REFORMING FINANCE IN TRANSITIONAL SOCIALIST ECONOMIES

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Financial reforms initiated in most transitional socialist economies do not yet adequately provide many of the financial services associated with market-oriented financial systems. Such services—mobilizing resources, selecting firms and allocating capital, monitoring firm managers, and facilitating the management of transactions and risk—are a necessary condition for economic reform to improve living standards.

This article envisages four central strategies to guide reform of the financial sector:

• Building an infrastructure based on clear and enforceable property rights, modern accounting and auditing standards, reliable payments systems, sound prudential and enforcement regulations, and professionals trained in finance
• Ending the shell game of trying to hide the losses of state-owned enterprises, and separating government decisions to finance “priority” firms from the allocation decisions of independent financial institutions
• Privatizing some financial institutions early—although not necessarily precipitously—in concert with the privatization of firms and supervisory capabilities, meanwhile cleaning up bank loans to maximize the chances that firms and banks will succeed as private entities
• Improving the tax system and stressing a prudent interest rate policy to reduce uncertainty, distortions, and excessive repression of the financial sector.

A necessary condition for economic reform to improve living standards in transitional socialist economies (TSEs) is a financial system that provides more market-oriented service to firms. Financial sectors in socialist economies did not have to provide these services, and, although financial reforms have been initiated in most TSEs, governments are only now
beginning to learn what these services might entail and how to encourage the development of financial institutions to provide them.

Reform of the financial sector requires, first and foremost, the establishment of a sound financial infrastructure. For this purpose governments and managers need to concentrate on clarifying property rights; bringing accounting, auditing, and payments systems up to date; and training staff in modern, market-oriented, financial methods. Another prerequisite to effective reform is for governments to end the shell game of hiding the losses of state-owned enterprises. Early in the reform process, some financial institutions should be privatized, in concert with the privatization of firms, after bad debts have been cleared from the books, so that the reformed institutions start with a clean sheet. Finally, tax systems and interest rate policies need to be improved with the specific objective of reducing the uncertainty and distortions that currently encumber the financial sector in these economies.

Three assumptions are inherent in this study. First, it is taken as given that the TSEs have decided to move toward a primarily privately owned, free market system and that this decision is in part due to a reaction against government interference. The second assumption is that these economies have already adopted significant policies to liberalize prices and trade, so, monopoly problems notwithstanding, reasonable price signals are emerging to guide the allocation of resources. Third, we believe that reform in the financial sector is inseparable from reform in the enterprise sector. Consequently, the article repeatedly notes how the form and speed of enterprise privatization influence the nature and sequencing of financial sector reform, and how financial sector reforms that stimulate the availability of financial services will be necessary if economic reforms are to increase welfare.

The Growing Role for Financial Services in TSEs

To understand the role the financial sector should play in the transition to a market economy, it helps to recall both where the financial sector is going and whence it comes. In market economies, financial intermediaries as a group provide several services. They

- Make payments and facilitate transactions
- Mobilize savings
- Facilitate risk management (hedging and insurance)
- Monitor firm managers (corporate governance)
- Select firms to finance (credit assessment).

All financial systems, from the simplest to the most complex, perform these tasks. Although there are disagreements about which instruments excel at these tasks,1 each of these financial services is important to economywide growth, efficiency, and welfare (see Caprio, Atiyas, and Hanson, eds., forthcoming, and

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Privatization, for example, is a pervasive theme in modern, market-oriented transition economies. The logic of the private sector is that only if firms are allowed to fail, will the survival of firms be improved with the necessary innovations that currently are not occurring.

It is as given that the transition to a market-oriented, free market economy is not imminent, and that government interventions have already been made. Hence, the argument is that the monopoly problems that are experienced by the financial sector is not a problem that is going to be remedied by the article recommendations. The influence of the financial sector remains a problem, and the solution to this problem needs to be explored.

In conclusion, the transition to a market-oriented economy is going to be a difficult process, and the financial sector is going to play a crucial role. The financial sector is going to provide the necessary services that are required by the economy. The financial sector is going to be the key to the success of the transition to a market-oriented economy.

Payments Systems

One of the first areas where the need for expanded financial services reveals itself is in the payments system. The evolution from a centrally planned system to a market-oriented one entails an explosion of economic trades and financial transactions. In Russia, for example, the expansion in market transactions has overwhelmed the existing payments system: checks, even between banks within

King and Levine, 1993 and forthcoming, for evidence that financial services promote economic development.

Providing these services was not a matter of course in socialist economies before the transition process began. Banks, virtually the sole financial organizations before the transition, were charged with meeting the objectives of the planning ministry, and they essentially passively allocated credit in accordance with the ministry’s economic plan, passed a bill back to the government at the end of the exercise to cover loan losses. Most socialist economies had one mammoth savings bank charged with mobilizing resources from sectors that ran a surplus—largely households—and passed these on to the central bank to allocate among the few specialized banks that gave credit to agriculture and industry. Payments were made largely by cash or barter. Providing an efficient monetary payments system was unimportant because the “coin of the realm” was rights to real resources, which were allocated according to the central plan. In this respect, socialist economies were the nearest approximation to a neoclassical economist’s dream—a world in which money did not matter! Money and the financial system were simply a veil—an accounting device—for “real” activity.

Socialist banks did not devote much effort to selecting firms to finance, assessing their creditworthiness, or monitoring them; loan collection was not a priority, because the state budget was always available and routinely used to cover losses. State banks provided little in the way of risk management. Indeed, risk was a difficult concept to explain—even to the supposed bankers—at the start of the reform process because previously all risk had been borne by the state. Typically, the sole nonbank financial institution was a tiny insurance company that underwrote only trade-related risks. The state of demand for insurance, in fact, reflected the state of the reform process: only viable enterprises that were truly independent of the budget had any desire for insurance protection, because managers of nonviable state enterprises had much larger problems and believed that budget recourse was still available.

Far fewer financial services are provided in TSEs today than in other economies with comparable per capita income. For economic reforms to intensify, however, the provision of financial services will have to grow correspondingly; for economic reform to improve living standards, financial reforms will have to produce a financial sector that provides crucial services to the rest of the economy.
Moscow, often take more than a month to clear. Similarly, in Poland a sub-
standard payments system was subject to abuses that reduced confidence in the
financial system. Long lags in payments or a lack of confidence in the payments
system encourages barter or cash transactions; these were prolific in much of
the former Soviet Union and Viet Nam in 1992. For market activities to expand,
participants must be able to write and settle transactions quickly and
confidently. A poorly functioning payments system, especially in an environ-
ment of high inflation, will discourage market interactions and retard the entire
economic reform process.

Although private financial institutions can develop payments systems, an ef-
ficient and secure national payments system offers large social returns through
increased economic efficiency. Many countries consequently view the provision
of a payments system as a public responsibility. An immediate priority of cen-
tral banks in TSEs should be to adopt and ensure the safety of a sound pay-
ments system, one that lowers clearing times to a few days and minimizes
opportunities for abuse. Because payments systems are typically linked to
banks, financial reform may need to focus on creating a set of stable banks to
administer the system.

Savings Mobilization and Risk Management

In many TSEs there is also a noticeable dearth of services in savings mobil-
ization and risk management. For example, in 1992 Russia had one savings
bank, Sberbank, which held more than 90 percent of all household deposits.
Sberbank offered depositors an annual interest rate on deposits of approxi-
mately 3 percent during extended periods when monthly inflation rates were
more than 20 percent. Even during the first five months of 1993, Sberbank of-
fered annual interest rates of 40 percent on demand deposits, but inflation was
more than 400 percent. Limited competition for household deposits produced
fewer opportunities for savers to avoid the inflation tax and thwarted the emer-
gence of financial instruments to manage inflation risk. In Russia demand for
foreign currency increased, as a store of value and a hedge against inflation.
The economic implications of inadequate savings mobilization and poor risk
management are severe: savings are channeled to less productive uses, in-
creased uncertainty lowers investment, and human resources are diverted from
socially productive endeavors to efforts to avoid the costs of inflation.

Governments, as the owners of the concentrated financial system, have a
clear function to implement policies to create a more competitive environment
so that a healthier array of services can be provided to households and enter-
prises. In addition to permitting private financial intermediaries to emerge and
compete with state banks, governments of TSEs will need to reorganize state-
owned banks into smaller, more autonomous, competing banks and privatize
existing components of the banking system. The critical issue here is that pol-
ices to increase competition need to be initiated early in the transition.

Establishing a firm can develop may face difficulties in finding of treasury bills
for better inflation hedging or use the capital market as a source of funds.

Corporate Governance

Public policies to oversee firms’ activities in the hands of their managers will
decide whether the long-run performance of the economy will be high.

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group. Because consuming and investing are driven by expectations about how their
returns will perform in the long-run, they can face problems.

Consequently (creditors) and the economy. Firms and lower-costs will make pr

Coping with financial market risks requires new mechanisms for making deals in
the firm. Reliant on the combination of securities and ownership structures and
assesses the risk of the investment. If the accuracy of the firm’s management
is good, linking manager
Establishing a legal and regulatory environment in which capital markets can develop may facilitate risk management. For example, the recent auctioning of treasury bills in Moscow created a new financial instrument that is a better inflation hedge than current savings deposits and encourages others to use the capital market. Similarly, in Hungary security markets have expanded operations during the past two years.

Corporate Governance

Public policies will also have to propagate financial systems that effectively oversee firms' activities. Under central planning, with ownership concentrated in the hands of the state, responsibility for monitoring and evaluating managers rests with the government and relevant ministries. For the private sector to blossom in the TSEs, other mechanisms for monitoring and evaluating managers will have to be devised.

In market economies large private firms are typically owned by a dispersed group. Because obtaining and analyzing information about firms is time-consuming and costly, firm owners frequently know less than their managers about how their firms work. But managers may have interests different from those of shareholders and may act in their own interests instead of maximizing the long-run value of the firm. This divergence of interests is manifest in many TSEs. As the government grants more autonomy to enterprises, managers have greater opportunities to expropriate assets from their firms; worse, managers purchase subsidiaries of the main enterprise at very low prices and then lease the services of these subsidiaries back to the main enterprise at very high prices.

Consequently, the conflict between the principal (shareholders and other creditors) and the agent (management) may have costly implications for the economy. Firms operate and invest less efficiently and therefore produce fewer and lower-quality goods and services. Similarly, the principal-agent problem will make principals reluctant to invest in firms, and savings and investment in the economy as a whole may decline as a consequence.

Coping with the principal-agent problem is critical in shaping financial instruments and institutions in market economies and will be equally crucial for a successful transition in TSEs. Market economies have developed a number of mechanisms for the purpose. Some involve aligning the interests of the principal with those of the agent by tying management compensation to the value of the firm. Reliance on the stock market to align the interests of management and owners requires the market to reveal information about the firm efficiently, and assumes that the values of firms are closely tied to management performance. If the economy faces large systemic risk (as in most TSEs), a firm's long-run performance and its stock market price may not be closely associated with good management. Luck and circumstance may play a big role. Moreover, linking management compensation to stock price may induce managers to
focus on short-run performance, not long-term profits. Finally, although linking pay to stock price may play a part in coping with the principal-agent problem in TSEs, stock markets are not sufficiently well developed to be considered very reliable sources of information about management performance. Establishing the legal and regulatory environment for developing a stock market, however, should make it easier for principals to write incentive contracts that encourage managers to act in the long-run interests of firms.

Banks, as creditors and hence in some sense owners, also influence management decisionmaking. The very nature of a loan helps in this regard. Loans oblige firms to make regular payments. Failure to pay permits the creditor to demand changes in management or even to force the firm into bankruptcy. This restricts the latitude of managers and also encourages banks to monitor firm activities closely so that banks are not exposed to losses. The monitoring and financing functions give banks influence over managers; if a bank with superior information abandons a firm, other creditors will be reluctant to fund that firm. Thus, managers have incentives to satisfy the objectives of creditors.

Bank surveillance can be complemented by other financial institutions. Insurance companies, pension funds, and mutual funds, by pooling the savings of many individuals, may also find it worthwhile to pay the costs of monitoring firms, costs that individual investors would be unwilling to pay. Thus, the financial structure—the financial instruments and institutions—can help ensure that firms act in the interests of owners and creditors.

In TSEs, however, many of the legal and institutional arrangements basic to corporate governance do not exist. For example, clearly defined property rights and confidence in the legal system’s ability to enforce contracts are necessary for debt contracts to discipline managers. Financial statements and accounting procedures must be standardized, uniform, and audited so that performance evaluation is relatively easy. Yet property rights remain murky in most TSEs, legal enforcement of contracts is difficult, and few accounting standards exist. Moreover, banks in most TSEs are not ready to exert effective supervision: they have not been in the business of overseeing enterprise managers and need substantial training in market-oriented banking skills. Furthermore, bad loan portfolios, a very uncertain economic environment, and the ownership of many banks by the state or by the enterprises themselves all hamper the ability of banks to monitor firm managers. Because pension funds barely exist and the insurance industry is very small and state run, the government needs to fill the gap.

Reforms should begin with building a financial infrastructure: a sound legal system; trained financial professionals; standardized and transparent standards for accounting, financial reporting, and auditing; and prudential regulations and enforcement capabilities. But, to tackle the principal-agent problem, governments should at the same time initiate active public policies to reform banks and encourage the emergence of nonbank financial institutions.
Resource Allocation

Finally, in market-oriented economies, society in effect authorizes the financial system to allocate resources. Savers typically place their savings in financial intermediaries—banks, mutual funds, pension funds, and so on—which then evaluate investment opportunities and make allocation decisions. Better financial systems, by definition, are more skilled (among other activities) at choosing investments with the best opportunities.

Banks in TSEs have no experience in researching firms and allocating resources independently. Always costly, evaluation is further complicated by the enormous uncertainty these transitional economies face. Establishing financial institutions that can allocate scarce savings as efficiently as possible is crucial for successful economic reform.

Building Better Institutions and a Sound Financial Structure

Banks that issue loans are typically the principal conduits of external resources to promoting enterprises. But in TSEs structural shocks have left banks with a large percentage of bad loans, and the environment is very uncertain. Even (especially) if these countries had the "best" banks, bankers, legal structures, and regulators, banks would probably be reluctant to finance emerging firms and hesitant to lend to all but the very best credit risks. Thus, other sources of finance, such as retained earnings and nonbank financial intermediaries, may need to play unusually large roles during the transition.

Nonetheless, a priority should be to build better banks, for two reasons. First, institutions bearing the title "bank" represent almost the entire existing financial system in TSEs, yet they do not provide many of the financial services provided by banks in market economies. Second, banks are a key component of financial systems around the world, even where bank debt is shrinking in relative terms as a funding source: payments systems are typically organized around banks, capital markets and nonbanks typically rely on banks for various transactions services, households tend to save in banks, and banks are commonly the largest external creditors to corporations. Even direct placements, such as commercial paper, rely on banks to supply backup lines of credit. Thus, financial reform in TSEs should confront the problems existing institutions face and establish a viable banking system, while at the same time encouraging supporting nonbank institutions.

Bank Reform: Ownership and Concentration

In TSEs the banking system is typically highly concentrated and ultimately owned by the government. During 1991–92, the top five banks in Bulgaria, the former Czechoslovakia, and Romania accounted for at least 60 percent of commercial lending; in China and Poland the corresponding figures are 42 and 90

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percent, respectively. Similarly, in both Romania and Russia, the principal savings bank holds more than 90 percent of household deposits. The state’s ownership of banks can be direct or circuitous. In Bulgaria, commercial banks are owned by the state-owned central bank, the foreign trade bank (which is owned primarily by the central bank), and major state-owned enterprises.

State or enterprise ownership and a very high concentration of bank activity create several problems. First, high concentration may reduce competition among existing banks, discourage the emergence of new banks, and slow improvements in efficiency. Second, when a few large enterprises control the bulk of the banking sector, lending may be skewed toward owners, and enterprises can use their control of bank credit to discourage competitors. Third, central bank ownership can conflict with responsible monetary policy and prudential regulation. Finally, when the state still owns most of the sector, political priorities can easily influence decisions about capital allocation and managerial incentives.

Whether or not existing banks are privatized, policymakers can stimulate improvement by restructuring the highly concentrated banking sector to foster competition and contestability. The form that restructuring should take will depend on the country’s particular circumstances. For example, a few large commercial and savings banks could be broken into smaller banks to encourage competition in the retail and commercial banking market. Savings banks could be permitted to enter the commercial loan market, while commercial banks could be allowed to take household deposits, provide mortgages, and make other household loans. Where savings banks have a large branch network that holds almost all household deposits, and commercial banks have few branches and obtain most of their funds from savings banks, the central bank, and the government, components of the large savings banks could be merged with components of the large commercial banks.

Bank restructuring appears to be a prerequisite for increased competition, but its speed and scope should be tempered by the acute shortage of managers, staff, and bank supervisors competent to operate in a market-based economic system. Breaking up banks can create its own problems (indeed, many TSEs began by creating overly specialized banks from the initial monobank system). Breaking up banks along regional or operational lines may produce institutions that are functionally and financially specialized without stimulating competition, and successful reorganization typically requires above-normal managerial oversight for several years afterward.

Governments can facilitate competition and contestability by quickly devising legal codes, legal institutions, antitrust guidelines, licensing procedures, efficient payment mechanisms, and regulatory agencies necessary to support new banks. Some strategists even suggest letting new private sector enterprises and financial intermediaries bloom and grow until they overwhelm large state-owned institutions without necessarily fixing the problems with the state-owned institutions. Although encouraging new flowers to bloom is undeniably important, pruned prosperous country entrants have some system. Existing bank dictates to issue create a hard budget enjoy greater conflict until existing bank distinguished, the plan

Bank Reform: Privatization

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Demonstrable horizon in operations. For state-owned be could be privating a private, initiate this process coping with the emerging private state banks.

A Role for Foreigners

Foreign banks process. Their of financial s
important, pruning and rehabilitating existing structures may create a more prosperous country with a climate more hospitable to new entrants. New entrants have some significant advantages over the remnants of the monobank system. Existing banks are burdened with nonperforming loans and political dictates to issue credit to large enterprises. However, state-owned banks do not face a hard budget constraint, may confront easier tax requirements, and may enjoy greater confidence on the part of depositors than private banks. Thus, until existing banks are privatized and debts inherited from socialism are extinguished, the playing field is unlikely to be level.

Bank Reform: Privatization

Highly centralized banking systems must be broken down before they are privatized to avoid creating monopolies. Replacing highly concentrated state ownership with highly concentrated private ownership is unlikely to advance the cause of financial reform much. In the interim, investment trusts or independent boards of directors could be set up to establish targets for financial performance and incentives for managers that (with stated exceptions) mimic those of privately owned banks. Once banks have been restructured, efficiency and stability could be encouraged by privatizing some state-owned banks.

With unseasoned supervisory, regulatory, and licensing procedures and institutions, privatization of existing banks should proceed with caution. Nonetheless, authorities should begin privatizing the banking sector early even if implementation proceeds slowly. There is much to be done: at the beginning of 1992, private bank assets as a percentage of total bank assets were less than 5 percent in Bulgaria, the former Czechoslovakia, and Romania and were only 10 and 14 percent, respectively, in Hungary and Poland.

Demonstrating that privatization and increased competition are on the visible horizon may give remaining state-owned banks an incentive to improve operations. For example, some banks could be restructured, so that a few small state-owned banks are relatively unburdened with bad loans. These banks could be privatized early to establish the government's commitment to supporting a private, market-oriented financial system. The government should initiate this process even while considering more comprehensive approaches to coping with the inherited problem of bad loans. With such a strategy, the emerging private sector could be served by new banks and some privatized state banks.

A Role for Foreign Banks

Foreign banks and other financial institutions can be crucial in the transition process. Their skills and experience can be used to upgrade quickly the quality of financial services available to domestic firms (and households) and to local
bankers. The costs are, first, the potential political liability if foreign institutions earn substantial profits or gain excessive market share; second, the weakening of domestic banks' portfolios to the extent that foreign banks attract the best credit risks in the country; and third, the possibility that foreign banks might be more inclined than domestic banks to retrench in bad times. Most governments resolve these issues in favor of some foreign participation in banking, either as branches, subsidiaries, or joint ventures.

In Viet Nam wholly owned foreign subsidiaries and branches and joint venture banks are taking the lead in providing training to staff of the existing state banks. The historical ties and growing economic connections between Eastern and Western Europe suggest that substantial penetration by foreign banks is possible. Indeed, by the end of 1991, twenty-one joint venture banks with some foreign participation were already operating in Hungary. Furthermore the massive wave of privatization envisaged in the TSEs will substantially increase the need for the services foreign financial institutions can provide. Allowing foreign or joint venture banks an important role may be necessary if privatization is to advance rapidly.

*The Function of Nonbanks and Capital Markets*

In a highly risky environment, where banks that issue loans are reluctant to finance emerging firms, the decision by most TSEs to allow banks to purchase equity in firms increases the potential return (and risk) from financing risky ventures. Nonetheless, policymakers should assert prudential control over this process, because close ties between banking and industry have often had disastrous consequences, as they did in Chile in the 1980s. Most banks in TSEs are still learning the basics of commercial banking and, in addition to acquiring good debt, may acquire bad equity as well.

Nonbank financial intermediaries, such as mutual funds, pension funds, insurance companies, investment banks, and venture capital funds, may be increasingly important in evaluating projects, financing enterprises, and monitoring managers. For example, privatization in the former Czechoslovakia involved the distribution of vouchers to the public to bid on enterprises. But, after the Harvard mutual fund and then other mutual funds "guaranteed" tenfold annual returns, most citizens gave their vouchers to mutual funds to bid on enterprises. Mutual funds quickly became enormously powerful, with major responsibilities for appointing and monitoring boards of directors, and the managers of the major funds turned out to be the two major banks. Thus, the structure of the financial system changed in short order, with economic power increasingly concentrated in two banks. Policymakers need to anticipate such developments and adopt regulatory guidelines and enforcement mechanisms to oversee the range of financial market activities likely to evolve.

Many TSEs in Central and Eastern Europe are moving quickly to establish securities markets. As well as facilitating corporate capital financing through public offerings, banks by increasing the availability of funds after large-scale privatisations, making it easier for individuals to enter the capital market (see Pardy 1992) and financing investments, they also require well-funded payment systems.

*Financing Policy*

Should governments be involved in the provision of finance to either directly or indirectly by provision of guarantees or partial equity financing? Some state-owned commercial banks remain banking skill demanding businesses.

Financing policy issues. In the 1990s, especially in transition economies, it is often strongly necessary to promote a mixed economy. While future payments on financial obligations may be uncertain, new financial institutions may be created with the aid of new financial instruments and intermediaries. Many...
public offerings, these markets provide financial services that complement banks by increasing the liquidity associated with holding equity, making it easier for individuals to hold diversified portfolios and to adjust their portfolios after large-scale privatization occurs. Securities markets may also contribute to the evolution of mutual funds, investment banks, and venture capital firms (see Pardy 1992). Thus, the financial services and institutions fostered by equity markets are important complements to bank funding and retained earnings in financing investment. By the same token the burgeoning capital markets require well-functioning banks, so that even public policies whose principal aim is to nurture capital markets should concentrate on creating a sound banking system.

Financing “Priority” Firms

Should governments fund specific industries or set credit guidelines for financial intermediaries?

Large state enterprises are large employers, and governments will likely be involved in their financing and restructuring. Government can provide credit either directly or through specialized institutions. In the interests of accountability and of keeping the balance sheets of state-owned banks from deteriorating further because of political considerations, the government should not require either the state-owned banks that are to operate on commercial principles or private banks to finance state-owned enterprises. Explicitly separating commercial from noncommercial credit decisions—for example, by having some state-owned banks lend to the state-owned enterprises—should enhance banking skills, incentives, financial discipline, and the ability to privatize the remaining banks.

Financing emerging enterprises in the private sector raises another set of policy issues. In a high-risk environment banks may retrench, especially from providing long-term capital, just when firms most need financing. And banks are rarely an important source of finance for start-up firms, who usually rely (often exclusively) on retained earnings. Long-term finance has thus been lacking, even in Hungary, which began reforms much earlier than other transitional economies (Vittas and Neal 1992). In addition, decisions on current loans are often strongly influenced by past loans and government guarantees, rather than by future profitability. TSE governments moving away from excessive involvement in economic activity may be reluctant to impose directed credit guidelines on financial intermediaries, but they could spell out a schedule for reducing the proportion of total credit extended to state enterprises. This approach would prevent new private sector firms from being crowded out and would set a deadline for decisions to restructure or privatize. If directed credit schemes are used for new firms, government interference in credit decisions should be transparent and broadly based and should allow banks discretion in choosing customers. Many of the steps mentioned in discussing reform of the financial

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infrastructure will make the financial statements of local firms more transparent and accurate, which in turn will mitigate some of the informational problems that impede the provision of bank credit to emerging enterprises. Last, it is worth noting that in Hungary the resolution and restructuring of old debts is interfering with banks’ current endeavors to make loans to emerging firms. So far, the Hungarian government’s principal problem is not determining where to direct credit, but how to deal with the large inherited stock of debts.

Restructuring the Financial Sector

McKinnon (1991) takes the view that, because of problems of moral hazard, inherent risk, and insufficient supervision, all corporations should be financed through retained earnings and equity in the early stages of transition. He would also leave the privatization of banking until the reform process is complete. We agree that the environment is risky but would eschew his extreme position of banning debt finance, in part because the examples of financial systems that have relied solely on self-finance and equity are so few (McKinnon cites rural China in the 1980s and the Soviet Union during the 1920s). The absence of debt finance would probably limit investment and restrain growth, and without more rapid growth the entire reform process is in jeopardy. Moreover, TSE governments, in their desire to emulate the German-European universal banking model, may well be chary of a system without “real” banks.

An alternative would be to establish high ratios of risks to assets—15 to 20 percent or higher—to allow for the riskiness of the environment. A high capital ratio would automatically limit the number of commercial banks to be supervised, an important consideration for nascent supervisory systems. Such a ratio would also achieve the goal of a low leverage rate for nonfinancial firms. Similarly, as Caprio and Summers (forthcoming) argue, limiting the number of banks is one way to increase the franchise value of bank licenses. Preserving the franchise value of their banks then creates an incentive for bank managers and owners to operate prudently and effectively. Unaided by such self-monitoring, bank supervision alone might not ensure sound banking practices, particularly in TSEs. Governments can either hand out a limited number of licenses and allow the owners to accumulate substantial pools of assets to serve as a source of funds for new investment (as was done in the United States in the early 1800s), or charge a fee for admission, either by high posted capital requirements or by auctioning off the limited number of licenses. A special case of the franchise value or high capital option is discussed by Long and Talley (1993), who propose issuing a special class of bank license to a few banks as a way of gradually increasing the soundness of the Russian banking system.

Another extreme solution to the risk problem would be to set 100 percent reserve requirements. This approach, often dubbed the narrow banking model, would permit “banks” only to collect deposits and invest funds in short-term, low-risk instruments. Nonbanks (in common parlance, banks in every respect but title) would be market mutual funds. These nonbanks with capital ratios of banks. They would not be higher if the nonbanks (such as checkable or non-interest-bearing government deposits) could be part of the system, safeguarding the payments system.

A drawback of this approach to all debt finance, short-term paper, and greater than the hole in the reform process, for narrow bank deposits in narrow firms is the price of risk aversion, not less of what they then if they fail. So a narrow banking system would be...

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but title) would be permitted to take deposits or equity shares (such as money market mutual funds) and make loans or hold equity positions in nonfinancial firms. These nonbanks would still need to hold capital and to be supervised, with capital ratios and supervision increasing according to the proximity of instruments to the payments system. That is, capital and supervision should be higher if the nonbanks are permitted to offer fixed-rate, checkable deposits than if they only offer equity-like claims, such as money market mutual funds (checkable) or noncheckable mutual funds. With banks essentially risk free, the government should not rescue nonbanks that get into difficulties. Indeed, these nonbanks could be restricted from calling themselves banks. Only banks would be part of the clearing system, so this alternative has the advantage of safeguarding the payments mechanism.

A drawback of this option, which is close to McKinnon’s proposal to ban all debt finance, is the risk faced by banks if they are allowed to hold even very short-term paper of supposedly safe nonbanks or enterprises. Clearly, the greater the holdings of such paper, the greater the need for capital. Early in the reform process, only government paper might qualify as a potential asset for narrow banks. But, if citizens are risk averse—and demand for guaranteed deposits in narrow banks is consequently high—then small- and medium-scale firms in the private sector will be starved for funds. And if citizens are not risk averse, nonbanks will get bigger, and large financial institutions—regardless of what they are called—tend to become eligible for government bailout if they fail. So this solution may merely transfer rather than resolve the problem. High capital requirements, or tight entry limits and highly profitable banking, appear to be the more promising solutions.

Bad Loans, Official Guarantees, and Interenterprise Arrears

Many state-owned enterprises in TSEs are sustaining huge losses. These enterprises cannot service their bank debts without receiving new bank credits, and, when the funds are not forthcoming, they simply do not pay suppliers. Coping with large, loss-making, state-owned enterprises is the most difficult economic problem facing TSEs.

The size of the bad loan problem is hard to estimate precisely but appears to be very large in most TSEs. Estimates from selected audits in several Eastern European countries suggested that as little as 20 to 25 percent of total bank loans had a good probability of being repaid as of 1991. More serious than the stock of bad loans is the continuing flow of loans from state-owned banks to loss-making, state-owned enterprises, the growing use of implicit and explicit government guarantees to encourage banks to fund priority firms, and the ballooning of interenterprise arrears. Moreover these arrears typically do not net to zero: firms with negative value added—those using resources to produce output that is virtually unsalable—use arrears to cover their losses with little hope of ever repaying.

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Microeconomic Implications

The inherited stock of bad loans, new loans to loss-making enterprises, and growing interenterprise arrears are impeding improvements in bank efficiency and distorting the allocation of credit. Instead of concentrating on establishing business relations with emerging private firms, banks are busy issuing credit to troubled firms to help them pay wages and service old debts. At the same time, having to cope with their banks' insolvency is diverting bank personnel from undertaking more profitable operations, such as learning to compete for deposits, assess credit risk, exert effective corporate control, and create useful financial instruments for clients. Furthermore the unresolved state of old debts and interenterprise arrears, their potential seniority to new debts, and the difficulties they introduce in attaching secure collateral claims for new loans hinder efficient allocation of capital. And, because interenterprise arrears essentially are involuntary loans extracted by borrowers, which can only be countered by demands for payment at delivery, they represent a particularly inefficient form of credit that inhibits sound capital allocation.

A further disadvantage of large, loss-making, state-owned enterprises is that they complicate the task of establishing sound bank supervision and regulation in TSEs: the size of nonviable banks makes it hard for regulators to close them down, political pressures on the state-owned banks to lend to specific enterprises may conflict with sound regulations, and standard capital adequacy requirements cannot be applied to major banks because the net worth of the banks is often negative. Inadequate supervision and regulation can increase uncertainty about the financial system, create more unstable financial institutions, and thereby reduce the provision of crucial financial services.

Finally, the bad debt problem complicates and delays bank privatization. Assessing the market value of bank assets is fraught with uncertainties, and the negative net worth of banks implies, first, that many banks might be quickly liquidated if privatized, and second, that new owners with little capital at risk might engage in extremely risky ventures that could magnify losses. Furthermore, in addition to lowering the value of enterprises, the large stock of bad loans may complicate and politicize the privatization process. Domestic and foreign investors will have incentives to lobby the government to assume responsibility for past debts, which may produce case-by-case government involvement in managing enterprise debt and introduce delays and uncertainty into the privatization process. Privatizing existing state-owned banks (which compose the bulk of the financial system in these countries) in their current state could jeopardize the stability of the monetary and payments system.

Macroeconomic Implications

Macroeconomic stability in the TSEs will depend a great deal on how governments respond to fiscal pressures to fund the existing stock of bad debts in

the banking system and settle interenterprise arrears or cut expenses. Actual or contingent tax pressure on government budgets (as in Fiji, Yugoslavia), bad government guarantees, or large, undisclosed quasi-fiscal revenues or cut expenses (as in Russia) can create significant macroeconomic problems. These macroeconomic problems may require fiscal adjustments that are difficult to implement in the presence of uncertainty, with the authorities' ability to provide fiscal stabilizations constrained by their ability to raise revenue or reduce spending.

Resolving the Crisis

None of the measures described is very attractive because of the cost of reaching and implementing them. Furthermore, many of them, such as privatization of state-owned enterprises, are dependent on a stable macroeconomic environment. One option is to privatize quickly (where possible) and then deal with the value of the assets of bankrupt enterprises. Another option is to restore broad money growth, which could enable a modification of the state's role in the economy, to provide the central bank with a reserve of funds.
the banking system; cover new loans to loss-making, state-owned enterprises; and settle interenterprise arrears. In addition to traditional expenditure and taxation pressures, TSE governments are confronted by substantial uncovered actual or contingent liabilities of the public sector, often described as “quasi-fiscal” activities, such as large foreign exchange debts (Hungary, Poland, and Yugoslavia), bad debts of commercial banks, unfunded pension liabilities, and government guarantees for loans to large state enterprises. These obligations are large, and the threats to macroeconomic stability substantial; as explicit or quasi-fiscal revenue requirements rise, the government will have to raise revenues or cut expenditures to fund them. On the margin, countries often resort to printing money to satisfy large fiscal obligations. Many countries (for example, Russia) have experienced inflation rates that run above 20 percent a month as authorities attempt to monetize state responsibilities.

These macroeconomic developments have correspondingly important implications for the financial system. Growing fiscal revenue requirements increase uncertainty, which lowers productive investments; inflationary finance combined with rigid interest rates distorts prices; and large revenue requirements, especially in the absence of a well-developed formal taxation system, may encourage explicit or implicit taxes on financial market activities. All these impede the emergence of financial services and retard development of the financial sector. All sectors will have to bear the costs of adjustment, but the formal financial sector is an easy—although not necessarily an optimal—target for raising revenue.

Resolving the Problem of Old Bad Debts

None of the strategies for coping with large insolvent state-owned banks is attractive because they all involve the recognition and assumption of losses. Furthermore, the issue is not simply that there is a backlog of bad debts, but that continuing losses in the enterprise sector and an underdeveloped financial infrastructure may build up a new stock of bad debts, as has happened in Bulgaria, Poland, and Romania. Nonetheless, a cost-effective way to eliminate old bad debts must be sought as a first step toward formulating forward-looking financial sector reforms.

One option is to “tax” deposits. This tax could take many forms, from simple expropriation to inflation. In Bulgaria, Poland, Romania, and Yugoslavia (where government deposits in banks temporarily played an important role in restoring bank solvency), and more recently in Russia, inflation has lowered the value of deposits. As figure 1 illustrates, monetary depth—the ratio of broad money (currency plus demand deposits plus time deposits) relative to gross domestic product (GDP)—declined sharply when inflation accelerated in Romania and Russia in 1992. Because most TSEs have already reduced financial depth through inflation, even higher inflation rates would be needed to activate this source of revenue.

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A variant of the deposit tax strategy is a deposit-equity swap, which transforms a large fraction of deposits into equity claims on the bank. This device might encourage bank privatization but, if it is obligatory, it will raise questions of fairness, reduce confidence in the financial system, and depress the money supply without improving bank performance.

A second variant, the debt-equity swap, replaces bad bank assets with equities in the enterprises. One outcome, given the size of the bad debt situation, would be that banks would acquire very large shares of the enterprise sector—and it might be better for them to concentrate first on building banks, not enterprises. Furthermore, acquiring equity in nonviable firms does not resolve bank insolvency (put more succinctly, bad debt equals bad equity).

The most common approach to resolving the bad debt problem is the debt-bond swap—replacing loans with government-backed assets, such as bonds, guaranteed mortgages, or claims on privatization funds. But under current conditions it is difficult to distinguish bad loans from good loans, and the case-by-case, debt-bond swaps might politicize the process and create expectations of future government involvement. Levine and Scott (1993) suggest that the effect on the fiscal situation depends on the privatization process. If firms are sold to the public, a grand debt-bond swap is unlikely to increase the need to raise revenues significantly, whereas if shares in firms are simply distributed to the public, more revenues will have to be raised through traditional fiscal channels to satisfy the larger stock of government obligations.

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We suggest that balance sheets should be cleaned on the eve of privatization. If an enterprise is sold to the public, all its debts to state-owned banks should be absorbed by the government. The enterprise would then start its private life free of debt, its valuation by the public would be easier, there would be fewer pretexts for government assistance following privatization, and the government would receive larger bids for the enterprise during privatization because the firms have fewer obligations to banks. If the government gives the firms away by distributing shares, then the need to raise revenue would rise by the value of the "good" debts—those debts that would actually be repaid to state-owned banks. Levine and Scott (1993) show that, because good debts apparently represent a fairly small fraction of total debts, the fiscal costs of the government assuming debts on the eve of privatization are small, and the efficiency gains large. But bank balance sheets should be cleaned only as a precursor to privatization. Injecting capital without fundamental changes in the bank only sets the stage for another round of losses.

**Resolving the Problem of New Bad Debts**

Coping with the flow of resources to inefficient state firms is crucial for the development of the financial sector. Therefore, although the broader issues surrounding the restructuring and privatization of state-owned firms are outside the scope of this article, some points need to be raised here about reducing the flow in relation to financial sector reform.

First, simply stopping the flow of bank credit to unreformed state enterprises will not staunch their losses, but only transfer the bad debts to suppliers, so that growing interenterprise arrears contaminate otherwise healthy firms and impede financial and economic reforms. Because the government is ultimately responsible for the losses, this shell game may obscure the problem but in no way resolves it. The problem of loss-making, state-owned enterprises can be resolved only by reforming or closing the enterprises.

Second, closing down loss-making firms will not immediately resolve the macroeconomic problems they cause. In most cases the government will cover at least part of the costs of unemployment and retraining. Loss-making firms are large, so the costs of the social safety net will probably also be large. Figure 2 shows some scenarios for explicitly covering these transition costs under simple assumptions about the percentage of loss-making firms (those not covering variable costs with market prices), the replacement ratio (fraction of wages replaced by unemployment benefits), and the unemployment bill. We assume the wage bill equals 60 percent of GDP, a rough figure for many industrial economies, and that replacement ratios are high (60–80 percent of average wages, as is now the case in Eastern Europe). Three cases are considered: in case 1, 10 percent of the labor force is in loss-making firms, and the replacement ratio is 60 percent, at the low end of the current range in TSEs. Case 2 assumes a higher percentage (20 percent) of loss-making firms (as measured by the labor force),

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but with the same replacement ratio, while case 3 pairs the high percentage of loss-making firms with a higher replacement rate (80 percent).

The resulting deficits (4–10 percent of GDP) represent the costs of unemployment benefits—or the amount of subsidies paid to keep the plant open. We assume other budget expenditures are covered by revenues. These deficits represent a threat to macroeconomic stability, financial development, and economic reform. Thus, reducing expenditures on loss-making state firms must be coupled with encouraging the development of profit-making firms if TSEs are to become successful market economies. Allowing and supporting the development of the financial sector will bolster this effort.5

Third, financial reform should be well coordinated with the reform of enterprises. For many years there will be two economies—a growing private sector and a shrinking state sector—which might best be served by a correspondingly segmented banking system. One could envisage market-oriented banks serving both sectors, but a more plausible model is for the old state bank sector to be wound down or converted in line with the state enterprise sector, while new private banks and privatized parts of the state banking sector could serve the private sector. In the same vein enterprise reform should be paced with due regard to the state of the financial system. If the financial infrastructure can support only a limited private financial system, then the pace of reform should reflect those limitations.

To reduce the funding of loss-making firms and strengthen incentives for financial development, governments should explicitly recognize the size of enterprise losses and bear them. Although bank books is only at 50 percent and they are incurred in government institutions, they must be included in the current loan losses. The loan losses must be more readily transparent and transparently recognized.

Finally, because the system should be expected financial restrictions on deposits have the potential to limit financial sector activity. Therefore, ceilings on deposits and participations meant for the costs of financial intermediation are crucial to economic growth.

### Figure 2. Costs of Closing Loss-Making Firms in Reforming Economies: Some Alternatives

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- Loss-making firms (percentage of total firms)
- Replacement ratio (percentage of prior wage bill)
- Unemployment bill (percentage of GDP)

Source: Authors' simulations.

Interest Rates

In most monetary systems, interest rates are determined by the market. Many economiesexplicit or explicit—provide for ceilings or ceilings on interest rates to attract deposits at the expense of bankruptcy.
prise losses and take responsibility for those losses instead of trying to hide them. Although moving items from balance sheets to the government’s official books is only an accounting exercise, recognizing losses and obligations when they are incurred may induce measures to curb their growth. For example, if governments issue a liberal supply of loan guarantees to avoid current expenditures, they merely defer the actual outlay. Prompt inclusion of loan guarantees in the current budget could limit the proliferation of loan guarantees by revealing probable liabilities. Similarly, if authorities immediately recognized the loan losses of state banks as a claim on the budget, then governments might be more ready to limit loans to loss-making, state-owned enterprises. Explicit and transparent recognition of losses would also reduce uncertainty, to the advantage of both the financial and nonfinancial sectors.

Finally, because requirements for fiscal revenue will be high, the financial system should not be exempt from taxes. But taxes on the financial sector should be explicitly compared with alternative revenue options, because restrictions on development of the financial sector may stymie economic growth (see King and Levine 1993, and Schiantarelli and others forthcoming). As seen in figure 1, the decline in broad money, relative to GDP, in Bulgaria, Poland, Romania, and Russia has already been large, and there is no clear evidence of any remaining monetary overhang, as broad money is at or below what would be expected for countries of equivalent per capita incomes. In other words, depositors have already been taxed. Another example of large taxes on the financial sector are the limits set by Vietnamese authorities on deposit rates and maximum loan rates in 1992. Although the spread (13.7 percent) appeared generous, turnover taxes and high, essentially non-interest-bearing reserve requirements meant that the net spread was actually negative even before accounting for the costs of mobilizing deposits and lending them out. Excessive taxation of financial activities will impede the provision of financial services that are crucial to economic reform.

Interest Rate Policy

In most markets the argument for liberalizing prices rapidly is clear cut. But one price that should be dealt with carefully is the intertemporal price of money. Many economists view interest rates as just another price, but both the intertemporal nature of interest rates—in effect, an exchange of money now for the promise of money later—and the involvement of government through implicit or explicit deposit insurance, should give policymakers pause. The principal risk from premature attempts to liberalize interest rates is that, without ceilings on the rates, banks with little capital would bid up deposit rates to attract deposits as a way to fund continued loans to risky borrowers at the expense of worthier, safer ventures. Such practices would lead eventually to bankruptcies and a collapse of the banking system. The Chilean reforms of the

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mid-1970s and Turkey's liberalization in the early 1980s, often cited as examples, entailed reported (ex post) real interest rates of 20 to 50 percent (and even higher in some cases) that were sustained for long periods. Bankruptcies also soared, particularly in Chile. Furthermore, high real rates may serve little purpose in TSEs: until state-owned enterprises (often monopolies) respond to competitive market signals, they will either pass on such costs or simply not pay.

In general, full liberalization of interest rates should be considered when

- Macroeconomic conditions are reasonably stable
- The financial condition of banks and their borrowers is sound
- Financial markets are reasonably sophisticated
- Financial markets are sufficiently competitive or contestable.

In some of the TSEs, none of these criteria is met. Controls on interest rates should be maintained wherever there is no control or market incentive system at the level of the firm; otherwise, risky or loss-making firms will not be eliminated from bidding for credit no matter what the interest rate (Dooley and Isard 1991). In Hungary (and Egypt, also in effect a TSE) indirect methods of monetary policy implementing through treasury bills are in use and appear to be working well, and many rates (those not associated with directed credit) are essentially driven by the market.7

Authorities in countries not yet ready to liberalize interest rates can try to rationalize their structure—that is, eliminate the largest interest subsidies—and aim for positive real rates. Given the difficulty of estimating expected inflation, attaining positive real rates will not be straightforward. Because monetary policy in most cases is being determined by aggregate credit targets, the authorities' main goal is to make sure that deposit rates are high enough to mobilize sufficient resources and that banks are allowed a sufficient spread. Unless a deliberate attempt is being made to erase a monetary overhang by inflation or by a wave of privatization, authorities should at least raise interest rates on very short-term deposits either when overall deposits cease to grow in nominal terms or (preferably) in line with some estimate of inflation. The banks should then be allowed to set remaining deposit rates themselves. Minimum deposit rates could be linked to a central bank discount rate, adjusting automatically whenever the latter varied.

In some TSEs competition is limited, with most borrowers in practice able to borrow only from one or two banks. In these countries a cap should also be considered for the average spread between deposit and lending rates. But the limit should be kept well above the average deposit rate to allow for the financing of projects with a high rate of return as well as to provide for adequate remuneration for banks, who will surely need to be taking liberal provisions on new loans in a risky environment. (This recommendation assumes that the banks' portfolios have already been cleaned; it should not be used to allow banks with numerous nonperforming loans to cover their losses with high spreads on new loans, the consequences of which are elaborated in World

Bank [1989].) A borrowing rate for riskier projects realized that banks commissions or allowed to per

**Concluding**

The argument for economic liberalization of TSEs is important for two reasons. One is the potential of opening to foreign banks and debt markets. The other is the need for inclusive economic reforms.

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Bank [1989].) A limit on spreads between average lending rates and average borrowing rates would provide more flexibility for banks to lend to somewhat riskier projects than an absolute limit on lending rates. However, it should be realized that banks can evade interest rate ceilings (for example, by charging commissions or requiring compensating balances), especially if the limits are allowed to persist.8

Concluding Notes

The arguments in this article are based on the notions that finance is important for economic development, that banks are needed to help with the transition of TSEs to market-oriented economies, and that private incentives are important for financial sector performance. On that basis, our analysis points out the pitfalls of certain strategies and gives a qualified green light to others. One firm recommendation is to end the shell game early in the transition process. It is important to consider the consolidated balance sheet of the government—that is, the balance sheet that includes assets and liabilities of state-owned enterprises and state-owned banks. Loss-making, state-owned firms that remain open must cover their losses through credit from the state-owned banking system, budget subsidies, or interenterprise credits or arrears. In any of these cases, the government—broadly defined—is incurring losses and should explicitly recognize them, rather than hiding them in bank or interenterprise accounts, because early recognition offers the best chance for limiting their growth. The government should assume responsibility for financing loss-making, state-owned enterprises and discourage reforming banks from issuing credit on the basis of nonmarket criteria.

We also suggest a mix of bold steps and caution in reforming existing institutions. Both of the two extreme positions on bank privatization—privatize everything or nothing—are strategically and economically unwise. Bank privatization should begin early, because incentives matter as much in the financial sector as in any other. Demonstrating a commitment to privatization, even by privatizing small banks or branches of banks, will vitalize competition in all financial institutions. Additional competition can be gained by very carefully breaking up mammoth state banks, encouraging the entry of foreign banks, and creating the necessary legal and regulatory environment for nonbanks and capital markets to flourish. Starting the privatization process early should stimulate the availability of financial services, but committing to a “big-bang” privatization of the whole financial sector could be disastrous. In countries with implicit or explicit deposit insurance and a large stock of inherited bad loans, rapid large-scale privatization could overburden existing supervisory capabilities and lead to a financial crisis that impedes the entire program of economic reform. Another mistake would be to privatize parts of the state-owned banking system with a bundle of losses still in existence. Thus, we rec-

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ommend initiating privatization as soon as possible, but in conjunction with establishing a sound regulatory and supervisory system, and immediately after portfolios of existing banks have been cleaned.

A main message of this article is that much of what needs to be accomplished in the financial sector in many TSEs is development, rather than reform. Given the relatively high educational levels in TSEs, strategies that emphasize training and building skills in various aspects of finance and its supervision will yield high returns. Starting and maintaining the long process of building a sound financial infrastructure should be given the highest priority, or the necessary financial services will not be available when enterprises need them. Thus, writing and enforcing laws and prudential regulations, training financial specialists, establishing modern accounting and auditing standards, and operating a sound payments system will encourage the development of market-oriented financial services.

Finally, to promote the long-term development of financial intermediation, governments need to develop their formal tax systems so that they will not have to rely excessively on the financial system for tax collection. To do that TSEs must move as rapidly as possible to a regime of at least near-positive real interest rates and to allowing private intermediaries to allocate credit on market terms. The state may not be able to remove itself completely from setting interest rates or allocating credit for some years to come, but it is important to reduce taxation of the financial sector so that formal sector financial intermediaries become a more attractive place for mobilizing savings and allocating it on rational, market-based criteria.

Notes

Gerard Caprio, Jr., and Ross Levine are with the Finance and Private Sector Development Division, Policy Research Department, at the World Bank. This article has benefited from comments from Farid Dynani, Alan Gelb, Millard Long, Diana McNaughton, Dan Mozes, Robert Pardy, David Scott, Andrew Sheng, Larry Summers, Samuel Talley, and Dimitri Vittas. Nonetheless, responsibility for views expressed herein lies solely with the authors.

1. For example, Mayer (1988) argues that bank-based systems, such as those found in Germany and Japan, do a better job of monitoring loans because they have closer links to their clients than do the more market-based systems of the United Kingdom and the United States. Others debate the comparative value of debt and equity in allowing funding units (principals) to control the borrowers (the agents).

2. Direct foreign investment, trade credits, and foreign loans may help fund corporate capital formation, but these matters are outside the scope of this article, which discusses international finance in the context of foreign financial intermediaries establishing or undertaking cooperative ventures with domestic financial institutions in TSEs.

3. If residents are quite risk averse, the interest rate on government paper might fall to zero, or below. For a discussion of narrow banks in a U.S. context, see Lawrence (1985), Lawrence and Talley (1987), and Litan (1986).

4. The debt problem appears to be smaller in Viet Nam, and may also be small in China, as a consequence of the superior macroeconomic climate.

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5. In Viet Nam neither arrears nor bad debts have developed on the scale experienced in Eastern Europe and the former Soviet Union for two reasons. First, a large proportion of workers' pay consists of bonuses. These bonuses are paid only when there are profits after paying bank debt and suppliers. Thus, wages directly reflect firm efficiency. Second, a system of committees has exerted relatively tight oversight of corporate governance regarding interenterprise arrears and bank obligations.

6. Monetary overhang—that is, excess supply of money given per capita income and other determinants of money demand—often result from the involuntary savings in many socialist countries that occur when goods are rationed.

7. In some countries, such as Romania, interest rates supposedly were liberalized but in fact were adjusted little, implying that these concerns are overstated. Actually, however, the central bank stopped setting rates but limited the average spread that banks could earn. The locus of authority for setting the structure of rates shifted to the state savings bank, which controlled about 70 percent of total deposits. The lending banks were able to borrow funds directly from the savings bank at rates far below the central bank’s refinancing rate and then pass on funds to borrowers at rates constrained by the cap on spreads. So complete deregulation did not occur.

8. In China this type of administered interest rate policy has been followed with mixed results. The main success has been in the field of deposit mobilization, attributable in part to the maintenance of realistic deposit rates. Average real deposit rates were, with one exception, slightly positive in real (ex post) terms between 1970 and 1984 and have returned to positive levels following their drop in 1988–89. The absence of substantially negative real interest rates likely played a role in maintaining China’s high savings rate. However, the authorities allowed only a very narrow spread (sometimes negative) between deposit and lending rates, and continue to allocate credit, thus contributing to a misallocation of resources, albeit one that is difficult to measure.

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