powers; for example, to remove managers, enforce new capital injections.
- Have on-site supervision, with file-by-file scrutiny for large loans; regulation with no supervision is useless.
- Use external auditors only as a complement to internal staff.

The general consensus and the high degree of clarity on these specific issues contrasted sharply with the absence of clear guidelines about the most desirable future shape and structure of financial systems in the reforming
Is There One Blueprint for Financial Sector Reform?

Economies. Long’s general proposition was accepted; financial systems evolve out of a specific country’s history. Thus, it is difficult for one country to borrow another’s financial structure. Participants also broadly accepted the notion that the success of universal banking in Germany does not guarantee a similar degree of success for universal banking in the economies in transition. Nonetheless, it was agreed that in Poland, Yugoslavia, and Hungary universal banking is indeed the naturally evolving model, and these countries have little reason to seek out alternative models. It remained unclear whether this natural evolution would lead to sound and robust financial systems. Several participants expressed serious reservations on this point. Long noted, for example, that if inexperienced bankers are given universal licenses and broad new banking powers with little effective supervision, they are likely to make costly mistakes. In addition, it is clear that the existing banking expertise in the traditionally segregated banking systems of Central and Eastern Europe is extremely narrowly based. This is exactly the combination of circumstances that gave rise to widespread failure in the U.S. savings and loan organizations following their deregulation in the 1980s.

There is also considerable uncertainty about how important nonbank financial institutions and securities markets will, or should, become until such time as the nature and needs of the private sector in the reforming countries becomes clearer.

When pursuing financial sector reform, it is always necessary to take some risks and accept that some mistakes will occur. What now seems important is that the process whereby one country can learn both from its own mistakes and experiences, as well as from those of others, should be accepted as the way to make progress. If this is done, it will also be beneficial to all the countries concerned if the frank admissions of both knowledge as well as ignorance, which characterized this particular seminar, can continue in similar meetings in the future as the case studies and experiences to enrich what we currently know gradually appear.
Annex A

List of Papers Presented at the Seminar

"Issues in the Introduction of Market Forces in Eastern European Socialist Economies"
Manuel Hinds

"Prudential Regulation and Financial Stabilization"
Aristobulo de Juan

"Bank Restructuring in Transitional Socialist Economies: From Enterprise Restructuring to Bank Restructuring"
Andrew Sheng

"Enterprise Restructuring"
Hernan Buchi

"Financial Sector Reform in Socialist Economies in Transition"
Millard Long

"Are High Interest Rates Effective for Stopping High Inflation?"
Guillermo A. Calvo

"Financial Reform in Socialist Economies"
Christine Kessides, Timothy King, Mario Nuti, Catherine Sokil

"Managing Financial Adjustment in Middle-Income Countries"
Alan Roe & Paul Popiel

"The Restructuring of Financial Systems in Latin America"
Alan Roe & Paul Popiel
Annex B
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