

Fischer, Bernhard; Reisen, Helmut

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Bernhard Fischer and Helmut Reisen\*

## Full Currency Convertibility in Eastern Europe?

*In the countries of Eastern Europe the question as to the degree of currency convertibility is among the most important decisions to be taken when setting the framework for a free market economy. This article attempts to indicate the monetary and fiscal measures that will be required if the reform countries willing and able to be integrated into the EC and OECD are to proceed rapidly to the liberalisation of capital transactions.*

Fred Bergsten and John Williamson advise the Eastern European reform countries to concentrate on achieving current account convertibility and to treat full currency convertibility as a luxury that should be postponed until the completion of reconstruction.<sup>1</sup> The overwhelming majority of economists endorse their recommendation not to deregulate capital transactions until a later stage in the reform process.

Economic policymakers in the reform countries are inclined to be far more impatient in this regard than their economic advisers. This is particularly true for politicians in Czechoslovakia, Poland and Hungary, who want to integrate their countries into the European Community (EC) and the OECD as quickly as possible. The Common Market within the EC requires members to permit complete freedom of capital movements; the OECD liberalisation code commits countries to remove controls on trade in services and capital movements. It is therefore no surprise that the National Bank of Hungary recently stated that the forint would become fully convertible within a matter of months.<sup>2</sup> The reply of the Czech Finance Minister, Václav Klaus, to the economists is that "the only problem with convertibility is declaring it".<sup>3</sup>

This article attempts to indicate the monetary and fiscal measures that will be required if the reform countries willing and able to be integrated into the EC and OECD, namely Czechoslovakia, Poland and Hungary, are to proceed rapidly to the liberalisation of capital transactions. The ineffectiveness of the exchange controls still being applied in these countries obviates the usual need to discuss the optimal order for liberalising capital transactions during the transformation process taking place in Eastern Europe.

The lack of enthusiasm among most economists for a rapid deregulation of capital movements may be based on liberalisation experiences such as witnessed in Chile and New Zealand (see Table 1).

Asset values, such as share prices, initially soared in response to the liberalisation of capital transactions in Chile in 1978 and New Zealand in 1984. Although the economic reforms undertaken by Chile and New Zealand had been the most far-reaching until the transformation occurred in the previous socialist countries, the deregulation of capital transactions led to serious problems. In Chile it resulted in capital flight, widespread loan defaults, bank crises, a fall in manufacturing output and massive unemployment. Capital controls were eventually reintroduced. The liberalisation fiasco was marked by persistent interest rate differentials (leading to massive capital inflows), overvaluation of the currency (causing a narrowing of profit margins in industry and agriculture) and the collapse of many financial institutions. New Zealand, which combined a sudden deregulation of capital transactions with a pure float of its currency, shared

<sup>1</sup> Cf. F. Bergsten and J. Williamson: Currency Convertibility in Eastern Europe, in: The Federal Reserve Bank of Kansas City (ed.): Central Banking Issues in Emerging Market-Oriented Economies, 1990, pp. 35-49.

<sup>2</sup> See: Der Forint ist bald konvertierbar. Gespräch mit dem Vizepräsidenten der ungarischen Nationalbank, Dr. Frigyes Hárshegyí, in: Die Wirtschaft, Berlin, 42/91.

<sup>3</sup> Quoted in M. J. Fry and D. M. Nuti: Monetary and Exchange-Rate Policies During Eastern Europe's Transition: Some Lessons From Further East, in: Oxford Review of Economic Policy, Vol. 8, 1992, No. 1, p. 40.

<sup>4</sup> An assessment of liberalisation experience in OECD countries, Latin America and Asia is to be found in B. Fischer and H. Reisen: Zum Abbau von Kapitalverkehrskontrollen: Ein Liberalisierungsfahrplan, Verlag Weltarchiv, Hamburg 1992. I. Joumard and H. Reisen: Real Exchange Rate Overshooting and Persistent Trade Effects: The Case of New Zealand, in: The World Economy, June 1992, examines the interaction of financial deregulation, exchange rate reactions and trade effects.

\* Hamburg Institute for Economic Research (HWWA), Hamburg, Germany, and OECD Development Centre, Paris, France, respectively. The article expresses the authors' personal opinion.

Chile's experience of a heavy appreciation of the currency in response to monetary tightening. Despite stringent fiscal discipline, the stabilisation costs were above average in both countries owing to the overvaluation of the currency, which had a lasting adverse effect on foreign trade.<sup>4</sup>

### No Interest Rate Convergence

The attitude of economists towards the dismantling of exchange controls was probably most influenced by Chile's experience, where real interest rates remained extremely high, even after the deregulation of capital movements. According to the interest rate parity theory, domestic interest rates should have fallen towards world market levels. Various micro-economic and macro-economic explanations have been put forward to account for this lack of convergence:

- first, there was a dramatic increase in credit demand, triggered by the supposed wealth effect of overall liberalisation and the improvement in private property rights;
- secondly, the segmentation of the domestic credit markets prevented interest rate arbitrage between specialised credit institutions and sectoral uses of financial resources. The spread between deposit and lending rates did not narrow, owing to oligopolistic price setting;
- thirdly, inadequate banking supervision and excessive interlocking ownership between banks and firms led to an accumulation of non-performing loans. The banks subsequently raised interest rates for good borrowers in order to compensate for losses;

□ fourthly, bad loans led to further distress borrowing and generated additional credit demand;

□ fifthly, foreign lenders and domestic residents perceived the heightened exchange risk resulting from the increasing overvaluation of the currency and demanded higher yields.

### Substantial Appreciation of the Currency

The liberalisation of financial transactions was followed by a substantial real appreciation of the currency, triggered by the massive capital inflows due to persistent interest rate differentials. The attempt to stabilise inflationary expectations by announcing future rates of devaluation that were below current inflation rates (active "crawling peg") ended in a real overvaluation of the currency. Anchoring inflationary expectations to the exchange rate backfired; capital inflows were far greater than the central bank could sterilise and weakened fiscal and wage discipline. They therefore undermined the central tenet on which the anchor approach was based.

The applicability of Chile's experience to Eastern Europe is admittedly very limited. In Chile the deregulation of capital transactions occurred at a time when western commercial banks were almost desperate in their pursuit of lending opportunities to recycle OPEC payments surpluses. The problem of credit rationing did not apply to Chile at that time, whereas today it is an important factor for Eastern European firms and banks. Consequently, so far Eastern European currencies have been made convertible only as far as visible current account transactions are concerned, while the capital account remains strictly regulated, primarily to avoid capital outflows.

**Table 1**  
**The Liberalisation of Capital Movements in Chile and New Zealand**

	Year	Exchange rate <sup>1</sup>	Interest rate <sup>2</sup>	Growth rate <sup>3</sup>	Share prices <sup>4</sup>
<b>Chile</b>	1978	100.0	22.0	8.2	100.0
	1979	101.1	10.3	8.3	190.3
	1980	118.4	14.9	7.8	283.6
	1981	143.9	38.3	5.5	196.4
	1982	130.0	16.2	-14.1	140.2
	1983	106.0	2.9	-0.7	95.2
<b>New Zealand</b>	1984	100.0	8.5	5.0	100.0
	1985	101.8	8.0	1.2	101.9
	1986	103.0	4.9	2.5	153.1
	1987	118.9	5.2	0.5	154.2
	1988	126.9	9.1	-1.4	91.4
	1989	120.4	5.6	1.3	96.2
	1990	116.8	5.3	-1.3	78.3

<sup>1</sup> Index of the real weighted exchange rate. <sup>2</sup> Real deposit rates in Chile, real treasury bill rates in New Zealand. <sup>3</sup> Real gross national product.

<sup>4</sup> Index, adjusted for inflation.

Source: IMF: International Financial Statistics, Washington, D.C., various years.

### Exchange Controls

The new currency laws in Czechoslovakia (since the beginning of 1991) and Poland (since the end of 1989) are based on the principle that all currency transactions are permitted unless otherwise specified. Hungary, by contrast, is still applying a restrictive ordinance dating back to 1974. The three countries have established current account convertibility remarkably quickly. Rapid liberalisation of the trade account was simply essential for the former socialist countries; it establishes consumer sovereignty, gives manufacturing industry access to foreign inputs, intensifies foreign competition, introduces scarcity prices and can attract foreign capital.<sup>5</sup> Except in Poland, the most important restriction on the completely free movement of current account transactions lies in the smallness of foreign exchange allocations for private travel abroad (see Table 2). In Czechoslovakia and Hungary this restriction stems from the fear that generous travel allowances would create a vehicle for capital flight and shopping in neighbouring countries.

A similar concern, namely the desire to secure adequate foreign exchange reserves and to lock in domestic savings, also lies behind the controls on capital movements. Whereas the treatment of capital inflows is relatively liberal, the controls on outflows are very

restrictive. The unhindered repatriation of profits from direct investments reflects the desire to avoid the reputation of "mousetrap currencies", but lending to foreign borrowers and both direct and portfolio investment abroad are largely prohibited. The Eastern European countries are therefore following the sequence recommended by most economists, namely first the liberalisation of prices and foreign trade, then the removal of restrictions on capital inflows and finally the deregulation of capital outflows.<sup>6</sup> However, this raises the question whether controls on capital movements are an instrument available to economic policymakers in Eastern Europe in any case. In other words, can controls on capital movements be effective in Eastern Europe?

### Ineffectiveness of Controls

Controls on capital outflows are usually only effective if long-term institutional savings are available, and then only to a limited extent. Here one is thinking especially of the savings of public social security institutions, company pension funds and public enterprises. It is thanks to these that Korea and Taiwan have largely managed to buck the international interest rate trend and hence to secure a basis for monetary autonomy and interest rate subsidies for purposes of industrial policy. The same applies to

**Table 2**  
**Foreign Exchange Regulations in Eastern Europe, Spring 1992<sup>1</sup>**

	Czechoslovakia	Poland	Hungary
I. Current account			
Payment periods:			
Compulsory surrender of export proceeds	30 days	2 months	Upon receipt
Use of domestic currency to buy imports	Prohibited	Prohibited	Prohibited
Trade credit	Subject to authorisation	Subject to authorisation (over US\$ 1 million)	Subject to licence
Travel	Allocation: US\$ 250 per person per year	Unrestricted (US\$ 2,000 per trip)	Allocation: US\$ 50 per person per year
II. Capital account			
Credit:			
Borrowing abroad	Generous approval procedures	Unrestricted for banks; generous approval procedures for non-banks	Unrestricted for banks; generous approval procedures for non-banks
Lending abroad	Prohibited	Prohibited	Prohibited
Portfolio investment inward	Restrictions on repatriation of interest	No information	Restrictions on repatriation of interest
outward	Prohibited	Prohibited	Prohibited
Direct investment inward	No restrictions on repatriation	No restrictions on repatriation	No restrictions on repatriation
outward	Prohibited	Prohibited	Prohibited

<sup>1</sup> The regulations listed here apply to residents.

Source: Data collated by the authors.

countries such as Singapore, Malaysia and Indonesia, which are able to pursue a relatively autonomous monetary policy despite the removal of capital controls, thanks to provisions regarding the savings of the social security institutions and public enterprises.<sup>7</sup> The most important motive for controls and capital outflows is to lock in long-term institutional savings, but such funds scarcely exist in Eastern European countries.

However, indications that the controls on capital outflows have little effect in Czechoslovakia, Poland and Hungary are to be seen in:

- the fact that the difference between the official exchange rate and the rate on the uncontrolled black or parallel market has been virtually eliminated. In all three countries the two rates have been largely identical since the abolition of the black market premium;
- pronounced statistical discrepancies between the foreign trade statistics of the three Eastern European countries and those of the corresponding trading partners;
- occasionally conspicuous fluctuations in foreign currency deposits, which moreover are to be regarded as a time bomb for control of the money supply and price stability.

## Scope for Circumvention

It is hardly surprising if the existing controls leak like a sieve, given the Eastern European population's decades of experience with black markets in the previous command economy. Other factors also help explain the low effectiveness of capital controls<sup>8</sup>:

- Almost complete current account convertibility has opened up many loopholes in the capital account. Since exports and imports account for around 25% of these countries' GNP, even a two-month delay in the invoicing of exports and a shortening of import payment terms by one month leads to a capital outflow equal to around 6% of GNP. This potential outflow is equivalent to the current stock of official foreign exchange reserves. In Hungary, for example, expectations of devaluation in 1991 led to the

postponement of the repatriation of export receipts estimated at US\$ 600 million.<sup>9</sup> Capital can also be transferred by overinvoicing imports and underinvoicing exports, as the experience of Latin American countries in the eighties amply demonstrated.

- A lack of administrative resources, book-keeping and accounting rules and inadequate electronic data processing facilities explain why the existing controls do not work in practice. The banks, which have been made responsible for most of the work of administering the foreign exchange regulations, lack the experience to apply the controls, and probably also the will. The second administrative pillar of the exchange control arrangements, namely the tax and customs authorities, is still seriously underdeveloped in all three countries.
- The relatively wide freedom the new foreign exchange laws give to foreigners creates additional channels for evasion. Bogus companies jointly owned by foreigners and residents provide opportunities for substitution. The growing number of international corporations further increases the potential for outflows by means of internal transfer pricing and other techniques.

## De Facto Capital Convertibility

Much of the literature on the pros and cons of capital account liberalisation and the sequence in which measures should be taken is obsolete as far as Eastern European countries are concerned, given their strong desire to integrate and the impossibility of controlling capital movements. It is more a question of recognising and eliminating the institutional and economic policy risks inherent in their de facto capital convertibility.

The macro-economic environment is therefore set by the *operational ineffectiveness* of controls on capital exports and the simultaneous *credit rationing* operated by foreign commercial banks. Now that the money overhang created by the command economy has been eliminated, a two-tier banking system introduced and exchange rates unified, this specific set of conditions in Czechoslovakia, Poland and Hungary requires as a matter of urgency:

- a lasting consolidation of the public budget in order to avoid repression of the domestic financial market and to free monetary and exchange rate policy from "fiscal dominance"; and
- a deepening of domestic money and financial markets in order to cushion the loss of monetary autonomy that accompanies the de facto freedom of capital movements.

Healthy public finances and functional money markets are the best long-term way of avoiding at one and the same time capital flight and unemployment, inflation and currency overvaluation.

<sup>5</sup> Cf. H.-P. Fröhlich: Währungspolitische Reformen in Osteuropa, Institut der Deutschen Wirtschaft, Beiträge zur Wirtschafts- und Sozialpolitik No. 197, Cologne 1992.

<sup>6</sup> Cf. for example J. Williamson: Capital Account Convertibility: A Cost-Benefit Analysis for Developing Countries, in: H. Reisen and B. Fischer (eds.): Financial Opening. Developing Country Policy Issues and Experiences, OECD, Paris 1992 (forthcoming).

<sup>7</sup> Cf. B. Fischer and H. Reisen: Capital Account Opening: Pitfalls, Prerequisites and Perspectives, OECD Development Centre Studies, Paris 1992 (forthcoming). See also H. Reisen and H. Yerkes: Time-Varying Estimates on the Openness of the Capital Account in Korea and Taiwan, in: Journal of Development Economics (forthcoming).

<sup>8</sup> Cf. P. Poret: Exchange Control Issues in Partners in Transition Countries, in: OECD Observer, Paris (forthcoming).

<sup>9</sup> Cf. OECD: Economic Survey, Hungary, Paris 1991.

### Need for Budget Reform

Financial repression and inflationary money creation are the direct consequence of weak government finances. Base money is an interest-free liability of the public sector which can finance real spending to the extent that the private sector holds domestic currency and the domestic banking system holds reserves with the central bank against its deposit liabilities. The dismantling of controls on capital movements reduces the monetary base for financing public expenditure. It also makes it difficult to expand the public debt, in as much as controls force purchasers dependent on the state (civil servants, banks, pension funds) to buy low-yielding government securities. This is particularly important in Poland and Hungary, whose heavy foreign debt is financed by domestic public sector borrowing, given the rationing of foreign credit.<sup>10</sup>

The transformation taking place in Eastern Europe has also led to an alarming decline in tax receipts. Tax revenue, which in the command economy was derived by appropriating the surpluses of state enterprises, has been automatically reduced by privatisation and falling profitability. Tax reform involving the introduction of income tax and value added tax is therefore urgently needed. However, tax reforms take time to draft and implement if they are to be an economic and fiscal success. The list of failed tax reforms is a long one; in many cases too little time was allowed to prepare and introduce the measures. The preparatory period needed to create the necessary administrative and technical conditions (expansion or modernisation of the accounting system, training of tax officials and changes in administrative structures) can be expected to last about two years.

Sound government finances are also a prerequisite for a more active fiscal policy for managing domestic demand. As experience in Singapore and Indonesia has

demonstrated, the use of state surpluses to influence bank liquidity frees domestic interest rates from their function as a demand management tool.<sup>11</sup> They are therefore available to be used for exchange rate management. This avoids overburdening economic policy instruments – namely the maintenance of competitive exchange rates and the use of interest rates to manipulate domestic demand – which cannot be reconciled in the absence of capital controls.

### Development of the Money and Financial Markets

A fragile international credit standing and the lack of securities markets are common obstacles to the dismantling of capital controls in Eastern Europe, as in developing countries. This precludes absorbing external shocks and financial crises over a longer time-span. Full currency convertibility therefore requires the creation and deepening of money and securities markets; otherwise, the monetary authorities will repeatedly fall back on direct credit restrictions to combat capital flight and recession, using measures that are inconceivable without controls on capital movements.

The creation and deepening of domestic money and securities markets often fails because of the continual repression of the financial sector. For example, the liberalisation of interest rates, which is indispensable to the development of domestic financial markets, threatens the profitability and security of banks that have been burdened with bad loans as a result of the state allocation of credit. As the regulation of interest rates hinders the development of issue and secondary markets for bonds and shares, monetary policy must make do without open market operations. If in addition a large proportion of central-bank credit consists in the automatic rediscounting of subsidised bank loans, the discount window can play only a limited role in indirect money supply management. Finally, the undercapitalisation of domestic banks makes it difficult to use changes in minimum reserve ratios as a means of controlling domestic liquidity.

In order to cushion domestic liquidity from speculative shocks, which manifest themselves in fluctuations in foreign exchange reserves as a proportion of monetary base, small countries with open economies have frequently resorted to credit rationing based on the control of short-term capital flows. In order to avoid the need for such controls, domestic money markets must be created and deepened to equip the monetary authorities with price-oriented instruments. For instance, to prevent inflation being fuelled by an excessively large exchange reserve component in the monetary base and to avoid an unwelcome appreciation of the currency at a time when the

<sup>10</sup> On the connection between foreign and domestic government borrowing, see H. Reisen: Public Debt, External Competitiveness, and Fiscal Discipline in Developing Countries, in: Princeton Studies in International Finance, No. 66, Princeton, N.J., November 1989.

<sup>11</sup> Cf. B. Fischer and H. Reisen: Capital Account Opening, op. cit.

<sup>12</sup> Czechoslovakia, Poland and Hungary are now engaging in a "dirty" float of their currencies, which are (passively) pegged to a basket of currencies. We believe they are well advised to follow this course; see also P. Kenen: Financial Opening and the Exchange Rate Regime, in: H. Reisen and B. Fischer (eds.): Financial Opening, op. cit. The advocates of completely flexible exchange rates should note that the foreign exchange markets of Eastern Europe are underdeveloped and monopolistic; for example, Bank Handlowy controls around 70% of the Polish foreign exchange market. The proponents of fixed (nominal) exchange rates should consider that curbing inflationary expectations by pegging the currency has failed more often than it has succeeded; furthermore, the Eastern European countries need a certain level of foreign exchange reserves to create confidence and service their debts.

country is a preferred destination for portfolio investment, sterilised foreign exchange intervention is the central bank's most important instrument for exchange rate management.<sup>12</sup>

A sterilised purchase of foreign currency leaves the money supply unchanged, as the central bank sells an equivalent amount of domestic assets to the private sector. As long as the domestic securities markets remain thin, the direct (contractionary) supply-side effect of sterilisation will be felt more quickly than in OECD countries. The sectoral distribution of the domestic contraction in credit is more concentrated, the cost of working capital rises more rapidly for non-favoured borrowers in the residual informal markets, the liquidity position of domestic banks is more directly affected (if the yield on the securities used in the sterilisation operation is not at market rates) and the crowding-out resulting from the contraction in credit can more easily weaken the thin markets in corporate bonds.

The creation of domestic money markets normally begins with trading in short-term government bonds. The greatest obstacle to the development of money markets is usually the reluctance of the finance minister to pay market interest rates on public debt. Similarly, the dependence of state revenue on subsidised international loans causes a shortage of government paper in the domestic market.

Laxity in the collection of corporate income taxes constitutes a further obstacle to the establishment of private securities markets. The avoidance of corporate taxes by showing very low book profits is irreconcilable with creating confidence in bonds and shares among potential investors. These obstacles can be removed if independent credit rating agencies are set up to make a sound market assessment of private debt issues. Subsidised bank loans are a further impediment that must be eliminated if domestic money markets are to develop. The time needed to create and expand money markets therefore depends crucially on the speed with which the domestic financial repression is overcome.

In the past, financial deregulation has often had the opposite results to those intended, owing to sectoral and geographic segmentation of credit markets, a lack of competition in the banking system and inadequate banking supervision. The presence of these characteristics in all the Eastern European countries entails the risk of great financial instability, especially in view of the existing macro-economic imbalances. If the deregulation of such imperfect financial markets is not carefully prepared, there can be little prospect of a narrowing of interest rate differentials, an increase in domestic competition in the banking sector, an

improvement in allocative efficiency and a reduction in banks' operating costs. If in addition the entry of foreign banks threatens the existence of domestic banking institutions burdened with bad loans, stability may be rapidly undermined by bank failures.

The introduction of a two-tier banking system, which has already occurred in the Eastern European countries, and the creation of a formal structure for the development of market-oriented financial intermediation are only the start of the transition towards a functional financial system. Time will therefore be needed to develop market relationships, to train bank staff, to create a banking culture, to develop new investment and financing instruments and to promote market-related behaviour on the part of investors and borrowers. There are however two policy areas that brook no delay if potentially adverse effects of liberalisation are to be avoided, namely action to promote competition among existing financial institutions and rigorous measures to regulate the banking system and consolidate bad bank loans.

### **Strengthening of Competition**

Measures likely to strengthen competition among existing financial institutions include the removal of interest rate ceilings, the abolition of subsidised loans and credit corridors for priority sectors and the privatisation of state-owned financial institutions. The development of direct securities markets is an effective way of intensifying competition. The success of privatisation depends on whether the privatised banks are able to reach independent lending decisions. Banks must therefore be placed in a position to protect their capital base against loan losses with which they have been or are being saddled as a result of state credit allocation. This can only take place after their existing balance sheets have been strengthened by writing off bad loans and they have been injected with additional capital. A solution must also be found to the problem of the overhang of enterprises' debts dating back to the era of the command economy, as company failures due to this cause are a serious threat to the stability of the banking system.<sup>13</sup>

If appropriate prudential rules are already in force, new domestic and foreign banks should be permitted and even encouraged to enter the market. If domestic competition is insufficiently strong, competition from abroad will be all the more important. Financial repression must be ended if undistorted competition is to be established between domestic and foreign banks. For example, excessively high minimum reserve requirements give foreign banks a

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<sup>13</sup> Cf. R. Portes: Is There a Better Way?, in: International Economic Insights, May/June 1992, pp. 21 f.

competitive advantage, as their liabilities derive more from foreign sources than from domestic deposits to which the requirements apply.

A further obvious disadvantage for domestic banks stems from the obligation to purchase government securities and to grant high-risk loans at interest rates below the market level. Fair competition also requires that domestic banks' holdings of bad loans be largely consolidated before the refreshing winds of foreign competition begin to blow. Once consolidation has taken place, the authorities might consider merging some banks with foreign investors. This could help domestic banks reduce their disadvantage in terms of reputation and provide scope to diversify their portfolio.

In the same way as macro-economic stability, prudential regulation and supervision of the banking sector are a *conditio sine qua non* for successful financial opening. These preconditions are important to minimise moral hazard (including corruption, fraud and excessive risk-taking) in the banking system, to ensure the viability and health of the banking industry and to make interest rate liberalisation more effective. The ultimate objective of prudential regulation and banking supervision is to achieve stability of the financial system (and public confidence in such stability), to manage systemic risk and to protect clients. The authorities must therefore strengthen banking supervision, which should pay particular attention to compliance with rules on capital adequacy, risk spreading and solvency.

### Consolidation of Bad Loans

The overhang of bad loans in the domestic banking system is a particular stumbling-block for financial deregulation in the Eastern European countries, and especially for the free entry of foreign banks. However, it is almost impossible to quantify the volume of bad loans at present in view of the lack of reliable balance sheets and the difficulty of distinguishing between solvent and insolvent enterprises.

Experience in Argentina, Uruguay and Chile in the early eighties suggests that the scale of the problem is easily underestimated and that the cost of rescue operations is far from negligible. In Chile, for example, the costs incurred between 1982 and 1985 are estimated at 44% of the country's GDP for 1985.<sup>14</sup>

As in most developing countries, financial institutions in the Eastern European countries are seriously

undercapitalised, and there are often no clear guidelines on the minimum level of capital and reserves. In Czechoslovakia, for example, the capital ratios of the two commercial banks were only 1.5% at the beginning of 1991, and those of the savings banks were even lower.<sup>15</sup> In view of the small number of rehabilitation operations that have been successful, no optimal approach to the problem of bad loans can be suggested. In addition, reform of the financial sector in the Eastern European countries must be closely co-ordinated with the restructuring of the corporate sector.

### Reform Models

The reform of the financial sector and the restructuring of enterprises could essentially follow two models, which need not be mutually exclusive. In the first model, efforts would be concentrated initially on re-organising and privatising the enterprise sector, and only later would attention be turned to the problem of bad loans. The advantage of this gradual approach would be that the burden on the government budget could be spread over a longer period. On the down side, the privatisation of state enterprises is likely to proceed slowly and the banks will probably tend to continue to increase their bad loans. This would seriously impede the channelling of financial savings into new and more promising activities.

In the second model, the reform of the financial sector would be tackled first and the banking system used as the driving force for the restructuring of the enterprise sector. To this end, the banks would have to be recapitalised in order to make provision for bad loans and write off irrecoverable loans. The preconditions for successful rehabilitation of the banks are adequate recapitalisation and the pledge that this is an exceptional, one-off measure. The advantage of this model is that the banking system would become an agent with an institutional interest in the restructuring of the enterprise sector. However, the major problems with this approach are the enormous burden it would place on the government budget and the associated problem of macro-economic instability. There is also a danger that the sheer volume of non-performing loans and the uncertain economic prospects of the Eastern European countries will prevent governments from credibly excluding the possibility of future capital injections.

The dilemma facing the Eastern European countries with respect to full currency convertibility is that the administrative and institutional requirements for effective capital controls are not met, nor are the conditions for a smooth transition to full convertibility. Until one or other of these sets of conditions is satisfied, Eastern Europe will remain at the mercy of serious financial crises and capital flight.

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<sup>14</sup> Cf. B. Fischer and H. Reisen: Zum Abbau von Kapitalverkehrskontrollen, op. cit., p. 29.

<sup>15</sup> Cf. OECD: Economic Survey, Czech and Slovak Federal Republic, Paris 1991, p.105.