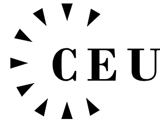
CASE-CEU
Working Papers Series

Center for Social
and Economic Research



Central
European University

38

Lajos Bokros

Experience and Perspectives of Financial Sector Development in Central and Eastern Europe

Warsaw, 2001

Responsibility for the information and views set out in the paper lies entirely with the author.

The publication was financed by the BRE Bank SA within the joint project "Seminaria BRE-CASE" (BRE-CASE Seminars)

Graphic Design: Agnieszka Natalia Bury

DTP: CeDeWu Sp. z o.o.

ISSN 1506-1639, ISBN 83-7178-256-X

Publisher:
CASE – Center for Social and Economic Research
ul. Sienkiewicza 12, 00-944 Warsaw, Poland
tel.: (4822) 622 66 27, 828 61 33, fax (4822) 828 60 69
e-mail: case@case.com.pl

Contents

Abstract 5

1. Trust Based on Culture and Tradition 6

2. Initial Conditions 6

3. Common Features in 2000 7

4. Increasing Differences Among Countries in Financial Sector Development 10

5. Advanced Reformers 11

6. Reluctant Modernizers 13

7. Struggling with Double Legacy 17

8. Desperate Reformers 20

9. Prolonged Crisis Cases 24

10. Three Pillars of Financial Sector Development 28

Lajos Bokros

Director of Financial Advisory Services, Europe & Central Asia Region in the World Bank. Former Hungarian Minister of Finance, Chairman of the Budapest Stock Exchange, and Director of the State Property Agency (privatization agency). Author of the successful Hungarian stabilization plan in the mid-nineties.

Abstract

Financial sector development in Central and Eastern Europe has proved to be a very dramatic process characterized by some well trumpeted success stories but even more so by many unexpected collapses of seemingly decent institutions and some systemic meltdown as well. The overall record of transition in the area of financial sector development is much less impressive than achievements in macroeconomic stabilization, economic liberalization and privatization of formerly state owned enterprises. There are several reasons for this. Among others I would highlight the specific complexities of the financial business and the intense political as well as emotional sensitiveness attached to any major move in this area. Influential stakeholders such as politicians, government officials, business and media people tend to overestimate the real value of particular institutions and at the same time overemphasize their importance to the national economy. In the absence of strong external and internal governance structures managers and at times also owners of banks, brokerages and insurance companies abuse this situation to increase their own influence and perceived importance. The story and history of financial sector development in most countries of Central and Eastern Europe in the first decade of transition, therefore, has been an uphill struggle to restore reliable channels and prudent practices of financial intermediation – to create a new culture of trust and confidence against all odds of a dire legacy sometimes characterized by crime and corruption, cronyism and collusion.

Key words: financial sector, transition Central and Eastern Europe, banking, corporate governance.

1. Trust Based on Culture and Tradition

It is of course of crucial importance that financial intermediation be reestablished in a credible way since there is no economic growth without channeling effectively and efficiently the financial savings of the enterprise and household sectors into investment. This is precisely what is lacking in the transition world after the devastating experience of communism where reallocation of funds was carried out by orders rather than business decisions based on calculated risk taking. This has clearly created a different culture and tradition, one, which did not require the involvement of trust. To change this culture and tradition, back again, to a market orientated one, takes a long time even if the political class understands what it takes to recreate this trust and behaves accordingly. But the first decade of transition shows that the constituting elements of this trust have not been fully understood and even less so promoted in practice. In most countries there has been some abuse of the incipient public trust and in some countries – notably Russia – public trust has been systematically destroyed by consecutive abusive degradation of the financial system. In Russia, for example, those who put their money into licensed banks may have lost it at least twice; first, when hyperinflation in the first half of the 90s wiped out most savings and second, when the banking sector collapsed in August, 1998. Those who kept their savings in foreign currency either under the mattress or abroad still have it. (This means that capital flight is not only a phenomenon reflecting illegal and massive exportation of funds by some wealthy businessmen and a few criminals but it is a well established everyday practice even for small people reinforced by hard ways of learning.)

2. Initial Conditions

Some countries started to reform their financial system – first and foremost banking – even before the political changes. Hungary and Poland had established a two-tier banking structure as early as in 1987 and 1988, respectively. Yugoslavia, having always had formally a two-tier arrangement throughout the socialist period, started to liberalize banking regulation gradually in the second half of the 80s. Czechoslovakia, Romania, Bulgaria and member states of the Soviet Union were much less fortunate; financial sector reform could start only after the rather tumultuous political events and under the auspices of the first democratic governments. It is interesting to note, however, that in all countries regulation for the establishment and operation of banks and other

intermediaries was quite liberal – sometimes even too liberal – which unleashed substantial initiatives leading to rapid growth in the number and size of these institutions. The good news was that – apart from initially restricting banks' ability to collect household deposits and/or engage in foreign exchange related transactions – there were no significant administrative restrictions in attracting clients, setting fees and interest rates. Competition was not restricted by administrative limitations on client range, lines of business and product pricing. The bad news was that prudential regulation did not exist either, minimum capital standards, liquidity ratios, the concept of solvency and capital adequacy, requirements for asset classification and provisioning, adequate tax rules, etc. were all missing at the beginning of transition. This created a somewhat "wild east" type of environment for liberal capitalism where clients and managers of still state owned financial institutions as well as owners and managers of newly established private ones could use and sometimes abuse many of the legal and regulatory loopholes for their own personal advantage and at the expense of depositors, creditors and ultimately that of taxpayers as well.

3. Common Features in 2000

After ten years of transition the financial sector in Central and Eastern Europe is characterized by:

- Low level of financial intermediation (5–40% of GDP only),
- Relatively poor asset quality and serious undercapitalization,
- Still quite narrow range of services, especially in non-banking,
- Largely immature governance structures, external and internal,
- Increasingly sophisticated legal and regulatory framework,
- Shallow implementation and enforcement capacity.

Compared to either the developed industrialized countries or even some of the fast growing Asian or Latin American ones financial intermediation in Central and Eastern Europe is still very shallow. Not only the level of savings channeled through the banking and insurance systems lags behind mature economies but even more so the amount of funds directly injected into the real sector in form of loans, corporate bonds, secondary share issues, etc. seems to be well below comparative standards and genuine demand. Even the most advanced Central European economies – Poland, Hungary and the Czech Republic – show a large deficit in corporate lending; the outstanding amount of loans to the real economy do not exceed 40% of GDP. This marked shortfall is the direct result

of quite a few factors: in all countries we have seen excessive and generous lending for some years followed by a credit crunch and extreme risk aversion after the collapse of some banks and brokerages and the tightening of both monetary policy and prudential rules applicable to asset classification, valuation of collateral, provisioning, etc. While the expansion in the first period was clearly assisted by directed and insider lending promoted by influential members of parliaments, government officials and well connected businessmen the backlash to this lavish and sometimes imprudent behavior has resulted in starving of even the most creditworthy and viable ventures. Many banks in the transition world continue to act like brokerages in money and capital markets by trying to link their business partners directly and offering them fee generating services rather than taking any risk in their own balance sheets by properly intermediating available funds.

Consecutive attempts to clean up the mess and improve the quality of assets by government intervention have also proved to be a double-edged sword. While rehabilitation of the largest state-owned banks (SOBs) was clearly inevitable given the sizeable amount of inherited bad loans, state orchestrated programs of bank recapitalization and restructuring were too generous, too broad, too many and too costly. Managers of SOBs were inclined to understate the true size of their losses before it was too late and then rushed to overstate it once a program of rehabilitation had been announced. Since it was very difficult to distinguish between bad assets truly inherited from the past and generated after the political changes and it was almost impossible to establish who was responsible for the sharp deterioration of the loan portfolio in light of the collapse of a good number of corporate clients, governments had no choice but to admit defeat and proceed with pumping fiscal funds into ailing flagships of the banking sector. This was not a good excuse, however, for the lack of serious efforts to define and enforce an adequate set of time bound, quantifiable and monitorable performance criteria against which the achievements of old/new management should have been evaluated. For this reason and also for the rather loose design of other aspects of the rehabilitation plans coupled with serious flaws in understanding and realizing the magnitude of implicit losses in case of individual banks quite a few governments were falling into the trap of being forced to repeat bank and insurance consolidation, thus spending a disproportionately large amount of fiscal resources on an economically unavoidable but politically very painful process. Even Hungary, which is considered to have achieved the best results in financial sector development by now, spent more than 10% of its GDP in more than three rounds of banking sector rehabilitation. In Romania, the flagship bank Bancorex, the former foreign trade bank had been recapitalized five times before the government finally decided to liquidate it. In other countries – most

notably in Croatia – governments felt obliged to rehabilitate large private banks as well in order to avoid a systemic collapse. But in countries where private commercial banks had not played any significant role in collecting household deposits and channeling them to the real sector even a systemic collapse did not necessarily trigger any meaningful governmental action for banking sector rehabilitation. Russia is obviously the best known example for this quite rational inaction.

"Banks have much money but all that belongs to other people"

There is terrible confusion about the nature and role of banking business in the transition world. People tend to have rather distorted views about the essence of banking especially if they make judgements while having only very superficial understanding of what financial intermediation is all about. In the early period of the evolution of banking it was quite common and publicly accepted to demand that banks should pay high interest on deposits, charge low interest on loans and still remain profitable in order to maximize dividends after corporatization. Managing risks and liquidity in a prudent manner while keeping growth at check and optimize the costs for gaining maximum productivity were concepts largely unheard of or clearly misunderstood. Private businessmen, local governments, even some churches wanted to establish their own banks in order to attract other people's money to finance their own particular businesses and related activities. In name of promoting the establishment, expansion and proliferation of new firms, banks, private and public alike, were expected to accumulate a largely illiquid investment portfolio of corporate equity. SOBs were openly criticized by government people for not bailing out important enterprises and placing too much money into risk free government debentures. Those few managers who wished to set aside more reserves to cover eventual losses of their banks were raided by the tax police. There was no consistent set of behavioral guidelines established by governments to be followed by the managers of SOBs.

Representatives of various state institutions sitting in boards and supervisory boards of SOBs were following either the narrow interest of their respective government department at best or their own personal interests at worst. These representatives were replaced very frequently and in many cases were sent there to promote openly specific political interests of their own constituencies. There were no prudential rules guiding their activity either. Modern banking legislation was introduced late and changed quite frequently. Regulatory and supervisory agencies have remained weak and overpoliticised even in the most advanced economies. In sum, the structures of both internal and external governance have remained largely inadequate except for those financial institutions which were finally privatized to strong and prudent investors, in most cases to first rate and reputable foreign strategic partners.

4. Increasing Differences Among Coutries in Financial Sector Development

Behind this generally opaque picture there are huge and growing differences in financial sector development among countries explained mainly by varying degree of government policies and reforms implemented for modernization. Since these divergences are gaining increasing importance by the day and greatly contribute to the ever growing differences in mid-term development potential as well it is indispensable to highlight them more in detail.

In this study I will basically compare the experience of ten Central and Eastern European countries [1] which can be characterized as belonging to five groups:

1. Advanced reformers: Poland & Hungary;
2. Reluctant modernizers: Czech Republic & Slovenia;
3. Struggling with double legacy: Slovakia & Croatia;
4. Desperate reformers: Bulgaria & Romania;
5. Prolonged crisis cases: Russia & Ukraine.

It needs to be emphasized, however, that the above classification reflects the achieved level of progress made in financial sector modernization only and may not necessarily imply that the countries in question have reached similar degree of development in other areas of structural reform. In contrast to macro reforms, where shock therapy and comprehensive packages of adjustment can occur and be successfully implemented all at once, in case of structural and institutional reforms at the micro level there is only gradual progress in a rather evolutionary path which shows a cyclical pattern over time. Nevertheless, after the first ten years of transition one lesson is clear: the maturity and consistency of reforms aiming at financial sector modernization has proved to be the most important factor behind the sustainable and healthy growth of financial intermediation which, in turn, has greatly contributed to the rejuvenation and emergence of a competitive and fast expanding real economy producing sustainable growth.

One more caveat: other factors, such as initial conditions (e.g. the degree of freedom tolerated and achieved under the communist system, the relatively free flow of people and ideas, the openness of higher education, the level of private property and experience in entrepreneurship at large, etc.), geographic location (i.e. proximity to Western markets), political factors such as democratic stability and maturity, cultural attitudes like

[1] There are other important subgroups in the transition world: the Baltic republics, the reconstruction economies of the Balkans, countries of the Caucasus and Central Asia. For lack of knowledge deep enough, I largely ignore them in this study.

popular sentiments towards foreign investment, widespread and genuine desire to access NATO and EU, etc. have also been playing a very important role in determining overall progress in economic adjustment and modernization of the ten countries in question. No doubt that all these factors have shaped policies and reforms targeted towards financial sector restructuring and the results and failures of these policies and reforms have modified the impact of all other factors as well.

5. Advanced Reformers

- Most large banks are controlled by foreign strategic investors;
- Foreign capital has a dominant role in overall banking;
- Most banks have good portfolio, adequate reserves and capital;
- Internal corporate governance is close to Western practices;
- Quality of services is improving rapidly in corporate business;
- Fast development and wide selection of services in retail banking;
- Fairly large and liquid capital markets (gov't bond and equity);
- Advanced regulation with improving enforcement;
- Competitive environment, well-regulated entry and exit;
- Almost complete liberalization of cross-border financial services;
- Pockets of resistance in privatization and regulation;
- Advanced stage of pension reform and fund management.

Poland and Hungary both had a very liberal approach in attracting foreign direct investment in their move to modernize the financial sector. Newly established foreign subsidiaries and joint ventures with SOBs and insurance companies appeared in the market even before the political changes. Interestingly enough, Hungary sold off the controlling stake in its two large state owned insurance companies by 1993 just to avoid their bankruptcy and eventual liquidation. Moreover, all other newly established smaller ventures in the insurance business were acquired by foreign strategic investors in the first half of the 90s. Poland, in turn, was much more cautious and somewhat timid in this area: its single state insurance firm has been restructured only partially and still awaits privatization.

Banking was much more exposed to fast track modernization in Poland. Large SOBs, originally established to serve certain well defined regions and partially modernized through twinning arrangements with experienced Western financial institutions have now all been absorbed by foreign investors and are competing at the level of the national

market. Interestingly enough, the only exception is by far the largest bank, part of the former specialized savings bank, PKO BP, which is still owned completely by the state treasury and keeps being overburdened with the unresolved stock of the non-performing housing loan portfolio. This is a primary example of the more sensitive and complex nature of savings bank restructuring; the political class tends to nurture the illusion that it is really a very special type of business, a crown jewel not to be sold to foreign investors.

Hungary has also fallen to the same trap to a certain extent when Postabank, a newly established and formally privately owned large spin-off emerging from the postal savings business went bankrupt in 1998 as a consequence of brutal mismanagement and eventual fraud. The government felt obliged to rehabilitate this bank with a huge dose of taxpayers money and there was extensive debate whether to keep it in state ownership or privatize it again, and, if yes, whether to sell control to a strong and prudent strategic investor or to aim at an initial public offering only. The former savings bank, OTP is actually privatized in that manner. (Postabank was intended to be sold to OTP without any tender but the Hungarian government finally could not accept the price offered by OTP which was considered ridiculously low. At present, in April 2000 the government is talking about selling or transferring Postabank to the state owned Post Office.) In Poland, Bank Handlowy was proud of having no controlling stakeholder for a long time just to see itself being swallowed by Citibank almost completely at the beginning of 2000 after a not so disguised takeover bid from the German Commerzbank had been opposed by the Treasury. This example clearly shows that, despite political resentment and fierce debate, privatization by selling control to a reputable foreign strategic partner is by far the most successful way of stabilizing and modernizing ailing SOBs. If control is effectively kept either by the government or self-serving management even in case of majority private ownership it can easily lead to a sharp downturn of the fortunes of the bank. In turn, if and when management is prudent and supported by quality investors, the bank may fall prey to large strategic bidders in a fast consolidating market.

Foreign strategic investment in most leading banks have proved to be an unqualified success in both Poland and Hungary after several consecutive efforts of government orchestrated and financed consolidation of insolvent SOBs. Foreign strategic partners have been able and willing to provide not only much needed additional capital and management skills but contributed considerably to product development and innovation, modernization of risk management and treasury operations, internal audit and control, information technology, etc.

It is no coincidence that Poland and Hungary provide the best example for capital market development as well. Both countries have a fairly large, well capitalized and rather liquid equity market by regional standards. This regional leading position is a very

significant achievement in light of either the absence (Hungary) or the very subordinated importance (Poland) of a mass scheme in privatization. Instead, governments and market participants decided to rely on two important factors: a gradual and by the mid 90s complete liberalization of foreign portfolio investment (coupled with early capital account convertibility for this type of investment) and high level of transparency by adopting and enforcing the latest Western standards on information dissemination, listing rules, price formation, clearing and settlement, etc. High level of self regulation has characterized both institutions all along which has helped tremendously to recreate the culture and trust needed for a steady growth of turnover in capital market transactions. Apart from trading in equity, the Warsaw Stock Exchange has developed a sizeable corporate bond market while the Budapest Stock Exchange has become very active in trading government securities. Derivative instruments, such as options and futures are also traded, albeit this market is still in an incipient stage in both countries. Poland and Hungary has already started a comprehensive overhaul of their pension system by establishing a three-pillar structure with fully funded and privately managed mandatory and voluntary schemes. These latter – together with the private insurance companies – are now providing the backbone of domestic institutional investment by channeling a growing amount of contractual savings through the recognized capital markets.

The deepness of financial sector reform in these two countries are reflected by the high and sustainable level of economic growth achieved in the last 4–5 years. There is already a wide choice of financial services readily available for real sector firms on a competitive basis. Due to the broad liberalization of cross-border financial transactions at least in the longer end of the market the largest ventures – including the foreign ones – can easily finance themselves even from abroad. Mid-size companies have dozens of banks wooing them and also have access to the less heavily regulated segments of the private capital market. Small firms, however, still face certain difficulties – only a few banks have decided to serve this market segments. At the same time difficulties of banks with keeping a track record of these small ventures, assessing their risk-return profile and foreclosing collateral in case of default has to be acknowledged as well.

6. Reluctant Modernizers

- Largest banks are still under government control or just recently privatized;
- Postponed and half-hearted moves to invite foreign strategic investors;
- Rehabilitation of leading banks is under way or recently completed;

- Portfolio of other, mostly midsize banks is relatively healthy;
- Corporate governance is to be strengthened further considerably;
- Quality of services, retail banking are developing rapidly;
- Smaller, quite fragmented and rather illiquid capital markets;
- Improving regulation with few loopholes and uneven enforcement;
- Increasing competition in domestic financial services;
- Non-bank financial intermediation is in need of further reforms;
- Some resentment and resistance against further liberalization;
- Pension reform and fund management are still at an incipient stage.

The Czech Republic and Slovenia are prime examples of countries where certain favorable initial conditions – especially high level of per capita income based on rich industrial tradition and a sophisticated economic structure well developed by regional standards; new impetus provided by becoming liberated from being obliged to support less developed parts of the country as a consequence of the breakup of both Czechoslovakia and Yugoslavia – have turned out to be a mixed blessing. Both countries enjoyed unprecedented political stability and a quite extended honeymoon period with the same government or grand coalition for a long time. The tremendous success of early macrostabilization coupled with a successful shift of export orientation to Western markets has produced a sense of complacency and great reluctance to undertake more substantive and painful structural reforms such as financial sector modernization. Both countries undertook an early recapitalization of their largest financial firms and then decided to stop there. Governments were clearly and publicly against selling control of the flagship banks and insurance companies to any foreign investor. Quite the opposite; either they claimed that banks were already in private hands (in case of the Czech Republic large banks were formally half privatized as a consequence of the mass privatization) or decided that in the absence of strong domestic investors it is better to keep them under close state control (Slovenia).

Mass privatization does not seem to have helped financial sector modernization. In the Czech Republic at least two of the largest banks – Komercni Banka (KB) and Investicni a Postovni Banka (IPB) – felt obliged to continue financing many of their traditional and still unrestructured clients a good number of which became also owned by them through the investment management companies they established. Increasing equity holdings of banks in their clients' capital was seen as copying the seemingly positive German practice of intimate relationship between banks and industrial enterprises without having the burden of German regulation and the German investors themselves. Slovenia used to have similar aversion toward foreign investors. Even foreign financial investors have not always been welcome in large banks, brokerages and insurance companies. The Yugoslav

way of mass privatization has created even more conflicts of interests because in this latter case banks were frequently owned by their less than fully creditworthy clients rather than the other way around. This is clearly considered the most dangerous way of interlocking ownership representing a vicious cycle.

The cost of reluctance and complacency has proved to be especially high for the Czech Republic. This is perfectly reflected by the forced renationalization and immediate sale of the falling IPB to Ceskoslovenska Obchodni Banka (CSOB) in June, 2000 which was a really unprecedented move in the history of bank consolidation and privatization. There are several lessons drawn from this case.

First, there is no point to sell even relative majority stake to any foreign entity if real management control and responsibility is not transferred. Second, not all good sounding foreign names represent trademarks of truly prudent strategic partners. Third, and most important, governments should prepare very carefully the legal documentation for all transactions making sure that after due diligence, the value of the assets is reasonably and realistically assessed and any remaining uncertainties regarding asset value and contingent liabilities are perfectly identified and the assets involved clearly ring-fenced. Unfortunately, none of these fundamental conditions seem to have been met when the formal transaction of selling IPB to Nomura took place in 1997. As a consequence, a textbook case of moral hazard emerged where the private partners were able and allowed to privatize all the gains and the (new) Czech government finally got obliged to socialize all the losses. The cost of rehabilitation for the three large Czech banks will also finally exceed 10% of GDP. It could have been much lower had these banks been sold to reputable and prudent foreign strategic investors right after the initial cleanup. (That happened well before the breakup of Czechoslovakia and eliminated all non-performing assets inherited from the communist period.) Even though the Czech Republic can now easily afford the resulting increase of its public domestic debt, this is a serious loss of opportunity in terms of lower growth and slower catching up with the EU.

Slovenia has been less complacent in policy making and declarations but equally reluctant in inviting foreign stakeholders in financial sector institutions. The two largest banks, Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM) are still controlled by the treasury and no specific plans for their final privatization are in sight. Although some foreign banks established wholly owned subsidiaries and started to compete with the two large banks as well as the smaller regional financial institutions, the small Slovene market has become so much overcrowded that now there is a serious threat that the two large public banks will lose market share quickly especially when free branching will be the rule of the game by the time of EU accession. In addition, Slovenia imposed quite a few breaks on the flows of not only short term but also equity capital in

an apparent move to defend the domestic currency and has kept them in place until very recently. Even direct investment in non-financial firms has been sometimes discouraged perpetuating the inefficiencies of enterprises caused by the flawed mass privatization program which, in turn, have effectively blocked any major restructuring by making impossible to reduce excessive labor and keeping salaries much higher than affordable, sustainable and reasonable.

Government policies did not facilitate quick adjustment and deep restructuring either. Payroll taxes are intolerably high just to support a very generous and hardly reformed pay-as-you-go pension system and an overextended health care. Private initiative in managing pension funds as well as insurance premia and other contractual savings are in an incipient stage – only partially accessible to foreign players. In sum, it is a fair statement that the Slovene financial sector is clearly underperforming its potential because – apart from successful bank rehabilitation – it has not been exposed to any major fundamental reform so far.

It is also the irony of history that both the Czech and Slovene equity markets are much smaller and less liquid than the Polish and Hungarian ones not so much despite but largely because of the unfavorable initial conditions created by the mass privatization schemes. Again, the Czech equity markets constitute a perfect example of what went wrong. At first sight mass privatization programs seem to have provided a magnificent one time boost for the formal capitalization of open markets especially in the absence of any meaningful criteria for listing and information dissemination on stocks. Ideological extremism have even praised the lack of requirements for entry in name of unlimited liberalism to create markets first rather than kill them with burdensome regulation and heavy supervisory structures. But the lack of transparency and enforceable rules have proved to be an open invitation to abuse and finally resulted in a backlash by creating widespread disillusionment with and even hatred against stock markets.

Negative sentiments especially among foreign portfolio investors coupled with heroic efforts of some enlightened officials of the otherwise weak and politically targeted supervisory agency have recently resulted in tightening regulations just to recreate trust and confidence which has either been lost or never created. The Prague SE have delisted hundreds of firms in the last couple of years but despite introducing and enforcing tough rules for listing and continuous disclosure its overall turnover was still less than one third of the Budapest SE in 1999. (Hungary constitutes by far the best comparator for the Czech Republic for having the same size of its economy – roughly GDP 50 bn USD – and with the same population – 10 million people – shrinking and ageing quite rapidly).

7. Struggling with Double Legacy

- Largest banks are or about to be sold to foreign strategic investors;
- Strong drive to privatize all banks after costly systemic rehabilitation;
- Number of insolvent banks still to be rehabilitated or finally liquidated;
- Portfolio quality is largely poor except for some midsize banks;
- Prudential behavior is still marginal in corporate governance;
- Quality of services, retail banking are slowly improving;
- Small and illiquid capital markets with low foreign participation;
- Improving regulation but still timid and uneven enforcement;
- Weak competition with regional and sectoral segmentation;
- Non-bank financial intermediation is in an incipient stage;
- Serious intention and efforts to liberalize cross-border transactions;
- Deep fiscal and structural problems; pension reform postponed.

The political and economic development of Slovakia and Croatia during the first decade of transition is strikingly similar while they constitute a marked antidote to the Czech Republic and Slovenia with which they used to have a common fate and history for almost 70 years, respectively. Both countries had nationalist and autocratic governments for a prolonged period after regaining independence in early 90s. Since Croatia was involved in an armed struggle for restoring its own territorial integrity and indirectly also in Bosnia, nationalist tendencies have become more deeply rooted and caused more distortions in the weak economy and fragile social fabric than in Slovakia. Charismatic and populist political leaders attempted to create a domestic oligarchy in both countries which gained prominence quickly in insider transactions following the mass privatization programs which had been started still in Czechoslovakia and Yugoslavia.

Initial conditions were much less favorable for the development of financial institutions in many respects. Both countries have inherited a more inward and eastward oriented and less competitive real economy with disproportionately high emphasis on less than state-of-the-art heavy industries (e.g. shipbuilding in Croatia and armaments in Slovakia). Markets for these products have collapsed very quickly and neither of these countries have been able to regain sustainable export led growth ever since. Overall real sector modernization has proved to be painstakingly slow as weak insiders – in most cases former managers and newly emerging political clients – effectively blocked external participation, including much needed foreign investment. Relatively high growth in the mid nineties was short lived because it was based on an artificial boost of demand fueled by corporate borrowing in both countries and, in addition, by reconstruction boom in

Croatia as well. Since inherited foreign debt of both countries was minimal, fiscal overspending made it possible to hide structural weaknesses and postpone serious reforms addressing them for long.

Major financial institutions became formally private almost by definition as a consequence of the mass privatization schemes, too. Croatia – like any other former Yugoslav member state – had experienced the least advantageous form of privatization. When workers' self-management had formally been transformed into share ownership for insiders, banks immediately and almost automatically fell into the hands of their still unrestructured clients. In addition, the strong regionalization of Croatia – reflected also in the name of its banks – created local monopolies with little or no competition. Autocratic governments in both countries promoted very actively a sense of national unity by assisting the establishment of interlocking ownership between local firms and financial institutions blessed and sanctioned by local governments. An intimate web of mutual services and the lack of transparency created an extremely fertile ground for political abuse and corruption which finally resulted in the collapse of many banks in 1997–98. Rehabilitation has proved to be an unusually broad and expensive exercise in both countries and covered almost the whole sector, public and private financial institutions alike.

The legacy of this futile experiment with oligarchic development is as damaging as that of the communist system. Broad coalitions of democratic parties are now trying to overcome the dire consequences of these distortions by implementing bold reforms aimed at catching up with the most advanced transition economies.

In Slovakia, the government has cleaned up the portfolio of the three largest SOBs, Vseobecna Uverova Banka (VUB), Investicna a Rozvoja Banka (IRB) and Slovenska Sporitelna (SS) and has announced its determination to sell controlling stakes in all of them to first class foreign strategic partners as quickly as it is possible. (The sale of SS to Erste Bank has already been effectively completed.) Legal and regulatory modernization as well as corrections of insider privatization deals take place at a rapid pace together with a strong drive to attract foreign direct investment in large non-financial firms. Sweeping financial liberalization and other bold structural reforms resulted in Slovakia becoming the 30th member of OECD in 2000.

Croatia, for its part, has successfully completed the privatization of its flagship bank, Privredna Banka Zagreb (PBZ) while continuing its serious efforts to attract strategic partners for a number of midsize banks. (The sale of control to strong foreign professional investors in Rijecka Banka (RB) and Splitska Banka (SB) have also been finalized.) However, the liquidation of a number of deeply insolvent midsize banks – including one of the largest and most important, Dubrovacka Banka, need to be

completed in Croatia before good governance could become predominant in managing financial institutions. Insurance still remains largely unrestructured in both countries while foreign players are gaining ground very quickly at the expense of the state owned former monopoly.

Again, the irony of history is that the Slovak and most likely the new Croat authorities will show more genuine desire to introduce the most advanced best practices of corporate restructuring, insolvency, liquidation, restructuring and at the same time spare no real effort to woo much needed foreign direct investment just to compensate for the worse image their countries have acquired compared to the more favorable perceptions of international investors about the Czech Republic and Slovenia. Given their double legacy and their less developed economic structure, Slovakia and Croatia are encountering more difficulties in attracting a sizeable amount of FDI carried out by truly reputable foreign firms. This is especially true in case of financial institutions where the prime motive of interest and action on the part of foreign strategic investors is not so much the present net asset value of existing ventures but the future growth potential of the whole economy and the chances of the country to access quickly the EU. Slovakia tends to be much more fortunate in this regard. It may even be able to catch up with the first tier accession candidates and join the EU together with them at the same time while Croatia has yet to start serious negotiations at all.

As far as capital market development is concerned mass privatization coupled with the lack of adequate regulation and enforcement proved to be detrimental to substantive takeoff. Within the equally bleak picture there are certain differences leading the observer to conclude that the Slovak equity market has more stocks and perhaps more liquidity but the Croats have some larger firms with better quality (Pliva, Podravka and Zagrebacka Banka are well known names even in the international arena.) Legislation and regulation have improved recently but enforcement still has much to desire. Latecomers are struggling not only with the already mentioned dire legacy of oligarchic development but with the lack of enthusiasm for going and remain public. The small size of the domestic market coupled with the lack of institutional funds to be invested constitute additional impediments in the short run. Fiscal constraints and strong vested interests in maintaining generous pension privileges – especially in Croatia – will make any effort to provide a strong boost to contractual savings highly unlikely in the foreseeable future. Conversely, government bond markets have a better chance to expand quickly due to the sizeable fiscal deficits and debt in both countries.

It is an interesting feature of the institutional arrangement in both countries that their central banks play a crucial role not only in overall banking regulation but also in supervision and oversight. Since both institutions assumed the role of a proper central

bank and started issuing money and regulating money supply only ten years ago it is no surprise that there is a relatively weak institutional capacity to carry out all these new functions. Both central banks have made an almost impeccable job in implementing strict monetary policies which has contributed significantly to the maintenance of macroeconomic stability throughout the nineties. Prudential regulation and supervision, in turn, proved to be politically sensitive and controversial because of the strong vested interests, which, more often than not, worked against prudent practices. It is not so much the weak intellectual capacity but the lack of political support which has prevented the tough rules of prudential regulation and supervision from implementation.

8. Desperate Reformers

- Few large insolvent banks are still in government hands;
- Desperate attempts to sell systemic banks to foreign strategic investors;
- A number of insolvent banks still to be rehabilitated or liquidated;
- Good portfolio expands slowly because creditworthy clients are few;
- Prudential behavior is still marginal in corporate governance;
- Quality of services slowly improving, retail banking expands faster;
- Very small and illiquid capital markets with low foreign participation;
- Improving regulation with uneven and unpredictable enforcement;
- Weak competition, foreign subsidiaries play marginal role in Romania;
- Non-bank financial intermediation is in an incipient stage;
- Liberalization of cross-border transactions yet to be achieved;
- Lack of institutional investors, no pension reform in sight.

Except for Albania and the former members of the now defunct Soviet Union, Romania and Bulgaria have truly inherited nothing but the worst from the communist system in Eastern Europe. Both countries used to have extremely rigid, neo-Stalinist economic management systems, maybe with more tolerance toward small scale auxiliary ventures in Bulgarian agriculture but especially devastating autarchic tendencies in Romania. While preserving national statehood after World War II may have been an asset, public institutions have proved to be very weak with a quite shallow implementation capacity ever since.

Political fragmentation, especially in Romania, has led to a further weakening of the reform drive which has not resulted in a critical mass of consistent measures to be introduced in almost any important area of the transition agenda. Romania lost not only

the first six years of transition by postponing structural reforms but also the next four when a center-right multiparty coalition government remained largely paralyzed by constant factional fighting. Bulgaria, in turn, has been more fortunate. After the deep crisis of 1996 and 1997 an unusually strong and unified government has tried to make up for the lost time by restoring not only macrofinancial stability but starting also corporate restructuring, privatization and financial sector modernization. Despite the additional negative impact of external factors, such as the Russian crisis and the war in Kosovo, the disruption in trade and transportation links, etc. Bulgaria has managed to distinguish itself as having an economy with the best mid-term perspectives in the whole Balkans. Nevertheless, both countries have a long way to go before they can truly satisfy membership criteria for EU and close the income gap with other candidates.

Banking sector development was started with the establishment of three or four large (typically a foreign trade, an industry and an agriculture orientated) SOBs without transforming the old savings bank into a universal financial institution. The left-leaning socialist governments in the first half of the nineties did not consider bank privatization seriously. All they did was to allow the proliferation of new and small private commercial banks as a consequence of a quite liberal policy on entry which could also be interpreted as a lack of adequate regulation on minimum capital standards and prudential requirements of ownership. These small banks constituted a mixed blessing because most of them turned out to be almost like pyramid schemes and went bankrupt quickly providing good excuse for those who opposed privatization of banks altogether. However, the large SOBs did not perform better either and virtually all of them in both countries proved to be technically insolvent by the mid nineties as well.

Reactions to this disappointing development were somewhat different in the two countries mostly because of the diverging political solutions to the emerging crisis. In Bulgaria, the whole unreformed economy collapsed at the end of 1996 and the new authorities made a complete U-turn on policy. They decided to rehabilitate all SOBs by cleaning up entirely their loan portfolio and announced an uncompromising and ambitious privatization program involving foreign strategic investors. The Bank Consolidation Company (BCC), established in 1992 to manage the rehabilitation of SOBs, was empowered to direct individual transactions of selling control to reputable foreign investors. Given the dire situation of the Bulgarian economy in 1996–97 and the quite negative image of the country it has been extremely difficult to attract prudent foreign partners. But the steadfastness and perseverance of the government has actually paid off.

The Bulgarian government has made very wise and careful decisions on timing and sequencing and it was able to build up momentum and change gradually the perception of the outside world on the perspectives of the Bulgarian economy. The easiest target,

Postbank, a newly established and hence relatively unspoiled small SOB plus a spinoff of the large foreign trade monopoly, the United Bulgarian Bank (UBB) went off the hook first, followed by two somewhat larger, regionally important and but still more easily restructured SOBs (Expressbank and Hebrosbank). The privatization of the largest and by far the most important bank, the former foreign trade monopoly, Bulbank, which covers almost 40% of the economy was finally successfully completed in 2000 despite fierce and open resistance of the incumbent management to the sale of control to foreign strategic interests. Only two large SOBs remain to be sold – Biochim and Savings Bank – which may not be too difficult given the good momentum generated by recent transactions.

Romania has been able to make much less progress in both bank rehabilitation and privatization. While BancPost, a similar newly established and healthy SOB was easily sold together with the relatively clean and small Development Bank (BRpD) there has been no real progress on the very large, truly systemic banks. On the contrary: the flagship bank, Bancorex, the former foreign trade monopoly had been recapitalized five times costing more than 1 bn USD to the Romanian taxpayer just to see itself finally liquidated in 1999. Banca Agricola (BA) had also been rehabilitated several times and cut drastically in size without any hope of a quick sale apparently due to the lack of political agreement on a coherent privatization strategy and, lately due to very little outside interest. Banca Comerciala Romana (BCR), which was perceived as the healthiest one among the large three remains in government hands as well. Given the volatile political environment and the excessive bargaining power of the managers of the SOBs – who were appointed on the basis of their political affiliation according to coalition agreements – there seems to be no quick fix for these two large SOBs, nor for the recently corporatized Savings Bank (CEC).

Given these circumstances, it is almost inconceivable to expect substantive improvements either in corporate governance and prudent behavior or quality of services, quality of assets, internal audit, risk management, credit allocation, etc. While legislation has improved considerably in the second half of the nineties in both countries, enforcement has remained uneven, unpredictable and sometimes politically conditioned, especially in Romania. Shallow implementation capacity constitutes a real bottleneck in both jurisdictions. None of the two central banks have ever been up to the requirements of crisis prevention and management.

The lack of confidence and the confusion about rules and values to be upheld are clearly highlighted by the events in the series of mini banking crises hitting Romania in 2000. As a side effect of the collapse of a sizeable investment fund crowds also run on BCR for retrieving deposits while at the same time three other midsize banks were

brought under receivership. (One of them was the proudly named International Bank of Religion.) In the meantime courts rejected the request of the National Bank of Romania (NBR) for declaring a powerful regional bank, Dacia Felix (DF) bankrupt – precisely two years after it had originally been submitted. And when the bank was finally declared insolvent, the new leftist government forced NBR and CEC to accept a partial settlement in order to pull DFB out of liquidation in early 2001. This clearly reflects the lack of clear interpretation and enforcement of banking regulation as well as the continuation of arbitrary political interference in managing the financial sector.

Capital markets are very small and illiquid in Romania and Bulgaria despite or because of the flawed and botched mass privatization programs which flooded the initially underregulated equity markets with hundreds – in case of Romania with thousands – of low quality stocks. While there have been heroic efforts in both countries to introduce serious confidence building measures by creating all necessary infrastructure for trading, clearing and settlement as well as listing and information dissemination neither domestic nor foreign participants have invested any meaningful amount of money in those two markets so far.

The underdeveloped nature of banking, insurance and capital markets in Romania and Bulgaria is strongly correlated with the incipient results in restructuring the real economy. It is absolutely clear that the severe distortions caused by inept and irresponsible communist megalomania render the legacy extremely difficult to deal with – again, especially in Romania. A very large number of sizable industrial firms are not privatizable at all even after financial liquidation and dismemberment. In quite a few important cases only the physical closure of enterprises makes sense because markets are completely lost, the technology involved is outdated and harmful to health, there is immense ecological degradation and only financial liabilities rather than any assets at all.

In light of these extremely disadvantageous initial conditions the predominance of mass privatization schemes in both countries was even more harmful than in more mature industrial economies, like the Czech Republic and Slovenia. Mass privatization not only created an illusion of acquiring real positive value but also a formidable obstacle to painful restructuring and aversion to realize losses. It is no surprise that prudent banks find it extremely difficult to lend to the real sector because creditworthy clients with manageable risk are very few are far between. This is especially true in Bulgaria where most of the systemic banks are now in the hands of reputable and strong foreign strategic investors.

The establishment of a market economy depends largely on new ventures both domestic and foreign. Since foreign direct and portfolio investment have been quite negligible in non-financial sectors, both economies have depended mostly on the

expansion and organic development of domestically owned small and medium size enterprises (SMEs). Due to the rapid contraction of the state sector the incipient and vibrant private sector simply has not been able to compensate for all losses in overall output. In addition, SMEs are much less bankable and have little access to open capital markets as well. Thus the state of affairs in the financial sector is just a mirror image of the hardships in the real economy.

Apart from the growing arrears in certain enterprises, especially in large public utilities and the ballooning intercorporate debt reflecting soft budget constraints and lack of strong market discipline which would involve credible threats of bankruptcy and liquidation, fiscal prudence has largely been maintained in the second half of the nineties in both countries. Bulgaria was clearly helped by the currency board arrangement (CBA) introduced in the summer of 1997 but even Romania, which was reported as being on the verge of a financial collapse from time to time has been able to maintain fiscal discipline and outperformed even Hungary in terms of general government balance. The sad irony here is that fiscal prudence alone is not a recipe for restarting economic growth especially if there is no supply side adjustment in the economy due to the lack of flexible micro structures able to respond to market signals. Postponing structural reforms time and again might render prudent macroeconomic policies largely useless or even harmful. Romania has proved to be an almost textbook case for this lesson.

9. Prolonged Crisis Cases

- Most banks are in private hands and the majority of them insolvent;
- Selective rehabilitation and reluctance to invite foreign strategic partners;
- Large number of banks to be delicensed and liquidated;
- Portfolio quality is very poor, hardly improving;
- Rampant corruption, crime and cronyism;
- Low service quality, rudimentary retail banking;
- Small, discredited and abused capital markets;
- Weak regulation and openly politicised enforcement;
- Fragmentation and monopolization of domestic markets;
- Non-banking financial intermediation is almost nonexistent;
- Largely hostile attitude towards financial liberalization;
- Permanent fiscal crisis, pension reform is not on the agenda.

Russia and Ukraine represent such peculiar cases that they hardly find their place in international comparison. Russia is very special for its sheer size and strategic importance while Ukraine is unique for its truly permanent crisis and apparent lack of opportunities. Russia could well afford not to implement any serious structural reform because its vast exportable natural resources coupled with its fine ability to extract large amount of financial assistance from the Western countries have always helped to survive the worst of its crises. Ukraine has given up its nuclear arsenal and does not posses any meaningful amount of natural wealth. Moreover, regaining full sovereignty after 300 years of Russian dominance is not an easy task. The Ukrainian state is particularly weak, became very fragmented and has easily fallen prey to the emerging local oligarchy. In Russia the ruling elite (the political class and the oligarchy) is largely unwilling while in Ukraine it is unable to introduce substantive market oriented reforms.

Financial sector development was very similar until the mid nineties. Like in Romania and Bulgaria, three to four large SOBs were originally carved out of the mainframe of the former central bank of the Soviet Union. Saving banks which were operating throughout the communist period maintained their narrow focus for many years. There was also hyperinflation which eliminated not only the value of banking assets but also that of the liabilities, realizing a very special "bank rehabilitation scheme" financed exclusively and involuntarily by the depositors. This devastating crisis, however, created a magnificent window of opportunity to strengthen the hard core of the banking sector by privatizing the SOBs of systemic importance in a prudent and efficient way. Unfortunately this moment was lost because the political class in both countries remained at least very suspicious if not openly hostile to the idea of selling their perceived "crown jewels" to foreign investors. Instead, they decided to create quickly a domestically rooted echelon of large entrepreneurs by allowing some well connected people to emerge as tycoons by acquiring immense chunks of former state property for a symbolic price. This artificially and deliberately accelerated "original accumulation of capital" was first assisted by selective licensing of foreign trade transactions in a still largely closed economy then by the mass privatization schemes which resulted in concentrating large amount of wealth in the hands of insiders and finally – mostly in Russia – by the "loans for shares" schemes when a handful of these previously privileged individuals were offered the chance to take over the controlling stakes in large chunks of the extractive industries. In Russia the emerging oligarchy was able to acquire control over the large SOBs as well while in Ukraine most of them are still in government hands but have lost considerable market share to new and private financial institutions.

Another common feature of banking sector development in Russia and Ukraine was the rapid proliferation of small private financial houses in the first half of the nineties. Like in Romania and Bulgaria this tendency was not so much the result of a genuine drive for liberal market reforms but rather due to the lack of meaningful and consistently applied legislation and regulation for a long time. Although banking laws and rules have been improved considerably in the last three years in both countries, central banks are still struggling with the immense backlog of delicensing these small, frequently non operating banklike creatures.

From systemic point of view, however, it is more important to analyze the situation and health of the large banks operating nationwide. It is a common feature of banking in both countries that even the large banks play only a very marginal role in financial intermediation in general and in financing the real sector in particular. That is one of the most important reasons why the collapse of the whole Russian financial system in August, 1998 did not really trigger a serious downturn in the real economy. On the other hand, the insignificant role of banks in financing real sector activity did not prevent the same banks from accumulating huge losses in their loan and investment portfolio. Although it is true that the August 1998 meltdown was basically triggered by the collapse of the government debt market and further exacerbated by the devaluation of the Russian currency this is not to conceal the fact that the crisis was only making illiquid already insolvent banks. At present the reverse is also true; the actual refloating of the Russian economy as a consequence of the exceptionally high export prices for oil and some other natural resources coupled with newly found fiscal discipline and real sector growth largely due to opportunities of import substitution has restored liquidity for quite a few banks while in most cases their more fundamental problem of deep insolvency has not been addressed at all.

There are at least two more reasons why financial intermediation have not developed in a more satisfactory manner. First, real sector decline was dramatic in both countries. Russia lost roughly half of its former output while Ukraine more than 60% in the 90s. Contrary to what happened in Romania and Bulgaria, even SMEs could not develop fast enough in these rapidly declining economies due to another important factor worth mentioning here: self-serving bureaucratic bottlenecks, devastating criminalization of economic and social life and finally rampant corruption. Rent seeking behavior and public acceptance of corruption is predominant. It cripples almost all economic activity but first and foremost productive investment. As a consequence, except for firms in the export sector, creditworthy clients are few and far between while opportunities to make money in corporate lending are scarce and profitability is much higher in other areas.

Retail banking was even less lucrative under these dire circumstances, therefore banks did not put high emphasis in developing these services, either. Banks were and have largely remained much more interested in acting as brokerage firms in the incipient but at least in Russia at one stage fast expanding capital markets.

Capital market developments are very different in the two countries concerned. Russia was a real magnet for foreign portfolio investors at least before the crisis even though legislation and regulation concerning property rights, transfer of title, minority protection, clearing and settlement, foreign exchange controls, etc. are still far from perfect even today. This exceptional appeal for investments in Russia was explained by the sheer size of the potential rather than actual market, the overall attractiveness of the export oriented extractive industries, the marked liberalization of foreign portfolio investment and finally the significant amount of public borrowing which created a speculative market for state debentures. In Ukraine none of these factors were present except for the last one which proved to be insufficient in light of political instability and lack of strategic importance.

Things have changed considerably after the outbreak of the Russian crisis. Since influential people – including reputable foreign firms – have lost a fortune when capital and foreign exchange markets collapsed, it is very unlikely that the same enthusiastic rush for Russian equity and government paper will materialize in the foreseeable future. Russia is not keen to step into the same river either. Recent efforts to keep tight budget controls and at the same time implement fundamental reforms in taxation suggest that the authorities do not intend to restart massive foreign borrowing even after the oil bonanza. There is more hope to see a gradual revitalization of the equity markets in the long run if and when much needed changes in basic legislation and corporate behavior will take place.

While clearly there is opportunity if not certainty for the Russian real economy to take off, Ukraine is likely to prolong further its permanent crisis. The political class is more fragmented than ever and the government – which is led by the former central bank governor as a last resort to technocratic leadership – does not seem to have either the impetus or the political support to undertake any of the desperately needed basic reforms, such as public expenditure reshuffle, tax administration, legal environment and practice for corporate bankruptcy, bank rehabilitation and real privatization as well as alleviating the burden on SMEs, reducing red tape, fighting corruption and crime, reorganizing agriculture, the energy sector, physical and human infrastructure, creating a favorable, appealing environment for foreign direct and portfolio investment, etc. Unfortunately, in terms of implementing efficient public policies and micro reforms, there is no one single bright spot on the horizon of Ukraine in the short and medium run.

If there are countries and cultures where the vast majority of the population has lost its trust almost entirely in public institutions and domestic financial firms it is Russia and Ukraine – and without doubt, most other countries of the CIS. To change this still deteriorating trend will require heroic efforts and a sea change in behavior on the part of the respective governments and the ruling oligarchies.

10. Three Pillars of Financial Sector Development

As it is quite obvious even from a sketchy analysis of the political economy of financial sector development in the transition world, the formation and evolution of reliable channels of financial intermediation throughout the 90s has been very different from one country to the next and there is no reason to believe that this trend of marked divergence will be soon replaced by strong convergence toward well developed and mature structures. Some countries will join the dream land of the European common market within a very short historic period of time. Others will perhaps wait for another generation before getting in. There might be a tendency towards equalization in income generating capacity among the transition economies after another decade of differentiation. But there will be no easy reversal of the culture and tradition which is so detrimental to the expansion of healthy financial intermediation fostered by efficiently managed and prudently behaving institutions. The emergence and dominance of local oligarchies, sometimes stronger than the state itself and characterized by rent seeking behavior, asset stripping, state capture, crime and corruption could well become so embedded in the social fabric that it is no longer possible to get rid of it without a devastating, full blown crisis of the economic and societal system.

Slovakia and Bulgaria have been very fortunate for having been able to change course relatively early on; Croatia has now every hope to follow suit. Romania, however, is fast approaching a historic crossroad: the results of parliamentary elections in 2000 clearly strengthened nationalist and populist elements. Some other countries, most notably Russia and Ukraine do not seem to have a historic chance to break the overarching influence of their oligarchies in the short run. But the strongly appealing perspectives of EU-accession and the genuine desire of the local electorate to achieve Western economic standards by embracing not only the values of an open and competitive market economy but also accepting all its consequences can be crucial in a mid term horizon and may bring about substantive change. It is clearly in the interest

and the moral obligation of people involved in the development business to facilitate the accumulation and strengthening of all creative elements which promote prudent civic culture and establish a tradition of individual integrity and honesty in business and civic life.

In the area of financial sector development there seem to be three fundamental pillars determining the scope, nature and quality of institutions emerging there and influencing the basic course of development these institutions embark upon:

1. Internal and external governance structures;
2. Domestic and international competition;
3. Prudential regulation and supervision.

These three pillars are mutually complementary and overlapping: improvements in one area clearly help the modernization and strengthening in the two others. Nevertheless, there is a critical mass in all three areas which must be achieved in order to reach maturity of the financial system and put it upon a secure path of sustainable expansion and development while maintaining high level of trust and confidence at the same time. Unfortunately none of the transition countries have reached that stage of development yet; the regulatory and supervisory structures need to show considerable further progress even in Poland and Hungary.

10.1. Corporate Governance

- Once for all rehabilitation of viable SOBs of systemic importance;
- Recapitalization of private commercial banks only in exceptional cases;
- SOBs to be privatized immediately after restoring minimum solvency;
- By selling controlling stake to reputable foreign strategic investors;
- General depoliticization and professionalization of financial intermediation;
- Discontinuation of all directed and insider lending and investment practices;
- Management contracts with time bound and monitorable performance criteria;
- Adequate representation of all stakeholders' interests in supervisory boards;
- Proper checks and balances in internal management, credit allocation, etc.;
- Implementation of management information systems and internal audit.

In light of the growing tide of anti-foreign sentiment and fierce debate about the "desirable and acceptable" level of foreign participation in the financial sector it seems impractical and unwise to advise governments that they should sell their largest and systemically most important financial institutions to foreign strategic investors. Even

enlightened and pragmatic governments appear quite reluctant to offer management control to foreign professionals at least in the large saving banks and insurance firms no matter how prudent and reputable the prospective foreign buyers might be. (PKO BP in Poland, OTP in Hungary are good cases in point.) People might find it also strange that a kind of an "universal panacea" is being offered to remedy the most if not all fundamental illnesses of the financial sector. Continental European experience does not seem to justify this peculiar type of sweeping privatization either; there are quite a few countries, like Germany, France and Italy, where state – or at least local government – control as well as dispersed ownership of domestic non-financial institutions and individuals have characterized important segments of banking, insurance and capital markets without substantially deteriorating the quality of governance. Why is it not possible for Central and Eastern Europe to follow their example?

There are several reasons for that; some of them decisive. First, communism was too long and too successful in destroying trust in domestic private institutions and tradition of prudent behavior in economic and social life. Second, when the futile communist experience in economic management was finally over, world markets were already characterized by massive cross-border transactions and international competition was producing new and improved services at a scale never seen before. Third, the demonstrational impact of liberal capitalism – very much magnified by modern telecommunication – coupled with the strong desire to catch up with the most developed world produced an almost insatiable thirst of clients in Central and Eastern Europe for getting access to the latest and best services without any delay. The interplay of these and many other factors make it impossible that people finally free to choose should wait another fifty years before enjoying the same quality of services as their Western counterparts. But people demanding the best as customers are unfortunately unable to create them as producers. They themselves demand that reliable and proven foreign products and services should be clearly available to them immediately while they may refuse to accept those structures – including those of foreign governance – which actually create and maintain this high level of quality for those products and services. (Communist deputies of the Russian parliament indicated privately that while they cannot accept foreign control in flagship domestic banks, they would also place their own money mostly in foreign banks domiciled in Russia or abroad. Nationalism and populism just perpetuate the rule of the oligarchy.)

Selling control in financial institutions to foreign strategic partners is the best way to bridge the huge gap between the very demanding and fully Westernized consumer mentality and the very slowly escapable ignorance of what it takes to be a prudent provider of the same quality products and services. Since there is no point to resist or

slow down the influence of consumer capitalism the only way to go is to accelerate the (re)creation of the culture of confidence and the tradition of prudence inherent in an efficient, well functioning market economy.

10.2. Competition

- Equal opportunities for entry and exit with maximum transparency;
- Decisive drive against all sectoral and regional market fragmentation;
- Elimination of administrative limits on credits, interest rates and fees;
- Gradual liberalization of cross border transactions and capital flows;
- Simple, reasonable, transparent and equitably enforced rules for taxation;
- Strong culture and regulation of creditors protection in corporate life;
- Strict enforcement of insolvency across the whole spectrum of clients;
- Level playing field in all separate areas of financial intermediation;
- Only temporary fiscal preferences to increase creditworthiness of clients;
- Direct state involvement in building physical and human infrastructure.

Managing transition is an art rather than a science, timing and sequencing are key. While fostering unlimited domestic competition is indispensable from day one, international competition could be increased gradually but according to a well established and publicly announced set of operational criteria. Countries preparing themselves deliberately for adopting the single market of the EU will be able to catch up more quickly not only in terms of income and productivity but of culture and tradition as well. Enhancing the creditworthiness of corporate and individual clients by introducing proper incentives for stimulating financial savings and investment could also multiply the growth and profit opportunities for financial intermediaries, thus creating a virtuous cycle of trust and prudence.

Competition, while being a strong incentive and disciplinary force to enhance quality and increase efficiency, should also be properly managed. Governments should focus on creating their own single market by eliminating all remaining administrative barriers on the one hand and helping disadvantaged clients, like SMEs on the other. Transparent, easily accessible guarantee schemes, one-time grants to cover initial costs, training and marketing subsidies, infrastructure support make a lot of sense together with the strict and even enforcement of regulation on bankruptcy, liquidation, secured lending, foreclosure of collateral, title transfer, share and company registration, minority protection, taxation, etc.

10.3. Prudential Regulation and Supervision

- Implementation of Basle core principles on banking;
- Even higher capital adequacy and solvency standards;
- Strictest application of rules on portfolio classification;
- But only gradual increase of provisioning requirements;
- Deposit insurance extended only to reputable institutions;
- Independent rating of leading financial intermediary firms;
- Close cooperation or consolidation of supervisory agencies;
- Political and financial independence of supervisory agencies;
- Strong cooperation between host and home country regulators;
- Relentless fight against crime & corruption, cronysm & collusion.

Finally, the weakest point. After ten years of transition there is no one single country in Central and Eastern Europe where the financial regulatory and supervisory agencies are really free from – sometimes very open and brutal – political interference and thus would be able to apply the highest professional standards without compromise. It is less of a problem in those jurisdictions where governance in and competition among individual financial institutions is strong enough not to leave much to desire in prudent behavior. Nevertheless, this is still a very dangerous situation because the accelerated pace of churning out new financial products and services requires constant attention to market developments, frequent licensing and deep analysis of complex problems with increasing reliance of discretionary judgements. If the underlying values and mandates governing the behavior of management and staff of these agencies are shaky or inconsistent then there is little hope to ensure that public confidence prevail in these financial markets. Task number one for the next decade is to strengthen considerably the institutions of prudential regulation and supervision.