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Approaches and Progress

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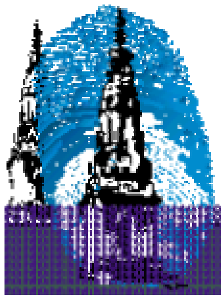

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Financial Sector Reform in Central and Eastern Europe: Approaches and Progress

Clas Wihlborg

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Financial Sector Reform in Central and Eastern Europe: Approaches and Progress

Clas Wihlborg, CBS

1. Introduction

Reform of the financial sector is probably the most controversial aspect of the transition from a centrally planned to a market economy. One reason is that allowing banks to allocate credit based on market principles implies almost inevitably that an important instrument for supporting politically favored projects is removed. Another reason is that the financial sector often is viewed as a symbol of market capitalism in that power over economic resources shift from the government to private individuals. Thus, it should come as no surprise that efforts to reform the financial sector along the principles of a market economy have met more resistance than other transition reforms such as price liberalization, privatization of industries, labor market reform, attempts to achieve macroeconomic stability.

In a market economy where ownership of the means of production is private, the financial sector carries out essential functions formerly handled by the central planning agency. Financial resources are allocated to investors and consumers through the credit allocation process in banks and/or in markets for stocks and bonds. If the financial sector does not perform its functions effectively many of the objectives of the reform process may not be met. This point will be discussed in more detail below.

In this chapter the progress of financial sector reform in Central and Eastern Europe will be discussed, and the relative progress of different countries will be compared in the light of different approaches to reform and historical factors influencing these approaches. The role of financial sector reform or lack thereof in the general economic development of different countries will also be addressed.

The immediate problems facing financial reformers in the transition were two-fold. On the one hand, the commercial banking system was laden with “bad loans” of state-owned enterprises that showed little promise of becoming profitable as independent enterprises. On the other hand, the same banks were expected to allocate new credit to profitable firms that would be able to repay in order not to generate more bad loans. Therefore, bank managers’ incentives and objectives had to be re-oriented. Furthermore, the banks had to be able to provide liquidity and participate in a functioning payment system.

Another issue facing reformers in the early transition was whether they would encourage a regulatory and legal structure of the Anglo-Saxon type dominated by decentralized capital markets,

or a regulatory and legal structure dominated by large banks as in Continental Europe. The Anglo-Saxon financial system puts more restrictions on the activities of commercial banks, and it generally provides for stronger protection of the common investor in securities markets.

The financial system and its functioning depends not only on the regulation and law for financial institutions and markets but also more generally on the legal and political infrastructures. For example, dispute settlement in courts needs to be predictable and enforceable in order for firms and individuals to enter and rely on contracts. The political decision-making process can become intertwined with decision-making in financial institutions, when, for example, there are close personal and financial relations between politicians and bankers. The politicians have the power to grant favors to bankers, and bankers have the power to provide politicians with financial favors. Lending to "related parties" is a source of bad loans in many countries where politicians are able to support the bankers' schemes to hide or be compensated for non-performing loans.

Effective banking supervision can prevent various forms of corrupt practices, as well as contribute to effective credit allocation procedures in banks. Thus, the building up of effective supervisory agencies is one of the tasks of the reformers during transition.

In Section 2, the functions of the financial system in market economies, and its potential contribution to economic growth and welfare are reviewed. Thereafter in Section 3 the legacy of the central planning and the problems facing financial sector reformers in the early transition are discussed. Approaches to the main problems caused by the legacy of central planning are discussed in Section 4. Specific country cases illustrate progress and failure. In Section 5 a leap to the present day is taken. The current state of financial development and progress in developing a legal and regulatory infrastructure are described. Approaches to reform, and historical and political factors that may explain the differences in financial sector development are discussed in Section 6.

2. Functions of the financial system

In a market economy the financial system is expected to perform a number of important functions influencing the efficiency of the economy as a whole. Most textbooks would distinguish among the following three functions:

1) Organize the payment system
2) Enable consumption smoothing for households facing a variable income stream
3) Enable trading in and sharing of risk of firms and projects in order to allocate financial resources in accordance with wealth-holders' risk-return preferences.

According to traditional welfare oriented models which assume zero costs of transactions and information, households are able to maximize their wealth if the financial system is efficient in terms of functions 2) and 3) in particular.

The above three functions can be performed in decentralized markets for securities or within intermediary organizations like banks. In decentralized markets, risky securities are priced in trading to reflect information about risk and expected returns. Alternatively, households deposit their savings in financial institutions, and managers in these institutions determine the allocation. Among financial institutions banks are special, because they accept very short-term deposits available on demand. Thereby they become an important part of the payment system.

An economic model without transactions and information costs cannot be used to evaluate alternative institutional arrangements. Once such costs are recognized, the financial system has additional and conceptually more complex functions. Furthermore, institutional arrangements become important. Rybczynski (1992) emphasizes that the financial system must reallocate accumulated old savings already invested in projects and firms according to wealth owners' prefences for risk and return. This function implies that transactions and information costs, and dynamic aspects of the financial system must be recognized. As new information appears accumulated capital should be reallocated at the lowest possible cost. This reallocation of old savings requires that some activities are terminated while others are initiated, and financial resources must be withdrawn from the control of some managers of projects in order to be made available for more productive managers. Managers are in control of financial resources under specific contractual arrangements as specified, for example, in company law. Thus the reallocation function depends on a set of legal and contractual arrangements between managers and wealth-holders. We enter here into the area of corporate governance.

Taking dynamic aspects into account, two more functions of the financial system should be added to the three listed above (payment system, consumption smoothing, and risk-sharing):

4. Provide liquidity of claims and securities
5. Provide a system of corporate governance influencing managerial incentives, and mechanisms for changing management.

Liquidity can be created through the banking system by the acceptance of short term deposits coupled with longer term lending, or in securities markets by the trading of equity, bonds and bills. Liquidity of securities cannot be obtained without substantial volume of trading. A high

volume of trade requires heterogeneity of information and/or risk preferences at any time. Since risk preferences are nearly constant over time, it is the heterogeneity of information, causing speculative activity based on differences in expectations, which must be relied upon. Lacking liquid securities markets, commercial banks act as intermediaries, issuing highly liquid assets for depositors, while managing the depositors' funds in such a way that depositors' preferences for return, risk, and liquidity are satisfied.

Corporate governance issues have increasingly come to economists' attention during recent years. Financial economists in particular study this issue, because most financial contracts more or less explicitly include rights to control or influence management under some conditions. Equity in firms carry obvious control rights as specified by a vote or a fraction of a vote in shareholder meetings.

Banks and corporate bond-holders lending money to a firm are usually able to obtain direct control rights under specific conditions when the firm does not deliver cash flows as contracted. Lending contracts often include specific rights of monitoring or conditions with respect to the financial performance of the borrower. The latter solution is common when there is direct lending, i.e. when a firm issues securities to the public. Monitoring rights, on the other hand, are associated with indirect lending from households to banks, and from banks to firms.

Clearly, institutions matter for both liquidity and the effectiveness of corporate governance structures. In a bank-oriented system, banks' monitoring of managers on behalf of relatively uninformed wealth-holders plays a major role. In financial systems dominated by directed lending through securities markets, information about management must either be publicly available or gathered and analyzed by individual buyers of securities.

In order to analyze the effectiveness of financial systems with respect to corporate governance, it is common to start from the premise that managers and wealth-holders are asymmetrically informed about both the available projects and managers' characteristics and actions.

The financial system must solve two problems.[1] First, as a result of asymmetric information about managers' and projects' characteristics, wealth-holders and lenders in general face the so-called adverse selection problem. This problem arises, for example, when prospective borrowers of different quality face the same loan price. The relatively low quality borrowers have stronger incentives to borrow than the high-quality borrowers.Therefore

lenders must act to avoid being saddled with bad loans. Credit rationing is one instrument available to bank managers.[2]

The second problem arising from asymmetric information is the moral hazard problem, also called the “hidden action”, or “principal agent”, problem. This occurs when managers’ objectives may differ from shareholders’ and lenders’ objectives with the possible consequence that the manager’s unobservable actions may serve his own interests rather than those of the shareholders and other lenders.

The term “agency costs” is often used to describe the efficiency costs caused by both the adverse selection and the moral hazard problems. An efficient financial system with respect to corporate governance would minimize the sum of agency costs and costs of reducing agency problems. Varying institutional set-ups differ with respect to these costs. For example, the Anglo-Saxon financial system dominated by securities markets relies on the threat of hostile take-overs to align the incentives of managers and shareholders. If this threat is weak, managers become “entrenched” and agency costs rise. The European and the Japanese financial systems are more bank-oriented. They rely on bank-monitoring and relatively few dominant shareholders to influence managerial incentives and to fire inefficient managers. It is not obvious, however, that the banks and the dominating shareholders always serve the interests of the many smaller shareholders.

There are necessarily conflicts and trade-offs among the five functions of the financial system described here. For example, optimal risk-sharing and consumption-smoothing in securities markets requires that all relevant information about projects and securities is quickly reflected in prices. However, if prices quickly incorporate information from various sources, then the threat of hostile take-overs is reduced and management entrenchment becomes pervasive to the possible detriment of shareholders.[3]

Another trade-off may exist between payment system efficiency and efficiency of corporate governance. It is often argued that without government protection of depositors the payment system is subject to the risk of bank-runs that could be contagious. Government protection of the banking system reduces the incentives of bankers to devote resources to credit evaluation and monitoring, and the protection induces excessive risk-taking in limited liability banks.

In the debate about Eastern European banking reform it is often said that banks fail to impose a “hard budget constraint” on the borrowers. This term can be interpreted as a

condition for effective corporate governance. Without a hard budget constraint, firms' managers have the incentive to cover losses with new borrowing even if the firm's net worth is zero or negative. The banks' incentives to impose hard budget constraints on firms by means of monitoring and contract enforcement are weakened by protection of depositors, and further weakened by protection of shareholders.

3. The legacies of central planning and the task of reformers

The banking system of the socialist economies in Eastern Europe performed only the payment function among the five functions described in the previous section. Financial resources were allocated by central planning authorities and the financial institutions did not have a role in the selection of managers. Well into the 1980's, the banking systems consisted of a "mono-bank" performing the roles of central bank and, in a limited sense, commercial banks. In addition, specialized banks were set up for long-term financing of investments but the credit allocation of these banks was also determined by central authorities. The allocational role of prices, wages, and interest rates was obviously limited in the planning system.

During the late 1980's reforms of the central planning system began. Prices and wages were liberated during the course of a few years, although price controls remain in some forms in many countries. Prices and wages were given a much larger allocational role, however.

The banking systems in Eastern Europe were restructured during the late 1980's. Two-tier banking systems were created by separation of the central banks from the commercial banks. In most countries, the commercial bank function was split into a number of formally independent but still state-owned banks. Table 1 from Thorne (1993) shows the dates for the creation of the two-tier systems in Hungary, Poland, Czechoslovakia (CSFR), Bulgaria, and Romania. The table sets out the starting conditions for the financial systems in these countries in 1989.

The number of commercial banks created out of the mono bank, the small number of privately owned banks at the time of the break-up, the number of specialized banks, and the number of savings banks are shown in the table, The numbers are relevant for gauging the degree of competition that can be expected in the liberalized economy and for the privatisation process. A large number also implies that the "too big to fail" argument applies less strongly if the legacy of bad loans creates a crises for one or two more banks. It is noteworthy that Bulgaria in particular divided its mono-bank into 59 new units. Poland

divided its mono-bank into nine banks while the other countries kept the concentration high with four or fewer "new" commercial banks.

Table 1 also shows the relative importance of different types of financial institutions at the time of the break-up. Specialized banks were particularly important in Poland, where the assets of the commercial banks represented only 8.5 per cent of the total assets in the banking system. At the opposite extreme, 67.8 percent of the total assets were held by commercial banks in CSFR. Household deposits were almost exclusively held by savings bank in all the countries.

Banking reform started in Russia as early as 1987--ahead of the other Eastern and Central European economies. Three sectorally specialized commercial banks and a central bank were carved out of the Gosbank (Pohl and Claessens, 1994). Similar reforms took place in other republics of the former Soviet Union. In Estonia, for example, five sectorally specialized banks and a central bank were created. Until 1990, Estonia's central bank co-existed and shared responsibility with the Russian central bank. The Bank of Estonia was established in 1990 but it did not become a full-fledged central bank until the Estonian branch of Gosbank was taken over at the beginning of 1992.

After the creation of two-tier banking systems all the countries allowed a rapid increase in the number of new bank establishments. Few have reached a significant size, however. In Estonia, 12 new banks had started up by mid-1991 (Hanson, 1994) and the number reached around 40 in 1993. In Russia, 2,000 new banks denoted zero banks (as opposed to spin-off banks) were established. They were usually owned by one or more enterprises. In the other Eastern European economies the number of banks established by the end of 1991 were 19 in Hungary, 86 in Poland, 27 in the CSFR, 75 in Bulgaria, and 16 in Romania. In most of the countries, the banking system became dominated by a few large commercial banks existing in parallel with a large number of small banks usually associated with a group of enterprises. The exception was Russia, and to a lesser extent, Estonia, where hyperinflation reduced the real asset value of the large banks created from the mono-bank. The banking system in Russia became dominated by the many small banks.

Table 1: Banking Systems' Starting Conditions (source: Thorne, 1993)

	Hungary	**Poland**	**CSFR**	**Bulgaria**	**Romania**
Date of political opening	1989	April 1989	November 1989	November 1989	December 1989
Date of break-up of the mono-bank and start of the two-tier banking system	January 1987	January 1989	January 1990	January 1990	December 1990
Number of state-owned commercial banks 1/	4	9	2	59	4
Number of private or foreign-owned commercial banks 1/	2	5	0	0	2
Number of specialized banks (excluding foreign exchange banks). 1/	10	1	1	8	2
Number of banks specialized in foreign exchange transactions. 1/	1	3	2	1	1
Number of Savings Banks. 1/	1	1	2	1	1
Date of last revisions of last legislation. 1/	January 1987	January 1989	January 1990	May 1990	April 1991
Ratio of all specialized banks' assets to total assets. 1,2/	47.7	79.1	32.2	54.0	52.3
Ratio of commercial banks' assets to total assets. 1,2/	35.0	8.5	67.8	25.5	18.2
Ratio of total savings bank deposits to total deposits. !/	52.5	12.1	52.3	46.2	80.8

1/ Estimated at the date of the break-up of the mono-bank. Because the central bank held a large portion of the banking systems' total assets in Hungary, the sum of the ratios of commercial and specialized banks' assets to total assets is low relative to the other countries.

The legacy of loans to SOEs (State Owned Enterprises) resulted in a build-up of bad loans, as SOEs were being kept afloat. The situation worsened over time in the new economic order, because many SOEs failed to become competitive while new credits were given to them.
Table 2 from Thorne (1993) shows the size of the non-performing loans at the end of 1990 and mid-1991 in the five Eastern and Central European countries. The ratio of non-performing loans to total loans loans in 1991 was around 50 per cent in all the five countries. The fiscal costs of removing these loans from the balance sheets in one stroke by the governments were 5-7 per cent of GDP in Hungary, Poland, and the CSFR. The corresponding figures for Bulgaria and Romania were 18 and 23 per cent of GDP. The bad loan problem in the republics of the former Soviet Union became less pronounced because hyperinflation effectively reduced the real value of old bank loans as well as intracompany debts.
The dependence of many SOEs and former SOEs on direct subsidies and unconditional credits was another legacy strongly linked to the bad loan problem of the banks. The inability of governments to cut off subsidies, and the money creation that followed both from fiscal deficits and from the flow of unconditional credits to the enterprises, led to high initial inflation. Table 2 shows that the annual inflation rates in the Eastern European countries ranged from 36 per cent in Hungary to over 500 per cent in Bulgaria in 1991. In Poland and the CSFR the rates were between 70 and 80 per cent. The near-hyperinflation in the ruble zone is well known.

In 1991, most of the countries discussed here embarked on programs to deal with the mounting costs of the legacy of bad loans combined with continued lossesdue to new bank-loans. New banking laws were enacted in 1991 and 1992 in the Eastern European countries in preparation for the privatisation and restructuring of banks. With the exception of Hungary, the universal banking model of Germany was applied. In other respects, international standards for capital adequacy, and schemes for limited deposit insurance were implemented, at least on paper. Estonia is noteworthy because the currency board legislation for the Bank of Estonia implied that the ability of the central bank to contribute to the bailing-out of banks was limited. Two bank failures in 1994 led to losses for depositors.

Table 2: Macroeconomic Indicators, Non-performing Loans and Fiscal Costs in the Early Transition (source: Thorne, 1993)

	Hungary	Poland	CSFR	Bulgaria	Romania
Ratio of Enterprises' Bank Credit to GDP (in percent)					
In end of 1990	25.8	15.6	60.5	78.8	38.6
In June 1991	24	18.4	62.4	47.8	44.6
Real Interest Rates					
In end of 1990[1]	1.9	-44.4	-32.6	-35-5	-96.8
In 3rd Quarter of 1991	8.1	15.6	2.3	-71.9	-31.7
Annual Rate of Inflation (in percent)					
In end of 1990	33.4	250	16.6	64	150.1
In June 1991	36	79.9	71.3	554.6	224.9
Memo Items:					
Estimated Ratio of Non-performing to Total Loans in 1991 (in percent)	50	40	55	44.2	36.6
Estimated Fiscal Cost of Removing all Bank Non-performing Loans (in percent of GDP) in June 1991[2]	5.4	6.5	5.6	17.7	22.9
Source: Countries' official statistics and author's estimates.					

[1] Because the end of 1990 CSFR's real interest rate was not available, I have used the first quarter of 1992.

[2] It is the interest cost of either swapping government bonds for bank non-performing loans or of providing a government guarantee on these loans. Since there is no market government bonds in these countries, I have used the average nominal lending rate as a proxy.

In 1992, with the legal and regulatory framework essentially in place, the Eastern European countries faced the following policy problems with respect to the banking sector:

1) For the sake of the long-run efficiency of market economies, the banking system needed reform tto be able to contribute to effective corporate governance, imposing "hard budget constraints" on borrowers.

2) In the short run, imposing hard budget constraints on borrowers would lead to widespread failures of many SOEs and, as a consequence, more unemployment.

3) Without imposition of hard budget constraints on SOEs, attempts to reduce inflation by reducing monetary growth would lead to a credit crunch for aspiring new enterprises in the private sector.

4) Since the net worth of many banks was negative or near zero, privatization of the banks or inducing banks in other ways to function as commercially oriented firms, would lead to "perverse" lending incentives.[4] Thus, recapitalization was necessary.

5) Cleaning the balance sheets of the banks through recapitalization would entail large fiscal costs.

6) The cleaning of the balance sheets and the recapitalizing of banks with low or negative net worths could create expectations of similar bail-outs in the future. Such expectations would reduce the incentives of bank managers to impose hard budget constraints on firms and encourage excessive risk-taking.

7) The legislative framework for dealing with distressed firms was incomplete or lacking leading to uncertainty about claims in case of liquidation of firms.

8) The legislative framework for property rights, registration of, and trade in property was incomplete, leading to a lack of assets for entrepreneurs to offer as collateral against loans.

The policy conflicts were clearly challenging. There was a conflict between achieving long-run efficiency in corporate governance (1), and avoiding near-term costs (2 and 5) of restructuring enterprises and banks. There was a conflict between avoiding costs of perverse lending incentives (4) due to a back-log of bad loans and the incentive effects of bail-outs of banks (6).

4. Approaches to early reform

The immediate employment effects, as well as the expected fiscal costs (se Table 2) of rapid banking reform explain why most governments in the transition economies hesitated to

implement strong reforms. Even in the Czech Republic—as a part of the former CSFR--and in Poland, which led the way to market oriented reforms, the governments took only very tentative steps in the early 90s. Hungary was also unable to make quick progress. Bulgaria and Romania did not even approach the problems before 1995. The near-hyperinflation in the former Soviet Union actually simplified the reform problem in the former republics, but only Estonia took active measures to influence the incentives of bank managers at an early stage.

For the purpose of creating financial systems that could impose hard budget constraints on firms and banks wherein management would have incentives to allocate credit effectively, a number of approaches were available:

1) Privatization without recapitalization of banks.
2) Recapitalization with delayed privatisation.
3) Simultaneous privatisation, restructuring, and recapitalization.
4) A mixed strategy of commercialisation and partial recapitalization.
5) An ad-hoc strategy (Hungary); privatization when opportunities arise, recapitalization when necessary.
6) The creation of new banks.
7) "Tie the hands" of government by the creation of policy rules.
8) Encourage securities market development.

1.Privatization without recapitalization

Privatization of banks as well as of SOEs can be an effective way of introducing commercial incentives for management. It is, of course, necessary to cut off direct subsidies and expectations of subsidies protecting the wealth of the owners in order to achieve effective corporate governance. Privatization has the potential advantage of reducing the strength of bankers and businesses as political pressure groups.

As the Russian experience shows, the ability of privatization to rapidly change the incentives and the political strength of managers depends to a large extent on the method and speed of privatization. One reason is that expected privatisation creates uncertainty for managers about the future of their position of power. This uncertainty can create incentives for diversion of profits by incumbent managers and a lack of incentives for the same individuals to invest in skill development[5].

Another danger of privatization occurs, as already mentioned, if a firm's or a bank's net worth is zero or negative. Given limited liability, the owners of a bank with a small or a negative net worth have the incentive to continue lending to non-profitable enterprises in the hope of a turn-around. Given the magnitude of the bad loan problem in Eastern Europe in the early 90s, the privatization of firms and banks with low or negative values seemed to be a dangerous process.

2. Recapitalizing with delayed privatization

The incentive effects of recapitalization alone have already been mentioned. The problem is one of time-consistency, in the sense that recapitalization of banks must not create expectations that there will be future bad loan bail-outs. Much delay in recapitalization has occurred because of fears that the one-time policy will not be credible. Without credibility recapitalization may slacken bankers' incentives to impose hard budget constraints on firms in the future.

3. Simulateous privatization, restructuring and recapitalization

Banks operating under commercial principles must not have low or negative net worths and owners and management must not expect to be bailed out after making bad credit decisions. Thus there is a strong case for simultaneously privatizing and transferring resources to cover bad loans. The incentive effects of relieving the banks of bad loans can be counteracted by changing the "rules of the game". Privitization can be thought of as a signal of such changes. Statements by governments that banks will not be bailed out in the future are certainly made more credible by the simultaneous restructuring of ownership.

The credibility of a no-bail-out policy can be enhanced in several ways. First, the reforms should occur as close as possible to the regime shift from central planning or to other reforms of the economic system. If after economic reforms there is delay before banks are recapitalized, a share of the bad loans have been created under the new regime and they are associated with behavior under this regime, The more far-reaching the economic reforms are at the time of recapitalization of the banks, the more credible are statements that the rules of the game are different.

A second policy to enhance the credibility of statement is to allow one or more particularly mismanaged banks to fail. Of course, if privatization has occurred, losses must be borne by management as well as owners and depositors if they are the only private suppliers of financing to the banks. Hanson (1994) argues that the credibility of the Estonian central bank was much

enhanced by its refusal to bear the costs of losses associated with the failure of three private banks in November, 1992. The flow of new bad loans has slowed thereafter, meaning that the budget constraint on enterprises has hardened.

A third credibility-enhancing policy is to divide the state-owned banks into several small units when privatizing them. The too-big-to-fail argument for bail-outs is otherwise always present.

While discussing Bulgaria's failure to carry out early reforms, Thorne (1992) argued in favor of a policy of rapid privatization at an early stage in the transition process combined with simultaneous bank and enterprise restructuring. The restructuring would include the removal of bad loans both from banks and from SOEs that have built up large intercompany payables.

The restructuring of the banks in Thorne's scheme includes dividing each commercial bank into one viable bank with a clean balance sheet and one institution with the problem loans. The first bank could be privatized quickly and be restricted to lending to the emerging private sector. The second bank would become an investment bank that could be privatised more slowly. Its task would be to get involved in the restructuring of former SOEs. The government would have to transfer funds to the investment banks over time when the bad loans from the enterprise sector appear.Thus, the fiscal costs would have to be realized.

Many industrialized countries have established separate institutions managing the bad loan portfolios that appear after bail-outs. In the USA, the Resolution Trust Corporation was created to manage the bad loan portfolio after the Savings and Loan crisis in the late 80s. In Sweden, several big commercial banks established separate units to recover as much as possible of bad loans. The most prominent one, Securum, was an off-shoot of the state-conrolled Nordbanken.

The schemes of removing the bad loans from the balance sheets of banks are often criticized on the grounds that they distort competition. Thus, relieving banks of the bad-loan problem should be combined with a change in management and an absence of rewards for the outgoing management team.

4. A mixed strategy – commercialization and partial recapitalization

The fiscal costs of removing bad loans and political difficulties associated with privatization hindered the quick reforms suggested above. The Czech Republic and Poland embarked on partial reforms including partial privatization and partial recapitalization in the first country and commercialization combined with partial recapitalization as a step before beginning a rather slow process of privatization of the nine state-owned commercial banks in Poland.[6]

One controversial issue is whether the incentives for effective corporate governance structures can be created without rapid privatization. Poland in particular created boards and management teams for the state-owned commercial banks and according to, for example, Mulineux (1994), and Aghion, Blanchard, and Carlin (1994) there is strong evidence that the "commercialization" of state owned banks was successful in hardening the budget constraint on borrowers.

Aghion, Blanchard, and Carlin (1994) discuss the incentive effects for bank managers of commercialization versus rapid privatization. Their essential point is that, if privatization is expected at a later date, commercialization can be successful, because managers and board members have a chance to prove their effectiveness. Thereby they increase the likelihood that they will remain in charge after privatization.

If privatization is delayed but not sufficiently long for managers to prove their worth, commercialization is less likely to succeed because managers do not have the time to demonstrate their abilities. Great uncertainty about the method of privatization, and fears that managers will not remain in charge, can also lead to increased short-sightedness among managers.

The success of commercialization according to the above mentioned theory depends on expectations of privatizations at some future date, Without such expectations, commercialization is less likely to succeed because of the difficulty of the government as an owner to credibly commit to abstaining from political considerations when evaluating and selecting board members and managers.

The Polish privatization program was, as noted, slow. It was nevertheless credible because by the end of 1994, three of the nine large state-owned commercial banks had been privatized. A share of the bad loans had been lifted off the balance sheets against securities issued by the government under a bank reconstruction law. To relieve the fiscal burden of the reconstruction the privatised banks had to keep a share of non-performing loans. This policy may also have improved incentives to avoid adding to the stock of bad loans during the period before privatization. The Czech Republic was less successful in attempts to change the incentives of bank managers tthrough commercialization and privitization. We return to this issue in the next section.

5. An ad hoc strategy – the case of Hungary

The privatization strategy of SOEs in Hungary was relatively piecemeal and ad hoc relative to the planned mass privatization in Poland and the voucher scheme in the Czech Republic.

The Hungarian approach to recapitalization of banks was to unconditionally cover loans classified as losses but not loans classified as doubtful or substandard. The lack of a clear privatization plan left the banks partially recapitalized but with little change in the incentives for managers to harden the budget constraint on firms. Further bail-outs were correctly expected according to Bugske and Vogel (1993).

The loans taken from the banks were transferred to an organization intended to become a state development bank. This organization was understaffed and had to ask banks to continue managing the bad loans.

There was an attempt in Hungary to force a hard budget constraint on firms by means of a very strict bankruptcy law. This law was implemented to substitute for the weak incentives of bankers. Firms were obliged to file for bankruptcy under strict conditions. The law failed, however, because the courts were unable to handle the enormous number of cases.[7]

6. The creation of new banks

Frydman et al (1992) argued that the "modus operandi" of commercial banks carved out from the old mono-bank was bound to be strongly influenced by the inefficient procedures and behavior patterns of the socialist system. They preferred that new banks be created to take over the operations of the old system.

Pohl and Claessens (1994) and Hanson (1994) argued that in Russia and Estonia, as well as in the other Baltic states, hyperinflation in the ruble zone shrank the old banks in the early 90s. Therefore, private banks came to dominate the banking system and these banks had no strong government safety nets. Privatization of SOEs was slow, however. Nevertheless, government subsidies became transparent when banks performed their corporate governance role more effectively. Thereby political pressures to reduce the subsidies increased. Estonia also had a credible privatization plan in effect at an early stage.

7. "Tie the hands" of governments

This approach is characterized by constitutional or other laws prohibiting certain actions by governments. In banking reform, a law that makes it politically impossible or difficult to bail

out banks with negative net worth forces bank managers to consider bankruptcy as a real consequence of bad lending decisions. As discussed above, privatization may have such an intent.

Estonia's currency board arrangement for the central bank implemented in June 1992 implied severe restrictions on the government's ability to bail out banks that suffered from large credit losses. First, currency board arrangements prevented the central bank from carrying out a "lender of last resort" role by providing a bank with liquidity, because under the rules of the currency board, the central bank must not conduct operations that affect the supply of base money[8]. In the crisis of two Estonian banks in 1994 there was no bail-out and even depositors lost money in the bank failures. Second, associated with the currency board arrangement in Estonia was a law that prohibited the government from printing money (borrowing from the central banks) to finance deficits. Thus, fiscal costs of bail-outs had to be financed through taxes or borrowing from the public. Thereby, the costs of bail-outs became transparent to the public.

In the Estonian case the currency board seems to have been an effective constraint on the government's ability to bail out non-profitable banks. The task of imposing discipline on banks was simplified to a degree in Estonia relative to, for example, Poland, by the ruble inflation in previous years that shrank the old banks and their bad loan portfolios. Instead, new private banks were allowed to take over a large share of the banking system. Their political clout was possibly low. Thereby, the currency board arrangement became more easily acceptable politically.

8. Developing securities markets

As a substitute for bank credit, firms can obtain external financing by issuing equity, long-term corporate bonds, and short-term commercial paper directly to financial investors. The Anglo-Saxon financial system is characterized by a larger role for securities markets than the continental European banking oriented financial systems. It could be argued that in the early transition, the development of securities markets could have substituted for a banking system that is constrained in its lending as a result of an overhang of non-performing loans.

A securities market oriented financial system requires that trading in markets becomes sufficiently large for securities to be liquid. Furthermore, it requires that information about firms be made available to potential investors at low cost. Investors demand transparency. La Porta et

Table 3: Financial Development Indicators

	Inc/cap 2001 PPP-rates	BCPS Ratio Bank credits Private Sector/GDP	Stock Mkt cap % of GDP*	Change BCPS ratio 1998-2002 (turning point)	Non-performing Loans/Total Assets***		Asset Share of State Owned Banks		Asset Share of Foreign Controlled Banks	Index of Banking and interest rate lib**	Legal Transition Indicator (Com'l Law)**
					1998	2001	1999	2001			
Slovenia	17819	38.4	15.3	21.6 (1992)	5.6	8.5	41.7	48.4	18.4	2.59	3.53
Czech Rep.	15146	42.6	15.4	-15.0	27.0	13.7	23.1	3.8	84.0	2.79	3.40
Hungary	13030	29.3	18.7	9.2 (1997)	8.2	1.6	7.8	9.0	84.9	3.00	3.73
Slovak Rep.	11252	31.5	3.3	-20.1	9.5	22.0	50.7	4.9	88.6	2.50	3.06
Poland	9790	28.0	14.0	12.9 (1996)	4.7	9.2	24.9	24.4	49.6	2.76	3.20
Estonia	9555	46.0	27.0	35.3 (1994)	2.0	0.7	7.9	0	82.0	2.74	3.55
Croatia	8304	45.6	16.8	20.8 (1994)	15.5	7.4	39.8	5.0	84.0	2.33	3.35
Latvia	7547	29.8	9.2	17.9 (1997)	6.0	1.3	2.6	3.2	70.0	2.68	3.20
Lithuania	7521	12.3	10.0	2.5	5.0	7.0	41.9	12.2	-	2.29	3.46
Romania	6927	8.3	6.0	1.3	40.0	0.3	50.3	45.4	-	2.05	3.73
Bulgaria	5947	15.6	3.7	11.0 (1998)	6.4	3.2	50.5	19.9	74.0	2.14	3.73
Serbia Montenegro	5826	14.7	3.1	2.3 (2002)[1]	7.9	7.1	89.0	68.0	15.1	1.10	-
FYR Macedonia	4851	17.8	2.0	-9.1	44.0	16.9	1.3	1.3	44.0	2.24	3.46
Bosnia and H	3869	21.9	4.8	9.2 (2001)[1]	15.0	6.3	75.9	8.9	66.3	1.48	1.93
Albania	3650	4.9	0	1.5	39.9	0.6	81.1	59.2	44.7	1.74	2.33
Euro Area	24428	95.3	>70								

1) From turning point
*** EBRD (2002) end 2001**
**** EBRD average 89-2002 Scale 1-4**
*****World Bank; Bank-Regulation and Supervision Database 2001 and 2003:**
The 1999 column refers to one of the years 1998-2000. The 2000 column refers to end of year

al (1998) argue that securities market legislation aimed at protecting small investors also supports the development of securities markets.

Even in the United States, securities markets do not substitute for bank credit across firms of all types and sizes. Small and medium-sized firms rely on bank loans. It seems that banks complement securities markets for many firms in the sense that bank loans are viewed as a signal of creditworthiness by investors in securities markets. Nevertheless, encouragement of securities markets can reduce the pressure on the banking system to provide credit for large firms in particular.

The Czech mode of privatization of SOE in the early transition can be viewed as an attempt to create liquid equity markets for large firms. While most countries aimed to privatize in such a way that controlling owners with a large stake in the firms would exist, the Czech Republic used a system of vouchers for each household. Each voucher could be used to bid for equity in firms at auctions. Ownership thereby became extremely decentralized. The voucher system could have laid the foundation for a liquid equity market while the creation of value-enhancing larger controlling stakes could have occurred over time. However, the Czech strategy for securities market development did not succeed well, as we will see in the next section. One reason is that households owning vouchers had little information about the value of auctioned firms, and they owned too little to make information gathering worthwhile[9]. Thus, the foundations for an effective pricing process did not exist. Most individuals sold their vouchers to a few funds that came to dominate equity ownership. A share of the funds was linked to banks that remained state owned.

Section summary

Alternative approaches to the problems of an overhang of non-performing loans to SOE's and of the formation of incentives to allocate financial resources in an efficient way have been reviewed. Most transition countries faced the prospects of substantial lay-offs in SOE's if credit contracts were to be enforced, if fiscal costs of recapitalizing banks were large, and if there was risk that recapitalization would undermine incentives of bank managers to allocate and manage credit efficiently.

Successful reform depends on a combination of political will and ability, credibility in reform efforts regarding recapitalization and privatization, and a willingness to bear fiscal costs. The advantages of a credible privatization plan, the simultaneous recapitalization of banks and the changing of the rules of the game for banks have been emphasized. Experience shows that the

lack of credible statements about bail-outs being one-time events can be very damaging. Similarly, the lack of a credible privatization plan created incentives among bank managers to keep on supporting loss-making enterprises and possibly to divert resources to themselves.

The Estonian experience shows that the currency board system forcing monetary discipline contributed to the enforcement of hard budget constraints on banks and firms. Estonia and the other Baltic countries faced a less severe bad loan overhang as a result of high inflation in the ruble zone in the late 1980s. The CSFR conducted privatization with the purpose of encouraging the development of decentralized securities markets to substitute for bank lending to large enterprises. This effort was as a whole not successful; however, Hungary attempted to create conditions for a hard budget constraint on borrowers through Draconian bankruptcy laws. This effort had to be abandoned within a couple of years.

5. Financial development after a decade

What has been achieved during the 90s? In this section a leap in time is taken in time in order to judge the successes and failures of the various approaches to financial sector reform.

A number of indicators of financial sector development are presented in Table 3. Data are presented for Central and Eastern Europe, including the Baltics in the north and the Balkan countries in the south. The countries are ordered by national income/capita in 2001 in order to get a picture of any obvious relation between income/capita and financial development. The second column shows an indicator of financial intermediation through the banks, i.e. bank credits to the private sector relative to GDP (BCPS). It can be seen that all the countries remain far below the average for the Euro area. Although the ranking of the countries by BCPS is not obviously the same as the ranking by GDP/capita, the BCPS ratio for the relatively wealthy countries is substantially higher than the ratio for the relatively poor countries.

In the previous section it was noted that borrowing through securities markets may substitute for banks' credits, if liquid informative markets exist. The third column shows that the stock market capitalization as a percent of GDP in each country is quite low relative to the Euro area. Furthermore, the countries with relatively high BCPS are also the countries with relatively high stock market capitalization. Thus, securities markets do not seem to substitute for development of a well-functioning banking system. This observation supports Rybczynski's (1988) view that financial systems generally develop through a banking-oriented phase towards a phase when securities markets become more important.

The initial conditions in terms of wealth and financial intermediation were closely correlated, as Table 2 shows. It is therefore more meaningful to evaluate the accomplishment of reforms by looking at changes in financial intermediation and other variables. The fourth column shows the change in credit to the private sector from 1998 through 2000. The year 1998 is chosen because 1997 was a year when the BCPS ratios turned upwards in several countries after having fallen in the early years of transition. This early fall was caused by the drag of SOEs and the time it took to create conditions for banks to work on a commercial basis with incentives to enforce loan contracts. The turning point year for BCPS is shown in parenthesis. Those countries where no turning is noted have not yet experienced a sustained increase in the BCPS ratio. In other words, their banks are still not functioning as commercial banks are expected to in terms of supplying credit to the private sector..

The most rapid expansion in bank credit to the private sector has taken place in Estonia, Slovenia, Croatia and Latvia. Poland, Bulgaria and Hungary show modest increases. In Lithuania and Romania, bank credits to the private sector have changed very little since 1998. The Czech and Slovak Republics share negative figures along with Macedonia.

Countries with increasing BCPS ratios seem to have come to grips with the bad loan problems and successfully privatized or, at least, "commercialized" the banks. The column for non-performing loans shows that Estonia and Latvia are among the high BCPS growth countries to have very low shares of non-performing loans, while the share was falling in Croatia from a relatively high level. Bulgaria and Hungary, among the countries with modest growth of the BCPS ratio also had falling shares of non-performing loans. In Poland, as well as in Slovenia, the share was rising but from relatively low levels. The figures for the share of non-performing loans in the Czech and Slovak Republics indicate that these countries have not come to grips with the bad loan problem. Although the share was falling in the Czech Republic, it remained at a high level. In Romania, the share was 40% in 1999, indicating a very severe problem. The figure reported for 2001 is incredibly low (0.3 percent). It is disregarded here.

The countries with falling or constant BCPS ratios also seem to have been slow in privatizing the banks. In the Czech and the Slovak Republics and in Lithuania and Romania, the share of state-owned banks was still high in 1999 – in Romania, the share remained near 50 percent in 2001. Among the countries with rising BCPS ratios, the share of state-owned banks was either low or falling sharply as in Croatia and Bulgaria. Slovenia seems to stand out as a country with rapidly growing credits to the private sector, a reasonably low (but rising) share of bad loans,

while nearly 50 percent of the banking system remains in state hands. This country seems to have been able to reform the incentive structure in banking while retaining a high share of state ownership. The rising share of non-performing loans is a source of worry for the future, however.

The column for the asset share of foreign controlled banks shows that foreign banks in 2001 controlled more than 50 percent of the banking system in all countries except Slovenia, Serbia and Montenegro, FYR Macedonia and Albania. Thus, privitization has been accompanied by foreign direct investment in banking. Figures are missing for Lithuania and Romania. Much of the foreign bank expansion in the Czech and Slovak Republics, Croatia and Bulgaria took place between 1999 and 2001. The shift in ownership could be an indicator that the performance of the banks in the Czech and the Slovak Republics are about to improve, since foreign ownership of banks in Eastern Europe has been associated with a strengthening of the commercial orientation of bank activities.

The indexes for banking and interest rate liberalization and the legal transition indicator in the last two columns of Table 3 are similar across the countries with the exception of Bulgaria, Bosnia and Herzegovina and Albania. These data indicate that the formal regulatory and legal framework for a commercially oriented banking system has been put in place in most of the countries. The existence of formal law does not guarantee enforcement, however. This aspect of the legal system is dicussed below.

Table 4 presents data for restrictions on bank activities, concentration and supervision. A high figure for restrictions indicates that banks cannot supply a full range of financial services within a universal bank as in Germany. The figures show that most countries impose fewer restrictions than the USA, but stronger restrictions than Germany.

Bank concentration is very high in all countries that are covered by the data. The share of deposits of the five largest banks range between 57 and 90 percent. The potential drawback from such a high concentration is that competition in retail banking may suffer and that a bank in crisis may be considered “too big to fail”. The concentration is a result of a rapid consolidation of the many start up banks in the early 90s. The consolidation has been driven by, for example, minimum capital rules.

Supervisory capacity has been built up in all countries for which the table has data. The number of supervisors per bank ranges between 0.8 and 2 except in Slovenia where the number is as low as 0.2. Slovenia is also the only country without explicit deposit insurances. These

figures could be an indication of substantial risk for depositors but the Slovenian banking system is largely controlled by the state as was shown above. State ownership often implies a degree of implicit deposit insurance.

Table 4. Concentration and Supervision

	Bank Activities and Ownership Restrictions 1-4, 4= Restrictions	Percent of deposits in five largest banks	Professional Supervisors per bank	Legally Liable	Explicit dep. Ins.
Slovenia	2.3	64	0.2	No	No
Czech Rep.	2.0	75	2.0	Yes	Yes
Hungary	2.3	n.a.	1.0	No	Yes
Slovak Rep.					
Poland	2.5	57	2.4	No	Yes
Estonia	2.0	95	2.5	Yes	Yes
Croatia	1.8	57	0.8	Yes	Yes
Latvia					
Lithuania	2.3	90	0.8	No	Yes
Romania	3.3	59	2.0	Yes	Yes
Bulgaria					
Serbia-Montenegro					
FYR Macedonia					
Bosnia and H					
Albania					
U.S.	3.0	21	0.1	No	Yes
Germany	1.3	12	1.0	No	Yes

Source: Barth, J, G. Caprio Jr. And R. Laine, "The Regulation and Supervision of Banks Around the World: A New Database", Brookings-Wharton Papers on Financial Services 2004

Characteristics of the legal systems in transition economies are shown in Table 5. Shareholder rights are included in order to discover whether stock market development is closely associated with the strength of such rights. Creditor rights are included in order to seek a relation between the strength of such rights and financial intermediation to the private sector. More general characteristics are also shown in the columns 'Rule of Law', and 'Enforcement'. The latter is particularly interesting, since many countries may have laws on the books without enforcing them.

Starting with the general legal system characteristics, the following countries score above 7.5 for "Rule of Law": Hungary and Poland (8.7), Estonia (8.5), Slovenia (8.4), the Czech Republic (8.3), and Latvia (7.5). The scores for enforcement produce the following top 6 rankings:

Hungary (.76), Poland (.70), Slovenia (.65), Croatia (.04), Estonia (.61), and Bulgaria (.59) along with the Slovak Republic. There is no score for Latvia.

Table 5: Legal Rights

	Stock Mkt CAP	Shareholder rights				Rule of Law, 1-10	Enforce-ment, 0-1	BCPS ratio	Creditor Rights				1998
		LLSV	SMINT	VOICE	EXIT				LLSV	CREDCON	COLLAT	REMEDY	Sum of rights, except LLSV
Slovenia	15.3	2.5	3	3.75	3	8.4	0.65	38.4	4	5	1	1.75	7.75
Czech Rep.	15.4	3	5	4.5	2.5	8.3	0.44	42.6	3	4	1	1	6
Hungary	18.7	3	5	6.75	0.5	8.7	0.76	29.3	3.75	3.75	3	1	7.75
Slovak Rep.	3.3	2.5	2	4	1	6.4	0.59	31.5	4	4	1	2	7
Poland	14.0	3	4	6.25	3	8.7	0.70	28.1	2.25	4.25	3	1.5	8.75
Estonia	27.0	3.75	4	9.5	2	8.5	0.61	46.0	4	4	3	1	8
Croatia	16.8	2.5	6	5.25	1	7.0	0.64	45.6	4	5	1	2	8
Latvia	9.2	3.5	1	7.25	1	7.5	n/a	24.8	4	5	1	1	7
Lithuania	10.0	3.75	1	9.75	1	7.2	0.39	12.5	3	3	3	0	6
Romania	6.0	3	1	5.75	1	5.6	0.52	8.3	4	4	1	2	7
Bulgaria	3.7	4	5	10.75	2	5.9	0.59	15.6	3	4	3	2	9
Serbia-Monten.	3.1	-	-	-	-	-	-	14.7	-	-	-	-	-
FYR Macedonia	2.0	2.5	5	5.75	0.5	5.4	n/a	17.1	1	0	3	0	3
Bosnia and H	4.8	0.5	0	3.5	0	2.1	n/a	21.9	4	4	0	0.75	4.75
Albania	0	3	1	7.5	1	2.7	n/a	4.9	3	3	1	2	6

Rule of Law. Scale 1-10; 10 high: Regional expert rating in Central European Economic Review.
Legal Effectiveness. Range 1-4 i EBRD Survey of Legal Practitioners
Enforcement: EBRD Survey, "Proportion" confident that legal system will uphold contracts and property rights in business dis
LLSV: Range 1-10; From La Porta et al (1998)
SMINT: Range 0-6; Quality of Securities Market Regulation
VOICE: Range 0-16; LLSV plus aspect of minority shareholder rights
EXIT: Range 0-14; Rights of minority shareholder w.r.t. transfers of shares
LLSV: Range 0-4; From La Porta et al (1998)
CREDCON: Range 0-5; LLSV for creditor rights plus automatic tigger for bankruptcy and creditors' consent required in reorga
COLLAT: Range 0-3; Strength of Security Interest
REMEDY: Range 0-3; Legal provision enhancing creditors' rights in bankruptcy
Source: Pistor, K., M. Raiser and S. Gelfer (2000) "Law and Finance in Transition Economies". EBRD Working Paper No. 4

Relating these observations to the discussion of financial sector development above it can be noted that all countries that either have achieved a high BCPS ratio, or have had rapid growth in this ratio, are among the countries ranked here. A second observation is that the two relatively developed economies that have not succeeded in reforming their banking systems have low

scores in one of the two dimensions. The Czech Republic scores low (.44) on enforcement while the Slovak Republic scores relatively low on Rule of Law.

It seems that there is a clear relation between the effectiveness of financial intermediation to the private sector and the above characteristics of the legal system. A causal relationship is less obvious, however.

Turning next to creditor rights the data is harder to interpret. There are many aspects of credit market and bankruptcy law and they are difficult to weigh together. LLSV is the score created by La Porta et al (1998) based on the sum of four aspects of the law.[10] CREDCON includes a few more aspects of creditor rights (see table notes). This score, COLLAT and REMEDY cover different dimensions and can be added. The sum, being the most comprehensive measure of creditor rights, is shown in the last column.

The highest scorers in the sum column are Bulgaria (9), Poland (8.75), Croatia (8), Estonia (8), Slovenia (7.75) and Hungary (7.75). Bulgaria's high score may seem surprising but it should be noted that the scores refer to the letter of the law. In Bulgaria's case, strict creditor rights are not matched by equally strict enforcement. The group of countries scoring relatively high is the same group scoring relatively well in general characteristics of the legal system and showing evidence of positive development of bank credit to the private sector.

Turning to the development of stock markets and scores for shareholder rights, Table 5 includes four different measures of these rights.[11] The measures are not independent and they are not obviously closely correlated. The broadest measure is VOICE, which includes the score produced by La Porta et al (1998) and aspects of minority shareholder rights. The scores can be seen as measures of governments' attempts to encourage stock market development by providing legal protection of shareholders aginst management and dominant shareholder abuse. The top scorers are Bulgaria (10.75). Lithuania (9.75), Estonia (9.5), Albania (7.5), Latvia (7.25), and Hungary (6.75). Poland follows with a score of 6.25. As for creditor rights, the existence of formal law does not necessarily translate ino effective law.

There is clearly not a strong relation between the number of formal legal measures to protect shareholder rights and stock-market development. Parts of the explanation can be a weak legal system (Albania), and weak enforcement (Lithuania). Another explanation is that large private corporations may not exist in large numbers in the relatively poor countries (Albania, Bulgaria, and Lithuania among those mentioned above). More surprising is that Slovenia, the Czech Republic and Croatia among the countries with relatively high market capitalization of stock

markets, score relatively low on shareholder rights. Clearly, protecting shareholder rights in law is neither sufficient nor necessary for development of trading in stock markets at the level of development we are concerned with here.

With this picture of financial sector development and the legal and regulatory infrastructure, we turn in the next section.to a discussion of political and cultural factors possibly explaining the great differences in pace and level of development of the financial sectors.

6. Explaining Reform Progress and Failure

Can the great differences in level and pace of financial sector development, which were observed in the previous section, be explained? Is it possible to draw policy conclusions for the benefit of policy-makers, whose job is to speed up the reform of the financial system? Without being controversial, is it safe to say that sustainable economic development requires that banking systems must be made to provide liquidity and credit to the private sector on a commercial basis and, once credit is provided, to enforce credit contracts? Different approaches to reform of the banking system were discussed in Section 4 but even if a set of reforms have been identified, these reforms have to be viewed within the political and institutional environment of the country. This environment may or may not the receptive to the reforms.

The progress of financial sector development has been associated with specific reforms such as privatization, recapitalization, absence of strong government guarantees of bail-outs, and the implementation of effective bankruptcy laws. If there is general agreement that most of these reforms are prerequisites for effective financial intermediation, why have some countries succeeded in their reform efforts while others have not? To answer this question, it is necessary to analyze political decision-making and its determinants.

The role and influence of various political interest groups are emphasized in economic analyses of political decision-making. In the immediate aftermath of the collapse of the communist system, various interest groups had not yet organised themselves in the new political environment. Therefore, a "window of opportunity" to initiate a reform path existed. This issue was discussed in the introduction to this part of the volume.

There were great differences in how this "window of opportunity" was used, and it is of interest to explain these differences, as well as the progress of reform once the new political systems were established.

It is obvious that the cultural and political legacies from the communist period, as well as pre-communism, must have influenced the reform process, both during the window of opportunity and after its closing. It is very doubtful, however, that all differences in the transition process can be explained by history and culture. Differences in development have certainly been accidental and unpredictable to some degree, and the result of actions by particular policy-makers. It must also be taken into account that there was great uncertainty about the appropriate approach to reform of the financial sector. Thus, for each country, an element of good or bad luck should be considered.

Broad historical, political and cultural factors that could be considered when comparing countries' progress in the transition are the following:

1) Collapse of communism was followed by war in some countries.
2) Scope of private property rights and functioning markets during communism differed across countries.
3) Duration of communist rule was not the same in all countries under consideration.
4) Pre-communist heritage of market institutions and political democracy differed across the countries.
5) Level of economic development achieved by the time of the collapse of communism differed.

These factors will not be discussed in depth here but the purpose is to discover what factors, if any, successful reform countries have in common.

Tables 3-5 contain measures of financial sector and institutional development. It was argued that a high level of financial sector development is associated with a high level of financial intermediation as measured by the BCPS (Bank Credit to the Private Sector)-ratio, while progress is measured by the change in this ratio. What factors explain the level of financial intermediation, and relatively rapid or slow progress of the financial sector's ability to provide financing for the private sector?

Both questions were addressed to some extent in the previous sections in conjunction with the discussion of approaches to reform and the characteristics of the legal systems. Here we draw together the different factors affecting level and pace of change of financial sector activity relative to the private sector.

The BCPS-ratios in 1998 are used as proxies for the level of financial sector development after the early years of transition. This year was chosen, because it was the year after the turning point (from a declining to an increasing BCPS ratio) for many countries in Table 3.

To classify the countries into groups based on their level, as well as their progress, of financial sector development Table 6 is created. In this table the countries are grouped buy High (>.30), Medium (.15 - .30), and Low (<.15) BCPS-ratios in 1998, and by Fast (>25%), Medium (5 - 20 %), Slow (-10 - +5 %), and Sinking (< -10%) rates of change of this ratio from 1998 through 2001. The input data comes from Table 3.

Table 6. Grouping of countries based on BCPS ratios in levels (1998) and percent change (1998-2001)

Growth of BCPS / **Level**	**<.15 (Low)**	**BCPS-ratio .15 - .30 (Medium)**	**> .30 (High)**
> 25% (Fast)			Estonia Slovenia Croatia
5-20% (Medium)		Hungary Poland Latvia Bulgaria Bosnia-H.	
-10 - +5% (Slow)	FYR Mac. Lithuania Romania Serbia-M. Albania		
< -10% (Sinking)			Czech Rep. Slovakia

Although there is no obvious relation between the BCPS levels and their changes, there emerges a pattern when the groups are created. Most of the countries can be placed in the diagonal groups High-Fast, Medium-Medium, and Low-Slow. The only outliers are the Czech Republic and Slovakia. This countries can be classified High-Sinking. Their BCPS-ratio-levels are high but the ratios have been declining fast.

At a glance, the countries within each group seem to be very different in terms of history and politics. If this observation is correct the progress of reforms may have to be explained largely by events and decisions within the transition period rather than by historical and cultural factors.

Before discussing differences within the groups we ask whether legal system indicators in Table 5 above vary systematically across the groups in Table 6? The discussion in the previous section indicates that we should expect a pattern. Without repeating the data, it can be seen that the High-Fast and the Medium-Medium countries generally have higher scores for "Rule of Law" and "Enforcement" than the Low-Slow countries. The two groups are not clearly different in these respects. "Creditor rights" are also relatively strong in these two groups. The main exception from this pattern is Bosnia-Herzegovina, scoring very low (2.9) on "Rule of Law" (Lacking data for enforcement). Bulgaria also scores below the other countries in these groups. In the High-Sinking group, the Czech Republic scores high on "Rule of Law" but quite low on "Enforcement" and "Creditor rights". Slovakia scores in the middle on all legal indicators. Clearly, these outliers are not explained by the legal system.

Looking in more depth at the individual countries within each group, the High-Fast group includes Estonia, Slovenia and Croatia. No common heritage or similarity of political environments explain the relatively rapid progress of these three countries. Slovenia and Croatia were relatively wealthy parts of Yugoslavia, wherein a somewhat market-oriented form of communism was practiced. Estonia on the other hand was a part of the Soviet Union where communist repression was strong. Slovenia has been very slow in privatizing banks, while Estonia privatized and restructured the banking system rapidly. Croatia achieved a large part of its restructuring and privitization after 1998 (see Table 3) after being set back by the Balkan war. Foreign banks have taken over the major banks in Croatia and Estonia, while owner ship in Slovenia is still in state

hands to a substantial degree. Thus, it seems that privatization is not a necessary requirements for banks to function on a commercial basis.

The Medium-Medium Group includes Hungary, Poland, Latvia, Bulgaria, and Bosnia-Herzegovina. Two of the leaders of the reform of financial systems, Poland and Hungary, are found along with a former Soviet Republic, Latvia, a late starter, Bulgaria, and war-torn Bosnia-Herzegovina. Poland and Hungary are among the relatively well off countries wherein market economic principles had made some headway under communist rule. Both countries initiated reform of the financial system early although they followed different paths as discussed in Section 4. By 1997 the banking systems were by all accounts fuctioning according to market economy principles in both countries. Latvia and Bulgaria had repressive communist systems and they were not among the relatively well-off countries. Their pre-communist backgrounds are very different. Latvia reformed and privatized its banking system before 1997, while Bulgaria was a slow starter. The fundamental problems identified in Section 3 were not delt with before 1997. Bosnia-Herzegovina belongs to the very poorest countries in the group. It has been torn by war on its land. Nevertheless, privatization has been rapid after 1999 and the share of non-performing loans has come down substantially (Table 3).

The Low-Slow group consists of Lithuania, Romania, two former Yugoslavian republics--FYR Macedonia and Serbia-Montenegro--and Albania. It is not surprising to find the last three countries in this group. Albania was and still is among the poorest countries in Europe, while the two former Yugoslavian Republics have been preoccupied with war and ethnic conflicts. Lithuania, however, would seem to have had the same early conditions for reform as Estonia and Latvia, but the reform efforts stalled in Lithuania. The political environment did not allow the necessary reforms to be pushed through in spite of rapid democratization as in the other Baltic states. Romania had one of the most repressive and corrupt communist governments. Both political and economic reforms have been slow and governments willing to take make far-reaching economic reform efforts have been unable to survive long. It is nevertheless hard to point to historical factors that explain why Romania and Lithuania would not be able to make as much progress as their neighbors. Instead the slow pace of reforms in these countries must be explained by the failure of reform minded political groups to remain in power in the specific political environments of the countries.

Finally we turn to the High-Sinking group consisting of the two countries coming out of the former CSFR. This country was on the leading edge of reforms in the early nineties before the split occurred and the Czech Republic and Slovakia were formed. The former country continued its rapid

pace of reforms including radical privatization programs as mentioned above. The relatively high BCPS ratio in 1998 is explained by this early progress of reforms. Slovakia on its own turned towards a rejection of rapid reform. What the two countries have in common except their origin in the CSFR, is that they did not restructure the banking systems along the lines discussed in Section 4, and kept supporting the SOEs of the communist era, although for different reasons. In Slovakia rapid privatization and the cut-off of support to SOEs were rejected, while the Czech Republic embarked on radical and rapid privatization. The banks were not privatized at the time, however, although they were expected to be managed as commercial enterprises. The voucher privatization programs led to funds being set up to buy up vouchers and, therefore, equity in the firms. The still state-owned banks set up such funds, and as a result much of the privatized equity returned to the state. If the banks could have functioned independently of the political pressures on the state to support the former SOEs (as in Slovenia), the state ownership odf banks would have been irrelevant. However, the banks did not have this independence. As a result, the support of the corporations continued and non-performing loans were accumulated. The share of non-performing loans reached crisis proportions in 1999 (Table 3) and credits to the private sector shrank. Both the Czech and the Slovak Republics have embarked on bank privatization programs since 1999 and foreign banks have obtained control over large parts of the banking systems. The stage is therefore set for the development of functioning banking systems that can contribute to private sector expansion.

6. Concluding Remarks

Without summarizing the different sections of the paper a few conclusions can be drawn about the factors that have led to successful reform of the financial system in some countries and lack of development in others.

(1) The successful countries are heterogeneous in terms of history, culture and initial conditions for the reform process. This heterogeneity indicates that successful reform should be explained by the particular reforms that have taken place during the transition years and by the political environments that developed in the aftermath of the collapse of communism. Time specific country-idiosyncatic factors seem to have played a greater role than historical legacy. For example, Estonia's success may have a lot to do with openness to Finnish radio and TV during the communist days, and a language related to Finnish, while the neighboring Baltic states had no such Western media access.

(2) It is never too late to change. Bulgaria's reform process was sluggish through most of the 90s but the country seems to be catching up in terms of financial development.

(3) Privatization is not an absolute requirement for successful banking reform, if the banks can be made to function on commercial grounds without political interference under state ownership. Slovenia demonstrates this. However, there is a question of long term sustainability of the independence of political interference if the banks are not privatized. The development of non-performing loans in Slovenia after 2000 could be an indication of problems to come.

(4) The one factor that seems to be required for effective financial intermediation is a reasonably well functioning legal system. With one exception--Bosnia-Herzegovina--all countries that were classified as at least modestly successful in terms of financial sector development have above average scores (among transition countries) for Rule of Law and Enforcement of law.

(5) Foreign control of the banking system can be controversial but seems to have enabled banking system in many countries to adopt effective credit evaluation, enforcement, and payment procedures more rapidly through knowledge transfer. Other advantages of foreign ownership is that the banks' power as a political interest group may be relatively weak, and their independence of political interference relatively strong..

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[1] Milgrom and Roberts (1992) includes a clear textbook analysis of the problems described below.
[2] The adverse selection problem is often known as the lemon problem.
[3] See, for example, Grossman and Hart (1986).
[4] The reason is that a bank that has lent to loss-making firms and has a zero net worth has nothing to loose and can only gain by keeping the firms afloat with new loans.
[5] See Hinds (1995) and Aghion, Blanchard and Carlin (1994).
[6] (1994), Mullineux, Pruski and Klacek (1995), Levine and Scott (1992), Roland (1994), and Blanchard (1994).
[7] The Czech and the Polish cases are discussed in, for example, Begg and Portes (1993), Aghion, Blanchard and Carlin.
[8] A lender of last ressort provides liquidity to a solvent bank in a liquidity crisis. Central banks often misuse this policy instrument to provide liquidity to insolvent banks as well.
[9] See Goldstein and Gultekin (1998)
[10] The data for creditor rights are taken from Pistor, et al (2000). This paper provides details about the various legal provisions protecting creditors rights in different ways.
[11] These proxies for shareholder rights are also taken from Pistor et al. (2000)