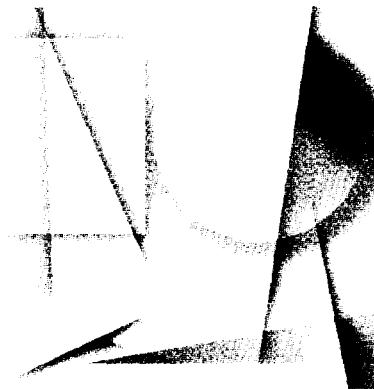


Building a Financial System



Markets spur economic efficiency by allocating resources to their best uses, in response to supply and demand. A good system of financial markets and institutions is integral to this process, allocating savings to high-return investments. Worldwide experience confirms that countries with well-developed financial systems grow faster and more consistently than those with weaker systems and are better able to adjust to economic shocks. Transition implies vast reallocations of resources and ownership, a task at which effective financial systems could help enormously. Yet financial systems in transition economies start out in no fit state to help, with passive state-owned banks, often distressed, with limited capacity to assess credit risk, and an absence of financial regulation, key supporting institutions, and capital markets.

Reformers seeking to address these failings face a particularly thorny version of a common transition problem. The success of other market reforms depends on the health of the financial system; yet efforts to reform it cannot proceed independently of those other reforms, especially macroeconomic stabilization, enterprise reform, and the development of supporting legal institutions. Often transition countries respond to this dilemma with inaction, with the result that financial reforms lag behind.

The challenge for reformers is to find ways to help the financial system overcome the legacy of central planning, while at the same time sowing the seeds of a new system in which banks and other financial institutions will have to stand on their own two feet. The choice of approaches to banking reform brings this problem into stark relief. Should reformers use government funds to rehabilitate heavily overindebted state banks, and run the risk of their always coming to expect government bailouts? Or should reformers start afresh, encouraging the rapid entry of new banks and possibly the liquidation of old ones? Experience in transition economies to date provides evidence with which to assess both strategies and draw some tentative

lessons for future reform. Whichever approach—or combination of the two—countries follow, one clear lesson is that governments have a vital role in promoting the development of a stable financial sector and regulating it over time. That role does not necessarily extend to the direct allocation of financial resources, even though governments in transition economies can face strong pressure to intervene, particularly in the rural sector. Another lesson is that developing a financial system takes time. Reform must seek ways to nurture a system of banks, nonbank intermediaries, and capital markets that will evolve not in response to government dictate but to the changing needs of the market.

The legacy

Under central planning, banks were mere accounting agencies, passively taking in household deposits (which were often the only asset households could hold) and keeping track of the financial transactions that corresponded to allocations under the plan. Indeed, in China the credit plan still covers a large part of investment and remains an important lever of government policy. Normal banking skills, including risk management, project screening and selection, and a diversified menu of instruments to attract savers, were unknown. The other components of a financial system—including the payments system itself—were rudimentary; in most countries nonbank finance simply did not exist. Initially, one bank performed all lending. Early attempts at market reform in most countries replaced this monobank with a two-tiered system, comprising one central bank and a number of commercial banks, often specialized by sector. But this reorganization had little effect on banks' behavior.

Transition has shown up the tremendous weaknesses of the inherited banks. In CEE and the NIS many bank loans turned bad, as their traditional clients, the state enterprises, were exposed to competition. During the early stages of

reform many banks continued to extend new loans to unprofitable enterprises. Unpaid interest and principal were rolled over, increasing dramatically the banks' stock of nonperforming loans—which sometimes amounted to most of their portfolios—and crowding out good borrowers. Even in China, where economic growth has been rapid and lending rates are below inflation, 20 percent of loans are officially recognized as nonperforming. Eventually these financial flows from banks to enterprises dried up, as stabilization took hold in almost all CEE countries and many NIS. In some countries high real lending rates caused net transfers (net new lending minus real interest payments) from enterprises to banks, instead of vice versa. In many NIS the flow of resources to enterprises simply stagnated: old loans continued to be rolled over but few new ones were made, so that net transfers in either direction were small. In China, by contrast, high household savings deposited with the banks have allowed substantial net transfers to enterprises to continue (see Chapter 2).

Many banks in CEE and the NIS currently limit their role to financing trade and some working capital, making negative contributions, or none, to enterprises' aggregate investment. The near-universal reluctance to lend for investment reflects in part the strains of stabilization, but also the banks' increased perception of both the risk of lending and the absence of effective means of recovering debts. Although bank lending has started to rebound and maturities have lengthened in some of the more advanced reformers, in most countries good firms have little access to bank financing, and that at very short maturities. The privileged access to financing that large state enterprises in many countries continue to enjoy is yet another financial barrier to the emergence of new private firms.

As already noted, the evolution of financial systems has also been heavily affected by the pace of legal and enterprise reforms. Banks rely on the legal system, including procedures for collateral recovery and bankruptcy, to enforce their claims and perform their role as monitors of firms. Capital markets require company laws to define the rights of shareholders of joint-stock and limited-liability enterprises and allow them to exert their influence on management. More progress in these and other economic laws is needed to make financial systems more effective (Chapter 5). Enterprise reform, including privatization and the entry of new private firms, is needed to resolve the bad loan problem and create new lending opportunities. Better firms also generate demand for better banking services and so advance institutional progress. Demand forces are strong in CEE and some NIS and have led to considerable improvements in the quality of banks. China's limited state enterprise reform, on the other hand, has delayed commercialization of its state banks. In the Baltics and the NIS, state enterprises have established

new or acquired parts of old banks. This carries risks, but governance of these banks has tended to improve with the privatization of the parent enterprises, greater diversification of ownership, and the introduction of prudential controls to limit lending to owners.

Approaches to banking reform

Transition countries have two main tasks in approaching banking reform. The first is for each country to develop its central bank into an institution that independently formulates and conducts monetary policy. Evidence from transition economies confirms the worldwide finding that greater central bank independence, including the right not to finance the government and to set interest rates without government interference, is associated with lower inflation and more effective monetary policy. All transition economies have established basic instruments and procedures of monetary policy, although their effectiveness varies across countries, in part because interbank payments systems are often still poorly developed. Building them up is essential to creating a market-based financial system. Central banks have often also played a constructive role in formulating general macroeconomic and fiscal policies. In China, however, more reforms will be needed to make the central bank an effective player in monetary and supervisory policy.

A much larger and more complicated task is to address the weaknesses of the commercial banks. Responding both to initial conditions and to developments early in transition, countries' approaches to banking reform have been based on either entry of new banks, rehabilitation of existing banks, or (usually) some combination of the two. Some countries, however, have yet to choose a consistent financial reform strategy. The new entry approach involves the entry of a relatively large number of new banks, the breakup and privatization of state banks, and in some cases the liquidation of old banks. Estonia and Russia have both taken this path, although not always as a strictly deliberate policy choice. In many of the NIS, the confusion surrounding the breakup of the Soviet Union created an environment in which many new banks emerged spontaneously (Box 6.1). The alternative, rehabilitation approach, adopted by Hungary and Poland among others, stresses recapitalization of existing banks, together with extensive programs to develop them institutionally and to privatize them as soon as possible.

Two factors largely determine each country's approach to banking reform: the depth of the financial system (the ratio of financial liabilities to GDP) and the institutional legacy. During the late 1980s, financial depth was similar across the transition economies. But their different experiences with inflation—and the collapse in confidence in financial assets in the high-inflation countries—have since caused an equally wide divergence. Money holdings

Box 6.1 Russia's radical banking reform

Following the creation of a two-tier banking system in 1987, Russia's approach to banking reform rapidly—and partly unintentionally—diverged from that of other transition economies. In 1988 a new law permitted the creation of cooperative banks to serve the nascent private sector. Establishment of joint-stock banks became possible with the 1990 banking law, with licensing subject to only minimal requirements. Competition between a reformist Russian government and a more conservative Soviet government led to a separation of Russian banks from Soviet banks and, in Russia, to the breakup of several state banks into independent regional banks. Together these events fueled an explosion in the number of Russian banks: from 5 in 1989 to 1,500 in 1992 and 2,500 in 1995.

Macroeconomic developments during this period created a competitive advantage for these new banks over the old state banks. Lack of fiscal and monetary control led to rampant inflation, and loan balances soon shrank to only a few weeks of production. This provided the new banks with an opportunity to gain market share quickly by providing higher-quality banking services to the newly emerging private sector. The voucher privatization program provided another new business opportunity, as many banks invested in enterprises directly or lent to other investors buying shares. As a result the share of the new banks in total banking system assets has risen sharply, to more than two-thirds as of early 1996, with the three remaining state banks holding the rest. Some of the larger new banks have rapidly become the country's leading commercial banks, with balance sheets of \$1 billion to \$3 billion. They move quickly into new business lines and

financial products, and quite a few are at the center of emerging financial-industrial conglomerates.

The banking industry's main problems are the large number of poorly capitalized and badly managed banks and an associated severe lack of transparency. As stabilization has taken hold in Russia, the environment for banking has become more difficult. A third of Russia's banks reported losses in 1995, almost immediately after real interest rates turned positive. Although Russia has started to address its bad banks problem by withdrawing licenses and restricting operations, many troubled banks remain. The authorities will need to deal with these banks quickly, in many cases through liquidation, to restore confidence and prevent a major crisis, and to allow resources to be intermediated by the better banks instead.

Increased transparency is another must. Accounting and disclosure standards are still rudimentary, a well-developed auditing profession does not yet exist, and banking supervision remains embryonic. These limitations open the door to fraud and imprudent investment and undermine confidence in the financial system. To address this problem the Russian government, with assistance from the World Bank and the European Bank for Reconstruction and Development (EBRD), has introduced an international banking standards project. Some of the best banks have been selected to on-lend World Bank and EBRD funds to the private sector. In return, the banks must submit to annual audits by international accounting firms and adhere to prudential norms with respect to capital adequacy, portfolio diversification, asset and liability management, and so on. It is estimated that some twenty to forty banks will eventually participate in this bottom-up approach to banking reform.

presently equal 89 percent of GDP in China but average only 42 percent in CEE countries and a mere 20 percent in the NIS (Figure 6.1). With inflation having wiped out bad loans and savings, leaving depositors with little confidence in the financial system, most NIS countries have little to lose by starting afresh. Countries in CEE started out with stronger institutional bases than did the NIS or the East Asian transition economies. This advantage, together with their deeper financial systems and generally better fiscal positions, led most CEE countries to opt for a more phased approach. China's very deep financial system has prompted its government to choose a phased approach for its banking reforms, even though banking skills are relatively undeveloped.

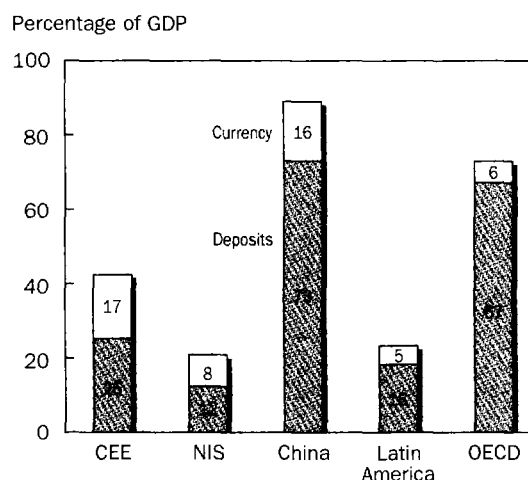
Financial reform with a stress on entry, including entry by foreign banks, can be a good approach for less advanced

countries. Comparison of countries according to the institutional capacity of the better segment of their banks shows that, while the reformers with more entry generally had much worse starting conditions, some have now caught up with the other countries. Progress has been particularly rapid in Estonia and Russia, despite an unfavorable starting point. A period of relatively free entry can thus stimulate decentralized institution building. But confidence can be undermined while the sector undergoes convulsive restructuring and as poor-quality banks spring up. Complementary policies are therefore needed to better screen new bank applicants, to weed out weak banks, and to improve the infrastructure for banking, including through enterprise and legal reform.

The rehabilitation approach has the advantage that it maintains a higher degree of confidence in the financial

Banking systems in transition economies vary greatly in size.

Figure 6.1 Money in circulation



Note: Regional and group data are simple averages of quarterly ratios for 1994 for ten CEE countries, thirteen NIS, twelve Latin American countries, and eighteen OECD countries. Source: IMF and World Bank staff estimates.

system and thus limits financial disintermediation (the tendency for financial transactions to bypass the banking system altogether). The downside is that it maintains a large role for existing state banks. Rehabilitation can also severely undermine banks' incentives to adopt prudent investment criteria, by fostering the expectation that, having bailed out troubled banks once, governments will do so again. In Hungary, for example, some banks have been recapitalized as many as five times. Thus, like the entry approach, a consistent rehabilitation policy requires a good many complementary reforms. These should focus on improving the interim governance of state banks, ensuring a strong commitment to privatization, and, perhaps, imposing certain restrictions on the state banks' activities. Poland started out with just such an approach (Box 6.2), although the privatization side of the program has slowed recently.

Where government should lead . . .

As we have seen, initial conditions are an important consideration in striking the balance between an entry and a rehabilitation approach to banking reform. Some coun-

tries may adopt a mixed strategy, limiting the activities of state banks while a new, private sector banking system develops in parallel. Whichever approach is followed, the crucial factor is the incentives it creates, and these depend significantly on government policies and how they are perceived. Experience to date yields several policy lessons.

Deal with problem banks quickly

Transition creates a difficult banking environment in which sizable loan losses are unavoidable, especially when

Box 6.2 Poland's rehabilitation approach to banking reform

Poland's commercial banking reforms accelerated after 1990. In 1991 the government advised its banks not to make new loans to enterprises that were in arrears on past loans; that restriction became law with the passage of the Enterprise and Bank Restructuring Program in February 1993. The Ministry of Finance required regular audits of all banks according to international standards, thus encouraging transparency and exposing the magnitude of the bad loan problem. The restructuring program further required banks to set up debt workout units and take actions to resolve loans that had been classified as nonperforming at the end of 1991. The program also provided for a new bank-led workout process (see Box 3.1).

Indirect incentives were also used. In 1992 bank employees were given the opportunity to purchase up to 20 percent of their bank's shares at half-price upon privatization. This strengthened incentives to adopt prudent policies with respect to both the workout of existing loans and new lending. Seven banks entered into intensive technical assistance programs with foreign banks to accelerate their institutional development. Experience in Poland and other countries shows that such technical assistance can be a valuable complement to a bank's desire for institutional change but is no substitute for a clear, commercially viable strategy on the part of owners and managers.

Bank recapitalization was implemented in September 1993. The aim was to determine the amount of the recapitalization on the basis of loans that were nonperforming at the end of 1991. This was intended to avoid penalizing banks that had already taken action to deal with their problems, and to maintain incentives for managers to try to keep other loans in their portfolios performing. The program was accompanied by a plan for privatization of the nine treasury-owned commercial banks.

real interest rates rise and firms have trouble servicing their loans. Unless governments act decisively, many transition economies can expect major financial crises to originate from troubled banks and from spillovers of problems at other financial intermediaries. Resolving financially distressed institutions requires three steps. First, financial flows to insolvent banks, whether from the government or from deposits attracted by high interest rates, must be stopped. Too often, troubled banks continue to receive normal or even preferential treatment. In Poland, for example, two state-owned banks specializing in housing and rural finance have poor performance records yet are covered by higher explicit deposit insurance than other banks, allowing them to attract funds at relatively low cost. Second, management, often a primary source of the problem, must almost always be changed. Third, to reduce incentives for excessive risk taking, private shareholders should completely lose their stakes in liquidated or restructured banks. Depositors may also have to bear part of the losses. Countries that have moved decisively in this way have incurred lower costs and restored household confidence faster, even when households have suffered some losses, and have had fewer subsequent problem banks. Estonia approached these problems forcefully in late 1992, and Croatia, Kazakstan, the Kyrgyz Republic, and FYR Macedonia are taking steps to liquidate or drastically restructure weak banks. Many other transition economies, however, still have to come to grips with their problem banks, often because the authority to intervene is missing, or because ad hoc and often damaging forms of intervention are attempted.

Develop effective supervision, screen new entry, and improve disclosure

All transition countries need improved prudential regulation and supervision of commercial banks and other financial intermediaries, including financial-industrial groups and investment funds. Establishing such mechanisms demands a fully independent and market-oriented supervisory agency. Every transition economy now has a supervisory structure in place, either as a part of the central bank or as a self-standing body, and has issued laws and regulations aimed at improving the functioning of the financial system. Much less progress, however, has been made in translating these reforms into effective regulation and supervision. It takes time to train bank examiners and for them to acquire adequate experience; therefore supervision is likely to remain weak in many transition countries for an extended period and will not be able to prevent every banking failure. Supervisors should focus their limited resources on addressing problem banks and non-banks, screening entrants, and improving incentives for banks to adopt prudent practices.

Countries that allow relatively free entry of domestic banks have benefited from increased competition and fast institutional progress; for many, a period of market-driven consolidation of banks and closure of weak banks should reinforce this progress. But these countries also need to introduce high minimum capital requirements, checks on the suitability and integrity of owners and managers, and other formal guidelines to keep out applicants with poor prospects or fraudulent ventures. Even then, supervision will prevent only a few cases of fraud—a cause of many financial crises—and supervisors may lack the political support to intervene. Many warning signals were ignored, for example, prior to the fraud-induced failures of some large banks in the Baltics. Banks also need incentives to act prudently in the absence of adequate supervision. Greater transparency, through better disclosure of bank balance sheets and profitability, will help by allowing depositors, other investors, and bank supervisors to better assess banks' quality. In most transition economies accounting and information disclosure standards for banks—and other enterprises—are far below those in market economies. Supervisors and international agencies need to set mandatory standards, especially on improved classification of nonperforming loans and more realistic provisioning for losses, and require annual audits.

Beware of recapitalizing banks

Large numbers of nonperforming loans and undercapitalized banks can undermine macroeconomic stability, lead to high interest rates, and forestall a decentralized, case-by-case restructuring of enterprises. Some observers have argued for early, comprehensive loan forgiveness to make a clean break with the past. Canceling the nonperforming debt of state enterprises to state banks has no impact on either national or government wealth, or on bank profits or fiscal revenues, but it raises a serious danger that money-losing firms will fail to restructure once freed from the burden of servicing their old loans, and it sends a perverse signal to other borrowers. No country has simply forgiven debts across the board, and in those that forgave debt on a large scale (such as Bulgaria and Romania) unprofitable enterprises continued to borrow rather than adjust. Forgiveness also creates no incentives for banks to develop skills in debt workout and recovery.

A decentralized, case-by-case approach, such as that adopted in Hungary and Poland (see Box 3.1), can be more useful. Banks are held accountable for their problem loans and must take the lead in resolving them. As part of the operational restructuring of individual enterprises and farms, banks can limit new loans and restructure old ones. The strategy works, however, only if banks and the enterprises concerned are properly governed and managed and if banks have enough capital to recognize and make pro-

visions against problem loans. This may mean increasing their capital. As noted above, recapitalizing banks—by injecting cash or bonds, taking over bad loans, and providing other forms of fiscal support—has been an important component of a rehabilitation strategy. But recapitalization is a wise use of taxpayers' money only if it quickly restores the health of the financial system and improves the prospects for bank privatization. Experience elsewhere with recapitalization is mixed. Banks often continue their bad lending policies, resources are frequently squandered or used fraudulently, and recapitalizations often are repeated again and again. Argentina, Chile, and the United States have all undertaken repeated recapitalizations of their banking systems. Recapitalization poses particularly large risks in transition countries. The adverse incentives it gives to already poorly governed state banks tend to be exacerbated by the fact that their privatization—a necessary complement to the rehabilitation approach—has proved difficult, making the endpoint unclear (Box 6.3).

Instead of relying on recapitalizations and other forms of government support, policies should promote self-help for banks to encourage them to build up their capital base. Relative to their large volumes of bad loans, banks in most transition economies make smaller provisions for loan losses than is usual in high- and middle-income countries. Almost all the transition economies tax banks heavily, both through profit taxes and indirectly through high reserve requirements, which yield little interest. In some countries, banks are still saddled with quasi-fiscal responsibilities,

Box 6.3 Privatizing banks is essential, but difficult

Enterprises in many NIS have acquired parts of the state banks and established new banks in the early transition. These enterprise-owned banks were then privatized when their owners were privatized. As their ownership diversifies, and provided that strict limits on lending to owners are applied, such banks are generally no worse managed than others. The privately owned banks in these countries typically are the most dynamic and dominate new lending to private firms.

In many CEE countries state banks still dominate; as elsewhere, privatizing these banks has been difficult for both economic and political reasons. Privatization of large state banks through cash sales has been rare. Hungary and Poland have had some success, privatizing a total of six large banks (two in Hungary, four in Poland), but such divestitures have become progressively more difficult, in part because local stock markets lack depth and are already dominated by bank shares.

which deplete their capital. In China, for example, the profitability of state banks is depressed in part because interest rates on loans to enterprises are kept below household deposit rates, and the credit plan dictates a large part of their lending. To allow banks to grow out of their bad debt problems, governments need to pay higher interest rates on required reserves, eliminate quasi-fiscal demands on banks, raise or liberalize lending interest rates, and encourage banks to make more realistic provisions for loan losses.

Establish at least a few reliable banks early on

A combination of low confidence in the financial sector and sizable unofficial economies has meant that cash represents a large share of the money stock in CEE and the NIS, even compared with other countries with poor payments systems (see Figure 6.1). (In China, the limited payments system rather than lack of confidence explains the high level of cash.) To restore confidence, governments should aim to certify a few reliable institutions and try to protect the payments system from bank failures. Entry by foreign banks is one quick way to increase the quality of banking. In Armenia, for example, the entry of the Midland Armenia Bank promises to enhance the financial system greatly. But in almost all transition countries regulation or other barriers have impeded foreign entry. Another approach, adopted in a number of CEE countries and NIS, is to single out a few select banks for financial and technical assistance. This approach signals to enterprises and households which banks may be most deserving of their trust (see Box 6.1). Still another route, most relevant

Even when state banks are strengthened through capital injections, foreign commercial banks have shown little interest in acquiring them because of difficulties in evaluating their loan portfolios and integrating them with their own systems. Most foreign banks prefer to establish new banks. The potential for cash sales to domestic investors is limited in transition economies because of lack of capital markets and expertise. Political concerns have often complicated the pricing and methods of sales, particularly to foreign buyers. Transferring ownership through vouchers has been somewhat more successful. Large stakes in five banks in the Czech and Slovak Republics were transferred in this way. It has also proved difficult for the state to withdraw credibly from ownership. Like their privatized counterparts in Chile and Mexico, several banks in transition economies returned to state ownership when they ran into problems.

for the NIS, is to establish “safe” banks in the meantime, possibly built on the national savings banks. These banks would primarily collect household deposits and be allowed to invest only in safe assets such as government obligations or engage in limited interbank lending. Their presence can help restore households’ confidence in the banking system and allow authorities to remove, or at least reduce, the (implicit) deposit insurance now provided to state banks and sometimes to other financial institutions.

The measures just described would be more useful and far less costly than large-scale formal deposit insurance. Deposit insurance is often proposed for two reasons: to contain the risk of an individual bank’s failure spreading through the payments system to other banks, and to increase households’ confidence. Experience suggests, however, that deposit insurance is not essential to contain the contagion effects of bank failure. Especially where banking supervision is weak, banks and other investors will discriminate on their own—often better than regulators—between insolvent banks and banks with temporary liquidity problems. Insuring deposits, by contrast, can create significant moral hazard problems because insured banks are able to attract low-cost funds regardless of how risky their loans are. The U.S. savings and loan debacle, which led to losses of more than \$100 billion, was largely due to generous deposit insurance combined with weak supervision. Policymakers might decide to introduce a modest form of deposit insurance, for banks meeting tough eligibility criteria, to foster depositor confidence. But any such scheme would have to be accompanied by much-improved banking supervision, with strong powers to intervene in weak banks, to counter the moral hazard problem.

Provided households have access to reliable banks, conditions in many transition economies make the more liberal, universal banking model, common in continental Western Europe, more attractive than the U.S. practice of separating commercial and investment banks. Allowing banks to own shares in enterprises (subject to reasonable limits) and to engage in a variety of financial activities (including, for example, securities trading and insurance) exploits banks’ advantages at collecting and analyzing financial information, which are at a premium in the high-risk, limited-information environment of many transition economies. The bank-centered financial systems of Germany and Japan, for example, are generally considered to have led to better monitoring of firms.

Most transition economies have, in fact, opted for some type of universal banking model. This model has its risks, however, especially given the generally weak supervision in transition economies. In the Czech Republic and Russia, for example, conflicts of interest may arise from substantial cross-holdings between banks, investment funds, and enterprises. Exposure guidelines, which limit

individual investments to a certain fraction of assets or capital, and disclosure standards will need to be strictly enforced for banks as well as financial-industrial groups, especially for lending to managers and affiliated enterprises. In addition, some activities will need to be capitalized separately to protect depositors.

. . . And where government should fear to tread

Some governments in transition countries still intervene in the financial sector to allocate resources, typically to unprofitable enterprises or sectors. In Belarus, for example, the six largest commercial banks have been brought under state control by presidential decree, and the functioning of the central bank is now monitored by a council chaired by the prime minister. In other countries enterprises and ministries are directed to hold deposits in distressed banks. Schemes where the government directs credit to certain sectors have been proposed in many transition economies. These types of administrative measures and pressures to direct resources inhibit the development of a strong, market-based financial system. They weaken the better banks, undermine the efficient functioning of the financial system, and reduce the credibility of financial regulation. China’s credit plan, for example, is increasingly circumvented and has led to new avenues of rent seeking through an informal market as well as nonbank financial intermediaries that profit from low, controlled interest rates. Any government financial support to private and privatized firms should be on commercial principles and encourage, not impede, institution building in the financial sector through technical assistance and training programs.

Limit state ownership

Keeping state-owned banks that specialize in financing certain sectors or activities risks carrying on the legacy of poor resource allocation under central planning. Specialized banks have disappeared in many countries. State-owned development banks have generally performed poorly and cannot be expected to do better in the weak institutional environment of most transition economies. Where government-owned banks have been effective, lending has been tightly circumscribed. The government financial institutions in Japan, for example, employ well-designed, focused credit programs of relatively limited duration. It remains to be seen whether the new policy banks in China, which attempt to combine directed lending for infrastructure with commercial lending, will have the same success (Box 6.4).

Rural and housing finance: Should government fill the institutional void?

Most governments face strong pressure to provide credit for rural finance, which is in crisis in many transition

Box 6.4 China's new policy banks

Most bank lending in China has been directed by the government, rather than by commercial need, and undertaken by four banks, specialized by sector. As part of its financial sector reform China decided to free the banks of this policy-based lending, leaving them to transform themselves into true commercial banks. To facilitate this, three new policy banks were created in 1994. The State Development Bank makes loans for infrastructure and key industrial developments. The Agricultural Development Bank finances crop purchases and food reserves and lends for poverty alleviation and rural infrastructure. The Export and Import Bank focuses its support on machinery and electronics exports, mainly through suppliers' credits. The banks are funded by a combination of bonds (administratively placed with commercial banks), capital contributions from the government budget, and central bank lending. The three banks' operations are already significant: all bank-financed government investment is expected to flow through them, and their lending is expected to be about 9 percent of all investment, or 3 percent of GDP in 1995.

The new banks have removed the burden of one type of policy lending from the specialized banks. This move also makes the cost of subsidizing such policy

lending more explicit. If professional banking standards are applied, it could also generate efficiency gains in the management of public investment. The signals are mixed, however: most of the new banks' staff come from the Planning Commission or its subsidiaries; on the other hand, the State Development Bank did refuse to finance some 10 percent of proposed projects in 1994.

The policy banks represent only one aspect of policy lending, however. The Chinese government sets many interest rates according to industrial or broader policy objectives rather than commercial ones, and the commercial banks are still obliged to carry the loans. Moreover, the commercial banks' biggest burden is working capital loans to cover public enterprise losses. The policy banks have no role in financing these, and there is no sign yet whether these loans will be transferred to the already strained government budget. The creation of the policy banks is therefore just one step toward a comprehensive reform of China's financial sector. If applied with rigor, it could prove a significant step. On the other hand, the policy banks may just as easily turn out to be merely another layer of government, and one that perpetuates market segmentation and the role of planning.

economies, especially among the NIS. Agricultural banks, like most specialized banks, are illiquid and often bankrupt and are likely to emerge from reform much smaller—if they survive at all. New banks are usually reluctant to serve agriculture, because the risks are high, profitability is low, credit histories are short or absent, and land is poorly registered and difficult to collateralize. Some countries, including Croatia and Poland, have made progress toward a legal framework that allows other farm assets, such as agricultural stockpiles and farm equipment, to be used as security for loans, but these are still the exceptions (see Box 5.1). In addition, farmers are usually heavy savers, so rural areas need access to reliable and competitive savings instruments as well as commercial credit.

Creating cooperative financial institutions, in some cases out of the remains of the agricultural bank, can be a constructive approach to self-sustaining rural finance. Credit cooperatives—which already exist in Hungary, China, and Vietnam—have many strengths: active peer monitoring of borrowers, close links with clients, and an emphasis on mobilization of savings. These benefits can be undermined, however, if the cooperatives depend on government as the source of finance. Modest initial injections

of budgetary funds can help capitalize the new institutions, but, as with other financial intermediaries, the key objectives must be to foster self-help and the long-term development of healthy institutions. One temporary solution might be the approach used in Latvia, where a specially created institution operates on commercial banking principles but has a limited life span, after which it will be closed or merged with a commercial bank. Alternatively, working capital finance could be used to capitalize a cooperative lending structure: in the Kyrgyz Republic, for example, temporary financial support for working capital will be made available to farmer cooperatives. In other parts of the world, commercial suppliers of inputs and providers of marketing services often offer credit to farmers. These entities can generally evaluate the credit risks of individual farmers as well as banks can, if not better. But in the initial stages suppliers may need some coaxing to enter these markets: the Moldovan government, for example, is providing insurance against certain policy changes that would adversely affect repayment, to encourage foreign suppliers to provide inputs on credit.

Housing construction has dropped sharply in many transition countries, partly for lack of finance. In most

countries housing finance is constrained by low saving and a weak institutional framework. Sometimes, unfair competition from state-owned banks has also inhibited the development of market-based housing finance. Various specialized financial institutions and government-funded schemes have been proposed to revitalize the housing market. But these schemes do not address the fundamental constraints on housing finance in many countries: the poor legal environment for mortgages, controlled rents that discourage home ownership, the lack of institutional investors, and macroeconomic instability and high inflation. Indeed, such schemes may distract attention from what is really required to develop a good housing finance system, and they can have heavy fiscal costs.

The role of nonbank financial intermediaries

Many nonbank financial institutions, such as portfolio capital funds (mutual funds), venture capital funds, and leasing and factoring companies, are well suited to the needs of transition economies. They can fill the disintermediation gap now prevalent in many transition economies. They also tend to finance small and medium-size enterprises, which are important to overall growth, and they can require less in the way of legal infrastructure than other types of intermediary. Portfolio and venture capital funds have indeed grown rapidly in transition economies. By early 1995, just six years after the first venture capital fund was set up in CEE, there were more than eighty such funds, managing assets valued at \$4.4 billion. These funds have proved an attractive way for one or a few large foreign investors to meet the equity needs of small firms. The venture capital funds in which the International Finance Corporation (IFC) participates, for example, have an average investment per firm of only \$500,000. Such funds can be particularly useful in transition economies, not simply because equity investments offer some hedge against inflation, but also by providing for considerable control over management, with fund managers able to help inexperienced managers develop business plans and upgrade standards. They can also make for better audits and build up contacts with foreign firms. The IFC's venture capital manager, for example, helped a Ukrainian manufacturer of surgical needles by providing the company with U.S. equipment and training, enabling it to meet U.S. medical regulations. Demanding venture capital fund managers can also help spur the development of local capital and financial markets.

As noted elsewhere in this Report, entry of new firms has been the driving force behind private sector development in transition economies. But new small and medium-size enterprises have often found it particularly difficult to attract external finance. In this context, leasing—of machinery, say, or vehicles—offers many advantages over

traditional bank loans, not least that it can work well even where collateral laws are still extremely weak. In Romania the existing civil law, although a century old, was used to draft watertight leasing arrangements, enabling leasing companies to operate effectively without a special leasing law. Furthermore, it is usually easier to assess the value of a leased asset than the credit of a firm, particularly one with a short credit history. Unsurprisingly, perhaps, leasing has come to finance a large share of new investment in transition economies: nearly a third in the case of Slovenia, and about one-sixth in some other countries. With most leases awarded to smaller enterprises, the average lease has likewise tended to be small. In Slovenia, for example, the leases extended by an operating company in which the IFC participates average \$13,000. Leasing has also complemented the development of other forms of finance, including bond and commercial paper markets, as well as supported a more general improvement in the regulatory and legal frameworks in place for lending. The development of other nonbank financial institutions, such as insurance companies, will be slower, but over time they too can become important institutions for intermediating savings. Nurturing them, however, will require further improvements in countries' legal frameworks, particularly in the areas of property rights and contract law (see Chapter 5).

Developing capital markets

Capital markets are, at their most basic, easy to define and almost as easy to create. In a sense, a capital market exists wherever financial securities—vouchers, stocks, or bonds—change hands, whether on a formal securities exchange, within a less structured but established medium such as an over-the-counter market, or informally between any buyer and any seller. Yet as with so many of the institutions outlined in this part of the Report, the trick to capital markets is not bringing them into being but nurturing them so that they play their proper supporting role in the broader process of transition. For capital markets, especially the more formal kind, that role is largely one of facilitating the reallocation of property rights. Capital markets are especially needed after the initial distribution of vouchers and shareholdings in a mass privatization program, but also for the sale of state assets through direct share offerings. Some of the standard benefits of capital markets in a market economy can often be even more valuable for transition countries: capital markets improve corporate governance by monitoring managers and trading shares actively; they allow cash-strapped governments to issue bonds, and firms to make share and bond offerings; and they support long-term housing finance and pension reform. But even healthy capital markets are not self-sufficient; they rely heavily on well-functioning banks, to process payments and act as custodians, and money

markets, to provide benchmarks for pricing securities. Both are sorely lacking in many transition economies. In addition, property rights are often poorly defined, there is a lack of necessary market skills and experience, and minority shareholder protection is extremely limited (see Chapters 3 and 5).

The more formal, centralized type of securities exchange is not particularly difficult to set up. At least nineteen transition economies have done so. And almost all countries in CEE, several NIS, and China and Vietnam have adopted (or are adopting) supporting, comprehensive securities laws. Yet both market capitalization and share turnover in these formal markets have tended to be low by both developing and industrial country standards (Figure 6.2). Accordingly, the new markets have raised only limited funding. In CEE and the NIS only the best firms have been able to raise any financing, altogether less than \$1 billion from 1991 to 1995. In China new equity offerings have been comparatively large, amounting to more than \$1 billion in 1993 alone. They still, however, account for only a small portion of total enterprise investment. In Russia and the Czech Republic, capital markets—including informal markets—are mostly used to build up controlling stakes, which investors then tend to hold; turnover on formal markets is consequently low. In very few countries has equity trading been active and had a disciplinary effect on managers.

Bringing capital markets to life in transition countries will mean raising both the supply of securities and, naturally, the demand for them, as well as improving the institutional background for transactions. On the supply side, bond markets, which often precede stock markets, have tended to develop because governments need to raise non-inflationary finance. Similarly, rapid privatizers among developing countries have experienced much faster growth in stock market capitalization than have slow privatizers. This is also true among transition economies: stock market capitalization is greater in relation to GDP in mass privatizers such as Russia and the Czech and Slovak Republics (see Figure 6.2). Yet trading activity and individual share prices are generally much lower among mass privatizers than in other countries, largely because demand is low and institutions are weak. China, with its limited privatization, is a notable exception, with high turnover due in part to speculation.

Boosting domestic demand for securities, and boosting securities trading, will require stable macroeconomic policies to raise saving, as well as the emergence of institutional investors such as private pension funds (see Chapter 4) and insurance companies. Policymakers will also need to improve the protection of creditors and investors, especially minority shareholders, and vigorously punish fraud and other white-collar crimes. Enhanced disclosure

requirements could help capital markets develop, just as the disclosure provisions of the Companies Act of 1900 promoted markets in the United Kingdom. Although many transition economies have made significant progress in enacting modern securities laws, few have succeeded in enforcing them, since supervisory institutions are often still lacking. There have been many cases of outright fraud, such as the Caritas scheme in Romania. And many transition economies still lack effective trading frameworks and supporting financial services.

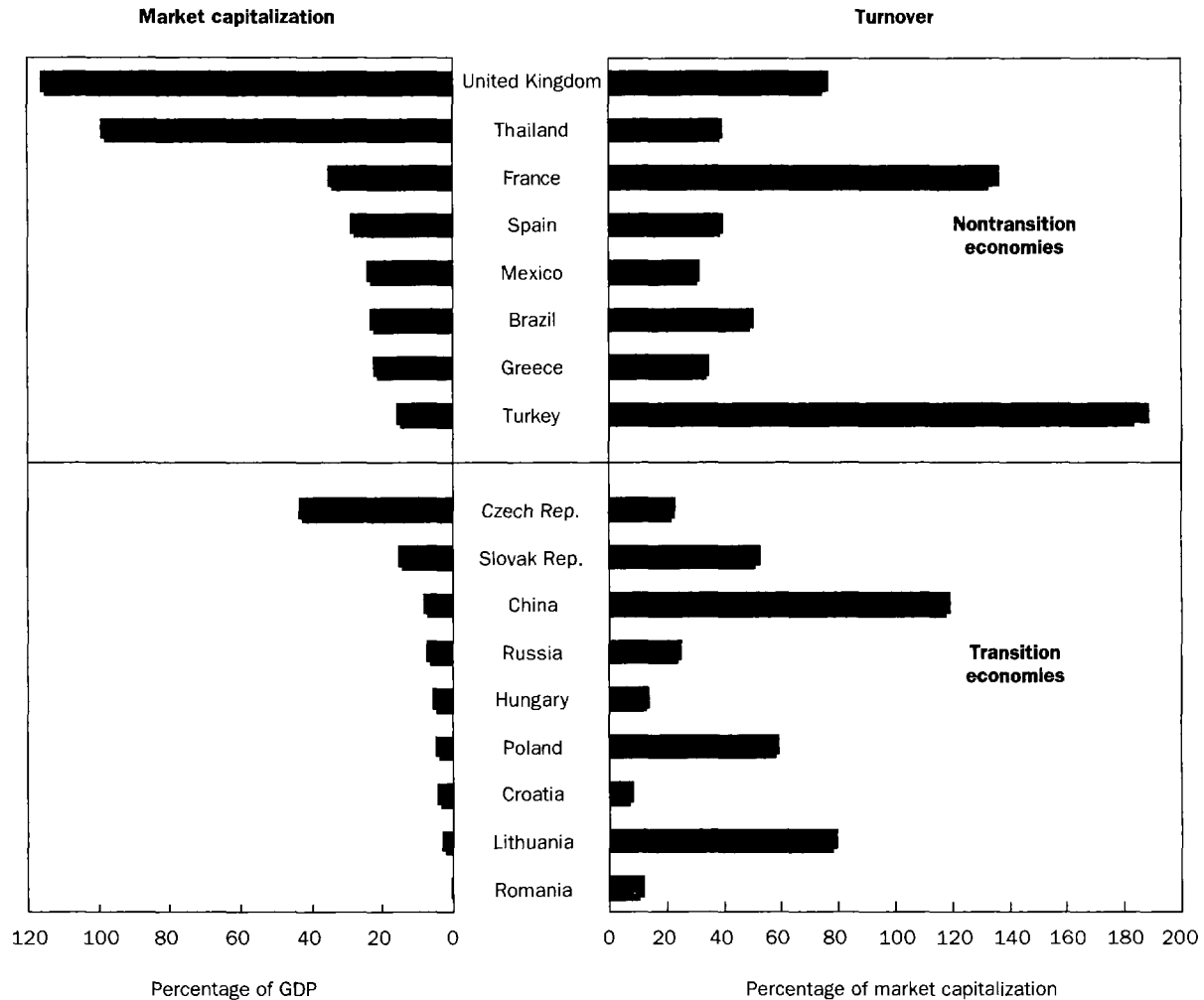
In developing and improving rules and institutions, countries need to strike a balance between a top-down approach, where the government takes the initiative, and one that is more bottom-up, in that supply and demand create pressures for the types of markets countries need and the rules and institutions to govern them. Top-down strategies can deliver higher standards but risk overregulation and may fail to meet markets' true needs. Standards in several CEE countries, for example, are relatively high, but only government bonds and several dozen stocks are actively traded. This is especially likely when infrastructure is developed well in advance of demand or supply. Albania, for example, enacted a well-designed capital markets law, but its capital markets are not yet functioning for lack of strong banks, institutional investors, functioning courts, qualified lawyers, and a well-staffed regulatory commission. Top-down approaches are especially problematic since most countries need rapid change in the way firms are managed—through mass privatization and other programs—and this can be slowed by overregulation.

A bottom-up approach can have advantages. Experience in transition economies and elsewhere shows that more-effective rules and institutions tend to develop when they advance in step with demand and supply, rather than behind or well in front of them. There is also evidence that market participants, seeking to protect their own interests, tend to self-regulate through cross-monitoring, especially when trading in large volumes. In Russia, a system for over-the-counter trading in stocks and rules governing trades were introduced because brokers realized that it was in their own interest to share information with others and agree on common standards. The bottom-up approach still requires a supportive role for the government, especially in promoting the necessary institutions and in vetting the rules of the game, but it does not risk stifling a nascent market. China is an example of bottom-up regulatory development: the emergence of regional exchanges prompted regional regulators to formulate their own rules first, which were later absorbed into an overarching national regulatory framework.

Foreign demand can be particularly helpful in lifting standards and increasing confidence. Foreign portfolio investors stimulate infrastructure improvements because

Stock markets in most transition economies remain small and illiquid.

Figure 6.2 Stock market capitalization and turnover in selected countries



Note: Capitalization is the market value of shares outstanding at the end of 1995. Turnover is the market value of shares traded during 1995. Some economies with short histories of operating stock exchanges are not shown, as complete data are unavailable. Data do not cover all stock exchanges or over-the-counter trading, and only the most liquid stocks are included. Source: International Finance Corporation and World Bank staff estimates.

they demand good custody, trustee, audit, and bank payments systems—fiduciary functions missing in many transition economies. In Russia, for example, a British company acquired 20 percent of the shares of an aluminum company, but its share ownership was later annulled by the

company's management. The resulting international outcry spotlighted the deficiencies of Russia's regulatory process, leading to pressures for third-party registry facilities and a national registry company. A joint venture between Russian and several foreign institutions (the Inter-

national Finance Corporation, the European Bank for Reconstruction and Development, and the Bank of New York) now handles custodian arrangements for shares, making purchases much easier and more attractive. Capital market development can also be accelerated through “demonstration” projects, such as portfolio and venture capital funds.

Capital markets in their various forms have played an important role in the transfer and initial reallocation of company ownership (vouchers and shares), particularly in mass-privatizing countries. Individual shareholders (including insiders) have sold their shares, often through informal markets, and strategic investors have sought to establish controlling ownership stakes. There are historical precedents for this process. In post-World War II Japan corporate ownership structure changed rapidly from one of wide distribution among individuals to one of institution-centered ownership with extensive cross-holdings. But increasing ownership concentration leads to illiquidity, especially in formal markets. In many transition economies with mass privatization programs, investors have held on to their stakes after the initial round of trading. Trading often occurs in blocks off the formal exchanges—such is the case with 80 to 90 percent of shares exchanged in the Czech Republic—as investors try to build up controlling stakes. Other countries show a similar tradeoff between concentration of ownership and market liquidity. Given the lack of sound corporate governance and scarcity of financial skills, concentrated outside ownership (combined with monitoring by banks) has its advantages in most transition economies. At least in the short run it is probably preferable to highly liquid and speculative capital markets that may impose little or no discipline on managers (see Chapter 3).

The agenda

All transition economies face similar obstacles in building strong, active financial systems, but they have approached them in very different ways. One lesson of the past few years is that reforming existing banks can be less efficient than decentralized institution building that stresses new entry. The best approach to banking reform for many countries, particularly the less advanced ones, might be to restrict the activities of state banks while a new or parallel private banking system develops. But the inherited weaknesses of the financial system and the way these tend to play out during transition demand a series of determined complementary reforms, no matter which approach governments take. Likewise, all transition governments should aim to minimize their direct and indirect role in the allocation of resources. Premature bailouts in particular have often undermined the credibility of reforms. Governments should instead encourage banks to be more self-reliant in building capital—for example, through more generous loan-loss provision rules—and improve the general framework for debt collection.

Accelerating the development of nonbank financial institutions—an essential part of any financial system—is important in all transition economies, because such institutions often finance the small, dynamic new firms that are proving central to economic growth. Capital markets are essential for raising financing and improving the governance of firms, and here transition economies may prefer to rely on demand and supply pressures when developing the supporting framework. In the long run, as evidence from other countries shows, the roles of banks, capital markets, and other intermediaries are complementary, and all have a positive influence on development and growth.