

# Eastern Europe and the Financial Sector: Where Are They Going?

## 1. Introduction<sup>1</sup>

The transformation which has taken place in the countries of central and eastern Europe and those of the former Soviet Union as a result of "perestroika" has all the characteristics of a revolution – political, economic, social and cultural; moreover, "perestroika" had the merit of permitting the emergence of the widespread dissatisfaction about the poor functioning of planned economies. It follows that no single specific reform, taken by itself, is sufficient to ensure the success of the transformation or transition, however large or pervasive the sector, for example, the financial one; a synergic effort is necessary for the system to be able to change its functioning, and not to limit itself to renaming processes which remain unchanged in their economic and political fundamentals. Indeed, the consensus is that there should be a critical mass of reforms and that they will take differing time spells: macroeconomic stabilisation and liberalisation of prices and foreign trade can definitely be achieved more rapidly than the institutional changes which require legislation, and those in the ownership and productive structure of the economy. The critical sequence of the reforms has attracted much attention (McKinnon, 1991; Nuti, 1991) and obviously depends on the initial conditions (Fischer and Gelb, 1991); since the latter have a strong and variable political and social component, any rigid type of prescription is risky.

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Such a profound palingenesis cannot be achieved in all its aspects in a few months or, in many cases, even in a few years; the length of time depends fundamentally on the degree of preparation for the change which took place before the Soviets abandoned the "foreign empire", as in the case of Hungary or Poland, or on the capitalist tradition which preceded the Soviet post-war occupation, for example in Czechoslovakia. Particularly where the latter is weak or inexistent, as in other eastern European countries and the former Soviet Union itself, we could ask whether the revolution we are witnessing is based on a great illusion: that the change of regime will achieve western living standards more or less automatically.

If this were possible, there would certainly be political acceptance of a new trade-off between equality and efficiency also in the East, as happened – even though on a much reduced scale – in Europe and, above all, in America in the 1980s. It is now clear that in countries such as Poland the decrease in activity rates up to now is such that *per capita* income could only rise back up to the levels prevalent at the eve of the transformation over a number of years, even if the intertemporal comparison is anything but easy for the change of regime; moreover, the absence of information about the present dimension and the dynamics of the "black" economy does not allow one to estimate how much the decrease in production is the result of defective statistical measurement and, in particular, to what extent the "irregular" economy will contribute to the recovery of activity. It follows that a huge "expectation gap" has formed, or is in the process of doing so. In various countries, the coalition of forces which initiated or governed the palingenesis is now disintegrating or has been beaten in recent elections; obvious examples are Poland, Rumania, and Lithuania. Since the parliamentary institutions are young and the political parties are too numerous, with fluctuating supporters, the trade-off between the various interest groups will probably take place more on the social level, by means of strikes and agreements, than on the political one. The risks of a loss of legitimacy of the present forces or government coalitions should not be underestimated.

In order to avoid the installation of a "crisis of disillusion" (Rosati, 1992) in one or more of these fragile systems under the political, economic and social profile, it is indispensable that the reforms proceed at speed, that the reinforcement of the initial critical mass renders the reform process not only irreversible but also a

producer of benefits which the population can appreciate. Of all the institutional changes, the one I feel to be instrumental – in the phase of macroeconomic stabilisation, in that of mobilisation and allocation of resources along the lines of the western model, as well as in that of the control or governance of the productive structure, once it has been denationalised and, if possible, privatised – is banking reform, and the associated setting up of financial markets. Where are the different countries in this respect and, above all, where are they going?

The search for a reply will go through various stages. Firstly, we consider the mechanism for the creation of a two-tier banking system, the emergence of a central bank with formal characteristics of independence, the need to make the credit decision an instrument of efficient allocation (Section 2). Successively, we analyse the way which has been made, and that still to be covered, for the allocation of credit by the central bank, as well as that of the commercial ones, to be based no longer on rationing schemes, but on market mechanisms, with a brief note on the role of monetary policy in the stabilisation process (Section 3). The factors which impede the correct functioning of the new commercial banks, above all their size, public nature and unpreparedness to compete, are dealt with in Section 4, followed by an analysis of the banks' most serious problem, that of bad loans (Subsection 4.1). In Section 5, we touch on the development of bond markets, necessary to finance Government deficits and for the conduct of a market-oriented monetary policy, and of stock markets, antecedents or consequences of privatisation, particularly if effected with mass methods. The question covered by Section 6 is that of the control or governance of firms after they have passed from the public to the private domain; the theory of asymmetric information constitutes a possible theoretical underpinning for the choice to be made. Lastly, some conclusions and a commitment to a long haul are condensed in Section 7.

## 2. Towards an effective two-tier banking system

The first important step for the reform of the financial sector of the centrally-planned economies was the institution of a two-tier banking system, in which the state bank or national bank took on the traditional functions of the central bank, mainly restraining its activity

to the regulation of credit conditions and to interest rates policy, while the newly-instituted commercial banks were assigned the functions of granting credit and collecting deposits from both firms and individuals. The existing specialized banks, for example in the export area, have been maintained and have had their operational autonomy increased. This profound restructuring started in Hungary in 1987, and in the following years in the USSR, Poland, Czechoslovakia, Rumania, etc., by the splitting up of the "monobank" into a group of publicly-owned commercial banks and a central bank. The increase in intermediaries has rendered it indispensable and urgent, among other things, to create an efficient system of payments with procedures for clearing and settlement.

On the basis of legislation enacted in Hungary, Czechoslovakia and Poland – the three countries to which we refer almost exclusively because they have made the most progress in the transformation process and for which some economic indicators are provided in the Appendix – the fundamental characteristics of a modern central bank were assigned to their issuing institutions. For example, prominent among the objectives to be followed are the stability of the domestic purchasing power of the currency, the strengthening of the payments system, the development and the international integration of the economy. Regarding Treasury financing, the Hungarian law on the central bank specifies that starting from 1991 it can never again exceed three per cent of the forecast budget revenue and must be charged at the base rate fixed for credits to the economy. The objective of stability and the Treasury financing limit provide a basis for the provisions regarding autonomy which, in the Hungarian and Czechoslovakian cases, for example, forbid the government to give orders to the central bank regarding the conduct of its institutional tasks, and force the bank to report to Parliament. Similar stipulations have also been adopted by the Polish legislature.

Obviously, the legal precept has planted the seed, but it cannot be said that it has already borne fruit. Due to the difficulties of transformation, both at the macroeconomic and organisational levels, the clear separation of the commercial banking functions from those proper to the central bank have required more time than initially forecast; furthermore, the central banks have continued to carry out fiscal activities, subsidising for instance some types of credit. Until the concerns about the rather depressed economic conditions and the poor state of firms and banks take precedence over monetary stability, the central banks will end up loosening the budget strings by means

of credit management. However, no long-lasting reform will be possible without the introduction of, and the respect for, the hard budget constraint (Kornai, 1980; Campbell, 1991). Central bank identity and role are in the process of being defined, a process which could take more or less time, depending on the different political and constitutional environments; the events which led to the non-confirmation of Governor Suranyi at the head of the Hungarian central bank, and to the arrest of the Polish Governor Wójtowicz; accused of not having prevented the public banks, and therefore the Treasury, from being swindled by value date "gamblers" in a rather slow and inefficient payments system, are examples of the travail to which the new institutions are subject. Even though in a less clear institutional context, politically much more unstable and therefore less easily interpretable such as that of Russia, one cannot avoid mentioning the replacement of Governor Matiukin, who tended to accept the IMF's severe precepts for stabilisation, by the former Governor of the Gosbank, Gherashchenko, who is more sensitive about the depressing consequences on production of a restrictive credit policy. And in Ukraine Governor Hetman was the latest victim; he did not follow the new Prime Minister's orders...

In choosing the type of banking system, the legislators in the three most advanced countries oriented themselves towards the universal bank, as outlined in the EEC's Second Banking Directive. In Poland at least, the concept of universal bank has not been fully defined and, in fact, seems to coincide with that of commercial bank. The securities trading, which must take place through a special intermediary in Hungary, is so much in its infancy that it has not yet even allowed the banks to take on fully the configuration that the law has accorded them.

Apart from the systemic aspects, the major unknown element is the *modus operandi* of the new commercial banks, with respect to the functions that the "monobank" offices carried out in relation to the firms under the former regime. The granting of credit, from being an administrative order which rendered an economic-plan decision operational, must become an allocation to the most efficient uses. This requires that: *a)* the risk represented by the borrower must be accurately and professionally evaluated; *b)* the concession of a loan, which has to contribute positively to the profit-and-loss account of the bank, must not be dictated by a special relationship with the borrower, nor must it, generally speaking, be the inevitable consequence of another, previously taken decision to extend credit; *c)* the

resort to bankruptcy procedures and disqualification of managers must be the inevitable sanction for those who do not honour their debts at maturity (Tanzi, 1992).

None of these tasks was undertaken by the "monobank", thus its officers assigned to the public commercial banks must learn an art which they had never practised when risk-evaluation was absent, the relationship with the borrowing firm was extremely close and bankruptcy was excluded from the system. A vast training programme and some injection of foreign management seem indispensable to allow the banks to participate actively in the transformation process and prepare themselves possibly for a bigger role in the governance of the economy.

### 3. Instruments of monetary control and the role of monetary policy in stabilising the economy

There have been fundamental changes in the exchange rates systems and the instruments for monetary control, both closely associated with the banking reforms. The liberalisation of current account transactions and the unification of the exchange rates, with some progress towards the creation of foreign exchange markets, have been prominent aspects of the reforms in Czechoslovakia and Poland (Sundarajan, 1992). Recently, some indirect or market instruments (for example, auctions of treasury or central bank bills) have been introduced in all three of the most advanced countries.

Examining in some detail the Hungarian case, we have a meaningful view of the evolution of the instruments at the disposal of the central bank, of the constraints which are still affecting such a development and of those which have been removed. The main mechanism which has been used recently is the imposition of limits on National Bank refinancing for the commercial ones. Changes in the reserve coefficients have also become potential instruments for short-term monetary control; however, pretty little use has been made of them so far. In the initial phases of the reforms, these innovations did not allow sufficient monetary control and, therefore, generated rapid expansion of money and credit. Only in 1988 did the interest rates become less rigid. In 1990, a stringent credit policy was effected by raising the cost of resorting to the central bank and by lowering

the refinancing ceilings in order to try to keep the rate of increase of the money supply below that of the GDP at current prices. After that, an interbank money market developed in Hungary, thus allowing the central bank to undertake a more flexible monetary policy.

The regulation of interest rates is now relatively liberal, and their levels are moderately positive in real terms. The National Bank lays down the conditions for the operations with the banking sector, while the banks are free to fix their own rates for transactions with their clients. The bank lending and deposit rates for firms were liberalised in 1987, while those for operations with the household sector began to be made more flexible with the reform of the housing finance system in 1989. Previously, housing loans were given by the National Savings Bank at a low rate of interest. With the aim of limiting the losses for this institution, the return on individuals' deposits was strictly controlled. At the beginning of 1989, a new fund for residential construction took on all the housing loans in the accounts of the National Savings Bank and of the savings cooperatives, against the issue of special bonds giving a market rate of return. The restructuring of the activities of the National Savings Bank was followed by the liberalisation of the rates on deposits from and loans to the household sector, opening the way for the integration of the banking system, until then divided into separate sections dealing respectively with firms and with individuals.

This development allowed the creation of markets for financial instruments. Since 1988-1989, deposit certificates and treasury bills have been offered to households as an alternative to bank deposits and bonds. The introduction of deposit certificates gave the commercial banks their first chance to compete with the savings institutions for the collection of available liquid funds from households. The first treasury bills were issued at the beginning of 1988 and sold by the National Savings Bank. The sale of the bills through other channels started at the end of that year, when a small quantity was sold at the first auction of financial products in recent Hungarian history. Until now, most of this paper was bought by insurance companies and local authorities.

In general, the process of specific assignment of credit provided for by the plan in central and eastern Europe has been replaced by various controls, direct and indirect, such as bank-specific ceilings on refinancing by the central bank and on credit granting to customers; to these were added – as necessary – compulsory reserves and special

deposits at the central bank. The mechanism for allocating central bank credit, which in market economies is based on auctions, in central and eastern Europe is still characterised by rationing; the lack or the insufficient presence of money markets makes it difficult, if not impossible, to resort to auctions. Moreover, the presence of public banks, burdened by portfolios of bad loans, could make the auction an instrument of inefficient allocation, if their managers forced up the rate with the aim of securing the necessary liquidity to keep alive their clientele of state companies in serious difficulties. Finally, there is another factor which directly tends to weaken the restrictive impulses of monetary policy: inter-firm loans. The disintermediation of the banking system and the increase in the velocity of money, at least in the short term, have increased with the degree of monetary restriction. For example, in Czechoslovakia between end-1989 and mid-1991, inter-firm loans increased twenty-fold (Hrncir and Klacek, 1991); similar experiences happened in Poland and Hungary.

The phenomenon is presently also very brisk in the former Soviet Union, where a search is being made for instruments to check it. And economic policy must deal with it quickly if one wishes to avoid the entire spider's web of inter-firm credit relationships embroiling both healthy and unviable firms, creating thus a systemic risk. To the extent that efficient and profit-making units are induced to lend to sister-companies whose production has negative added value, often because of the continuing conviction that the soft budget constraint will, sooner or later, lead the government or the monetary authority to carry out a rescue, the disciplinary action of bankruptcy would be rendered more difficult and more costly; indeed, it cannot be said that it has started operating there... Any direct intervention on this type of inter-firm relationship would not only be impossible to manage, but also mistaken; firms in the West are free to develop debit and credit relationships on the basis of mutual convenience.

In general, it is advisable in a relatively short period to liquidate firms with no future, to restructure the debts of those with good prospects for survival, to recapitalise and/or privatise banks; in the meantime, selective controls which constrain a minimum quota of credit towards the private sector seem to be preferable to an increase in the intermediation margins which would discourage precisely the emerging private initiatives (Begg and Portes, 1992). In systems which are so distorted on the microeconomic level, it is no surprise that the interest rate is unable to discriminate between the various

initiatives by favouring the most productive ones; on the contrary, as already noted regarding the allocation of the central bank credit, full reliance on the interest rate could create additional distortions, if it constrained the managers of firms to pay any price for credit, in the absence of the sanction constituted by bankruptcy. Thus, here also we see that we cannot help accepting forms of rationing based on selective credit controls, such as that already noted in favour of the private sector.

Although the interpretative problems are enormous owing to the great structural changes in the central and eastern European economies, it has been stated that the fall in economic activity and the price trend observed can be attributed only with difficulty to the effects of monetary policy, even in Poland and Czechoslovakia, and that the incomes and fiscal policies were the real protagonists of macroeconomic control (Bofinger, 1992). Other scholars (Calvo and Coricelli, 1992) instead tend towards the opposite theory, as did the OECD (1991) in the case of Czechoslovakia. While it is difficult to swallow that the reduction of credit or liquidity due to high cost of credit has no effect on production and prices, it is just as hard to believe that, in economies without efficient transmission channels for monetary policy, which have not experienced high real interest rates in the transition and which have banks afflicted by soft loans and bad credits, the monetary lever by itself would have accomplished macroeconomic stabilisation. On the other hand, in economies which have been severely tested by the collapse of intra-COMECON trade, it is doubtful that an ultra-restrictive monetary policy, even if it were implementable, would be suitable.

#### 4. Obstacles to the correct functioning of the new commercial banks

There is no doubt that the reform which has achieved the two-tier banking system has been of great moment. However, until now, this has not created a banking system able to mobilise savings and channel them efficiently towards the most productive uses, since the reform has not solved many of the problems inherited from the past. The new commercial banks were born with the weight of their history in the Soviet regime, so that the lack of information and of

efficient institutions precludes the expansion of "good credit" (Calvo, 1991).

First of all, such banks are almost always very large, obviously public and not accustomed to operating autonomously; all these characteristics mean that competition is very limited. The Polish authorities, for example, tried to install an initial regime of competition in the banking system by creating, with a decision taken in July 1988, new commercial banks which were wholly-owned by the state, each one located in a large region of the country and authorised to carry out any type of banking activity. However, in practice each of them confines operations to its region, with little or no competition with the others to attract clients or offer new banking services on the market. The competition between Polish banks is still influenced by the segmentation of banking activity between individuals and firms and by the high degree of monopoly in the collection of individual savings by a few specialised banks, in particular that for housing. New private banks were authorised by the National Bank of Poland after 1989 with the aim of increasing the degree of competition; their ability to compete effectively is severely reduced by the presence of a total state guarantee on deposits collected by the public banks. The private ones, because of the greater difficulty of directly obtaining deposits, must generally borrow funds on the interbank market, thus also incurring higher funding costs. In an effort to constrain the banking system to finance the emerging private sector, it appears that, on the basis of instructions by the National Bank, a third of all new bank credit extended during 1992 has to go to firms not belonging to the state. As to privatization, a start has been made with two important public banks.

Even in the CSFR the banking system is still highly monopolised. Just one bank has on its books some seventy per cent of the loans in the Czech republic, while its Slovakian equivalent has more than fifty per cent. Almost half their funding comes from the two savings banks, one for each republic. At the moment I write, there are some forty banks, including the savings banks, and nine affiliates of foreign banks, wholly-owned or established as joint ventures, but the new intermediaries control only a small, although increasing, share of total deposits and loans.

In the case of Hungary, the state now has less than thirty-five per cent of the direct ownership of the financial institutions, but its quota becomes much higher if one considers the indirect link, that is,

through firms and other public financial organisations. This second type of control will diminish to the extent that the public enterprises are privatised; furthermore, the government has recognised that it is advisable to set out a timetable for reducing state ownership in the financial institutions. The new banking legislation lays down that no single owner, including the government, can hold more than twenty-five per cent of the shares in any financial institution after 1997, with certain specific exceptions for specialised banking activities, such as those in favour of export and housing. The banks are therefore obliged to launch privatisation plans in order to satisfy the imperatives of the banking law. The sale of an important Hungarian bank is expected by early 1993.

I am afraid the process of privatising banks will not be as fast as the legally-codified intentions imply. Presumably, not only economic obstacles but also political constraints will slow down a process which anyway has to start in the near future. Therefore, these countries cannot avoid considering the way in which, for instance, the French or Italians have ensured their public banks the kind of management autonomy which since many decades has allowed them to behave in a competitive way and thus to contribute to the efficient allocation of resources. Where, as in Hungary, the state enterprises control or have a stake in the banks, the privatisation of the former does not solve the problem of keeping at "arm's length" those who ask for credit and those who grant it. Above all in the former Soviet Union, the bank-firm relationship is of concern: the great majority of the commercial banks recently set up is a direct emanation of powerful state industrial groups, which tends to recreate in a more articulated way the traditional and inefficient subordination of the credit function. The efficient allocation of resources would in such a case be irremediably compromised.

This is only one aspect of a framework of banking regulation which is incomplete in many parts and certainly has not yet been tested, or has been only marginally, by experience. And the task becomes excessively large if, from banking supervision, one goes on to consider overseeing the other newly-constituted or advocated intermediaries, above all those which will have to manage the privatised enterprises with mass methods. However, more worrying is the poor state of supervision by the authorities in charge of the commercial banking sector; despite the assistance provided, for example, by certain western central banks such as the Banque de France

and the Bank of England respectively to Poland and Russia, the function is made more nominal than effective by the lack or loss of sufficiently specialised personnel. To those who are better qualified the emerging private sector is extremely more attractive than the Government or the central bank: high salaries, self-realization opportunities, and social status can be grasped in the former only.

Further obstacles to the correct functioning of the commercial banks are constituted by their continuing dependence on the central bank for soft funds, even though the latter has tried to increase the cost of this resort; by the lack of highly professional management, since it is still generally headed by the people who were there before the banking reform; by the dearth of statutory operational limits, etc. On the functional level, one should also note that high rates of inflation are making medium- and long-term intermediation particularly difficult, or just impossible, thus confining banking activity to the short term. On the one hand, this generates increasing interest in the constitution of specialised banks; on the other, it accentuates the pressure for a rapid development of the financial markets, in an effort to find – mistakenly – in a more articulated financial structure the solution to a problem deriving from the lacking, or insufficient, macroeconomic stabilisation, which remains *the* cornerstone of any strategy to introduce market economy.

#### 4.1 *The problem of bad loans*

However, the major obstacle on the path which should lead the commercial banks to become efficient allocators of resources is constituted by the mass of bad loans which shows no sign of stabilising. Many of the assets inherited by the commercial banks from the “monobank” consisted of soft loans to state enterprises, most of which are actually doubtful or clearly non-performing. Furthermore, the banks have gone on lending to state enterprises in order to keep them afloat, or at least to allow the formal servicing of the outstanding loans, and thus continue to count among “good credits” those which are so no longer. It is a pity that the absence of a secondary market does not allow some sort of evaluation of these assets, as is the case for the foreign bank credits to developing countries. If there were such a market, their exchange value would be far inferior to the book value. Not only Poland but also Russia, Ukraine, Rumania or Slovenia are afflicted by bad loan problems. What we note for the

first country is therefore also valid for all the others, except Hungary and Czechoslovakia, where some half-measures have been taken, although they do not appear to have solved the problem (Bruno, 1992).

Faced with an increasing amount of bad assets in the banking system and with a tangle of doubtful inter-firm credits, the Polish government recently decided to separate them from the good assets in the balance sheets of the nine major public banks. The former will constitute a work-out fund in each bank for the management to restructure or liquidate; the latter will be administered separately by each bank by using, however, normal business criteria. Both the commercial and the specialised banks owned by the government, which essentially make up an ample network for retail deposit collection, find themselves managing a portfolio of loans extended, mainly as a result of non-banking decisions, to enterprises which are negatively influenced in production and profit prospects by the new economic regime.

Considering the poor working of the banking environment and the too-wide risk limits for borrowers, it is no surprise that some of the private banks also ended up taking unwise decisions. The imposition of a ceiling on credit granted by the public commercial banks has made the situation more dangerous for inexperienced private bankers. Some of these have been able to increase their loans to clients too easily, owing to the large supply of funds on the interbank market from the public banks and by the lack of adequate banking supervision. The National Bank of Poland has forced a small commercial bank into liquidation, thus hoping to impose some discipline on the financial sector.

A large portion of the internal loan portfolio of the Polish banks, both public and private, has to be classified as below the minimum qualitative level; seven of the nine commercial banks have 25-60 per cent of substandard loans in their portfolios. Moreover, these portfolios may deteriorate further: as enterprises are privatized, they could meet greater difficulties in servicing their debt. Until now, the Polish authorities have tended to treat the poor quality of banking portfolios as a banks' problem, even if attention has been paid to the proposal of transferring the bad credits to a specialized agency, directly financed by the budget.

The poor quality of loans reduces the profits (or increases the losses) of the banks in economic terms, even though this is not

disclosed in the accounts. As a consequence, there is an increase in the subsidies received or to be obtained by the commercial banks from the central bank (or in some cases from the government) and/or a decrease in the return paid to depositors, thus discouraging financial saving. Finally, to the extent to which the lending activity in favour of public enterprises absorbs much of the available funds, new private initiatives come up against greater difficulties and higher costs of borrowing. Since this problem is an obstacle to the development of the private sector, it is vitally important to solve it rapidly, not only in order to eliminate the allocational distortion but also to proceed with the privatisation of banks, which cannot possibly take place until their balance sheets have been restructured. Indeed, the accumulation of bad loans makes it ever more difficult to estimate the capital value of a bank.

If the profitability of the banking system and its solidity tend to worsen because of the loan-portfolio quality and of the commercial banks' credit behaviour, large and growing debts could materialise for the government, which poses questions about the time frame needed to balance future public budgets. Furthermore, the absence of a clear and credible system of protection for depositors, once the total and discriminatory government guarantee has been abolished, would discourage savers from depositing their liquid funds with banks; owing to the uncertainty about the implications for the public budget, it might also induce foreign investors to become even more cautious. From this follows the need to act rapidly, both on the banking and on the enterprise fronts. In Hungary, 400 of the 2,400 state enterprises have already been liquidated or privatised. Even though the bankruptcy axe must necessarily strike again, many of the firms which survive will need to be restructured. Likewise, of the 1,700 public enterprises scrutinised by the Polish government with the aid of experts, 362 are candidates for liquidation, the others require privatisation and/or restructuring. In Czechoslovakia the law on bankruptcy, one of the most severe, was approved in 1991 and should have come into effect one year later, but when this term expired, an extension of the "grace period" was requested and granted for six more months. The far from satisfactory state of bankruptcy laws and court enforcement has led (Saunders and Sommariva, 1992) to suggest that private mechanisms be developed and get the upper hand over costly and lengthy legal procedures. That would be wonderful, but it is rather problematic owing to the passivity of creditor banks and the scarce availability of local people with experience in arbitration practices.

In the dilemma between the cancellation of debt and its socialisation (Calvo and Frenkel, 1991), I feel that the second course should be chosen, if one wishes the banking system to become an instrument for the restructuring of the economy and possibly, after that, for its control or governance. Obviously, the means should be such as to minimise the moral hazard, that is, the expectation that the rescue could be repeated in the future. It has been proposed (Phelps, 1992) that the state, in exchange for the cancellation of a part of the bad loans of the banks, should transfer an equivalent amount of deposits to new institutions, the liabilities increase to be covered by the assignment of government bonds. Obviously, in order to benefit by such a manna the new intermediaries should have their own solid capital base and, possibly, a favourable rating. Such a mechanism would have the advantage of reducing the weight of the public commercial banks in the system and of "forcing" the market share of new intermediaries, but poses for the government problems of moral hazard in case one or more of the latter go bankrupt for mismanagement or any other reason, to say nothing of the political predicament of choosing the few to be bestowed without their having any specific "merit" except a clean balance sheet.

## 5. Development of the bond markets and the stock exchanges

The policy of macroeconomic stabilisation in these countries requires, no less than in those of the West, very tight control of the public budget, which is difficult to achieve and above all to maintain at a time when the tax revenue is negatively influenced by the fall in production and the outlays are enlarged by the increased demand for social protection as a result of the fall in real incomes; the introduction of inflation-linked mechanisms, to which it is often necessary to resort, renders the instability even more chronic and sometimes results in hyperinflation. Since, given these conditions, the introduction and the observance of the principle of a balanced budget is socially unacceptable and macroeconomically damaging or dangerous, as it might lead to even lower activity levels than those justified by the change of economic regime, it follows that the public deficit must be financed as much as possible by non-monetary means if one wishes to achieve the objective of stabilisation.



This requires a rapid development of the bond markets, both primary and secondary; in addition to a minimum legal structure, their growth depends essentially on the paper supply with rate structures and maturity terms suitable for "green" and macroeconomically unstable financial environments. Moreover, the issue of short-term bonds, much more attractive in such conditions, makes possible the transition of monetary policy from a *modus operandi* based on rationing and direct controls to a market-oriented one, aimed at influencing the interest-rate structure by means of the monetary base supply. This is another reason in favour of a high priority for the establishment of bond markets.

While banking systems are subject to reforms and bond markets are set up, ambitious programmes of privatisation are being studied, formulated and – more rarely – effected in central and eastern Europe. The creation of financial markets is held to be of fundamental importance in such a process, since they would ensure liquidity for newly-created financial assets like shares and in the future would allow firms to obtain funds from savers. Were stock markets to develop rapidly, they could be directly involved in the privatisation of enterprises. But in what state are they?

Hungary has done more than any other country in developing its nucleus of financial market. After an interval of some forty years, the reorganisation of the stock market was initiated at the beginning of the 1980s, allowing the issuing of bonds. An agreement on share transactions, signed in 1987, on the one hand consolidated by regulation the current practices and, on the other, marked the beginning of the process which later led to the foundation of the Budapest Stock Exchange. The bond market suffered a complete collapse in 1989 due to accelerating inflation, the absence of fiscal deductions and government guarantees on newly-issued stocks, and the appearance of short-term deposit notes, issued by commercial banks, with attractive rates of return. The 1990 law on the public offering of shares created the legal framework for the functioning of this market. The Stock Exchange was set up on June 19, 1990 and has an encouraging activity rate, with a daily average of Ft. 40 million in 1991. There are some fifty brokers, with eighty per cent of the total volume controlled by six or seven intermediaries. Foreign investors contribute some 60-70 percent of the turnover. The bond market, in turn, overcame the crisis thanks to the issue of variable rate bonds. Obviously, the share segment should increase its size and role as privatisation proceeds.

In Poland, genuine financial markets have developed slowly and are still in a rudimentary state. Those dealing in government bonds have been negatively influenced by the erroneous conditions of issue (long-term and low-interest, negative in real terms), by the lack of a properly set out legislation regarding supervision and regulation and by the ignorance and mistrust of savers. The development of the public bond markets, as already noted, should represent an important objective, both in order to finance the Treasury deficit and, above all, to allow the conduct of an efficient and non-distortive monetary policy. The stock market is still too small and speculative; the Warsaw Stock Exchange opened in April 1992 with ten shares, and the number has been growing rather slowly.

Czechoslovakia decided to create a stock exchange which reflected the political situation of a federation in dissolution. Two stock markets, one in Prague and the other in Bratislava, are being set up with the help of foreign consultants to lay down rules, regulations and operational procedures. With regard to the negotiation method, the two markets at one time seemed to be set for choosing different bases. Prague opted for a daily fix, using a computer programme developed by the Paris Bourse; Bratislava, after considering the Swiss model of continuous negotiation using the simple call method, finally selected a modified version of the Paris Bourse procedure. As rehearsals and simulations have already been taking place for some time, it is thought that the activity will increase rapidly immediately after the first wave of privatisation by means of the conversion of vouchers, probably at the beginning of 1993.

In all the other countries of the region there have been no significant developments in the area of stock exchanges. In the former Soviet Union, and particularly in Russia and Ukraine, stock exchanges have developed rapidly but in a disorganised way: most of those existing are in fact commercial centres, where cement, for example, can be exchanged for oil; timber for computers or furs. The less numerous bond markets also raise some concern. The access to the profession is scarcely and badly regulated, computer links between the markets do not exist, the number and the quality of bonds are scarce, so that activity tends to slip towards speculative intermediation of "large credits".

The development of markets for shares and other private stocks is particularly important for economies that wish to pass speedily from state capitalism to popular capitalism; however, in designing the

structure of the financial system, is it more advisable to be guided by this need – important but incidental – or by that one – strategic and long-term – to set up an efficient mechanism of accumulation of capital, allocation of savings and control or governance of firms?

#### 6. Is it better to favour intermediaries or markets?

It cannot be denied that the stock market – for good or bad – is often considered to be the greatest expression, almost the symbol, of the capitalistic system. Abhorred by the communist regime – in which only labour, certainly not capital, had to generate income – as a natural reaction, it has come to be considered by many in central and eastern Europe as the conjuring trick which can transform the economies run by the principle of administrative orders into market systems. The desire to get closer to the western model as soon as possible has not yet given some countries the time and opportunity to identify clearly which type of financial system they want to set up to fit their present and future needs. This defect of political reflection is, to some extent, also the responsibility of the consultants, almost all British and American, who have poured into the East and whom, coming from the countries with the most developed stock markets in the world, have naturally preached their own word and have ended up strengthening conviction in some eastern quarters that there is only one financial system in the West. As is well known, this is untrue and the choice requires an evaluation of the starting conditions and, at the same time, a prefiguration, however crude, of the mechanisms of accumulation, allocation and control of each economy. It should not be forgotten that the Anglo-American financial structure represents the most advanced point of financial capitalism and, precisely because of this, constitutes more the exception than the rule in the western world.

According to a distinction which has had great success and which is still sufficiently interpretative – even if some (Corbett and Mayer, 1991) see it as a crude simplification which should be substituted by the dichotomy between corporate sectors which are insider-controlled and those that are outsider-dominated – financial systems tend to be subdivided between the market-oriented ones and those

which are intermediary-oriented; no system, thus, is completely pure, but each one has markets and intermediaries in a composition resulting from cultural influences, political developments, economic and financial events; in a word, the history of the economy. Obviously, the balance of the components is modified dynamically, as recent Italian experience also demonstrates; however, in the absence of fundamental political upheavals, the changes are not such as to modify the overall balance of the system and to require its reclassification.

In deciding what system to choose, it must be remembered that there is a definite advantage of intermediaries over markets due to the greater flexibility and prompt renegotiability of bank credit, the smaller reduction of access to the latter during economic recessions, the provision of liquid funds, essential for the correct functioning of these very markets (Garber and Weisbrod, 1990). In addition to such aspects – since for the central and eastern European countries, and above all for those which arose out of the ashes of the Soviet Union, history started (or restarted) with the collapse of the communist regime – this is a unique opportunity to design the financial system and, with it, a fundamental mechanism for the control of the economy. Recently, quite an interesting proposal was put forward (Szegö 1992), that of organising the eastern European financial systems along four, strictly specialised tiers (payments services, lending activities, investments, and central banking). Besides being against the tide in favour of despecialization, it is not clear whether the system would make away with economies of scale and scope in the financial system and how it would cope with innovation and the difficulties of having demarcation lines fully respected. Moreover, the scheme is based on the assumption of efficient financial markets, which is acceptable only up to a point. Finally, is it reasonable to saddle central and eastern European countries with the experimenting of a system that, if successful, would be of great interest also for western countries since it seems able to economise on capital?

If the objective is to favour capital accumulation above all, current opinion is that a system oriented towards intermediaries, that is, mainly the banks, is the most suitable. In this respect, the experiences of Germany and Japan are examples whose financial systems are clearly influenced by universal-type banks and whose stock exchanges are heavily dependent on them, although in the case of Tokyo one can no longer say that its stock market is small, while this is still relatively true for Germany.

An analysis of the reasons which could explain the better performance of the post-war German and Japanese economies is out of place here, even though the control or governance mechanisms based on indebtedness seem to have been instrumental in securing these results. However, it suffices to note that it does not seem possible to refer to a kind of historic constant between greater accumulation and a stronger role of intermediaries. Goldsmith (1969) showed that in the second half of the 19th century, era of the second industrial revolution, the main economies went through a phase of security capitalism; that is, direct financial relationships prevailed over those intermediated by the banks, despite the ratio between financial assets and real wealth being at minimal levels, as seems now the case for the central-eastern European economies. But looking even further back, the financial history of France shows that the banks had a lesser role than the markets before the Revolution, whereas afterwards the former became more important than the latter in the allocation of financial resources; even though it is difficult to prove the causal relationship, the connection between the change in the financial structure and the rapid industrialisation and development of the country is certain.

If historical experience is not unequivocal, and thus it is possible to learn some lessons from it, rather than derive models (Ciocca, 1991), even theory is not resolute in this respect. It is known that in a Walrasian environment, which tends towards perfect competition and where the markets become more efficient and less subject to friction, the financial intermediary becomes ever less a risk-transformer and ever more a mediator; in other words the bank has to transfer its allocative function to a stock market made up of brokers. If the hypothesis of perfect markets is unrealistic – I am convinced of this – and if in the imperfect ones we know of the prices are not full disclosers of private information – of which there seems to be some evidence – for the consumer/saver it becomes more advantageous to rely on one of the many intermediaries who offer professional services of savings management; only they have the abilities and the opportunities to accumulate information. The asymmetric availability of information renders the market mechanism insufficient and justifies the financial regulation aimed at ensuring the quality of the products and/or the transparency of prices (Masera, 1991).

The problems of information do not only require the intervention of the authorities, of the professions, of internal as well as external auditors, but also push the market itself to react by means of

a mechanism which, based on credibility, creates a reputation. The existence of the latter with regard to a few intermediaries is usually not enough to push the competitors with lower credentials out of the market, which reconfirms the necessity for some sort of regulation, and can often enter into conflict with the needs of financial innovation, since the quality of the “new” product is unknown. What interests us here is that the reply of the market does not tend to create conditions of perfect competition, but to reinforce the imperfect structure which is the basis of a financial system oriented towards the intermediaries who are risk-transformers. I am therefore convinced that, from the point of view of capital accumulation, economic analysis provides enough elements for preferring bank-oriented systems rather than market-oriented ones, where brokers only operate. This explains the transformation, which also took place in Italy, of the stock exchange in a market of intermediaries which can transform risks, by taking positions. However, even a stock exchange with a good number of dealers suffers, compared to bank-type intermediaries, of a tendency to “short-termism” which can harm the accumulation process.

Another purpose to be kept in mind by those responsible for the economies of central and eastern Europe when designing their own financial system is that of ensuring an efficient control mechanism of firms, whose initial conditions – it is worth recalling – are strong concentration, high indebtedness and scarce management. Czechoslovakia, possibly due to its rigid orthodoxy in the 1970s-1980s, kept the responsibility for the management of firms in the hands of the government, while in Hungary and Poland it resides respectively in the managers and in the workers' councils; these in-house control systems are anything but efficient for the purposes of transition, but the Czechoslovak centralized system has deprived managers of their “animal spirits”, thus hampering the development of small and medium enterprises. In the former Soviet Union there is a strong claim by the local authorities to exercise control on firms situated in their areas. Furthermore, the productive, technological and financial restructuring of firms will require large sums of capital which it is unrealistic to assume can be provided, together with control over its managers, by a scattered multitude of share-holders, more inclined to achieve some modest return on capital in the short term than to take on long-term risks; the free-rider problems so well known in the West would be much greater.

Even assuming that the East develops capital markets on the Anglo-Saxon model, this will ensure the control of listed firms by means of hostile takeovers; in the very countries where this is in vogue, it attracts criticism under various aspects, for example because the hostile takeover only takes account of the interests of the share-holders and not of the other stake-holders, like the employees, the suppliers, the clients; because it can be prevented or impeded by the strategic actions of the managers; because it is costly in that it will only be successful if the buyer pays too much and the value of the shares is expected to fall after the acquisition of the firm; because it forces the company management which does not wish to be taken over to concentrate on short-term income-producing objectives, etc. The conclusion reached by theoretical research is that the manager is not controlled by anyone, but that a large number of individuals and institutions influence his behaviour (Stiglitz, 1985). And the institutions which exercise this influence most are indeed the financial intermediaries and, among these, the banks.

Indeed, on the basis of the theory of asymmetric information, the costs of agency and monitoring should, in principle, be lower than those incurred by scattered individual investors who go for direct financing. The monitoring carried out by intermediaries takes advantage of economies of scale; furthermore, the diversification of their portfolio makes the information problems less important. It should not be forgotten that financial activity is permeated, in environments characterised by information asymmetries, by problems deriving from adverse selection and moral hazard; the former does not allow, for example, financing of valid projects at the best conditions because the markets cannot distinguish their different rates of profitability on the basis of their intrinsic characteristics, while the latter – also by way of example – concerns the riskiness of business strategies where the principal (or financier) and the agent (or manager) have different objectives. One must infer that the intermediaries, in a necessarily second-best world, produce results that the markets could not achieve by themselves. Obviously, the banks are not the only ones to exercise control over managers. They are flanked by the principal share-holders who, having a large enough share of the firm to justify the costs for the acquisition of information, are able to exercise efficient control over management. Neither should one forget the market reply, which is manifested in the creation and defence of managers' reputation.

If the central and eastern European countries, thus, do not wish to abandon completely the control of the economy into foreign hands – obviously a harbinger of negative political reactions in the medium

term – or, worse, leave it on the shoulders of the state by replacing yesterday's arbitrary actions of the planners with today's irresponsible decisions of bureaucrats, or else give it to enterprise managers who serve their own interests, there is no doubt that they should devote great attention to the financial intermediary system and to their inter-relationships with the productive structure; obviously, the intermediaries which I have in mind, at least for the immediate future, are not the commercial banks which have emerged from the dismemberment of the "monobank" and which, at least on the basis of the law, may become universal banks. These are part of the system to be transformed, being afflicted by the same ills the productive firms suffer from; however, in a somewhat longer term they could contribute to the solution of the general problem, if they are able to solve their own.

One type of intermediary of this kind, referred to in various countries, are the pension funds, in an effort to orient the social security systems – until now based on the principle of distributing to to-day's beneficiaries what is simultaneously collected from those charged – towards that of funding; in the West, however, such funds are not particularly active in the management of the firms in which they have invested. The most interesting proposal is that which provides for the institution of *ad hoc* intermediaries (Frydman and Rapaczinski, 1991) whose mandate seems to oscillate between a financial intermediary's and a holding company's. Indeed, both the Polish and Czechoslovakian authorities have laid down that shares acquired by individuals by means of vouchers should be concentrated in the hands of a number of funds, which seems to be too few in Poland and too many in Czechoslovakia, where an extremely aggressive advertising campaign by one of these financial intermediary-holding company has made the expectations of capital gains grow excessively since the beginning of the operation. Obviously, privatisation will make clear the state of collapse of some of the firms, and the need to recapitalise others, and thus the increases in value, if at all, will be very selective. Finally, the success of such a transformation depends on the way the portfolio is managed by the intermediaries; if it is oriented to achieving short-term capital gains, the investment and restructuring needs of the firms can only suffer. The plight of the economy would not be lessened, either.

It is clear that the stock and financial markets will also have a role to play which must not, however, be overestimated; above all, one should not take it that the Anglo-Saxon financial combination between market and bank as an unavoidable paradigm for the devel-

opment of a capitalist economy. Having said that, the debate about the optimal financial structure, even for the developed countries, is nothing like over. In the last issue of May 1992, *The Economist* (p. 18), debating the probable losses that the property group Olympia & York would cause to the financing banks and the serious difficulties of the Japanese banks, so concluded its leader entitled "Bonds, not Banks": "If banks, as traditionally conceived, measure risk more expensively and less accurately than markets, it may soon be time to ask: who needs them?". The question is provocative, but certainly legitimate. However, more than inducing us to doubt the fundamentals on which I think one should base the choice between intermediaries and markets, it should remind us that even banks make mistakes, that every care should be taken in evaluating and diversifying risk, that competition must ensure conditions of minimum cost, that the survival of the intermediaries in the evolution of the financial species is given by their ability to ensure the allocative and dynamic efficiency in investments and the safeguard of funds, which often have monetary characteristics.

## 7. Brief conclusions and a long-term pledge

In the next few years, the success of the reform processes and the creation of market-oriented economies will depend crucially on the provision of financial resources to the emerging firms of the competing sector. The strategy for the development of the financial infrastructure must be oriented towards the institutions, made consistent with the policies of macroeconomic stabilisation and aimed at improving the allocation of resources at the microeconomic level. To this end, it will have to be designed in such a way as to increase: *a)* the capacity for action by the authorities through market instruments; *b)* the efficiency of regulation and supervision; *c)* the degree of responsibility of individual financial intermediaries; *d)* the availability of a variety of banking and financial instruments. However, since financial reform is not a sufficient lever to force the restructuring rhythm of the productive sector, the strategy must ensure that its time-phases are carefully planned with the liquidation, restructuring and/or privatisation of state enterprises (Brainard, 1991), particularly those which are vertically integrated and have monopolistic characteristics. During the period between corporatization and privatization of

firms appropriate incentives have to be introduced in order to make managers accept financial discipline (Dooley and Isard, 1992). An articulated financial structure is, in any case, a necessary condition for local and foreign entrepreneurs to be driven to invest.

Consequently, one of the more urgent tasks is the overhaul of the commercial banking sector, which includes the restructuring of its balance sheets by cleaning up their loan portfolios, together with an improved capacity to evaluate risk and carry out transactions professionally. There is also an urgent need to create new financial intermediaries, not only to manage the privatised enterprises with mass methods, but particularly to support the small firms; the fabric of a market economy is an ample range of small- and medium-sized productive firms.

The path to follow will not be easy, almost certainly it will be longer than expected by most people, but it has neither short cuts nor alternatives. The international community can be of help both through bilateral programmes and multilateral action plans. In particular, the international institutions<sup>2</sup> can be of assistance, encouragement, and support to governments in their endeavours to transform, but the former can never replace the latter. Economic and civil liberty is a public good. It must be supplied and guaranteed by the political system, which will only manage to do so if it never loses sight of the public interest which must be served with great ethical sense and as little rhetoric as possible.

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<sup>2</sup> I am convinced that the European Bank for Reconstruction and Development will endeavour to contribute to the creation of a network of institutions to foster the development of small- and medium-sized enterprises through appropriate financing. Until now, the EBRD has invested substantially in activities of technical cooperation and has become involved in the organisation of training and specialisation courses for bankers, in the constitutions of a banking school in Moscow, in the financing of a similar institute in Rumania, in the consultancy in some thirty projects and, in particular, in a project for the introduction of a deposit insurance system in Poland with the aim of eliminating the state guarantee on the state bank deposits, thus unifying the market. On the lending activities front, we should mention certain "agency lines" in favour of branches or affiliates of western banks which operate in central and eastern Europe. Since the instrument has various limitations, both from the point of view of the intermediaries who administer them and from that of the objectives attainable by it, an initial operation has been launched regarding a public bank in Rumania, conditional on the improvement of its capital structure; by these means, apart from favouring the agri-business sector which is the final beneficiary of the funds, an effort is being made to improve the risk assessment, the loan portfolio and the operational procedures of one of the largest commercial banks in Rumania. Other operations will follow, in the conviction that they will be instrumental in achieving EBRD's objectives in the financial sector.

## APPENDIX

TABLE 1

SELECTED ECONOMIC INDICATORS FOR THE CZECH  
AND SLOVAK FEDERAL REPUBLIC  
(percentage rates unless otherwise specified)

	1987	1988	1989	1990	1991	1992 Forecast
GDP at constant prices	2.1	2.5	1.4	-0.4	-15.9	-7
Consumer prices (December/December)	0.1	0.6	1.5	18.4	53.6	n/a
Broad money supply (end year)	6.0	11.5	3.5	0.5	26.8	n/a
General Government fiscal balance as a ratio of GDP	-0.7	-1.5	-2.4	0.1	-2.0	-3
Lending rates <sup>1</sup>	4.73	4.66	5.20	6.16	15.32	14 <sup>2</sup>
Households financial claims on the banking sector <sup>3</sup>	252.2	266.5	279.4	280.5	301.1 <sup>4</sup>	n/a

<sup>1</sup> To state enterprises.

<sup>2</sup> First quarter.

<sup>3</sup> Billion crowns; end year.

<sup>4</sup> September.

Sources: EBRD, IMF, IBRD, IFF, Economic Plan.

TABLE 2

SELECTED ECONOMIC INDICATORS FOR POLAND  
(percentage rates unless otherwise specified)

	1987	1988	1989	1990	1991	1992 Forecast
GDP at constant prices	2.0	4.1	0.2	-12.0	-9.0	0
Consumer prices (December/December)	31.1	73.9	639.5	249.0	60.4	40.0
Broad money supply (end year)	34.1	63.3	514.6	166.0	45.0	n/a
General Government fiscal balance as a ratio of GDP <sup>1</sup>	-0.8	0.0	-7.4	3.8	-4.5	-8.0
Lending rates	12.0	16.7	64.0	101.4	49.0 <sup>2</sup>	n/a
Financial claims of the non-socialised sector on the banking sector <sup>3</sup>	14.487	31.659	171.402	145.938	232.156	n/a

<sup>1</sup> The General Government includes the state, the municipalities and extra-budget funds. The state budget deficit alone was 3.5% of GDP in 1991, and is forecast to reach 8-10% of GDP in 1992.

<sup>2</sup> Third quarter.

<sup>3</sup> Billion zlotys; end year.

Sources: EBRD, IMF, IBRD, IFF, Economic Plan.

Table 3

SELECTED ECONOMIC INDICATORS FOR HUNGARY  
(percentage rates unless otherwise specified)

	1987	1988	1989	1990	1991	1992 Forecast
GDP at constant prices	4.1	-0.1	-0.2	-4.0	-10.2	-2.0
Consumer prices (December/December)	10.8	14.8	18.9	33.4	32.2	20.0
Broad money supply (end year)	10.2	3.5	13.8	29.3	28.2	n/a
General Government fiscal balance as a ratio of GDP	-3.5	0.0	-1.3	0.4	-4.6	-7.0
Lending rates	11.5	13.0	17.0	17.0	30.0 <sup>1</sup>	n/a
Households financial claims on the banking sector <sup>2</sup>	n/a	326.0	323.9	399.4	541.1	n/a

<sup>1</sup> Third quarter.

<sup>2</sup> Billion forints; end year.

Sources: EBRD, IMF, IBRD, IFF, Economic Plan.

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