INTRODUCTION

Financial Reforms and Economic Transition: An Overview of the Major Issues

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The essays in this volume deal with banking sector reform and capital markets in transition economies.[1] To place these issues in broader context, however, we first discuss here a number of related questions that provide an appropriate framework for the understanding of the specific and crucial role played by financial reforms in the context of post-Communist transformation.

These questions have arisen because various transition economies appear to have achieved a relatively high degree of macroeconomic stability, especially compared with the situation observed at the beginning of the process, in the early 1990s.[2] First, once macroeconomic stability seems to have been achieved, should policy makers continue to pursue macroeconomic stabilization – should it remain a permanent concern in transition economies? Second, since transition should be, logically, a time-bounded process, what is the appropriate time horizon for policy makers? Should policy makers concentrate more on long-term issues or should they focus on immediate transition problems? Third, how do the trends toward economic globalization interact with financial development in transition countries? Finally, what is the role of commercial banks in transition and why are banking reforms so difficult to complete? We attempt to deal with these questions in order to provide a broad analytical framework for the contributions collected here.

[1] All the essays in the collection were presented at the Second Dubrovnik Conference on Transition Economies organized by National Bank of Croatia. The First Dubrovnik Conference on Transition Economies focused on macroeconomic issues. Papers presented in that conference are published in Blejer and Škreb 1996.
[2] See, for example, European Bank for Reconstruction and Development 1996.

SHOULD WE STOP WORRYING ABOUT MACROECONOMIC STABILITY?

Once achieved, the quest for price stability may lose its appeal (especially for politicians), as if, in fact, stable prices were a natural state of the economy. After inflation has been conquered, it is not unusual for macroeconomic populism to reappear, concentrating its efforts on seeking "development" with little concern for maintaining price stability. Situations of this sort seem to have arisen in a number of transition economies. As soon as stabilization is secured, people's impatience about standards of living starts to rise. Questions are asked and politicians, eager to be reelected, seem to like the notion of "instant" growth. The implicit belief about the existence of a long-term Phillips curve is very much alive in the thoughts of many decision makers and the maintenance of low inflation becomes an often neglected policy goal.

Such an approach could be highly dangerous in the long run. Many of those responsible for policy making seem to have reached the conclusion that inflation is, after all, not invincible and, therefore, if it reappears, it would not be such an arduous endeavor to deal with it. This, indeed, is a mistaken belief. It has been said that "inflation fighting is not like elephant hunting, where you first find the elephant, and then you fire." Inflation must be dealt with before it appears, and not be "shot at" only after it has been spotted. Once inflation is revived, it is usually too late to avoid significant social and economic costs.

There is, by now, a broad consensus on the issue of inflation and financial development: without stability it is not possible to have efficient financial intermediation, neither through banks nor through capital markets. Moreover, because of the initial financial underdevelopment prevailing in most of the transition economies, the need for macroeconomic stability in these countries could be even more crucial. On the other hand, it is equally true that stability per se is not enough to deliver increasing welfare (e.g., growth and equity). Therefore, if transition is to be successful, there is an obvious need to link macroeconomic policies with structural measures that promote sustainable economic growth, but it would be imprudent to neglect stability once it has been achieved, usually at a high cost.

Central banks are typically regarded as guardians of stability. Within the framework of promoting economic growth, it seems legitimate to ask whether central banks, in addition to fighting inflation, do more to foster growth. Most economists would probably answer no, particularly because for many economists the meaning of "fostering growth by the central bank" would simply imply a significant relaxation of its monetary policy stance ("printing more money"), which ultimately leads only to higher inflation. Clearly, although temptations are always present, a central bank cannot generate real (as opposed to nominal) growth just by printing money.

But there is indeed a role for the central bank in promoting growth. Central banks should be independent from short-term political influence, have a clear mandate to achieve and maintain price stability, (or an explicit inflation target), publicly announce their goals, and be accountable (Capie, Goodhart, Fischer, and Schnadt 1995). If those conditions are met, central banks can indeed deliver higher economic growth and prosperity by ensuring the necessary long-term stability of the currency and of the financial system, which are essential for higher savings and investment and for the efficient allocation of investments. Both of these elements – high and well-allocated savings – are necessary ingredients for achieving a higher and sustained growth path.

It seems, therefore, that while the focus of attention in transition economies has somewhat shifted from macroeconomic stability issues toward structural microeconomic-oriented questions (such as those discussed in this volume, related to banking and enterprise reforms and to the development of capital markets), it should be pointed out that both, macroeconomic stability and microeconomic reforms, are necessary conditions for attaining and sustaining a high rate of economic growth. Without economic growth, the economy is just playing a constant-sum game, and it would not be able to deliver prosperity, inducing disappointment and undermining institutional credibility.

SHORT-RUN VERSUS LONG-RUN POLICIES

Although it is indeed too early to summarize the lessons from the transition process, it is already evident from the existing experience that the transition is not a one-time effort nor a short-term undertaking, but rather a long-standing, continuous battle, a sociopolitical and economic endeavor that evolves over a long time horizon. Moreover, while it is evident that a successful transition will result in a substantial increase in the well-being of the population, the rewards would only appear gradually and after considerable sacrifices. This, of course, could lead to the design of shortsighted, and therefore wrong, policies or result in significant time inconsistencies in the decision-making process.

While it could be entirely rational for politicians to be tempted to adopt some sort of myopic behavior, given the immediacy of the costs and the heavy discount usually applying to the future benefits (particularly in conditions of political instability), it is crucial to insist that long-term goals should not be neglected. The list of transitional matters that cannot be resolved overnight is a long one, including privatization, enterprise restructuring, and institution building. High in that list, however, we find a number of issues closely related to banking sector reform and capital-market development. We concentrate here on three of these issues: the notion of risk, credibility of economic policy, and the promotion of long-term savings.

Risk is inherent to a market-based economy. Socialism could be seen, in fact, as a big insurance company: enterprises could not fail, and workers did not run the risk of loosing their jobs. In particular, credit and foreign-exchange risks were meaningless concepts since losses of commercial banks were socialized by the state and, frequently, exchange losses were also explicitly covered. The state (broadly speaking) was the main insurer, and insurance premiums were paid independently of the underlying risks. It goes without saying that moral hazard was a dominant force in such a system. Changing this situation, however, is not an overnight task. It not only requires a change in the ways that economic agents reason and react but it also necessitates active training in order to learn risk measurement and risk management techniques. Financial markets would only fulfill their roles efficiently when such changes in mentality and in operational practices become widespread, but this is, indeed, a long-term goal.

A similar long-term outlook should be adopted regarding the issue of policy-making credibility. If the government is unable to send a clear message to the public that it seriously intends to conduct stable policies and to establish and maintain firm financial discipline, the cost of actually pursuing these policies would increase significantly. In the central-planning context the question of credibility of policy making was not present because there was no scope for indirect market instruments and therefore no room for individual discretion in decision making. But building credibility during the process of transition becomes a crucial issue.

This can be particularly appreciated in the context of financial sector development. Unless policy credibility is strengthened, it would be very difficult to generate credibility in the emerging banking system, and without credibility in the banking system there will be no available sources of long-term funds and no available long-term bank financing. The lack of trust in domestic banks would tend to induce long-term capital flight that may, in certain circumstances, coexist with short-term, usually speculative, capital inflows. Since short-term capital inflows do not resolve the problem of scarce long-term funding, it is necessary to focus attention in strengthening credibility, certainly a prolonged process, as the only way of stabilizing the economy's balance of financial resources.

When speaking about credible long-term policies, financial discipline deserves special attention. The role of the government is essential in this process. If the government does not set an example (by meetings its obligations and forcing other agents to do so), it may undermine all the efforts made in other areas of transition. Moreover, without financial discipline on the part of the government, a generalized credibility gap may arise, resulting in financial disintermediation or in "short-termism," a clear consequence of the lack of trust in the banking system.

The third relevant long-term issue relates to the promotion of savings during the transition. If transition economies are to achieve long-term high and sustained rates of growth they must adopt policies that encourage domestic savings. Domestic savings are crucial in financing capital formation and in fostering economic growth. Foreign savings may be able to substitute for the lack of domestic savings, but only temporarily. While capital inflows and foreign direct investments play an important role, the evidence is that, in the long run, sustained high growth rates cannot be achieved without sufficient domestic savings. Aggregate domestic savings were very high during central planning, but have fallen significantly during the transition. There is, therefore, a genuine need to promote policies that increase aggregate savings in all its components – that is, government, enterprise, and household savings. But, promoting saving cannot be achieved immediately, and therefore, again, a long-term, comprehensive approach is called for.

GLOBALIZATION AND THE FUTURE OF TRANSITION ECONOMIES

The future is always uncertain. But there are some clear global economic trends emerging, which are becoming considerably visible and which should not be neglected as economic policies in transition economies are designed. It is evident that the world economy is globalizing rapidly while also strengthening regional currencies and trade blocks. The globalization of the world financial markets and the increasing sophistication of financial instruments (such as derivatives) make it increasingly obvious that crises are contagious. Regardless where they start, they can very quickly spill over to other countries. Therefore, it is not enough for a country to pursue "sound policies at home." It has to watch world developments closely and respond to them promptly. At the same time, globalization also demands permanent "good behavior." Increasing financial integration and greater transparency augment the responsibility of domestic policy makers since their decisions are constantly watched by international economic agents.

As mentioned before, "right" economic policies may not always be popular with voters, and therefore may be shunned by politicians, but the cost of the alternatives could be extremely high. While decision makers cannot, and probably must not, neglect local public opinion, a more global perspective should be adopted. How, then, should transition economies behave in a rapidly changing world? Like Alice in Wonderland, if transition economies want to catch up with the developed world, they have to run twice as fast, which can be achieved only by adopting adequate policies. And there is no more evident area than the financial sector where a promising future depends crucially on the nature of today's decisions.

COMMERCIAL BANKS IN TRANSITION

Schumpeter once said that the only important institution in capitalism is the bank. Banks should collect savings and be responsible for the efficient allocation of resources. In most transition economies, however, financial markets are both shallow and narrow. Given the underdevelopment of their capital markets and their relatively high country risks, raising equity capital either on the stock exchange or through direct foreign investments is indeed more difficult than in developed market economies. Thus, enterprises must rely much more heavily either on self-financing, or on bank lending. Banks fulfill, therefore, a very important function in the overall financial system of almost all transition countries.

Banks in transition, however, cannot fully fulfill one of their most significant roles: the efficient allocation of savings throughout the economy. Starting in most cases from monobanking, old (usually state controlled) banks are not prepared to measure risks adequately, are overstaffed, and frequently are burdened with bad loans. Their decision making is often more influenced by political considerations than by sound banking principles. New, emerging, private banks are usually too small and their influence is not enough to create a competitive banking environment. Thus the thorough rehabilitation and restructuring of commercial banks is an essential ingredient in the creation of a sound banking system. After stabilization has been achieved, bank rehabilitation and bank restructuring (linked with enterprise restructuring) appear as the highest priorities for transition economies.

In practice, however, bank rehabilitation has proved to be a very slow process in transition economies, which has led to the emergence of serious banking crises. Of course, banking sector problems are not restricted to transition economies. Since 1980 about 130 countries have experienced significant banking sector problems, while 36 had serious banking crises (Lindgren, Garcia, and Saal 1996). But banking crises seem to have been particularly endemic in transition economies. Why has it been so difficult to rehabilitate banks in transition countries before a full-blown banking crisis erupts? The usual answer is that bank rehabilitation (including carving out bad loans, bank recapitalization, and restructuring) is very costly and budgetary resources are scarce. This is, however, only partially true as bank rehabilitation appears to be just a redistribution problem. With budgetary expenditures of about 50 percent of the GDP, as is the case in most transition economies, devoting, say, two percentage points to bank rehabilitation does not look like an unattainable objective. The lack of determination to pursue bank rehabilitation is therefore a problem of intertemporal redistribution (because it essentially involves the decision about what budgetary expenditures should be lowered in order to finance the process) and therefore it is largely a problem of social and public choice. Consensus in this area seems to have largely eluded transition economies.

Why is that so? If financing is really not the problem (or at least not the main one), why is bank rehabilitation postponed? Why are optimal decisions in bank rehabilitation not taken? Probably the key to these questions is a correct assessment of the reasons behind the lack of political support for this type of endeavor. Bank rehabilitation is usually faced with significant resistance from various groups of economic agents. Resolving systemic banking problems is a practical exercise in multiple enterprise restructuring. This again means substantial redistribution. In transition economies, banks need restructuring because, in most cases, their loans were granted on the basis of political criteria (without adequate measuring of the risks involved) and not on the basis of sound banking practices. Banks were usually state-controlled, and their decisions were easily influenced by politicians. Banks were managed by individuals who were closely linked with the political elite and their aim was to fulfill certain "duties" (such as "support the economy") rather than to protect bank liabilities (deposits and capital).

It is not surprising that resistance to bank rehabilitation arises from many quarters. The most clearly defined groups that are expected to oppose restructuring include politicians, bank managers, bank personal, and state-controlled enterprises. Bank managers were usually appointed by the political elite before the transition. If this political elite has not withdrawn from the scene (or has reemerged as is the case in some transition countries), it may be difficult to change the management of a bank during the process of rehabilitation. Politicians are aware that they will have much less power if stripped of their influence over banks through the appointment of new management. Friendly management can grant loans for wages to enterprises on strike, finance local sports teams, newspapers, and the like.

Bank managers clearly have vested interests within the existing power structure. High wages and political influence are strong enough motives for their active opposition to any change that implies the loss of their position. They may go along with rehabilitation plans as long as they themselves bear no consequences on account of their previous behavior. But if supposedly rehabilitated banks operate under the same management, we are clearly faced with a moral hazard problem and probably minimal efficiency gains could be expected.

Bank personnel resist rehabilitation and restructuring because the process creates uncertainty. Clearly, as most of the old banks need serious downsizing, the fear of layoffs is widespread.

State-controlled enterprises based their existence on soft loans from state-controlled banks. It was common that the largest debtors of a bank were sitting on supervisory boards of the banks, thus creating interlocking incestuous relationships. Those firms would engage their resources in rent-seeking activities aimed at retaining the status quo rather than investing time and effort in restructuring their operations in order to become profitable in a competitive environment. Thus, from the management of those enterprises as well as from their employees one can expect strong resistance to bank rehabilitation.

Clearly, while the implementation of sound banking principles is bound to increase the welfare of the population at large, it would significantly hurt some groups of people. One should, therefore, expect various interest groups to offer strong resistance to banking reforms.

If banks are not rehabilitated, if they continue to extend loans based on political criteria, and if insolvent banks remain in the system, severe banking problems and crises could emerge sooner or later. The costs of banking problems are, in general, huge and can severely affect a country's fiscal and financial soundness. That is why it is extremely important to seek and reach firm political consensus on the necessity of bank restructuring. Without such consensus, bank rehabilitation cannot proceed.

One has to note, however, that even when this consensus is reached, the problems are not eliminated. Governments seldom act quickly and decisively. Delays are usually common and the process could be affected by dilution – that is, by undertaking measures to rehabilitate banks that are not radical enough. In such a case bank rehabilitation may have to be repeated again and again. If this happens, future bank rehabilitation would be more difficult and more costly. Indeed, the only thing that could probably be even worse for the economy than doing nothing about needed bank rehabilitation is to proceed with improper rehabilitation. This is so because improper rehabilitation substantially decreases the government credibility and increases the cost of future bank restructuring.

To summarize, commercial banks play a significant role in the transition process. But to fulfill their demanding task the banking sector must be restructured and depoliticized. In the long run privatization of banks, increasing competition in the banking industry, and integration into world financial markets are the best remedies for ailing banking sectors in transition, but immediate action from the state in this sector appears to be fully warranted. Financial stability (comprising a sound banking sector) is a public good and the state has an important role to play in this particular area.

CONTENTS OF THE BOOK

The themes discussed here are thoroughly treated in the various essays of this volume. The book is comprised of four chapters dealing with issues related to the financial sector in transition from a general perspective and five studies focused on specific country experiences. An afterword summarizes some of the emerging conclusions.

The opening essay, by Martha De Melo and Cevdet Denizer, concentrates on the most significant reforms involving the objectives and instruments of monetary policy during transition. As such, this study provides important elements in order to assess the background within which financial transformation is taking place. The authors examine the implementation of monetary policy in twenty-six transition economies (in Europe and Central Asia), analyzing the period 1989–95. De Melo and Denizer proceed to evaluate the specific impact of six monetary policy instruments, both direct and indirect, on the rate of inflation and on the level of