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Klaus Schröder*

Banking Reforms in East Central Europe

The first step towards the establishment of a banking sector geared to the market economy, the introduction of a two-tier banking system, has long since been taken by the countries of East Central Europe. A large number of shortcomings are still to be found in their banking systems, however, and the speed of reforms, after a lightning start, has slowed down to a snail's pace.

Since 1990 the countries of East Central Europe (Bulgaria, Poland, Romania, Slovakia, the Czech Republic, Hungary) have achieved undeniable successes in various areas of reforms such as improving price stability and severing their export trade from the traditional and economically irrational structures of the Council for Mutual Economic Assistance. The privatisation of economic activity is also progressing, although this is not true everywhere of the state-owned enterprises. Not least of all, in 1993 nearly all of these transforming countries swung back into a growth phase, after having seen their national incomes drop by 20-30% in the preceding years.

A radical new orientation has also been ventured upon in the monetary, financial and currency systems: henceforth, money is to be the decisive regulatory factor in determining the economic fate of these societies. The centralised mono-bank system has thus been abolished and the two-tier banking system introduced. The national central banks were rudely awoken from their bureaucratic Sleeping Beauty-like quiescence and had to concentrate, to a large degree autonomously, on defending the domestic stability of their national currencies. To this end, they began to develop a corresponding set of monetary instruments.

While old, planned-economy institutions were disappearing, new ones were founded with a determinative influence on the monetary system. State-owned and private-sector commercial banks, which sprang up like mushrooms, are mostly run as in Germany, as universal banks. After a break of over forty years bank customers were thus once more able to choose as they wished between different financial institutions, and place their savings with banks in which they had greater confidence, or where they could earn higher interest rates. Foreign banks participated in the tide of new start-ups and thus

complete the picture of the departure to a market-oriented financial system.

Things that had previously been viewed as superfluous or had been prohibited by the system now very quickly established themselves. Suddenly there were substantially free foreign exchanges on which companies or private individuals could buy or sell other currencies. The private ownership of foreign currency was not only no longer forbidden, it was becoming the symbol of the change and the new departure. Flourishing, and often hectic exchange dealings began in the banks and in the bureaux de change in the streets.

A further stage was completed with the establishment of stock exchanges. In the meantime the state, banks and industrial enterprises are issuing a wide range of securities in order to obtain long-term risk capital. The level of competition is there for all to see, given the strength of state demand and the attractive yields on offer. The up-and-coming bond markets are particularly prominent. For the first time investors have a realistic choice of investments, compared with the state-owned savings bank of earlier years which offered only a modest interest rate. As a result of the privatisation of the state-owned businesses and the issuing of privatisation coupons amongst other things, equities are again experiencing an upturn and are being quoted on the stock exchanges.

Alongside the developing capital markets, money markets have been established where short-term funds are dealt daily between banks to balance their liquidity. Because of the large number of commercial banks which have emerged, there are also credit markets in which investors can borrow capital under improved competitive conditions.

The moves to establish a new market order in the financial sector have been largely completed in all the countries under examination here. Yet the situation still leaves a good deal to be desired. There are still considerable problems to tackle in aspects of

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structural policy. Despite all efforts, decisive preconditions for an improvement of domestic capital formation, capital accumulation, and the allocation of credit have not been fulfilled. Attention will be drawn to this below and it will be stressed how difficult it will be for these countries to achieve the modernisation and the economic structural change they strive for, if the monetary and banking sectors are only operating below their optimum.

Need for Reforms in the Financial Sector

The need for monetary reforms is a consequence of the different functions of the financial sector in a planned economy compared with a market economy. The fundamental difference arises from the fact that banks in the planned economy system of Eastern Europe were not autonomous, but merely functioned as executive or support institutions of the state central planning authority. It was not the state "mono-bank" system which ultimately determined the supply of money, but the central planners. In Eastern Europe monetary stability used to be administered and did not belong to the domain of monetary policy-making. This is why the inherited monetary fine-tuning instruments have proved inadequate to the task during the transformation period.¹ As monetary bodies did not have their own lending powers, their supervisory function also had a different emphasis. It was restricted to monitoring the implementation of central plans. The task of matching different amounts of money, loan periods and risks likewise only lay in the hands of the banks on a pro forma basis. In fact it was determined by the planning authority. Hence in the planned-economy banking system no capability had been developed for judging the returns and risks of an investment project.

The basic need for the reform of the financial sector should therefore concentrate on three areas. Firstly, of the institutional changes, the introduction of a two-tier banking system is of primary importance; it is the precondition for a separation of the two tasks of matching volumes, terms and risks on the one hand and maintaining price stability on the other. While the central bank endeavours to control the value of money by means of interest-rate and money-supply decisions, the commercial banks can concentrate exclusively on the goal of maximising profits. This is the best institutional way of guaranteeing that an effective allocation of credit will take place independently of extraneous stability considerations.

From a practical viewpoint a two-tier system offers banks the advantage of a clearing centre for payment

transactions without the need to organise this themselves. They must in any case have an account with the central bank in order to have access to central bank money. During an economic transformation, which usually involves high inflation and great uncertainty, it is a significant help if payment transactions function smoothly.

Since at the time of planned economies price stability did not come under the state bank's area of responsibility, monetary instruments for fine-tuning (discount rate, lombard policy, open market and security pension operations) now have to be developed as soon as possible.

Banks which operate autonomously are not automatically trustworthy. Previously the state had guaranteed savers' deposits. But reasons of moral hazard forbid the continuation of such arrangements. Hence a deposit guarantee fund is needed, financed by the banks. Tied up with this is the question of the creation of a banking supervisory body to ensure that confidence in the banks is not undermined by unsound business practices and that a run on deposits does not start.

Secondly, attention should be turned to the promotion of competition among banks, since at the outset of the reforms, a concentration of market power has, in numerous respects, stood in the way of healthy development. In the state-owned savings bank, for example, deposits exceeded the volume of loans to domestic customers many times over, and they dominated the financial market by holding a monopoly of supply. On the other hand, the few, mostly regional, banks which specialised in particular sectors, commanded a monopoly position in respect of commercial enterprises and other creditors. Competition between banks was limited further by the fact that all the financial institutions were initially state-owned and had no fear of being displaced by "sister institutions", nor indeed of bankruptcy.

In order to promote competition therefore, the privatisation of the commercial banks must be driven on and the founding of new banks supported. A further improvement in the provision of banking services would be achieved if foreign banks could be successfully attracted into the country.

Thirdly, the solution of the problem of bad loans presents a heavy burden that will delay the transformation.² It consists of the high number of pre-reform debts in the corporate sector or its equivalent,

¹ Cf. K. Kalicki: Monetary Policy in a period of Economic Transformation, Friedrich-Ebert-Stiftung, Economic and Social Policy Series, No. 5, Warsaw 1991.

which represent doubtful or loss-making loans in the books of the commercial banks. Such bad loans were not only an inheritance from the planned economy of the past but also the consequence of the passive allocation of credit to loss-making state-owned enterprises after the reforms had begun. New funds had to be borrowed to service the old loans in order to avoid insolvency. From the outset the opening balances of the state-owned commercial banks contained a portfolio which was riddled with bad loans, which in turn tended to generate distorted competition and higher interest margins.

The banks ought to be released from these bad debts, preferably by writing off creditors and debtors, together with a recapitalisation of the financial institutions by means of government securities. This would be the quickest, probably least expensive, and at the same time the most just way of eliminating the burden on society. The commercial banks would be free of old commitments and as competition intensified, they could transact new business on the basis of profit calculations alone.

Transforming the system, to establish decentralised economic control, is fraught with major micro- and macroeconomic risks. Traditional skills and strategies have to a large extent become worthless. Mechanisms and institutions for containing risks are hence all the more important. The required restructuring demands an especially high degree of ability and willingness to act. It falls to the banking sector to promote this by reducing the risk of loss for investors, accumulating sufficient long-term capital for producers, and securing the sensible contractual use of capital for both. In view of their restricted brief within the mono-bank system, the Eastern banks inevitably have not been well prepared to carry out this transformation task.

² Cf. Holger Schmieding and Claudia Buch: Better Banks for Eastern Europe, in: Kieler Diskussionsbeiträge, No. 197, Institut für Weltwirtschaft, Kiel 1992; M. Sacrinelli: Eastern Europe and the Financial Sector: Where Are They Going?, in: Banca Nazionale del Lavoro, Quarterly Review 1992, No. 4; Lawrence J. Brainard: The Financial Sector in the Transition to a Market Economy. How to Reform Eastern Europe's Banking Systems, New York 1991.

³ Cf. Mileti Mladenov: Money, Banking and Credit: The Case of Bulgaria, in: David M. Kemme (ed.): Monetary and Banking Reform in Postcommunist Economies, Boulder, Co. 1992.

⁴ Cf. Plamen Minkov: Banks and Banking Reform in Bulgaria, in: Russian and Eastern European Finance and Trade, Vol. 29, No. 2 (Summer 1993), Armonk, N.Y.

⁵ Cf. Reuter News Service: Bulgaria: Bulgarian Banks Post 95 Billion Levs Bad Loans, 15th February 1994. For further estimates of this problem, cf. William C. Hunter: Banking and Financial Systems in Bulgaria, in: The World of Banking, May/June 1993.

⁶ Cf. Euromoney: Bulgaria: EBRD Special Report – New Players, Old Tunes, London 1994; Reuter News Service: Bulgaria: BNB to Put Two Ailing Banks under Direct Control, 8th March 1995.

Bulgaria in a Difficult Transition Phase

The trend in the Bulgarian banking system is quite clearly towards a two-tier system along Western lines. Some fundamental problems, particularly arising from political instability, still await a solution. In comparison with the other reforming countries of East Central Europe Bulgaria sits quite squarely in the group which is furthest behind.

The central bank not only lacks important monetary control aggregates for influencing financial institutions by means of market forces and interest rates.³ It has also been difficult for it to make its mark as a centre of reform in the face of continual struggles between opposing political views and also because the web of interests linking government authorities, state banks and the state-owned enterprises has remained mostly intact.

Commercial banks, which are still predominantly state-owned, are not in a position to act as effective watchdogs over their corporate customers' performance, nor to invest scarce investment capital in the most economically rational manner. Although the quantitative consolidation of the bank market has been achieved by a reduction in the number of financial institutions from 80 to 10,⁴ the merger of the many state banks has not been accompanied by a quantitative and qualitative "clean sweep" of their balance sheets. The resolution of bad debts,⁵ cleaning up the loan portfolio, and recapitalisation continue to be unsolved problems.

In addition, the Bulgarian banks are undergoing a serious liquidity and earnings crisis.⁶ This instability is a result of the general delay in reforms in the business sector. The weakness of the banks is the mirror-image of the loss-making state-owned businesses, the privatisation of which is scarcely progressing.

The privatisation of the state banks has been slowly beginning since autumn 1994, but has mainly been confined to the sale of minority stakes. Clearly, only vague plans exist for the privatisation of the big state banks.

As a consequence it has scarcely been possible to give any impetus to competition between the banks. The effect of this disadvantage is all the more detrimental since there has been no discernible impetus to competition from participation by foreign banks. It has been equally disadvantageous that no deposit funds and no reliable banking supervisory authorities have yet been installed to protect depositors.

What is positive, is that to a large extent a "dollarisation" of the country has been avoided, in

spite of negative real interest rates. There are three stock markets for carrying out capital market transactions. Comprehensive regulations to govern funding via the capital markets and also a bankruptcy law are said to be under preparation.

The new Videnov government has come out clearly critical of Bulgaria's previous banking and monetary policy. To overcome the growing instability and the decapitalisation of the banks, progress is to be achieved by allowing specific state intervention, stricter controls of the banking sector and of money supply, and more effective supervision.

Sustained Strengthening in Poland

Poland began the reforms of its banking sector⁷ with a boldness similar to that with which it began its general reform programme and has hence been comparatively successful, even if some unfortunate delays have occurred. The foundations for a two-tier banking system were already laid in 1989;⁸ two years later the independence of the central bank was further strengthened. The statutes are thus comparable with Western central banks.

As early as 1989 the International Monetary Fund (IMF) and Western banks were aiding the appropriate implementation of the new areas of responsibility and the setting up of an adequate infrastructure. Within a short time a central clearing system for interbank payments and market-based accounting guidelines were in operation. Nevertheless, even the Polish central bank had to resort to the device of directly influencing the volume of credit. Its policy of imposing a credit ceiling on the state banks through "moral suasion" was highly significant at first as a means of firmly implementing a restrictive credit policy and reducing the high inflation rate.⁹ The bank's monetary instruments, in particular discount and securities lending policies, were further developed at an early stage in order to manage the commercial banks along market lines.

Despite the increasing number of participants, the state-owned banks are the main determinative influence in the Polish market. Half of the country's approximately 100 banks remain state-owned, and they account for around two thirds of total bank lending. The low-intensity competition resulting from regional and functional specialisation is only gradually being broken up. In contrast to Hungary, foreign banks are scarcely represented, due among other things to unreasonable licensing requirements (the take-over of indigenous financial institutions in need of rehabilitation). The quick introduction of strict capital requirements and the Basle guidelines, which

lay down an 8% ratio of core capital to risk-bearing assets, have had the effect of increasing stability.

Since the reforms began Poland has experienced around 20 bank collapses. Additionally, aid programmes are running for around one third of the cooperative banks. At the end of 1993 the requirement for writing off Polish banks' assets was estimated at US \$ 1.8 billion. A further \$ 2 billion were needed to achieve the Basle 8% ratio. Poland is regarded as "overbanked" and needs stronger banks, not new ones. The reconcentration of the sector through mergers is what is required.

Originally the Polish government hoped to have privatised the 9 banks which had been created out of the old central bank by the end of 1994.¹⁰ Differences over the basic way of proceeding and a scandal over the second state bank's stock market flotation created unimaginable delays, despite the fact that five Western commercial banks had already entered into partnerships in 1991 with five Polish banks due for privatisation and were expected to knock them into shape. For the remaining seven banks 1996 has been set as the new deadline. The main reason for the sluggish progress is the difficulty in estimating the risks resulting from the bad loans to state-owned enterprises which have grown over the years.

The 1993 law on the financial rehabilitation of banks envisaged a decentralised mechanism with a broad spectrum of compensatory arrangements for the settlement of the doubtful debts. From today's point of view this operation can be regarded as having been successful and it will enable progress to be made both in privatisation and in intensifying bank competition. A considerable amount of foreign aid, totalling \$ 450 million (11% of the estimated capital requirement of \$ 3.8 billion) has contributed to the recapitalisation of the Polish banks.

Romania: More Promising Prospects

Romania began its monetary reforms comparatively late and because of political instability has not

⁷ Cf. Pavel Wyczanski and Krzysztof Novinski: Poland's Banking System: Current Developments and Prospects, Friedrich-Ebert-Stiftung, Economic and Social Policy Series, No. 4, Warsaw 1991.

⁸ Cf. Stefanie Hamacher: Die geld- und währungspolitischen Probleme osteuropäischer Reformländer, Stuttgart 1992; Andrzej Rudka: Reform of the Banking System in Poland, in: David M. Kemme, op. cit.

⁹ European Bank for Reconstruction and Development, EBRD Economic Review, July 1993.

¹⁰ Cf. S. Sikora and M. Miszerak: The Privatisation of the Banks in Poland, in: OECD: Transformation of the Banking System: Portfolio Restructuring, Privatisation and the Payment System, Paris 1993.

yet found a consistent reform course. Although the banking system has been deregulated and newly structured since the beginning of 1991,¹¹ and the legal and institutional framework for a two-tier banking system is now firmly in place, nevertheless the concepts actually applied in individual monetary measures have not been consistent. A change in the trend has only become discernible since 1994, as a result of close cooperation with the IMF and the World Bank.¹² The most difficult part of the banking reforms has yet to be tackled.

The national bank is only autonomous *de jure*. The government has repeatedly attempted massive intervention into practical decision-making processes, against the resistance of the central bankers. After a constant rise the 1993 inflation rate of 295% was hence the highest since the reforms began. It was also the highest rate of all the reforming countries of East Central Europe that year.

As a consequence, all the other areas of reform have been burdened with this handicap. The interbank money market requires further development, as does the strengthening of the instruments of monetary policy. The most important means of limiting the money supply has been direct credit control.¹³

The commercial banking sector, as the second level of the banking system, has clearly changed in both quantitative and legal aspects. Nevertheless, decisive tasks of a qualitative, structural nature remain to be resolved. At the start of 1995 a total of 27 financial institutions were registered as universal banks. The Romanian banking market is regarded as "underbanked", partly because of the central bank's strategy of restricting the allocation of licences, and it continues to suffer from structural deficiencies, in particular from the supremacy of the state-owned banks and from regional and sectoral concentration. The market is dominated by four large state banks. They run the biggest branch network and cover over 80% of the credit market. Three quarters of all lending

still goes to state-owned businesses. The presence of purely private-sector banks, which achieve a market share of around 20%, is impossible to overlook. In comparison with the slow-moving apparatus of the state banks, they are regarded as flexible.

The state-dominated banks are now exposed to unprecedented competition. The state-owned savings bank, for example, at which 80% of all private savings were deposited in 1993, lost almost half of these within the following year as a result of the more intense competition and the higher interest rates offered by other banks.

In order to create a modern payments system, 42 clearing houses of the central bank are to be set up in 1995.¹⁴ The entries will, however, continue to be made manually. Some banking regulations which are comparable with Western standards are also established in law in Romania, for example in respect of liquidity reserves or the strengthening of the capital base. In 1994 the minimum equity capital was quadrupled to 8 billion lev. However, the usual international rules for capital provisions have still not been laid down. The same applies to deposit guarantees among private-sector banks. So far, in spite of only partially improved banking supervision and some cases of banking abuse, there has been neither a run on the banks, nor a bank closure or a bankruptcy.

Thus far the Romanian authorities have been unable to overcome adequately the problem of neutralising doubtful assets.¹⁵ The financial recovery of the state banks still remains wishful thinking. It is hence not surprising that moves towards privatising the state banks have only been established after five years of programmatic manoeuvres and that two of the six big state banks are to be privatised in a first step "probably at the end of 1995".

The change of direction introduced under the influence of the IMF helped the country to turn its back on the period of self-deception and high inflation. A second basic defect is still to be eliminated: the vicious spiral whereby the state banks finance the state-owned enterprises as before and get new bad assets in the process.

Sound Basis for Czech and Slovak Banking

The Czechian Central Bank Law of 1991, which was closely modelled on German legislation, is laid down in exemplary fashion, especially the independence of the central bank. Up to 1992, the restrictive monetary policy was implemented by

¹¹ Cf. Ion Dragulin: Banking in Romania, in: The Vienna Institute, Monthly Report, No. 2, Vienna 1994.

¹² Cf. Dan Ionescu: Romania's Currency Plummeting, in: RFE/RL Research Report, No. 2, 10th December 1993, p. 49.

¹³ Cf. Emil I. Ghizari: Banking Reform in Romania, in: David M. Kemme, *op. cit.*

¹⁴ Cf. Reuter News Service: Romania: Romania Central Bank Launches New Settlement System, 23rd March 1995.

¹⁵ On the first measures taken, cf. Eric V. Clifton and Mohsin S. Khan: Interenterprise Arrears in Transforming Economies, The Case of Romania, in: IMF Staff Papers, Vol. 40, No. 3, Washington D. C. 1993.

imposing credit ceilings and firmly fixing interest rates; later, more market mechanisms were used by auctioning credit allocations, and by bill discounting and securities lending, while existing maximum margins were lifted. From the beginning the stability of the currency was higher than in all the other transforming countries. The same is true of Slovakia, which took over the legal framework of Czechoslovakia with its own currency. It formally has at its disposal the entire set of monetary instruments normally used in market economies, and has applied them successfully with an inflation rate of 13% (1994), despite a serious lack of specialist staff.

A real founding boom in the Czech banking sector has raised the number of commercial banks from 7 to around 60.¹⁶ Foreign banks have influential involvement. Despite the high number of active institutions, the five state banks, which boast an extensive branch network, dominate the scene with nearly 80% of the market. The lack of cooperative banks has a negative effect on competition. A clear overview of the market is made more difficult by accounting standards which are as yet inadequate. The state banks remain quite predominantly the banks of the state-owned enterprises. Several bank collapses brought about the spontaneous promotion of the bank supervision, a more restrictive allocation of licences and a doubling of the capital base to around \$ 20 million. The qualification requirements for bank managers were also tightened further. To protect savers, the banks are to set up a fund which secures 80% of deposits up to a maximum of 100,000 koruna.

The stagnation of the settlement of bad debts since 1991 must be seen as a handicap. As 20% of the bank loans are still classified as doubtful, this problem could soon rear its head once more.¹⁷ The privatisation of the five leading Czech banks was begun with the big privatisation of 1992. The remaining state share is currently around 40%. Newly founded banks must abide by the Basle 8% ruling. For banks which are burdened with bad debts this ruling applies from the end of 1996 and they seem to be well on their way to achieving it. However, whether they will ultimately do so will depend on how they can clean up their credit portfolios.

The Slovakian banking market has also undergone rapid development. 30 separate banks are registered, including considerable foreign participation. As in the Czech Republic, semi-state banks dominate the picture: they lead the market and are exceeding their self-imposed targets of a 30% market share on both the loans and the deposits sides. Despite their dominance competition has increased; this has certainly been helped by privatisation which has begun but is not yet complete and is not as far advanced as in the Czech Republic. The proceeds from privatisation are to be used to strengthen the capital base. Shortcomings in the accounting rules and a lack of awareness of risk make the volume of bad debts appear too small. Hence the risk-weighted level of core capital is presumably still well below the 8% limit. As in the neighbouring republic, creditor protection is an unresolved issue. Only savers with the state-controlled banks enjoy a legal guarantee.

Obstacles in Hungary

Moves to establish a new system took place earlier in Hungary than in the other transforming countries. The rapid transformation of the legal and institutional framework did not however lead to an equally fast stabilisation of the financial and banking system. Nevertheless Hungary can be counted among the countries with clearly improved financial discipline, greater security and growing competition.¹⁸

In practice, the central bank has been able to pursue monetary policy independently since as early as 1989, even though banking legislation was only passed at the end of 1991. The new policy on money supply began with the typical handicap of an incomplete set of central bank monetary instruments. The replacement of direct credit control with market-oriented loan allocation gained in importance from 1993. Interest-rate policy coupled with open market operations increasingly became the main policy instrument of the Hungarian central bank. It has not yet summoned the resolve to set quantitative target ranges for the money supply.

Although a deposit guarantee fund has existed since 1993 and banking supervision has been improved, Hungary has not succeeded in setting up a modern giro system. Most banks can only meet half of the required 8% core capital provision. This weakness was made even worse by high reported losses in 1993. What is also conspicuous is that in spite of all efforts at stability positive real interest rates have only been achievable in two very short periods and that for a long time no clear decision of general principle in favour of a universal banking system was reached.

¹⁶ Cf. Jörg Bornmann, Andrea Manzotti and Frank A. Schmid: Die Entstehung des Bankenmarktes in der CSFR, in: Osteuropa-Wirtschaft, Vol. 37, December 1992, No. 4; Miroslav Hrnčíř: Financial Intermediation in Czechoslovakia, in: Prague Economic Papers, 1993, No. 4.

¹⁷ Cf. EBRD Economic Review, July 1993; OECD, op. cit.

¹⁸ Cf. György Csáki: Recent Improvements in Hungarian Banking, in: Institute for World Economics, Working Paper No. 27, Budapest 1993.

The commercial banking sector has expanded quickly since 1988. Every second bank includes foreign shareholders, which has given fresh impetus. That gives Hungary the highest foreign presence of all the East Central European countries. Nonetheless, of the more than 40 banks, the three state banks which were created out of the national bank dominate the market, with a share of around 70%. The process of removing this imbalance is slow.

The perennial problem of bad loans was only resolved in 1994 after various attempts at consolidation.¹⁹ A banking crisis was avoided by recapitalisation, albeit at the cost of rising state debt and growing state power. This can only be reduced by way of capital increases in which the state is not involved, and privatisation. A comprehensive programme of partial privatisation was begun in 1994. By 1997 the state's share of ownership must be reduced to a maximum of 25% of the banks' equity. This road is largely clear now that the balance sheets have been put back on an even keel.

Main Conclusions

The banking sector plays a crucial role in the link between macroeconomic stability policy and microeconomic financial discipline. Only an effective banking system can fulfil this pivotal function. Everything that is needed for the constitution of a functional banking sector, particularly during the initial phase of transformation, has been shown above. Private banks which are in competition with each other, free of doubtful debts, recapitalised and equipped with healthy balance sheets, are just as indispensable as state supervision, deposit guarantee funds and a reliable giro system. Equally essential are businesses which comply with the same strict financial and budgetary regulations, and a corpus of laws with unambiguous and dependable rights of ownership and bankruptcy rules.

The main conclusions can be summarised to the effect that most of the transforming countries are on the right path but that there are still, in spite of numerous efforts, many regrettable shortcomings in the banking systems, in particular:

- ☐ The state banks perform sub-optimally in their most important function of allocating scarce capital to its most successful uses.
- ☐ Large state banks dominate the deposit and lending markets in all the countries. This general problem can only be solved by privatisation.
- ☐ The attempt by the state banks to loosen their links with state-owned enterprises and to diversify their

lending policy is often neutralised by the threat of new losses. If enterprises are forced into bankruptcy by a refusal to provide further loans, this can lead to a huge erosion of assets and ultimately to the insolvency of the banks themselves.

☐ The big state banks nevertheless operate cautious lending policies due to their low capital provision and high shares of bad debts. Many private investment projects and the encouragement of small and medium-sized enterprises have fallen victim of this caution.

☐ The modernisation of the banking systems has often been accompanied by a depletion of total assets and loss of returns. The implementation of new accounting guidelines often revealed for the first time just how much had been pumped into funding loss-making state enterprises, leaving behind dead capital in the form of bad loans.

☐ Banks should be the starting-point for tightening financial discipline. Since they remain weak if their balance sheets are not rehabilitated and they do not have adequate skills in evaluating enterprises, a stricter approach to business monitoring, including internal financial discipline, can only come about gradually.

☐ The distortion of the optimum allocation of credit must be rectified primarily by stepping up the pace at which bad debts are written off and state banks are privatised, as well as by properly implementing the bankruptcy laws. As a consequence the previously limited mobility of capital will also improve.

☐ The banking system of the reforming countries is not in a position to finance the transformation single-handedly. State and foreign assistance is essential for banks to be able to finance modern growth.

The first step, the introduction of a two-tier banking system to deregulate the processes of capital distribution, was taken by all the countries a long time ago. The second step, the writing-off of dubious debts and privatisation, is proving difficult for them all; Hungary, Poland, and the Czech and Slovak republics have come furthest. But even the leading reforming countries have an enormous amount of hard work to do to achieve the third step, that of financing durable growth and greatly needed structural changes.

¹⁹ Cf. Rczso Nyers and Gabriella Rosta Lutz: Restructuring of the Banking System in Hungary, in: OECD: Transformation of the Banking System; Mihaly Patai: Bank Consolidation in Hungary, Statement to the conference on "The Role of International Financial Institutions in Central and Eastern Europe", Munich, 12th-14th April 1994.