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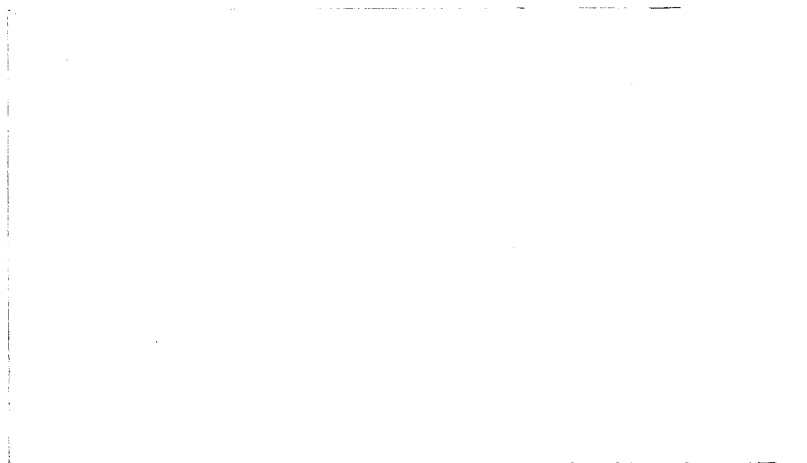
## **The Role of the Banking Sector in the Process of Privatisation**

Domenico Mario Nuti\*



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## **The Role of the Banking Sector in the Process of Privatisation**

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## 1. Introduction.

The progress of privatisation, broadly understood to include both the transfer of state assets to private owners and the autonomous growth of old and new private enterprises, depends crucially on a variety of functions to be performed by banks and other financial intermediaries. These functions clearly are exceptionally important in a transitional economy because of the particularly large initial size of the state sector, and the systemic features of both the old and the transitional economic regimes.

This paper discusses seven such functions. Two of them are strictly connected with typical transitional problems, namely:

i) assisting the financial restructuring of state enterprises to be privatised;

ii) financing private acquisitions of state assets, without undue deflationary or inflationary effects.

Two of the functions considered here are general forms of credit intermediation for the provision of risk capital:

iii) financing the restructuring of inappropriate productive capacity, whether before or after privatisation;

iv) financing investment in new capacity (including the working capital necessary to operate it) by existing and especially by new enterprises.

The other three functions involve the discipline role of credit relations; they are routinely exercised in any market economy but are particularly important during the transition to such an economy, to make privatisation work:

v) enforcing, through the privatisation of state banks themselves, financial discipline in enterprises formerly subject to "soft budget constraints" (of the kind discussed by Kornai 1980, 1986);

vi) exercising control over enterprise management, by monitoring and voting on behalf of clients, and possibly even of state agencies, as well as on their own behalf as shareholders;

vii) funding financial transactions essential to the discipline function of stock markets, such as buy-outs or takeovers.

The paper stresses the crucial importance of these functions and the need to implement essential preconditions and desirable accompanying reforms.

## 2. Essential preconditions and accompanying reforms.

We presume that the transitional economy under consideration has already achieved market balance, the introduction of private ownership legislation and the setting up of financial markets for bonds and shares.

There are also other accompanying reforms, highly desirable if not outright indispensable. They include:

- the establishment of a regulatory framework, with provisions for the disclosure of information, prudential controls 1 limiting risk-taking by banks, control of monopolistic concentration and practices, prevention of fraud. This is particularly important in the absence of jurisprudence and tradition, in economies subject to considerable uncertainties and inherent macroeconomic instability, and lack of competition in banking.2

- the enforcement of liquidation and bankruptcy procedures ; 3

- the overhauling of the system of penalties and rewards for state enterprise managers, i.e. their linking to enterprise short term profitability and longer term performance;

- a suitable infrastructure of communications and data processing facilities;

- the provision of training.4

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1. Here the task is made easier by the recent establishment of international standards, such as the Basle Convergence Agreement on capital standards (1988), and the EC directives on own funds and on solvency ratios (1989) which are to be adopted by member states by 1-1-1993. However, the early temporary enforcement of simpler, less stringent standards might be in order.

2. In Poland, for instance, until 1992 most prudential regulations were not binding, but were in the form of recommendations by the National Bank of Poland. Poland still misses a law on collateral (Sommariva and Miurin, 1992).

3. It has been argued that in Hungary the "queueing" system, whereby bank loans are given a prior claim on enterprise assets with respect to suppliers' credit, reduces the incentive to initiate bankruptcy proceedings for both groups of creditors (Estrin et al., 1992). On "creditor passivity" in enforcing liquidation and bankruptcy procedures see Mitchell 1992.

4. Beside the establishment of specialised institutes,

These points should not be controversial: obviously the contribution of banks to privatisation progress is handicapped in a system where unviable, negative-value-added activities are kept artificially alive by credit; where whatever entrepreneurial ability potentially supplied by state enterprise managers is hampered by an outdated incentive system; where banks can be founded by persons with a criminal record, and anybody can issue nicely printed pieces of paper and sell them to the public; where it takes months to clear a cheque, while in the meantime interest is being earned both on the account on which the cheque is being drawn, and on the account to which the cheque is being credited; where commercial banks and the Ministry of Finance are staffed by personnel redeployed from the former Central Planning Commission. These are real, not hypothetical examples. In what follows it is presumed that these problems have already been tackled to a satisfactory extent.

However, for banks to be able to play a role in the privatisation process it is necessary for some other specific preconditions to be satisfied, consisting in the dismantling of those features of the monetary and financial system strictly associated with central planning (for an illustration of those features see Arnold 1937, Garvy 1966, Grossman 1968, Nuti 1989 and 1992a).

These features of the old system, which tend to survive during the transition, are:

i) The segmentation of monetary circuits into cash (and accounts convertible into cash, for transactions with and among the population) and non-cash (for transactions involving enterprises and/or other government institutions). Thus the two circuits must be integrated, with the two types of money being freely transferable. One might have expected this integration as a matter of course, but in reality it has been often overlooked. In all the former Soviet republics, still in mid-1992, such segmentation - a residual vestige of the old system - is still present: there is a shortage of banknotes, for a combination of technical difficulties (the capacity constraints in the printing of money at times of sudden inflation) and grotesquely misguided policy (the belief that inflation can be controlled by making banknotes scarce, rather than restricting the overall money supply by acting on the factors that raise it). In such conditions there is at the same time an overhang of non-cash money and a curious

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which are being set up throughout the area, a particularly effective form of training appears to be the formation of joint venture banks and, in Poland, the "twinning" of seven state banks with major western banks for the purpose of transferring modern banking technology. This kind of links is expected to lead in due course to participation in shared activities and joint ventures.

"under-hang" of cash; the unavoidable eventual unification of the two circuits is bound to have an inflationary effect when it occurs. Until such a unification current prices cannot be regarded as equilibrium prices even if markets clear, and without equilibrium prices both the operation of banks and the whole privatisation process cannot be guided by markets. In the other transitional economies this segmentation has disappeared, but there is still a certain residual segmentation in the banking system, between banks dealing primarily with households or with enterprises.

ii) The monopolistic concentration of all credit in the Central Bank and in the monopolistic segments of the banking system which strictly depend directly from it (such as an Investment Bank, an External Relations Bank, a Bank for Agriculture, etcetera; the Central Bank depended strictly from the Ministry of Finance, and other banks were subject not to reserve requirements but to direct instructions). In the old system, which took shape in the Soviet Union in 1928-32, the Central Bank was not only the lender of last resort but the only lender, thus dubbed "Monobank"; such a monopoly of credit was reinforced by the strict prohibition of inter-enterprise credit. Thus it is absolutely essential to transfer all functions other than central banking to new state and private commercial banks and other intermediaries, and to give a degree of independence to the Central Bank (now answerable to Parliament almost everywhere in the area).

This process of credit de-monopolisation was pioneered by Hungary, though only as recently as 1987 (see Blejer-Sagari 1991; Hungarian State Banking Supervision 1991) 5, and has now been completed everywhere in the transitional

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5. On 1 January 1987 the National Bank of Hungary hived off its credit activities by transforming its lending directorates and some local branches into associated but separate banks, soon joined by other banks with substantial foreign participation. An obligatory reserve ratio of 20 percent was established for demand deposits and 10 percent of time deposits; the discount rate, which until the end of 1984 was decided by the government, was put under the control of the President of the Central Bank. A Law on bankruptcy (1986) gave initiative to creditors and established rapid proceedings. A market for share issues by private and state enterprises to the general public was set up from 1-1-1989. The 1988 Law on the Transformation of Enterprises and subsequent legislation laid the foundation for the privatisation of state enterprises (which had occurred spontaneously since the mid-1980s); in June 1991 a bank privatisation plan was announced, which may permit foreign ownership of up to 20 per cent of even the largest commercial banks. However the growth of the private sector, especially in banking and financial activities, has proceeded mostly through new institutions rather than through privatisation of the state sector.



economies of Central Eastern Europe (except for Albania).<sup>6</sup> While the former Monobank legal monopoly has been broken, a de facto state monopolistic position has been preserved. The five largest state-owned Hungarian banks account for 90 per cent of total assets. In Poland the nine state commercial banks and six specialised state banks still account for 95 per cent of total assets (their deposits are still covered by a state guarantee). In the CSFR the Comercni Bank and the General Credit Bank still enjoy a virtual monopoly in their respective republics. Such degree of monopolistic concentration of banks in the state sector suggests the need for an early privatisation of state banks to guarantee competition.

iii) The automatic granting of credit to enterprises and other state organisations, for the conduct of their statutory activities, for the covering of losses and the payment of taxes. This facility made enterprises budget constraints "soft" (Kornai 1980, 1986) or, more precisely, sufficiently elastic relatively to insufficiently high price increases as to preserve a state of excess demand and to lessen incentives to cut costs and improve efficiency.

Such automatic credit effectively contained a hidden subsidy (in addition to open subsidies also obtained by enterprises); often all or part of the state budget deficit could be made invisible and financed through enterprises borrowing automatically in order to pay taxes. Such a practice has not disappeared altogether: the automatic

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<sup>6</sup>. In Poland this kind of banking reform was implemented at the beginning of 1989; there are over one hundred licensed private banks, of which about 50 currently operating, and another 8 banks with foreign participation; two state banks, the Bank Slaski and the Wielopolski Bank Kredytowy, have been selected for privatisation in 1992. In Bulgaria the banking sector was reformed at the end of 1989; there are now 80 commercial banks including 50 former branches of the National Bank.

In the CSFR similar reforms were introduced in 1990-91; the Statni Bank functions other than central banking were attributed to the Komerčni Bank in the Czech Republic and the General Credit Bank in the Slovak Republic, which are to be privatised (though the government will retain a 40-50 per cent stake); new banks were encouraged and all banks permitted to act as universal banks.

In Romania the banking reform took place in April 1991; there are now five state-owned banks and four main private banks (two of which have a cooperative form). In Albania three commercial banks were created out of state institutions in the second half of 1991 and one private bank has been licensed, but otherwise the reform of the banking system is lagging behind. (For a review of banking reform progress to date, see Sommariva and Miurin, 1992).

build-up of enterprise payment arrears towards the banking system, and of tax arrears towards the budget (whether negotiated or de facto; including social security payments) are still a deplorable feature, for instance, of the Polish economy. Enterprise arrears towards the banking system (140 trillion zlotys in Poland in mid-1992, of which 40 per cent are regarded as bad loans; see Jezowski 1992) amount to direct credit expansion, whereas tax-arrears and social security arrears contribute to monetary expansion indirectly by raising government borrowing requirements. Moreover, while on the whole credit extension to state enterprises may have been severely constrained, there are still enterprises whose unprofitable activity is sustained by credit.

It is essential that these forms of automatic credit should be totally replaced by contractual loans based on credit-worthiness. Any government support to enterprises, which might very well be justified by preoccupations about employment, or by the desirability of protecting those among unprofitable activities which still make a positive contribution to value added, should be replaced by direct subsidies from the state budget (e.g. wage subsidies, or grants <sup>7</sup>), or by other instruments (e.g. tariffs). The undesirability of subsidies and tariffs on other grounds should be no reason to replace them by credits, which are no more desirable but are less transparent.

Another form of automatic credit has been the rapid build-up of large scale payments arrears between enterprises. This problem is typical of the transition, when the relaxation of the former prohibition of inter-enterprise credit is not yet accompanied by the parallel enforcement of liquidation and bankruptcy procedures. Thus it is reported that in the CSFR during 1989-91 inter-enterprise credit grew from 7 bn crowns to 155 bn crowns, while bank credit to state enterprises as a whole increased only from 531 bn crowns to 611 bn crowns; in Poland the ratio of inter-enterprise credit to bank credit increased from 70% at end-1988 to over 150% in 1990 (Begg and Portes, 1992; for Hungary, see Kornai 1992); in Poland in 1991, at a time of monetary austerity, interenterprise payments arrears appear to have increased by 70 per cent; by mid-1992 they amounted to a staggering 200 trillion zlotys (Jezowski, 1992). In Russia in the first six months of 1992 inter-enterprise arrears have increased from 30 bn roubles to over 2,000 bn roubles.

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<sup>7</sup>. Such grants are similar to the EFLs (External Financing Limits, on total cash usable from any source) or "cash limits" on state enterprises operated in the UK (Nutti, 1991b); they should be "fixed annually in advance, and fully budgeted in the aggregate fiscal projections which are the subject of conditionality in international loans from the IMF and others" (Begg and Portes, 1992).

The build-up of inter-enterprise arrears cannot be regarded, as it is often suggested (for instance, by Estrin et al. 8), as equivalent to monetary expansion, as in the consolidated accounts of the enterprise sector these arrears cancel out; it does, however, lead to the forced redistribution of liquidity from "good" to "bad" enterprises; to pressure on banks for the extension of credit to those enterprises to whom net arrears are owed (Begg and Portes, 1992); and to the build-up of bad debts which are an obstacle to privatisation, directly and indirectly (e.g. through greater difficulties in performance assessment and in net assets valuation).<sup>9</sup> The solution of this typical problem of the transitional economy requires the involvement of the banking sector and is an additional argument for the early privatisation of banks.

### 3. Financial restructuring of state enterprises.

For those enterprises which are not to be closed down, and which therefore have productive assets that have a positive present value greater than the value they would have in alternative uses, financial restructuring involves the cancellation, through a state grant or a book operation, of any outstanding debt in excess of that positive present value, and an injection of credit adequate to finance working capital for the best scale of operation. In theory, financial restructuring should make no difference: the higher the liabilities of the enterprise to be privatised, the lower the price paid by the investor, who then should be able to raise the capital necessary to restructuring. In

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8. "... there was no control over money created by non-payment", which is regarded as "in fact a money substitute" (Estrin et al., 1992). It is worth stressing that wages cannot be paid out of interenterprise credit; enterprises obtaining forced or voluntary credit from other enterprises are still constrained by their cash flow for the payment of wages, and so is the consolidated enterprise sector.

9. Strictly speaking one should distinguish between that subset of inter-enterprise arrears which could be multilaterally cleared (much of which is bound to have been voluntarily extended by enterprises to their customers) and therefore can be eliminated through a modest injection of liquidity, and the remaining subset. This, in turn, is made up of "good loans", i.e. credit extended to enterprises with sufficient though illiquid assets to cover them, and "bad loans", i.e. forced credit extended de facto to insolvent unviable enterprises, which are the irreducible core of the problem. A common form of arrears is the non-payment of supplies by public utilities. On the question of enterprise arrears I have benefited from discussions with Dariusz Rosati and Richard Portes.

practice, however, restructuring is necessary in order to avoid having to pay investors to take over an enterprise as it stands when its net present value including liabilities is negative (though, as we have postulated, the net present value of the underlying productive assets is positive and the enterprise is viable). Paying the new owners to take over net liabilities seems a bad idea, as new owners can also go bankrupt and default on those same liabilities. Moreover, within the state sector financial restructuring can be undertaken administratively, for instance taking over the bad credits of enterprises and banks and recapitalising them, instead of leaving to their new owners the time and cost burden of going through judicial procedures.

The best way of dealing with inter-enterprise payments arrears is that of making debt tradable. In this way, first that part of payments arrears which involves the same enterprises both as creditors and debtors should be netted out through transfers of debt at par among them, leaving out only the arrears of net debtors. Then, trading net arrears within the enterprise sector effectively makes that debt legal tender in transactions with the debtor enterprises that have issued it, thus draining the cash flow of insolvent enterprises and revealing insolvency cases through the appearance of a discount in the secondary re trading of debt. Thus the part of inter-enterprise arrears which consists of bad debts would come to the surface. Net creditor enterprises, if otherwise viable, would have to be recapitalised, not from credit but from the state budget or from a specialised state agency taking over those bad debts. Indeed, banks might be barred or discouraged from handling inter-enterprise old debt at all, in order not to add to their stock of bad loans.

A similar process for the banks themselves is a necessary complement of their privatisation: their balance sheets must be cleaned of the bad loans which in most cases make their net worth actually negative and which, through the automatic credit involved in the capitalisation of interest, limit the amounts of new lending to viable enterprises and raises intermediation margins (Sommariva and Miurin, 1992; Begg and Portes, 1992). 10

10. Begg and Portes (1992) point out that the "bad debts" problem, often linked to financial repression, is familiar from the experience of less developed countries and middle-income industrialising countries. However in central eastern Europe the problem is larger and qualitatively different (as inherited bad debts bear no relation to real assets and profitability and debtors are usually "too big to fail"). Begg and Portes claim that, as both debtors and creditors are state owned, bad debts clearing has no effect on the consolidated balance sheet of the public sector. They emphasise that "Since most activities in Central and Eastern Europe were in the public sector, it must be possible, with the stroke of a pen, to cancel debts of one public agency to another without affecting the consolidated wealth of the public sector. Contrary to the frequently

The scale of bad loans is difficult to assess with any precision but is probably large: according to external audits of the Polish state banks, carried out by foreign accountancy firms in June 1991, bad loans in state banks ranged from 24% to 68% of assets (Eastwood and Durski, 1992). A relatively large amount of bad loans, unfortunately, have been accumulated also by a number of new private banks;<sup>11</sup> a Polish private bank, the Bank Handlowy Przemyslowy of Katowice, recently collapsed. New bad loans by new private banks, however, raise problems substantially different from the "cleansing" of old loans from old state banks: the case for possible state support rests on the need to protect depositors rather than on the needs of enterprise financial restructuring.

In the CSFR the problem of bad loans has been handled partly by setting up a new Consolidation Bank, to take over a certain amounts of those loans; in Bulgaria a more broadly based institution, the Bank Consolidation Company, has been set up with a view to undertake the reorganisation and privatisation of banks as well as the management of bad loans.<sup>12</sup>

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held view that action on debts may have adverse consequences for the public finances, it is simple arithmetic to demonstrate that its impact effect is zero **provided the public finances were being properly measured**" (emphasis in the text). The reasoning is unimpeachable; nevertheless, the recapitalisation of state owned banks after the clearing of bad debts is still a burden on public sector borrowing requirements: the state capital injection into banks will not be fully recouped by the state through additional revenue from bank privatisation when the net worth of banks before such an injection is negative. Of course the public sector borrowing requirement necessary to perform this operation is only the manifestation of liabilities incurred a long time ago by a previous economic and political system. It is not a net cost of transition, but it still is a cost to be financed today, nevertheless (see Nuti, 1992b).

<sup>11</sup>. Apparently in Poland the imposition of credit ceilings on state owned commercial banks has allowed private banks to "increase their imprudent lending even faster than the non-bank deposits allowed, because the rapid expanding interbank credits from government owned commercial banks and the lack of adequate banking supervision" (Sommariva and Miurin, 1992).

<sup>12</sup>. In the CSFR the Consolidation Bank took over 110 bn crowns of loans by banks to enterprises for "perpetual credits for inventories" which had no fixed maturity and a low fixed interest rate (6%); see Begg and Portes, 1992. The Bulgarian Bank Consolidation Company has taken over bank shares formerly owned by state enterprises.

The problem of bad loans is not resolved simply by concentrating the monitoring and management of bad loans in a single new organisation; the non-performing assets transferred to the Consolidation Bank may be worth next to nothing, but their transfer still represents a net deduction from bank assets, thus making the negative-worth of banks even more highly negative. Simple cancellation of debts, as suggested for instance by Dornbusch 1990, is not a solution either, as presumably bank debts (deposits) would not be cancelled and banks would not improve their position.

The solution must necessarily be a recapitalisation of those banks, as a necessary step prior to their privatisation (see Begg and Portes 1992) but indeed as a desirable step regardless of privatisation. This can take the form of banks swapping their bad loans for government bonds (as it was also partially done in CSFR in 1991, and it is proposed to do in Romania)<sup>13</sup>; prior to privatisation the "bad" liabilities of the banking sector must be "socialised" in this way (see Calvo and Frankel, 1991). Such recapitalisation of banks would have to be, and to be seen to be, a once and for all step, "not a government pledge to underwrite banks in perpetuity" (Begg and Portes, 1992); unfortunately the "socialisation" of bad liabilities may have to include loans extended during the first stage of the transition, before the new standards are fully established.

#### **4. Funding private acquisitions.**

An obvious role of banks in the privatisation process is that of making loans to the public in order to finance their purchase of state assets; whether such loans should be made only to the domestic public or also to foreign investors is a matter primarily for political choice. This role applies to both "small privatisation" (land, shops, hotels and catering establishments, housing) and in the "large scale privatisation" of state enterprises, although different intermediaries are bound to be involved. For instance, financing the purchase of owner occupied houses is best performed by institutions like building societies; financing the purchase of financial assets through loans

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<sup>13</sup>. Begg and Portes (1991) suggest recapitalisation through the issue to banks of indexed bonds (which "would raise the credibility of monetary policy") or of short term Treasury bills, instead of "long nominal bonds vulnerable to expropriation through future inflation". However, presumably the interest rate differentials on indexed and non indexed bonds, and on short versus long term government bonds, or in any case the banks' freedom to restructure their portfolio, would make the type of bonds to be used in bank recapitalisation largely a matter of indifference.

secured by the assets purchased is an ordinary banking operation, whereas the purchase of large scale share stakes, or of entire enterprises, is more in the nature of merchant banking.

In an economy with a settled ownership regime current savings may be capable of financing new issues of bonds (including state bonds) and shares; in a economy privatising state assets this may not be enough, other than for share prices drastically lower than the underlying value of assets; in a rapidly privatising economy this is certainly not enough. True, in transitional countries there is often at first a currency overhang,<sup>14</sup> but experience has shown that privatisation of state assets is too slow to absorb such an overhang, when it is present and large, fast enough in the early stage of a stabilisation programme. If such a programme is urgent, as it instantly becomes with the political changeover, the overhang has to be absorbed through price rises, after which the real value of the stock of liquid assets in the hand of the public, already small relatively to the value of state assets to be privatised, becomes even more inadequate.

This paradox, of excess liquidity followed by liquidity shortage in rapid succession in the first stages of the transition, can be handled in three possible ways: credible detailed announcements of the privatisation programme; free handouts of state assets to employees and to the general public; ad-hoc credit.

Credible and detailed announcements would induce the public to voluntarily hold larger liquid assets than they would otherwise, in anticipation of subsequent investment in privatised assets, thus reducing or eliminating any monetary overhang for a lower rate of inflation, and reducing the subsequent liquidity shortage for privatisation finance. In view of experience in a recent past and in other countries, when and where the speed and methods of privatisation have changed rapidly and frequently, this kind of announcements

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<sup>14</sup> The actual size and presence of monetary overhang in the 1970s have been the object of controversy, since measurement presumes a reliable estimate of what the demand for money would be if current prices were market clearing; but there is generalised consensus both about its presence in the 1980s and on its significant size, as witnessed by large price differentials between the official level and that prevailing in secondary re trading ("black" or grey markets) and by a number of alternative indicators of true inflationary pressure (see Nuti, 1986). Monetary assets appear to be large relatively to market economies in normal conditions: for instance, in the Soviet Union at the end of 1991 the liquid assets of households and enterprises exceeded 1 trillion roubles, equivalent to almost as much as its GDP in the previous twelve months.

would not be credible even if governments had a clear and agreed policy, which is not often the case.

Free hand outs, or "privatisation without capital" (for details, see Blommestein, 1992) are not a convincing alternative (see Nuti, 1991a). There is no such a thing as a free portfolio of assets: citizens will have to pay for their supposedly free shares through higher taxes. Expectations are bound to be disappointed: President Walesa's 1990 pre-electoral promise of 100 mn zlotys hand out to every Pole, raised to 500 mn in June 1992, is a delusion. If share entitlements or actual shares are transferable, the scheme amounts to a distribution of cash (equal to the total or partial subsidy on the distribution of shares), which is bound to encourage consumption expenditure and revive inflation. If the entitlements and the actual shares are not transferable, owners are being prevented from transacting in the market and therefore the control function of private shareholdings goes by the board. In addition, the conversion of vouchers into shares may run into unnecessary complications and inefficiencies, especially if the vouchers are denominated not in monetary units but in special units such as "investment points", with bidding processes truncated before equilibrium prices are reached (see Svejnar 1992, on the oddities of the CSFR voucher scheme).<sup>15</sup> The choice among the many ways in which such mass privatisation schemes <sup>16</sup> can be conducted is bound

<sup>15</sup>. At first the EBRD appeared to favour voucher schemes, but its position has now changed: "... voucher schemes are likely to be complicated, ... they do not properly address valuation and restructuring issues, ... they turn out to slow down the privatisation process compared to more pragmatic and traditional approaches (such as direct sales and auction)..." (Aghion and Burgess, 1992). Giving away shares in state enterprises has been proposed on the ground that their value is i) difficult to calculate; ii) in many instances negative (the instance of Treuhandanstalt, which is expected to end up incurring large scale liabilities instead of net revenue from privatisation, has been quoted as an example). However, Treuhandanstalt loans and guarantees are not necessarily net liabilities; the valuation does not (indeed should not) be done administratively but can be done by the market in the sale process; it is implausible that the entire state capital stock should have a negative present value; if it did, free handouts would have no advantage on sales.

<sup>16</sup>. What proportion of state assets should be so distributed? Should a portion be set aside for restitution to old owners, how much and for whom? Should all citizen be included in the scheme, or should the under-age or the expatriate be excluded (and, if so, from what date)? Should the distribution be graded according to age? Should there be a registration fee, and how large? Should the handout take the form of a certificate, or of a simple registration, or an investment account? Should the allocation be



to lead to debates that slow down the process; implementation is also time consuming. In any case, the quick transfer of ownership titles should not be expected to introduce equally quickly the incentive role of asset markets.<sup>17</sup> Ultimately, the only justifications for voucher schemes are "based essentially on political considerations and the reduction of incentive barriers to privatisation" (Aghion and Burgess, 1992). Such schemes are politically respectable and, as long as they are monetised and simple, quickly executed, counterbalanced by taxation, accompanied by other forms of privatisation, and are not expected to implement capitalism at a stroke, can be quite harmless in the short run and fairly effective in the medium-long run.

The alternative or combined solution to the problem of privatisation finance is the extension of ad-hoc credit, both for the purchase of shares in state enterprises and for any form of privatisation ("one-by-one", direct sales, liquidations, buy-outs, leaseings).<sup>18</sup> Usually bank loans for the financing of share purchases are speculative in nature;

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transferable? Should there be one round, or more? Should individual allocations be denominated in monetary units, or in other intermediate units? Should shares be allocated at random, or should a market immediately develop through the initial choice of investors? Should state assets be vested in investment trusts, whose certificates would then be distributed to (or purchased by) the public? Should the various state enterprises be distributed among investment trusts at random, or through a bidding process (in which case, how many iterations should be allowed, if any, for the bidding to lead to, or approach, an equilibrium allocation at market clearing prices?). Who should manage the investment trusts, and on what terms? Should shares (or certificates) be immediately transferable? The number of combinations and permutations is inordinately large; no wonder debates, decisions and amendments take years, not months.

<sup>17</sup>. "Privatisation is not merely the transfer of property rights from the state to the private sector. A crucial consideration is whether this transfer leads to effective control by private owners" (OECD 1992).

<sup>18</sup>. Staszek Gornulka had put forward a scheme of delayed privatisation, with a special role for banks: state enterprise shares would be first entrusted to the management of banks, then, subsequently and gradually, banks would be privatised and with them also the state enterprise shares. For this to be the case, however, share ownership would have had to be transferred to banks in the first place, in which case we are back to the same scheme entrusting shares to investment funds (discussed by Blommestein, 1992), with banks in place of investment funds.

rather than involving banks in a time consuming and costly scrutiny of individual purchase plans it may be better to grant to all citizen limited investment credit, possibly leveraged and in any case secured by the shares purchased with that credit.<sup>19</sup>

It is important that the state should provide all the liquidity necessary to the operation, in order not to crowd out real investment and unduly depress share prices; at the same time it is important not to recycle any of the state receipts funded through this credit (Nutti, 1991a). The neutrality of the operation is essential.

Net sales of state assets have a deflationary effect on money supply, like any open market operation of the Central Bank. Some deflation may actually be one of the government target (although there are now indication that transitional economies may have gone too far in this respect: see Calvo and Coricelli, 1992, on the output losses due to credit squeeze in the central eastern European countries in their stabilisation programmes); beyond the desired rate of deflation, the deflationary effect of privatisation of state assets must be neutralised, through an injection of liquidity by the Central Bank into the banking system. At the same time, such a liquidity injection should be sterilised as soon as it is drawn, through use of privatisation receipts to retire government debt towards the public or towards the Central Bank.

#### **5. Financing capacity restructuring.**

Much of the productive capacity of state enterprises is inappropriate, with respect to relative prices of inputs and outputs, to domestic and world demand, to the needs of environment protection. Capacity restructuring may be undertaken before or after privatisation, and therefore can be "decoupled" from financial restructuring of enterprises and bank. It is less important to restructure capacity than it is to restructure enterprise finances before privatisation: it is less practicable because it takes more time than financial restructuring and better judgement; concern for capacity restructuring should not delay the process of privatisation.<sup>20</sup> The financial requirements of enterprise capacity restructuring involve cost-saving,

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<sup>19</sup>. Investment checking accounts granted to citizens for bidding in the privatisation process have been announced in Belarus; it is easy to make them an automatic overdraft facility instead of a grant.

<sup>20</sup>. With reference to one of the questions raised in OECD 1992, this means that it should be possible and perhaps desirable to decouple financial restructuring from industrial restructuring.

quality-improving, energy-saving, pollution-reducing investment, which might restore enterprise competitiveness.

Short term profits or even losses are not always a reliable indication of medium and long term economic viability of an enterprise. The difficult task of banks, in applying credit-worthiness criteria, is that of distinguishing between three kinds of enterprises:

i) negative value added enterprises incapable of restructuring themselves so as to positive value added (calculating value added at international prices); these are moribund enterprises artificially kept alive through life support, to be abandoned;

ii) enterprises which, though ill are capable of convalescing into financial viability, i.e. not only into positive value added but into prospective profitability; resources should be concentrated in these enterprises;

iii) those enterprises which, at once or after some short term restructuring, are capable of producing positive value added but not enough to be profitable; these should be receiving either temporary tariff protection or budgetary investment funds and/or wage subsidies, but, most emphatically not credit (see section above).

For enterprise economic performance to be assessed by banks, it is necessary that the burden of taxation should also be related to performance, instead of consisting of lumpsums or being related to variables other than profits or turnover (such as revalued historical capital, as in the Polish so-called "dividend", or wages, as in the Polish excess-wage tax or "Popiwiek"). Moreover taxation should be non discriminatory between the private and the state sector.

In the allocation of credit, some rationing may be appropriate; this is standard practice even in western economies, where it has been argued that financial market clearing via the interest rate may actually lead to "perverse selection" (Stiglitz).

There is no reason why banks should not be allowed to hold significant equity stakes in enterprises to be privatised, becoming indirectly involved in the restructuring; equity holding is bound to have the advantage of longer term time horizon with respect to lending (and would enhance market constraints on managerial discretion; see below, sections 7 and 8).

## **6. Financing investment in new capacity and working capital.**

Privatisation debates have been focussing primarily on the transfer of state assets to a wider public. Yet the adjustment of inappropriate capacity is more likely to be undertaken through new ventures; Herbert Levine emphasises

this point thus: "The selection process in economic evolution ... tends to favor new firms and small firms which are not encumbered by strongly entrenched routines. Such firms are able to respond more flexibly to environmental changes. ... The best hope lies with the entry of new small and medium size firms, especially in the early years of a market system, in the consumer goods industry, so that the people will see early evidence of the benefits of the market. For this to occur, the early development of appropriate financial institutions is crucial. The successful entry of new firms requires the provision of capital by financial institutions" (Levine, 1991; emphasis in the text).

Different types of institutions can be envisaged: a state development bank, for instance aiming at mobilising entrepreneurship through financing cooperative enterprises, and investment in depressed regions; merchant banks, launching new share issues; and commercial banks with both investment and commercial credit functions.

A number of difficulties appear in this respect. First, stock exchanges in transitional economies are thin and highly speculative <sup>21</sup>; the number of financial products needs extending, to include for instance options, warrants, futures, interest futures. Thinness makes for both instability and for inability to capture economies of scale in broadening the range of financial products.

Second, the context of banking operations, in the first stages of reform and stabilisation programmes, is usually a fairly drastic credit contraction in real terms, mostly due to a combination of nominal money targeting and of actual inflation exceeding expected inflation, i.e. a contraction of enterprise liquidity and of credit of unwanted severity (Calvo and Coricelli, 1992). Output elasticity to credit appears to have been higher than it might have been expected. These macroeconomic conditions restrict rather drastically the contribution that the banking sector should be able to make to the privatisation process from a microeconomic angle. A corollary is the need for fiscal austerity, without which the budget deficit is bound to crowd investment by both private and state enterprises.

While estimates of the eastern and central European "financing gap", based primarily on catching-up models, have been probably overestimated, there is no doubt that the financing gap is large relatively to domestic savings and foreign exchange requirements. Thus the domestic banking sector has an important role to play in channelling foreign capital to domestic (private and state) enterprises, for the

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<sup>21</sup>. In Poland, for instance, in mid-1992 the stock exchange meets twice weekly to process bids received in the intervening periods, handling shares in thirteen companies held by 120,000 investors.

acquisition of privatised assets, for direct investment in enterprise equity and for loans.

The EBRD is understood to be considering at least initially "apex" style loans in support of the private sector. This involves the Bank lending under government guarantee to a single institution, normally the Central Bank, for lending on to small and medium size private enterprises (Charap, 1992). This procedure is being considered in order not to face directly the distortions and risks of the transition period, but it is important that loans should not be made directly by the Central Bank, as this would involve a return to the old system, but through suitable financial intermediaries. In all instances of foreign loans to domestic enterprises (and joint ventures) it is important that borrowers should bear the cost of foreign exchange risk, either directly or indirectly by paying domestic financial institutions for their bearing of that risk.

#### **7. Hardening budget constraints**

The privatisation of banks can be expected to make, by itself, an important contribution to the privatisation process in addition to those discussed above, namely, the hardening of budget constraints in the state sector. Janos Kornai's notion of "soft budgets" in the state sector was perhaps overdone, as even in centrally planned economies no budget was ever infinitely soft, but the notion has substance, in that it epitomises financial indiscipline and automatic credit. Contractual credit relations between private enterprises and state enterprises should put an end to de facto indexation of credit and funding of losses.

It is often wondered whether privatised banks should or should not lend to the state sector at all (OECD, 1992). As long as the direct "petty tutelage" of enterprises by central "founding organs" has been removed, and state managers' incentive structure duly overhauled (see section 1 above) it seems desirable that both types of enterprises should be treated on conditions of equality. Otherwise the economic system moves from excessively loose to excessively tight enterprise constraints, leading to undesirable de-capitalisation or the continuation of grants from the state budget or soft loans from state banks. Preoccupation about private access to credit is better dealt with by a stipulation of a minimum share of all new bank credit being reserved to the private sector, as the one-third rule implemented in Poland in 1991 (Begg and Portes, 1992).

#### **7. Constraining managerial discretion.**

The implicit model of financial reform in central eastern Europe is the UK-USA system, where in general equity is not held by banks, but by a large number of private investors (USA) or non-bank intermediaries (UK), with

corporate control exerted indirectly by outsiders through takeovers bids. It has been suggested that a model more appropriate to the centralised and undeveloped financial systems of central eastern Europe would have been the German-Japanese system of control by insiders, with banks direct and indirect holdings and involvement in the control of industry (de Cecco, 1989; Corbett and Meyer, 1992).

The merits of German-type supervision of industry by banks are controversial and the system has come under strong criticism, especially in Germany (see Nuti, 1989, for a review of the drawbacks, and in particular: conflicting interests vested in different functions of banks as lenders, shareholders and advisors to investors, their emphasis on short term performance and the dangers of monopolistic practices). However, in central eastern Europe the case for German-Japanese practices is being supported by the special restructuring and modernisation requirements of enterprises that are to be privatised, as well as by slow progress of privatisation throughout the area, given the lower dependence of this model, relatively to the UK-USA model, from the completion of privatisation. The German-Japanese model is certainly feasible in central eastern Europe: in general banks are permitted to take equity stakes in other enterprises 22, and it would be simple to allow and encourage shareholders to lodge their shares with banks and delegate them to vote; this could be a way of alleviating the effects of the excessively fragmented share ownership likely to result from mass privatisation schemes.

Of course the German-Japanese model relies on a full-fledged and well functioning stock exchange and other financial markets, and on a completely private banking sector. Thus it is dubious whether state banks might exercise such a role of supervising and control, and whether the present thinness of financial market would allow private banks to exercise such functions effectively. Reliance on managerial control by banks would not eliminate the importance of privatisation and of developing financial markets. Moreover, a distinctive feature of the German system is the absence of hostile takeovers, sometimes costly but necessary to establish stock market discipline on the managers of private companies, through fear of their dismissal by successful bidders. Thus bank control over managerial activities would replace other market checks, rather than establishing an additional form of control. 23

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22 In Poland the amount of equity in and lending to any one enterprise is subject to respective ceilings of 25% and 15% of bank capital, beyond which NBP approval is necessary.

23. In broader sense, this function of managerial control by banks could be understood to include advice, directly or by financing access to specialist advice by consultants.

The opposite development, i.e. ownership of banks by enterprises, has also appeared. In the Yugoslav experience this practice has had adverse repercussions, as banks have often acted as instruments of "socialisation of losses", channelling funds to shareholding enterprises to finance loss-making activities.<sup>24</sup> Analogous phenomena have been reported for Hungary.<sup>25</sup> In the light of experience, this practice, at least temporarily, ought to be discouraged.

#### **9. Funding leasings, buy-outs and takeovers.**

One of the lesser known success stories of Polish privatisation has been the "liquidation" of a number of state enterprises and the ensuing buy-outs (largely on credit) or leasings by employees and managers as well as redeployment of physical assets. This process has received less publicity because it is not open to foreign investors but, unlike other kinds of privatisation, has proceeded faster than anticipated and has involved over 1,000 state enterprises (of which 600 have completed the process by the end of 1991). This procedure is constrained partly by the availability of willing and credible takers, partly by the availability of finance. This kind of liquidation, also called "restructuring privatisation", is to be distinguished from the proceedings applied to insolvent state enterprises, which lead to privatisation through dispersal and redeployment of assets; it is, however, another track of privatisation which requires finance. Both types have been somewhat neglected, if not in privatisation plans, in the provision of finance.

Finally, one of the roles of the financial system is that of providing the resources to enable other forms of challenges to the incumbent managerial team of private companies, by easing the possibility of mergers and especially of takeover bids. It has almost become a common place, in official circles in transitional economies, to say that what is most needed to put the fear of god in

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<sup>24</sup>. On the Yugoslav banking system, see Dimitrievich and Macesich, 1983; on Yugoslav socialisation of losses through the banking system, see Uvalic, 1992.

<sup>25</sup>. "At the time of the establishment of the commercial banks the state was a majority shareholder in all of them. The rest of the shares were mainly purchased by state-owned enterprises, very often financed by loans from the bank in question ... Thus, representatives of the largest debtors were elected to sit on the boards of banks, making decisions unfavourable to them extremely difficult to impose" (Estrin et al., 1992).

enterprise managers is a large scale, spectacular bankruptcy. The time has come for official circles to look forward, instead, to the first successful hostile takeover bid, and to create the conditions for it to occur.

## 10. Conclusions.

In short, there are a number of important preconditions for banks to make their important contributions to the progress of privatisation. First, all residual features of the monetary and financial system associated with central planning should be dismantled, such as the segmentation of monetary circuits, and forms of automatic credit (including forced credit in inter-enterprise relations). Second, accompanying reforms should include the enforcement of liquidation and bankruptcy procedures, the overhauling of managerial incentives in the state sector. the provision of a regulatory framework, the provision of training, and of a suitable infrastructure of communications and data processing facilities.

In order to resolve the paradox of transitional economies - that of initial excess liquidity at the stabilisation stage followed by liquidity shortage at the privatisation stage - credit must be provided to fund private purchases of state assets, but not recycled into the state budget. This seems preferable to popular schemes of "voucher" mass privatisation "without capital".

The financial restructuring of enterprises, and of banks themselves, involves the clearing of bad loans (including that part of interenterprise arrears which consists of bad loans) and the recapitalisation of enterprises and banks; it is a necessary step prior to privatisation; it involves a current budgetary allocation, in spite of being the delayed manifestation of budgetary losses incurred in a distant past.

The financing of capacity restructuring, whether before or after privatisation, involves a difficult classification of enterprises in order to decide whether or not to fund cost-saving, quality-improving, energy-saving, pollution-reducing investment, which might restore enterprise competitiveness.

The early privatisation of banks can be expected to make, by itself, an important contribution to the privatisation process in addition to those discussed above, namely, the hardening of budget constraints in the state sector.

Through direct equity holding and through proxy-voting on behalf of clients, as in the German-type banking system, banks can exercise control over managerial discretion - a function made all more important by the special restructuring and modernisation requirements of enterprises



that are to be privatised, as well as by slow progress of privatisation throughout the area.

The adjustment of inappropriate capacity is more likely to be undertaken through new ventures; different institutions can be involved, such as development banks, merchant banks, investment and commercial banks; difficulties are the thinness and speculative nature of stock exchanges in transitional economies, associated with a small range of financial products, and the deflationary context of macroeconomic policies during the early stages of the transition.

Last but not least, banks can contribute to privatisation progress through funding leaseings, redeployment of physical assets (made available by bankruptcy procedures and by enterprises subjected to a credit squeeze), buy-outs by managers and employees of state enterprises, as well as mergers and especially take-over bids which appear to be essential to the enforcement of market discipline over managerial discretion.

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