The Transformation and Restructuring of the Financial Sector in the Transition Economies and the Search of a Model of Capitalism

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Introduction

The transition economies of Central and Eastern Europe have had a diverse range of experiences in the development of the financial sector in the present decade. As a main trend of the transformation to market economy the monetarisation of the former socialist economies has played an important role in the growth of emerging markets and in the development of the financial sector. The different extent of economic liberalization in the transition economies under review has lead to some divergencies in the course of financial sector reform and in the overall sustainability of the macroeconomic policies pursued in these countries. Thus Central and East European countries provide different opportunities and obstacles for the financial markets development and the capital mobility within and outside their boundaries.

The financial sector development has shown important features of reforming and restructuring the East European economies towards *the rebirth of the capitalism*. On one hand, it clearly has involved the recognition of private property rights and the full range of functioning of the money, especially the possibilities of channeling the savings to investments by profit oriented financial intermediaries. On the other, the options of creation of the financial intermediaries and reforming the monetary and financial system have given rise to different models of transforming the domestic economy and its institutions and institutional order. A common trend in the financial development has been the reconsideration of the currency and exchange rate regimes as well capital controls in favor of greater openness of the transitional economies.

Main Tends in the Financial Deepening of the Transitional Economies

The different approaches and modes of achieving the financial system's reform have had different consequences for the overall macroeconomic and financial stabilization and structural reform. The financial sector reforms in most of the transition countries have been undertaken in order to overcome the inefficiencies associated with heavy intervention and state control on the financial system and to adopt market oriented policies. By improving and modernization of the banking services important changes in the payments and settlements system have been introduced and the functioning of two-tier banking system has made possible the conduct of the monetary policy of the Central bank.

The efforts to reform the financial system represent a substantial part of the general reconsideration of *the government's role in the economy* and of the socio-economic transformation as a whole. The proceeding simultaneity of the financial sector and real sector transformation in the transition economies complicates attempts to evaluate their relevant contribution for the development of each country respectively. *Significant differences* between the economies and their respective banking *as regards their start up conditions of transition* do not alter this general conclusion.

As a whole, the higher degree of successful transformation of the former centrally planned economies of the Central European countries is indispensably connected with the more efficient development of their financial sector. The transition countries developing as better performers in the overall economic transformation have experienced higher efficiency of the development of their financial sector. Neither of the 'good" performers has allowed for a higher cost of the banking reform by running into a banking crisis in the present decade. On the contrary, the countries lagging behind in their overall economic performance in general have undergone banking disturbances and crises.

Both the financial deepening and the less costly transformation of the banking system in the Czech Republic, Poland and Hungary may be considered indicative of the mode of the capitalist development embarked. The more *consistent policies of financial market development have made possible for their transitional economies to adapt to the new environments more quickly and successfully than others without experiencing a prolonged transitional collapse typical for other countries.*

Two aspects of the financial development may be considered as a sound ground for the better performance of some transitional economies compared to others:

- Higher efficiency of the democratic decisions' processes and of the enforcement of the law as part of the socio-economic and political framework of the transformation of the economic system;
- The dirigist approach to the capitalist transformation by applying more strict requirements and surveillance of the banking and financial sector reform;

The transition countries experiencing unsuccessful macroeconomic stabilisation and political instability have been bound to delay the financial deepening and the financial intermediation development. In countries like Albania, Bulgaria, FYR Macedonia the political confrontation has caused the inconsistency of the implementation of the market oriented reforms. The lack of proper legislation or its unadequate enforcement made possible the high social cost of the financial pyramides and of the banking crises.

In *the case of Russia* vested interests created under the so called controlled market conditions have been bound to oppose reform. Financial regulation has involved protecting the commercial banks (from which the government has expropriated significant seniorage) and discouraging direct markets. Thus due to non-competitive market situation and the fragmented market conditions the financial market instability has been enhanced by the worsening of the overall economic performance. The "controlled "type of financial sector reform in Russia has entered a profound financial crisis thus showing for a significant "gaps" in the structure of its financial system. In fact these "gaps" in the financial system at the existence of capital flight and worsening economic performance can have a large impact on the robustness of the financial system as well as the whole economy.

The types of financial sector reforms undertaken in the transition countries subsume a diversity of phenomena. The common problem for all transitional economies is that the restructuring, rehabilitation and the privatization of the banks have to overcome serious threats of systemic instability. By the end of the present decade perhaps there is even more diversity now than there was at the outset of the transition. Thus there is a need to evaluate the degree of financial liberalization as an indicator of the implementation of a given model of capitalism in the transitional economies.

In the typical economic development process David Cole, Hal Scott and Phillip Wellons[1] identify four stages :

1) The controlled system;

2) Initial liberalization;

3) Retrenchment after crisis;

4) More aggressive development.

If we apply this approach to discern the stages of financial liberalization the main difference among the "good performers" and the "losers" in the transition so far may be related to *the order of sequencing of liberalization* in each separate country.

The good performers of the Central European countries have passed successfully through the first two stages. Though in different ways Hungary and the Czech Republic have coped with currency weakness and crisis which offer crucial lessons for all transitional countries. The scope of their learning by doing in the financial liberalization made possible to pass through the stage of retrenchment from the crisis without running into high social costs. Hungary avoided a full-blown crisis in 1995 and has continued the financial sector reform. The Czech Republic succumbed to speculative attacks on its currency in May 1997 and was forced to abandon its peg and let its currency float. The rising current account deficit had been widening since 1994 and the main reason for it was that productivity growth had been generally weak, whereas there was excessive real exchange rate appreciation and the wages were allowed to grow both in real domestic and in dollar terms. One of the most important lesson of the Czech experience is that macroeconomic factors alone are not precise enough as indicators of the underlying financial and economic stability of the economy. Institutional and microeconomic factors must be taken into consideration as well.

Some of the transitional countries, like Bulgaria, Estonia and Lithuania have experienced deep financial disorder and banking crisis either at the start of the transition or as a result of

[1] Cole, D., Hal, S.Scott and Philip A.Wellons, (1995), "The Asian Money Markets: An Overview", in Asian Money markets, ed. By David c.Cole, Hal S. Scott and Philip A. Wellons, N.Y., Oxford University press, 1995, pp.3-38

bad sequencing the stages of the financial liberalization. The Currency Board regimes introduced may be looked upon as making a "better try" for financial liberalization by passing once again through the first two stages.

In the case of Russia the present financial crisis may be considered as the end of the initial liberalization. The financial crisis has taken various forms and inevitably it will take time for any government to establish a new track of sound finance having in mind the banking crisis, the distorted markets, the capital flight, the exchange rate and balance of payments crisis. A set of austerity measures will be needed to reconcile any government's commitment to carry out a stabilization program with the society's expectations to introduce profound changes in the socio-economic policies. Thus the controlled by the political elite financial reform has led to a crisis not only of the financial intermediation but of the real economy as well.

The transitional countries have not embarked upon the stage of "more aggressive" development. The Central European countries are adjusting to more vigorous competition. Prudential supervision and regulation can play a vital role in maintaining stable rather than unstable competitive conditions. The need to enhance competition at the domestic financial markets will make necessary providing better access for the domestic investors and broadening the investors' base. In order to open the domestic financial markets to foreign investors they must meet international standards with respect to the market microstructure, trading practices, registry, transfer and settlement systems, etc. as well as to have established a track record.

Financial reforms have caused both benefits and costs in the transition to market-oriented economy. The wider choice of savings - investment possibilities have become an advantage of the reforming financial intermediaries allowing for lower transaction costs as well. However, the expectations that through the financial sector development a more market-oriented allocation of capital to its productive uses will take place haven't been automatically fulfilled. In the course of financial reform the bank behavior has been susceptible to significant changes, as the banks have grown out of the former state control and intervention. Two opposite reactions of the banking sector during the transition have raised once again the problem of the stages of the financial regulation and of the prudential regulation.

On one hand, the banks in some cases embarked upon a reckless expansion of lending even not sticking to the principles of prudential banking, especially in transition countries with inadequate legislation and its enforcement as well as in the case of controlled "markets" by vested group interests.

On the other, following financial reform, for instance upon implementation of the Currency Board regimes, the banks have retrenched from all but lowest-risk lending thus worsening the possibilities for the revival of the domestic economy.

In spite of the diversity of experiences of the transitional economies in the financial reform there is a common awareness that the gradual financial liberalization is to be preferred. The transitional economies that are better performers in Central Europe present convincingly the case of the gradual financial liberalization. As regards the analytical approach economists like Cho and Khatkhate, McKinnon , Villanueva and Mirakhor all underline the need to resort to financial reform and liberalization only upon achievement of macroeconomic stability and adequate bank supervision as preconditions for the successful financial reform.[2] The lessons drawn from the experiences of developing countries seem to be confirmed to a great extent in the experiences of the transitional countries in the present decade.

As regards the transitional economies that have undergone financial repression without achieving macroeconomic stabilization and by mid90s had to have a ‘second round’ of stabilization programs, there exists a controversy as regards the choice between the rapid and gradual financial liberalization.

The financial repression has been applied as a combination of heavy taxation, interest controls, government - intervention in the credit allocation and politicization of the money supply. It has not allowed for a better channeling of savings to investments but instead it has depleted savings in the domestic economy and worsened the moral hazard and asymmetric information problems in the allocation of credits. The non-performing loans and the high indebtedness in the economy became a vicious circle causing banking crises and economic decline. Both a decrease in the depth of the financial system (the so-called shallow finance) as well as loss of efficiency with which savings have been intermediated have been observed.

In such cases the countries under consideration have started a process of reexamination and revision of the role of the financial reform in the overall economic development. The alternative monetary regimes of the Currency Board have been accepted in Eastern Europe as a way to introduce financial discipline, prudential banking and market-based rules of the functioning of the domestic economy. The Currency Board regime denies the government any possibility of using credits from the central bank in financing its budget deficit and thereby forces it to raise financing from the capital markets.

Thus we may consider the present state of financial sector reform in the transitional countries as crucial for the better timing of further liberalization.

In any case only macroeconomic stability and creating better institutional and regulatory order and structures may permit a better mode of shaping the resiliency of the financial system in good times and bad.

The Reforms of the Banking System

The transitional economies have encountered a great deal of difficulties in the restructuring and creation of market-oriented commercial banking. The prevailing influence on the reshaping of banks has been related to the current European Union countries’ practices, the prudential banking practices of the USA, as well as experiences in the restructuring of the banks in the Latin American and Asian countries.

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[2] Cho, Y. and Deena Khatkhate, (1989), Lessons of financial liberalization in Asia: A comparative study, WBDP, N 50
McKinnon, R., (1988), Financial Liberalization and Economic Development: A reassessment of interest rate policies in Asia and Latin America. Occasional Paper No. 6, International center for Economic Growth
Villanueva, D., and Abbas Mirakhor, (1990), Interest rate policies, stabilization and bank supervision in developing countries: Strategies for financial reform, IMF Working Paper WP/90/8

On the whole, the process of ‘learning by doing’ has been the main driving force of the restructuring and modernization of the banking systems. Yet the inefficiencies of the conceptualization of the bank model developing in the transitional countries is a specific feature of the search of contemporary model of capitalism for the transitional countries. Proper conceptualization might be understood as designing a bank regulation and prudential practices more adequate to the transitional countries’ needs and problems. In general neither the Basel recommendations for prudential banking nor the EEC directives have been meant to serve as a model to be copied. In the process of realignment of the banking practices of Eastern Europe to the Western standards the transitional economies have still to undergo significant adjustment changes. This makes necessary their own adequate choice of the sequenced measures of banking development and financial deepening of their economy.

Several main obstacles to the proper modernization of the banking systems in the transitional countries persist to exist and evolve in various forms at the different stages of transformation. In broad sense in may distinguish two aspects:

First, *the restructuring and regulation of the banking system.*

Within the scope of this group of problems may be considered: 1) the extent of the accomplished rehabilitation of banking systems; 2) the introduction of central bank independence in the conduct of the monetary and exchange rate policies and the eventual outcome of the politicized central banking; 3) introduction of western prudential and regulation standards; 4) liberal licensing and low entry requirements; 5) risks of quick adjustment of the asset prices due to the risks involved with the indebtedness of the enterprises of the real sector. The combined results are rather controversial so far.

Second, *the problem for the ownership and the control over the banks.*

The restructuring of the former socialist banking systems is centered on the problem of bank-government relationship. The transitional economies have to balance the usage of two policy instruments: the ownership and the regulations of the banks. Privatization issues combine both the aspects but they involve higher complexity of the restructuring. This is the reason for the more gradual process of bank privatization in some cases like Poland or for the eventual delay in the accomplishment of large scale programs of privatization (as is the case of Bulgaria). The better sequencing of the implementation of the two policy instruments is instrumental for the success of the bank-enterprise restructuring in the transitional economies.

So far the better performers among the transitional economies have succeeded to pay adequate attention predominantly to the regulations of the banks and hereafter to the ownership restructuring.

The government policies adequately addressing the problems of control-ownership of the banks are important ingredients of the transition to a modern type of capitalist development. The more dirigist approach of the governments in the regulation of the restructuring of the banks in the neoliberal doctrine of economic policy has given visible results in the rehabilitation process. On one hand, the restructuring of the liabilities’ side of the banks has involved in most of the cases: 1) recapitalization with private and non-private equity (including international financial institutions); 2) raising of the own capital of the banks through attracting new shareholders or by consolidation procedures for existing banks.

On the other hand, **the restructuring of the bank assets side** has presented greater possibilities and more challenges for the contribution of the financial sector reforms to the introduction of modern capitalism in some of the transitional countries. Important contribution to the introduction of capitalism has played the application of the practices and methods of: 1) bank loan hospital techniques and agencies; 2) debt-for-debt exchange; 3) equity-for-debt swaps; 3) loan swaps; 4) government bond-for-bank loans swaps; 5) debt swaps as privatization methods. In all forms of bank restructuring an important role have played the government intervention and consistent government policies (though in some of the countries there hasn't been any such consistency of the policies pursued and failures to restructure have had greater social cost).

The allocation of credit through the banking system has not been adequately reformed to fulfill market based criteria and the dependence on the government intervention in the transitional economies has remained high. Credit rationing, credit crunch, government guarantee schemes, non-performing loans of the public sector and government instruments for rescheduling and restructuring of the public enterprises bank debts' remain still widely applied practices of the posttotalitarian forms of government involvement in the banking system.

On the other hand, in all transitional countries where too liberal practices of licensing regime and low entry requirements have been applied the banking bankruptcies and crises have become inevitable. In the context of the neoliberal doctrine of the economic policy of some transitional countries the banking and the financial capital creation have undergone higher risks of failures. Major aspects of banking activities have remained outside overall supervision and surveillance thus causing problems for their credibility of the financial and the economic system as well .

The most recent evolution of the financial crisis in Russia raises the case of the conflict between the "controlled" by the elite financial intermediation and the deeply segmented domestic economy where the economic and financial liberalization has not proceeded alongside market based criteria thus deepening the economic crisis. The failure to restructure the financial system and the overall adjustment of the Russian economy thus may cause threats for the political and social stability.

As regards some small East European countries in the process of macroeconomic stabilization the high nominal interest rates and other financial repression policies have had some unfavorable effects on the financial deepening of their economies due to : 1) the lack of proper market structures and still persisting politicization of the monetary policy; 2) the monopolistic lending behavior by individual banks; 3) the persistent practices of non-performing loans leading to bank bankruptcies and crises.

The bank restructuring process has engaged to a different extent *the direct government intervention.* Some countries like the Czech Republic have established government Agency for the management of the bad debts of the enterprises and for the rehabilitation of the distressed banks. In other (less successful in their transition) countries the policies of bank rehabilitation have been inconsistent and have been left much more to the private initiative, the growth of private economic groups and the inconsistency and fluidity of the political process.

Thus the banking systems in the transitional economies have undergone restructuring to a different extent but *the structural defects still remain*. There are pending problems in the proceeding restructuring of the banking systems in most of the transitional countries related to the real sector and its low efficiency.

The ongoing financial crisis in Russia and its disturbing effects on all emerging markets raises problems for the prospects of the division of roles between the banks and the direct capital markets as sources for the external financing of the enterprises. As consequences of this crisis the bank lending may increase its importance for the business credits in Eastern Europe. Thus prudential banking criteria have to be observed more adequately as the moral hazard problem and the asymmetrical information gain higher significance in periods of financial crisis.

The conclusion may be that the most important hallmark of the East European banking systems remains the close interrelation between the bank and the enterprises of the real sector. The revival and economic growth of the transitional economies is a precondition for the rehabilitation and growth of their banking sector.

Although government's participation in the process of the financial deepening of the transitional economy has been unavoidable and necessary there have been unfavourable trends and disadvantages of its involvement in the marketization. There is a trend of increasing the control over the banking systems, the transfer of risk of the banks''losses to the government has continued to create fiscal problems for the state budget deficit and thje government debt management in most of the countries concerned. In genetal there has been a delay in the prospects of privately governed and operated banking system , additional government subventions for some of the state banks that have been considered "too big to fail" and last but not least the continuation of the liquidity dependence of banks on state budget activities or on providing services for the Government debt management.

The prospects for the banking systems in the transitional economies are to be shaped to mirror the Western benchmark. Yet the controversial problems of the ongoing development of corporate structures and competitive performance will have substantial impact on the development of the banking systems. The main models of the universal banking system that have been embarked upon in the transitional economies (true universal banking model through the initation of the EU directives, the American model through growing advisory potential based upon the narrow banking and the core banking) may prove to set the road for *the process of eventual convergence* of the East European banking practices to the Western ones in medium term prospect.

There are three possible ways of the development of the convergence process : 1) through the transitional restructuring and rehabilitation; 2) through the regulation and the regulatory framework of interrelations between the banks, the private and public sector and the Government policies; 3) the regulation of competitive capital markets.

Conclusion

The transitional economies present a typical case of segmented financial markets (See Table 1). The segmentation approach to the growth of banking and non-banking financial intermediaries is deeply rooted in the specifics of the capital structure formation, the inadequate regulatory environment and the concerns about corruption and political risks involved in the emerging markets. The cases of illiquidity of some of the underlying financial markets present the conflicts of economic interests which remain a crucial bottleneck to the economic development. Policy options are not exhausted for the rehabilitation of the financial sector and for creating well functioning financial relations. New networks of financial interrelations may emerge between government, enterprises, household and banks and financial firms. The institutional functions of the future financial sector's building as essential for the market economy will have to undergo important changes in order to meet the transitional challenges.