Financial Reform in Socialist Economies in Transition

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The restructuring of banks must be tied to the restructuring of industrial enterprises, to macroeconomic stabilization, to price reform, and to the resolution of ownership problems. These problems, which will take years to resolve, require a commitment to reform, clear ideas about what is to be achieved, and realistic expectations about the difficulties that will be encountered.
This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in PRE to analyze sector reform in socialist economies in transition. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Maria Raggambi, room N9-033, extension 37657 (19 pages).

Focusing mainly on banking reform, Long and Sagari propose a model for the financial structure of a socialist economy in transition.

Such a financial system, they say, would include a few large, competitive national commercial banks. These banks would not be specialized in the sectors they serve or their type of lending. They would be commercial rather than universal banks — that is, they would not own firms or engage in securities or insurance business. However, in countries that follow the universal model, banks could be owned by holding companies that would also own other financial intermediaries but not industrial or commercial ventures.

Long and Sagari rule out greater universalization of banking at this time to limit mismanagement, fraud, risk, and losses. They prefer simpler financial intermediaries because they are easier to manage, more transparent, and easier to supervise.

Equity in the banks or bank holding companies should be widely distributed to the private sector through whatever method is selected for privatizing firms. But the banks should not be privatized (unless by sale to foreign banks) until they have been made financially solvent — by cleaning up their portfolios. For socialist economies with excessive bad debts, this means making hard decisions about the major loss-making industrial enterprises.

Bank restructuring must proceed in pace with industrial restructuring, price reform, and macroeconomic stabilization.

Fast administrative restructuring of the banks is preferable to slow restructuring, contend Long and Sagari. But once the basic structure is efficient, further changes — such as new entries, mergers, and the sale of branches — can be left to the market process.

Other measures that should be taken:

- Interest rates should be raised on the outstanding mortgages of the savings banks and on other subsidized credits to market rates.

- Central banks should absorb the huge foreign exchange losses of the foreign trade banks.

- In countries where it has not been done, new legislation and regulations should be drafted, auditing and accounting improved, supervisory procedures established, and bankers' training institutions developed.
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I. Introduction

Neither in theory nor in practice have financial economists confronted a problem as all encompassing as the reform of financial systems in the socialist economies in transition (SET). In the economics literature, the impact of the financial system on the productive sectors has been a subject of much dispute, and the analysis has not been completely satisfactory. In particular, country experience has only involved the diagnosis and design of remedies for comparatively limited specific problems and the implementation of marginal changes in working systems. The problems being tackled today in the SET are hence beyond both our theoretical range and our prior experience in country work. The purpose of this paper is to raise some of the important issues that emerge in the process of financial reform and venture some tentative suggestions.

Prior to reform, the financial systems of most SET consisted of a central-cum-commercial bank, providing both central banking services and corporate finance, a savings bank which took deposits from households and then relent a fraction of the deposits to households primarily for mortgages at very low interest rates, a foreign trade

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1 The World Bank, Country Economics Department, Financial Policy and Systems Division. The views and interpretations in this document are those of the authors, and should not be attributed to the World Bank, to its affiliated organizations, or to any individual acting in their behalf. Thanks are due to Bela Balassa, Alan Gelb, Andrew Sheng and Ilham Zurayk, for helpful comments and suggestions.

2 A first comprehensive attempt to look at these issues is found in Kessides et al's (1989) proceedings of the workshop on Financial Reform in Socialist Economies held at the European University Institute in Florence in 1987. The workshop focused mainly on China, Hungary, Poland and Yugoslavia.
bank which handled external borrowing and payments and a range of other foreign trade activities, and an insurance company. All of the intermediaries were state owned.

The reforms to date have consisted of rewriting the financial laws and restructuring the central-cum-commercial bank by hiving off the commercial functions.\(^3\)

Governments are establishing the infrastructure to regulate and supervise the newly created commercial banking systems. For the most part the new commercial banks are owned by the central bank, but ownership may be shared with the foreign trade bank and/or some of the large industrial borrowers, as in the case of Bulgaria and Hungary, for example. The law allows the newly formed commercial banks the widest array of financial powers. It also encourages competition; however, at least in some of the SET, the way in which the commercial banks have been set up does not encourage competitive practices. In most of the countries the savings banks still dominate transactions with the household sector and the commercial banks are either specialized by region or by economic sector. Furthermore, the assets transferred to the commercial banks were not cleansed of the non-performing loans at the time the banks were established; hence many of the banks were insolvent from their first day of operation. Problems also remain in the savings banks, where the interest rates on the mortgage portfolios are below the rates paid on longer term deposits. In some of the countries the foreign trade bank, which had been responsible for foreign borrowing, has serious trouble servicing

\(^3\) Yugoslavia was perhaps the earliest to divide the national mono-bank into a "two-tier system" (1971) followed by China (1983), Hungary (1987), Poland (1988), Algeria (1989), Bulgaria (1987-1990), Czechoslovakia (1990).
the external debt. Most of the SET are aware of these problems and recognize that the reform of their financial systems has only begun.

Clearly, the issues surrounding financial reform in the SET are too many to be covered in a single paper. The discussion here is centered mainly on banking, which in the SET is the dominant segment of the financial sector. However, most of the remarks concerning structure, regulation, and efficiency apply equally to the non-bank financial institutions and the securities markets. Section II considers the link between financial structure and the productive sector. Section III deals with a range of structural issues, including efficiency, contestability, ownership, separation of banking and industry and regulation. Section IV examines the transitional problems involved in implementing the new structure, and the sequencing of reforms. Section V concludes with our tentative suggestions for financial reform in SET.

II. The Framework for Financial Reform: Link with the Productive Sector

Financial reform in the SET is more comprehensive than in market economies because it involves not only liberalization but also reshaping the structure and functions of the financial system. The objectives of the reforms are multiple. First, since more liquidity and financial resources will be left for free disposal by both the household and the enterprise sectors, instruments that can channel surplus funds toward the financial markets must be made available. Second, since the intermediation role of the financial markets will increase, an institutional framework must be developed that can supply

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4 Blejer and Sagar (1991) identify these objectives and provide an assessment of the achievements of the Hungarian financial reform process.
needed financial services efficiently. Third, since credit planning will be utilized to a lesser degree, it is important to develop decentralized mechanisms so that credit will be allocated efficiently among enterprises. Fourth, as financial decisions become increasingly decentralized, an adequate, prudential regulatory and supervisory framework must be built that, without unduly restricting the operations of financial intermediaries and capital markets, prevents excessive risk-taking. Fifth, most of the SET wish to use a reformed financial system to help resolve the thorny issues surrounding ownership and governance of the industrial enterprises. The skills and structure needed to handle these added tasks must be developed.

Some reformers seem to feel they can force the pace of productive sector restructuring through reform of the financial system. "Install" a market financial system and restructuring and decentralization of production will follow. And as reform of the financial process is relatively easy, it is seen as the lever for restructuring the whole economy. Unfortunately, the very difficult tasks of restructuring the firms, reorganizing production and resolving the ownership and management issues must be attacked explicitly and directly. Ultimately, financial sector reforms are constrained by real sector developments and bank restructuring cannot succeed without enterprise restructuring.

The design and operation of a financial system must be tied to the design and operation of the productive sector it is to serve. The mono-banking system common in the socialist economies is a case in point. Centralized control of finance was a useful adjunct to the planning process; a decentralized financial process would not have been
consistent with centrally planned productive sectors. The design of a future financial system for an SET must be based on the expected organization of the productive sectors. To what extent will production and investment decisions continue to be made centrally rather than by a decentralized market process? Are large firms to be subdivided to create greater competition? Who will own and manage industrial firms in the future? What is to be the role of the financial system in monitoring and controlling firms’ behavior? How open will the economy be to foreign trade and financial flows? The answers to these questions are likely to differ among the SET, in response to their different needs and different histories. China is likely to remain for some time a planned economy with a correspondingly government controlled financial system. The former East Germany is rapidly becoming a market economy supported by private banks. Other SET will fall somewhere in between.

Any discussion then of the structure of the financial system must be based on some assumption about the organization of the productive sectors. The working hypothesis for purposes of this paper is that SET will become predominantly market economies, that production and investment decisions will be decentralized, that the pricing, distribution and management of investment and production risk will be done through the financial system, and hence that financial institutions will become important in the monitoring and control of firms. Even given these assumptions, there is considerable leeway in the design of country specific financial systems: witness the differences in the financial systems of the developed, market economies.
III. Structure of the Financial System

Today in the SET most banks provide only a limited range of banking services. Foreign has been separated from domestic financing and corporate from household banking. In some countries, Bulgaria for example, term financing has been further separated from working capital financing, and different banks have provided term financing to various sub-sectors of industry. To shift, as envisaged, from a high degree of specialization to universal banking is very likely to strain the competence of existing bank management and of the supervisory system. While the ultimate goal may be universal banks, movement should be by stages. Discussed below are some of the issues we consider most important in creating a new structure for the financial system.

Contestability and Efficiency. To be efficient there must be competition or contestability in financial markets, reasonable economies of scale and good management of institutions. Though endowed with universal banking licenses, the financial intermediaries in the SET are today extremely specialized in terms of the services they provide and the clients they serve. Many banks have such highly concentrated portfolios that the failure of even a single large client would leave them bankrupt. The banks should certainly become more diversified both with regard to the financial services they provide and the firms to which they lend. This will both reduce their exposure to specific risks and bring greater competition to the financial markets. But as noted below, the speed of change must not outpace the banks' acquisition of skills and information or else major mistakes in resource allocation will be made.

\[5\] That is, a credible threat of entry of new institutions.
The structures being put in place in specific countries raise the questions of contestability of markets, economies of scale and quality of management. In Czechoslovakia, for example, with the present structure, most commercial lending will be concentrated in two institutions, one in each of the two regions. While the institutions can compete, it will be a long time before contestability in lending actually develops. On the other hand in Bulgaria and Yugoslavia with close to seventy banks, competition will develop more rapidly, but there are more banks than good managers and many of the banks are too small to achieve reasonable economies of scale. The governments of the SET should probably not wait for the markets to correct these problems. Given that in most cases they still own the institutions, they could well undertake further organizational reforms to make the systems both more competitive and efficient.

An area in need of further reform is the present separation of household and corporate finance. The household sector has been served almost exclusively by the savings banks, which have mobilized more resources than they have been able to lend. On the other hand, the banks which lend to the productive sectors do not mobilize the funds they need and must borrow from the savings bank or from the central bank. Of course it is not, a priori, inefficient to have some banks mobilize more funds than they lend and others the reverse, with refinancing arranged in the interbank market. But it is questionable whether the present separation of household and corporate finance is likely to produce an efficient banking system. There is little competition today for the mobilization of household deposits or for providing mortgage credit and other household loans. Over time the commercial banks will move into retail banking but the central
bank could speed the process by directing the savings banks to sell branches to the commercial banks in order to produce a better match between lending capacity and resource mobilization. Alternatively as only the saving banks are set up to handle the large number of household deposits, some commercial loans could be sold to the savings banks. A further argument for this alternative is that because of their size, the savings banks have the potential, though definitely not the skills, to lend to large commercial borrowers without becoming overexposed to a single firm. Of these alternatives we think that in most SET it would be better to achieve balance between mobilization and lending by breaking up the savings banks, as it would be more difficult for them to develop skills as commercial lenders. But as with other structural questions, there are alternatives and the answers may vary across countries.

Considering other issues of efficiency, in many of the SET too little resources have been devoted to financial intermediation. There are too few bank offices; the offices are under equipped; the number of bank staff is too few and the existing staff is in need of additional training. Many banks in the SET plan to acquire needed skills through an association with a foreign bank. This is certainly a good idea; the question is whether and under what terms such association can be arranged. The number of interested foreign banks is likely to be small, given the present banking climate. Where a potential partner can be found, to get really effective assistance, an attractive offer will have to be made to the foreign bank, in many cases involving ownership and management, that is a joint venture. But the foreign banks are unlikely to accept joint

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6 It is also hoped that foreign partners will bring in additional capital and help promote greater competition.
ownership as long as the banks’ balance sheets are filled with non-performing loans, as
discussed below in the section on transition.

Ownership Much thought is being given in the SET to the privatization of the
means of production. Less thought has been given to the question of the ownership of
banks. Present arrangements in some of the SET are questionable. In Bulgaria for
example, the Central Bank owns a significant proportion of the equity of the commercial
banks. The remainder is owned by the largest borrowers and the Foreign Trade Bank.
Ownership by the central bank is not privatization and it does raise the questi    e the
independence of banks. Central banks do need to control commercial banks but
through appropriate regulations not ownership. Ownership of banks by the central
bank can be problematic. Ownership can conflict with the central bank’s responsibility
for credit rediscounting, prudential regulation, etc. In Yugoslavia most banks are owned
by industrial firms. Ownership of banks by their major borrowers has proved
problematic wherever it exists. It is very likely to lead to insider lending, which can
encourage bad loan and investment decisions. Furthermore, firms are likely to use their
control of finance to discourage the development of competitors in those industrial sub-
sectors in which they operate. The reverse position, i.e., banks owning significant
positions in firms, though also prone to abuse (such as insider lending), seems to be less
problematic. The SET are considering alternative approaches to privatization. It would
be preferable if the shares of the banks were held by the public, either directly or
indirectly through investment trusts, than by the central bank or major borrowers from
the banks.
Separation of Banking and Industry. In the SET two of the most perplexing issues are the future ownership and governance of the industrial firms. Most of the SET seem to be opting for universal banks, which will be allowed to provide a full range of financial services and to own industrial subsidiaries. Present bank managers, unfamiliar even with modern banking, are to be given broad supervisory powers over industry, because no one else is available to play that role. The universal banking approach is appealing because close connections between banks and borrowers improve the flow of information. Universal banking may also, in some cases, increase competition. Developed countries already allow or are moving toward allowing banks to provide a wide range of services, but generally the model is more restrictive than now being proposed in the SET. In the G-10 countries there are strict controls on the relationships between banks and commercial firms. Of the G-10 countries only in Germany do banks through their equity holdings exert significant ownership control over industrial firms and even in Germany there are restrictions. In the other G-10 countries in which banking-commercial ties do exist, banks typically own commercial enterprises through a holding company with safeguards for the independence of the bank’s credit decisions.

Based on our observation of developing countries, we must sound a note of caution. Links between banks and commercial firms have frequently produced insider lending with the financial system failing to exercise its responsibilities for independent monitoring and review of firms’ investment and operating decisions. Clearly in the SET case, government ownership and management of firms and intermediaries has created
such problems in the past. Given the lack of market development, the absence of competition and the poverty of information, the problem of corporate governance is likely to be acute in the SET during the next decade. Whether and how the financial system will have a role in choosing corporate boards, appointing and overseeing management behavior are questions that need to be carefully examined. Germany's universal banking model has served the country well, but whether similar arrangements are feasible today in the SET is questionable.7

**Appropriate Specialization in Banking.** Another issue concerns the separation of banking and non-bank financial services. Which non-bank financial services are compatible with banking and under what corporate structure these services should be provided are questions which many developed countries are addressing today. Historically the major industrial countries have had considerable specialization among financial intermediaries. In addition to commercial banks most developed countries have had specialized institutions in the areas of term finance and insurance, and other institutions operating on the securities exchanges. In recent years the trend has been toward less specialization. Competition and innovation have made financial services closer substitutes for each other. In roughly half the G-10 countries universal banks now provide a wide array of financial services, including underwriting, trading and investment in securities, though insurance underwriting remains separate for the most part. In the remaining G-10 countries there is greater separation among classes of

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7 Various articles in Kessides et al (1989) discuss the pros and cons of universal banking for SET.
institutions, though with some degree of overlapping activity allowed, particularly in the government securities markets.

Service and client diversification in the SET would enhance competition and reduce banks' exposure to specific risks. Certainly banks in their lending should be less specialized by industry, region, or maturity of loans. This could be furthered by judicious mergers of existing banks or sale of branches or swap of assets. But allowing banks to provide a very broad range of financial services can be problematic in a fledgling financial system. The management of universal banks is more difficult than traditional commercial banks and, in parallel, they are more difficult to supervise. The bankers (and supervisors) in the SET have so much to learn about modern banking that at least for a few years the banks should be discouraged from providing insurance or securities services. Rather they should build on what they know and their existing client base.

In the past the foreign trade banks have had a monopoly on external funding and payments. This monopoly is beginning to break down with other banks allowed to deal in foreign exchange. The future role of the foreign trade banks is unclear. Despite being run by some of the best bankers with the greatest exposure to international finance, some of the foreign trade banks are in a perilous state. Several of the countries cannot service their external obligations. As a result correspondent banks have cut their lines to the foreign trade banks making them illiquid. Though the foreign trade banks are the largest banks in terms of assets in many of the SET, they are today without

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* Unless these services are provided by subsidiaries, with appropriate safety walls built around them.
funds or a clear niche in the financial markets. The SET governments must assume the foreign liabilities of the foreign trade banks. Possibly the institutions should be dissolved so that their skilled personnel can be employed by other banks.

**Non-bank Financial Intermediaries and Securities Markets.** In addition to the banks there should be a set of other financial institutions providing financial products that are both complementary and competitive with those offered by the banks. Securities markets are likely to be important in the future financial systems of SETs, given their desire to privatize corporate ownership, to find non-inflationary ways to finance government and enterprise deficits and to develop competitive financial markets. In Hungary and Yugoslavia some securities are already being traded. We can imagine that financial sector development in the SET might be quite different than usually contemplated for developing countries. Equity markets in developing countries are, for example, the last markets expected to develop. But in the SET, however the problem of privatization is resolved, the initial distribution of claims is likely to be quite different from the desired longer run distribution. The secondary markets in which existing claims are traded may be more important than the primary markets in which to fund new activities. Securities markets have been slow to develop in countries with well established universal banks. This has been unimportant in countries like Germany, with a well established ownership structure. But in SET having securities markets may be important for the process of privatization.

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In addition to the securities markets, efforts should be made to develop contractual savings institutions, particularly life insurance and provident funds. If government budgets can be financed without forcing insurance companies and provident funds to invest their surplus in government instruments as is now the case, these institutions could become over time the main avenue for mobilizing term finance for the private sector. The regulatory agencies and the tax authorities should insure an even playing field, that is, fair competition among banks, non-banks and securities markets. We would like to comment on one other form of non-bank institution, that is, government run development banks. By and large these have not been successful in developing countries, but there are exceptions. We can imagine that in the transformation of the SET there will have to be financing for certain high risk ventures, both small and large, that will appear too risky to newly privatized commercial banks. Some of the large enterprises will be able to find foreign financing, but domestic capital for smaller ventures is likely to be in short supply. We can imagine a role for a publicly funded, though commercially operated, development bank. The danger is that such an institution could become a soft option for funding existing, loss making institutions. But this is not the concept. Rather, the development bank would provide risk financing to small and medium sized enterprises during the transformation process. Such an institution should be limited in size and, to prevent many mistakes from the past, it should be operated on strictly commercial principles, with profit as an important objective.
Regulation and Supervision. When loans were made according to government directives and the intermediaries were part of the central bank, prudential bank regulation and supervision were unimportant. But as the process of reform progresses, banks become independent entities making their own loan decisions. Because of their particular characteristics, financial intermediaries are open to fraud and mismanagement. Financial liberalization increases the opportunities for such practices and is likely to lead to instability if an adequate prudential regulatory and supervisory framework is not in place. The costs of omissions in this area have been well documented in the case of the financial liberalization of some countries in Latin America.  

Finding an effective system of regulation and supervision is far from easy. The problems faced by the United States with its financial system, and in particular with the savings and loans institutions are clear evidence of the difficulties in designing and implementing such a system. Hungary, Poland and Yugoslavia have already taken steps and other SET are in the process of redrafting central and commercial banking laws, developing a regulatory framework, and establishing a system for supervising compliance. Because of the time needed to build up the system of bank supervision, it is important that it be started early in the reform process.

10 See for example Diaz Alejandro's (1985) "Good-bye Financial Repression, Hello Financial Crash".  
IV. **Transitional and Sequencing Issues**

**Reform and Instability.** Reform can bring on or exacerbate existing macroeconomic instability. In western economies control of the macro aggregates is exercised through monetary and fiscal policy and control of micro efficiency at the firm level through the market, pricing-profit process. In socialist economies fiscal and financial discipline at the macro level were in the past less important; macro control was exercised through physical planning, and prices were administratively set. A soft budget constraint gave considerable leeway to individual firms. Official markets did not clear. As a result, in a number of SET people could not find goods to buy, leading them to hold excess cash balances. In other countries (or sometimes in the same country) there existed a second economy in which goods traded at higher prices.

In some of the SET partial economic reforms seem to have aggravated these conditions. Eliminating price controls allowed implicit inflationary pressures to become explicit. The changes made in the public revenue system, such as shifting from profit remittance to profit taxation, seems to have cut government revenues more rapidly than expenditures, enlarging budget deficits, which in turn had to be financed. Greater autonomy for firms, without market controls over firm behavior, seems to have fueled either investment hunger (as in China) or excessive wage payments (as in Yugoslavia), financed by government transfers and bank loans which have not been repaid. Higher prices have forced currency devaluations. As exchange rate losses accrued primarily to the central bank, devaluations led to quasi-budget deficits and further expansion in the money supply.
It is impossible to have effective control of the monetary aggregates without resolving the problems of the monetary overhang, government and enterprise deficits, proliferation of bad debts and the central bank losses generated through currency devaluations. Financial discipline has to be imposed by an adequate mechanism for controlling the monetary and credit aggregates. SET which lack such a system must develop it. In China the loss of control over credit and the monetary aggregates and the ensuing inflationary pressures were very disruptive and were in part responsible for the halt in the reform process.12

**Interest Rates.** A topic that has occupied central stage in the discussion of financial reform in the developing economies has been the level and structure of interest rates. The interest rate issue is likely to become important as the SET move from planned to market economies. During the transitional period, the central bank may have to play a significant role in interest rate determination. Much can be learned from the experience of the developing countries: deposit rates should not be allowed to fall significantly below the rate of inflation. If they do, the public will flee from domestic financial assets into real goods or foreign currency. In practice maintaining positive real interest rates is feasible only if the inflation rate is relatively low and stable.

Going further, financial transactions should not be taxed too highly (either through inflation or reserve requirements) or the spread between the deposit and lending rates will become large and financial intermediation will be discouraged.

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12 See White and Bowles (1988) for a concise evaluation of China's financial reforms.
Lending rates should not be distorted by a complex system of selected credits allowing preferred borrowers to obtain funds at below market rates. Rather lenders should be allowed to charge more on loans of higher risk, maturity and administrative cost, or else they will not extend credit to small and risky enterprises. Controlled interest rates have a tendency to become distorted; hence countries should switch from controlled to market rates as rapidly as conditions in the market permit.  

**Portfolio Quality.** One of the most pressing transitional issues is the quality of the portfolio of the existing financial intermediaries. The banks in the SET have inherited a loan portfolio built under the economic principles of the previous regime. It is clear in many cases that the book value of the inherited loans is much larger than their current market value, and as a result the institutions holding them have either a very weak capital structure or are insolvent. The portfolio of these institutions must be reviewed and, as needed, restructured and the banks recapitalized. But as the problems of the firms and intermediaries are closely related, it will not be possible to resolve them independently. Politically, technically and economically the solvency problems of the productive firms are more difficult to resolve than those of the financial intermediaries.  

For some banks, particularly the savings banks, the problem is not loan repayment but the fact that long term loans have been extended at lower interest rates.

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13 Two specific interest rate questions that need to be addressed in SET are what to do about the stock of outstanding low interest rate loans, especially those to households, and how rapidly the present low interest rates can be raised without putting excessive pressure on firms.

than must be paid for term deposits, which affects profitability and in turn solvency. In
the case of Hungary, the National Savings Bank (NSB) extended loans with average
maturity above 30 years at a fixed interest rate of approximately 3%. In 1989 the
interest rate subsidy implicit in NSB loan lending rate was equal to 2.3% of GDP and
had to be covered by the Government from the budget. In Poland, on the other hand, a
similar situation was solved through a parliamentary decision to re-write all heavily
subsidized housing loan contracts to make them yield market rates.

**Sequencing.** A difficult issue is the sequencing of the different components of the
reform program. While financial reform without macro stabilization, pricing reform
and restructuring of the productive sectors will not succeed, some elements of financial
reform can begin before or be carried out in parallel with other reforms. In most SET
the break up of the mono-bank into a two-tiered banking system is well underway.
Countries are drafting new legislation for the central and commercial banks. Central
banks (or independent agencies as in Hungary) are improving their capacity to regulate
and supervise banks. The level and structure of interest rates are being reformed.
Internal management of the banks is being improved, and programs for training
managers are being put in place.

Whether to restructure insolvent banks in advance of corporate reform is a
critical issue. In general, the experience of other countries has been that the longer the
restructuring of insolvent banks was delayed, the worse the problem became. Given the
widespread nature of the problem in the SET and how closely it is related to the need to
carry out price, wage, and tax reforms and industrial restructuring, the question arises
whether it is realistic, or even desirable, to restructure banks prior to the other reforms. While bank audits can be begun, and have already begun in Hungary, Poland and Yugoslavia, portfolio review and bank recapitalization cannot be finalized prior to the reforms in the productive sectors, as these will have a substantial impact on the ability of firms to service their obligations to the banks.

Lastly, moving too quickly from the high degree of specialization now in place to universal banking could lead to serious problems. In the United States it is recognized that in large part the saving and loan crisis erupted because in the early 1980s managers of savings and loan institutions were given broad banking powers, which they had limited experience in exercising. The problem was compounded by a lack of effective supervision. These very conditions are what prevail in SET today. If inexperienced bankers are given broad new banking powers with little effective supervision, they are likely to make costly mistakes. Whatever the ultimate structure desired, the transition needs to be managed carefully.

V. Summary and Conclusions

Let us summarize by putting forth our own model for the financial structure of an SET. This model is not meant to be applied in all SETs or in fact in any one SET in all its particulars but might serve as a reference point. At its heart our system would have a small number of large, competitive national commercial banks. These banks would be non-specialized in terms of the sectors they served or the types of their lending, but they would be commercial rather than universal banks; that is, they would not own
firms, or engage in insurance or securities business. However, for countries wishing to follow the universal model, the banks could be owned by holding companies that also owned other financial intermediaries but not industrial or commercial ventures. While realizing that "Chinese walls" in terms of functions and "fire walls" to limit the transmission of problems can only be partially effective for institutions owned by a single group, we would still rule out greater "universalization" of banking at this time, though not necessarily a decade from now, to limit mismanagement, fraud, risk and losses. Our preference for simpler over more complex financial intermediaries is based on the notion that simpler institutions are easier to manage and are more transparent and hence easier to supervise.

The equity in the banks or bank holding companies should be widely distributed to the private sector through whatever method is selected for privatizing firms. But the banks should not be privatized (unless by sale to foreign banks) until they have been made financially solvent, which means cleaning up their portfolios. In those SET in which their are excessive bad debts, more is involved than simply recapitalizing the banks. Decisions have to be taken about the major loss-making industrial enterprises. In the interim it may be difficult to introduce into banking a hard lending constraint. In our view bank restructuring must proceed in pace with industrial restructuring, reform of the pricing system and macroeconomic stabilization. This does not mean that the financial reform should wait until the other aspects are in place. The banks can be reorganized into a small number of national banks as suggested. Furthermore, we think the SET should consider the sale of some branches of the savings bank and dissolution
of the foreign trade banks with its functions and personnel distributed to the new, national banks. We are not against specialized intermediaries, but these are artificial institutions unlikely to survive in a market economy. In our mind a fast administrative restructuring of the banks is preferable to a slow market restructuring. However, once the basic structure has been made reasonably efficient, further changes - new entries, mergers, sales of branches, etc. - can be left to a market process.

Other measures that should be taken include raising interest rates on the outstanding mortgages of the savings banks and other subsidized credits to market rates. The huge foreign exchange losses of the foreign trade banks should be absorbed by the central banks. And in those countries where it is not yet done, new legislation and regulations must be drafted, auditing and accounting improved, supervisory procedures established, and bankers training institutions developed.

Even with a clear view of the desired design, it will not be easy to remake the SETs' financial systems. Restructuring the banks is tied to the restructuring of the industrial enterprises, to macro-stabilization, to price reform, and to the resolution of the ownership problem. All of these problems are difficult and will take years to resolve. Commitment to the reform process, clear ideas as to what is to be achieved, and realistic expectations as to the difficulties to be encountered are important, for the path of reform is rocky and the end uncertain.
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