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Economic Reform

CAER Discussion Papers

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Financial Sector Reform in Central and Eastern Europe: Synthesis of Four Country Analyses

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Financial Sector Reform in Central and Eastern Europe:

Synthesis of Four Country Analyses

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EXECUTIVE SUMMARY

This report, commissioned by A.I.D. in spring 1993, is the result of an assessment of financial sector reform in four Central and Eastern European (CEE) countries — Bulgaria, Hungary, Poland, and Estonia. It is a snapshot of a process in midstream. Astonishing transformations have already occurred in the financial sector, and countries are making ambitious plans to continue the process, which is still far from complete. Although this report is derived from analysis of the countries listed above, many of its findings are also likely to be applicable to other CEE countries and to the new states of the former Soviet Union.

The assessment was commissioned to assist the U.S. Government (USG) in planning its future programming in this sector, and, with this purpose in mind, the report discusses the ways donors, particularly USG, have supported financial sector reform in the four countries and makes recommendations on areas and methods of focus for future USG assistance.

Financial sector reform in CEE countries is of high priority because it is integral to the broader process of economic restructuring. Financial system reform is an essential complement to enterprise privatization, both in enabling privatization to proceed and in creating a receptive environment for newly privatized companies. Privatization depends on financial sector reform because:

- Banks are the creditors of enterprises to be privatized;
- The banks, through active enterprise-level debt restructuring, become the vehicles for privatization; and
- Newly privatized enterprises need competent banking services to help them be productive — as does the entire rapidly emerging private sector.

Nowhere is the connection between enterprise privatization and the financial system more urgent than in the need to reorient the state-owned commercial and specialized banks, which hold most of the banking sector's assets. Because of their holdings of state-owned enterprise (SOE) debt, much of which is delinquent or unrecoverable, reform of these banks must proceed in tandem with privatization. This report focuses on the incentive structures surrounding plans to resolve the bad loan problems of these banks.

However, while state banks will and should continue to dominate financial sector reform efforts, this report emphasizes several other areas that require greater attention: the development of central banking, including bank supervision; the private banking sector; and the development of retail banking.

STATUS OF THE FINANCIAL SYSTEMS IN CEE COUNTRIES

Central Banks

Central banks in most countries of Central and Eastern Europe are struggling to become the independent and effective institutions they are — or should be — in market-based economies, but several factors hamper their development. The most important of these is their lack of clear authority over the state-owned banks that constitute the bulk of the banking sector, and the resulting informal subordination to decisions made by ministries of finance. Governments, as owners of the large banks, have not been

willing to cede responsibility for these banks to the central bank. While there are legitimate reasons for government to retain authority, one consequence is the slower development of the role of the central bank. Because of inherent conflicts of interest within government (for example, between the interests of the banking sector and government budgetary and tax interests), it is crucial that central banks gain substantial autonomy and authority in the near future.

The other structural factor slowing development of central banking is the legacy of the portion of the original monobank system from which current central banks have evolved. The inherited tradition revolves around information collection as a primary function, without a corresponding analytic capability to put the information to use. Central banks have been developing their capacities, and in some countries have made substantial progress (and have achieved some important results) in the conduct of monetary policy. However, capacity building remains a high priority.

Accordingly, the report recommends an expanded program of policy dialogue and technical assistance with central banks, focusing on areas such as collecting and processing of accurate and timely data on the financial sector, analysis of the data to provide inputs for the formulation of monetary policy, and the implementation of monetary policy.

Estonia offers an instructive lesson for solving these problems during the extended transition and perhaps beyond. By adopting a currency board, Estonia has established a credible monetary policy (because it is completely automatic), established credibility in its currency, and closed off the possibility of central bank financing of budget deficits. This path may be attractive in other countries where central banking capacity and autonomy is not well established.

Bank Regulation and Supervision

Effective bank supervision has been slow to develop in most CEE countries, for many of the reasons discussed above, including the lack of clear supervisory authority over state banks (government decision making will prevail) and a lack of a tradition of bank supervision that focuses on assessment of risk and financial soundness. Until the state banks are privatized, or until they fade from dominance of the financial sector (which has happened to an important degree in Estonia), bank supervision will suffer from ambiguity in its role.

Nevertheless, there are important immediate functions for the supervisory authorities, and they must prepare to take on greater responsibility for the state banks:

- The domestic private banking sector, although small, requires immediate supervisory attention. The failure rate is high among these banks, and yet, if provided a sound regulatory framework, these banks have the potential to bring additional innovation and competition to the financial sector. The urgent need to improve supervision of private banks could be the focal point for donor assistance programs that would contribute to increased capacity of bank supervision agencies and improve the framework for emergence of private banks.

- During the transition, the supervisory authorities may be able to perform several useful, though limited, functions with respect to the state banks: acting as early warning signals for particular problems, establishing requirements for information gathering and analysis, and exercising some behavioral sanctions. Sorting out what supervisors can and cannot accomplish during the transition is an important near-term task.

Assistance to supervisory authorities should be geared toward helping them improve their ability to define the appropriate role of information in the supervisory process; build capacity to merge, liquidate, and rehabilitate insolvent banks; and define and use enforcement mechanisms that result in appropriate behavior by banks. The information issue is particularly complex because of bank secrecy laws, which may not be fully compatible with the aims of supervisory practice.

Resolving the Bad Loan Problems of State Banks

The resolution of the bad loans at the state banks is central both to the needed transformation of the state banks into market-oriented financial institutions and to the future privatization of the debtor SOEs. It is important to note that the bad loans now on the books of the state banks (and accounting for major asset shares of those banks, such that many are technically insolvent) spring mainly from the period immediately after reform. Bad loans accumulated after commercial banks had been split off from the original monobanks but before the commercial banks had been able to reorient their lending practices. In some countries, the bad loans continue to accumulate because banks continue to extend loans to non-creditworthy customers.

It is clearly acknowledged that the bad loan problem is the responsibility of government, and plans are in various stages of development for resolving it. In some instances, a major concern in shaping plans has been to disguise the budgetary cost of the losses. Such a concern is misdirected, as the debts become government losses at the time when the loans go bad, and thus must be financed.

In considering plans for resolving the bad loan problem, the incentive structure is of crucial importance for determining whether the plan will succeed. Incentives must ensure that:

- The insolvent banks are returned to solvency and given a sound basis for future market-based operation and privatization;
- The incentives facing management have been changed in a convincing way to encourage an appropriate combination of profit-maximizing and loss-avoiding behavior; and
- The plan will yield serious and effective steps to collect the bad loans and restructure or liquidate companies appropriately.

In two countries reviewed, Poland and Hungary, plans have been developed to a degree that allows analysis and comparison. The general conclusions from comparison of the various approaches to the bad loan problem are:

- Solutions should be as comprehensive as possible, so that the problem can clearly be dealt with once (and only once);
- Decentralization of responsibility for loan work-outs may help increase recovery at the same time it builds capacity of commercial banks; and
- Bank managers require clear signals about what practices are acceptable, which can be enhanced by near-term prospects for privatization.

In addition to resolving the bad loans, state banks face a major agenda in terms of building their capacity as market-based institutions, developing profitable lines of business, and preparing to become privatized.

The Development of Private Banks

Private banks make up a very small share of total banking sector assets in most CEE countries, with the exception of Estonia, where they have rapidly come to play a major role. Despite their small size, private banks are important to the future of the banking system for several related reasons: the upward trend in their market share, their potential to provide much-needed competition, and their potential to innovate in financial services and products. Unfortunately, however, private banking has been hampered by a number of factors: ownership by public and private enterprises that see the banks as in-house sources of funds; banks' low level of experience in lending, leading to high loan losses; and small capitalization. These features were encouraged by a laissez-faire attitude about private banking that characterized the first round of private banking reforms, leading to a lax regulatory environment — and many private bank failures — in a number of countries.

If private banks are to realize their potential, they must be better regulated and must build their internal capacity. Thus, it is recommended that bank supervision departments place high priority on assessing the financial condition and policy environment for private banks, and that bank training programs be open to private banks on the same terms as they are to state banks. Both these areas are recommended for future donor focus.

Retail Banking and the Savings Banks

The development of banking services for households and small enterprises is another area that requires greater attention from policy makers and donors. Few commercial banks, whether state or private, have shown an interest in retail banking, regarding it as unprofitable. The amount of credit on market terms now afforded to the household sector in almost all the countries under review was negligible. Deposit services remain far from adequate: interest rates have generally been negative in real terms during most of the 1990s, and transaction services for individuals are still slow and costly (though they are clearly improving).

In each country, however, one or more savings banks or postal banks continue to serve the public. Typically, these banks take deposits but often do not make loans of their own. The savings banks, fully owned by government, are regarded by many policy makers as inefficient monopolies that should be broken up. Alternatively, these banks are attempting to restructure themselves as full-service banks, with corporate banking arms. This report argues that breaking up the savings banks would result in fewer services to households in the near and medium terms. Instead, it is important to support competition in this sector wherever it can be introduced, such as between postal and savings banks. The report also suggests that rather than becoming universal banks, the savings banks should consider developing their deposit-side comparative advantage in the retail business into a lending-side business with the customer base they already know. Savings banks may be candidates for an innovative approach to privatization based on sales of shares to depositors. Governments should also promote positive real interest rates on deposits among the savings banks they now own.

Development of Banking Services to the Private Sector

It is a goal of financial sector reform that banks develop the ability to act as major allocators of investment for the economy. However, at present, loans to private enterprise represent a small share of bank assets, and the range of credit products is narrow.

A diverse array of factors contributes to the low level of private enterprise loans. Many of these are macroeconomic: bank funds are financing government budget deficits, bad loan portfolios tie up funds and cause banks to increase lending spreads, high and varying inflation puts nominal interest rates beyond the reach of borrowers unsure about whether sales will keep pace with inflation, and foreign exchange restrictions promote movement of deposits offshore. Even more constraining are sector-specific bottlenecks such as:

- Internal bank capacity. There are shortages of skilled credit officers, weak internal credit systems, and few loan products;

- Shortage of good private sector clients (although the number grows steadily). Private borrowers present a high business risk because of rapidly changing market conditions and lack of experience;

- Lack of widespread application of accounting standards, such that prospective borrowers have difficulty establishing the credibility of their financial statements. There are few effective credit reference systems;

- Inadequate legal foundation for secured lending, encompassing laws governing collateral, registries for liens, and the transitional status of property rights;

- Underdeveloped interbank markets. Banks can extend more loans (and at longer terms) when they have adequate means for managing liquidity risk, through interbank markets; and

- High reserve requirements restrict funds available and, because reserves are unremunerative, push up spreads.

This list demonstrates that there are no shortcuts to increasing private sector credit. The best strategy is to strengthen the banking sector, with a particular emphasis on creating conditions for lending to take place.

Transaction support services such as payments are also important for the private sector, and these appear to be developing rapidly. It is important to note that progress in payment systems is not simply a matter of installing better technology (as it is sometimes treated), but also of improving incentives for banks to process payments quickly, which, in turn, depends on regulation and increasing service competition.

RECOMMENDATIONS FOR USG ASSISTANCE

USG has provided assistance to CEE financial sector reform through a wide variety of mechanisms, including placement of advisors in commercial and central banks, development of bank training programs, and specialized short-term technical assistance. Topical coverage has also been extremely broad, including stock market development, bank supervision, collateral law reform, government securities markets, and many others. By most accounts in the countries reviewed, USG assistance has been of high quality, has been well received, and has made important contributions.

At this juncture, however, it would be practical for USG to shift its approach somewhat, in two directions:

- To develop a more focused strategy for applying its limited resources; and
- To place greater attention on engaging recipient institutions in policy dialogue.

With regard to strategy, USG should develop a way of working that recognizes the limitations on its resources for financial sector development, particularly in comparison with several other donors. USG is not in a position to take the lead in this sector, but does have important expertise to share. Therefore, it is recommended that USG select a limited number of topic areas for more intensive assistance and coordinate the delivery of services by different providers so that they complement each other in these focus areas.

USG could select focus areas highlighted in this report. Two areas in particular deserve note. The more important of the two is a focus on improving bank supervision with a strong emphasis on developing a better framework for growth of private banking. This focus area would combine two of the priority areas identified in this report — bank supervision and private banking — in a single set of activities supporting supervisory authorities. A second focus area might be retail banking and the future of the savings banks, which had not previously been viewed as taking priority.

With regard to policy, the team finds that USG assistance has concentrated not on policy but on supplying expertise to meet identified opportunities. With some notable exceptions, USG has not had a major role in shaping the debate about the direction of financial sector reform. In addition, the team found several instances where donors (not just USG) and decision makers in CEE countries moved to address technical matters before resolving the more fundamental policy framework into which technical improvements fit. Topics that the team found to be ripe for greater policy analysis include bank regulation, the conduct of monetary policy, the playing field for private versus state banks, the appropriateness of deposit insurance, the future of savings banks, and the use of directed credit. Greater emphasis on policy analysis by USG could enhance the effectiveness of resources from short- and long-term technical assistance. Policy dialogue would require greater emphasis on extended substantive discussions with counterparts, as well as employment of tools such as seminars, joint analysis and diagnosis, and short-term expert visits, carried out to coincide with upcoming counterpart decisions.

Finally, there are several recommendations on specific USG activities:

- The Treasury advisor program would be strengthened by additional policy dialogue with prospective counterparts to ensure full understanding of the counterpart's objectives and the role of the advisor in meeting those objectives; by greater use of short-term technical assistance to support advisors; and by more selective placement of advisors, based on releasing constraints to financial system development.
- The Treasury bank training program is endorsed, as is the importance of bank training in general. It is recommended that the strategy of working directly with banks to tailor training offered to specific bank needs be continued and enhanced.
- USG should curtail support for directed credit lines for favored sectors, particularly at subsidized interest rates. Where special programs are established, they should be aimed to develop — not substitute for — the capacities of financial institutions, with the expectation that services offered will become profitable in a reasonably short time.

SECTION ONE

THE ASSESSMENT

It has been four years since the great reforms of 1989 placed the nations of Central and Eastern Europe on a path toward democratic societies and market-oriented economies. These years have seen a tremendous volume of activity, much of it supported by donor organizations, to restructure the economic systems in these countries, including dramatic changes in their financial systems. During these years, both the magnitude and the urgency of the changes required countries and donors to move ahead quickly, often through untrodden territory. By mid-1993, as this report is being written, the dust has settled a bit. It is becoming possible to assess the progress that has been made during the initial stages of reform and to plan in more deliberate fashion for the next stage.

This report on the financial sector is the culmination of one of several assessments on Central and Eastern Europe (CEE) commissioned by the U.S. Agency for International Development to help it review progress and formulate future directions. This summary report is drawn from studies carried out in four CEE countries, chosen for their diversity: Bulgaria, Hungary, Poland, and Estonia. Team members visited each country in April and May 1993 and produced a detailed report on financial sector reform in each country.

This report details the major findings of the team. It does not attempt to be comprehensive. Much has been written about financial sector development in CEE countries (including the four country reports), which relieves this report of some of the descriptive burden that might otherwise be necessary — rather, the report highlights findings that team members believe to be particularly important for planning future country and donor activities in the sector, especially findings that, in the team's judgment, have received insufficient attention in the reform process. Thus, inclusion of a topic in the report should signal that the team considers the topic to need continued emphasis during the next stage of reforms.[1] The report also states findings on specific U.S. Government (USG) programs and makes some recommendations for their future.

Throughout this report, there is an attempt to make general statements about the common issues facing CEE countries, drawn from the four countries covered in the review. Many of the observations are likely to apply to other countries in the region, including the countries of the former Soviet Union. At the same time, any particular conclusion does not necessarily apply to all four countries under review, each of which has unique experiences. Where there is a question, the reader may refer to the country reports.

Financial sector reform in CEE countries is of high priority because it is integral to the broader process of economic restructuring. Financial system reform is an essential complement to enterprise privatization, both in enabling privatization to proceed and in creating a receptive environment for newly privatized companies. Privatization depends on financial reform because banks are the creditors of enterprises to be privatized; the banks, through active enterprise-level debt restructuring, become the vehicles for facilitating privatization; and newly privatized enterprises need competent banking services

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[1] The banking sector — commercial banks and central banks — is the primary focus. Non-bank capital markets such as stock exchanges are treated here only as they relate to banking sector development or enterprise privatization. The choice not to expand on capital market development stems from the substantive observation that these markets are less urgent and are well supported by donors, and from the practical need to limit the range of inquiry in the assessment.

to help them be productive, as does the rapidly emerging private sector. Conversely, banks are helped by privatization to the extent that privatization results in a stronger enterprise sector and, thus, better banking customers.

The report is divided into four main sections, following this introduction. Section Two provides some of the macroeconomic background necessary to understand the context in which financial sector development is occurring, and focuses on an area the team considers a high priority: the functions of central banks, including bank regulation and supervision. Section Three considers the future role of the state banks, an area that has been receiving the greatest share of attention in financial sector development. The future of these state banks is closely tied to the resolution of bad loans among their main clients — the state-owned enterprises (SOEs) — and hence is bound together with the progress of privatization.[2] Section Four reviews the evolution of banking services to businesses and individuals and provides suggestions on ways to relieve current constraints on their development. The team finds that the development of retail banking should receive greater attention. Section Five covers bank training and donor assistance. Most of the specific recommendations of the report are contained in that final section, including recommendations for the design of U.S. Government assistance.

[2] Bad loans are nonperforming loans, also known as nonperforming assets.

SECTION TWO

THE MACROFINANCIAL ENVIRONMENT AND CENTRAL BANKS

THE IMPACT OF MACROECONOMIC CONDITIONS ON THE BANKING SECTOR

Financial sector development in CEE countries is taking place during (and is part of) major economic restructuring that is creating macroeconomic stress. The resulting macroeconomic conditions determine the immediate realm of possible directions for progress in the financial and banking sectors. This section briefly recounts the impact of some macroeconomic conditions on financial sectors in the four countries reviewed.

Government Fiscal Deficits

With the exception of Estonia (since the adoption of its currency board), government fiscal deficits have tended to range between 5 and 10 percent of the gross domestic product (GDP). Faltering economies and rising unemployment have made it difficult to restrain government social expenditures, and tax collections have been hurt by falling profits of state-owned enterprises and by the lack of administrative skills in collecting taxes from the growing private sector (the problem of the underground economy). In addition, in most of these countries a substantial government debt lies hidden in the nonperforming loans of public sector banks, which presents a serious fiscal problem — that is, a hidden interest bill, regardless of when and how the consequences of these nonperforming loans are officially recognized.

Fiscal deficits have been financed largely through money creation and, hence, the inflation tax, although some of the Central and Eastern European countries have been able to rely, to some extent, on foreign borrowing and on selling bonds in their incipient domestic money markets. Obtaining domestic financing has been made easier by a dramatic increase in personal savings in many of the countries and by a lack of demand for credit by creditworthy enterprises because of weak economies. As a consequence, inflation has retreated from the extremely high rates some of these countries experienced during the early 1990s. Furthermore, where interest rates have been freed from control, they have not reached high levels in real terms, although spreads between deposit and lending rates have been quite high because of nonperforming loans and implicit taxes on financial intermediation (for example, high reserve requirements that are not remunerated). Nonetheless, large fiscal deficits and their financing through inflation and other taxes on financial systems have clearly retarded financial deepening and could pose increasingly serious problems when the demand for credit by enterprises recovers.

Foreign Exchange Policy

The breakdown in trade relations among the formerly socialist countries of Central and Eastern Europe, and especially with the former Soviet Union, has not affected the balance of payments in most of these countries as severely as might be expected. Exports have tended to recover during the past year or two, through expanded trade with market economies and some recovery of trade with former partners. At the same time, imports have been restrained by a combination of trade restrictions and fairly depressed aggregate demand. Capital inflows have also been a positive factor through direct foreign investments, commercial credits, and assistance provided by international agencies (and, in the case of Bulgaria, by

foreign arrearages). The countries of Central and Eastern Europe have tended to adopt flexible exchange rate policies — either managed floats or fixed rates with frequent small adjustments — where the exchanges rates are paired to an appropriately restrained monetary policy. At one extreme, Estonia has adopted a fully fixed exchange rate paired to a monetary policy rule based on a currency board. Bulgaria adopted a free float because of its inadequate foreign exchange reserves. Because of the generally favorable balance-of-payments situations, real exchange rates have tended to appreciate — that is, inflation has typically been more rapid than the depreciation of the nominal exchange rate.

In spite of strong balance-of-payments situations and appreciating real exchange rates, several Central and Eastern European countries have continued to maintain exchange controls — often requiring immediate conversion of export receipts through the banking system and restricting outward capital transfers by residents. However, such exchange controls have proven hard to enforce almost everywhere. Moreover, Asian and Latin American countries that have recently liberalized their foreign exchange regimes in major ways have typically experienced substantial inflows of foreign exchange rather than outflows, especially if they have been maintaining credible programs of fiscal and monetary restraint. The inflows occur because foreign exchange decontrol enhances credibility, as an economy becomes an even more attractive home for new capital with increased assurance that capital can freely be taken out again.

BUILDING STRONG CENTRAL BANKS

The creation of separate central banks and commercial banks from the socialist monobank system throughout CEE countries laid the initial groundwork for development of market-oriented financial sectors. While much attention has been given to the development challenges facing the commercial banks, there are equally daunting challenges involved in creating strong central banks. Many of these challenges are technical, but there are also deeper fundamental issues concerning incentives and authority.

Central banks in most countries of Central and Eastern Europe have been hampered in the practical implementation of their duties by three major factors:

- De facto (though not de jure) subordination to finance ministries;
- Lack of clear authority over state-owned commercial banking systems; and
- Lack of a systematic analytical focus and modern monetary instruments for developing and implementing monetary policy.

These factors are related to the legacy of the monobank system. The part of the original monobanks that have become central banks do not draw upon a tradition of independent action as policy-making institutions, and have inherited a bent toward collection of information as a primary function, without the corresponding analytic capability to put the information to use. By contrast, ministries of finance are government entities of long-standing importance in most formerly socialist countries. It is thus only natural that finance ministries would tend to dominate the early stages of financial system development and that international agencies would tend to seek out finance ministries to initiate dialogue on policy decisions for the provision of technical assistance and training for financial system development.

However, the dominance of ministries of finance over central banks has in most regions of the world been inimical to the conduct of monetary policy to achieve optimal financial sector development with minimal inflation and a stable exchange rate. First, a ministry of finance is central to a

government's day-to-day conduct of economic policy and by nature cannot be politically independent. In addition, ministries of finance are always in search of low-cost sources of revenue, which can often be found on a short-run expediency basis through high and unremunerated reserve requirements on banking systems, through forced purchases of government securities at low rates of interest, and finally, of course, through money creation and the inflation tax. Thus, establishing central banks as the key institutions responsible for financial systems and granting the central banks substantial autonomy (and systems of governance to ensure this autonomy) are likely to be essential for optimal financial system development.

As soon as the traditional monobank systems in CEE countries were split between commercial banking and central banking components, considerable attention focused on modernizing the commercial banking components. Such a focus is not surprising, given the importance of providing credit and other financial services to the productive sectors during the transition to decentralized and privately owned market economies. However, transition periods have so far generally been longer than expected and there has been considerable pressure on commercial banks — especially on the large state-owned commercial banks that evolved from the old monobank systems — to continue to provide substantial amounts of financing to non-creditworthy state-owned enterprises.[3] This pressure in turn puts pressure on central banks to provide the funding to commercial banks for this financing — through directed credit lines or through general liquidity lines and other lender-of-last-resort arrangements.[4] The subordination of central banks to commercial banks thus includes the pressure on central banks to support insolvent commercial banks that are themselves supporting insolvent enterprises.

To implement monetary policy, central banks in Central and Eastern European countries have recently developed markets and technical skills to use a wider range of modern monetary instruments. After initial reliance mainly on changes in reserve requirements and credits to the banking system to achieve monetary targets, central banks in countries where there is adequate development of domestic money markets have begun to rely to an increasing extent on open market operations. Although the policy instruments have improved, in several countries less progress has been made on the basic decision of the appropriate target for monetary policy. Debates at some of these central banks continue on whether interest rates; the exchange rate; or some monetary aggregate such as international reserves, net domestic assets, or liabilities of the central bank is the basic target or whether the main focus is on the rate of inflation, unemployment, or the growth of real GDP.

Discussions with central bank officials must emphasize not the choice of target itself but, rather, the suggestion that any central bank can ultimately choose only a single target. Attempts to achieve multiple targets simultaneously can succeed only by chance in the short run and cannot be maintained consistently in the long run. Despite shortcomings in these areas in some countries, several countries have managed to maintain monetary policies that have achieved objectives in reducing inflation.

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[3] State-owned enterprises have faced major challenges in adjusting to realistic market-based price structures. Among these enterprises are some that can eventually be profitable and others that will never be profitable but that governments do not wish to liquidate, even in the medium term, because of their social importance (for example, as providers of employment). When commercial banks continue lending to the never-viable group, they directly compromise their own solvency. In addition, through a demonstration effect, they encourage other borrowers not to repay and commercial bank loan officers to apply standards loosely.

[4] The role of central banks in providing credit needs to be carefully monitored not only to ensure a consistent monetary program but also to help curb the pressures to develop directed credit lines for non-creditworthy state-owned enterprises or, more generally, for any sector that claims that it does not have adequate access to credit. Experience from around the world shows that directed credit not only fails to overcome barriers to access to credit but also weakens financial markets and institutions that participate in these credit lines.

By adopting a modified currency board, with a fixed exchange rate, the Bank of Estonia has managed to avoid many (although not all) of these problems. It is not subject to pressure to finance the budget deficit, because of its mandated role; it has virtually no monetary policy discretion; and it can be only a very limited lender of last resort. The limitations of the scope of central bank duties not only help provide clear and sound market signals to financial sector participants, but they also provide "breathing space" for the Bank of Estonia to develop its capacity more fully before having to exercise discretion under the inevitable pressures that will come if the currency board system is changed.

Discussions with central bank officials in the target countries of this study reveal awareness that current organizational structures and technical capabilities are less than fully adequate to carry out all the functions of modern market-oriented central banks — especially the design and implementation of monetary policy. Although central banks have received external support to improve specific functions, their overall structures and capabilities have often not been adequately examined, including the possibility of overstaffing left from the monobank era. The International Monetary Fund (IMF) has traditionally provided excellent technical assistance in all aspects of central banking, but the recent demands on IMF for technical assistance have been enormous. As a result, IMF technical assistance teams are now often composed mainly of central bankers from a variety of countries, with only a few core IMF staff members, so team members may often have quite different views of the most appropriate structure for a central bank. This situation makes it easier for an IMF team and the host country's central bank to agree on specific areas for subsequent technical assistance than to decide on an overall restructuring plan for the central bank.[5] Meanwhile, the technical assistance and training provided to the financial sector by other donors has focused on state-owned commercial banks.

In order to enhance the effectiveness with which central banks formulate and implement monetary policy, some key units are potential targets for assistance because they will need to be established or strengthened:

- The unit responsible for collecting and processing accurate and timely data on the financial sector (and the economy in general);
- The unit that analyzes these data to provide the basic technical inputs for the formulation of monetary policy (and to carry out other analyses of the financial sector as required by high-level central bank policy makers); and
- The (preferably single) unit responsible for the implementation of monetary policy, although operationally there may be specialized sub-units for foreign exchange markets and for domestic money markets.

[5] For several of these central banks, it might be useful to promote planning for overall restructuring through seminars where experts in central banking from countries of similar sizes and levels of development share relevant experiences in reorganizing their own central banks. New Zealand, which has undergone one of the most thorough financial liberalization and central bank reform programs, and Chile, which developed highly innovative programs for bank rehabilitation and supervision after its financial crisis of the early 1980s, are possible candidates. The seminars are likely to reveal both a need and a receptivity for expanded programs of technical assistance and capacity building.

Bank Regulation and Supervision

Even though banking systems in most CEE countries may currently be largely state-owned, there are nonetheless good reasons to invest resources immediately in improved prudential regulation and supervision — especially because it takes considerable time to promote the wider disclosure of more accurate information about the condition of all banks and to develop procedures and train personnel needed to supervise the private banking systems of the future. In addition, the possible initiation of deposit insurance in several countries requires more rigorous supervision as soon as possible to avoid excessive risk taking by banks when depositors no longer have clear incentives to monitor bank solvency.

Who Can and Should Supervise?

In most CEE countries, responsibility for bank regulation and supervision lies with the central bank. Hungary is the main exception; responsibility for supervision lies with the State Banking Supervision, which reports to the Ministry of Finance. The Banking Department of the National Bank of Hungary performs partially overlapping oversight functions. In addition, the imminent creation of a deposit insurance fund in Hungary could soon add another participant to the regulatory process in that country. In fact, almost every country in Central and Eastern Europe is currently considering whether to introduce a deposit insurance program, and, in each case, the role of the deposit insurance agency in bank supervision would need to be defined. A multiplicity of bank regulatory agencies may add to costs and reduce efficiency somewhat, but the critical point is to have at least one entity that is clearly responsible for bank supervision and has the autonomy, power, and technical capacity to deal effectively with problem banks. Autonomy is a crucial element in the effectiveness of any regulatory body, especially in the economically and politically sensitive area of bank supervision, but experience in countries around the world does not give any clear recipe for where a bank supervisory agency should best be located to ensure autonomy. The fact that the State Bank Supervision in Hungary reports to the Ministry of Finance may limit its autonomy. For example, tax treatment of loan loss provisions is an issue between regulatory and taxing authorities in every country, and especially so in Hungary, where nonperforming loans are substantial and profit taxes on banks are an important source of revenue.

Some argue for putting bank supervision in the central bank, others for creating a separate entity, and still others for combining supervision with deposit insurance. Where they exist, deposit insurance entities are said by some to have a particular advantage in bank regulation and supervision as the entities that are most directly affected by bank failures, in that they have to pay the bills. On the other hand, the crucial central banking function of being a lender of last resort means that central banks must have accurate and timely information to be able to ascertain whether a bank that is asking for help is just illiquid or is also insolvent. In addition, central bank responsibilities for monitoring reserve requirements and implementing monetary policy similarly require accurate and timely information about the financial condition of banks. Thus, central banks everywhere must either carry out certain bank supervisory functions themselves or be fully assured that some other entity will provide accurate and timely information.

An important aspect of the ability of a central bank or of some other regulatory entity to carry out bank supervision effectively is the legal and accounting infrastructure. There must be a law that defines the autonomy and the powers of the regulatory entity, and there must be a set of accounting rules that give precise meaning to the financial statements provided by the banks to be supervised. In addition, there must be broader legal infrastructure, including commercial and central banking laws, contract and bankruptcy laws, commercial codes, and so forth, and the rules, regulations, and systems necessary to implement these laws. Among the CEE countries, Hungary appears to have made the most progress in providing good legal infrastructure, but, even in Hungary, there are serious gaps in implementation.

Many of these gaps result from the time required to train professionals in legal and accounting skills for the operation of the financial system in general and bank regulation and supervision in particular.[6]

The lack of skill in this area throughout the economy reduces options for bank supervision during the transition. For example, if the regulatory approach were to rely heavily on external bank audits to supply information to bank regulatory agencies, which these agencies would then analyze and thoroughly check from time to time for reliability, it might be possible to operate regulatory agencies with relatively small staffs. However, although such an approach could be useful, it would rely on external audit capabilities that are unproven in most Central and Eastern European countries. In any case, this approach does not appear to be what most regulatory agencies in Central and Eastern Europe envision.

Who Should Be Supervised? State, Foreign, and Private Domestic Banks

In addition to the inexperience of staff and the lack of supervisory tradition, an important explanation of the slow development of supervision departments concerns their varied relationships to the three major groups of banks: state, foreign, and private.

The purely domestic private banking sector requires immediate supervisory attention. These banks have been the source of most of the problems that fall squarely on the bank regulatory authorities, particularly in Estonia, where they hold a major portion of banking system assets. Not only do such banks account for most of the recognized bank failures in Central and Eastern Europe, but they also represent potential government liabilities if the government is forced to guarantee to pay depositors in order to forestall bank runs.[7] When regulatory agencies have not moved aggressively to deal with problem banks (for example, to require the injection of additional capital or to move quickly toward merger or liquidation), it is not clear whether this has been because of a lack of accurate and timely information about the status of these banks, a lack of professional staff with the technical expertise to liquidate or restructure these banks or to secure merger partners, a lack of funds to carry out such activities, or a lack of political support. In any case, the failure to deal with these problem banks promptly and effectively almost always increases government costs.

The financial condition and future of the private banks have received too little attention from policy makers, both because these banks are small and because, unlike the state banks, which receive the most attention, private banks are not seen as the government's problem. The urgent need to improve supervision of the private banks could be the focal point for an assistance program aimed at establishing a clearer policy framework for private banking and developing and testing the skills and procedures of bank supervision agencies.

State-owned banks with large portfolios of nonperforming loans currently dominate the banking systems in most CEE countries. Because the state banks are owned directly by the state (and not generally by the central bank), the supervisory authorities play a subordinate role in oversight of these

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[6] Moreover, even in Hungary, there are areas in the banking laws that warrant revision. For example, presentation of consolidated accounts for an entity with all of its parents and subsidiaries is not required, so that risky assets (such as nonperforming loans) and other problematic items can be "parked" in the financial statements of related entities and thus not be appropriately reflected. In addition, equities are not included among risk assets, so that loss provisions and capital may be less adequate than they appear, especially since nonperforming loans can also be effectively parked by converting them to equity positions.

[7] The government has little choice about paying the depositors of state-owned banks in cases of failure.

banks. Effective regulation of state-owned banks has everywhere proven extremely difficult, if not impossible; in most Central and Eastern European countries, the crucial task of dealing with portfolios of nonperforming loans and, ultimately, with the banks themselves (for example, in liquidation, rehabilitation, and privatization) has been assigned to other government agencies. The authority of the supervisory bodies in these countries is further weakened by the fact that full reporting on the financial condition of these banks would place the supervisors in the awkward position of declaring that many of these banks are insolvent. Such declarations may not be welcomed by the orchestrators of government plans for restructuring the banks.

During the current transition period, the supervisory authorities may be able to perform several useful although limited functions with respect to the state banks: acting as early warning signals for particular problems, establishing requirements for information gathering and analysis, and exercising some behavioral sanctions. Also, during this period, the supervisory bodies must gear up for the day when the banking system will be largely in private hands, through bank privatization and growth of private banks. The urgency of starting to gear up should not be minimized, given the time needed to develop well-trained bank examiners and an effective system for bank supervision.

Several important banks in some CEE countries, particularly in Hungary, are foreign- owned or are joint ventures in which the foreign partners are clearly in control. Such ownership can reduce the workload of bank regulatory agencies. As long as these foreign banks are audited by internationally recognized auditing firms according to international standards and are subject to supervision in their home countries according to international standards that require consolidation of all types of significant foreign interests, relatively little work remains to be done by the host country regulatory agency. Moreover, to the extent that the foreign banks operating in CEE countries have international reputations that they want to protect (which should always be the case), the workload for host country regulatory agencies with respect to these banks will be further reduced.

Strategic Questions for Bank Supervision

It is important for each central bank to develop an integrated plan for establishing a sound policy, regulatory, and supervisory framework for the banking system and for developing its own capacity to implement that framework. Such planning will have to answer critical questions such as the way to develop competition among banks and decrease existing market segmentation, whether different types of banks do and should face a level playing field, whether (and if so, how) to introduce deposit insurance, and the process for shaping the regulatory environment. Two areas deserve further elaboration: the role of information in the supervisory process and the nature and use of corrective actions when banks fail to meet required standards.

An early strategic decision about the approach to bank supervision involves how much the control mechanism for the system should be weighted toward direct examination by the regulatory authority or toward the full disclosure of information to the deposit-making public. In fact, the burden on regulatory agencies to take direct actions can be greatly reduced by the full disclosure of information that allows potential depositors and other bank creditors to make informed decisions that will consequently put pressure on banks to maintain their solvency. However, even in a system that relies on regulator action, the quality and use of information are crucial to supervision.

Regulatory authorities need the power to impose high standards of information collection, analysis, and reporting on banks. Banks themselves — especially banks with problems — will have limited incentives to undertake information systems improvements; supervisory agencies can play an important role by forcing this process, regardless of their ability to act on the basis of the information

provided. However, in many CEE countries, bank secrecy has been defined so broadly that it impedes the flow of useful information about the financial condition of banks and makes it impossible to provide borrower ratings or form credit bureaus. In reality, the concept of bank secrecy, which had its origins in the protection of depositors, is now often used to conceal important information that should be revealed about defaulting borrowers and nonperforming loans.

Regulatory authorities also need to examine the mechanisms they will use to encourage bank compliance with regulatory standards — that is, the appropriate combination of penalties and incentives.

The U.S. Government, while offering to provide technical assistance and training on specific issues (for example, adequate loan loss provisions in spite of tax consequences, definitions, and limits for insider lending) and to support the overall strengthening of the supervisory entities, is likely to maximize the impact of its assistance if it focuses on certain strategic issues that have not yet been dealt with adequately:[8]

- The importance of full disclosure of all relevant information so that interested parties can make their own informed decisions — which needs special emphasis in the face of widespread preoccupation with bank secrecy;

- Resources and technical capabilities for supervisory agencies not only to examine banks but also to merge, liquidate, or rehabilitate banks that are found to be insolvent; and

- Adequate enforcement powers for supervisory agencies — including political independence and the availability of penalties that are substantial but not so draconian that they will not be used. This requires a critical review of existing legislation within the region and of the best models used in other countries for effective bank supervision.

[8] U.S. technicians in bank regulation and supervision may have some difficulty in convincing policy makers in some CEE countries of some of their positions because of a fairly widespread view that the U.S. savings and loan crisis points to inadequacy in U.S. bank regulation and supervision methods. In fact, the savings and loan crisis illustrates clearly the need for autonomy of supervisory agencies, not only to take action but also to disclose information.

SECTION THREE

THE TREATMENT OF STATE BANKS

The central task in CEE financial sector reform has been the transformation of the state-owned commercial banks into modern market-oriented financial institutions. The state banks began life with the overwhelming majority of each country's financial system's assets, as well as the physical and human infrastructure. They were and are by far the dominant institutions in the system. Moreover, the reform of these banks must be a clear priority in the economic transition, as it is integral to the process of reforming and privatizing state enterprises and allowing scarce financial resources to be allocated efficiently.

This report argues that aspects of financial sector reform other than the state banks should now begin to receive greater attention than they have in the past few years. Nonetheless, the treatment of the state banks will have to remain the central issue in financial sector reform for the next few years. This part of the report discusses progress in reforming these institutions.

THE STATUS OF THE STATE BANKS

The current state banks of CEE countries began in one of two ways. Most or all of the nonspecialized state banks were created from the break-up of the original monobanks into two tiers — commercial and central banks. In some countries (such as Romania and Albania, not analyzed in this study), commercial operations of the former national bank were transferred into a single new state-owned commercial bank with a nationwide network of branches. In other countries (Bulgaria, Poland, and Czechoslovakia) these operations were divided into smaller banks, each with an effective or at least partial monopoly in their respective geographic areas. In either case, competition — in collecting deposits, making loans, or providing basic banking services — has been slow to emerge.[9]

The remaining state banks are specialized banks, created before the reforms to serve specific sectors or functions (such as foreign trade or agriculture). Many of these have been reorganized into joint stock companies and are attempting to evolve into full-service banks. However, they often lack the branch networks to compete effectively in mobilizing retail sources of funds and reaching prospective borrowers.

At the time of the reforms, these banks did not operate on market-based financial principles. Rather, they were effectively part of the budgetary allocation process, not pretending to be banks as Western market-oriented economies recognize them. Money and prices, including interest rates, had played a secondary, accounting role, which inhibited their allocative function. Over time, the system generated significant macroeconomic distortions, including the overextension of credit by state-owned commercial banks to enterprises. Misallocation of credit continued after the reform, in part through the sheer momentum of past practice, and in part because incentives remained to continue lending to traditional customers regardless of creditworthiness. The perception was hard to change (for both bankers and their customers) that loans were no longer a form of budgetary advance. It is, therefore, not

[9] In Hungary, because the process of transformation began in 1987, there is greater competition and diversity among the state-owned banks, as well as competitive pressure from new private banks.

uncommon in the countries of the region to find bank balance sheets dominated by state-owned enterprise loan assets, with about 50 percent of those assets nonperforming.

In addition, the interdependence and credit arrangements of state-owned enterprises is a hindrance to the reconstitution of the financial sector. Bulgaria exemplifies the complexities of this facet of financial reform, although the same phenomenon occurs throughout CEE countries. Of the roughly 100 billion leva in debt owed by Bulgarian state-owned enterprises, more than one-fourth is owed to other state-owned enterprises, and about half is owed to Bulgarian commercial banks. The interdependence of the balance sheets of state-owned enterprises and commercial banks in Bulgaria — and throughout the region — impedes the financial markets by obscuring which firms are economically viable and which are not. This situation makes it almost impossible for banks to make rational credit decisions, even if they are willing to do so. The fortunes of well-run firms and banks remain linked to poor performers, slowing the transition to a market economy.

At present, the state-owned banks of all countries retain, for the most part, their sector orientation and connections with state-owned enterprises, despite being given nominal management autonomy (although the degree of autonomy varies by country). Considerable pressure and incentives to continue lending to enterprises in default exist because of institutional connections, concerns about further declines in output and employment, and pressure not to recognize nonperforming assets in the portfolio. Long-established links with large state-owned enterprises have led to excessive concentration of lending in the portfolios of state-owned banks.

The desired economic transformation in the financial and enterprise sectors will depend, crucially, on the ability of banks to disentangle themselves from their nonviable customers and begin allocating credit more efficiently. Reform of state banks requires a two-track process, which should culminate in bank privatization. One track is the resolution of bad loans, and the other track, less controversial but no less difficult, is development of bank staff competence in modern banking techniques and services in growing market niches.

RESOLVING THE BAD LOANS OF THE STATE BANKS

The Characteristics of a Good Solution

Before discussing particular schemes to deal with bad loans, it is useful to consider some of the basic concepts that underlie the need for a government to take action.

For private banks, bad loans become a government problem when they threaten the solvency of a bank and can lead to perverse behavior: the explicit or implicit insurance of depositors or other bank creditors by the government leads to excessive risk taking by bank owners and managers who have nothing left to lose. When the bank is state-owned, the situation is different in two respects. Insolvency is only technical. Thus, there is no clear reason to expect behavior to change (for example, toward excessive risk taking) because the incentives facing bank owners (the government) and managers no longer necessarily change.[10] Moreover, there can hardly be any question that the depositors and other creditors of a state-owned bank will be honored by the government, so that bad loans immediately become a fiscal problem for the government. These points suggest that discussions of resolution of the bad loans

[10] Unfortunately, little is known about bureaucratic behavior in state-owned banks, solvent or insolvent, since the usual rewards and punishments associated with profit-making institutions do not exist.

of state-owned banks should not be dominated by the issue of the impact of loan losses on government debt and deficits, particularly as preoccupation with this issue may result in larger losses through inappropriate actions. Rather, the solution should focus on the resulting incentives facing bank managers.

When a loan goes bad at a government bank, the government immediately suffers a loss, whether it is recognized or not. Government net debt increases because there is a liability without a corresponding asset, and the government's deficit increases because this debt must be financed. The government no longer has interest income but still must pay interest to the bank's creditors (even depositors on current accounts with no explicit interest receive implicit interest through liquidity-related services that must be paid for in the form of salaries to bank staff and other expenses). The government can increase tax revenues (or reduce expenditures) to pay this debt immediately, it can increase tax revenues (or reduce expenditures) enough to pay only the interest on this debt, or it can simply accumulate additional debt through capitalization of interest, leading to even larger interest obligations in the future. All of this is given and separate from any scheme a government may design to deal with bad loans at state-owned banks.

There are two procedures for restoring solvency to the state banks. Suppose there is a state-owned bank with so many bad loans that its liabilities exceed its assets after appropriate adjustments have been made to its balance sheet to account for these bad loans (that is, it is technically insolvent). If the government should wish to make this bank solvent again for some reason (for example, as a possible prelude to privatization), there are two approaches: increase the assets or reduce the liabilities. Reducing the liabilities of this bank (for instance, by canceling some debts that it owes to the central bank) in fact solves two problems:

- The bank becomes technically solvent; and
- Claims on the bank's reduced operating revenues (because of the bad loans) are thereby reduced by the amount of interest the bank formerly had to pay on these liabilities, so that the bank can better cover its operating expenses without having to try to operate with spreads higher than those of its competitors.

Despite the attractive features of the liabilities approach, none of the countries under review has pursued it to date. The more frequent approach is for the government to increase the assets of the bank (perhaps because the central bank objects to writing down some of its own assets — that is, its claims on the insolvent bank). Asset injection, however, raises questions such as:

- What rate of interest will be paid on the new assets provided by the government? If no interest is paid, the problem of the bank's reduced revenues from bad loans will not be resolved;
- Will the assets be negotiable? If they are, the bank can have potentially significant amounts of funds available for new lending; and
- Will these new assets be given in exchange for the bad loans? If they are, then further questions arise about whether anyone will continue to attempt to collect any part of these bad loans.

In short, even though the asset approach can appear attractive, especially if it reduces the apparent short-run fiscal costs (which it can do only in appearance because the fiscal costs were incurred immediately when the loans became bad), it is difficult to implement the approach in a way that avoids further losses. An effective incentive structure for asset-based plans is difficult to craft.

With any approach used, the crucial aspects of the outcome are:

- Whether the insolvent banks are returned to solvency (noting that, if they are given additional funds for lending, these can be lost);
- Whether the incentives facing management have been changed in a convincing way to encourage an appropriate combination of profit-maximizing and loss-avoiding behavior; and
- Whether serious and effective steps will result to collect the bad loans and restructure or liquidate companies appropriately.

These three points should be the main criteria against which possible plans are judged.

The preceding discussion has implications for current efforts to deal with bad loans in several CEE countries. Most important, it is extremely unwise to provide funds to the state-owned banks to resolve their bad loans without dramatically changing the incentives facing owners and managers — most definitively at the moment of privatization of the bank (perhaps as part of the privatization deal itself). In addition, it may be preferable to reduce liabilities rather than to substitute good assets for bad loans, so that the lending banks themselves — which presumably know their own borrowing clients better than anyone else — can attempt to maximize the recovery of these bad loans and thereby augment their profits and their capital positions. Although this does not in itself provide changed incentives to improve bank management, it does avoid providing additional funds to lose (and without such funds, bank management may become more serious in order to ensure that there are adequate funds for continuing the operation of the bank).

Centralized versus Decentralized Approaches

Plans for resolving the bad loans of state banks are in various stages of design and implementation in Poland, Hungary, and Bulgaria.[11] One major dimension along which these plans differ is their degree of centralization of the loan work-out function. Poland has opted for a decentralized approach, based on forcing banks to restructure their debtor companies in return for recapitalization and subsequent privatization. Hungary and Bulgaria are following more centralized approaches, involving moving bad loans off the balance sheets of the commercial banks and into centralized "hospital" banks. Bulgaria is the least advanced in this process, in keeping with its relative general lack of progress in privatization and because of a lack of funds for recapitalization of banks. Poland's plan, by contrast, has been greatly facilitated by the availability of nearly $1 billion in donor funds that will cover the greatest share of recapitalization costs.

Comparing the approaches taken by Poland and Hungary illustrates many of the principles outlined in the previous section and speaks to a broader debate about whether centralized or decentralized approaches are preferable. The brief conclusion is that the Polish plan represents a well-crafted decentralized plan, while the Hungarian plan represents a less convincing centralized plan (in other words, it would be hard to find a better decentralized plan, but easy to find a better centralized one). However, in the team's judgment, the decentralized plan is the better designed, because there are incentive features and timetables that demand action by the banks.

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[11] In Estonia there is no plan, because less than one-sixth of banking system assets are held as loans to SOEs, and government-owned banks are not as dominant in the system.

The Polish plan, in brief, meets the characteristics described above for a sound asset-based plan. It provides new funds for lending, in the form of interest-bearing government bonds, and it provides them in the context of a series of changed incentives for bank management. The recapitalization funds are available only after the bank has taken clearly prescribed steps to deal with its bad loans, beginning with establishing loan work-out capacity in its staff, and ending with putting the worst nonperforming loans into liquidation. The required actions for the portfolio are taking place in the context of government-established measures that prepare the banks for privatization. The prospect of privatization carries a striking incentive effect because the Polish government has set out a specific publicly announced privatization schedule and because the public response to the successful sale of the first of the state banks was enthusiastic. Moreover, because bad loans are to be handled by the banks rather than by a centralized entity, incentives are in place to maximize the value of the debtor state-owned enterprises (rather than to sell off their constituent inventory, plant, and equipment, as is otherwise likely).

The biggest questions facing the Polish plan are whether the government will hold firm — that is, whether it will refrain from recapitalizing banks that have not adequately restructured their portfolios when the deadline comes — and whether the funds that have been set aside for recapitalizing the banks are sufficient to put them on a firm footing, as the true magnitude of the unrecoverable debts becomes known.[12]

The Hungarian plan involves moving bad loans individually or in groups from the balance sheets of the commercial banks into a central work-out bank, in return for government bonds that match the size of the assets transferred. One round of this plan has already been attempted but was not very successful. A more comprehensive plan is being negotiated, based on a centralized model. The Hungarian plans still have not met the three outcome and incentive criteria outlined at the end of the previous subsection. They did provide new funds but were not accompanied by requirements for changed behavior on the part of the banks, particularly in the face of a lack of clear government commitment to privatize the banks, and funds were insufficient to restore the banks to solvency. Bank managers could sensibly conclude that they have received the first of an ongoing series of bail-outs, which seems to be occurring — with the second round planned for 1993. The Hungarian plan also has not established the most positive setting for the restructuring of debtor companies. It transferred debts to a centralized institution that had little expertise in work-outs, with the result that many state-owned enterprises had no effective creditor supervision for some time after the transfer. Although the banks that sold the loans may also have lacked experience in the work-out process, they at least had detailed knowledge of the debtor companies and could have used that knowledge to develop work-out plans and maintain relationships with those firms that proved viable. Apparently, the partial nature of the initial Hungarian plan sprang from the desire to hide the loan losses from the government balance sheet, in order not to show an increase in either government debt or the fiscal deficit. It may be possible for the plan recently negotiated to overcome some of the shortcomings of the previous attempt.

Comparison of the plans in Poland and Hungary leads to the following conclusions about the types of plans that meet the criteria established above for resolving bad debts in state banks:

- The solution should be as comprehensive as possible. Partial solutions cannot easily create the environment necessary to change behavior;

- Decentralization of responsibility for loan work-outs can enhance the incentives surrounding the work-outs and maintain bank-client relationships, while building the capacity of the commercial banks; and

[12] For a full explanation of the Polish and Hungarian plans, see the country reports that accompany this paper.

- To change the behavior of bank managers requires clear signals about practices that are acceptable, and can be enhanced by the prospect that banks must reach privatization within a short — but manageable — time frame.

DEVELOPMENT OF SKILLS AND MARKET ORIENTATION AT STATE BANKS

Restructuring of the state-owned banks is clearly dependent upon a comprehensive solution to the bad debt problem. However, it is clear that without an improvement in the banks' management abilities, continued poor credit assessment for new loans will lead to further accumulation of bad debt.

Banks and bankers have little real experience of operating in a competitive environment. Moreover, the uncertain environment during the transition phase will severely test the ability of management and staff to cope with great change. Stabilization or financial liberalization programs typically call for flexible and differentiated interest rates that require banks to make independent decisions on the creditworthiness of individual borrowers and the value of pledged collateral. The maintenance of positive real interest rates, while providing better signals for decentralized decision making and greater discipline in lending, presents managerial challenges and increased risks to existing financial institutions. The strain on the pool of human resources available to the financial sector is evident in the lack of development in areas such as credit evaluation, management information systems, administrative efficiency, audit and internal controls, loan work-outs, foreign exchange operations, marketing, and compliance with banking regulations.

Financial restructuring needs to be supplemented with administrative restructuring, including the potential layoff of staff, the rationalization of the branch networks, the streamlining of credit assessment procedures, establishment of loan monitoring and collection systems, asset and liability management, and an automated payment system. Many aspects of these problems are being left to individual banks to address on the basis of their business plans and their judgment of market opportunities (the consolidation process in Bulgaria is an example of local bank initiative). However, it remains clear that human resource constraints will continue to require experience transfers from abroad.

THE FUTURE OF STATE BANKS: PRIVATIZATION

Privatization of the state banks is both an ultimate goal of attempts to resolve bad loan portfolios and develop market competencies and a major facilitator of progress toward that goal. However, in some Central and Eastern European countries, privatization of banks has not received adequate policy attention. There appears some ambivalence about privatization, including questions of how soon to privatize and what the ultimate role of the government should be. As a short-term concern, effective governance of state banks is needed during the preparatory period.

The prospect of privatization can provide strong motivation for bank managers to improve operations and balance sheets. In Poland, the successful April 1933 sale of a major state-owned commercial bank, Wielkopolski Bank Kredytowy, has made privatization a real and potentially prestigious goal for managers at the other banks.

The basic question surrounding privatization of banks is where effective ownership and governance will come from. Widespread public ownership may not bring effective governance in a setting where stock markets are in their infancy. However, effective local institutional owners may be

difficult to find. Countries appear to regard foreign owners with some suspicion, although foreign banks can offer much-needed technical skills. State enterprises are among the most eager prospective purchasers, but banks must be protected against enterprise owners who see the banks as their own source of funds. In part because of these questions surrounding ownership, some Central and Eastern European governments are envisioning a long-term role for themselves, at least as minority shareholders. Here, different forms of governance for the state shares may lead to better or worse behavior by bank management. These questions are difficult to answer at this time and in the abstract. This report stresses that privatization of the state banks should be a clear goal of financial sector development and that these ownership questions should receive greater analysis and debate.

SECTION FOUR

THE DEVELOPMENT OF BANKING SERVICES

CREDIT TO PRIVATE BUSINESS

A chief test of financial system health is the active engagement of banks in lending to private enterprise. In fact, the emergence of large and varied private enterprise loan portfolios and the decrease in spreads earned on those portfolios by Central and Eastern European banks will be among the indicators that the banking sector has completed its transitional phase.

Bank lending remains far from the goal of granting sound loans to the private sector in the four countries under review here. Loans to private enterprise represent a small share of bank assets (compared with that share in most economies represented in the Organization for Economic Cooperation and Development) and currently are not growing. In Poland, for example, where the private sector is relatively large (more than 45 percent of GDP in 1992) and is growing rapidly, banks hold 35.5 percent of assets in loans to enterprises, but most of those are loans to SOEs. It is generally believed that new net credit to the private sector has increased very little, if at all, in real terms during the past year (no aggregate banking sector data separate private from state enterprises). Net lending to the entrepreneurial sector in Hungary is 63 percent of total assets, but, as in Poland, most of these are SOE loans, and new net credit is decreasing. In March 1993, 26 percent of total Estonian bank assets were loans to the private sector, and there was no significant upward trend in real value. The percentage is significantly lower in Bulgaria.

The range of credit products offered is narrow. The overwhelming majority of loans are short-term (less than one year) with few long-term loans. Such conservative lending may be good for the soundness of the banking system, but it implies that banks are not yet able to act as major allocators of investment throughout the nonfinancial sector.

Many factors contribute to the low level of private enterprise loans. These can be classified into three groups: macroeconomic conditions, structural constraints, and incentives induced by bank regulatory policy.

In most Central and Eastern European countries, macroeconomic conditions are depressing the volume of funds available for lending to private enterprise. In Poland, Bulgaria, and Hungary, banks are being called upon to finance most of the government budget deficit. Similarly, the large nonperforming loan portfolios tie up funds and, more important, cause banks to increase lending spreads on all loans to compensate for lack of income on the bad loans. High inflation and volatile inflation rates have an effect on the pricing of credit, and borrowers are reluctant to pay the high nominal interest rates banks demand when they are unsure of whether their own sales will keep pace with inflation or what future inflation will be. Finally, foreign exchange restrictions promote holding of deposits offshore, again reducing the funds available in the banking system. These macroeconomic factors have a large and rapid effect on aggregate financial sector behavior, but for the most part they are driven by factors beyond the scope of direct banking sector policy. Moreover, prospects for paring back fiscal deficits and, hence, government credit absorption are not positive in the near term. In assessing progress in financial sector development, however, it is important to abstract somewhat from these macroeconomically induced phenomena, to look at sector-specific bottlenecks to private credit. If structural progress has been made

on those bottlenecks, there will be a rapid response when the macroeconomic problems are brought under control.

There are reasons to believe that the underlying problems have not yet been solved. The fact that banks in each of the countries reviewed are now excessively liquid reveals that it is more than lack of available funds that keeps banks from lending to private enterprises. Structural conditions are not conducive to sound borrower-lender relationships.

Some of the structural problems are internal to banks, particularly shortages of skilled credit officers. The need of banks for skilled loan officers and related bank staff is so strong that demand for credit-related training will exceed supply for years to come. Similarly, banks need to develop their internal credit systems and policies. Loan products that fit the environment, such as leasing, are only beginning to be developed. Technical support and policies that promote competition between banks will move this process forward more quickly.

Other problems reside among borrowers. An obvious (but easy to overlook) fact is simply the small size of the private sector — there are still relatively few prospective borrowers, although the number grows steadily. In addition, private sector borrowers present banks with two types of problems: actual risk problems and information problems. High business risk is endemic throughout the CEE private sector. Businesses face rapidly changing market and competitive conditions, and they have relatively little experience on which to draw. In all countries, it is reported (though not well documented) that portfolios of private loans contain high percentages of nonperforming loans.

At the same time, borrowers often lack the ability to provide adequate and relevant information to banks. The lack of widespread knowledge of the accounting standards that are being put into place means that prospective borrowers have difficulty establishing the credibility of their financial statements. A high percentage of applicants have short track records and minimal credit histories. Credit reference systems are embryonic at best and, in some countries, are hampered by bank secrecy laws. Finally, the legal foundation for secured lending remains less than satisfactory in most countries. This problem encompasses laws governing collateral and the establishment of registries for liens, as well as the transitional status of property rights and ownership in these countries.

Another set of constraints to bank lending operates at the level of banking policy and regulation. Bank regulations and the development of various forms of interbank cooperation shape the incentives that can encourage or discourage banks from making more business loans. Banks are willing to extend a higher percentage of their assets as loans (and, accordingly, to require lower lending spreads) when they have adequate means for managing liquidity risk. Availability of liquidity management tools is also important for allowing bankers to extend the average term of their loans. In the more advanced of the review countries, Hungary and Poland, interbank markets are well on their way (although limited to the larger banks), and the central bank also offers liquidity management assistance as a lender of last resort. Liquidity management tools in Estonia are practically non-existent. Banks do not trust one another's financial status enough to place deposits, and the central bank, functioning as a currency board, does not act as lender of last resort.

High reserve requirements also restrict the amount of lending that banks do, and because reserves are not remunerated, they push required spreads up as well. Reserve requirements are gradually being reduced from previously high levels in Poland and Hungary. Furthermore, a wide constellation of regulations works to define what kinds of loans banks will undertake. This includes rules on provisioning, taxation of banks, and foreclosure of assets and requirements governing the nature and size of security. In many countries these regulations are in flux. It is difficult to tell what effect they have

on banks. On one hand, frequent changes of regulations may lead banks to act with caution while, on the other, lack of adequate supervision of the regulations reduces caution.

Finally, willingness to lend will be influenced by expectations about the government's response to bank insolvency. By making it clear that insolvent banks would not be bailed out, Estonia's central bank has induced banks to minimize risk exposure. The governments in Poland and Hungary have allowed some signals that they are willing to engage in bail-outs (and not only those connected to problem SOE loans), particularly for state-owned banks. This issue is at the heart of the debate over deposit insurance, which is being considered in each country. As noted above, it is crucial that any deposit insurance program be limited enough not to encourage banks in excessive risk taking and be created in the context of effective bank supervision. More generally, if there is a trade-off between banking policy that promotes cautious institutions and policy that promotes more credit, it is better to err on the side of creating strong banking institutions. The alternative course is ultimately self-defeating.

It is evident from the multiplicity of causes that an increase in lending to the private sector will be a gradual process, synonymous with the development of the banking sector itself. Therefore, the best strategy for increasing private sector credit is to strengthen the banking sector, with a particular emphasis on creating conditions in which lending will take place, such as by focusing on constraints like secured lending law.

THE LEGAL AND ACCOUNTING FRAMEWORK FOR LENDING

The prospects for increased lending by banks depends on the clear recording and effective enforcement of financial obligations. Risks and costs increase in proportion to the difficulties encountered in collecting against loans in default or in settling disputes of ownership and control. Higher collection costs and uncertainty lead to higher interest rates and costs of investment. In the old CEE system, the rights of creditors and the obligations of debtors had little commercial significance, due to the subordination of credit allocation to the central plan through the state budget. Obligations between state-owned enterprises were not rigorously enforced, because the state ultimately settled (or ignored) claims. The distinction between a budgetary advance and the provision of credit accompanied by an obligation to repay in the future was not clear.

Constructing an appropriate framework to govern financial contracts is a major task that includes the enactment of appropriate laws, regulations, and rules governing financial transactions and the establishment of institutions with the skills and experience to monitor and enforce the laws and regulations and apply appropriate penalties. Several countries have enacted wide-ranging legal reforms in company law, securities regulation, and banking that should provide an important framework for financial sector development. However, establishment of efficient courts and regulatory bodies has just begun. Court systems are becoming clogged with civil and commercial cases, which they have limited capacity to process.

Effective bankruptcy laws and procedures are an urgent priority, not only because of their effect on willingness to lend, but also as part of the resolution of the state enterprise debts discussed in Section Three. Hungary and Poland have had limited experience with bankruptcy procedures. In Hungary, the laws themselves are reasonably adequate. However, the tendency has been to employ such procedures mainly for smaller enterprises. The selective use of bankruptcy laws for all enterprises would provide financial and legal incentives for creditors and debtors.

Laws governing private ownership and title to land and other assets are required for banks to be able to value and ascertain ownership of assets pledged as security for a loan. Notwithstanding the problem of valuation, which is difficult where markets do not yet exist, clear title is an important prerequisite for standard banking business, as are laws on secured transactions.

Reliable information is also a crucial input into the environment for lending. It is crucial that such information be presented on a consistent basis, to enable comparisons over time and among firms. At present, the quantity and quality of information is extremely limited. Historical financial information derived from the price structure of a firm's inputs and outputs was severely distorted under centrally managed systems. Previously recorded profits are therefore only notional. Concepts of value based on the discounted present value of future flows are poorly understood and rarely applied.

Improvements in the quality and quantity of information available will come only gradually, as banks and other financial intermediaries begin to demand them. However, immediate steps can be taken in training at the level of individual institutions and, more generally, through the education system and specialized bank training institutions. The domestic accounting and auditing profession, in particular, needs support — to ensure that this usually self-regulated profession evolves into a respected arbiter of the accuracy of financial statements. A less desirable alternative is that the responsibility for ensuring accurate financial reports could rest with government regulatory authorities, particularly until the accounting profession is well established.

SPECIALIZED CREDIT PROGRAMS

During the transition to a market-based financial system, before banks lend to private enterprise actively, representatives of various economic sectors (such as housing, agriculture, small business, and municipalities) often argue that there is an overriding national interest in financing the expansion of their sectors and that this interest cannot be postponed until the financial system matures. They argue for the establishment of specialized lending directly to the preferred sectors.

Many of the specialized financial institutions now operating were part of the old regime, established prior to the major banking reforms. They include networks of agricultural cooperative banks in each country and, in some countries (such as Poland), use of the savings bank as the vehicle for below-market housing construction loans. More recently, several other specialized institutions have been set up to fill perceived vacuums in the financial system. Converting these institutions to operate on a self-sufficient basis is complicated by the continued channeling of lines of credit through them by donors and government, often at highly concessional rates. The U.S. Government, through the Department of Agriculture, is one of the donors that have done this in Estonia. Donors have also been setting up lines of credit to run through nonspecialized banks.

The detrimental effects of subsidized lines of credit have been extensively documented around the world. Problems include the disincentives they create for deposit mobilization and for development of similar lending on a for-profit basis. In essence, these programs slow the development of the financial system, perpetuating the problem they were meant to address.

Before deciding that there are needs for financing targeted or preferred sectors that donors or government should accommodate, program designers should investigate sources of finance that enterprises are actually using, which will include informal sources. The informal financial sector has received virtually no attention in CEE countries, in the belief that informal mechanisms do not exist. However, the rapid rates of increase in private sector activity demonstrate that finance is available through some

mechanism. Anecdotal evidence (such as that regarding the investment societies operating in the area around Krakow, Poland) confirms this notion.

Program designers should also investigate why highly liquid banks are not adequately serving their preferred sectors. Such investigations might reveal why the establishment of a specialized institution or line of credit is not the best way to solve the perceived problem, but that work on the underlying structural constraints could be the basis for a permanent solution.

If specialized credit programs are designed, they should be crafted to minimize negative repercussions on the financial sector. To illustrate, small business lending efforts such as the Polish American Enterprise Fund's Enterprise Credit Corporation can be helpful if:

- They are designed as demonstration projects to overcome lack of familiarity or lack of information about how to serve the client group, with the expectation that the activity will be profitable;
- They bring technically qualified people into the process in a long-term, effective way (as opposed to the standard line of credit that offers short-term banker training in specialized lending); and
- They are stopped or are converted into for-profit institutions operating without subsidy as soon as the banking sector begins to pick up on the example.

SAVINGS BANKS AND RETAIL BANKING ACTIVITIES

Retail banking is a relatively neglected activity in CEE countries. Commercial banks — including banks with foreign participation, large state-owned banks, and smaller private domestic banks — have tended to focus on what they perceive as the relatively profitable activities of corporate and investment banking. As a consequence, retail banking and, especially, the provision of credit and deposit services to individuals and small-scale businesses have been neglected, although they can in fact be profitable. For commercial banks in the aggregate, the amount of credit provided to households and small-scale entrepreneurs is only a small fraction of the amount of credit going to larger-scale enterprises. For deposits, especially short-term deposits that would be relatively attractive for small-scale enterprises and households in need of frequent access to liquidity, interest rates have been almost continually negative in real terms during the 1990s in most CEE countries. Moreover, while payments systems in most of these countries seem able to handle transfers among banks quite rapidly, long delays are reported to be typical before individuals can have access to the funds they have deposited.

The general neglect of retail banking notwithstanding, there is one institution in the banking system of each CEE country that is dedicated to providing banking services to individuals (and, to a lesser degree, to small enterprises) — the savings bank. In addition, many of these countries have systems of postal banks that are oriented toward the same clientele and, like the savings banks, have widespread branch office networks because of their connections to their countries' postal systems. In a few countries, especially in the rural areas of these countries, there also are systems of savings and credit cooperatives that provide credit and deposit services to individuals and small-scale enterprises. Finally, in Poland and one or two other Central and Eastern European countries, larger commercial banks have occasionally shown some interest in deposit mobilization, but no interest in lending to individuals and little interest in lending to small enterprises. The remainder of this section examines how retail banking services can most effectively be enhanced in these countries in the short and medium terms, given the current lack of

interest of most commercial banks and the predominant, perhaps monopolistic, position of the savings banks.

Most savings banks in CEE countries were founded many years ago to mobilize deposits from individuals and pass these funds to the monobank system for their subsequent allocation to state-owned enterprises. With the beginnings of financial reform and the separation of monobanks into central banks and commercial banks, the savings banks continued to pass most of their funds to central banks, where they were used to provide liquidity to commercial banks and to finance governments' fiscal deficits. During the years, most savings banks also acquired a few other functions, such as providing housing loans and payments services; with the advent of financial reform, these functions typically expanded to include other types of lending. Although savings banks in most CEE countries have now acquired the right to carry out regular banking functions, they still can easily be distinguished from commercial banks according to several characteristics:

- They have hundreds of branches and thousands of employees throughout the country;
- They have a very high portion of the individual deposits of the total banking system, but far fewer enterprise deposits;
- Most of their lending is to the central bank, or to commercial banks if an interbank market exists; and
- Their remaining lending is largely unfocused (as they search for appropriate market niches) but typically contains a high portion of problem loans, particularly old housing loans at fixed low-interest rates in the face of recent high inflation and new nonperforming loans to enterprises with which they have had little prior experience.

In addition, savings banks in some countries provide financial services to local governments (municipalities), including both loans and deposit facilities.

There are two quite different views of savings banks held by international agencies (and possibly also by government officials in CEE countries, although these were less outspoken):

- Most international agencies perceive savings banks as monopolists providing poor service to their retail banking clients, with their monopoly positions maintained in part by their infrastructure of widespread branch office networks, but mainly by government guarantees of their deposits.

  The failure of commercial banks in Central and Eastern Europe to enter the retail banking market aggressively, with serious programs of deposit mobilization in particular, appears to have more to do with their current strategic focus on corporate and investment banking than with the costs of developing branch office networks. In addition, there is no empirical support for the view that deposit insurance is a crucial factor in deposit mobilization in most CEE countries, as no relevant studies could be found.[13] Serious studies of depositor

[13] Proponents of deposit insurance generally base their arguments on the possibility of runs on banks rather than on the need to put all banks on an equal footing competitively. The discussion of deposit insurance elsewhere in this report emphasizes the point of not introducing deposit insurance until bank supervision is strengthened enough to handle the moral hazard problems of deposit insurance.

behavior and preferences are clearly quite important from the perspectives of government policy makers and bank marketing strategists.

A frequently heard recommendation of those holding the view that savings banks are inefficient monopolists is that savings banks should be dismembered and sold off piece by piece to other commercial banks. The problem with this recommendation, as suggested above, is that, although other banks in Central and Eastern Europe are not in fact interested in retail banking in general or deposit mobilization in particular, these other banks might be quite interested in buying savings bank branches to obtain the deposits that would come with the branches, especially if liquidity is tight — even though these other banks might have no intention of providing an appropriate range of services to depositors.

- The other view, with its corresponding recommendation, is that savings banks in Central and Eastern Europe should be strengthened through training and technical assistance and, especially, through policies that favor competition. While some of the training and technical assistance might focus on improved service for depositors, at least equal emphasis should be given to improved lending and to the investment of surplus funds in the interbank market and elsewhere. Many savings banks have, as noted above, already experienced significant difficulties with lending to larger-scale enterprises. Thus, a preferable strategy may be for savings banks to continue to focus on the markets they know best — individuals and small-scale enterprises. In these markets, savings banks have the special advantage of key information about potential borrowers, provided by their past histories as depositors.

An innovative approach to privatization can also be pursued for savings banks. Instead of selling savings bank branches to other banks, savings banks could be privatized by offering depositors the opportunity to convert their deposits at their savings bank into shares in their savings bank, thereby adding to equity capital and creating more widespread ownership than for most other banks.

Additional government actions to improve retail banking services provided by savings banks include more aggressive policies to promote positive real interest rates on deposits, technical assistance and incentives to speed the clearing of payments, and — especially important — actions to encourage greater competition from other financial institutions. In the short run in Central and Eastern Europe, the main potential competitors of savings banks are probably postal banks rather than commercial banks (with the possible exception of Poland, where the state-owned commercial banks do enter the retail market on the deposit side). Postal banks have not only widespread branch office networks of their own, but also additional outlets stemming from their connections to their countries' postal systems. Like savings banks, they focus on individual retail deposits, and, in some countries, they have the added advantage that ownership is partly foreign (for example, in Hungary, with Austrian postal bank ownership) and is able to provide major managerial inputs.

In some CEE countries, there also are systems of savings cooperatives or land banks that provide credit and deposit services to individuals and small-scale enterprises and that could further enhance the range of retail banking services available and provide additional competition for savings banks. The savings cooperatives sometimes operate in a manner similar to credit unions in the United States and have, in some cases, received technical assistance from the U.S.-based World Council of Credit Unions (WOCCU). In Poland, for example, the U.S. Government sponsors WOCCU to assist in formation of employee-based credit unions at major enterprises (though not with the existing rural cooperative banks). Although the vast majority of savings cooperatives may be small and weak, they nonetheless may have considerable potential outreach in small towns and rural areas where most of them are located and where there are few other providers of financial services. U.S. Government training and technical assistance activities might be expanded to include savings cooperatives, but detailed analytical work by experts

would be advisable to assess the current situation and the potential of these savings cooperatives and to decide which model is the most appropriate approach for the countries of Central and Eastern Europe.[14]

THE EMERGING PRIVATE BANKS

The patterns of newly established private banks in Central and Eastern Europe differ widely by country, from Estonia, where private banks dominate the financial system, to Bulgaria, where private banks are barely beginning. Where private banks have been allowed, they tend to be growing faster than the state-owned banks, although they still make up a small amount of banking system assets in most countries (in Poland, 10 percent). Although the histories of private banks in each country differ, some recurrent patterns have emerged, and this report argues that the private bank deserve greater attention.

Despite their present small size, private banks are important to the future of the banking system for several related reasons: their increasing market share, their potential to provide competition, and their potential contribution as innovators to service improvements. A growing number of the private banks show these characteristics already. Because these new banks focus on basic trade and working capital finance, they are beginning to draw high-quality business away from the state-owned banks. However, the extent of their contribution will be reduced if some of the other patterns accompanying many of the private banks are allowed to prevail: ownership by enterprises (public and private) that see the banks as in-house sources of funds, the banks' low level of experience in lending (leading to high loan losses), and their small capitalization. In fact, some banks combine the positive features (service innovation) and the negative (shaky financial structure). These features have been encouraged by a laissez-faire attitude about private banking that characterized the first round of banking law reforms, with the result that private banking did not begin on a very sound footing in many instances. The subsequent high failure rate and scandals such as the Art-B check-kiting episode in Poland have lowered confidence in private banking. Most countries are in the process of tightening regulation of private banks — for example, by restricting insider lending and by increasing minimum capital requirements — but still face the existence of weak institutions with high portfolio risk.

This report makes two suggestions concerning private banks: that the supervisory authorities develop a more comprehensive approach to the private banks and that private banks gain greater access to expert technical resources through bank training or through support to bodies that serve banks, such as bankers associations.

TRANSACTIONS-RELATED SERVICES: PAYMENTS

The range and quality of payment-related services in CEE countries has improved dramatically during the past three years. Payment delays are no longer measured in weeks or months, but, for the most part, in days. Two factors account for these changes — incentives and technology. The team argues that greater attention needs to be paid to the incentives affecting payments, which will lead to a

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[14] Because these are deposit-taking institutions, consideration should be given to their prudential regulation and supervision. This has proven problematic in even the more advanced developing countries, where such institutions may not only be numerous but also weak and thus in need of significant attention from supervisory agencies already fully occupied with larger financial institutions.

focus on increasing competition among banks and implementing regulatory policies that prohibit banks from simply maximizing float.

There has been a great deal of investment in technology. Payment systems at all central banks have been the recipients of assistance in upgrading technology and improving operations. The new systems are in varying states of completion, and, in some countries, the new systems have not yet been tested.

Banks have invested internally as well. Reorganizing internal transfer of funds has in many cases been a major undertaking. For example, in Poland, before the reforms, each branch of the state-owned banks communicated directly with the central bank in making payments. Not only equipment but also procedures had to be overhauled in order for the headquarters of each bank to gain control over the activity of its branches. One measure of progress is the ability of banks to form domestic payment networks among themselves. The leading banks in Poland created an interbank clearinghouse that began operations at the start of 1993. Similarly, banks throughout the region are increasingly able to join the Society for Worldwide Interbank Financial Telecommunication (SWIFT) for international funds transfer. CEE banks that participate in domestic or international systems must cross thresholds in terms of financial soundness, quality of financial statements (because of the risk exposure involved in payments), and technological capacity.

Payment-related services still have far to go to reach international standards. For example, in most countries, customers must initiate payments through teller transactions, and nearly all payrolls are paid in cash. Checks, credit cards, and debit cards have been introduced in some places, but are not widely available or widely accepted yet.

In the focus on technology, the importance of the incentives surrounding payments has been underemphasized. Yet the shape of incentives governing speed and accuracy of payments has a strong and pervasive impact on bank behavior. Banks are slow in making payments — particularly between bank and customer, not just bank to bank — either because they are inefficient or because they wish to take advantage of float. Both of these reasons demonstrate a lack of proper incentives. Improved incentives result from increased competition among banks (when customers can demand better performance with the threat of going elsewhere) and from regulations prohibiting abuses. In the old system, neither banks nor the SOEs they served were called to account for their financial standing, so there was no effective customer demand for prompt payment. In each country under review, with the possible exception of Bulgaria, dramatic changes resulted from placing SOEs and banks on a more businesslike basis so that clearing accounts became more important to all parties. The imposition of a hard budget constraint on SOEs, where it has occurred, has been a crucial step in making SOEs more demanding of improved payments. Change related to increasing commercialization of banks and their SOE customers may account for a greater share of the improvement in payments than does new technology.

Competition has also driven improvements. The first step toward competition among banks was the creation of the two-tiered system, and the second was the entry of private and foreign banks. For many of the private banks, quality of service has been one of the main means of competing, although, because they are weaker financially, they are at a disadvantage with respect to larger banks, mainly because they lack access to the interbank funds market. Similarly, customers in smaller towns are likely to suffer from poor payment services because of a lack of local competition among banks. Observers in several countries report that competition has taken place in terms of quality more than price. Bank charges in Estonia, for example, are quite high. Foreign and joint venture banks in Hungary have been strong competitors, but the effect of their competition is diminished by market segmentation — they serve

few local Hungarian clients. Performance is particularly lagging in payments to individuals, because of the lack of interest in retail banking.

Direct policies to penalize poor payments performance have been used to increase speed. The most dramatic example of this is Estonia, where payment delays had lengthened to several weeks in the fall of 1992 because of liquidity problems at three of the largest banks (which were actually insolvent). After halting operations at these three banks, the Bank of Estonia issued a regulation requiring steep penalties for delays of payments beyond two days. Reportedly, nearly all domestic payments are now made within the limit.

SECTION FIVE

CAPACITY DEVELOPMENT AND THE ROLE OF DONORS

APPROACHES TO DONOR ASSISTANCE IN CEE COUNTRIES

The creation of modern financial systems throughout Central and Eastern Europe requires an enormous transfer of knowledge. The facts of the situation are simple: the newly democratic CEE countries are committed (to a greater or lesser degree, depending on the country) to building market-based economies, including the financial systems that help those economies to function. At the time of the great reforms of the late 1980s, very few Eastern Europeans had relevant, first-hand experience of the ways such systems worked. Their existing systems were based on such different principles (for example, the central plan) that they could hardly be characterized as financial systems as understood in the West. The relevant expertise resided largely in the market economies where such systems operate. Thus, the question has not been whether external experience is needed, but how best to transfer and adapt it, and who should take roles in organizing the transfer and adaptation.

Most of the transfer and adaptation takes place spontaneously, regardless of whether any donors are involved. It happens whenever an Eastern European banker reads a Western accounting book or financial newspaper or travels to another country to attend school or visit a correspondent institution. The eagerness with which participants in the Eastern European financial system have learned about banking in market economies on their own or with the support of their institutions is impressive. One could argue that spontaneous transfer will ultimately be the most important mechanism for bringing external experience to CEE countries.

Many initial attempts of donors to support financial system development in CEE countries were essentially ways to accelerate and finance spontaneous transfer, both by bringing experts to CEE countries and by sending CEE bankers abroad. These efforts succeeded because during the initial stage almost any contact involved the exchange of new information. The marginal value of each new contact was high. This model of assistance was also appropriate because recipient governments and institutions were still very new or recently reoriented and had not yet learned how to work effectively with donors. Donors also had to learn what was needed and how to provide it.

More recently, however, most donors and their local counterparts have evolved a more strategic approach toward assistance. A strategy for deployment is needed whenever resources are scarce and expensive. More particularly for financial sector development, it has become apparent that:

- Progress in key areas (such as the central bank) can relieve systemwide constraints, accelerating development, and, therefore, some activities are more valuable than others; and

- As time goes on and more knowledge is transferred, donor activities where the marginal value of assistance exceeds the cost become fewer. Accordingly, most of the donors and governments have begun to develop strategies around which they plan their programs, although, in each instance, the source of the initiative has been different.

In many cases, one of the host government or other local institutions (such as the central bank and, perhaps, the bankers association) is in a better position than donors to know where the most

important targets are and to organize assistance so that it meshes with its own plans for development. Poland's plan for the Financial Restructuring of Enterprises and Banks is an example of such a country-led program, orchestrated by the Ministry of Finance in close consultation with donors.[15] When government is taking a strong leading role, and when the direction it sets is congruent with the views of donor organizations, plans will be well conceived and assistance is most likely to be effective.

Unfortunately, however, government and other key institutions have not always been strong enough to take this leading role, or they have not considered this area a priority until recently. Almost by definition, when it comes to financial sector expertise, country institutions need to develop their own capacities — for example, in strategic planning — before they can take on the responsibility to plan the next steps in reform. Alternatively (but having the same practical consequence), government and donors may have fundamental differences of opinion about the direction of change and the types of technical assistance required. Such situations, which prevail frequently, constitute the greatest challenge to the U.S. Government in designing assistance programs.

In such a situation, it is tempting for donors to take the lead, developing a program to which the government assents in return for receipt of financial and technical resources. This model has been operative in Bulgaria, with the World Bank's bank consolidation plan. However, the drawback of this way of proceeding is that government and other key local institutions are unlikely to pursue the resulting plan wholeheartedly, because they face political pressures that the donor ignores, because they do not understand the plan, or simply because it is not "their" plan. Thus, expertise supplied as part of such a plan is less likely to be effectively used.

In situations where donors and government do not agree, or where government is not capable of moving forward, the task of donors is certainly much more difficult. Assistance programs must be pieced together from several elements. Arguably, the most important of those elements is policy dialogue, in which donors and government (or other relevant institutions) examine policy issues together on an ongoing basis. Other tools to use in situations where the local plans are not well formulated include:

- Focusing on the specific areas where there is policy-level agreement (even if in a very limited set of activities);
- Carrying out selected demonstration activities that have the potential to change thinking on critical policy questions; and
- Supporting spontaneous transfer.

With these comments as background, the next section examines the activities of the U.S. Government and other donors in CEE financial sector development.

SUMMARY OF USG ASSISTANCE ACTIVITIES

USG's flagship financial sector assistance project is the Treasury advisors program. Through this program, 29 long-term advisors are in place, of which 19 are focused on financial or banking sector activities (the remainder work on tax, fiscal, or budget policy). The advisors currently work in leading government offices and financial institutions in nine countries, including former Soviet republics. Of the

[15] As discussed earlier, greater involvement of the central bank would be beneficial.

19, nine work in state-owned commercial banks, five in central banks, and five in a range of other institutions. Many of these advisors are native speakers of the local or national language, and all have technical skills directly relevant to their assigned tasks. The success rate of the recruitment process Treasury has carried out is impressive. With few exceptions, the advisors have had the technical and personal skills to make significant contributions to their host institutions. This program will be analyzed in greater detail below.

Treasury also offers a program of banker training, carried out through a contract with KPMG Peat Marwick. The approach taken through this contract is to work with banker associations to develop bank training schools. The assessment team concurs with the activity's two guiding principles: first, the decision to concentrate on building long-term bank training capacity (as opposed to simply providing training courses), and, second, the principle that banker associations should play a leading role in developing bank training institutions. This program is discussed more fully below.

A.I.D. has begun to implement discrete financial sector activities, largely through the mechanism of its indefinite quantity contract (IQC) with KPMG Peat Marwick on privatization. The activities in the four countries reviewed include work on strategic planning and development of part of an on-site inspection manual for bank supervision with the National Bank of Poland and advice to the Bank Privatization Working Group in Hungary on loan consolidation. There are additional activities in countries not covered in this review.

Several other mechanisms have been used to provide assistance in financial sector reform: short-term specialized assistance through the Financial Services Volunteer Corps (FSVC), primarily in capital markets development; short-term assistance to central banks from the staff of the Federal Reserve System, generally under the direction of the International Monetary Fund; and a range of other activities such as advisors from the Securities and Exchange Commission and legal reform efforts such as the Iris project in Poland. The Enterprise Funds, operated privately with USG funding, have made investments in selected banks and have opened small business credit windows.

Finally, there has been one major commitment of funding for development of the financial sector, in the agreement of USG to reprogram the Polish zloty stabilization fund for use in bank recapitalization in support of the Polish Financial Restructuring of Enterprises and Banks program.

The remainder of this section discusses the findings of the review team regarding USG approaches to financial sector development in CEE countries. As the core program of Treasury advisors covers the states of the former Soviet Union, the following discussion may have some bearing on planning for assistance in those countries as well.

TREASURY ADVISORS: PLACEMENT OR DEVELOPMENT

The Treasury Advisor program may be best understood as a placement program rather than as a development program of the type normally associated with A.I.D. As a placement program, it concentrates on carrying out four functions:

- Selecting positions for advisors to work in;
- Securing agreement regarding placement with recipients;

- Recruiting qualified advisors; and
- Supporting them in the field.

These four functions form the basis on which this program should be assessed. The program generally stops short of the more ambitious goals of development programs, in which USG and the recipient negotiate specific program objectives that the recipient strives to achieve. The difference between the two is the extent to which, in a development program, the agreement centers on commitment by the recipient to reach certain objectives, rather than on the technical assistance, which instead plays a supporting role.

On the basis of interviews with a number of Treasury advisors and many of their clients, the team finds that a straightforward emphasis on placement, as opposed to detailed development programming, was and continues to be appropriate, given the resources USG has to bring to CEE financial system development. Furthermore, the team finds that Treasury has implemented the program well in most respects. In particular, the program got well-qualified advisors into the field quickly, at a time when acting quickly was a most important element of the strategy. There are a number of issues that deserve mention, discussed below. These issues give rise to specific suggestions for improving the program, which would move it more in the direction of a development program, while preserving its basic current character. The four main program functions are discussed in turn.

Strategy for Identifying Placements

The Treasury program appears to be guided by a straightforward set of principles in identifying placements. These include following the suggestions of a ministry of finance, spreading advisors among prominent institutions, and participating in the plans being developed by government with other donors, particularly the World Bank. Two questions arise with respect to placement strategy.

The first of these is the choice of institutional type: commercial bank, central bank, ministry of finance, or some other institution. The current Treasury program involves all these institutional types, with commercial banks predominating. The economic rationale for placing an advisor in a state-owned commercial bank depends on the role of that particular bank in broader financial sector development and the tasks assigned to the advisor. There may be little rationale for assigning an advisor to work on general development of banking capacity for a bank that is both profitable and dominant in its market, essentially increasing the competitive advantage for that institution.

Placement of advisors should support overarching financial sector development goals identified as important in earlier sections of this report. These include increasing competition, privatizing state banks, and generating a demonstration effect of important financial sector innovations. For example, in some instances, supplying a general advisor to a particular bank might not meet this test, but supplying an advisor to work on privatization plans would.

Establishing a hurdle in terms of broader financial sector development will still leave a wide range of possible institutions and tasks. One of the more important arguments in favor of continuing to support commercial banks is that Treasury is likely to be able to continue to attract very talented bankers, given the large number of experienced commercial bankers in the current soft domestic banking market.

This paper has emphasized the need for greater assistance to central banks, particularly in the formulation of strategy and policy, including bank regulation and supervision. Development of capacity at central banks is clearly a constraint to financial sector development, and, thus, the rationale for

supporting central banks is strong. However, a note of caution is that it is significantly more difficult to recruit appropriate advisors for central banks than for commercial banks. Central bank policy advisors should have exceptional qualifications involving policy analysis and strategic planning. It may be easier to identify people with specific, more limited technical expertise. However, as noted above, the greatest need appears to be precisely at the higher level, where fewer top candidates are to be found.

Similarly, for bank departments devoted to loan work-outs and privatization, recruitment is also more difficult than for general banking staff. Extensive banking experience is not sufficient. Advisors should have the requisite economics and finance background to be able to analyze the effects of policy choices. During the course of interviews with advisors, the team observed that the U.S. Treasury tax and budget advisors in ministries of finance appeared to be particularly successful. Treasury has been able to identify individuals from state tax and budget offices who have faced in their own work a similar array of concerns to those facing their counterparts. This success may result in part from the fact that Treasury's own domestic role in tax and budget gives Treasury relevant expertise.

The second question on placement strategy concerns the relationship of USG assistance to plans and assistance developed by other donors, such as the World Bank. Where the international donors have developed programs, in Poland, Bulgaria, and Hungary, the Treasury program has sometimes supplied advisors in support of that program. In Bulgaria, the advisor's task relates directly to fulfillment of conditionality imposed by the donor agencies but not fully internalized by the recipient. In these cases, the advisory relationship is not working well, or is working well only by dint of the advisor's personal skill in overcoming an initially unfavorable environment.

Given the small number of advisors that the Treasury has resources to provide, it is important that the Treasury consider how to avoid this problem. As discussed above, in cases where donors and government disagree about basic policy direction, or where the host institution is simply not yet capable of setting and implementing policy directions, specific technical-level assistance should generally not be supplied. If assistance is given, it should remain at the level of policy dialogue. The U.S. Government could reduce the risk of entering prematurely into specific technical-level assistance by becoming fully involved from the beginning in the analytical work that leads to these programs. For example, USG staff or consultants could participate in World Bank project identification and appraisal missions. This type of participation would have the dual advantages of flagging early for the USG problems of inadequate host country receptivity or commitment and giving USG an opportunity for greater input into the direction these plans ultimately take. Alternatively, there will be cases where it is better for Treasury simply not to work in settings that are connected to imposition of conditions on unwilling (or unprepared) organizations.

Negotiating Placement with Recipients

In working out specific placement arrangements, Treasury has taken the stance that it should not specify too closely the tasks the advisor will perform, preferring to obtain general agreement on the range of likely tasks and concerns. It argues that this approach is only realistic, given that needs shift quickly in the rapidly evolving CEE financial sector.

In interviews with advisors and their counterparts, the team found advisors to be welcomed by counterparts, and counterparts expressed appreciation for and satisfaction with the advisors. However, in several instances, the advisors described problems they face which appear to the team to show evidence of inadequate prior agreement on the terms and focus of the counterpart relationship between USG and

the recipient institution.[16] The team believes this preparatory stage to be an area for potential improvement of the Treasury program. Any placement should meet a number of hurdles at both the substantive and practical levels before the advisor arrives. These include the following:

- That the advisor's proposed tasks fit clearly into the strategy embraced by the recipient, and that major supporting decisions have been made;
- That the specific counterpart personnel and their relationship to the advisor are clearly identified, both at the top and day-to-day levels, so that advisors have a secure foundation within the institution; and
- That specific issues integral to the advisor's task, such as access to information, have been clearly resolved.

Answering these questions, particularly the first, may require more extended and intensive dialogue with counterparts than is currently provided, including somewhat broader forms of dialogue than might be implied by negotiating an advisory placement. Policy dialogue is discussed more fully below.

Recruitment

Recruitment is one of the strongest aspects of the Treasury program. Advisors appeared to be technically well qualified and to have good interpersonal skills; some were often native speakers of the local or national language. The one note of caution, raised above, is that recruitment for central government posts requires extra care in ensuring that advisors have appropriate training and experience, emphasizing capability in policy making and policy analysis.

Support in the Field

In addition to the logistical support required to maintain advisors (which is not discussed here), support on substantive and technical matters is available through short-term assistance that Treasury occasionally supplies at the request of the advisors. The team finds that this element of the program has potential value and should be expanded. At present, short-term resources are used infrequently, because advisors are not thinking in terms of potential short-term activities, because their requests have been turned down, or because the lag between request and response was too long. More extensive and regularized provision of short-term assistance in direct support of advisors would, however, be a means of enhancing the effectiveness of both advisors and the short-term assistance and training resources provided by USG. Linking long-term with short-term advisors may avoid the standard problem short-term assistance encounters — that it starts too often without adequate preparation and that it ends too often without adequate follow-up. Long-term advisors are in a unique position to know precisely which topics their organizations are taking up, when, and in what context. Thus, they can ensure that short-term advisors arrive both knowing the situation and having a receptive audience. They can also continue to work with counterparts in following through on decisions that may be taken as a result of the assistance. From the start, advisors and their counterparts should be aware of the potential they have for drawing on short-term resources; anticipated short-term needs should be an item of initial negotiation. The suggestion to increase and regularize the advisors' use of short-term assistance applies to assistance

[16] Treasury staff in Washington perceive that they engage in substantial and adequate policy dialogue, particularly with ministries of finance, in preparation for placements.

supplied directly as an adjunct of the Treasury program and to assistance supplied through other USG mechanisms, including A.I.D. contracts.

To summarize the foregoing discussion, the team believes that the Treasury program is an important USG resource that has been performing well on the whole. There are several suggestions that may enhance the effectiveness of the program.

- Selection of placements and tasks should be based on releasing bottlenecks to financial system development, not on enhancing the competitive position of individual banks. This restriction would not eliminate the placement of advisors in commercial banks, but would require greater selectivity in choice of both institution and assignment.

- Treasury should increase the amount of preplacement dialogue with counterpart institutions, to ensure that advisors enter a setting in which their role in a development process embraced by the institution is well understood by all parties. This may require a broadening of the tools used in policy dialogue. In addition, regular reviews of performance should be held, in which feedback from both counterparts and advisors is obtained.

- Short term technical assistance and training resources available at the request of advisors should be increased, and their provision should be regularized. This will improve the effectiveness of both advisors and short-term assistance.

Bank Training

Throughout the banks of Central and Eastern Europe, there is a tremendous need for staff training at all levels. The vast majority of bank staff is either young and inexperienced, but often with some exposure to Western banking — or older, with training suited to the old system. Only a few staff have extensive experience in Western banking. A shortage of basic financial and accounting skills is in evidence throughout the region. Basic concepts such as profit and loss, depreciation, and discounting are often poorly understood. A problem regularly encountered is an inadequate appreciation of the concepts of value, for example, in asset appraisal processes. It is clear that, given the magnitude of the task of raising the level of knowledge and skills, a broad range of training activities should be encouraged. The challenge in bank training is to develop efficient mechanisms for transfer of knowledge from Western banking, while developing the in-country capacity to provide training on an ongoing basis.

Typically, CEE banks are not giving training high priority in their own staffing and management, even though in conversation many often stress the importance of training. In most of the banks visited, the team found that the person in charge of training also had other duties, usually in personnel, and that internal training programs were in their infancy at best. This situation may be due to a lack of experience in establishing training programs of this nature. Nevertheless, bankers appear to be learning market skills very rapidly, by taking advantage of training opportunities in other countries and by reading foreign texts. In addition, banking expertise is rapidly transferred in those countries where significant foreign investment in the form of joint venture banks has occurred, especially in Hungary and Poland. Donors have facilitated this form of transfer — for example, through the twinning arrangements established by the International Finance Corporation for Polish state banks and private Western counterparts. This spontaneous transfer of knowledge does have spread effects (one person with Western exposure trains others or develops systems that embody new principles), but such transfer is far from the institutionalization of the training function that will be needed in the longer run.

In interviewing bankers about training needs and experiences, it became apparent that banks — and bankers — rapidly move beyond the stage in which an "introduction to banking" is useful. Training needs involve all levels of banks, from routine teller operations to specialized services (such as international transactions) to professional techniques (such as credit analysis, risk hedging, and asset and liability management). Training in accounting (not only for bankers) is a closely related priority, as noted in Section Four. Frequent criticisms about training offered by donors (across the board — not singling out any particular donor) were that the material is too general and that it does not adequately adjust for local differences. Similarly, there appears to be a tendency to select trainees without sufficient attention to their need for the course in question. This situation argues for development of internal training capacity. It also suggests that when external trainers are used, they should commit to repeat their training several times, so that a cadre of trainers who have learned country specifics can be developed.

Donors have recognized that their efforts in bank training should be tied to development of longer-term training capacity. The European donors have focused on developing bank training institutes, often sponsored by the central bank. These institutes have tended to embody an academic approach, involving broad-based training leading to degrees or certificates in banking. One of the reasons for this approach is the fact that few institutions of higher learning, such as universities and polytechnics, now provide courses with related content (although this is changing quickly).

USG, through Treasury's bank training program, has selected a different model of bank training, a model much closer to the ongoing needs of the banks. This model works with institutes sponsored by bankers associations and places a greater emphasis on coordinating training with bank requirements for improvements in service and lending. Treasury's program does supply some short-term training, but the intent is that these courses will serve as testing exercises for the new institutes — testing curricula and formats, training trainers, and providing a jump start in implementation for the institutes. Because bank training should be responsive to the needs of the banking industry, the team concurs that the decision to work with bank associations is a good one, and believes that the emphasis on working outward from needs identified within banks should be even stronger. The only difficulty is that bank associations are not sufficiently active in all countries to form the basis for developing a training institution. In such cases, Treasury should be more flexible in working with different types of institutions or, perhaps, should hold off on working with that country until further progress is made in developing the association. The eventual aim should be the availability of a wide variety of training opportunities. Users would select those of most potential value and pay at least part of the cost.

USG ASSISTANCE: STRATEGY AND POLICY DIALOGUE

The following comments apply to USG work in CEE financial system development as a whole, encompassing both Treasury and A.I.D. activities. In brief, the team recommends that USG develop a more strategic approach to assistance that contains a larger component of policy dialogue. What is meant by "policy dialogue" and "strategy" is the subject of this section.

Throughout this report, there have been references to examples where CEE institutions are embarking on technical improvements and donors are providing technical assistance before more fundamental issues about the future vision for the relevant aspects of the financial system have been satisfactorily resolved. Topics the team found to be ripe for greater policy analysis in various CEE countries include bank regulation (for example, the role of information, or the authority of the supervisors), the conduct of monetary policy, the playing field for private versus state banks, the appropriateness of deposit insurance, bank privatization and governance, the future of savings banks, and

the use of directed credit.[17] This signals a greater need for policy dialogue, at the broad level of policy development and at the specific level of negotiating technical assistance agreements. It should be clear from the preceding list that the team believes much of this dialogue would have central banks as its focal point, whereas USG dialogue has tended to center on ministries of finance. These topic areas represent potential opportunities for USG to make a contribution in currently underemphasized aspects of financial sector development.

The conduct of policy dialogue means many things to many people. A brief definition might be the engagement of the recipient in an extended examination of the issues involved in prospective policy changes, with the object of helping the recipient make more informed choices about the likely consequences of the changes. A variety of mechanisms could be brought to bear in an expanded version of policy dialogue. By far, the most important of these mechanisms is the development of an ongoing relationship with counterparts that involves the give and take of substantive policy advice. This aspect of policy dialogue requires continuity of personnel over a long period of time for development of sufficient trust and knowledge of the local context. Brief visits by high-level officials, while important for securing access and commitments, play a supplementary role in this process. Accordingly, USG assistance could potentially be made more effective if USG had someone more or less continually involved in policy dialogue with each CEE government on a range of financial sector issues. In the current setting, only the Treasury advisors are in a position to provide this kind of continuity of dialogue. The recommendations made above may help strengthen their ability to carry out policy dialogue. However, it might be noted that for advisors to be successful in such a role they need a strong macrofinancial background so that they will have the analytic skills needed to contribute to broad policy questions. Few of the existing advisors have been selected on the basis of their macroeconomic or financial economic training — the emphasis has been on specific technical or practical qualifications.

Additional mechanisms of policy dialogue are aimed at increasing the amount of knowledge that relevant officials share as they approach key decisions. This includes knowledge of how similar issues have been resolved in other countries, knowledge of a range of expert opinion, and policy research that assesses the likely impact of alternative decisions. Mechanisms for bringing this knowledge to bear include seminar series, joint research, study tours, and short-term expert visits. For these to be effective, they should be carried out in close cooperation with counterparts, timed to coincide with upcoming decision making. General conferences or research are not what is meant here. Examples of research topics that may bear on some of the issues that earlier sections of the report identified as candidates for further policy dialogue include the extent of informal financial markets (regarding the rationale for directed credit) and consumer deposit behavior (regarding deposit insurance).

Use of these kinds of tools by USG in financial sector development appears to be quite limited. The team believes these to be among the most effective ways for donors to influence major policy decisions, and recommends that USG consider using them in support of its financial sector strategy.

With respect to that strategy as a whole, the USG program is characterized by a variety of mechanisms operating in a wide range of topic areas and institutions. USG appears to have opted for a strategy based on developing a stable of providers and deploying them as needed. The resulting array is spread relatively thinly across most of the financial sector, from ministries of finance to stock exchanges to bank training. The quality of services provided has been good. One generally hears praise for the American technical experts that have come to work on a long- or a short-term basis. Many have

[17] In contrast to the relative lack of in-depth dialogue on these issues, policy dialogue regarding the resolution of bad debt portfolios among state banks, while not always resolved, has been high on both country and donor agendas.

made significant contributions. However, it appears that USG could enhance its overall contribution by developing a more strategic approach to assistance that would concentrate its available resources in order to maximize their effectiveness. This would consist of selecting certain areas for more intensive work and coordinating delivery of services by different providers so that services are complementary.

One of the main arguments in favor of concentrating on selected subject areas stems from the USG position compared with those of other donors. USG is far from the leading donor assisting Eastern Europe in financial sector reform, standing behind the multilaterals (IMF, IBRD, EBRD, and EC PHARE), which all have active financial sector programs. Moreover, bilateral European donors can take advantage of the desire of most CEE countries to move toward integration with Western European markets and, therefore, to adopt Western European techniques and policies. Given this setting and the relatively limited volume of resources available to USG, a broadly based program in the financial sector is necessarily one in which the United States will generally be following the lead of other donors and in which the U.S. contribution will be incremental. In fact, in this setting, the United States will find itself (as is already apparent in several cases) competing with other donors to supply assistance to the most desirable recipients.

For these reasons, it is recommended that USG select areas of focus. The selection could be based on some of the underemphasized areas identified in this report or it could be based on recognized pre-eminence of American expertise in a particular field. The recent Treasury development of a program to provide Eastern Europe with technical assistance in government securities markets is a promising example of the latter. When U.S. assistance is particularly sought, it is often because of the American reputation for top-quality expertise in financial sector matters, and this appears to constitute one of the major advantages that USG has to offer in this sector.

Having selected focus areas, the next step will be to concentrate resources on those areas. One of the main tools for this is improved coordination between the various windows maintained by Treasury and A.I.D. (and to a lesser degree, the Federal Reserve and the Securities and Exchange Commission). In contrast to the strategy of avoiding overlap, which appears to prevail in much of donor programming, the strategy would involve programming resources in the same area in mutually reinforcing ways. One example is the earlier recommendation to increase short-term technical assistance in support of Treasury advisors. Others would include placing more than one advisor in a given location to work as a team, having advisors draw on FSVC (as may happen informally already), and programming A.I.D. institutional contracts together with advisor placements (as in the example of assistance to the National Bank of Poland in bank supervision). The observed institutional tensions between A.I.D. and Treasury may inhibit the kind of joint programming that could enhance USG effectiveness; therefore, priority should be given to finding a way to reduce those tensions.

During the next few years, USG can make an important contribution to financial sector development in countries throughout Central and Eastern Europe. If USG does so at this critical time, CEE countries and the United States will reap substantial future benefits from that investment.

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