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Transforming the Financial System in Eastern Europe's Emerging Market Economies
A Proposal for Clean Balance Sheets and an Institutional Transfer

by Holger Schmieding

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Transforming the Financial System
in Eastern Europe’s Emerging Market Economies

A Proposal for Clean Balance Sheets and an Institutional Transfer

1. The Major Capital Market Deficiencies

In developed market economies, banks and other financial institutions perform a variety of vital tasks:

- they mobilise savings and allocate funds to the optimal uses,
- they pool investment risks,
- they exploit scale economies in the evaluation and monitoring of borrowers, and
- they match the preferences of lenders and borrowers for liquidity and for specific term structures of portfolios.

Driven by self-interested owners whose own capital is at risk and by equally self-interested top managers who care for their reputation on the market for top executives, the banks exert financial discipline on their customers.

On paper, the emerging market economies (EMEs for short) have made substantial progress towards a modern financial system: The old one-tier system of state banks has been dissolved into a central bank and a variety of commercial banks at an early stage

1) This paper has benefited from financial support from the EC’s Action for Cooperation in the Field of Economics (ACE) in the framework of a joint research project on "Reintegration of Poland into the West European Economy by Internal and External Liberalisation" undertaken by the Warsaw World Economy Research Institute, the Milan SDA Bocconi Institute and the Kiel Institute of World Economics (Grant No. 90100081 P).
of the transformation process; new commercial banks are being established; financial intermediation takes place as significant funds do in fact flow between banks and enterprises and among enterprises. Nonetheless, the financial systems in the EMEs are still in disarray. As stock exchanges and securities markets are in their infancy, banks and firms acting as de-facto banks will play the pivotal role in financial intermediation for the time being (Brainard 1991, Saunders and Walter 1991). Unfortunately, the banks are not up to the task of channelling funds to the most worthy borrowers (Winiecki 1991a,b). Whereas some promising enterprises suffer from a dearth of funds, some hopeless duds continue to receive credits to stay afloat and crowd out other firms on factor and input markets. A variety of deficiencies impede a proper financial intermediation:

(1) In the turbulent phase after the abolition of central planning, little is known about the future prospects and hence the creditworthiness of enterprises. The pervasive uncertainty concerns the potential viability of an individual firm relative to others under given circumstances (specific risk) as well as the course of economic policy and the path and pattern of economic development under any given policy (systemic risks).

(2) Many potential borrowers can offer little collateral, or only collateral of dubious legal status. Borrowers usually need collateral to signal their creditworthiness. The problem of insufficient collateral in the EMEs is compounded by the pervasive uncertainty about the value of things that might serve as a collateral and, possibly, also by the asymmetric distribution of information about such a value.

2) A two-tier banking system is in place since 1987 in Hungary and Poland, since 1990 in Czechoslovakia and since 1991 in Bulgaria and Romania.
(3) In a similar vein, many firms have little equity and little investible funds of their own. Hence, major investments need to be financed largely by credits. A small downward deviation from the expected rate of return (which depresses the rate of return on investment somewhat below the interest rate of the credit) suffices to consume the little equity of the borrower in many cases. Whereas the lender would thus bear the major part of any unexpected losses, he would not participate in any unexpected gains. To make up for this asymmetry, the lender has to demand a correspondingly higher interest rate.

(4) As the banks are almost exclusively state-owned, they have little incentive to act as prudent advocates of capital, be it their own capital or that of their depositors. Furthermore, the market for managers is underdeveloped. And because many bank managers may justly assume that they will be replaced by younger, better trained or politically untainted newcomers in the future anyhow, they have little reason to care for their professional reputation. Instead, it is rational for them to discard the long-run impacts of their actions and to concentrate on short-run measures and accounting tricks to make their banks look artificially healthy on paper - and hence to enhance their own chance of escaping closer attention for the time being.

(5) Threatening banks with bankruptcy to improve their performance is hardly credible; the expectation that government would have to bail out the banks anyhow is well entrenched. Bank failures on a substantial scale could undermine whatever confidence the public already has in the nascent financial market (Hinds, 1990, p. 99). And politically, governments have little choice but to stand in for existing deposits as the depositors

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3) Furthermore, the distribution of investible funds among firms is arbitrary. This reflects the distortions in the EMEs which cause an exceptionally low congruence between the ultimate viability of a firm and its present cash flow.
mostly did not even have a choice of banks when they opened their accounts in socialist times.

(6) Bankers often do not possess the necessary skills and expertise.

(7) The emerging market economies lack a well-established and well-tested system of prudential regulation and supervision. Accounting rules and practices to not yet conform to accounting procedures in the West. Prudent accounting is likely to reveal that not only a few institutes of negligible importance but a major part of the banks have a net value that is negative.

(8) Specific banks and firms are tied to each other in various ways which impede competition between banks and grossly distort financial flows. To facilitate financial control under central planning, firms had been forced to deal almost exclusively with a specific bank while banks had been specialised towards serving enterprises in a specific branch or region. As a legacy of this past, the portfolios of many commercial banks are highly concentrated. These banks become hostage to their dominant customers on whose willingness or ability to pay the fate of the individual bank depends (Hinds 1990, pp. 133, 147). Out of pure self-interest, the banks tend to channel fresh money to their dominant customers and not to more promising potential borrowers.

(9) Banks have inherited a heavy burden of bad loans to state enterprises. Neither banks nor firms are to blame for that sorry state of affairs: both had little financial discretion in the past anyhow, central decisions on finance and investment were unrelated to profitability, and the past set of relative prices differed radically from the present one so that whatever rudimentary calculations of investment viability and hence creditworthiness may have been made in the past are obsolete anyhow. To postpone the moment of truth when losses on bad loans have to be written off in their own books, banks let fresh money follow the bad loans: they refinance existing obligations and provide new credits to cover the interest due (see i.a. Brainard 1991, p.
97). Betting on an eventual government bail out of insolvent firms may also be a cause of this malpractice.

(10) The portfolio problem consists not only of loans that are not being serviced at all; it is also unclear which further loans will eventually turn out to be unrecoverable. Furthermore, in socialist times banks had granted sizeable amounts of long term credits at extremely low interest rates fixed in nominal terms. Due to inflation and some financial liberalisation, the bank's present nominal costs of refunding are far above these old lending rates. Hence, banks lose sizeable amounts of money even on loans that are fully serviced (see i.a. Hinds 1990, Annex 2). To stay solvent nonetheless, banks would have to charge new customers excessive interest rates. The likely result is a slow process of adverse selection, with borrowers turning increasingly to new banks or to those old banks which by chance have inherited a comparatively clean portfolio.4)

(11) Apart from portfolio concentration and bad loans, the personal contacts established in the days when there was little or no choice of business partners are a third factor which links banks to specific firms (see also Winiecki 1991a). To some extent, favouring clients whose top managers a banker has known for a long time is quite rational: in the turbulent transformation period in which even the best calculations of viability are fraught with problems, in which law enforcement is uncertain, in which collateral is hard to come by and in which informational asymmetries abound, it helps to know from experience whether one's partner tends to honour contracts or not.5) In the peculiar

4) A particularly complex problem are the low interest mortgage loans from state banks to private borrowers; a discussion of this issue, which cannot be solved simply within the state sector, is beyond the scope of this paper; see for instance Blue Ribbon Commission 1990.

5) Information between long-standing chums is distributed less asymmetrically than between strangers. The partners know each
situation of the EMEs however, such systematic favouritism also reflects a perverse system of mutual insurance: Trusting each other and trying to keep their old cosy jobs for as long as possible, bankers and firm managers try to bail each other out to avoid bankruptcy proceedings and other kinds of outside scrutiny; they collaborate to cook the books and to channel financial flows so that both the bank and the firms look sufficiently healthy on paper for the time being.

(12) The financial links between firms and their banks are similar to those among firms. Personal contacts, dependence on a dominant supplier or outlet, neglect of the long-term capital value of the state-owned firm, a reluctance to initiate bankruptcy proceedings against other firms and possibly also the expectation of an eventual government bail out are major factors which prompt many of the more liquid firms to extend inter-firm credit to less liquid ones (see Dabrowski et al. 1991). Incidentally, the links between firms and the network of inter-firm credits of dubious quality further complicate the task of assessing the solvency of firms.

Whereas the actual capital market is underdeveloped in the emerging market economies, the need for efficient financial intermediation during the transformation process is even far greater than in a mature market economy: The large-scale privatisation of state property, the need for substantial restructuring of firms and the comparatively great role which new firms play in the transformation process put above-average strains on the capital market.

By their very nature, some of the capital market problems cannot be completely resolved by economic policy. The pervasive uncertainty in the early phases of the transformation process will not vanish completely for quite some time; it can at best be

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other's reputation and can comparatively easily inform themselves about each other's activities.
mitigated by appropriate policies. Other problems can be better addressed. The following sections deal with three major issues, namely (i) the issue of old loans, (ii) suitable ways to speed up the establishment of an appropriate regulatory framework as well as the development of the banking sector and the transfer of know-how from abroad, and (iii) possible strategies to counteract the collateral gap. Finally, the role of financial reform in the timing and sequencing of the transformation process is discussed.

2. Cleaning the Balance Sheets for a Fresh Start

a. The problem of old debt

The network of old loans between banks and firms is one of the most pressing problems for the emerging market economies. The consequences which this particular legacy has for firms are bad enough: the debt burden is distributed arbitrarily between firms, a firm's debt is unrelated to the value of its assets; by pure chance, many unviable firms carry a comparatively light debt and hence enjoy an unwarranted competitive edge over other firms while more promising but less lucky enterprises collapse under the burden of debt service. The privatisation of firms is complicated and delayed by the need to identify and deal with the bad loans; the restructuring of the economy is deferred because banks are reluctant to initiate bankruptcy proceedings against those loss-making firms which are their dominant clients. The consequences for banks and hence for financial intermediation are even worse: Scarce new funds are wasted to postpone the bankruptcy of unviable firms. The bad loans - and the uncertainty about the extent of the problem and the future fate of the dubious loans - also impede the privatisation of existing banks. In the same vein, they make it much more difficult politically to open the national financial system to foreign banks. Thanks to their fresh
start, outsiders would enjoy a clear competitive advantage over the local banks with troubled portfolios.  

b. The logic of cancelling old debt

The legacy of old debts necessitates a financial restructuring of both state firms and state banks. In the literature, a virtual consensus has evolved on three aspects of a solution:  

7) The old-debt link between firms and banks has to be cut, at least part of the old debt has to be taken from the books of the banks, and the banks need to be recapitalized by an infusion of funds from the state budget in the form of long-term bonds with positive real rates of interest. Two serious questions remain:

(i) Should the respective loans be written off, i.e. be removed from the balance sheets of the debtor firms as well, or does it suffice to let the banks off the hook? In this case, the liabilities of firms need not be cancelled. Instead, they could be transferred from the banks to some other institution.

(ii) Should all loans incurred under the old regime or only the supposedly bad ones be affected?

In his seminal paper, Manuel Hinds (1990) has proposed a solution which many other authors have endorsed in principle: After some audit of the books of firms and banks, government should purchase only the problem loans from banks. These loans should not be cancelled; instead, some institution should try to recover the outstanding amount as best as it can from the debtor firms. The institution, which would be paid by government for the task,

6) World Bank 1991, Annex 4, p. 6. In this respect, Poland's attempt at "twinning" its local banks with foreign ones is in principle laudable; however, it may deter foreign banks if they have to bear the risks of old debt.

could be the respective bank itself (Hinds 1990, p. 75) or a special government fund (Brainard 1991).

Building on Hinds, Brainard advocates a comparatively restrictive approach: He proposes in-depth audits using Western accounting methodology that permit governments to rank enterprises and bank loans from best to worst as a precondition for cleaner balance sheets. Furthermore, firms' access to new credits should be tied to the servicing of old loans according to their ability (Brainard 1991, p. 106).

The more radical alternative would be to write off all old debt completely so that both banks and firms could start with a clean slate. In comparison with this clean sweep, which has been proposed at an early stage for East Germany (Schmieding 1990), the more restrictive approach outlined above has a number of serious disadvantages:

(1) It addresses merely one aspect of the problem. Only the state banks are relieved of the debt burden. For state firms, the uncertainties and competitive distortions which arise from the old liabilities persist. 8)

(2) Given the uncertainty about the future viability of individual firms and the pervasive linkages between firms, the audits may yield little hard information on the ability of

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8) One aspect of the East German example is quite instructive in this respect: In the summer of 1990, financial intermediaries in East Germany could start into the German currency union with clean balance sheets. Two West German commercial banks took over the branches and the staff of the former East German state bank while all old liabilities were transferred to a special fund; newly established banks were by definition unaffected by old debt. Nonetheless, the old debt of firms continued to aggravate the operations of the "clean" banks. The debt was not cancelled, instead its final fate was to be determined on a case-by-case basis upon the privatisation of the respective firm. The unresolved debt problem of firms added to the difficulties of banks to assess the creditworthiness of firms and increased the uncertainty about what the firms could provide as collateral for new loans (World Bank 1991, Annex 4).
firms to serve and repay their inherited debt; the classification of loans into "good" and "dubious" ones may mean little.

(3) Thorough audits of balance sheets of firms take considerable time. As the banks have to carry the old loans until the respective audit has identified the dubious ones, the process of restructuring the portfolios of the banks and hence of making the banks better equipped for their tasks in a market economy is delayed.

(4) The initial audits and the case-by-case work-out of each dubious loan necessitate a considerable input in terms of human capital and administrative capacities and capabilities. This runs directly counter to one of the most urgent priorities for the design of a rational policy strategy in the emerging market economies: namely to economize on scarce financial and administrative skills.

(5) The case-to-case approach implies considerable administrative discretion over the treatment of huge financial assets and liabilities. It thus begets a vast scope for lobbying and outright corruption.

(6) The attempt to recover dubious loans according to the actual ability of firms to serve their old debt at any point in time creates a strong disincentive: Why should firms which still carry old debt try hard to improve their financial situation if the fruits of the endeavour would not benefit the firms but simply accrue to the institutions which administer the old loans?

c. Objections against a clean sweep

Because of the above arguments, a complete write-off of all old debt is the superior option. Nonetheless, governments in the emerging market economies are very reluctant to simply cancel old debt (Manasian 1991, p. 23). There are two serious objections: (i) the danger of creating an unwarranted precedent and (ii) the supposed costs for the state budget. These objections are considered in turn.
(i) The first objection appears quite convincing at first glance: Debt relief, especially if apparently granted at the expense of the state, could foster the expectation that government bail-outs will happen in the future as well. This could induce economic agents to lend and borrow carelessly, or rather to continue to do so. However, the objection is beside the point. Substantial funds have already been wasted, irrevocable losses have been incurred regardless whether and how they presently show up in the more or less unaudited books. Hence, major debt write-offs cannot be avoided anyhow. The real question is whether debt should be cancelled at one stroke or whether it is preferable to sort out the loans case-by-case and over the course of time as part of the bankruptcy proceedings for firms in default and the worst-hit banks, or as part of the privatisation process.

Waiting for bankruptcies could promise the advantage of stimulating a more efficient behaviour on the part of bank and firm managers in the meantime. After all, managers may be eager to avoid such a procedure which could well cost them their jobs. However, bankruptcies of banks are a particularly unpalatable option for countries in which the nascent financial system enjoys little public confidence anyhow; and many of the short-term strategies which managers of state firms adopt to delay bankruptcy are grossly inefficient, their major effect being to run-down the remaining capital value of the firm. And advocating bankruptcy as a convenient way to get rid of old managers is not very convincing as the privatisation of firms offers such an opportunity anyhow.

Shying away from an immediate write-off postpones the solution of the debt problem. It retards the restructuring of firms and banks and contributes to a continuing waste of fresh financial funds. Furthermore, it gives rise to a severe disincentive effect: Knowing that they have no other way of cleaning the books of their firms, managers may willingly steer their firms into bankruptcy, if need be by shifting selected assets to newly registered companies and deliberately mismanaging the remaining assets until the old enterprise collapses (Manasian 1991, p. 24).
(ii) The need for the state to recapitalize the banks after debt cancellation appears to place a burden on the state budget. However, appearances may deceive. The debt relief has no direct effect on the net asset position of the state. It merely clarifies the distribution of assets and liabilities within the state sector: the value of state firms rises by the amount of erased liabilities; within the balance sheets of state banks, the claims on state firms are converted into claims on government. In a proper account of public wealth, the government liabilities to banks would be offset by the increase in the net value of state firms. Upon the sale of state firms, government recoups the equivalent of the cancelled debt in the form of higher privatisation revenues. As to the current budget of the state, only the time profile of outlays but not their amount is directly affected by the choice of methods. In the case of a debt write-off, the budget has to bear the annual interest payments on the recapitalization bonds for banks; in the case of a piecemeal and gradual approach, the state receives less privatisation revenue than otherwise and has to foot the bill of the debt-caused bankruptcies of individual state firms. 9) It is not even clear a priori under which strategy the direct budgetary outlays are more front-loaded.

However, the two strategies of an immediate clean sweep or a protracted work-out of the balance sheets of firms differ substantively in their indirect budgetary effects. This is so for two reasons: First, a debt write-off removes one important aspect of uncertainty about the true value of firms and banks. Hence, risk-averse purchasers of state banks and state firms would be willing to pay more for them than otherwise. The overall revenues from privatisation rise by more than the value of the cancelled loans. Second, and most importantly, a rapid debt write-off

9) Mutatis mutandis, the same arguments apply if only the balance sheets of state banks and not that of state firms were cleaned. In this case, not the value of firms but that of state banks would directly rise by the amount of bad loans taken from their portfolio.
facilitates the privatisation of firms, the emergence of an efficient banking system and a rational allocation of fresh funds. This solution contributes to widening the tax base via faster economic growth.

To sum up: removing only the dubious loans from the balance sheets of banks as proposed i.a. by Hinds and Brainards promises no significant gains relative to the radical approach of a clean sweep for banks and firms. Instead, it would imply some serious disadvantages. Most importantly, it would be costly in terms of the factors which are among the scarcest of all in the EMES: namely time, administrative capacities and budget revenues. Hence, all old debt between banks and firms and among firms that has been incurred before a certain date should be written off. Naturally, the state needs to make it clear that debt relief will not happen again. Making this credible would be much easier in the case of a decisive break with the past, i.e. a highly visible and once-off clean sweep, than in a drawn-out process of financial restructuring. In the latter case, some relief for old debt will have to be granted for a long time to come. This casts doubt on government announcements of a tough stance on new debt, especially as it may get increasingly difficult to disentangle old and new liabilities.

d. Modifications to the radical approach

The resolution of the old-debt issue is complicated by the fact that, in most emerging market economies, considerable time has already elapsed since the main steps of microeconomic deregulation (abolition of quantitative central planning, liberalisation of prices) were taken. Firms have already carried their inherited debt burden in the new micro-environment for some time; furthermore, the privatisation of state enterprises is already under way.

Consider the implications of the privatisation progress first: The standard approach so far has been to cancel a substantial part of the old loans upon privatisation on a case-by-case basis.
Changing tack and cancelling all old debt of the firms which are still state-owned could arouse allegations of unfairness from the new owners of those already privatised firms who still have part of the old debt on their books. In principle, the objection is completely invalid: the conditions of previous privatisations reflected what the parties knew about the net value of the firms (assets minus liabilities); if the firm had been privatised with less debt, the state could have demanded a correspondingly higher price (or tougher non-price conditions). Hence, the differential treatment of old debt for the already and the not-yet privatised firms does not result in any discrimination.

However, a genuine problem arises if some ownership titles have been and will continue to be given away to specific groups for (almost) free. In this case, the previous recipients of such a gift, say the employees of already privatised firms which still bear part of their old debt, have indeed obtained less net value than the corresponding beneficiaries of future privatisations will receive after debt relief for their firms. For these cases, special provisions like a further reduction in the old debt carried by the already privatised firms may be needed for reasons of political expediency. Unfortunately, this would indeed constitute a drag on the state budget.

This point can be put more comprehensively: If the conditions of privatisation are not related to the value of the property, i.e. if ownership titles are given away, it does matter for the public purse to which extent the value of the gift is increased by debt relief for the firms. The more property values are given away for free, the more does the state have to finance its outlays by corresponding increases in taxes. Nonetheless, the advantages of

10) Note however that the already privatised firms are often among the few obviously promising ones in the EMEs. Even with part of the old debt still on their books, these firms may be worth more than most other firms after debt relief. Hence, the case for ex-post changes in the conditions of previous privatisations is weaker than appears at first glance.
getting rid of the old-debt problem - including the long-run increase in the tax base - are likely to outweigh these particular short-run budgetary costs.

Now consider the implications of the fact that state firms have already had some time to cope with - or to ignore - their inherited debt. In Poland for instance, the major steps of deregulation date back to late 1989 and to January 01, 1990; Czechoslovakia had followed suit on January 01, 1991. The state firms have not exploited their vastly increased scope for autonomous action in a uniform way. ¹¹) Some have struggled to serve and repay their old debt while others have refused or were unable to do so, forcing their banks to add the arrears to the amount of debt outstanding and to let fresh money follow the bad loans. Simply cancelling all old debt would punish the firms who have tried hard to honour their inherited liabilities relative to those who have not.

To avoid such an apparent act of unfairness, the debt settlement should reflect the differential behaviour of firms in the meantime. First of all, to discriminate old from new debt, a qualifying date needs to be fixed, preferably the one at which most markets were liberalized. All firms should be put in a position as if their debt had been cancelled at that time. Hence, the firms which served or even repaid old debt thereafter should be rewarded by a corresponding amount of long-term government bonds (worth the capitalized present value of the interim debt service and the repaid capital). Remember that, under normal circumstances, such an improvement in the asset position of firms is no drain on the state budget as it directly raises the privatisation value of these firms.

The case for debt relief is based i.a. on the presumption that the inter-firm distribution of old debt is not correlated with

¹¹) For an evaluation of the behaviour of Polish state firms after the "big bang" see Dabrowski et al. (1991) and Jorgenson et al. (1990).
the expected profitabibility of the firm; or that, in the present economic upheaval in the EMEs, it is next to impossible or prohibitively costly to ascertain whether any such positive correlation may exist or not. However, some guesses may be possible. At least in Poland, heavy industry carries a comparatively heavy burden of old debt.\(^{12}\) At the same time, many economists predict that heavy industry, i.e. the most-favoured branch of the erstwhile central planners, will be among the branches that have to shrink most. Debt relief may make it harder for a determined government to actually force heavy industry into bankruptcy soon.

However, if their current revenues do not cover their current outlays, firms in heavy industry will be a candidate for bankruptcy in the near future anyhow. The argument against debt relief for branches like heavy industry would only be valid if the cancellation of old debt (which at present many of these firms are not serving anyhow) enhances their probability of getting access to new funds. Private banks that care for their capital would have no rational incentive to provide such funds exactly to those industries which are supposed to shrink most. However, as long as banks are mainly state-owned, such an outcome cannot be entirely ruled out. On the one hand, cutting the debt link which used to tie firms to borrowers makes it easier for banks to refuse fresh money to bad customers; on the other hand, a state banker can point to the clean balance sheet of a firm which is managed by an old chum as an excuse to extend a new credit. Hence, a complete cancellation of old debt even for those major branches which are supposedly doomed anyhow makes most sense if it is closely linked to the privatisation of banks.

As long as major banks are still in the hands of the state, two modifications of the radical proposal for debt relief merit some discussion:

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12) I owe this point to Wojciech Kostrzewa.
(1) A widespread presumption among politicians holds that the largest technical units in the EMEs (which are frequently in heavy industry) are among the least viable. To keep these firms under strong pressure to adjust or to go bankrupt soon, debt relief could be restricted and biased against the big borrowers: up to a uniform amount per firm, all old debt would be cancelled; above that threshold, a fixed percentage of the additional old debt would remain on the books of the firms. The threshold could be set so high that the majority of firms would still get rid of all their old debt. To clean the books of the banks, the remaining part of the debt of the big firms should be transferred to and managed by a special fund. A clear and uniform rule should specify under which conditions this fund should initiate bankruptcy proceedings against its creditors.

(2) To minimize the scope for inefficient lending by state banks, a cap should be put on the funds (credit plus equity) which any firm can receive from state banks. The amount should be tied to the actual sales revenues of the firm, not to more or less arbitrary book values of assets. Incidentally, such a rule which favours private banks would give an impetus to the privatization of the banking system. Furthermore, remember that a radical debt write-off facilitates the privatization of banks.

e. A scope for debt-equity swaps?

An apparently elegant alternative to a write-off of old-debt could be debt-equity swaps. Such swaps even seem to deal with two problems at one stroke: the old debt vanishes upon conversion into equity held by banks, and correspondingly less ownership titles in state firms remain to be disbursed to the public during the privatization of firms. However, such debt-equity swaps have serious drawbacks relative to a write-off under the peculiar circumstances of the EMEs:

(1) In order to determine the conditions for the swaps, the value of the firm's assets and liabilities need to be calculated.
(2) The inherited links between state banks and state firms are strengthened rather than cut. These links are a major root of the capital market deficiencies in the EMEs.

(3) Whereas state firms would indeed be liberated from their old debt, state banks would not be better off. In many cases, they would simply have exchanged non-performing loans for equity stakes in loss-making firms.

(4) The state would still need to recapitalize the banks; the state purse does not save money in this way (see above).

(5) The present banks would be rather unqualified owners. The banks still are mostly state-owned and not equipped with the relevant management expertise. Only if they were privately-owned and had such expertise would they indeed have a strong incentive and the means to monitor the behaviour of the firms in which they have stakes.

(6) The assortment of ownership stakes in firms of dubious quality constitutes a burden which complicates a most vital part of the financial rehabilitation of the EMEs: the privatisation of the banks.

(7) The privatisation of state firms is not facilitated very much either. Sizeable ownership stakes that are already held by a state bank may deter strategic investors who, upon acquiring a dominant stake in a firm, like to have a major say in the distribution of the remaining ownership titles as well.

Despite their apparent elegance, debt-equity swaps are inferior to a debt write-off in this particular situation.

3. Importing a Banking System from the West

Cleaning the balance sheets of the existing state banks is only one step towards a mature banking system. It also facilitates the further major step of privatising the banks. Naturally, these steps do not suffice to create a sophisticated system of
financial intermediation. Such a system consists of three major ingredients:

(1) A legal framework. This framework encompasses (i) laws on the financial system, including laws on prudential regulation and supervision, as well as laws on other matters such as mortgages and other kinds of collateral which are of paramount importance to standard banking activities, (ii) the implementation of the rules and laws in practice, and (iii) the interpretation of the rules and laws in court and other institutions for the settlement of legal disputes.

(2) Organizations such as the central bank, commercial banks and other financial institutions.

(3) The skills and experiences of the agents operating the system.

Some major elements of a modern financial system can be established rather easily in the emerging market economies: In principle, a few strokes of a pen suffice to pass and enact the relevant laws and to create the needed organisations, at least on paper. The other elements of an indigenous financial system have to evolve over time. However, even the seemingly simple task of making the laws has been delayed in many EMEs by the desire to devise an optimal instead of just a workable financial system. Considerable time has been spent comparing various Western experiences and discussing which kind of financial system might best fit the pre-socialist traditions and the post-socialist peculiarities of the EMEs.

If time were a free good to be utilised without opportunity costs, such a slow and thorough approach might be appropriate. However, time is among the scarcest factors of all in the EMEs. A delay in the establishment of a workable financial system prolongs the transformation crisis. On purely economic grounds, it is dubious whether the discounted future gains from having finally found a better design for the local financial market outweigh the short-run sacrifices of getting that market later. Politically, time is an even more binding constraint: The longer
the recovery from the present transformation crisis is delayed by discussions on optimal approaches to specific problems, the greater is the hazard that the patience of major parts of the population will run out. This could jeopardize the entire transformation process. And finally, it is not even clear whether the quality of the design increases with the length of the discussion. The more local lobbies have time to gather strength, the more may the result mirror the influence of lobbies on the process of decision making rather than deeper insights into the economic logic of alternative arrangements.

Given the time constraint, the EMEs need to ponder more rapid ways of creating a sophisticated system of financial intermediation. Fortunately, such systems exist in the West. The very difference between the rudimentary banking systems in the emerging market economies and the sophisticated ones in the West gives rise to a twin opportunity: The EMEs do not have to design and build their own system from scratch if they can import essential features from the West; and the EMEs are potentially attractive locations for Western financial institutions because there is so much scope for better financial intermediation in the East.

As the emerging market economies are striving to become members of the EC, their future financial system need to be compatible with the EC laws and regulations anyhow. The EMEs could save time and evade a future need for adjusting their nascent financial system to EC requirements if they opted for an institutional transfer in the first place: they could copy the basic elements of the financial system of an EC member (or the system of an EC non-member which is compatible with the EC requirements).

One part of the institutional transfer is straightforward: the relevant laws and regulations need to be translated and passed into local law. However, a legal framework is of limited use without the relevant skills to operate in it; laws and rules can be implemented, policed and interpreted differently. For a wholesale transfer of a Western financial system, the EMEs would
thus have to go much further and encourage the import of the
organisations, the human capital and the reliability which make a
Western financial systems work smoothly. This would necessitate
the following steps for an EME:

(1) The EME adopts the relevant laws and rules of a Western
country.

(2) It commissions the body which is responsible for the pruden-
tial supervision of the banking system of the respective
Western country to set up a local branch and perform its
task in the EME as well.

(3) In a similar vein, the relevant court of appeal of the
Western partner country (or the EC Court of Justice) becomes
the ultimate arbiter on legal disputes in a few banking-
related fields like the law of collateral which the EME has
adopted.

(4) The EME ceases any discrimination between banks owned by
locals and by foreigners; the laws and the system of pruden-
tial regulation are applied to local and to foreign banks
alike.

(5) The EME privatises the existing local banks (with a clean
balance sheet) and invites foreign banks to enter the market
via the acquisition of existing banks or via the establish-
ment of new branches.

The wholesale institutional transfer removes the legal uncertain-
ties for Western banks. In conjunction with the cleaning of the
balance sheets of the existing banks, it constitutes the most
radical way of turning the presently underbanked EMEs into a
promising field of activity of foreign banks. Naturally, a
banking system comparable to that in developed market economies
would not emerge overnight. Even in an optimal institutional
framework, foreign banks are likely to be cautious, perhaps
restricting their net networks of branches to the major cities
initially. The case for a wholesale institutional transfer is not
that this would solve the problems of financial intermediation at
the stroke of a pen. Rather, under the given (and mostly adverse)
circumstances, this transfer makes it as easy as possible for Western banks to become active in the EMEs and to transfer and fully utilise their expertise.

Unfortunately, ascribing a prominent role to foreign banks could arouse allegations of a "sell-out" to foreigners. The opposite holds though: a banking system that is being made more efficient by free access for foreign banks helps to mobilize domestic savings and to enlarge the supply of credits to local entrepreneurs. Hence, foreign banks would actually widen the opportunities for citizens of the EMEs to establish their own private business or to purchase state property.

As the present banking systems in the EC are not identical, it matters which one the EMEs adopt. Even in the case of a wholesale institutional transfer, some rough comparisons of the benefits of the various arrangements need to be made. The most important difference among the banking systems in the EC concerns the question whether universal banking is severely restricted (as in the United Kingdom) or not (as in Germany). For the peculiar situation of the EMEs, universal banking is more appropriate than legal barriers between various banking activities. First of all, universal banking is the more liberal approach; the worldwide trend towards a deregulation of financial systems has lowered the old legal barriers between banking activities in various countries already. Secondly, universal banking makes it possible for banks to acquire significant stakes in enterprises. By admitting a further group of prospective owners, the choice of universal banking could thus speed up and facilitate the privatisation process. And thirdly, universal banking makes it easier for financial intermediaries to finance investments by a mix of credit and equity. Many firms are undercapitalized and have little investible funds of their own. To the extent that a bank provides equity as well as credits, it also participates in unexpected gains - and not only in the losses as in the case of a credit-only funding of investments (see above). The risk premium which the bank needs to charge per unit of credit disbursed would
be correspondingly lower; the bank has an incentive to provide more funds than otherwise.

Nonetheless, there are two serious objections against universal banking: (i) Ownership links between firms and banks can soften the budget constraint for firms and hence cause inefficiency (Hinds 1990, p. 132). This objection holds in the short term for firms which come to own their banks and can deplete the assets of the bank until the misconduct becomes obvious (or is noted by the supervisory body) so that the depositors switch to a more prudent institution. It does not apply to the standard case of universal banking in which private (!) banks become part-owners of firms. In this case, banks acquire an even greater interest in the profitability of the firm than if they had merely extended a credit. (ii) Banks which own significant stakes in firms may try to exploit their strong position in the local economy for political purposes. 13) However, such misconduct is less likely if foreign banks are involved who - unlike fledgling local banks - would put at risk a well-established reputation on the world capital market. And if the financial market is completely open for potential competition, there is little scope for any behaviour that is not primarily geared towards economic efficiency anyway.

4. The Collateral Gap

Even if the radical proposal advanced above was implemented, not all obstacles to efficient financial intermediation in the EMEs would be removed. Apart from the high degree of systemic and firm-specific uncertainty, the major remaining problem would be that many potential borrowers cannot post sufficient collateral.

a. On the importance of collateral

In a developed financial system, the provision of collateral is a standard means to counteract a moral hazard on the part of borrowers and to resolve the twin information problems of (i) a genuine lack of information on a borrower’s ability to serve and repay a credit and (ii) of an asymmetric distribution of such information. Banks often cannot discriminate sufficiently between good and bad risks. The asymmetric distribution of information leads to a problem of adverse selection: Being unable to charge a tailor-made risk premium, banks have to ask for an average premium which subsidises the bad and taxes the good risks. The latter are crowded out at the margin.\(^{14}\) Raising the uniform interest rate "would discourage low-risk borrowers more than high-risk borrowers, since the latter have a smaller probability of actually having to pay the higher rate" (Gale 1990, p. 52).

Not only the choice of investment projects but also the subsequent behaviour of borrowers can depend on collateral. Suppose that the success of a project is a positive function of the investor’s effort. The less collateral he has posted, the less incentive does he have to strive hard to make optimal use of the funds (moral hazard).

To assess the importance of sufficient collateral, consider a simple model (Gale 1990) with risk-neutral economic agents and suppose that all investment projects for which bank finance is sought are socially desirable ex ante (the expected return on investment net of risk of default exceeds the social opportunity costs). Investors have private information whether their project is of a low-risk or a high-risk type (both the actual rate of return in case of success and the risk of default are above those of low-risk ventures). If lenders charge a rate of interest which reflects the average risk of default of the projects financed

(pooling equilibrium), they crowd out low-risk projects. Lenders can get around this problem by using collateral as a sorting device,\(^{15}\) offering different types of contracts so that borrowers self-select into the appropriate category: knowing that their probability of default is small, low-risk lenders opt for a low interest rate and provide a large amount of collateral; high-risk lenders prefer a high interest rate without having to post any collateral because they are aware that their probability of losing the collateral is comparatively high. The resulting separating equilibrium is more efficient than the non-collateral pooling equilibrium. Whereas the outcome is still less efficient than it would be under symmetric information\(^{16}\), at least all worthy investment projects are being financed.

However, if the low-risk borrowers have insufficient collateral, lenders need a further sorting device to make sure that high-risk borrowers do not masquerade as low-risk ones and hence obtain unduly cheap credit. Lenders can do so by rationing the low-interest credit: Taking the limited probability of obtaining the cheap funds into account, high-risk borrowers are now better off applying for the unrationed high-interest credit while low-risk borrowers who cannot afford the high interest rates still seek only the low-interest funds. As some profitable low-risk investment projects are not financed due to the rationing of credit, the outcome is not socially optimal.

The consequences of insufficient collateral get worse if the above assumption is relaxed that all potential investment projects yield an expected rate of return that is at least equal to

\(^{15}\) Strictly speaking, borrowers who provide full collateral do not obtain additional funds from their bank; rather they switch assets with the financial intermediary, receiving a liquid asset (the credit) in exchange for a less liquid one (the collateral), and reswitch the assets upon repaying the credit.

\(^{16}\) This may be so for two reasons: (i) the provision of collateral causes transaction costs and (ii) the collateral may be worth less to the bank than to the firm.
the refinancing costs of banks. 17) A rational borrower-investor compares his benefits from the credit to his costs of default. These costs consist of

- the loss in the investor’s collateral,
- the loss in any own funds which he has committed to the project, and
- the damage which a default does to his reputation.

The lower these costs, the less self-selection can occur among applicants for credits: potential borrowers will also seek funds for projects with an expected rate of return that is below the opportunity costs of banks or even negative. 18) A tiny probability of a return on investment that exceeds the costs of borrowing suffices to make a project look worthwhile for the potential borrower-investor. In the extreme case, a rational borrower may not invest at all but simply consume the funds if the disutility of default does not surpass the utility which he derives from this consumption.

The less borrowers can be forced to self-select and to use funds prudently by sorting devices such as collateral, reputation or the posting of own funds, the more important does it become that banks can scrutinize loan demands and monitor borrowers. For the typically undercapitalized firms in the EMEs, the costs of default are comparatively low for the time being. In order to attain an allocation of capital that is as rational as in the West, the financial intermediaries in the EMEs would hence need to be even better at evaluating credit demands than in developed

17) In a Pareto-efficient equilibrium, the opportunity costs of banks, i.e. their refinancing costs, should reflect the social opportunity of the use of capital.

18) More precisely: The lower the costs of default for borrowers, the more will they seek funds for projects with (i) a high probability of default at a given expected rate of return (high variance at a given mean of the probability distribution) or (ii) a low expected rate of return at a given probability of default (a low mean at a given variance).
market economies in which collateral is more readily available and in which many potential borrowers have to safeguard an already established reputation.

b. Causes of the collateral gap
The collateral gap in the EMEs springs from a variety of factors:
- many firms are undercapitalised;
- as long as property rights problems are not totally resolved, banks cannot know with certainty whether a given asset can serve as collateral for new debt or not;
- it is unclear whether and to which extent future laws and court settlements will purport that some of the assets of a firm already secure old debt;
- a given collateral is less easy to sell and hence less useful to a bank than in developed market economies because of the comparatively high transaction costs in the EMEs;
- the uncertainty about the value of collateralizeable assets is particularly pronounced: the future relative prices in the EMEs are highly uncertain anyhow; and even in established market economies, the prices for typical kinds of collateral (real estate) vary procyclically; this problem is especially acute during the deep transformation crisis in the EMEs: a potential collateral may or may not be worth much less than in a few years;\(^\text{19}\)

Unfortunately, younger and growing enterprises are more likely to be constrained by a lack of collateral than larger and mature firms with more collateralizeable assets (Hubbard 1990, p. 5). This makes the collateral problem even more acute for the EMEs. Given the dismal state of many existing enterprises, start-ups will

\(^{19}\) As the markets are still very thin and fragmented at present, the prices for some kinds of real estate in top locations may decline once the markets are liberalised and become broader.
need to play a substantial role in the economic reemergence of the post-socialist states.

c. Potential remedies

One partial remedy is comparatively straightforward: A comprehensive old debt relief as proposed above would already constitute a major step towards closing the collateral gap. It would help to clarify the net asset position of firms. The real estate and other collaterizable assets which state firm have could then be used to secure new credits.

A further problem that needs to be dealt with is the pervasive property rights uncertainty. The legal problems stem from the facts that

- the distribution of property rights among those state firms that used to be subunits of a conglomerate may still be unclear, and
- that some assets may have to be given back to previous disposessed owners.

The uncertainty about the fate of the real assets cannot be eliminated comprehensively within a few months. Once appropriate laws are passed, it still takes considerable time until legal disputes are finally settled in court. However, the state could try to mitigate the adverse consequences of any residual uncertainty. For this purpose, a state agency could be set up to issue a guarantee that certain assets can in fact serve as collateral. If the physical asset is later taken away from the firm and given to somebody else - and if the firm defaults on the credit so that the bank has to take recourse to the collateral, the state agency would compensate the bank with long-term government bonds of corresponding value. The state agency could charge an insurance premium for offering such a guarantee.20) Because the insurance

20) A comprehensive (or near-comprehensive) private insurance is
is needed to compensate the failure of the state to sort out property rights problems immediately, a state subsidy to this insurance scheme is justified.\(^{21}\)

d. A case for temporary credit subsidies?

Given the high degree of overall uncertainty and the collateral gap in the EMEs, thoroughly restructured and privatised banks are likely to be rather cautious lenders. Credit subsidies may appear to be a warranted compensation for the remaining capital market shortcomings. However, a credit subsidy resolves neither the problems of asymmetric information nor of moral hazard directly: it does not provide firms with additional collateral (or own investible funds or a reputation for that matter). State support for financial intermediation could only induce banks to increase lending nonetheless.

To assess the potential merits of transitory credit subsidies, remember that the collateral gap causes two distinct problems:

- banks may rationally ration low-interest credit to deter high risk-borrowers from applying for these funds, and

- banks may demand a spread between their costs of refinancing and their lending rate which crowds out marginal borrowers

Footnote unlikely to emerge spontaneously in the market for the time being. The property rights risk is partly systematic, it depends on future legislation and on how courts interpret the relevant laws. Actions of the state directly impinge upon the resolution of property rights disputes (Schmieding and Koop 1991).

21\) The costs of any scheme to support financial intermediation in the EMEs would have to be financed via taxes, preferably the value-added tax. To some extent, such a scheme may be self-financing: if it succeeds and contributes to real economic restructuring and hence to economic growth, it widens the tax base. Furthermore, the benefits which state firms derive from easier access to credits add to the value of the firm and hence to the privatisation revenue of the state. This however holds only if these benefits are not consumed prior to privatisation via higher factor remunerations or a slow down in the restructuring process.
who seek to finance investment projects with an expected rate of return that is above the opportunity costs of banks but below the interest rate charged to borrowers.

In the credit-rationing model outlined above, the socially inefficient rationing serves to deter high-risk borrowers from masquerading as low-risk ones if low-risk borrowers cannot post sufficient collateral. A general credit subsidy would not solve this problem because the subsidy does not systematically change the relative attractiveness of the various types of credit contracts for potential borrowers. If both the high-interest/no-collateral and the low-interest/some-collateral type of credit become cheaper, high-risk borrowers still have the same incentive to apply for the low-interest funds. The need for rationing the low-interest credits persists.\(^{22}\)

The crowding-in effects of a credit subsidy are obvious. All measures that serve to reduce the lending rate of banks alter the cost-benefit calculations of potential borrowers: the benefits of a successful credit-financed investment increase relative to the (unaltered) costs of default. Marginal borrowers who otherwise would not have applied for credit at the unsubsidized interest rates are crowded in. The overall demand for funds increases.

The nature of the subsidy-induced changes in the pattern of credit depends on the policy instruments chosen. An interest rate subsidy creates a uniform wedge between the costs of lending for the bank and of borrowing for the investor. However, the same

\(^{22}\) However, a credit subsidy that is targeted exclusively to the high-risk borrowers could indeed induce a more efficient allocation of capital (Gale 1990). Such a subsidy would make it less attractive for the high-risk group of potential investors to apply for the low-interest credits that are geared towards the low-risk borrowers. Inspite of the constrained amount of collateral which low-risk borrowers can offer, banks could therefore relax the rationing of the low-interest credits. A differentiated credit subsidy which is inversely related to the collateral provided would be particularly difficult to administer though.
comparable incentive to step up overall lending could be attained if the central bank eased the refinancing conditions for commercial banks. The costs to the state purse would show up in a corresponding reduction in the profit of the central bank. On the macroeconomic level, an interest rate subsidy that succeeds to raise the overall level of credit is tantamount to a more expansionary monetary policy. Ceteris paribus, the net effect of a comprehensive interest rate subsidy would be more nominal demand and inflation, not a more efficient allocation of financial funds. Hence, this option should be discarded completely.

A state-supported credit insurance reduces the variance of the credit risk to banks as the insurer bears a fixed share in any loss on the credit.23) Unlike an interest rate subsidy, the partial insurance directly counteracts risk aversion on the part of the banks. It also promotes projects that banks deem risky relative to less risky ones: At the same expected rate of return on investment, the proportional reduction in the variance matters most for projects with the highest variance (the most risky ones).

Any comprehensive scheme of loan insurance would have to be accompanied by a tightening of monetary policy to keep the overall ratio of nominal demand relative to real supply at the desired level. The major effect of such an insurance is not to increase the overall amount of credit in the economy (a suitable monetary policy could steer nominal demand to roughly the desired level) but to change the composition of credit in favour of borrowers with comparatively risky projects. On the fragmented and underdeveloped capital market of the EMEs, the banks which are still comparatively small are likely to be particularly risk averse, at least once they are privately owned. Furthermore,

23) This argument presupposes that banks have some information (or at least some rudimentary guesses) on the riskiness of investment projects. Otherwise, the variance of the probability distribution of the rate of return on investment would be infinite for the banks.
investment risks in the EMEs are more pronounced than usually (probability distribution of the rate of return on individual projects exhibits a comparatively high variance at a given mean). In this situation, a partial loan insurance would serve to insulate banks to some extent against the peculiar risk characteristics in the EMEs.  

A loan insurance has one major drawback: it gives rise to a moral hazard on the part of the banks because it makes it less imperative for the banks to evaluate and monitor borrowers. Hence, any subsidized credit insurance should provide only a partial cover for the credit risk of banks so that a bank which intends to safeguard its own capital still has a strong incentive to carefully screen credit applications. For the same reason, such schemes should only apply to banks that are already private, not to state banks which lack a proper "advocate of capital" (to borrow a term from Winiecki 1991b).

As long as a private loan insurance is not yet available on the underdeveloped capital market or as long as an actuarially efficient insurance premium would crowd out a substantial part of low-risk investors (adverse selection under conditions of grossly insufficient collateral), a state-supported insurance can be warranted economically. After the transformation and privatisation of the banking system, a state agency could offer to insure a certain percentage of each credit (at most 50 per cent) disbursed by private banks. In each case of default, the insurer, i.e. the state, and the bank would have to bear the loss together. The percentage of each credit which can be insured in this way is stepwise reduced to zero over the course of, say, five years. The major problems of ownership transformation and property rights uncertainty should be resolved by then. The insureable percentage

24) Sure enough, to the extent that any scheme eventually succeeds in improving the allocation of capital, it contributes to the expansion of aggregate supply and hence warrants a corresponding increase in nominal demand.
of each credit is not differentiated among branches; however, it is inversely related to the duration of the credit: debt service and repayments due after, say, five years are not covered. The rate of credit default and hence the actuarially efficient insurance premium cannot be determined ex ante. As a rule of thumb, the premium could be set slightly above the credit default rates during recessions in Western economies. Banks whose credits have an above (below) average incidence of defaults should be charged above (below) average insurance premiums in the following year (or get a correspondingly differentiated refund of an insurance premium that was deliberately set above the expected average rate of default).

To sum up, the case for state support for financial intermediation in the EMEs is weak. A comprehensive interest rate subsidy would merely be inflationary. Instead, a subsidized insurance against property-rights risks is warranted. To some extent, a temporary and limited credit insurance could also mitigate some of the specific capital market problems in the EMEs. Sure enough, these second-best proposals are merely temporary and imperfect stop-gaps. Even if these proposals were implemented, the adverse consequences of the collateral gap would not vanish completely for the time being. The major task for the state is to create conditions under which the rudimentary capital market can mature quickly.

5. Financial Reform in the Sequencing of the Transformation

Some aspects of the proposals advanced in this paper, notably the need for a recapitalization of banks and the general desirability of a sophisticated financial system, reflect a consensus view among most economists dealing with the subject. Nonetheless, the major thrust of the radical approach goes against the grain of what many other authors propose. The majority view is exemplified by the Socialist Economies Unit of the World Bank: "fully liberalized financial markets and privatized intermediaries operating under tight budget constraints probably come late, rather than early, in the reform agenda ... the restructuring of loan
portfolios and recapitalization of banks cannot be finalized prior to reforms in the productive sector and adjustment to major shocks (such as the end of the CMEA system" (World Bank 1991, Annex 4, pp. 1, 4). The arguments presented in this paper boil down to a case for a transformation of the financial sector that is much more rapid and precedes the necessarily time-consuming restructuring and the real economic adjustment of most other sectors.

On the most fundamental level, the case for giving priority to financial transformation rests on an assessment of the different role which various sectors play in the economy. A delayed adjustment of, say, the steel industry harms only that industry and its local suppliers; it has little repercussions on the rest of the economy; the gap in steel output can be closed by imports from abroad after some devaluation in the exchange rate. A rudimentary state of financial intermediation and a haphazard pattern of credit distribution however harm almost all other economic activities. The success of the entire transformation process depends more on a rational allocation of financial resources in the economy as a whole than on the restructuring of a selected industry. A major part of the problems which make the privatisation and restructuring of the production sector so arduous stems from the very fact that financial intermediation is deficient. As it is impossible to do everything at once with the limited administrative resources at hand, choices on sequencing have to be made anyhow. Priority should hence be given to those transaction-activities\(^\text{25)}\) like banking which are most vital for the development of capitalism.

On a more practical level, it is true that under present circumstances the restructuring of banks is integrally linked to the restructuring of the enterprises (World Bank 1991, p. 29). As has been stressed above, this does indeed apply to financial

\(^{25)}\) I owe the terminological distinction between the production and the transaction sector to Wallis and North (1986).
restructuring: the inherited links between firms and banks need to be cut, the books of both banks and firms need to be cleaned of old debt. It does not apply to the real economic adjustment of firms though. Quite to the contrary: the ex-ante establishment of an efficient, privately owned banking system with a hard budget constraint, with access to the world capital market and a substantial element of foreign involvement facilitates the process of real economic adjustment. It increases the pressure on those unviable firms which would otherwise have enjoyed a soft budget constraint by courtesy of their old ties to the state-owned banks; and the more rational allocation of domestic funds plus the improved access to external funds enhance the credit opportunities for the more promising ventures.

Sure enough, private banks, be they thoroughly restructured and privatised old ones or newly established ones, may be cautious lenders, as they were in East Germany in the aftermath of currency union. However, cautious lending is preferable to the further misallocation of scarce investible funds which is the hallmark of the present state of financial intermediation. Furthermore, note that caution reflects both genuine uncertainty and risk-aversion on the part of financial intermediaries. While little can be done against the comparatively high degree of uncertainty which the transformation process entails, the radical proposal for immediate financial liberalisation helps to mitigate the element of risk aversion: (i) The larger a bank, the better can it pool risks. Hence, large foreign banks which enter the market are likely to be less risk-averse than the small local ones for whom a few mishaps could already be fatal; and (ii) the more open the financial market is, the more can venture capital

26) The East German experience is no reliable guide, though. In East Germany, local wage costs as measured in foreign currency rose by a factor of roughly six within a few months, causing the entire production of tradable goods to collapse under competition from the West. Without a comparable wage explosion, the prospects for the existing producers of tradable goods in the EMEs are much brighter; hence, it should be easier for them to get credit once a well-functioning capital market is established.
funds from abroad become active in promising but risky activities.

The standard proposal of linking the restructuring of the banking system to that of the real economy would imply that the introduction of financial rationality is delayed until the real economy has adjusted to market conditions and to the shock of the demise of the CMEA. It may be argued that firms need some transitional assistance during the adjustment period. However, simply continuing an irrational system of credit allocation which benefits those firms who happen to have strong links with their banks and which harms more creditworthy firms is not a sensible way of providing such transitional assistance (the limited merits of a partial credit insurance have been discussed above).

The recommendation for giving priority to financial transformation also appears to be at odds with a part of the literature on the timing and sequencing of structural reforms in developing countries (for a survey see Edwards 1989, chapter 2). Many authors have argued that financial liberalisation should follow rather than precede real economic reforms. Otherwise, an inflow of foreign capital could magnify the effects of the remaining distortions in the economy and cause a real appreciation of the exchange rate which unduly harms the tradable goods sector. Furthermore, as goods markets clear more slowly than asset markets, a proper synchronization of financial and goods markets reforms demands that the goods markets be liberalized first. Note however that these argument apply to the timing and sequencing of external liberalisation (trade account and capital account), not to the establishment of an efficient banking system at home. They are hence not directly relevant to the problem addressed in this paper.

Nonetheless, a few aspects of these counterarguments merit some attention. As almost all markets for goods are already liberalised in the EMEs in the sense of having free prices, internal financial transformation would to some extent merely serve to close the gap. Nonetheless, could the contrast between an
efficient (privately-owned) banking system and a distorted (state-owned) real economy still magnify the internal distortions via a misallocation of investible funds? This could indeed be the case if (i) the deficiencies in the real economy distorted the relative profitability of firms in a systematic way so that the wrong firms appeared to be most profitable and hence most creditworthy and if (ii) the banks would not believe in the removal of such distortions in the future. However, the far-reaching liberalisation of domestic prices and foreign trade has already removed major sources of distortions in the relative profitability of various branches in the real economy, the major remaining distortion being the prevalence of state-ownership. If banks indeed reacted to this distortion and (ceteris paribus) gave preference to private borrowers, this would even impart a further welcome impetus to the privatisation process. Ultimately, consider that the alternative to an efficient financial system in a still distorted environment would be far worse for the EMEs: It would not be a faster conversion of the real economy but a slower change in ownership, a slower restructuring of the real economy and the continuation of the present financial malpractices.

To some extent, the real-appreciation argument against early financial liberalisation applies to proposals advanced in this paper. Although the wholesale institutional transfer of a Western banking system could in theory be restricted to the EME’s domestic financial system, the foreign banks that are invited to enter the market of the EME are likely to demand easy access to their home base and hence to the world capital market. Apart from the transfer of skills, the easy access to financial funds from abroad is in fact one of the major arguments for — not against — the wholesale adoption of a well-established Western banking system.

At present, it seems highly unlikely that the emerging market economies could turn into such magnets for short-term capital in the near future that the real exchange rate would appreciate to such an extent as to cause politically disruptive short-run adjustment problems for the tradable goods sector. So far, the
EMEs struggle with exactly the opposite problems, namely the small trickle of foreign investment and - especially in the case of Poland, Bulgaria and Hungary - a huge external debt. Suppose nonetheless that excessive capital inflows would really constitute a temporary problem. In this case a temporary and uniform tax on short-term capital inflows (being progressively reduced to zero over the course of time) would be the superior remedy. It distorts the allocation of capital much less than the maintenance of the present financial irrationalities.

All in all, the case against giving priority to the financial aspects of the transition to a market economy remains unconvincing. Given the pivotal role which a sound financial system plays for the development of capitalism, an early and radical transformation of the financial system, notably a write-off of old debt and a wholesale institutional transfer from the West, could considerably facilitate the adjustment process in Europe's emerging market economies.
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