World Bank Assistance for Financial Sector Development

in the ECA Transition Economies

by

Fred Levy

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This report is a background paper to OED's Evaluation of Bank Assistance to the Transition Economies and OED's Review of Bank Assistance for Financial Sector Reform (forthcoming).

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Contact:
Operations Evaluation Department
Knowledge and Evaluation Capacity Development (OEDKE)
e-mail: eline@worldbank.org
Telephone: 202-458-4497
Facsimile: 202-522-3125
http:/www.worldbank.org/oed

Abbreviations and Acronyms

ADB	Asian Development Bank
ASAC	Agriculture Sector Adjustment Credit
AMC	Asset management company
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CEE	Central and Eastern European
CIS	Commonwealth of Independent States
CMEA	Council of Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
EFSAL	Enterprise and Financial Sector Adjustment Loan
EFSRP	Enterprise and Financial Sector Rehabilitation Loan
EIB	European Investment Bank
ES	Evaluation Summary
ESP	Enterprise Support Project
ESW	Economic and Sector Work
EU	European Union
FESAC	Financial Enterprise Structural Adjustment Credit
FESAL	Financial Enterprise Structural Adjustment Loan
FIs	Financial Intermediaries
FIDP	Financial Intermediary Development Project
FILs	Financial Intermediary Loans
FINSAC	Financial Sector Adjustment Credit
FSAL	Financial Sector Adjustment Loan
FSAP	Financial Sector Assessment Program
FSD	Financial Sector Development
FSU	Former Soviet Union
GDP	Gross Domestic Product
IAS	International Accounting Standards
IDA	International Development Association
IDP	Industrial Development Project
IFC	International Finance Corporation
IMF	International Monetary Fund
KAFC	
MEBOs	Manager-Employee Buyouts
MENA	Middle East and North Africa Region
MOF	Ministry of Finance
MOP	Memorandum and Recommendations of the President
MPPs	Mass Privatization Programs
NBFIs	Non-Banking Financial Institutions
OD	Operational Directive
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
PFESP	Private Farmers and Enterprise Support Project
PFI	Project Financial Intermediary
PMDP	Product Market Development Project
PPAR	Project Performance Assessment Report
PSAL	Programmatic Structural Adjustment Loan
PSDP	
SAL	Structural Adjustment Loan
SAR	Staff Appraisal Report
SCAs	Savings and Credit Associations
SOE	State-owned enterprise
UK	United Kingdom
USSR	Union of Soviet Socialist Republic

Contents

Contents (cont'd)

Boxes

Attachments

Annex Tables

World Bank Assistance for Financial Sector Development in the ECA Transition Economies

Executive Summary

Since 1990, the ECA transition economies have undertaken massive reforms of their economic systems, transforming institutions, processes, attitudes and fundamental concepts of individual and organizational behavior. Contrary to many expectations, the transition process has turned out to be long, complex, costly, and hardly amenable to a standard blueprint. Transformation of the financial sector was, from the beginning, seen in most countries as a key element of the overall transition process. The immediate objectives of financial sector transition were to create:

- An efficient and unified payments and settlement system;
- The policies, institutions, and instruments necessary for the design and execution of monetary policy operating through market processes; and
- An efficient system for mobilizing and allocating financial resources through independent, self-interested financial institutions and markets.

Most ECA transition economies made tangible progress during the first decade of the transition toward the development of market-based financial systems. In some cases the magnitude and speed of change were extraordinary. Levels of financial development varied widely by the end of the decade, however, with the CEE and Baltic countries significantly more advanced than those of the CIS. Moreover, major problems and issues remained in varying degrees in all of the countries, including undercapitalized banks, inadequate banking supervision and accounting standards, poor corporate governance, low levels of monetization and intermediation, small and illiquid capital markets, and weak bankruptcy laws and protection of creditor rights. In general, progress has been more evident in the banking sector than in the securities markets and non-banking financial institutions.

The World Bank faced an enormous task at the beginning of the 1990s to mobilize the resources and knowledge necessary to offer credible support to the new ECA member countries. Initial country strategies, with few exceptions, treated financial sector reform as a key element of the transition from central planning to the market economy. The development of a market-based financial system, along with price and trade liberalization, was viewed as essential for mobilizing and directing savings toward the most promising investors and investments by rationalizing borrower selection and bringing market discipline to bear on the decisions and management of the borrowers themselves. The number and volume of Bank loans for financial sector development rose rapidly after 1991. Lending began to taper off after 1996, reflecting progress in some cases, frustration in others, and a tendency of the EU accession countries to rely increasingly on European assistance.

This report is based on an intensive review of 26 country programs, including policy papers, ESW, and almost 200 World Bank projects identified as having financial sector development objectives in the ECA Region during the period 1991–

2000.[1] The paper does not attempt to assess the overall quality of the Bank's assistance to the transition process. While evaluation may be feasible at the individual country level, country experiences and the levels of Bank involvement have varied too widely, and too many political and other factors, internal and external, have had a determining role in outcomes to permit a meaningful aggregate assessment. The transition process itself is unavoidably complex, and the speed with which events unfolded were not amenable to careful strategy formulation. Both governments and external donors frequently found themselves having to respond with stop-gap measures to establish some modicum of control over the spontaneous forces that had been unleashed. Lending programs and policy dialogues were also interrupted by changing governments or by policy reversals that disrupted strategies and put planned operations on the shelf. Thus, although specific reform elements were common to most programs, it is not surprising that a review of Bank lending programs across the 26 countries does not reveal a consistent or common approach with regard to the sequencing of operations by type (i.e., adjustment, investment, or technical assistance loans), or a clear relationship between lending volumes and reform progress.

Given the unprecedented magnitude, complexity, and political and social ramifications of the transition process, it was inevitable that mistakes would be made, and that it would take time for the lessons of the experience itself to come into focus. Learning by doing was an essential part of the process, and throughout the decade the Bank provided intellectual leadership in drawing the relevant lessons and adapting approaches accordingly. The Bank, moreover, was only one player in the process. While it could be supportive, outcomes would necessarily respond also to other influences and depend ultimately on decisions taken by the countries themselves. Viewed overall, the Bank's analytical work, as reflected in policy papers and ESW reports, has been of high quality, and most of the issues and options involved were well understood and clearly set out.[2]

In broad terms, the focus of Bank financial sector assistance programs was also highly relevant. A basic understanding quickly formed in the Bank with respect to the essential elements of financial sector transition, and these elements were repeated in almost all the Bank's programs in ECA countries in which active programs and dialogues were sustained. Emphasis was commonly given to macroeconomic stability as a precondition for healthy financial development. Bank programs focused early and correctly on getting in place the basic legal and regulatory framework and accounting systems for a market-based financial system. High priority was given to the enforcement of hard budget constraints on both banks and enterprises to make market discipline effective in their decisions. The close interrelationship between the restructuring of enterprises and the financial system was well understood, and most country programs sought to integrate actions in both areas. Priorities also included modernization of the payments system and establishment of the authority and capacity of the central bank to determine and manage monetary

[1] The terms Bank and World Bank should be taken to include IDA. This review does not cover the activities of IFC or other donor agencies, except as noted.

[2] The impact of the Bank's analytical work cannot be evaluated solely on the basis of formal ESW. A large amount of informal work, not reviewed for this paper, was also carried out in the course of preparing lending operations, and staff across the Bank were contributing their accumulated knowledge and experience to the discussions of issues and options.

policy and to regulate and supervise the licensing and conduct of deposit banks. Capital markets recommendations focused on the legal and regulatory framework and the infrastructure needed for efficient markets. While these tasks tended to be viewed as largely technical in nature, with the solutions fairly well known on the basis of Western experience, less well charted were the revolutionary shifts in control over existing assets and reforms in governance structures required to establish the discipline and incentives for efficient markets. In their detail, moreover, programs did not always give due emphasis to some of the actions needed to meet their objectives.

Significant differences of view emerged within the Bank regarding some of the major transition issues, and some key issues were not given the attention they deserved in the early transition years and would come to haunt the process. In particular, the issues of corporate governance and managerial incentives, although recognized in many of the earliest policy papers and ESW, were sometimes downplayed or ignored in the advice given and the programs undertaken. This was especially the case with respect to the early enthusiasm in the Bank for voucher mass privatization and to reliance on bank-led, market-directed solutions for the restructuring of large enterprises and banks. Seriously underestimated was the extent to which the process could be subverted by the perverse incentives of bank and enterprise managers and interlocking owners who found greater personal advantage in stripping the assets of their firms and resisting the growth of competition and the imposition of financial constraints. These gainers from early, partial reforms would themselves become powerful sources of resistance to subsequent reforms. Overly optimistic emphasis was also given in some cases to capital market development as a principal vehicle through which corporate governance would be rationalized, and enterprise restructuring would be disciplined and financed. It was too facilely assumed that putting shares in the hands of millions of inexperienced stockholders would create the pressures necessary to enact the regulations, accounting standards, and other infrastructure necessary to give these markets the integrity, transparency, and liquidity necessary for them to play the desired role.

In more general terms, the Bank shared the excessive optimism of many early reformers and Western observers about the speed with which economic liberalization and legal and policy changes would produce robust supply responses, and consequently about the depth and duration of the initial declines in output and employment and the related social costs and political turbulence. In large part, this optimism was related to the misplaced expectation that the rapid shift of control over resources to private hands, along with the liberalization of prices and trade, would lead quickly to more rational resource use under market discipline. A common theme emerging from completion reports, OED assessments, and other reviews of the Bank's adjustment loans to the transition economies has been the limited capacity of most of the borrowing governments to design and implement the inevitably complex and difficult programs and the tendency of the Bank to underestimate the duration and intensity of the assistance needed. In some cases, the Bank overestimated the degree to which the authorities were in fact committed to carrying out the necessary measures.

Some adjustment loans were deficient in taking process measures—e.g., the drafting of laws—rather than their enactment and implementation, as sufficient for disbursement. Some of the laws that were enacted were hastily drafted and later had to be modified or replaced. The most serious shortcomings, however, were not in the laws passed or the specific regulations introduced, but rather in underestimating the time and additional assistance and human resource development required to make them effective. The virtual absence of specialized lawyers, judges, accountants, and other professionals was well understood and given considerable emphasis in the Bank's policy papers and ESW reports. While highly specific training was provided through technical assistance and investment loans to the staff of project implementation units, to financial intermediaries participating in Bank credit lines, and to the restructuring and privatization agencies, assistance programs devoted few resources to the extended training needed to operate the larger system. It is only in recent years that a concerted effort has been focused on judicial reform, even though its importance was highlighted early on in policy papers and ESW.

The implementation of programs has varied in a number of important respects. One is struck, for example, by the relatively tight rein kept on financial sector lending to Bulgaria and the Slovak Republic, as compared to the continuous high level of support provided to financial sector development in Russia, including major adjustment loans, despite a similarly slow pace of reforms and an often frustrating dialogue. This disparity seems to have had more to do with differences in external pressures on the Bank than with specific developmental objectives in the respective countries.

About half of the financial sector operations in the ECA transition economies over the past decade have included lines of credit intermediated through private or public financial institutions. Not unique to the ECA Region, the wide variation found in the timing, design, implementation, and subsequent evaluation of these loans suggests a continued widespread ambivalence within the Bank about the proper objectives of such FILs and the conditions under which they should be carried out. Only in a relatively few countries and operations has the financial sustainability of the financial intermediaries been treated as a serious object of analysis and support. As a general matter, however, the quality of FILs in ECA did improve, particularly as the focus in a number of countries shifted toward microfinance.

Section VI of this report sets out in bullet form some of the major lessons drawn from the review. Principal among these are the following:

- The transition from a centrally planned economy requires a vast web of interrelated changes in attitudes and concepts as well as laws, policies, and institutions. It is necessarily wrenching, complex, and time-consuming. A carefully crafted external assistance program can help to design and implement these changes and to ameliorate their social costs, but it cannot simplify them.

- Given the complexity of the process, as well as changing country circumstances, it is almost assured that initial strategies will require modification over time. Perhaps the most important component of a successful strategy for supporting transition is flexibility.

- However well designed the program, the rate of progress will be largely determined by the government's ownership of it and the degree of consensus it is able to mobilize in the society at large.

- An effective strategy for the dissemination of its analyses and of international experience, and for informing the public debate on the issues of transition, should be an integral part of the Bank's overall country assistance strategy.

- The constitution of a proper legal and regulatory framework is a *sine qua non* for an efficient market-based financial sector. Equally important, as one of their highest initial priorities, the Bank and other donors should support the intensive training of bankers and bank supervisors, lawyers and judges, accountants and auditors, and the other skilled professionals on which the effectiveness of the legal and supervisory framework depends.

- Strong, financially sustainable banking institutions are essential to the development of stable financial systems and to the efficient intermediation of financial resources. State-owned banks, especially those emerging from the central planning tradition, have seldom demonstrated good long-term prospects for becoming sound and efficient financial intermediaries, and early efforts should be made to attract private and reputable strategic investors. In the meantime, however, given their predominant role in the early transition banking system, they cannot be ignored. While fully commercialized behavior may be an overly optimistic expectation, substantial efforts are still needed to improve their management and the incentive framework which guides and constrains their behavior.

- Privately owned banks strongly interlinked with major borrowing enterprises also make poor candidates for sound and efficient intermediation. Measures are needed early in the transition process to strictly enforce prudential regulations limiting loan concentration and related-party lending.

- Bank ownership and governance issues should, along with financial viability, be given careful scrutiny in determining the eligibility of financial institutions to participate in Bank technical assistance programs and in credit line operations. Institutional development programs for participating banks should attach highest priority to the strengthening of basic banking skills, including credit policies and procedures, risk management, internal controls and information systems, including accounting standards.

- Support to the development of sound financial and regulatory institutions requires a multi-year commitment and is highly supervision-intensive. Task managers should be provided sufficient resources to do it properly.

- Financial sector staff should be systematically involved in the design and vetting of financial intermediary operations to ensure that all the factors that will determine the sustainability of the financial flows, instruments, and institutions being supported are adequately taken into account.

- The development of efficient capital markets is an important component of financial sector development, but does not have the same urgency in the early stages of transition as the attention needed to build a strong banking system.

World Bank Assistance
for
Financial Sector Development
in the
ECA Transition Economies[3]

I. Introduction

Over the past decade, the countries of Europe and Central Asia have undertaken massive overhauls of their economic systems, transforming institutions, processes, attitudes and fundamental concepts of individual and organizational behavior.[4] The ultimate rejection and collapse of the command economy throughout the region resulted from many factors. Not least of these was the system's gross inefficiency of resource use, characterized by queues and supply shortages in some parts of the system, while huge inventories of unused and unwanted goods accumulated in other parts of the system. These imbalances led increasingly over time to diversions of products and inputs from the administered distribution system into black markets, with the corruption associated therewith, and to declining overall growth rates despite massive investment.[5] An evolution toward market-mediated resource allocation processes and the effective re-privatization of property had thus been set in motion both by spontaneous movement into the vacuum left by the collapse of administrative controls and by government decisions taken in the hope of raising efficiency and spurring growth.

Contrary to the expectations of some, the transition process has turned out to be long, complex, costly, and hardly amenable to a standard blueprint. With the old system falling apart, new mechanisms, institutions, policies and processes were needed to achieve and maintain macroeconomic stability, while effecting the transfer of asset ownership and decentralization of decision-making responsibility to private operators. This would require, *inter alia*:

- A wholesale creation or revamping of laws and regulations to govern the privatization process and to provide the framework for the fair and efficient functioning of markets;

- The replacement, downsizing, restructuring, or reorientation of most public sector institutions, as well as the creation from whole cloth of previously non-existent institutions to ensure the efficient delivery of public services and to implement the new laws and regulations to provide an environment conducive to private sector initiative;

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[3] World Bank and Bank in this report refer specifically to the IBRD and IDA.
[4] Several countries, particularly Hungary and the former Yugoslav republics, had begun important market-oriented reform initiatives much earlier, and a few, e.g., Belarus, had barely begun the transition by the end of the 1990s. Countries varied also in the pre-reform scope of central control and the degree to which some private ownership and market transactions had been allowed. Given the number of countries involved, however, and the similarity of the fundamentals of the transition they are undergoing, much of the descriptive story line of this paper will necessarily be based on "central tendencies." Important differences among countries or groups of countries are noted in the course of discussion.
[5] Per capita income levels had been falling in most of the CEE and FSU since the 1960s.

- The reassignment of responsibilities for the social programs and safety net theretofore provided by the enterprise sector, and the introduction of new mechanisms for mitigating the considerable social costs of transition, particularly for the poor and vulnerable; and

- The acquisition and broad dissemination of the knowledge and technical skills needed to make all of the above work and for individuals to prosper in a market setting.

Transformation of the financial sector has, from the beginning, been seen in most countries as a key element of the overall transition process. Its achievement, however, has been exceedingly complex, in part because of the financial sector's central importance to the political and economic forces seeking to gain or maintain control over national resources and the transition process. At the same time, the nature of financial assets and financial transactions make them particularly prone to fraud and mismanagement. Consequently, market-based financial transactions depend heavily on the mutual trust of the participants and/or on their confidence that the overall framework of laws and regulations will protect them and give them adequate recourse in the event of abuse. Much of the evolution of financial sector laws, institutions, instruments and policies in the advanced market economies has had, as its primary purpose, the creation and maintenance of that confidence and/or the reduction of the costs to the actors of protecting themselves from the inherent risks.

Box 1 provides a brief overview of the multiple roles played by a well functioning, market-based financial sector in transferring resources from savers to investors, and in permitting individual households, enterprises, and governments to manage the risks inherent in market-based economic activity. Box 2, in turn, outlines the role played by the financial system in a typical centrally planned economy. The challenge in the transition economies with respect to the financial sector has been to move from the system described in Box 2, in which both macro and micro financial risks were largely unknown to most participants, to the more efficient and growth-promoting but risk-prone system portrayed by Box 1. In brief, the immediate objectives of financial sector transition have been to create:

- An efficient and unified payments and settlement system from the previously segmented systems of cash settlement for households and nominal accounting balances for enterprises;

- The policies, institutions, and instruments necessary for the design and execution of monetary policy operating through market processes rather than direct administration; and

- An efficient system for mobilizing and allocating financial resources through independent, self-interested financial institutions and markets.

Box 1: The Multiple Roles of the Financial Sector in a Market-Based Economy

The financial sector in a developed market economy can be described as providing three broadly defined, interrelated services: payments services, resource reallocation services, and risk management services.

Payment services:

The financial sector provides households, enterprises, and governments with generally accepted means of payment, largely in the forms of cash and checking accounts, and quick, safe, low-cost settlement of their exchanges of goods and services. In the absence of such services, the size, efficiency, and growth of economies would be severely constrained by the logistical costs of barter transactions.

Resource reallocation services:

During any given period of time, some economic actors—whether households, enterprises, or governments—earn incomes in excess of their current consumption needs, while other actors have expenditure demands greater than can be financed by their current incomes. The financial sector provides instruments and mechanisms for the voluntary transfer of purchasing power from savers to deficit spenders in exchange for a pledge to repay the transferred amount, plus a premium, in the future. This temporary transfer of control over resources facilitates the process of investment, on which the economy's growth heavily depends, as well as bridge financing for working capital and emergency or other consumption needs not synchronized with current income flows. Such transfers could be, and sometimes are, made directly between the individuals or entities involved, but the existence of specialized financial intermediaries (FIs) makes possible a far larger volume of transfers among a much greater number of parties at lower cost. Moreover, FIs are able to pool the resources of large numbers of savers, to exploit economies of scale in the resource transfer process and in the analysis of allocation alternatives, to diversify the risks they undertake, and to exercise discipline over borrowers. These capabilities enable FIs to engage in term and liquidity transformations, thereby making possible higher return/higher risk investments than individual savers acting alone could or would be willing to finance. In addition, the capacity of FIs to apply specialized experience and skills and to access information for their allocation decisions can result in more productive investment and innovation, and improve the trade-off between risk and return, to the benefit of all parties concerned. At the same time, the availability to investors of longer-term finance and a diversity of instruments through which they can share the risks of innovation and entrepreneurship with savers may encourage a higher level of investment.

Risk management services:

Households, enterprises, and governments save, and sometimes borrow, to ameliorate the risks of temporary income loss and unexpected expenditure, as well as to meet predictable future needs, (e.g., retirement, weddings, replacement of machinery and infrastructure, tax obligations, etc.). Financial institutions enable households and other economic entities to hold their savings in relatively safe and remunerable financial assets. The greater the diversity of savings and credit services and instruments available, the better each entity can match its own particular risk/return preferences. At the macroeconomic level, developed financial markets and instruments facilitate an active and continuous monetary policy and public debt management to reduce the overall risks of economic instability. In the aggregate, access to savings services, may encourage overall financial savings and thus make greater resources available for investment and innovation. (On the other hand, by enabling savers to manage risks more efficiently, financial services may reduce the perceived need to save.)

Finally, FIs themselves are major users of risk management services. FIs assume considerable risk in lending funds they are obligated to repay and in engaging in the term and liquidity transformations important to their overall role. The ability to buy and sell financial instruments in liquid markets in order to match or hedge their asset and liability risks, as well as to meet short-term liquidity needs, is crucial to their ability to perform their role and enables them to undertake greater degrees of risk transformation than would otherwise be prudent and feasible.

Box 2: The Financial Sector in a Centrally-Planned Economy

Finance in the centrally-planned system consisted formally of the state budget and the banking system. The banking system, in turn, consisted principally of a "monobank," which carried out its functions either through separate windows of the same institution or through nominally separate specialized institutions—typically a savings bank, agricultural bank, construction bank, and foreign trade bank—controlled from a central bank. The monobank was responsible for administrating and allocating credit within an overall credit limit. Both the overall limit and the detailed allocations were governed by the central credit plan derived from the plan for the real economy.

In financial terms, the economy consisted of two circuits: a cash circuit and a book entry or checking circuit. Households received wages or pensions in cash, which they used to pay for their daily consumption needs. (Many basic services, such as housing, health and education, were commonly provided in kind or at highly subsidized prices to households by the enterprises or government agencies where they worked.) Households paid taxes, in effect, through the acceptance of low wages. Household financial savings, partly reflecting the physical shortage of consumption goods, were deposited in the state savings bank, which channeled them back to the budget or to the central bank. Direct budget and credit plan allocations to the state enterprises were channeled through the checking circuit on the basis of planned deliveries of goods, authorized investments and working capital, and social expenditures, with residual profits flowing back to the state as owner of the enterprises. Enterprise managers were given little scope for discretionary expenditure, and the books kept by the monobanking system on enterprise cash use and interenterprise transfers provided an important vehicle for monitoring performance under the plan.

In effect, the banking system served little more than an agency role for monitoring and controlling compliance with the plan. Banks were passive actors in the credit process, making no independent credit decisions and simply repassing resources provided by the budget or the monetary authority. By the same token, the banks took no credit risks. Regardless of the results of an enterprise's operations, loan repayment was, in effect, guaranteed by the budget and/or central bank. Moreover, as noted above, enterprises had large social responsibilities in addition to their production responsibilities, accounting in many instances for a significant share of their cash deficits. Consequently, credit from the banking system was also going to finance large expenditures that would not produce future income flows to the enterprises from which to repay the loans. Neither borrowers nor lenders in the system were subject to hard budget constraints and had no own capital to protect.

The system overall facilitated massive mobilization of resources accompanied by central control of their allocation in accordance with state priorities. During the 1980s, growing concerns about the productivity of investment led in many centrally planned economies to some liberalization of both the financial and enterprise sectors, including a partial devolution of decision-making to enterprise and bank managers. With little or no change of corporate governance, however, and the continuation of soft budget constraints on both borrowers and lenders, the decentralization of decision-making failed to improve efficiency and instead facilitated the diversion of resources to privileged rent-seekers and to the progressive decapitalization of both enterprises and banks and the loss of state assets and income.

World Bank assistance programs for developing the financial sectors of the ECA transition economies focused during the period reviewed principally on the third broad objective—the establishment and strengthening of financial institutions, markets, and processes to mobilize and allocate resources for productive investment.[6] The development of a market-based financial system has been viewed as essential for mobilizing and directing savings toward the most promising investors and investments by rationalizing the borrower selection process and by bringing market discipline to bear on the decisions and management of the borrowers themselves. What progress was made in financial sector reform in the ECA Region, and what was

[6] The World Bank provided financing and technical assistance in most countries for the modernization of payments and settlement systems, but this was a small component of the overall programs. Assistance for the development of monetary policies and the central banking function have been largely the responsibility of the International Monetary Fund (IMF).

the World Bank's contribution to that progress? Did the Bank have a clear strategy for reform of the financial sector at the outset of its involvement in the transition countries? Was this strategy modified over time in the face of experience and evolving conditions? Was the strategy consistently applied across the countries? Were variations adapted to different country situations, preferences, and implementation capacities?

No unambiguous and irrefutable answers to these questions will be forthcoming from this report. The number of countries covered (26) is too many, their individual histories, situations and the factors impinging on them too unique, the information available regarding their multiple interactions with the Bank too fragmentary, the time too short, the space available for writing too brief, and the intellectual capacity of the author too limited to bring closure to all these issues. But perhaps a few useful generalizations can be made and lessons drawn from this fascinating and ongoing experience. In pursuing this evaluation, I have drawn upon documentation pertaining to almost 200 World Bank projects carried out in the ECA transition countries over the period 1991–2001 and identified as having financial sector development among their objectives.[7] I have read through most of the formal loan documents associated with these projects, as well as OED evaluations. In addition, I have reviewed the country strategies prepared for these countries during the period, a large number of formal country economic and sector reports dealing with financial sector issues, and OED Country Assistance Evaluations.[8] I have also read a large number of valuable policy and research papers, both published and unpublished, dealing with financial sector development and related topics in the ECA transition economies.[9]

The report is organized as follows. Section II briefly summarizes the progress of financial sector development in the Region, as described by some of the common indicators of the extent to which financial institutions are playing the roles described in Box 1. Section III describes, also briefly, some of the similarities in the early transition experience. Section IV discusses at somewhat greater length differences in approaches taken by the different countries to some key aspects of reform, and outline some of the key transition issues and crucial interrelationships with other aspects of structural reform that needed to be taken into account in the formulation and implementation of the financial transition. Section V examines the World Bank's assistance programs in the Region, with particular attention to how country programs

[7] Identifying all Bank projects with financial sector components was not easy, and it is likely that many have been missed. ECA itself recently combed its data base and discovered large numbers of projects containing credit lines intermediated through local financial institutions, about which the financial sector specialists in the Region had no prior knowledge. It should also be reiterated that this review covers only the activities of the IBRD and IDA. The work of IFC and other donor agencies in the financial sectors of the transition economies is mentioned only to the extent that it figured prominently in the documentation for Bank activities.

[8] It has been difficult to identify and locate, however, the large amount of informal economic and sector work that is known to have been done. Neither has it been possible to capture the undoubtedly large volume of interpersonal memoranda, memos of conversation, etc. discussing the relevant strategic and operational issues. Some of these information gaps have been filled in the course of interviews with staff involved, but a more thorough historical study would undoubtedly enrich, and could modify, some of the judgments offered. It should also be noted that the detailed analyses prepared for many of the countries under the joint Bank-Fund FSAP program have not been available because of their confidentiality.

[9] A list of selected documents and papers expressly reviewed for this report is given in Attachment 2.

treated, and were affected by, the interrelationships and issues described in Section IV. Finally, Section VI attempts to bring together some of the lessons learned.

II. The Progress Toward Financial Sector Development

A. Public Confidence in the Financial System

Given the multi-dimensional nature of the financial sector transition, no simple indicator can capture all of its complexity. Following common practice in the financial literature, Tables A.1-A.7 present time series for a number of indicators of financial development in the ECA transition economies.[10] Tables A.1 and A.2 show, respectively, the evolution over the 1990s of the level of broad money (M2) as a proportion of GDP, and the proportion of M2 accounted for by currency in the hands of the public. These data taken together give an indication of the growth of public confidence in the stability of the value of money and in the strength of the banks and/or the quality of the state's explicit or implicit guarantee of deposits. In a developing financial system, one would expect to find a growing ratio of M2 to GDP and a declining ratio of currency to M2.

In practically all of the ECA transition economies, the initial period of transition was marked by sharp declines in the level of monetization, as hyperinflation quickly eroded the real value of financial assets and reduced the public's willingness to hold them. Overcoming this loss of public confidence in monetary assets has been one of the principal obstacles to financial sector development. Most countries have had rising M2 ratios since 1995, but recovery has thus far been only partial. A marked exception to these trends has been Bulgaria, which at the beginning of the decade had among the highest levels of monetization and intermediation of all the transition economies. Financial crisis and hyperinflation in 1996–97, however, caused a general flight from the banking system and from financial assets, from which the country in 2001 was only beginning to recover. Hungary also stands out for its relatively high and stable ratio of M2 to GDP throughout the period, with a marked decline in cash holdings outside the banking system indicating growing confidence in its stability. Tajikistan and Uzbekistan are notable as the only two countries where the M2 ratio declined through almost the entire decade. With few exceptions, the degree of monetization of economies evident in these data remains far below those of the advanced industrial economies. Only in Albania, Croatia, Czech Republic, Slovak Republic and Slovenia were the M2 ratios in 2001 roughly equivalent to those found in Western Europe in 1997 (50–65 percent), with Hungary and Poland close to those levels. For many of the countries, the M2 ratios shown in Table A.1, as low as they are, overstate the level of confidence in the local currency, since a large proportion of deposits included in M2 are held in foreign currency.

Similarly, the preference for holding financial assets in cash outside the banking system remained comparatively high in most of the transition countries.

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[10] King and Levine, in their study of the role of the financial sector in economic development, find strong positive relationships between the indicators presented in Tables A.1, A.4, A.5 and A.6 to long-term per capita growth rates, capital accumulation, and the growth of productivity in a cross-section analysis of 77 countries. See: Robert G. King and Ross Levine, "Finance and Growth: Schumpeter Might be Right," *Quarterly Journal of Economics*, August 1993, pp. 717-737; and Ross Levine, *Journal of Economic Literature*, June 1997, pp. 688-726.

Ratios of cash to M2 are typically 10 percent or less in Western Europe. Among the ECA transition countries, only Croatia and Slovenia had ratios below 10 percent by 2001, with the Czech Republic, Poland, and the Slovak Republic slightly above. In contrast, ratios above 25 percent remained common in the Region and suggest very low levels of confidence in the safety of banking systems.

B. Size of Banking System Intermediation

Table A.3 shows the levels of total banking system credit (the consolidated sum of credit outstanding from the central bank and from the deposit banks) to all domestic borrowers (both public and private sector) in relation to GDP. It is a measure of the relative importance of bank intermediation in the economy. It does not indicate, however, the efficiency of intermediation. Where banking systems remained under state control through all or much of the period, there is little reason to presume that credit was being allocated more efficiently than under the central planning system. Much of the credit growth that did occur went to bolster loss-making state enterprises as well as privatized enterprises that had thus far done little to restructure themselves in ways that would make them more efficient and competitive.

Consistent with the monetary aggregates reported above, bank credit outstanding in general shrank dramatically in the face of the high inflation and general uncertainty of the early transition years. In only a few of the countries—most notably, Estonia, Georgia (from an extremely low level), and Latvia—did lending show a significant recovery relative to GDP after the middle of the decade. Bulgaria and Russia saw dramatic declines in the relative volumes of bank credit, while even relatively successful reformers like Hungary and Czech Republic experienced significant reductions. The relative volume of Poland's bank loans remained stable throughout the decade. The highest ratio of banking system credit to GDP in 2001—just under 62 percent—was found in the Slovak Republic. This compares to 1997 ratios of 80 percent in the United States, 88 percent in Australia, 93 percent in Italy, 102 percent in France and 141 percent in Germany.

Table A.4 reports the ratio of deposit money banks' domestic claims to the consolidated sum of central bank and deposit money banks' domestic claims. As an indicator of financial sector development, it assumes that deposit money banks are more likely than are central banks to allocate credit according to market-based criteria and thus to do so with greater economic efficiency. The data show a strong growth of the relative role of deposit money banks in domestic credit allocation in practically all of the countries, and several reached the levels common in Western Europe. (Two exceptions were Estonia and Slovenia, where this ratio fell from levels of the early 1990s, but where all other indicators of financial sector development were positive.) Recall, however, the much smaller overall importance of banking system credit in the transition economies. The failure of banks to play a more vigorously growing role in the intermediation of credit to the domestic economy reflected varying combinations of tight liquidity, caution in the face of general economic uncertainties and stronger prudential regulation, and flight to the greater perceived safety of foreign assets. The latter was forced as well by the heavy exposure noted above of banks in some countries to foreign currency liabilities. In many countries, as a consequence, the total assets of banks grew faster than the level of credit outstanding.

In any event, this ratio may be a weak indicator of allocative efficiency in transition economies where the major deposit money banks remained under direct state control or under the control of major borrowers through much of the decade. On the other hand, to the extent, that a growing role of deposit money banks in credit allocation was accompanied by growing commercialization and privatization of banks, its impact on the improvement of allocative efficiency should have been magnified.

Table A.5 shows the proportion of deposit bank credit (including foreign assets) going to the domestic enterprise sector and, where the data are available, to the non-financial private sector.[11] As an indicator of financial sector development, the ratio assumes that credits to the private sector are allocated more in accordance with commercial market criteria on both lender and borrower sides, thus resulting in higher economic rates of return. All of these ratios would be expected to have grown, as an increasing proportion of economic activity was transferred to private hands. Indeed, a casual perusal of the table shows that the growth of credit to the private sector has been explained almost entirely by the pace of privatization of the enterprise sector and is matched by the offsetting shrinkage of credit outstanding to the state-owned enterprises. By 2001, loans to the private sector accounted for more than half of banking assets in only 9 of the 23 countries for which date were available. For the rest, banks' assets were predominantly claims on government or on the foreign sector. In several of the early privatizers, such as the Czech and Slovak Republics, Estonia, Lithuania, and Russia, the proportion of bank credit to the private sector actually fell after the middle of the decade.

Combining the relatively low level of credit to the private sector with the slow growth of bank credit overall, Table A.6, shows the evolving ratio of credit to the non-financial private sector relative to GDP. In only three countries for which data are available—Croatia, Czech Republic, and Slovenia—did this ratio reach or exceed 40 percent in 2001, as compared to ratios in Western Europe in 1997 ranging from 52 percent in Italy to 108 percent in Germany. Of the countries of the CIS, only Russia had a ratio above 15 percent.

In summary, bank liabilities, like banking assets, were sharply eroded by the high inflation of the initial transition period. On the positive side, inflation served to wipe out the heavy burden of bad loans on the books of many banks, which were then given the opportunity to rebuild their portfolios from a clean slate. The restoration of deposits has been slow, as savers have not forgotten the heavy losses suffered early in the transition, and uncertainties remain about macroeconomic stability, economic recovery and the safety of the banking system. The regrowth of assets has also been slow, particularly of loans to the private sector, reflecting in part more conservative attitudes by bankers facing both tightening prudential regulation and borrowers of

[11] The data in Tables A.5 and A.6 are from lines 22c and 22d of the IMF International Financial Statistics. Breakdowns of deposit money bank claims are not available for all countries. The numbers shown in bold are the sum of line 22c (claims on nonfinancial public enterprises) and 22d (claims on private sector), while the numbers shown in italics report only the latter. Where breakdowns are not available, the numbers in black include claims on both public and private sector enterprises, as well as claims on other financial institutions. It is assumed that the bulk of this credit in the transition economies has gone to enterprises.

uncertain creditworthiness, as well as continued heavy public sector borrowing in much of the region. The data on growth of credit to the private sector, moreover, should be interpreted with considerable caution, inasmuch as they may simply reflect changes of nominal enterprise ownership rather than changes of borrowers and do not necessarily indicate better or more productive loans. Moreover, declines in the data on credit outstanding in some countries may reflect the more aggressive write-off of old bad debts rather than an actual contraction of new lending.

C. The Cost Efficiency of Banking Intermediation

Table A.7 traces the course of deposit and lending interest rates in the transition banking systems, giving some indication of the evolving quality of competition in the system and of improvements in the cost efficiency of intermediation.[12] Some narrowing of spreads is evident in most countries over the period, but Albania, Moldova, Poland, and Romania were notable exceptions. Spreads even in the more advanced reformers remained high relative to those in the advanced industrial economies. Only in Estonia and Hungary had spreads fallen to levels common to Western Europe. In addition to the statistical problems mentioned in the footnote, caution is required in interpreting these data as indicators of competitiveness and cost efficiency, given the other variables that may be involved. The forms and levels of taxation of banks, the level and remuneration of mandatory reserve requirements, the quality of competition in the sector, and the continuing burden of nonperforming loans all affect the level of spreads required to cover intermediation costs. The first two are policy variables in the hands of the governments and central banks, while the volume of nonperforming loans reflects the quality of bank credit decisions.

D. The Size and Liquidity of Securities Markets

Tables A.8 and A.9 show the ratios of stock market capitalization to GDP and of the value of stock trading to market capitalization. These ratios indicate the developing importance of the stock market and of its liquidity. Stock markets provide enterprises with financing in a form that shares the risks of investment and innovations. It thus provides corporate managers with a greater cushion of support to undertake riskier and potentially higher-return investments than does financing with fixed maturities and interest obligations. The attraction of stock shares to savers is that they allow them to share more fully in the high returns of successful investments, in exchange for assuming a share of the risks that investments might underperform expectations. Shares also provide large stockholders the opportunity of exercising a degree of influence over the decisions and policies of the corporation directly through its board of directors or indirectly through the threat of a takeover. A highly liquid stock market, as suggested by a high rate of turnover, provides savers with the confidence that they can sell their shares easily and quickly when they want or need to. It also provides enterprises with the possibility of selling new shares into the market at a fairly predictable price.

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[12] Once again, caution must be used in interpreting these data. The sampling of interest rates varies across countries in terms of the types and terms of deposits and loans and the manner of averaging them. Inter-country comparisons are thus not reliable. In some cases, as indicated in the footnotes to the table, definitions in some country time series also vary over time.

By 2001, stock markets had been formed in 20 of the 26 transition countries reviewed, but, in general, the size and activity of the stock markets remained quite low. Only in Estonia, Hungary, Czech Republic, and Poland had they reached a size, relative to GDP, comparable to stock markets found in other developing countries at comparable income levels. Market valuations in some countries—e.g., Russia—were also quite volatile, reflecting both macroeconomic instability and speculative activity in the context of weak regulation. Market turnover was also relatively low and typically highly concentrated in only a few issues in each country. Turnover was also highly volatile from year to year, again reflecting macroeconomic instability and speculative behavior and, in some countries, large swings in foreign portfolio investment. The markets served largely to redistribute corporate ownership rather than to channel resources to new investments.

E. Summary: The Progress of Financial Sector Reform

None of the traditional indicators recounted above provide unambiguous evidence of successful financial sector transitions in the ECA economies. Apart from data problems, *per se*, the speed of institutional change taking place "underneath" the numbers, make them particularly difficult to interpret without detailed analysis of each country situation. Tables A.10 and A.11 report, respectively, the indices of banking reform and interest rate liberalization and of securities and nonbank financial intermediary reform as assessed by the European Bank for Reconstruction and Development (EBRD). The first combines the objective indicators outlined above with subjective judgments regarding progress in establishing the solvency of the commercial banks; the adequacy of the legal framework for banking and for banking regulation and supervision; and reductions in the importance of directed and subsidized credit. The second similarly combines quantitative measures of market activity with judgments regarding the adequacy of the legal and regulatory framework for issuing and trading securities, protecting the rights of minority shareholders, for effectively regulating and supervising nonbanking financial institutions (NBFIs), and the quality of securities market institutions, including the safety of clearance and settlement procedures.

According to these indices, most of the ECA transition economies had by 2001 made tangible progress toward the development of market-based financial systems. Within the financial systems, progress was much more evident in the banking sector than in the securities markets and NBFIs. Three countries—Hungary, Czech Republic, and Estonia—were judged in 2001 to have brought the quality and efficiency of banking services and banking laws and regulations close to the norms of the advanced industrial economies. But, even in these three countries, the banking sectors remained quite small in relation to the overall economy. A number of countries, including Belarus, Ukraine, Tajikistan, Turkmenistan, and Uzbekistan, had barely begun the transition process in the financial sector, having progressed little beyond the establishment of two-tier banking systems.

Progress was much slower in the reform of capital markets and NBFIs. Only Hungary and Poland were deemed to have approached industrial country standards and regulatory norms by 2001, with most financial markets in the Region exceedingly small, highly risky and non-transparent, and attracting little interest from either borrowers or savers.

The EBRD indices suggest a tentative grouping of the 26 countries covered in this report based on the rated progress of reforms through 2001. Four groups are identified as follows:[13]

Weak reformers: Belarus, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan

Partial reformers: Albania, Armenia, Azerbaijan, Bosnia-Herzegovina, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, and Romania.

Progressing reformers: Bulgaria, Croatia, Latvia, Lithuania, FYR Macedonia, Poland, Slovak Republic, and Slovenia.

Advanced reformers: Czech Republic, Estonia, and Hungary.

The countries of the CIS are concentrated in the two lower categories of financial sector development, while all of the countries in the upper two categories are in the CEE and Baltics. The following section will discuss some of the issues and factors that may help to explain these variations in progress.

III. An Overview of Financial Sector Transition

Financial sector reform cannot be viewed in isolation. It has necessarily constrained and impacted on, and has been constrained and impacted by, the other major structural reforms taking place in the transition economies. The sub-sections below will first discuss, in summary fashion, the crucial interrelationships between financial sector reforms and fiscal reforms, reforms in the enterprise sector, in the overall legal framework and judicial system, and in the financing of social infrastructure and social safety net. Some of the similarities noted in the transition experiences of the ECA countries will then be described before going on to set out some of the contrasts, including important differences in starting points. The difficulties of managing the speed and sequencing of this vastly complicated set of interrelationships and in widely varying country settings will be examined in Section IV.

A. The Interrelatedness of Transition Reforms

In the centrally planned economy, financial institutions directed credit in accordance with the priorities of the planners, and repayment in one form or another was guaranteed by the state. In a market economy, however, it is a truism that good and successful lenders must have good and successful borrowers. Financiers can grow and prosper only when those they finance are also, in the aggregate, growing and prospering and thus able to repay their debts. But this is a necessary not a

[13] Given the large number of factors and subjective judgments involved, particular weight should be put on the words "suggest" and "tentative", and little blood should be shed over the specific assignment of categories. An alternative ordering of the CEE countries is proposed by Lajos Bokros, who places Poland in the most advanced category with Hungary, while pairing the Czech Republic with Slovenia in a second place category. (See: "A Perspective on Financial Sector Development in Central and Eastern Europe," in Lajos Bokros, Alexander Fleming and Cari Votava (eds.), *Financial Transition in Europe and Central Asia: Challenges of the New Decade*, The World Bank, July 2001.)

sufficient condition. Lenders must also have adequate information and analytical filters to be able to identify the borrowers with the best potential and to manage the risks inherent in the inevitable uncertainties they face. For credit to flow to the most productive uses, borrowers must face prices determined by supply and demand, and the taxes and social obligations imposed on them by the state should not distort the relationship between their profits and their productive efficiency. Given asymmetries of information and the susceptibility of financial transactions to fraud, lenders and borrowers must be governed and protected by clearly defined and enforced legal obligations. And given the overall system's vulnerability to generalized loss of confidence, market-led financial sectors must be kept under close regulation and supervision. Finally, because the largest financial institutions and the largest borrowing enterprises tend to be organized in corporate structures that separate owners from managers, both must have within them incentive systems and mechanisms of control that motivate managers to maximize the profitability of the capital entrusted to them.

Virtually none of these institutional, legal, and behavioral underpinnings was in place at the start of the transition process. To become good potential borrowers, enterprises suddenly subjected to market discipline would have to be restructured to reduce their costs, modify and upgrade their products, and modernize their technologies. These steps in most cases would necessarily involve shedding labor and probably changing managers. The incentive to take the actions necessary would require the enforcement of hard budget constraints and the threat of liquidation for enterprises that failed to restructure and become competitive. International experience suggested that the actual enforcement of hard budget constraints and of the liquidation threat would further require the transfer of enterprise ownership from state to private hands. To make enterprises competitive, whether in private or state hands, would also require that they be relieved of the heavy burden of social responsibilities inherited from the past, as well as the overload of debt accumulated to finance past ill-advised investments directed by the state.

To relieve enterprises of their responsibilities for social expenditures, however, would greatly exacerbate the hardships already being suffered by workers and their communities and increase political resistance to reform generally. New means had to be found to finance and deliver these services. To relieve the enterprises of their debt overloads would mean explicit recognition of the insolvency of their lenders, which would in turn force either the restructuring and recapitalization of the latter or their liquidation. Heavy new demands would thus be placed on state budgets already suffering collapsing revenues in the face of declining output and loss of administrative controls. Drastic fiscal reforms would be required to stabilize the situation.

Financial sector reforms were necessarily an integral part of these interrelationships. The conversion of banks and other financial institutions to a commercial basis would require restructuring, both financial and operational, and a wholesale change of the incentives motivating their internal decisions. They too would have to be subject to hard budget constraints and the credible threat of liquidation in the event of failure. This would also probably require the transfer of bank ownership into private hands. Future success, whether under state or private ownership, would also require vastly improved information about borrowers and the clear legal definition and protection of creditor rights. For commercially oriented lenders to be willing to risk their funds, they would need to have confidence in an orderly, predictable, quick, and relatively low-cost process that protected their rights and position in the queue in the event of a borrower's default. Internal risk management, as well as the ability to attract and hold the resources of savers, would require more open disclosure of financial information processed through revamped accounting and auditing systems designed to international standards. Systemic safety and integrity would require the establishment of a whole new apparatus of prudential regulation and banking supervision.

The development of the financial system would also include the growth of securities and equities markets to provide competition to the banking system in the efficient allocation of funds, a vehicle for the concentration of enterprises and financial institution ownership in the hands of strategic investors, as well as for replacing weak owners and managers by others more capable of maximizing the value of their respective operations. Efficient and effective capital markets would require, *inter alia*, clear legal definitions of property and creditor rights, including the rights of minority shareholders, and an appropriate legal and supervisory framework to assure the disclosure of reliable information about the condition and prospects of the companies whose shares and securities were being offered for sale.

B. Common Features of the Early Transition

A number of features were common to the initial years of the transition process in virtually all the ECA countries. The need to move from the pseudo-financial system under central planning to a market-based financial system involved the same fundamental transformation for all the transition economies. It is not surprising, therefore, to find broad similarities in their evolution, in the issues, difficulties and obstacles to be resolved, and in the specific measures taken. Although there was necessarily much learning by doing, the transition economies could also draw upon lessons—both do's and don'ts—from the experience of the advanced market economies and from the rules and norms that had developed among them. Countries aspiring to eventual EU membership had even more precise models to follow and criteria to meet, and strong incentives to do so. Many basic reform steps had already been in progress since the early 1980s, particularly in the CEE countries, or were quickly forced by the massive political and economic upheavals of the early 1990s.

Macroeconomic Shocks and Policy Responses

In varying degrees, enterprises and supply chains had been under increasing strain prior to transition, as the weakening of central administrative controls and growing price distortions disrupted production and diverted goods in excess demand from traditional supply channels to black markets. The more adept managers had been able to adjust and still meet production targets, and sometimes enrich themselves, through informal markets and barter arrangements. Nothing prepared them, however, for the massive shocks brought about by the breakup of the Soviet Union and the CMEA trading bloc; and full price and trade liberalization. As a consequence of these shocks, large segments of the industrial sectors of the transition economies saw their markets suddenly disappear.[14] The immediate impact was a sharp and sustained decline in output and employment. In the face of collapsing financial flows and enormous economic and political uncertainty, the fall of investment was even greater than that of output, despite the need to replace the old and now largely obsolete capital stock.

Falling output was accompanied in most countries by high inflation, triggered by price liberalization and fueled initially by large monetary overhangs accumulated by households during the 1980s, when consumer goods were in increasingly short supply.[15] The loss of enterprise revenues also created large financing gaps in government budgets, at the same time that heavy new demands for budgetary support were coming from loss-making enterprises and from workers and pensioners facing new higher prices for consumer goods. Large current account deficits and capital flight resulted in sharp devaluations and a falling demand for money, exacerbating inflationary pressures. Governments reacted with efforts to reduce subsidies, restrain wage increases, and tighten monetary policy. Sharp increases in interest rates helped to restore price and exchange rate stability, but at the cost of worsening the financial distress of enterprises and the bad debt problem of banks.

Early Reforms in the Enterprise and Financial Systems

Privatization of enterprises was declared from the start a high priority of transition country governments, and most moved quickly to transfer small enterprises into private ownership. Political and economic concerns, wariness toward foreign investment, and the sheer size of the task, however, slowed the progress of privatizing medium and large enterprises. Budget constraints were hardened to an extent, forced by increasingly difficult fiscal situations, but their rigorous enforcement was also inhibited by administrative weaknesses and by political and economic concerns. With the exception of Hungary and Estonia, bankruptcy actions against large loss-making enterprises and their bankers were rare. New private enterprises grew rapidly in numbers and in their shares of output and employment, albeit from a practically zero base in most of the countries. Their size and productive capacity continued to be constrained, however, by administrative restrictions, red tape, and lack of land, credit, and other inputs to which the state enterprises continued to enjoy preferential access.

By the beginning of the 1990s, most of the transition countries had already taken steps to break up their monobanks and to create two-tier banking systems, formally separating the central banking function from credit allocation and creating

[14] Particularly traumatic for many transition countries was the sudden loss of subsidies on imported oil and gas from Russia. Governments faced the huge dilemma of either passing sharply higher fuel costs on to their domestic industries, which had been encouraged by the subsidies and by central planners to adopt highly energy-intensive technologies, or to assume themselves the fiscal burden of continuing the subsidies.

[15] It should be noted that official data overstate both the decline in output and the increase in inflation. The precipitous decline of output in the formal economy was to some extent offset by a shift of activity to the informal economy, partly to escape taxation and other controls. At the same time, official inflation data were to some degree recording price increases that had already effectively impacted consumers in earlier years, as transactions shifted to the black market, and official prices became increasingly irrelevant. Nevertheless, the welfare impact of actual production declines and increased living costs was severe, and by the end of the period under review few of the transition economies had yet recovered the real output levels of the pre-transition period.

the specialized state banks described in Box 2.[16] Most countries also had opened the doors to the establishment of new independent banking institutions. This resulted in a rapid proliferation of small, undercapitalized banks, many of which failed or were later forced to consolidate by increasing minimum capital requirements. In many cases, the new banks were hived off from the old state-owned banks and/or were established by enterprises, branch ministries, or local governments to provide treasury services, to access central bank credit, and to meet the financing demands of the associated enterprises, sector, or region.

A host of new laws and regulations were enacted to govern the transfer of ownership and to establish the responsibilities and powers of the new institutions. Efforts also began to build a body of prudential banking regulations and to strengthen the authority and technical capacity of the central banks to enforce them. In all countries, however, the legal and judicial systems were slow to fully accept, recognize and protect the rights of private property and of creditors. This reluctance continued throughout the period in most transition economies to undercut the confidence on which financial transactions were based, and thus to raise the costs of financial intermediation and risk management.[17]

High inflation in the early transition years served to sharply reduce the real value of banking liabilities as well as the weight of inherited nonperforming assets, offering banks a clean slate for rebuilding their balance sheets. This opportunity in most cases was squandered, however, as governments failed to shut down nonviable enterprises and, in many cases, shifted the burden of their support from the budget to the banks, leading to new accumulations of bad debt. Credit did tighten overall, however, as banks failed to reattract deposits, even as inflation abated, and their liquidity was further constrained by tight monetary policies, high levels of nonperforming assets and increasing provisioning requirements. Increasing risk-averseness in the face of tightening prudential regulation and general economic uncertainty also led banks to prefer the safety of government securities or foreign assets relative to domestic loans.

C. Some Differences in Starting Points

Concepts, Experiences, and Laws

Market “awareness” and the balance of pro-market and anti-market attitudes varied widely among the countries. The more industrially advanced countries of Central and Eastern Europe, for example, had been actively engaged in trade and financial relationships with the Western economies in the years prior to World War II, and some relationships were sustained afterward. Their collective experience, consequently, included varying degrees of knowledge of market institutions and international financial practices. Active stock markets had existed in a number of countries, including Poland and Czechoslovakia. Remnants of private property also remained throughout the communist period—e.g., farmland in Poland, housing in

[16] Yugoslavia, in contrast to the other transition economies, had maintained a two-tier system throughout the communist period.
[17] The protection of property and creditor rights has been given additional impetus in the more advanced transition countries by the desire to adapt their legal frameworks to that of the EU in anticipation of accession.

Bulgaria, small shops in Yugoslavia. For many of the countries, however, particularly in the CIS, the most fundamental obstacle to financial sector reform at the beginning of transition was the almost complete lack of experience and understanding of the role of the financial sector and why independent, self-interested, and financially viable institutions were necessary to achieve it.

Accompanying this initial lack of a conceptual framework was the absence in all countries of the necessary legal and regulatory framework, including the recognition and protection of basic property and creditor rights and a judiciary prepared to enforce them.[18] Also missing were the individual technical and managerial skills required for market-based financial processes to function. The basic intermediation skills, information systems, and analytical techniques required for sound credit decisions, risk management, and regulatory oversight were largely non-existent, having been unnecessary under the centrally planned system. A *sine qua non* for a program of assistance for financial sector transition, therefore, was a well designed program from the start of the transition process combining intensive dialogue and dissemination of international experience regarding:

- The basic concepts of financial markets and institutions,
- The importance of public confidence in the legal framework defining and protecting property and creditor rights in a context of appropriate regulation and supervision, and
- The kinds of skills that would be required by the staff and managers of market-based financial institutions and the associated regulatory institutions, including the judiciary.

Geography and Politics

There were important variations also in the degree of geographical concentration of countries' external trade. The republics of the FSU were more completely integrated among themselves and economically isolated from the West than those of the CEE. The collapse of the USSR and CMEA thus impacted more heavily on the former. The CEE countries were better equipped by geographical proximity and prior relationships to adapt and redirect their exports to Western markets.[19]

Differences in political cohesiveness have also strongly influenced the course of transition. A highly polarized political/ideological debate and the rise of strong economic vested interests have been central characteristics of transition in the Russian Federation and elsewhere. Frequent changes of key government officials during most of the 1990s thus resulted in policy reversals and slowed progress in many of the key

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[18] As one ECA manager interviewed for this report noted, many countries started from a sub-zero base in this regard, with strongly anti-market attitudes, laws and regulations, and agencies that would need to be dismantled.

[19] Some observers argue that the West should have done more, at least in an advisory capacity, to slow the disintegration of the CMEA. (See, for example, Jan Svejnar, "Assistance to the Transition Economies: Were There Alternatives?" March 2002). Given the powerful centrifugal political forces involved, however, little could probably have been done in this regard.

aspects of economic reform. In contrast, a generally clear and consistent policy direction was maintained in the Baltic republics through most of the decade despite frequent changes of government. This continuity of policies gave credibility and momentum to the reform agenda. Internal armed conflicts in several republics of the former Yugoslavia, in the Caucasus, and in Tajikistan have disrupted the progress of reforms in those countries, as well as contributing to uncertainty and instability in neighboring countries. Ethnic, ideological, and regional divisions have also inhibited progress in a number of countries.

In some cases, more mundane differences, such as the level of government debt at the beginning of transition, may have affected reform choices. The relatively rapid progress of Hungary, for example, in large-scale privatization and in the application of bankruptcy procedures to loss-making enterprises may be explained partly by the high level of public debt and consequent urgent need for fiscal resources. A similar high-debt situation in Bulgaria, however, did not produce an equal rate of progress but did effectively limit reform choices.

IV. Variations in Country Approaches

Despite the broad similarities of their respective starting points and of the transformation path they had to navigate, the speed, sequencing, and method of financial sector and related reform measures responded to factors unique to each country. The issues and variations in approaches discussed below are those considered by the author to be the most important to the course of financial sector development. Their importance for the financial sector transition derives largely from their impact on the macroeconomic framework, on the incentives of enterprise and financial institution managers to behave in ways supportive of or detrimental to reform, and on the political acceptability of reform to the general public.

A look at the different approaches taken by different countries is germane not only to understanding better the transition process itself, but also to understanding the variations among the World Bank country assistance programs that were supporting these different approaches. It is difficult to discern, on the basis of a desk study, the extent of the Bank's influence on the different approaches taken. Bank strategy and loan documents are commonly written as having been derived in support of country-owned intentions and initiatives. This assertion is both politically correct and usually true. The pertinent questions concern whether the approaches supported by the Bank were appropriate to the objectives for which, and situations in which, they were carried out.

How well were the interrelationships outlined in Section III understood and taken into account in the formulation and implementation of reform strategies? How, for example, did the manner of changing enterprise and bank ownership affect the incentives of their staffs and managers? For the reformed system to work as intended, both borrowers and lenders would have to be subjected to hard budget constraints and the effective decision-makers held accountable for the results. Did public policy and the new mechanisms of corporate governance that were put in place make this happen?

Even where the ownership and management of enterprises and banks had been effectively separated, the dilemmas posed by their financial links were manifold. Banks were expected to become important sources of discipline and budget constraint on enterprises, refusing credit when repayment capacity was in question and thereby forcing the needed restructuring of potentially viable firms or the liquidation of those unsalvageable. In addition to the heavy social and political costs of cutting off financing to the enterprises, banks' own portfolios were already heavily laden with outstanding credit to these enterprises. The enforcement of credit discipline would thus throw their own survival into jeopardy. Were these perverse incentives recognized and dealt with?

The enforcement of hard budget constraints and market discipline ultimately depends on the real fear that failed enterprises and failed financial institutions will be liquidated. At the same time, the confidence of lenders to risk their funds depends on the adequacy of protection of creditor rights. Have the reform of the legal framework and its enforcement been adequately understood and coordinated with the rest of the reform process?

Finally, the political and social acceptability of the reform process, and of the ability of financial institutions to exercise their intended disciplinary role on enterprise restructuring, depended in part on how well transition strategies dealt with the necessary withdrawal of the enterprises from the provision of important social services and elements of the social safety net. As noted earlier, pre-reform SOEs bore heavy costs as a result of their social responsibilities, to the detriment of their market competitiveness, and part of the pressure on financial institutions to continue the support of failing enterprises can be attributed to the importance of the social role of the latter.

A. The Macroeconomic Framework and Financial Sector Development

Prudent and efficient financial intermediation requires a minimum degree of macroeconomic and political stability to provide a reasonable basis for assessing the future prospects of borrowers and their investments. The early years of reform, as noted above, however, were marked by collapsing demand with the demise of the CMEA, high and variable inflation, and frequent changes in economic leadership. The disappearance of export markets and rapid changes in relative prices, including interest rates, exchange rates, and energy prices, resulted in (or made apparent) the non-competitiveness of a large proportion of existing productive capacity, and threw into doubt the future viability of large numbers of enterprises.

Stabilization of the macroeconomic situation was complicated by the precarious state of public finances. Governments that had previously relied on enterprises for the bulk of their cash flows now faced exploding deficits, as revenues declined and spending pressures rose rapidly to meet growing social demands and appeals to keep loss-making enterprises in operation. Finance ministries desperate for revenues saw the banks as "cash cows" and resisted recognizing that the profits shown on bank books were the illusory results of distorted accounting systems. The taxes thus collected from the banks merely ate further into capital that would ultimately have to be replaced, usually by the government itself. *De facto* taxation of the banks also occurred indirectly, as the banks financed enterprise tax payments and social expenditures with subsidized credits and loans that could not be repaid.

Thus, a vital factor defining the possibilities and shaping the course of financial sector transition has been the respective countries' success in managing the macroeconomic shocks that accompanied the breakup of the old system. The impacts varied among countries, depending, *inter alia*, on their varying degrees of dependence on CMEA markets and sources of supply, endowments of energy and mineral resources readily exportable to the West, and access to foreign financial flows to smooth the necessary adjustment.

Table A.12 compares the annual inflation rates over the decade in the transition economies. Most of the countries followed the general pattern described earlier, with sharp inflationary surges following the initial liberalization of prices and loss of fiscal control, exacerbated in many cases by large monetary overhangs. The highest initial inflations were suffered in the FSU countries, including the Baltics, which were particularly hard hit by the loss of energy and other subsidies and by the breakup of the Soviet banking system and administrative controls. By the second half of the decade, however, practically all the countries had had substantial success in bringing inflation under control, the weakest performers in this respect being Belarus, Romania, and Uzbekistan. Albania, the Czech and Slovak Republics, Hungary, Poland, and Slovenia experienced more moderate inflation rates than the rest, indicating more effective monetary and fiscal policy responses, probably less price distortion initially, and in Hungary and Slovenia a somewhat more gradual approach to price liberalization. Bulgaria experienced more moderate inflation than other countries in the early years, but suffered its hyperinflationary surge in the banking crisis of 1996–97. In general and as expected, there has been a high positive correlation between countries' success in macroeconomic stabilization and their indicators of financial sector development. Albania is the principal exception in this regard, having achieved considerable success in stabilization with little progress in other sector reforms.

The importance of a stable macroeconomic framework was well recognized by the World Bank. Policy papers, economic reports, and country strategy papers all gave explicit priority to macroeconomic stabilization as a precondition for financial sector reform and for World Bank support to financial sector reform programs. The Bank's general policy of requiring that an IMF program be in place as a condition for adjustment lending assured close collaboration with the IMF and provided the framework for the integration of fiscal and monetary policy reforms with financial sector reforms. One important exception to the primacy given to the macroeconomic framework as a precondition for financial sector lending concerned Bank-financed credit lines through financial institutions. Explicit Bank policy notwithstanding, many such credit lines went forward in the face of considerable macroeconomic instability. Such operations tended to treat financial sector development as a secondary objective to the promotion of immediate production objectives. This issue is discussed at greater length in the section treating financial intermediary loans (FILs).

B. The Interrelationships Between Enterprise Reform and Financial Sector Reform

Reform of the financial sector was inseparable from reform of the enterprise sector. Enterprises could not be fully transformed into market-responsive and market-disciplined producers, so long as their principal sources of financing continued to be directed by the state. Nor could banks be transformed into commercially oriented financial intermediaries, so long as their principal borrowers were state-sponsored, protected, and subsidized. In a market economy, preoccupation with competitiveness and financial sustainability are the goading forces leading to efficiency and innovation, but this was not the culture of the centrally planned economy, in which there was no effective budget constraint on either enterprises or financial institutions, no fear of liquidation, and little sense of ownership and responsibility for the capital with which they were respectively endowed. Under these circumstances, managers would have little incentive to concern themselves with restructuring the enterprises to raise productive efficiency and the competitiveness of their products. Indeed, for many enterprise managers in the transition economies, the incentive after the collapse of central administrative oversight was to falsify the books, sell goods, raw materials, and capital equipment "out the back door," and otherwise appropriate enterprise assets for themselves.

Much the same can be said of bank managers. They were under increasing pressure from the central banks and finance ministries to report positive financial results, and the old accounting systems permitted them to do so by reporting as income the accruing interest on nonperforming and frequently rolled-over loans. Making new loans to traditional, loss-making customers was viewed by managers both as a responsibility and as preferable to denying them credit and thereby forcing explicit recognition of the insolvency of both borrowers and lenders. With both under state ownership, the expectations were good, in any event, that they would be bailed out by transfers from the state budget.

The principal factors that would shape the incentives of managers of both banks and enterprises were: (a) the speed and method of privatization, (b) the effectiveness of the budgetary constraints enforced on them, (c) the conditions placed on any funds provided for enterprise restructuring, (d) the effectiveness of bank prudential regulation, and (e) the efficiency and effectiveness of the legal framework for handling the exit of failed banks and enterprises. Each of these is discussed briefly below.

The Speed and Method of Enterprise Privatization.[20]

To many policy-makers, advisers, and observers, the privatization of enterprises and of financial institutions was expected to bring about almost automatically the desired changes in incentives. In many transition countries, however, privatization, especially of large enterprises and banks, turned out to be a long, uneven, and difficult process and frequently failed to break the traditional

[20] The discussion of the privatization experience and the Bank's role draws heavily from John Nellis, "The World Bank, Privatization and Enterprise Reform in Transition Economies: A Retrospective Analysis," The World Bank, 2002.

attitudes or the formal and informal interlocking relationships between financial institutions and enterprises.[21] Even where privatization has been rapid, incentives have been slow to change. Moreover, the lending decisions of financial institutions remained the target of intense political pressures. The withdrawal of financial support from obsolete and non-competitive enterprises would have, in many cases, major economic, social and political ramifications. Enterprises in most ECA transition economies, and particularly in those industries most threatened by market forces, were frequently the dominant sources of employment and income in their local economies, and key links in a supply chain that could not easily replace its output however inefficient its production might be. The dependence of workers and local communities on the enterprises for providing much of the social infrastructure and social safety net (e.g., housing, kindergartens, health clinics, pensions) further exacerbated the situation and put heavy pressure on financial institutions as well as governments to continue to direct resources to non-creditworthy borrowers.

In these difficult circumstances, countries have varied significantly in the speed and methods adopted in privatizing their enterprise sectors.[22] Most transition countries were quick to privatize small enterprises, particularly in the commercial and service sectors. Many small enterprises were also carved out from the non-core activities of larger state enterprises. Such asset transfers were usually effected through auctions or through quick sales to managers and employees, often on preferential terms and offering extended installments. The privatization of medium and large industrial enterprises, however, was more problematic and in most countries much slower. Different combinations of privatization methods were employed in all countries, but with significant variations in the relative emphasis given to the various methods.

Voucher Mass Privatization. A number of countries, most prominently Russia and the Czech Republic, quickly privatized large numbers of medium-size and large enterprises through mass privatization programs (MPPs).[23] Typically, vouchers were distributed widely to the population.[24] The vouchers could be used to buy company shares directly or to purchase shares in newly established investment funds, which in turn bought company shares. The principal motivations of reformers for such wide and rapid divestiture of the large enterprises were to ensure the irreversibility of the old system's demise, to break the links between politicians,

[21] The sheer magnitude of the task must be recognized as overwhelming. In each transition economy, there were tens of thousands, in some cases hundreds of thousands, of enterprises to be privatized. This compares to the 20 enterprises privatized by the Thatcher Government in the UK over a 10-year period, and to the 150 enterprises sold by the Mexican Government over six years in the 1990s.

[22] The focus in this section is on the privatization of industrial sector enterprises. The privatization of farms, agro-processors and distribution agencies was made even more problematic in many countries by strong ideological resistance to the privatization of land, the liberalization of land markets, and freeing of food prices. These issues are touched upon briefly in later discussion of World Bank rural credit lines. The privatization of energy monopolies and of public utilities is also not discussed here, although they are referred to later in the paper as alternative *de facto* channels of credit from the state to loss-making enterprises.

[23] Other countries adopting voucher mass privatization as the primary method were Armenia, Bosnia, Georgia, Kazakhstan, Kyrgyz Republic, Lithuania, and Moldova.

[24] In a few cases, vouchers were also provided preferentially to specific groups for specific objectives—e.g., to compensate for pension arrears (Bosnia), deposits lost in the breakup of the Soviet Union (e.g., Latvia) and of Yugoslavia (e.g., FYR Macedonia), or to benefit families displaced by civil war (e.g., Bosnia-Herzegovina).

bureaucrats, and enterprises, and to mobilize popular political support for the reforms despite their heavy short-term costs. Some advocates also believed that rapid privatization would curb the asset stripping of state firms that had already begun with the earlier devolution of responsibility to enterprise managers, and would reduce the power of both managers and workers to resist the restructuring and downsizing of enterprises.

Manager-Employee Buyouts. The most commonly used primary method of privatization was the manager-employee buyout (MEBOs), in which shares were preferentially made available to the current managers and workers of the enterprise.[25] The motivation was a combination of the desire for speed, social justice, and political expediency. Managers and workers were both politically powerful and the most fearful of the job and income implications of privatization, and the MEBO was in many cases considered essential to win over their support. In the particular case of the former Yugoslav republics, the MEBO essentially adapted the worker and manager ownership that existed under the concept of social property.

In practice, the outcome of MPPs and MEBOs were similar in many countries (e.g., Russia) because of the preference given to enterprise insiders in the distribution and application of vouchers. In any event, voucher-based mass privatization and manager-employee buyouts both suffered from a similar weakness—the lack of a controlling owner or group of owners with the ability and incentive to ensure the efficiency and long-term viability of the enterprise. Investment funds, in the case of MPPs, were expected to fill that role, but most lacked the fundamental skills required to manage or govern enterprises. Moreover, with no effective regulatory oversight of their management, many became mere vehicles for plundering enterprise assets and ignoring the interests of their own or independent minority shareholders. Ownership consolidation following MEBOs were often impeded by restrictions on the secondary trading of shares, the lack of institutional investors, and the control of share registries by firm managers. Most workers were principally concerned about the protection of their jobs, while managers were content to continue milking the remaining assets of the enterprise. The two together were able to fend off competing shareholder interests. Thus, MEBOs, like MPPs, broadly failed to provide the incentives necessary to bring about a proactive restructuring of the enterprises. Without capable strategic investors, the pressures for enterprise restructuring would, consequently, have to come from outside, either from the state or from the financial sector.

Case-by-Case Sales. Several countries—Bulgaria, Estonia, Hungary, Latvia, Poland, the Slovak Republic, and Tajikistan—elected to privatize most of their large enterprises on a negotiated case-by-case basis. They were motivated by a number of factors, including the desire to maximize the revenues from sales, to avoid the governance problems associated with the MPP or MEBO approaches and thereby improve the prospects for effective enterprise restructuring, or, less positively, simply to slow the privatization of important enterprises.[26] Within the case-by-case approach, there were important differences in the emphasis given to the speed of

[25] This was the primary method of privatization used in Albania, Azerbaijan, Belarus, Croatia, FYR Macedonia, Romania, Slovenia, Turkmenistan, Ukraine, and Uzbekistan.
[26] Negotiations were frequently prolonged, or investors discouraged, by government overvaluation of assets or by the introduction of conditions regarding, *inter alia*, the maintenance of employment levels, retention of product lines, and the commitment of new investments.

ownership transfer and the preference to leave restructuring to the new owners, vs. the desire to restructure first in order to enhance the enterprise's economic viability and sales value. In some cases—e.g., Albania, Bulgaria, and Estonia—priority was given at the beginning to the restitution of properties (or providing compensation) to their original owners. The identification and sorting of competing claims inevitably slowed the process. Varying levels of emphasis were also given to attracting reputable strategic investors. Hungary, in particular, sought early on to attract foreign strategic investors to break the traditional links between the enterprises and the entrenched public bureaucracy and to bring in new technology and managerial and marketing expertise. Interesting hybrid approaches were those of Estonia and the Kyrgyz Republic, both of which sought to assure majority control by strategic investors by reserving controlling shares for sale case-by-case, while opening up minority shares to voucher privatization.

Over the decade, successful enterprise restructuring was most associated with sales of controlling shares to strategic investors, and particularly to foreign strategic investors.[27] Hungary and Estonia pursued this approach most vigorously from early on, with other countries coming around to it over time. In several countries, including Russia and the Czech Republic, however, there was strong and continuing domestic resistance to foreign control of major enterprises. Moreover, the case-by-case approach was not without problems. The successful transfer of enterprise control to progressive new owners depended heavily on the honesty and transparency of the transactions. Russia, the Slovak Republic, and Kazakhstan carried out case-by-case sales in the mid-90s that were plagued by corruption and resulted in the concentration of key sectors in the hands of politically connected domestic oligarchs.[28]

The case-by-case approach was also inevitably slower than the other methods and allowed opponents of privatization, particularly existing managers, innumerable legal and political loopholes for delaying the process. Thus, the case-by-case approach also implied a longer period in which the control of major enterprises and the speed of their restructuring would remain in state hands or *de facto* in the hands of the traditional managers. In Estonia, the slowness of the privatization process was combined with rigorous budget constraints. Banks, in the meantime, were unwilling to lend until enterprise ownership and the responsibility for debts were clarified. As a consequence, many enterprises were pushed into bankruptcy. A number of governments—e.g., Hungary, Latvia. Moldova, Kazakhstan and the Kyrgyz Republic—sought to improve control over enterprise governance by centralizing the exercise of state ownership rights in a single agency or under a special committee. Controls remained weak in most cases, however, leaving the companies open to continued asset depletion and "tunneling".[29] An interesting exception was that of Poland, where strong worker councils provided close oversight of enterprise management.[30]

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[27] See: Simeon Djankov and Peter Murrell, "Enterprise Restructuring in Transition: A Quantitative Survey," *The Journal of Economic Literature*, September 2002.

[28] In the Russian case, the now infamous "loans-for-shares" program permitted powerful groups already controlling major banks to extend their control over major utilities and other key enterprises.

[29] Largely on these grounds, Nellis (*op. cit.*) concludes that, despite the evident flaws in the process, Russia is probably better off having privatized the great bulk of its enterprises, citing the Ukraine as the counter example of a country that has retained the greater share of its enterprise assets in state hands and finds itself even farther behind in reestablishing a sustainable basis for growth.

[30] *Ibid.*

The Speed and Method of Bank Privatization

In most countries, the initial stages of transition were marked by a rapid proliferation of new private banking institutions, taking advantage of still nascent legal and regulatory frameworks and loose licensing requirements. In some countries, nominally new banks were carved out of the old state banks, typically on a regional or subsectoral basis, with ownership often devolved to their borrowing enterprises. These banks were privatized indirectly by virtue of the privatization of their owner-enterprises. Most of these new banks were exceedingly small and undercapitalized, and many were nothing more than "pocket banks" for the enterprises or government agencies that established them. In some cases, they were owned by one of the old state banks and used to get around continuing administrative controls. In the former Yugoslav republics, socially-owned enterprises had typically owned the banks that served them, and this interlocking relationship continued after the formal privatization of the enterprises.

Despite the proliferation of new banks, banking activity continued to be highly concentrated in the old state-owned banks. State savings banks, by virtue of their extensive branch networks and the implicit or explicit state guarantee of their deposits, continued to account for the bulk of bank deposits. On the assets side, they invested largely in government bonds or made loans through the interbank market or through the central bank to the state-owned specialized banks. In most cases, the specialized banks were nominally commercialized and converted into joint stock companies. They moved also to diversify their lending operations, but their lending tended to remain highly concentrated sectorally and/or regionally, serving principally their traditional large SOE borrowers.

Virtually all of the old state-owned banks carried large burdens of nonperforming loans, most of them uncollectable, and were deeply insolvent under proper accounting standards. A few countries—Estonia, Latvia, and Russia—moved quickly to privatize their state banks without recapitalizing them. In most countries, however, the precarious financial condition of the banks made them difficult to sell to private investors, and there was concern regarding the perverse incentives inherent in the management of insolvent financial institutions. At the same time, it would be extremely expensive for cash-strapped governments to restructure them.[31] Many governments were also reluctant to sell important banks to foreign investors. With a few notable exceptions, consequently, the large state banks were not privatized until late in the 1990s. Meanwhile, repeated partial efforts, with very high fiscal costs, were made to restructure them and improve their performance. The failure of these efforts continued through much of the decade to be major sources of inflationary pressure in many countries.

Hardening Enterprise and Bank Budget Constraints

Without hard budget constraints and the real threat of liquidation in the event of insolvency, enterprise managers would have little incentive to make either the

[31] Even the liquidity of many of the state savings banks was tightly constrained, with their portfolios of government securities or deposits with the monetary authorities carrying below-market interest rates.

difficult short-term restructuring decisions or the longer-term investment, innovation, and marketing decisions necessary to ensure the profitability or increase the capital of their enterprises. By the same token, lenders knowing that their borrowers would be bailed out in the event of bad investment decisions, or that they themselves would be recapitalized in the event of losses, would have little incentive to expend effort and resources to ensure good credit decisions and careful risk management.[32]

Most transition economy governments, faced with intense budgetary pressures, moved early in the process to reduce or eliminate direct budgetary subsidies to the loss-making enterprises. Many governments placed specific limits on the amount of subsidization that could be funded from the budget and set out rigorous and transparent criteria for allocating them. In most cases, however, other channels of financial support, particularly to the large state enterprises, were opened or expanded. Although most governments did act to eliminate directed credits and credit guarantees, the state banks continued to be sources of new loans, while simultaneously rescheduling, rolling over, or effectively forgiving the servicing of old loans. Alternatively, they remained passive in the face of loan arrears and the difficulties and costs of pursuing claims through the judicial system. In some countries—e.g., Bulgaria—the central banks continued to be major sources of support to loss-making enterprises. The consequent growth of bad debt lacked the transparency of direct budgetary subsidies while building up contingent fiscal liabilities that would have to be met in any eventual bailout of the bank itself and/or its depositors.

To the extent that credit from the banking system was effectively tightened, this source of enterprise funding was often replaced or augmented by subsidies from, or arrears to, the state utilities, particularly the energy companies, as well as by arrears to the pension funds, the tax collectors, and to workers. In some countries, the total of interenterprise arrears and cross-subsidies among enterprises and between the enterprises and the state, sometimes hidden in proliferating barter arrangements, has exceeded the total volume of bank credit. Like the banks, the energy utilities and other suppliers eventually presented the bill for their unpaid receivables to the state. The governments in many cases simply magnified the moral hazard by funding, or ordering the central bank to fund, large-scale arrears clearance exercises. By 1996, after three such exercises had been conducted in Romania, the 150 largest enterprises reported losses during the first half of the year twice as high as during all of 1995 despite having been put under a regime designed to impose financial discipline. As in other countries, the large energy companies and other utilities were unable or unwilling to seek legal recourse, or to cut off supplies to their nonpaying customers.

[32] The absence of hard budget constraints also undercuts the disciplinary impact of price and interest rate liberalization on production and credit allocation decisions. If the enterprise manager has little concern for the impact of higher interest rates on the net income of his company, his expenditure and borrowing decisions will be little influenced by them. Bank managers, at the same time, will have little concern for the impact of interest rates on borrowers' abilities to repay. The lack of hard budget constraints thus also weakens the influence of monetary policy on aggregate demand. Partly for these reasons, many observers have argued that interest rates were liberalized prematurely. For the most part, however, governments in the ECA transition countries had little choice as rates became impossible to administer in the hyperinflationary conditions that prevailed in the early years of transition.

The enforcement of budget constraints on the loss-making enterprises was analogous to the proverbial balloon: the more one squeezed in one place, the more it bulged somewhere else. Most governments have found it necessary to take a more concerted approach to force the needed restructuring of both the enterprise and financial sectors.

Institutional Approaches to Enterprise and Bank Restructuring[33]

Bankruptcy. A proper bankruptcy framework serves important multiple objectives. It is, on the one hand, a vehicle through which creditors can pressure debtors to honor their obligations with the threat of forced restructuring or liquidation if they do not. It is thus a goad to the managers and owners of debtor enterprises to maintain their competitiveness in the marketplace and to honor their contracts. On the other hand, it provides debtors temporary protection from their creditors, during which they have the opportunity to reorganize themselves, reach debt rescheduling or other accommodations with their creditors and thus avoid more painful remedies. In this way, bankruptcy proceedings can avoid the premature liquidation of firms that can be restored to profitability. Equally importantly, a good bankruptcy framework provides a clear set of procedures and timeframe for these workouts to occur, and defines the relative priority of creditors' claims against the assets of the enterprise in the event of liquidation. It thus provides creditors at the time they make a loan a basis for assessing the costs they are likely to incur and the likelihood of recovering all or part of their loan in the event of a default. By reducing lender uncertainties, it makes possible greater credit flows to "arms length" borrowers than would otherwise occur.

Almost all countries acted early in the transition to introduce bankruptcy laws for enterprises. Hungary, however, was one of the few transition economies that acted forcefully to push failing enterprises into court bankruptcy proceedings to effect restructuring or liquidation. Under Hungary's 1992 Bankruptcy Law, an enterprise was required to file for bankruptcy when its loan arrears reached 90 days. Within two years, more than 5,000 bankruptcy cases and 16,000 liquidation proceedings had been submitted to the courts for resolution.[34] The burgeoning caseload far exceeded the court system's capacity, however, and the automatic trigger had to be abandoned. Nevertheless, strong incentives had been created to repay debts, and the process did achieve a substantial transfer of assets from the state sector to the private sector. On the other hand, the slowness of the process in the face of the heavy case backlog allowed managers to divert assets in the meantime. Many large loss-making enterprises, moreover, were able to avoid bankruptcy or restructuring by rolling over their loans from the state-owned banks and/or by accumulating tax and social security arrears.

In almost all countries other than Hungary, bankruptcy laws proved ineffective in promoting enterprise restructuring, and very few bankruptcies, particularly of large enterprises, occurred.[35] Where tested, the initial laws often proved unclear or

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[33] A review of the early restructuring experience and the methods used is presented in Michael Borish, Millard Long, and Michel Noel, "Restructuring Banks and Enterprises: Recent Lessons from Transition Countries," *World Bank Discussion Paper No. 279*, January 1995.
[34] *Ibid*.
[35] Where the threat of bankruptcy was credible, however, especially in the case of smaller enterprises with relatively few creditors, that threat itself may have spurred out-of-court settlements.

provided loopholes permitting long delays, and were repeatedly amended and refined. More difficult to remedy was the incapacity and/or unwillingness of courts to bring restructurings or liquidations to closure. In the meantime, firms continued to operate and generate losses under the control of the old managers. The liquidations and restructuring of large firms depended instead on administrative procedures that often lacked transparency and predictability. The result from the creditor point of view was the reluctance to seek recourse through bankruptcy, knowing that it would involve high costs and low likelihood of redress. As a consequence, bankruptcy did not yet provide a stimulus to enterprise restructuring in most of the transition countries. Instead, the lack of adequate bankruptcy processes undoubtedly reduced the incentive to lend, and hence the supply of credit to promising borrowers, and has caused lenders to raise interest rates to cover the high risk involved.

The bankruptcy threat for banks is also expected to provide a spur to efficiency and sound management. The possibility, however, that the loss of confidence in one bank could quickly spread throughout the financial system and bring on a serious economy-wide crisis requires that different rules and expedited procedures be applied. In the advanced industrial economies, the treatment of failed banks is typically administered in a summary fashion by the national banking authorities with the principal roles to be played by the central bank, the bank supervisory agency, and the deposit insurance agency. Nevertheless, clear rules and procedures are required to assure fairness and consistency, including definition of the ordering of claims against the assets of the failed bank. Suffice it to say here that bank bankruptcy rules and procedures are not yet well defined in most of the transition economies, and although the liquidation of banks, particularly small banks, has been common, the steps taken have largely been *ad hoc* and non-transparent.

Out-of-Court Restructuring. However carried out, the restructuring of large enterprises had to be implemented in conjunction with the restructuring of their banks. Writing off, rescheduling, or otherwise reducing the present value of the financial obligations of the enterprise meant a simultaneous writing down of the assets of the banks, and parallel steps would be required to either liquidate the banks or restore their solvency. At the same time, the prevention of future flows of bad debt would require parallel reorganizations of both enterprises and banks to establish the ability of the one to compete in product markets, and of the other to enact sound credit policies and practices, and to provide the necessary incentive to both to respond to market signals and discipline.

Bank-led Restructuring. Massive information gathering and analysis was required to form a proper technical basis for restructuring or liquidation decisions, and close monitoring was needed to carry them out. The courts, as noted, were not capable of undertaking this responsibility. In a few countries, responsibility for administering the restructuring/liquidation process was decentralized and assigned to workout units established by the banks (e.g., Poland, Bulgaria, and Slovenia). It was believed that the banks would be less vulnerable to political pressures than state agencies, had better information and ability to monitor the enterprises, and stronger motivation both to collect old loans and push borrowers to take the measures needed to assure their long-term competitiveness.[36] The Polish banks were prohibited from

[36] See: Fernando Montes-Negret and Luca Papi, "The Polish Experience with Bank and Enterprise Restructuring," *World Bank Policy Research Working Paper No. 1705*, January 1997.

making new loans to bad debtors, unless a conciliation agreement had been reached between the borrower and its creditors, while the recapitalization of the banks was tied to improvements in the efficiency of the latter, including loan collection. Although Polish banks were better equipped than those in most other transition countries to play a lead role in restructuring, the experience was ultimately mixed.[37] It was most successful among the stronger commercial banks, particularly those that were sold to foreign strategic investors. Many of the weaker banks, however, including the large specialized banks, lacked the skills required to lead the restructuring of large enterprises and continued to support their weaker clients, often assuming an ill-advised ownership role through debt-equity swaps.

Centralized Restructuring. The restructuring or liquidation of the loss-making state enterprises and insolvent banks would necessarily involve huge financial costs and have enormous economic, social, and political ramifications. Given the magnitude of the problem (number of enterprises involved, the size of the bad debt burden, etc.), the normal mechanisms of a market economy would, in any event, have been overwhelmed. Moreover, there was need to break the interlocking relationships between banks and enterprises and the perverse incentives they engendered. Most transition country governments concluded, therefore, that enterprise restructuring, particularly involving the largest loss-makers, could not be left entirely to the market.[38] Several different organizational approaches were adopted. A number of countries (e.g., Romania and Kyrgyz Republic) began by targeting a defined set of their largest loss-making enterprises and putting them under the jurisdiction of a centralized enterprise restructuring agency or asset management company (AMC). In some cases, the restructuring agency assumed actual ownership of the enterprise. Diagnostic studies of the enterprises' prospects and restructuring needs were undertaken, and additional financing to these enterprises, whether from the state or from the banks, was to be conditioned on the implementation of agreed restructuring measures. Failure to reach agreement on a restructuring plan or to meet its performance targets would lead to liquidation.

In Croatia, the banks were assigned the lead role in pursuing the restructuring of the enterprises but under the guidance, and in some cases the direct ownership, of the Bank Restructuring Agency (BRA), which was also responsible for the restructuring and privatization, or liquidation, of the large banks. The BRA required the banks under its jurisdiction to establish debt workout units and to seek restructuring agreements or other remedies with problem debtors. The BRA itself could also offer financing to enterprises in the context of restructuring agreements, but the total amount of financing it could provide was limited to its collections from problem assets.

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[37] See: John Bonin and Paul Wachtel, "Financial Sector Development in Transition Economies: A Retrospective on the First Ten Years," paper prepared for the Fifth Dubrovnik Conference on Transition Economies, June 25, 1999.

[38] Even in Poland, enterprises considered too important to fail were put under a centralized program and provided budgetary support contingent on restructuring progress. The Czechoslovak and Russian authorities, in conformity with their drive for rapid mass privatization, adopted early on a policy of divestiture without prior restructuring with the expectation that the private investment funds, as controlling owners, would play the principal restructuring role. As discussed above, the result for most of the decade was little or no enterprise restructuring at all.

In practice, the variations in enterprise restructuring methodology mattered less than the rigor with which the approach taken was implemented. The crucial differences were in the mix of discipline and encouragement given to both enterprises and financial institutions. Bank-led restructuring was most successfully carried out in Poland, which had the advantage of several strong financial institutions familiar with Western banking concepts and procedures and the skills needed to undertake the lead in restructuring. And, even though the privatization of large enterprises was slower than in some other countries, enterprise governance in Poland benefited from strong, independent worker councils that were concerned for the long-term viability of the enterprise and able to counter the shorter-term vision and opportunistic propensities of traditional managers. In most other cases, however, including those involving the weaker banks in Poland, restructuring plans were hesitantly enforced at best, and financial support continued with little improvement in management, operational efficiency, or market prospects.

Without strong political will on the part of the governments, the banks and AMCs were unable to move quickly against the entrenched interests that continued to resist either restructuring or liquidation, and they often became themselves alternative sources of financing for keeping uncompetitive enterprises afloat. In the case of the Czech Republic, even though the majority of large enterprises had been privatized through the MPPs, the banks remained under state ownership throughout the decade. Moreover, the banks controlled many of the major investment funds that had acquired enterprise shares and continued to provide funding irrespective of restructuring efforts.

In the end, as noted above, enterprise revival has principally been associated with privatization to strategic investors and, in particular, to foreign strategic investors. Meanwhile, the greatest dynamism in the enterprise sectors of most of the transition countries came from newly formed small and medium-sized enterprises. These were largely concentrated in the commercial and services sectors, however, and industrial production in the aggregate continued to lag.

Bank Restructuring. Regardless of the approach taken to enterprise restructuring, with a significant share of assets written off of their books (thereby formally recognizing the losses they had, in fact, already suffered) the banks themselves would also have to be restructured and recapitalized or liquidated. In a few countries, most notably Estonia and several Central Asian republics, governments moved insolvent banks quickly toward liquidation. Where banks and banking systems were very small, as in these countries, little systemic or political risk was involved in permitting failures. In the CEE and other Baltic Republics, however, most governments attempted to restructure the large banks and keep them afloat for political reasons as well as to protect the payments system and the stability of the financial sector. The stated objective, in most cases, was to make the banks attractive to eventual strategic investors. It was also believed that a restoration of the banks' capital would improve incentives for sound lending in the future.

Two principal approaches were taken to state-guided bank restructuring. In some countries (e.g., Kazakhstan, FYR Macedonia), state agencies were created to assume responsibility for collecting the outstanding loans (thus becoming a force for stimulating enterprise restructuring) as well as for assessing the financial condition and prospects of the banks under their jurisdiction and determining and overseeing for each bank the steps to be taken to either restructure and privatize it or to liquidate it.[39] The mandate might also involve, as in the Bulgarian case, the consolidation of a large number of banks. While under this regime, the banks' operations were formally put on a commercial basis, prudential regulations and supervision were strengthened, and they were progressively required to adopt international accounting standards and subjected to external audit. Alternatively, under the so-called "good bank/bad bank" approach, bad debts were carved out of "good banks'" balance sheets and shifted to a "bad bank" created for the purpose (Hungary) or selected from among existing banking institutions (Estonia). The mandate of the bad bank was to pursue collection of the transferred debts and force, through bankruptcy or other means, the restructuring of the debtors, while leaving the cleansed banks to focus on the improvement of their credit and risk management practices in the making of new loans.

Neither approach was, in general, very successful. The agencies did not succeed in collecting much of the outstanding debt, with the highest recovery rate reaching only 16 percent (Hungary).[40] In practice, inadequate accounting systems, lack of reliable information about the actual debt-servicing abilities of the delinquent borrowers, and the incentives of both borrowers and debtors to play with the numbers greatly complicated the process of identifying bad debts and estimating the amount of recapitalization needed. More seriously, the financial restructuring did not succeed in most cases to change bank cultures and credit policies. As in the case of enterprises, the tying of bank recapitalizations to performance was not effectively enforced, and the banks continued to lend to loss-making state enterprises and their own affiliated parties. In the case of FYR Macedonia, the Bank Restructuring Agency, rather than enforcing debt collection and enterprise restructuring, further loosened budget constraints by providing debt-equity swaps, thus becoming a passive owner of the enterprise, and by effectively forgiving debt by reselling it back at steep discount to the debtor.

The financial restructuring of banks was intended to restore their capital to the legally required level through additions to their assets and/or reduction of their liabilities. The new assets could derive from new capital contributions by current or new bank shareholders. More commonly in the transition economies, new assets came in the form of government securities used to replace nonperforming assets that were removed from banks' books and either written off outright or transferred to another agency for collection or eventual write-off. In some cases—e.g., Hungary—the government sought to enhance the quality of existing bank assets with guarantees. The fiscal costs of these measures were justified in part as belated recognition that the bad debts had derived in the first place from government-directed credit decisions. To prevent a recurring flow of bad debts, these recapitalizations were to be accompanied by operational restructuring, including the reorganization of administrative structures,

[39] In Bosnia, this role was assumed by the Ministry of Finance. For reasons to be discussed later, state savings banks were generally excluded from this process.
[40] See: Helena Tang, Edda Zoli, and Irina Klytchnikova, "Banking Crises in Transition Countries: Fiscal Costs and Related Issues," *World Bank Policy Research Working Paper No. 2484*, November 2000. This is about half the recovery rate achieved historically by collection agencies in the United States.

upgrading of credit policies and procedures, management information systems, etc., and sometimes by the replacement of managers.

The discussion above described the differences among the transition countries in their institutional arrangements for distributing the responsibilities for leading the restructuring effort among the banks, the state and the enterprises themselves. Another important difference has been in their willingness to invest public funds in the restructuring of the banks. As previously described, Estonia and the Central Asian Republics have been more reluctant than CEE and other FSU countries to commit fiscal resources to bank recapitalization and have been more disposed to simply closing insolvent or illiquid financial institutions. Differences in the approaches of those governments that did recapitalize the banks with public resources revolved around two issues: the adequacy of the initial recapitalization and the degree to which financial restructuring was accompanied by strong insistence on operational restructuring to prevent new flows of bad debt.

In several countries, most particularly Bulgaria and Hungary, the need for additional future recapitalizations was practically assured by the inadequacy of the initial recapitalization. In the Bulgarian case, the bonds issued covered only a portion of the bad debt and were made illiquid by below-market interest rates and the fixing of a minimum selling price. The recapitalization thus did little to restore banks' solvency or liquidity. In Hungary, the government provided only a partial guarantee for the inherited bad loans. Moreover, the credibility of the initial bailouts was reduced, and the potential moral hazard inherent in any bailout enhanced, by the failure of the governments and restructuring agencies to change the culture of the banks or their policies and operating procedures through effective institutional and operational restructuring. The government exacerbated the credibility problem in Hungary by repeatedly extending the coverage of eligible loans and debtors. In the Czech Republic, the credibility of loan consolidations was undercut by continuing government control of the major banks, the continuing equity interests of the latter in the loss-making enterprises, and implicit or explicit government guarantees to repurchase bad loans from the three loan recovery agencies at full accounting value. The result in all three cases was a continuing flow of bad loans and the need for repeated recapitalizations (four in the case of Hungary) over the decade.

The Role and Sequencing of Capital Market Reform

Stock markets emerged early in the transition, principally in response to the distribution of shares under the mass privatization programs. As noted earlier, the stock markets were expected to provide an important vehicle for the improvement of corporate governance, first by facilitating the concentration of shareholdings in the hands of entrepreneurial investors, and afterward by making it possible for new investors to acquire control over poorly performing enterprises. As their depth and efficiency improved, they were also expected to become sources of new investment financing to the enterprise sector, in competition with and augmenting the resources available from the banks.

The countries of Eastern Europe were the quickest to take steps to create (or recreate) their stock markets. Two quite contrary approaches emerged.[41] In the Czech Republic, the stock market was viewed first and foremost as a vehicle for expediting mass privatization, and the introduction of regulations and oversight to ensure transparency, etc. was considered both premature and a potential hindrance to the desired concentration of ownership through the investment funds. This strong *laissez faire* approach was modified only late in the decade, partly under pressure from foreign investors. The more conventional strategy was that of Poland, which moved before opening trading to establish the laws, regulatory principles, licensing requirements, disclosure standards, and an institutional framework consistent with the standards of the advanced industrial countries. It is probably not an accident that the additional time taken to put these elements in place ran parallel to Poland's more gradual approach to enterprise privatization. The approaches taken in most other countries have been somewhere in between these two extremes. In general, most of the countries have gone far to establish the legal and regulatory frameworks defined by international standards, but with very few exceptions, as reflected in the ratings in Table A.11, adequate enforcement by 2001 had yet to become effective.

As described in Section II, stock markets in the ECA transition market economies have generally remained small and illiquid, with only a few companies accounting for practically all of the trading.[42] Several factors account for the slow development, including the macroeconomic instability that inhibited financial development generally. The confidence of potential stock purchasers continued to be undercut by the absence of reliable information about the companies listed, inadequate transparency and regulation of the markets and intermediary institutions (brokers, the exchanges themselves, the depository and settlement houses, etc.), and the lack of effective protection of minority shareholders' rights. There also existed a vicious circle in that the small size and weakness of the domestic markets leads larger "blue chip" enterprises to seek capital abroad at lower cost, thereby depriving the local markets of important sources of liquidity. Finally, institutional investors—pension funds, life insurance companies, and investment and mutual funds—which account for a large share of stock holding and trading in the advanced industrial countries and many middle-income countries, were still quite small in the transition economies.[43]

Summary: The Parallel Reform of the Financial and Enterprise Sectors

The slow progress of enterprise sector reforms in the ECA transition economies during the period reviewed was strongly interrelated to the progress, or the lack thereof, of reforms in the financial sector. On the one hand, the banks and incipient capital markets had failed to play their expected roles of both goading and

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[41] See: Wieslaw Rozlucki, "Emerging Stock Markets in Central Europe: Where Do We Stand?", in Lajos Bokros, *et al., Financial Transition in Europe and Central Asia: Challenges of the New Decade*.

[42] In 12 of the 20 countries with stock markets, five or fewer companies accounted for 95 percent or more of all market turnover. See: Stijn Claessens, Simeon Djankov, and Daniela Klingebiel, "Stock Markets in Transition Economies," in Lajos Bokros, *et al*, *Financial Transition in Europe and Central Asia: Challenges of the New Decade.*

[43] The total assets held by institutional investors in Hungary and Czech Republic in 2000 was equivalent to 19 percent of their respective GDPs, the highest ratio among the transition economies. This compares to 27 percent in Brazil, 38 percent in Korea, 58 percent in Chile, 73 percent in Germany, 250 percent in the U.K. and 262 percent in the U.S. (*Ibid.*)

supporting the process of enterprise restructuring and growth. State banks and private banks that either owned or were owned by the enterprises themselves continued to channel resources to their traditional customers irrespective of the creditworthiness of the latter and the productivity of the expenditures being financed. At the same time, given the scantiness and unreliability of information available about unrelated enterprises, banks preferred the relative safety and high returns offered by government bonds. Crowded out of the market were the potentially more productive investments of the smaller enterprises of the newly emerging private sector. Good borrowers among the large enterprises were frequently able to borrow abroad more cheaply and in larger amounts than from the domestic banks. Consequently, the banking systems of most of the transition countries have failed to achieve the expected improvement of credit allocation. In many countries, this failure was reflected, in turn, in the banks' low profitability and the continued accumulation of nonperforming loans.

Small and illiquid capital markets played some role over the decade in facilitating the concentration of enterprise ownership, largely in the hands of investment funds or of corporate insiders. Nevertheless, lack of information and of an adequate legal and regulatory framework for the protection of minority shareholder rights precluded the capital markets in most countries from becoming effective channels for the financing of new investment or for stimulating the improvement of corporate management.

The strong interrelationship between progress in enterprise and banking sector reforms is evident in the high correlation found between the EBRD's ratings of banking reforms reported above in Table A.10 and its ratings of progress in enterprise governance and restructuring. With the exception of Bulgaria, all of the countries shown as middle or advanced bank reformers are also among the top enterprise reformers as assessed by EBRD' rating system, which gives heavy weight to "significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g., through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation)."[44] In the Bulgarian case, large-scale privatization and rigorous enforcement of hard budget constraints did not take off until after the political and economic crisis of 1996–97.

Although other factors were clearly important, it is also interesting to note that all of the countries but one (Tajikistan) that selected the case-by-case approach as their principal vehicle for the privatization of large enterprises are in the top two groups of financial sector reformers as categorized in Section II. To the extent that this form of enterprise privatization led to more rapid and effective restructuring of enterprises, it also encouraged and supported the more rapid reform of the financial sector. (A marked exception was the Czech Republic, which relied heavily and early on voucher mass privatization of its large enterprises. Although rated by EBRD among the countries most advanced in financial sector reforms, the CR suffered

[44] EBRD, *Transition Report 2001*. The cited passage sets out the criterion for receiving a "3" rating for governance and enterprise restructuring under the EBRD system. No country, as of 2001, had yet received a "4" rating, largely because of the weak roles being played by capital markets and the continuing lag in new enterprise investments.

serious corporate governance problems and lagged in enterprise restructuring throughout the 1990s.)[45]

C. The Interrelationships Between Enterprise Reform, Financial Sector Reform, and the Financing of Social Expenditures

As noted above, enterprises under the communist system bore financial responsibility for a wide variety of basic social expenditures, including, depending on the country, pensions, housing, primary health care, pre-school education, vacation and recreational facilities, etc. The costs of these services were, to some extent, financed by workers' acceptance of lower wages or from the general budgetary subsidies received from the state. They were also financed indirectly by arrears on the credits received from the state banks. To leave enterprises responsible for these services constituted a heavy tax on their future competitiveness and reduced their attractiveness to private investors. At the same time, it greatly inhibited labor mobility and compounded the social costs of downsizing or closing enterprises. In some cases, marketable services were hived off and privatized to newly formed small enterprises. A few transition country governments shifted the responsibility for housing and other services to local governments, but in most cases the latter lacked the administrative skills and tax bases for taking it on. As a consequence, the quality of such services seriously declined, or in some cases disappeared altogether. In other cases, their costs simply added to enterprises' arrears to the state, the pension funds, to the banks, and to suppliers.

V. World Bank Assistance to Financial Sector Reform

The World Bank, like other international and bilateral assistance agencies, faced an enormous task at the beginning of the 1990s to mobilize the resources and knowledge necessary to be able to offer credible support to the new member countries of Europe and Central Asia. Specific country knowledge in the Bank at the beginning of the 1990s was limited to Poland, Hungary and Yugoslavia, which were already members of the Bank.[46] Before tangible assistance could be provided, a whole new Department had to be formed and organized, financial resources mobilized, and technical and managerial staff recruited from within and without the Bank. Intensive consultations had to be initiated with the authorities of the countries themselves, most of which were undergoing their own internal reorganizations, restaffing, and priority-setting. There were strong international pressures on the Bank to move quickly before the analysis, strategy formulation, and vetting process normal to Bank country assistance programs could be carried out.

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[45] The Czech Republic was also one of the last countries in the CEE to privatize its major banks, completing the process only at the end of the decade. As late as 1999, the stock of nonperforming loans on the balance sheets of the banks and the bank restructuring agencies amounted to more than 1/3 of total bank assets, equivalent to 26 percent of GDP. This was one of the highest ratios in the Region. A World Bank report issued at the end of 2000 pointed to continuing problems of weak corporate governance attributable to the mass privatization program and the absence of strong capital market regulation. (See: World Bank, "Czech Republic: Completing the Transformation of Banks and Enterprises," Country Report No. 21440, November 2000.)

[46] Romania had also been an early member of the Bank, but relations had effectively been broken off since the early 1980s, when the Government made a unilateral decision to prepay all foreign debt. Yugoslavia at the start of the 1990s was itself in the midst of political breakup and civil conflict.

The assistance strategies and programs in almost all the countries gave high priority to reforms in the financial sector, and the response was exceedingly rapid. Three World Bank loans containing financial sector elements had been made to the existing ECA transition country members in 1990. Over the next two years, a total of 17 such loans were made, of which 9 were to new members.[47] Lending with financial sector objectives during this early period was concentrated in the CEE, with the exception of two loans to Russia and one each to Armenia and Estonia. During 1993–95, the financial sector lending rate averaged 16 per year, doubling to a peak of 34 loans in 1996 before tapering off gradually over the rest of the period.. The following sub-sections will review the financial sector reform strategies pursued as illuminated by the country strategy papers, the Bank's policy papers and country economic and sector work, and its lending operations.

A. Country Strategy Papers

Initial country strategies, with few exceptions gave high priority to financial sector reform as a central element of the overall transition process.[48] In a few cases—e.g., Azerbaijan and Kyrgyz Republic—the financial sector entered the discussion largely in the context of the need to develop rural credit mechanisms, but most country strategies treated FSD more broadly and as a core issue of transition. In most countries, financial sector reform remained a priority element in the assistance strategy throughout the decade, reflecting not only its perceived importance but also the gradual nature of the progress being made. In some country programs, the priority attached to FSD was reduced in later country strategies, either because the job was perceived to have been largely completed (e.g., Hungary, Poland, and Kyrgyz Republic),[49] or, apparently, because of discouragement regarding progress (e.g., Romania, Russia, Uzbekistan). In several other programs (e.g., Kazakhstan, Lithuania, and Macedonia), it was indicated that primary responsibility for supporting future financial sector work was being assumed by IFC and/or EBRD.

Country strategy papers provide good background for understanding the evolution of assistance programs and about specific proposed "flagship" operations, and also set out the main country performance "triggers" that would determine the magnitude of the Bank's assistance effort in the period ahead. Country strategies typically referred to a specific three- or four-year programming period. Their discussions of the specific lending and non-lending activities that were planned vary widely in the detail provided, in their elucidation of the underlying rationale for the particular approaches adopted, and how specific elements in the program might fit in a strategic sequence of related interventions. Although interesting as summary statements of the country team's collective thinking about priorities, they do not

[47] All references in this report are to calendar years, rather than World Bank fiscal years. A lending "timeline" showing the financial sector operations by country and year is available on request.
[48] There was no country strategy during the period for the Czech Republic. The late 1990's country strategy for Belarus simply reported continued general lack of dialogue, agreement and program. The mid 1990's country strategy for Latvia included financial sector development among five priority areas, but assigned principal responsibility for the sector to IFC. The mid 1990's country strategy for Moldova noted only the need for improved banking supervision and the shortage of credit for private sector enterprises. Finally, the late 1990's country strategy for Turkmenistan reported a dialogue that was just beginning and focused on macroeconomic stabilization, infrastructure and social programs.
[49] A judgment that turned out in this last case to be excessively optimistic.

capture the full scope of the Bank's interventions and the analyses that lay behind them.

Banking regulation, supervision and restructuring were each indicated as priority objectives in about half of the country strategies that gave significant attention to financial sector reform. The privatization of state-owned banks was highlighted in slightly fewer than half of the strategy papers, receiving somewhat more attention in later country strategies than in initial ones, suggesting that country teams (and their country counterparts) might not have considered the time ripe earlier. Fewer than a third of the country strategies gave mention to the need for legal reforms in support of FSD, which contrasts with the attention to this topic in policy papers and the substantial support actually given in the lending programs. Only about one-third of country strategies gave priority to capital market development. This priority tended to be accorded principally in initial country strategies and was given diminishing importance over time. It is noteworthy that only 3 of the 46 country strategies reviewed mentioned the critical need to develop banking and supervisory skills

Half of the initial country strategies clearly set out the importance attached to financial sector issues in the larger reform context and interrelated to the restructuring and privatization of the enterprise sector. The mid 1990's country strategy for Croatia was extensively dedicated to this interface. About two-thirds of the initial country strategies emphasize the need to strengthen banking sectors as channels of needed credit to the real sectors, and in several instances this appears to have been the only reason for giving the financial sector strategic prominence. Notably, this emphasis of credit lines declined markedly in follow-up country strategies. Virtually all country strategies focused on the need to ameliorate the social costs of reform, with particular attention to employment services, unemployment insurance, pension reform, and support for the most vulnerable groups. Only two country strategies, the mid 1990's country strategy for Uzbekistan and the 2000 country strategy for Ukraine, treated specifically the problem of transferring the social expenditure responsibilities burdening the enterprises. Eight country strategies explicitly linked the need for judicial modernization and reform to financial sector development, this awareness increasing over time.

B. Policy Papers and Economic and Sector Work

From the start of transition, World Bank policy papers and economic and sector work played a lead role worldwide in the analysis of transition issues and policy options. Although only three of the transition countries were active members of the Bank in 1991, a substantial body of knowledge of the generic issues of transition had been built up in that work and from work in socialist countries outside the ECA region, most particularly China. A major "catch-up" effort vis-à-vis the ECA countries was initiated in the second half of 1990, when, with growing expectations that the Soviet Union would apply for membership in the IFIs, the Houston Economic Summit requested that the Bank, Fund, EBRD and OECD undertake a detailed study of the Soviet economy and make recommendations for reforms to be supported by Western economic assistance. That report set out most of the issues and interrelationships discussed above (extending also into other sectors and policy areas.)[50] The ECA Region, preparing itself for a major assistance effort, moved quickly to build and organize a substantial pool of expertise to deal with enterprise and financial sector issues, which were seen from the beginning as central to the economic transformation.

Some 41 specific country-focused reports have been reviewed for this paper, about half of which were financial-sector specific, and the rest containing broader coverage of the reform agenda but with substantial chapters dedicated to the financial sector.[51] The greatest attention in these reports is given to country banking sectors, while a few are focused on capital market development, local government finance, or rural finance. One cannot fairly evaluate the impact of the Bank's analytical work solely on the basis of the formal economic and sector reports. In addition to the informal work that has not been reviewed, a considerable amount of financial sector work was also carried out in the course of preparing lending operations and was not separately published from the loan documents themselves. Moreover, many of the same staff were involved throughout the decade in country strategy dialogues across the Region, both within the bank and with the countries, in the design of specific operations, and in monitoring, evaluating, and drawing lessons from the results. They were contributing their accumulated knowledge and experience to the discussions of issues and options, whether or not they were committing it to paper in each case.

It may nevertheless be worth noting that only 12 of the 41 country reports treating financial sector issues were completed during the first half of the decade (i.e., through 1996), as compared to more than half of the lending operations with financial sector components. Indeed, 20 of the reports were issued after 1998, several of them inspired by the Asian financial crisis and concerned about the potential similar vulnerability of financial systems in the ECA Region. A few others were contained in broader reviews of country readiness for EU accession. It is surprising also how late in the decade the first pieces of formal financial sector work appeared for some countries—e.g., Armenia (2000), Georgia (1999), Kyrgyz Republic (1999)—where substantial Bank interventions in the financial sector had already been undertaken. No dedicated formal financial sector work at all was found for Albania and Poland, despite 15 loans and 10 loans, respectively, identified as having been aimed at least partially at financial sector objectives.[52] Some 18 loans with financial sector components were made in Bosnia-Herzegovina without any formal ESW. These were mainly small credit line operations, but also included a major adjustment loan in support of bank and enterprise restructuring.

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[50] See: IMF, World Bank, OECD and EBRD, *A Study of the Soviet Economy*, 3 volumes, February 1991.

[51] Not included in this count or the discussion that follows are the FSAP reports that have recently been done jointly with the IMF for several of the ECA transition economies. As noted earlier, the coverage of ESW in this report is limited by the difficulty of identifying the large body of informal work that was done, as well as financial sector work included in Economic Memoranda and other broader-scope reports. Analytical work that may have been carried out by IFC or available to Bank staff from other sources are also not covered in this report.

[52] The count for Poland includes 5 loans made during 1990-91. OED Country Assistance Evaluations have specifically criticized the programs in Albania and Kazakhstan for the insufficiency of ESW. And, although the Polish EFSAL was considered in many respects to be "state of the art", it is also cited for the inadequacy of prior knowledge of the financial sector. According to the 1997 CAE for Poland, a major financial sector mission returned to Washington in August 1994 but was told to stop work on its report because of limited lending prospects and to shift its attention instead to Croatia.

Although usually intended as a precursor to a lending operation, ESW in the Region has in some cases been carried out as a stand-alone product. This was explicitly the case, for example, for recent reports on the Czech Republic and Slovenia. The value of ESW, in any event, is not limited to its contribution to the quality of the Bank's lending operations. Its greatest potential value comes in the advice it provides to member governments and the contribution it makes to theirs' and their constituents' understanding of the problems and issues that need to be confronted, the options available, and the lessons that might be learned from similar country experiences elsewhere. The cause-and-effect relationships are virtually impossible to draw, given all the factors and unknowables involved. It does appear, however, that the effort made by the Bank to disseminate the results of its analytical and advisory work beyond the narrow group of counterparts that may have requested it has varied widely among countries and over time. Some OED reviews highly praised country teams' dissemination efforts and credited them for having contributed significantly to subsequent reform progress (e.g., Lithuania), while in other cases (e.g., Russia) the lack of such effort is criticized.[53]

In general, the pertinent policy papers and ESW reports reviewed for this paper were of very high quality, and the issues and options involved in financial sector development were well understood and clearly set out. Although recommendations with respect to specific approaches sometimes differed (see below), a basic and widespread understanding quickly formed with respect to the essential elements of financial sector transition, and these elements were repeated in almost all the Bank's programs in ECA in which active programs and dialogues have been sustained.[54] In all the papers reviewed, emphasis was given to macroeconomic stability as a precondition for healthy financial development. Priorities also included modernization of the payments system, early establishment of the basic legal framework essential to establish and protect property rights and creditor rights, and the authority of the central bank to determine and manage monetary policy and to regulate and supervise the licensing and conduct of the deposit banks. The coverage and content of the key prudential banking regulations recommended, and the needs for developing an independent and effective supervision agency, were generally consistent with international practice, with particular emphasis placed on minimum capital requirements, capital adequacy ratios, and limits on concentrated and insider

[53] The Bank's attitude towards the dissemination of its analysis and advice and its role in informing public debate has evolved considerably over time. For many years, reflecting the sensitivities of client governments themselves, staff were guided to limit their contacts outside the executive branch to information gathering, except as they may be encouraged by the government itself to discuss issues with a wide audience. In recent years, the Bank has taken a more proactive role around the world in engaging legislatures, judges, local governments, and civil society groups in the discussion of reform issues.

[54] Bank assistance programs in the financial sector have, for varying reasons, been minimal in Belarus, the Czech and Slovak Republics, Estonia, and Turkmenistan. In the first and last of these, only single technical assistance loans were made, reflecting the virtual absence of policy dialogue. In the Czech case, the Government was disinclined to borrow from the Bank, although a dialogue was maintained throughout the period. With regard to the Slovak Republic, policy differences held up lending through most of the decade, and the dialogue was intermittent.

lending.[55] Capital markets analyses and recommendations principally focused on the legal and regulatory framework and infrastructural needs for efficient markets. Recommendations tended to vary only in terms of the relative urgency to be given to the capital markets in the overall development of the sector.

Nevertheless, there have also been some significant differences of view and advice with regard to the approaches to be taken to some of the major issues set out above. The discussion follows the order of their discussion in the previous Section.

The Method of Enterprise Privatization

Early in the transition process, the World Bank was an enthusiastic supporter of rapid mass privatization as pursued from the outset in Russia and Czechoslovakia. While Bank staff maintained an active dialogue with the Czech authorities, there was no tangible support given to the process (largely because of the CR's unwillingness to borrow from the Bank). However, the Bank provided active support to MPP programs in other countries, most notably in Russia,[56] and widely touted the Czech approach (e.g., in Croatia and Kazakhstan). It was recognized that there were serious risks accompanying widely dispersed ownership of an enterprise without the involvement of a strategic controlling investor. There was concern that the dominance maintained by managers and workers in the buyout process would result in sustained resistance to needed enterprise restructuring and would constitute a strong lobby for continued state subsidization of the loss-makers. It was further feared that managers, unrestrained by effective owners or legal protections for minority shareholders, would be able to accelerate the "tunneling" of enterprise assets already begun in the final years of central planning. Offsetting these concerns, however, were expectations that capital markets would act fairly quickly to concentrate ownership in the hands of entrepreneurial investors, that trade liberalization and increasingly commercially oriented banking sectors would force needed enterprise restructuring and management changes, and that new shareholders would play active roles in lobbying for the legal and regulatory changes required to make all this happen.

By the second half of the 1990s, most Bank experts were acknowledging that their initial concerns regarding the enterprise governance issues associated with mass privatization and MEBOs had been validated by experience, and that they had been overly optimistic regarding the hoped-for offsetting factors. While a positive supply response was coming from new private enterprises and from enterprises that had been sold to foreign strategic investors, the medium-size and larger enterprises that had been rapidly privatized to insiders and/or dispersed owners had been painfully slow to restructure. The extent of asset plundering in the Czech Republic and elsewhere was

[55] There was some variation among reports, however, in the details—e.g., the target level for the capital adequacy ratio (most referring to the 8-percent Basle standard, but some advocating a higher level in recognition of the higher risks in the transition economies) and the timetable for getting there (some recommending that the Basle standard be applied from the time of initial bank licensing, others proposing a phased approach towards reaching it). In general, international standards were themselves becoming more rigorous over time, partly reflecting financial crises and manifestations of corruption and abuse in the increasingly globalized world economy. Bank ESW likewise gave increasing attention to these concerns over the course of the decade.

[56] Nellis (*op.cit.*) reminds, however, that the 4-agency report on the Soviet economy in 1991 explicitly counseled against mass privatization because of the problems inherent in dispersed ownership.

increasingly coming to light, and many privatized enterprises remained inefficient, uncompetitive, and dependent on implicit or explicit subsidies for their survival.[57] Seriously underestimated was the extent to which the gainers from early reforms would become powerful sources of resistance to subsequent reform. Bank staff never had much intellectual sympathy with the MEBO, and favored cash auctions for the privatization of smaller enterprises. However, the MEBO was generally accepted as the only feasible way to quickly transform the ownership of tens of thousands of small firms that, in any event, were unlikely to continue to receive substantial subsidies and did not represent significant "systemic risk". With regard to large enterprises, the Bank shifted its support to case-by-case privatization with strong emphasis on the equity and transparency of the process and on attracting foreign strategic investors.

The Speed and Method of Bank Privatization

As described in Section III, many of the former state banks were effectively privatized by virtue of the privatization via vouchers or MEBOs of the enterprises that controlled them. A principal concern, therefore, was how to break these ownership links between borrowers and lenders and the perverse incentives that accompanied them. With regard to the banks that remained under state control, the chief concern was ending government interference in lending decisions.

Views within the Bank regarding bank privatization appear from the papers reviewed to have been less varied than in the case of enterprises. This greater convergence of views may perhaps be explained by the larger relative importance and systemic risks represented by major banks. Where the privatization of banks was to be pursued, the advice fairly uniformly was to concentrate ownership in the hands of strategic investors, with a particular preference for reputable foreign banks, both to assure independence and commercially-based incentives and to bring banking expertise and technology. It was also expected that foreign banks were less apt to take advantage of weak supervisory systems for fear of damaging their reputations. The differences in views and advice given had more to do with: (a) whether or not to privatize the large state banks, as opposed to liquidating them or allowing them to wither away in relative importance while focusing on the development of healthy private banks, and (b) if to privatize, how quickly?

While a 1993 banking sector study for Russia recommended that the large specialized banks be restructured in preparation for eventual privatization, the Bank's country strategy gave little attention to the state banks. Instead, it focused as the

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[57] Debate within the Bank became increasingly rancorous. Articles published as late as 1997 by the Private Sector and Finance Team of ECA/MENA, based on a data set for large enterprises, concluded that rapid enterprise restructuring was resulting from the new incentive framework that derived from voucher mass privatization programs, and that these positive developments were particularly evident in the Czech Republic, where ownership had concentrated in the hands of bank-controlled investment funds. (See: G. Pohl, S. Djankov and R. Anderson, "Restructuring Large Industrial Firms in Central and Eastern Europe: An Empirical Analysis," World Bank Technical Paper No. 332, August 1996; S. Claessens, S. Djankov, and G. Pohl, "Ownership and Corporate Governance: Evidence from the Czech Republic," World Bank Policy Research Working Paper No. 1737, March 1997; S. Djankov and G. Pohl, "The Restructuring of Large Firms in Slovakia," World Bank Policy Research Working Paper No. 1758, April 1997; and G. Pohl, R. Anderson, S. Claessens, and S. Djankov," Privatization and Restructuring in Central and Eastern Europe," World Bank Technical Paper No. 368, August 1997.) However, other Bank staff, whose views came to prevail, strongly questioned the quality of the data and assumptions on which these conclusions had been based.

"centerpiece" of its strategy on creating the nucleus of a healthy private banking sector that would gradually, through competition, win business away from the traditional banks. It would do this by providing a subgroup of selected private banks special incentives and assistance, while also subjecting them to more rigorous prudential standards. A similar program to create "international standards banks" was recommended in a 1995 report to be the core of the financial sector strategy for the Ukraine. A 1997 report for Azerbaijan recommended categorically that any state bank not privatized within 18 months should be liquidated. An exception was made, however, for the state savings bank, which was needed to ensure the continued provision of payments services and the safety of household deposits.[58]

In contrast, a 1994 economic report for Kazakhstan and the 1990'sAlbania country strategy both recommended that the privatization of state banks be carried out gradually only after sound regulations and banking supervision were in place. And a 1996 report on Latvia pointed out as one of the important lessons learned the usefulness of maintaining state banks as a source of strength to the system in the event of a banking crisis. It noted, however, that this was only possible if the bank had strong management and was relatively free from political interference.

Hardening Budget Constraints

The importance of budget constraints for achieving the desired supply response from transition reforms was emphasized in Bank reports from the beginning. Particular emphasis was put on the elimination of budget subsidies and credit directed to loss-making state enterprises, both because of their perverse incentive effects and because of their contribution to macroeconomic instability. The elimination of credit subsidies generally was also an early objective of bank assistance programs because of their detrimental impacts on resource allocation, bank income and balance sheets, and the building of sustainable credit flows to target groups or activities. The growing importance of interenterprise arrears and arrears on taxes, pensions, and wages, as well as the subsidies hidden in barter arrangements, were also recognized in many early policy and ESW reports. Their significance as a vehicle for evading budget constraints was well perceived, but the Bank was slower to recognize the direct implications for the development of the financial system. In its simplest terms, who would apply for an interest-bearing loan from a bank, if the alternative of unilaterally borrowing free from your suppliers, without fear of recourse, were available?

Bank and Enterprise Restructuring

The need for adequate enterprise bankruptcy laws and their enforcement was a constant and consistent theme in the Bank's financial sector policy papers and country ESW. Less attention was given in the reports to the procedures for the resolution of failed banks. A significant exception was the 1997 banking sector report for Russia, which provided detailed legal analysis and proposals for failed bank resolution. More generally, the advice given in mission work and technical assistance activities appears to have been consistent and based on the experience of banking authorities in the Western industrial countries.

[58] The Russia and Ukraine reports previously cited also recommended preserving the current role of the respective state savings banks for the same reasons.

World Bank staff early in the transition process generally preferred market-based, decentralized approaches to enterprise restructuring, leaving the decisions and investments involved to new private owners, the banks, and the capital markets. The desire to put these decisions on a market basis, after all, lay at the heart of the urgency given in Bank-supported programs to the rapid imposition of hard budget constraints, privatization, commercially oriented financial institutions, and enactment of bankruptcy laws. This stance was being questioned by 1994, however, in the face of local banks' limited capacities to lead the restructuring process and the risk of diverting them from their principal task of efficiently allocating new credits.[59] There was also growing concern that the privatization of banks to unsophisticated investors and without prior restructuring and recapitalization would only lead to the need for further government intervention in the future.[60] Nevertheless, a 1995 financial sector report for the Ukraine advised that government-funded recapitalizations of former state-owned banks should be avoided if at all possible. Instead, they should be given access to standard legal procedures for the enforcement of creditors' rights as the means to collect on the loans that remained unpaid. A similar stance was recommended by a 1997 report for Azerbaijan. In any event, advice in favor of the decentralized approach was widely rejected. Most Bank advisors recognized the weaknesses of markets and institutions in the transition economies and adopted a pragmatic approach to finding appropriate interim solutions.

Other Issues

It is worth mentioning a few other issues on which Bank policy advice has varied, if only to illustrate the difficulty of the issues and the legitimate range of views. One of these responded to the rapid proliferation of new private banks that occurred in most of countries at the start of transition. As described above, a large proportion of these banks were weak, undercapitalized, often captive to the enterprises that created them, and in some cases outright corrupt. Considerable energy and supervisory attention was given in the ensuing years to weeding out the weakest of these institutions. A 1991 four-agency report on the Soviet Union expressed alarm at the rapid entry of questionable banks and strongly advised that the authorities tighten licensing restrictions at the cost of slowing entry in order to assure a stronger banking sector. In a similar vein, 1997 information for Azerbaijan showed that it was easier to minimize the number of problem banks by rigorous screening at the point of entry than to use scarce resources to deal with problem banks later. It also pointed out the trade-off between spurring competition among banks and maintaining the profit base needed by banks to invest in improved skills and technology.[61] In contrast, a Bank paper commenting on the early Russia experience, argued that a simple process was needed that accepted imperfect regulation and supervision, and that the systemic risks were manageable so long as the banks were

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[59] See: Millard Long and Izabela Rutkowska, "The Role of Commercial Banks in Enterprise Restructuring in Central and Eastern Europe," World Bank, February 2, 1995.

[60] The privatization of unrestructured banks to sophisticated investors was also not without problems. The IPB bank in the Czech Republic had to be re-intervened, cleaned up at great fiscal cost, and re-privatized three years after its ill-advised sale to Nomura of Japan.

[61] Other financial sector experts referred frequently to the importance of maintaining bank "franchise values" to preserve the desired incentives underlying credit decisions.

small and numerous.[62] Opting to give greater weight to competition, a 1995 Bank paper argued that "strengthened bank supervision capacity and willingness to allow bank failures may provide some needed stability without creating obstructive barriers to entry."[63] In practice, the Bank could have very little influence over the rapid, spontaneous creation of new banks that occurred. It was, however, influential later in helping a number of governments and central banks to undertake programs of recertification of banks and to introduce higher minimum capital requirements and other measures to force needed consolidations of the banking system.

An issue that does not appear in many of the reports reviewed is that of deposit insurance, probably reflecting the widespread ambivalence of financial sector experts in general on this topic. On the one hand, some form of deposit insurance was thought important to give savers confidence in the banking system and thus to promote financial intermediation. On the other hand, evidence had grown over recent decades that deposit insurance beyond a minimum level of protection created serious moral hazard that encouraged reckless lending behavior by banks. Many insurance schemes around the world, moreover, had been inadequately funded for the risks inherent in the system and had to be bailed out at great fiscal cost to governments. The Bank consequently tended to recommend, as in a 1995 report for Ukraine and a 2000 report for the Kyrgyz Republic, that deposit insurance schemes be treated as long-term objectives to be introduced when other reforms were in place and the banks were strong enough to give it credibility. Nevertheless, the introduction of a deposit insurance scheme was made one of the conditions of the Ukraine FSAL, and adequate funding of the deposit insurance scheme was set out as one of the triggers for base case lending in the 1999 Croatia CAS.

Summary

Over the past decade, the World Bank, along with the other IFIs, donors, academics has been seeking to support structural changes of unprecedented speed and dimension.[64] Learning by doing was an inevitable part of the process, and throughout the Bank provided considerable intellectual leadership in drawing the relevant lessons and adapting approaches accordingly. The transition process itself gave a major boost, in the Bank and elsewhere, to recognition of the importance of institutions in economic development and in the proper functioning of the market economies. That views have differed and evolved over time is to be admired.

It should nevertheless be acknowledged that some key issues were not given the attention they deserved in the early years of transition and would come to haunt the process. In particular, the issues of corporate governance and managerial incentives, although recognized in some of the earliest policy papers, were later downplayed or ignored in the policy advice given and the programs undertaken. This was the case, for example, with regard to the enthusiasm for mass privatization and to reliance on bank-led, market-directed solutions regarding enterprise and bank restructuring. Similarly, although the problem of interenterprise arrears as a means of

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[62] Gerhard Pohl and Stijn Claessens, "Banks, Capital Markets, and Corporate Governance: Lessons from Russia for Eastern Europe," World Bank Policy Research Working Paper No. 1326, July 1994.
[63] Michael Borish, *et al, op.cit*.
[64] Top Chinese officials have aptly referred to their own often more cautious efforts in this regard as feeling their way across a dark, fast-moving stream with a rocky bottom.

enterprise subsidization and soft budget constraint was recognized early, it was not until late in the decade that this alternative means of easy financing was recognized as a major obstacle to the remonetization and re-intermediation of the economies and development of the financial systems.

Although the Bank was a leader in analyzing the interrelationships between banking sector and enterprise reform, and in developing comprehensive programs for reforming the two sides of the "balance sheet" in parallel, the interrelationships were largely ignored in some of the major analyses and assistance efforts. This was particularly true in Russia , where the early rapid privatization of both banks and enterprises apparently obscured the continuing ownership interlocks and accompanying governance issues that undercut the preferred reliance on private operators to realize the desired real sector restructuring and credit reallocations.

There have been strong differences of view within the World Bank and elsewhere regarding the priority that should be given to stock market development, particularly early in the transition process. Some early papers gave undue and overly optimistic emphasis to capital market development as a principal vehicle through which corporate governance would be rationalized, and enterprise restructuring would be disciplined and financed. The need and time required to develop an adequate legal and supervisory framework and market infrastructure were widely recognized, but it was too facilely assumed that putting shares in the hands of millions of inexperienced (and often befuddled) stockholders would create irresistible pressures to put in place the regulations, accounting standards, and other infrastructure necessary to give these markets the integrity, transparency, and liquidity necessary for them to play the expected role. That view had many skeptics, however, including the Bank's Chief Economist during much of the decade. They argued that capital markets functioned imperfectly at best, and that without the necessary oversight and requirements for reliable information disclosure, would be extremely vulnerable to fraud and resource misallocation. While the prevailing view has continued to be that capital market development is an important aspect of financial sector transition and important to long-term economic growth, later policy papers and country studies tended to downplay the attention given to capital markets and to treat them as a longer-term objective to be pursued after the banking system had been put on a solid base.

Finally, in more general terms, the Bank shared the excessive optimism of many early reformers and Western observers about the speed with which economic liberalization and legal and policy changes would produce robust supply responses, and consequently about the depth and length of the initial declines in output and employment and the related social costs and political turbulence. Country strategy papers consistently listed among the lessons learned in the previous Bank assistance period that institutional development and learning to live by a new set of rules takes much more time and intensive assistance than had been anticipated.

C. The Lending Programs

The present sub-section provides a summary review of the Bank's lending program in support of financial sector transition. It covers 192 loans containing financial sector components, including 74 adjustment or fast-disbursing loans, 23 technical assistance loans, and 95 investment loans, the great majority of which contained credit lines for onlending through local financial institutions.[65] As a general observation, a casual comparison of country programs where lending has been active shows no easily discernible pattern in the selection and sequencing of loan instruments, and these were not generally discussed in the CAS documents. In a few cases (e.g. the mid 1990's country strategy for FYR Macedonia), it was argued that Bank credit line operations would require the satisfactory implementation of banking reforms under the ongoing adjustment loan. In others, however, it was argued that credit was essential for spurring a supply response from the private sector and could not wait until the macroeconomic and sectoral policy and institutional framework had been perfected (e.g., Albania, Azerbaijan, and Bosnia-Herzegovina).[66] In a few cases, lending programs were limited to only one or two operations over the entire decade, either because of lack of agreement on strategy (Belarus, Turkmenistan, Slovak Republic), or lack of interest in borrowing (Czech Republic). Adjustment lending was explicitly precluded after the middle of the decade in a few instances by the lack of a balance of payments or budgetary justification (the Baltic states and Slovenia).

As a general matter, the Bank's involvement through lending in financial sector reforms in the Region markedly tapered off toward the end of the decade. To an extent, this reflected the positive progress that had been made, particularly in the CEE and Baltic states. With the strengthening of market-supporting infrastructure and of private financial institutions, the need for the Bank's support for reforms was diminishing, and the shift toward a greater focus on individual private institutions led to a natural shift of lead role to the IFC and EBRD. This shift was also motivated by the movement toward EU accession and the comparative advantage enjoyed by European institutions. The late 1990's country strategy for Poland and Slovenia, for example, both referred to the need for further bank privatization but noted that the EBRD was expected to take the lead. The 1999 Lithuania CAS reported that the government wanted the Bank in the future to provide technical analysis and advice, but that it no longer wanted to borrow for financial sector assistance. It would look to IFC for providing financing to the private sector.

The following paragraphs review the focus of Bank financial sector lending operations, which varied from country to country. These variations do not, of course, reflect only the strategic visions of World Bank country teams. More important are the specific country situations and receptivities at particular points in time. The Bank was also not the only source of assistance. To evaluate whether the coverage in a particular country was adequate, account would have to be taken of the assistance other donors were providing. To the extent that other donor assistance was made explicit in the loan documents reviewed, it is included here as part of the loan's coverage.

Adjustment Lending[67]

Support for the strengthening of the legal and regulatory framework for banking was practically a universal component of the programs supported by adjustment loans. The same is true for upgrading the authority and technical

[65] Not included are credit lines for which the state budget, rather than a financial intermediary, has taken the explicit credit risk.
[66] In Azerbaijan, some adjustment lending did nevertheless precede the first credit line operation.
[67] Seventy four adjustment loans were reviewed for this paper.

capacities of the supervisory authority and for modernizing accounting and auditing frameworks to bring them into conformity with international standards. Attention in most countries was given also to the issue of the independence of the supervisor from outside interference. The introduction or strengthening of bankruptcy law was from the start a standard element of Bank-supported programs and the design, adoption, or amendment of such laws was a common condition of adjustment loans. The Bank and other donors financed substantial technical assistance for drafting the laws.

High priority was given in adjustment loans to the hardening of budget constraints on both banks and enterprises. Although the effort to substantially eliminate direct budget subsidies was successful in most countries, lack of reliable information on the direction and quality of credit made it more difficult to attack continuing loans from the banking sector. Efforts in this regard focused on eliminating credit subsidies generally, and on cutting off credit to specifically identified large loss-makers in parallel with measures to restructure them or force them into liquidation. Governments were also encouraged to shift subsidies being channeled through the banking system to the budget to make them more transparent and more easily subject to control. The problem was also attacked indirectly through the privatization of the banks, the improvement of bank accounting and auditing standards, and the strengthening of bank prudential regulation and supervision. Even more difficult and less frequently attacked were the burgeoning interenterprise arrears. A few adjustment loans, beginning with the 1991 Romania SAL, tried to get at them by the enforcement of arrears ceilings, by putting conditions on the pricing policies of the major creditor enterprises (e.g., the energy companies), or by putting the major loss-making enterprises under special regimes that, among other things, forced them to pay cash for their inputs. Success tended to be short-lived, however, and, to the extent that arrears were reduced in this way, it was usually because other means of soft financing had been created.

The integration of financial sector and enterprise sector reforms was a guiding principle in many country programs. In 12 of the countries, adjustment loans combined actions to restructure and privatize both banks and enterprises. The need to move financial sector reforms in parallel with enterprise reforms was well articulated in the early work of financial sector staff and led to the conceptualization of integrated adjustment lending operations, the first being the EFSAL for Poland in 1993. At the time the EFSAL became effective, Poland appeared to be emerging from the decline in output and burst of inflation that marked the initial transition years. However, the banking sector and many state-owned enterprises were still suffering major financial difficulties. The authorities were thus seeking to design a viable program for simultaneously resolving insolvency in both sectors, while enacting legislative reforms that would accelerate the pace of privatization. The Bank was already supporting reforms in both banks and enterprises through a SAL and several investment loans.

Under the agreed program, targets were established for the privatization of some 1,000–1,500 viable SOEs. Also targeted was the resolution of around 2,000 problem enterprises via bank-led conciliation and restructuring agreements that would either restore an enterprise's capacity to regularly service its debt and facilitate its privatization, or alternatively push it into bankruptcy and liquidation if viability could not be achieved. At the same time, a group of large and socially sensitive, loss-making enterprises were made eligible for a one-time infusion of budgetary resources, managed by the state Intervention Fund and based on an acceptable restructuring plan. In parallel to these enterprise restructuring efforts, the program called for a full, one-time recapitalizaton of seven state-owned commercial banks that were then expected to be privatized.[68] An improved incentive structure for their future lending was to be ensured by strengthened prudential regulation and enhanced supervision capacity in the central bank.

The integrated conceptual framework set out in the FESAL framework, however, did not always move forward smoothly in practice. Its implementation required not only wrenching political decisions and difficult technical issues, it also severely taxed the limited administrative capacities of the governments, including the ability of the central economic authorities to mobilize and coordinate the support of the many agencies within the government that would be involved. The Polish program is widely considered to have been a success, although some of its key elements—the restructuring of large loss-making enterprises and the privatization of the state banks—moved more slowly than had been hoped. FESALs for Romania and Bulgaria, initially prepared in 1992, did not finally go forward until 1996 and 1997, respectively, and judging from results, the Romania FESAL was probably still premature. The most successful of the integrated operations was the 1997 EFSAL in Hungary. In contrast to previous Hungarian efforts, budget constraints were rigorously enforced, and the privatization of both enterprises and banks was virtually completed with significant participation of foreign strategic investors. The high priority given by the authorities to EU accession was an important motivating factor. At least equally important were the three years of intensive and collaborative preparatory work by the Bank and the government, and the Bank's insistence on substantial up-front actions prior to Board presentation.

In a number of *ex post* reviews, FESAL operations were criticized for having been too complicated, involving too many conditions and too many implementing agencies.[69] Other reviews, in contrast, criticized such operations for having failed to cover vital areas, such as corporate governance and judicial reform.[70] The salient point, I think, is to appreciate the enormous complexity of the transition process itself. Whether or not integrated in a single lending operation, the interrelationships among the needed reforms could not be ignored.

Regardless of the debate evident in Bank policy papers and ESW reports, and irrespective of the methods chosen in each country, support was given in practically all the adjustment loan programs to the restructuring and privatization of the state banks. A significant exception was the case of Russia, where no lending support was given to bank restructuring, bank privatization, or failed bank resolution despite recommendations in this regard in the 1993 and 1997 banking sector reports. As noted earlier, the attention of financial sector assistance in Russia was focused almost entirely on fortifying the private banking system and the regulatory environment to support it, largely ignoring the dominant state banks. A dialogue toward supporting the restructuring of the state savings bank and two other state banks was mounted at

[68] Excluded from the program, at government insistence, were the larger specialized state banks. Some of these, however, pursued conciliation and restructuring efforts on their own.
[69] Examples are the Croatia EFSAL and the Romania FESAL. See also the CAE for Albania.
[70] For example, OED's Country Assistance Evaluation for Bulgaria.

the end of the decade, and diagnostic studies were undertaken, but little tangible result has come of it.

Only 16 of the adjustment operations (in 11 countries) included explicit support for capital market development. All of these had to do with various dimensions of establishing or modifying the legal or regulatory framework for market development.

Several themes or lessons have emerged repeatedly from internal project documents, OED assessments, and other reviews of the Bank's adjustment lending to the transition economies. A principal theme has concerned the limited capacity of most transition economy governments to design and implement the inevitably complex programs that the Bank was supporting. Adjustment loans in particular are criticized in this context for the excessive optimism they conveyed regarding the speed with which governments were willing and able to carry out the promised reforms as well as the time required for those reforms to produce visible results. Where the issues were ones of technical complexity—e.g., the drafting of prudential regulations, the assessment of banking risks, the formulation of enterprise restructuring plans—the obvious lesson has been the need for intensive technical assistance, whether from the Bank or other donors, to give support to the policy commitments. The Poland EFSAL, among others, was praised by reviewers for the high level of technical assistance that accompanied it, particularly with respect to the development of banking skills. A number of other operations (e.g., the Kyrgyz FINSAC), however, were criticized for failure to provide or to properly supervise the needed assistance. More general, as noted elsewhere in this report, was the tendency of loan and strategy documents, at least implicitly, to underestimate the duration and intensity of the assistance needed and the time required to assimilate the assistance being offered and to make it effective. Growing recognition Bank-wide of the time required for the institutional changes needed to sustain structural change led, by the end of the period reviewed, to the introduction of new lending instruments—the programmatic adjustment loan and the APL—designed to provide continuing support over a longer time horizon.

Not all implementation problems, of course, were technical, and a common criticism of adjustment operations, and of programs overall, has been that the Bank often exaggerated the degree to which the authorities were in fact committed to the reform objectives and to carrying out the necessary measures (e.g., the Kyrgyz FINSAC, the Romania FESAL, and the Russia SALs). The borrower's "ownership" of the reform program is necessarily a question of judgment and is vulnerable to often volatile political currents. One can nevertheless not help but question the judgments made in the Russia case, for example, where every operation involving the financial sector, beginning with the 1992 Rehabilitation Loan and running through two of the three SALs in 1997-98 and continuing with the restructured FIDP in 2000, gave high priority to the adoption of international accounting standards and the strengthening of banking supervision. By 2002, little progress had been made in implementing these measures, or other key measures such as the establishment of effective bankruptcy and failed bank resolution procedures. The technical assistance financing provided for the implementation of these measures went largely unused. The common lesson drawn in *ex post* assessments, and endorsed here, is that adjustment loan disbursements should be based on concrete progress in implementation rather than only on procedural measures (e.g., the drafting and submission of laws, the preparation of action plans, etc.).

Technical Assistance and Non-FIL Investment Lending

Nine adjustment loans (in seven countries) were directly linked to parallel technical assistance operations. Some 21 other T/A operations and non-FIL investment projects also contained components in support of financial sector reform. Consistent with country strategy and the reform agenda set out by adjustment loans, these 30 projects provided support to the drafting of banking laws and regulations, to capacity-building in the supervisory authorities for both the banking systems and securities markets and for the bank restructuring agencies. Also prominent in these operations was support for upgrading accounting and auditing standards and for the modernization of payments systems through both technical assistance in system design and financing for computer hardware and software. Despite the emphasis given in ESW to the serious shortage of skills for both banking and banking supervision, surprisingly few operations gave support to serious training or to upgrading the capacities of private banks. Only in the Russia program, with the Management and Financial Training Project, was this given an important emphasis. (However, as discussed below, many FIL operations also focused on institution building at the level of individual banks.)

Financial Intermediary Loans

Some 95 loans, or almost half of the financial sector operations in the ECA transition economies over the decade included lines of credit intermediated through private or public sector financial institutions.[71] The objectives, proper enabling environment, and design of financial intermediary loans (FILs) have long been the subjects of debate and ambivalence within the World Bank. For many years, FILs were seen largely as convenient vehicles for directing resources toward particular sectors, activities, or groups of beneficiaries considered to be inadequately served by the financial system. These have included, *inter alia*, the rural economy, poor families and small enterprises, because of higher lending costs and risks and the borrowers' lack of collateral; investment in general because of the scarcity of medium and long-term resources; and activities with important external benefits—e.g., environmental investments—that private markets tend to undervalue. Directed credit and interest rate subsidies were considered acceptable means for overcoming these obstacles.

Over the course of the 1980s, however, the Bank became increasingly convinced that FILs should not be treated as one-shot resource transfers, but rather designed to develop sustainable financial flows to the intended borrowers. This conviction became embodied in a new Operation Directive (O.D. 8.30), which established, among other things, that the decision to undertake a FIL should take into

[71] The actual number is likely to have been greater given the difficulty of identifying such loans in the data base. Some credit lines financed by the Bank have been relent directly by the central government to other public sector institutions (e.g., local governments), or have used financial institutions as agents to administer funds with government assuming all of the risks involved. The present review is concerned only with credit lines relent through financial institutions, in which the latter take the credit risk.

account whether the macroeconomic framework, the policies in force in both the beneficiary sector and the financial sector, and quality of the intended intermediary institutions were conducive to the development of sustainable finance. If not, additional measures would be needed, either prior to the FIL, as part of the FIL, or in parallel with it, to ensure the achievability of the project's developmental objectives. It was also indicated that interest rate subsidies, in addition to their negative impacts on macroeconomic stability, resource allocation, and rent-seeking behaviors, were not conducive to sustainable financial flows.

Most of the FILs reviewed for this report were sensitive at least rhetorically to these principles. Almost all of them provided for market-based or at least positive real interest rates to final borrowers, often accompanied by measures to deal with policy or institutional distortions in the beneficiary sectors (e.g., price liberalization, land titling). Many sought also to improve the protection of creditor rights (e.g., laws on collateral and the establishment of collateral registries), and almost all of them offered institution-building technical assistance to the intermediating financial institutions as well as to the intended borrowers. Almost all the FILs set out eligibility criteria for participating intermediaries intended to assure their soundness and sustainability. These criteria were sometimes set below common international standards at the start, but included a graduated, time-bound program for raising the requirements that would have to be met over time to maintain eligibility.

Nevertheless, the wide variation found in the substantive application of these principles suggests a continued widespread ambivalence within the Bank about the proper objectives of FILs and the conditions under which they should be carried out. This ambivalence was reflected also in the *ex post* evaluations of FILs carried out by OED. Even in operations for which sustainable finance was declared as the primary objective, there often appeared to be considerable uncertainty about what was needed (e.g., in terms of the performance of the participating intermediaries) to achieve it. The purpose of the following discussion is to highlight continuing issues, not to criticize particular operations. Overall, a clear improvement is seen in the design of FILs over time in terms of their financial sector content and understanding and, hence, in their overall developmental impact. The low point in these respects was represented by the five FILs to Poland in 1990–92, which had practically no financial sector content and failed even to transfer the allocated resources to their intended beneficiaries. They are not discussed further. An equally ineffective agricultural credit loan (in developmental terms) was made to Romania in 1992 and is discussed below because of its full disbursement and the highly satisfactory rating that was accorded by an OED assessment.

FIL Sequencing. Country programs have taken explicitly different stances with regard to the sequencing of FILs in relation to other Bank efforts to support reforms in financial sector policies and institutions, and in regard to the macroeconomic framework. In the programs for Albania, Azerbaijan, and Kyrgyz Republic, for example, immediate credit infusions were seen as essential to achieve agricultural sector objectives that could not wait for the completion of financial sector reforms. The late 1990's country strategy for Bosnia-Herzegovina also pressed the urgency of credit lines to provide liquidity and to keep enterprises operating. In contrast, the mid 1990's country strategy for FYR Macedonia imposed satisfactory implementation of banking reforms under the FESAC as a condition for proceeding with credit lines. Similarly, the country strategy for Ukraine was to delay investment loans to specific banks until after the implementation of the 1998 FSAL, arguing the need to have institutional foundations in place first, as well as adequate accounting data, which was itself to be an output of the FSAL.[72] The mid 1990's country strategy for Poland attributed the failure of earlier credit lines to disburse to inflation, the heavy public sector demand for credit, and the reluctance of banks to lend in the face of weak enforcement of collateral laws. The late 1990's country strategy for Poland also noted as a lesson from past experiences that resource transfer objectives were better met through adjustment lending than through FILs, particularly when the banking system was not yet adjusted to operations in a market economy. Similarly, the late 1990's country strategy for Bulgaria listed as a lesson learned that credit lines should not be provided in the face of macroeconomic imbalances and problematic banks.

In practice, the Private Investment and Export Finance Project for Bulgaria had been approved in 1993, a year of 73 percent inflation and rising. When it was followed by the Agriculture Development Project in 1994, inflation had reached 96 percent. The Private Farmers and Enterprise Support Project (PFSEP) was approved for Romania in 1992, a year of 210 percent inflation and rising. The Industrial Development Project followed in 1994, when inflation was falling but still running at 137 percent. Inflation was also declining in Russia when the Enterprise Support Project was approved in 1994, but still recorded 311 percent that year. In almost all other cases, inflation was falling rapidly and in most countries had already reached single digits before FILs were undertaken.

Interest Rates to the PFI. It has been stated Bank policy since the adoption of O.D. 8.30 that interest rates charged to the intermediaries of Bank resources should be market-based. The rationale is that donor funds should not undercut intermediaries' incentives to mobilize domestic savings, nor give them an artificial competitive advantage *vis-à-vis* non-participating financial institutions. Nor should the intermediaries be encouraged to lend for projects offering below-market rates of return.

Most projects, as noted above, sought to enforce positive real and market-approximating interest rates to both the participating financial intermediaries (PFIs) and to the final borrowers. Efforts were also made, and sometime explicit conditions attached, to eliminate other interest rate subsidies in the system. The cost of funds to the PFIs was commonly set as a spread over the rate paid by the government to the Bank. Where loans to the PFI were denominated in local currency, a local benchmark was commonly agreed (e.g., the 6-month bank deposit rate in the Bosnia Local Initiatives Project, or the central bank refinancing rate in the Hungary Product Market Development Project), with a spread added to cover the government's administrative costs and risks. Such local currency benchmarks were not always sufficient to assure positive real interest rates, however, or even to approximate the cost of funds from other sources to the PFI. In the Hungary project, for example, the central bank refinancing rate was substantially below both the cost to the banks of deposits or of

[72] An Export Development FIL was nonetheless approved for the Ukraine in 1996, with the argument that the demand for export finance was demonstrably there, and that the intended PFI—the Eximbank—was a reasonably structured institution in a niche activity that was relatively isolated from the problems elsewhere in the system.

loans from the interbank market. In the Romania PFESP, the PFIs could access Bank funds for local currency loans at the central bank refinancing rate, which was raised to 28 percent in early 1992 as compared to inflation in that year of 210 percent. Consequently, the PFIs were receiving a considerable subsidy on their use of World Bank resources. In a few cases, an effort was made to assure positive real rates by setting the base rate on the basis of actual and/or projected inflation, as in the Rural Services Project in Moldova and the Rural Finance Project in the Kyrgyz Republic. In two loans in Georgia and Latvia, central bank auction rates were applied. The spreads added to the base rate have varied widely (zero to 5 percent on the loans sampled) with no apparent systematic reason for the differences. Periodic reviews were frequently stipulated to ensure that the spreads adequately covered the governments' costs and risks, but it is not clear how frequently or on what basis modifications were actually made.

In several cases (Estonia, Kyrgyz Republic, Latvia, Lithuania, and Moldova), the PFIs received funds from the government or from other donors in parallel to Bank resources. A portion of these funds were provided, effectively, as equity to build the capital bases of the lending institutions. In the 1997 and 1999 Kyrgyz rural credit projects, 15 percent of each withdrawal of the Bank's resources was designated as a capital contribution to the PFI, which in this case was a state-owned non-bank financial intermediary established to serve rural credit needs (see below). In the Baltic countries, the equity contribution was provided by Swedish resources, while in Moldova the vehicle was an interest-free loan from the government.

Interest Rates to Final Borrowers. Stated Bank policy has also been that loans to final borrowers should be market-based and normally positive in real terms. The objective is to ensure an efficient allocation of credit resources, sufficient spreads to the intermediaries to protect their capital and financial sustainability, and to prevent an artificial competitive advantage and rent-seeking opportunities for the sub-borrowers. Most of the FILs have called for market interest rates to be charged to the final borrower, meaning that PFIs would be free to determine the spreads needed on each subloan to cover their costs and risks.

A particular difficulty in assessing market rates has arisen when there was a lack of comparable local currency resources available in the domestic market, and hence no apparent benchmark to price against. When the PFIs have been state-owned banks, there has commonly been a provision for periodic review of the adequacy of the rates being charged in terms of the costs and risks to be covered, but again it is not clear how this has been used. In a number of cases, given the lack of local benchmark rates for term credit and the inexperience of the PFIs, spreads over the interest rate paid by the PFI were specified in the loan conditions. In a few cases, (e.g., Latvia and Ukraine), it was stipulated that the rates charged should not be unduly burdensome on the borrowers. The documents provided no clarification regarding how this caveat was to be interpreted in practice.

In most cases, it appears that positive real rates were achieved on the loans to final borrowers. A marked exception was in Romania, where a spread of 2–3 percent over the central bank refinancing rate was to be charged on local currency loans under the PFESP. That would have translated into a real interest rate of about minus 58 percent in 1992. Under the Kyrgyz Private Enterprise Support Project, loans to final borrowers were originally denominated in foreign currency. After having financed only one subloan in three years, however, the project was modified to permit onlending in local currency. According to the project file, the Bank accepted interest rates to final borrowers below the average lending rates in the country in order to remain in line with other foreign-currency, donor-funded programs, which were considered the only credible benchmark available. Since other lending rates on local currency loans did apparently exist, I take this explanation to mean that the Bank felt the need to remain competitive with other donor funds. Rates have also been below-market, albeit positive in real terms, under the PSDP in FYR Macedonia.

In several cases (e.g., the Latvia Rural Development Project), microfinance clients were offered partial loan guarantees by the government. The guarantees would be converted into grants (limited to 30 percent of the loan amount) at the time of final loan amortization, provided that the borrower had made all prior repayments on time and had complied with all other loan conditions. The non-grant portion of the loan (or the full loan if the guarantee were called) was repayable at full commercial interest rates. The guarantee was intended as a one-time opportunity providing new small-scale borrowers an incentive to comply with loan conditions and a stronger capital base that would qualify them for future loans on commercial terms. By attaching the capital grants to the loans, their allocation was left to the criteria of the lenders. It is reported in the Latvia case, that fewer than 1 percent of the guarantees have been called, and that about half of the recipients of the special credit line resources have gone on to become fully commercial borrowers.

Eligibility Criteria for PFIs. World Bank policy dictates that the intermediaries of Bank funds demonstrate their sustainability as viable financial institutions in order to give confidence that the funds channeled through them are likely to be efficiently allocated to creditworthy borrowers and end uses, and that the access to credit being opened by the Bank's operation will be sustained after donor funds are no longer available. The original O.D. 8.30 provided a substantial set of performance indicators to underpin this evaluation. In practice, however, it has been perhaps the most problematic of the FIL policy requirements. In the transition economies and elsewhere, its application has often been complicated by the virtual absence of strong banking institutions. The policy set out by O.D. 8.30 has permitted working with weaker institutions, provided there was a clearly set out and closely monitored program of institution building for achieving financial sustainability within a reasonable period of time. Parallel efforts should also be made to remove other obstacles in the policy or legal environment that may undercut financial sustainability (e.g., distortionary or destructive tax policies) as well as disincentives to providing the desired financial services (e.g., inadequate enforcement of creditors' rights).

The conditions set for PFI eligibility in the reviewed FILs varied widely in their scope and level of specification. In some cases, they did not go beyond stating that the determination would be subject to a financial and institutional assessment (Croatia Investment Recovery Loan) or to broadly stated criteria like "acceptable lending policies and procedures", or "satisfactory financial position", "acceptable risk profile", and "satisfactory operating procedures". In other cases, the emphasis was on the intermediary's project appraisal and supervision skills rather than on financial condition and performance. In a number of cases, the project documents listed the financial indicators that would be examined—e.g., capital adequacy ratios, profitability, liquidity, portfolio quality—but did not specify the standards to be applied. In a large number of cases, intermediaries were required to be in full compliance with the banking laws and prudential regulations, as certified by the supervisory authority, but the documents neglected to acknowledge the questionable informational and regulatory base on which those determinations would inevitably be made.[73] Many FILs also required external audits under international accounting standards as an eligibility requirement but again did not indicate the standards to be applied to the results.

Finally, as seen in the table, some of the sample FILs have applied quite precise eligibility criteria for PFIs. The details, however, have varied, particularly as regards the acceptable capital adequacy ratio and the acceptable loan repayment rate. The requirement for capital adequacy has usually specified the Basle 8-percent ratio, although in a few cases a higher ratio was called for in recognition of the higher risks faced by banks in the transition environment. In some cases, a bank could enter the program initially at a lower ratio, provided there was an agreed plan for reaching the standard within a defined period of time.

Acceptable loan repayment rates varied in the sample from 75 percent to 95 percent, with many considering a rate of 85 percent to be quite satisfactory. Comparisons are made difficult by variations in definition, which were not specified in the documents.[74] Few financial institutions in the world, however, would likely achieve sustainability with repayment rates below 95 percent.[75] It is striking that Bank loans for microcredit—e.g., the Microcredit Project in Albania, the Local Development Project in Bosnia-Herzegovina, the Agricultural Credit Project in Georgia, and the recent Rural Finance Project in Romania—have typically imposed more rigorous eligibility terms on financial intermediaries (as well as higher interest rates to final borrowers). In marked contrast to the subsidized approach to such lending in the past, the Bank's microcredit projects are now giving greater emphasis to the financial sustainability of the institutions on which these services depend.[76] The intermediary institutions in these projects have also achieved very high loan repayment rates (approaching 100 percent), far exceeding the standards set in other Bank FILs for established commercial banks.

In several cases, the Bank channeled its credit lines at least partially through existing state-owned specialized or commercial banks, even though they were known to be insolvent and poorly managed, subject to some conditions for prior or ongoing restructuring and recapitalization. In only one case (the Estonia FIDP), does this

[73] One exception was the project appraisal for the EFSRP for Latvia, which noted that the evaluation of PFIs was subject to a high degree of uncertainty because of poor accounting, and indicated that close monitoring would consequently be required. Even so, the precise standards to be applied were not indicated.

[74] For example, whether the rate included interest payments due or referred only to principal, and how loan reschedulings or roll-overs were to be treated.

[75] Just as a reference indicator, a financial institution that recovered only 85 percent of its outstanding loan principal annually would need to collect a real interest rate of 17.65 percent per annum just to restore the lost capital and without considering the additional interest income necessary to cover its operational and financial costs.

[76] The original Local Initiatives Project in Bosnia-Herzegovina shifted its objectives at its mid-term review from maximizing outreach in terms of the numbers of beneficiaries reached toward assuring the financial sustainability of the intermediaries.

appear to have had a positive outcome. The Romania PFESP was channeled through two state banks, including the deeply insolvent Agricultural Bank, which continued throughout loan implementation to be a channel for subsidized short-term credit to Romania's highly distorted agricultural sector. An internal Bank review for the project acknowledged that the PFIs were not in compliance with O.D. 8.30 but asserted that their participation in the project had contributed importantly to the strengthening of their loan portfolios and overall finances, even though this was not an explicit project objective. (The formal assessment made of this operation is discussed below in the section on FIL evaluations.)

In a number of cases—e.g., the Albania Agricultural Sector Adjustment Credit (which contained a credit line component), the Kyrgyz Private Enterprise Support and Rural Enterprise projects, and the Latvia Agriculture Development Project—it was acknowledged that no satisfactory banks or other financial intermediaries existed in the local economy. State-operated funds or nonbank financial institutions were thus set up under the projects to intermediate Bank funds and to provide financial services to the target beneficiaries. This alternative was usually intended as temporary, and it was expected that the new institutions would eventually be privatized or their activities otherwise assumed by private institutions. The Albanian experience was later judged to be a mistake, and the state-owned rural credit institution, The Rural Commercial Bank, was eventually liquidated. Despite having set up an independent lending unit to manage the ASAC credit line, it continued to suffer from political interference and corruption, and only about 24 percent of the subloans were repaid. The Region's evaluation of the Albania pilot project for urban microcredit also concluded that a state fund was an inappropriate vehicle, and the responsibility for the follow-up operation was moved to a specialized private foundation.

The PFI set up for the Kyrgyz Private Enterprise Project was also unsuccessful, and the responsibility for managing the project was later shifted to the central bank. The intermediary for the rural credit line (KAFC), established in 1997, has been more successful in disbursing funds, and a second World Bank loan is now disbursing through it. According to an internal project review for an earlier operation, however, KAFC suffered from very high operational costs, was far from achieving operational sustainability, and had achieved a repayment rate of only 88 percent.[77] Meanwhile, no other financial institutions had found it attractive to enter into the rural credit market, and KAFC was expected to remain the main financial institution in the rural sector for some years to come. The Latvia experience is generally judged to have been successful, and additional PFIs have been attracted to rural finance. The government, however, has resisted Bank prodding to privatize the state-owned lender, believing that it is still needed to provide leadership to the sector.

Institution-Building Support. As noted, practically all of the FILs reviewed have contained technical assistance components within the loan as well as complementary support from other donors. Although there is general agreement that the institution-building objectives of FILs require intensive technical assistance inputs to accompany the credit lines, the results in practice have been highly variable. In many FILs, the technical assistance allocated to PFIs was mostly aimed at

[77] Nevertheless, its capital base had grown over time by virtue of the government's continuing transfer of 15 percent of Bank resource disbursements as capital contributions. The internal review for the first project was written in 2002, almost three years after approval of the second project.

strengthening project appraisal and supervision skills, and/or for complying with Bank environmental and financial reporting requirements, rather than at strengthening general banking skills in credit analysis, risk management, internal management controls, and information systems, etc.[78] In a number of cases, the technical assistance funds went unused—e.g., the Kyrgyz Enterprise Support Loan, the Hungary Product Market Development Loan, and the Romania Industrial Development Project—often reflecting lack of interest on the part of the PFIs and the reluctance of governments and PFIs to borrow for technical assistance. In many cases, the T/A component was replaced by grant resources mobilized from other donors, but some internal project reviews also criticize failures of Bank supervision to give close attention and emphasis to the institution-building objectives of the loan.

In a couple of the cases reviewed—rural credit operations in the Kyrgyz Republic and FYR Macedonia—follow-up FILs were approved before adequate reviews had been made of the initial operations. The pressure to move quickly with the second loan was the rapid pace of disbursement and the legitimate desire to assure continuity. However, later internal project reviews covering the first loans raised important issues pertaining to institutional development that should have influenced the speed and design of the second operation. In the Kyrgyz case, the internal project review gave a positive assessment to the state-owned intermediary as a successful, innovative, and practical stop-gap model for channeling rural credit, but pointed to the continuing lack of an adequate MIS system or risk management capacity and expressed concern about the rapid parallel growth of credit lines from other donors that were putting visible strain on the management capacity of the PFI as reflected in deteriorating repayment rates. The FYR Macedonia case was apparently more dramatic, as a new project team drastically lowered the project ratings on the first project just as the rushed second project was entering it mid-term review. The institutional development aspects of the Macedonia projects had been left entirely to other donors (see below).

As described earlier, the Russia, FYR Macedonia, and Ukraine programs gave particular emphasis to the institution-building support of a select group of higher-echelon banks that, it was hoped, would become the core of the emerging banking system. The most concerted effort in this regard was in Russia, where a large FIL, the Russia Enterprise Support Project (ESP), was carried out in parallel with an even larger Financial Intermediary Development Project (FIDP), intended to screen, certify, monitor and provide support to the banks taken into the program. Banks that were found by the reviews to be relatively sound financially,[79] that volunteered to

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[78] The Bank's requirement that PFIs undertake or enforce environmental standards on the projects they finance is reported in many internal project reviews as having been a significant impediment to the take up of credit lines. The costs involved in these analyses put PFIs at a competitive disadvantage to other financial institutions not subject to similar requirements and, when passed on to borrowers, put the latter at a disadvantage to competing producers if they are not similarly held responsible for environmental impacts. It would instead be preferable for the Bank to work with governments to improve the enforcement of environmental standards on investments economy-wide. Under the Enterprise and Financial Assistance Project in Lithuania, enterprises were required to provide certification from the authorities that the projects to be financed were in compliance with environmental rules. This seems preferable to putting the burden of analysis on the PFIs.

[79] A Task Force, operating under the joint aegis of the MOF and central bank and advised by a Bank Review Unit composed of senior bankers and IT experts, was responsible for accrediting and monitoring the performance of participating commercial banks.

accept progressively more rigorous performance standards and supervision, and that were willing to enter into corrective action plans for removing deficiencies and building their intermediation and risk-management capacities would be accredited for participation in the program. Only banks accredited under the FIDP were eligible to intermediate the credit line provided by the ESP.[80]

The bank accreditation process itself was inevitably flawed, however, by the inadequacy and unreliability of the accounting data going into it. The financial soundness of the participating FIs, or progress towards it, could not be determined on the basis of the information that they would make available. Moreover, the expected introduction and application of international accounting standards in enterprises and banks was never accomplished and had never been "bought into" by the Ministry of Finance, which, among other things, feared the possible impact on tax collections. In practice, it appears to have been principally the public accreditation itself that motivated the banks to enter the program in order to gain access to other sources of finance, including foreign loans. They used these funds instead of the Bank loan to support their own associated enterprises, interbank lending, heavy involvement in forward foreign currency contracts, and purchases of government debt, all of which turned bad in the August 1998 crisis. The projects effectively came to a halt with the financial crisis, and the institutional development achieved in most of the participating banks was minimal.[81]

The few operations that have not included technical assistance—e.g., the PSDP in FYR Macedonia, despite the strategic emphasis given by the country strategy to developing the core banks—have depended on complementary technical assistance from other donors. The results in this latter case were disappointing. As reported in an internal project review, technical assistance was poorly coordinated and randomly implemented, and often unrelated to the needs of the PFIs. As a consequence, there was no evidence of any improvement in banking skills over the course of the project, and PFI portfolio quality actually deteriorated and was worse as of the end of 1999 than the average for the banking system as a whole.[82]

As a general observation, even when well done, the Bank's approach to technical assistance and institutional development has tended to be overly optimistic with regard to the time and intensity of effort required. This has been one of the repeated lessons coming from internal Bank project reviews and OED evaluations. The internal review for the Bulgaria Agriculture Development Project, for example, concludes that the impact of technical assistance should not be exaggerated and that the lack of strong PFIs cannot be overcome in the short term. The internal review for the Macedonia PSDP, on the basis of the poor experience of technical assistance in that program, reemphasized the need for strict PFI eligibility criteria going in.

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[80] The original concept called for limiting the number of participating banks to 10, but during the course of completing the underlying sector report and preparing the loan documents, this number was increased to 20. Political pressures during implementation eventually raised the number of "accredited" banks to 43.

[81] The projects were later restructured, and the number of PFIs sharply reduced. A fuller treatment of the FIDP and ESP in Russia, and of the Bank's overall program for financial sector development in Russia can be found in the background paper prepared for the Russia CAE. (See: Fred Levy, "Russia: Evaluating Bank Assistance for Financial Sector Development in the 1990s," January 2, 2001.)

[82] Some one-third of PFI portfolios were declared to be non-performing as compared to 28 percent for the system as a whole.

The Implementation of FILs. Two additional elements concerning the implementation of FILs deserve mention. As a large wholesaler of funds, and requiring a government guarantee of loan repayment, the Bank has usually found it necessary to channel resources through a government-operated apex institution or project implementation unit for onlending to the PFIs. Much of the responsibility for the selection and monitoring of PFIs and of the related institutional development programs has been delegated to the apex units. In only one of the operations reviewed (the Croatia Investment Recovery Project) has the Bank dealt directly through separate loan agreements with the PFIs. Putting an additional administrative layer between the Bank and the PFI, however, has its costs. Substantial resources are required to adequately train the staff of the apex, in addition to institution-building resources dedicated to the PFIs themselves. In a number of FILs (e.g., the ESP/FDIP in Russia and the PSDP in Moldova), western banking experts were attached to the apex units to provide experienced day-to-day guidance to their decision-making. Neither experiences were particularly successful, however. Ultimately, the success of such units has depended on the strength and political independence of their leadership and on the continuous close monitoring of the apex and the PFIs by the Bank.[83]

An additional issue concerns the heavy emphasis given in FIL documents and their supervision to disbursements as a primary indicator of project success. It is evident from the rest of the discussion that disbursement rates may have little to do with either the contribution to financial sector development or even to the advancement of real sector objectives. Fully disbursed loans have frequently been associated with PFIs that were soon liquidated, with subloans that were not repaid, and with resource flows that were not sustained once the project ended. The opposite has also occasionally been true. The Estonia FIDP, for example, realized only one subloan representing 24 percent of the credit line amount but, by most accounts, had an important catalytic impact on the significant banking development that followed.

On the design side, particularly in the early years of transition, project appraisals were often very wide of the mark in projecting the effective demand for credit as well as the banks' willingness to lend to unrelated and unknown borrowers. While there was evident need for enterprise restructuring and new investment, inadequate consideration was given to the impact on investment demand of the deep recessions and uncertain market conditions prevailing and the lack of motivation of traditional enterprise managers to pursue active restructuring investments even after privatization. On the lenders' side, emphasis in the FIL loan documents was given to the shortage of term resources to explain the lack of term credit. Not sufficiently appreciated were the disincentives to lend to new borrowers caused by economic uncertainties, the lack of legal protections, including the absence of effective collateral and uncertainties concerning enterprise ownership, weak capital bases and tightening prudential regulation, and the relative attractiveness of government debt and other high-return, short-term opportunities.

Savings Mobilization. The sustainability of a financial institution and of the credit flows that FILs are intended to catalyze ultimately depends on the FI's ability to mobilize deposits and other funds from the financial markets. Only one of the loans

[83] A review of worldwide experience with the use of apex institutions for the support of microfinance is found in Fred Levy, "Apex Institutions in Microfinance," CGAP Occasional Paper, October 23, 2001.

reviewed—the Moldova PSDP—included the PFI's own resource mobilization performance as an explicit eligibility criterion. The appraisal of the Rural Development Project in Latvia noted that savings mobilization was an important objective of rural financial institutions, but it is not clear in the documentation how the project was intended to contribute to that function. The internal project review for the Rural Finance Project in Moldova noted the failure of the Savings and Credit Associations (SCAs) to mobilize savings during the life of the project and suggested that the availability of external funds might itself have been an inhibiting factor.

The Evaluation of FILs. Although the criteria applied and the lessons drawn in the evaluation of adjustment lending operations have tended to be fairly consistent, wide variation is seen with respect to internal project reviews and, in a few cases, the follow-up evaluations done by OED, with regard to FILs. Like in the lending operations themselves, internal Bank project reviews over the decade reflect considerable ambivalence with respect to the relative importance given to real sector objectives and financial sector development objectives and to the criteria applied for assessing the latter. For its part, OED has become increasingly rigorous in evaluating FILs "through the prism of O.D. 8.30",[84] but it is worth noting a couple of exceptions to again highlight the issues and also to emphasize the importance of the signals that OED assessments give for the design of future Bank operations.

As a general matter, if the Bank's developmental role in supporting the financial sustainability of the intermediaries it works with is to be taken seriously, FILs need to be more sensitive to the nuts-and-bolts requirements of achieving it. Many of the internal project completion reviews and OED evaluations reviewed for this paper raised proper concerns about the lack of well defined eligibility criteria for PFIs, the quality of the technical assistance being provided to the PFIs, and the quality of Bank supervision of technical assistance components. None took issue, however, with specific criteria or performance indicators, especially loan repayment rates, that were inconsistent with the proclaimed sustainability objective.[85]

Two examples of ambivalent signals from OED stand out among the projects reviewed. The projects in point were the PMDP in Hungary and the markedly inconsistent treatment given the PFESP and IDP in Romania.

The objective of the Hungary PMDP was to open access to financing for investments by traders, wholesalers, warehouses, transport companies, etc. that link producers to the market. The attention of the project appraisal was almost entirely on the real sector objectives of the project with only broad qualitative criteria applied to the qualification of PFIs. The interest rate formula adopted resulted in highly subsidized credit to both PFIs and final borrowers, although interest rates were modestly positive in real terms. PFI staff were to be provided training only in appraisal and supervision skills specific to projects in the marketing, trade and distribution sectors. The project was strongly criticized in the Bank's self evaluation at completion, which noted that almost 60 percent of the loan was eventually cancelled despite several efforts to expand its scope and encourage take-up. It had

[84] See OED, "Financial Sector Reform: A Review of World Bank Assistance," March 6, 1998 and also "OED Review of Bank Lending for Lines of Credit," forthcoming.
[85] One of the few references in an OED report referred to the 87-percent loan recovery rate in the Kyrgyz Rural Finance Project as "promising" (The 2001 CAE).

been approved when there were already several existing Bank credit lines in Hungary that were also disbursing slowly, and some of whose funds could have been used for the same purposes. It also faced competition from other donor credit lines being offered on even more favorable terms. The Bank noted that, on average, only some 75 percent of the subloans were current in their repayment, and some had already been sold off to the government as bad debt under debt consolidation programs. Some, if not all, of the PFIs deemed eligible at the time of appraisal were found later to be insolvent. Nevertheless, the project was formally rated at completion as satisfactory (although the text rates the outcome as marginally satisfactory, there was no formal rating of marginally satisfactory available at that time). The review also criticized the lack of attention to the PFIs' needs for strengthened credit, risk management and other general banking skills, but rated the Bank's performance as (marginally) satisfactory at both the appraisal and supervision stages.

OED downgraded the project outcome and Bank performance ratings from satisfactory in the ICR to "unsatisfactory", taking a harder line on the project weaknesses noted above. However, a later OED Project Performance Assessment (PPAR), based on field work, restored the "satisfactory" ratings on the grounds that the objective of improving product marketing was relevant, and that a strong catalytic effect had been achieved in this regard. The technical assistance provided during project preparation was considered of particular importance toward this end. What is striking is the PPAR's almost complete lack of attention to the issues of financial intermediation and financial sustainability, a decade after the issuance of O.D. 8.30. Indeed, the PPAR criticized the estimate of payments arrears given in the OED desk review on the grounds that the data were insufficient to make the calculation. That the data were incomplete, however, indicated precisely the lack of importance given by the project to the financial performance and sustainability of the PFIs. Finally, the PPAR reconfirmed the Bank's own comments about the excessive restrictions placed by the Bank on its credit lines and the negative implications for their competitiveness.

The other example concerns the quite different treatment accorded to the two Romania FILs. The PFESP was approved in 1992 and the IDP in 1994, both in the context of great macroeconomic instability, financial and real sector price and other distortions, and weak financial institutions. The PFESP, helped by deeply negative real interest rates and two insolvent state-owned PFIs unconcerned with budget constraints, realized 100 percent disbursement of the Bank's funds. The project appraisal explicitly acknowledged the problems in the policy environment but explained that they would be taken care of by parallel adjustment operations. In the event, the SAL, approved in 1992, was only marginally successful in dealing with price and trade distortions in the agricultural sector, and the FESAL was not approved until four years later. Nevertheless, the Bank's self evaluation at completion rated the project outcome as highly satisfactory, noting that, in addition to the investments financed, the PFIs had been strengthened by the appraisal skills gained through the project and by the profits earned on the credit line. The alleged institutional strengthening of the Agriculture Bank, the principal PFI, was belied by every other Bank document that refers to that institution and by its later massive recapitalization and subsequent liquidation. Nevertheless, an OED desk review of the self-evaluation disagreed only slightly with the outcome rating, downgrading it from highly satisfactory to satisfactory, repeating the lesson drawn in the Bank's evaluation that a carefully managed credit project, focused to support private initiative, can be successful even in the face of distortions in the economy.

The Romania IDP was approved more than a year later than the PFESP, but neither the macroeconomic nor the general incentive environment in Romania had much improved. The project sought to channel resources to exporters and export industries through qualified private PFIs. Although the eligibility criteria were stated in qualitative terms, the evaluation was closely supervised by Bank staff, and, in the event, very few banks were certified to participate. The loan provided substantial resources for technical assistance focused on developing credit and risk management skills and internal control and information systems. Interest rates to both PFIs and final borrowers were denominated in dollars and were positive in real terms. Nevertheless, the project ultimately disbursed only about 55 percent of the loan, and none of the monies available for technical assistance was taken up. The Bank's self-evaluation at completion concluded that the project had substantially overestimated the demand for term funds in the prevailing atmosphere, and had also been much too optimistic with regard to the speed with which financial institutions would be able to acquire the skills and meet the performance criteria necessary for eligibility. Insufficient attention had also been given to the technical assistance needs of the potential sub-borrowers. The Bank also criticized the performance indicators set out for the project for having emphasized disbursement and the number of PFIs rather than the financial performance, portfolio quality, and lending behavior of the latter.

Despite these shortcomings, the project outcome was rated as satisfactory on the grounds that PFIs had confirmed their interest in supporting the export sector, and that the annual updates of PFI eligibility evaluations had provided a significant vehicle for their strengthening. In OED's subsequent desk review, however, the project outcome was downgraded to unsatisfactory on the grounds that no evidence had been provided to show that the project had significantly improved banks' ability to make sound loans, or that borrowers had utilized the funds effectively to generate a supply response. The project ratings for sustainability and institutional development were similarly downgraded. Bank performance was also downgraded to unsatisfactory, with the general observation that credit line operations should not be made when prices were still distorted, and when banks and enterprises lacked the incentives to operate efficiently. It was also remarked that the loan had been based on hopes for essential reforms rather than on real progress. In sum, the project should have been delayed or greatly reduced in size.

The observations that OED made about the IDP could appropriately have been made about the PFESP. This emphasizes the importance of relying on consistent and objective indicators on the performance of financial intermediaries in the evaluation process because of the role it plays as a guide to future Bank interventions.[86]

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[86] This point has been underlined by a recent OED review of lines of credit, which found that indicators were frequently absent regarding financial intermediary performance or repayment rates. The OED review recommended that Bank Management, the Quality Assurance Group which assesses quality at entry, and OED all need to ensure that such indicators are reported on before making judgments on design, performance, and outcome of lines of credit. See "OED Review of Bank Lending for Lines of Credit" forthcoming.

D. Summary Assessment

It is practically impossible to assess the World Bank's assistance to financial sector transition by somehow adding up or averaging the programs carried out in the 26 different countries covered by this review. Nor can one learn much from simple analyses relating the choice and sequencing of instruments, the volume of lending, the choice of particular reform methodologies, etc. to outcomes. The variables affecting all of these decisions in a particular country or at a particular time were too many, and most are not amenable to quantification. At the extremes, a very modest Bank intervention in Estonia was associated with highly positive results because of the reform dynamic and skills already existent in the country. Limited interventions in Belarus and Turkmenistan, on the other hand, were associated with virtually no progress at all, and were explained largely by the countries' resistance to change. After a very large lending program with financial sector objectives, Russia was still in the lower echelon of countries in terms of financial sector development. Of those rated among the top performers by the end of the decade, Poland and Hungary each benefited from substantial financial sector lending programs.

As summarized in the EBRD ratings described at the beginning of this report, there has been wide variation in the progress in financial sector development made by the ECA transition countries over the past ten years. World Bank financial sector reports and other assessments of progress at the end of the period, while varying in degree, provide almost identical lists of problems and issues still outstanding in most of the countries, including undercapitalized banks, weak banking supervision, inadequate accounting standards, poor corporate governance, low confidence and levels of intermediation, small and illiquid capital markets, ineffective bankruptcy laws and protection of creditors' rights—in short, most of the problems described at the start of the transition process. But, in almost all cases, progress has been made, and in some cases the magnitude and speed of change has been extraordinary. Moreover, even the most critical assessments have concluded that greater progress was made as a result of the Bank's intervention than would have been made otherwise.

Mistakes were made. Some of the laws and other measures enacted under Bank-supported programs, for example, were later found to be inadequate and had to be modified, leading to proper criticism that they were premature and too hastily formulated. But one also has to take into account the circumstances. A thousand cats had been let out of the bag, and the pressures to establish some kind of control or direction to their course were enormous. Stop-gap efforts may have been the only viable option in the short term. Lending programs and policy dialogues were also frequently interrupted by changing governments or by policy reversals that disrupted strategies and sent planned operations to the shelf or into the waste basket. In some cases, operations intentionally went forward without originally planned complementary interventions in order to "keep a foot in the door". These were calculated risks that managers were paid to take, and it is difficult to second-guess them on the basis of a desk study alone. All this said, some modest generalizations seem appropriate. Some of them have been stated before in the internal project documents, CAEs, and other reviews, and this report simply confirms them.

Relevance

In broad terms, the focus of Bank financial sector assistance programs has been highly relevant and backed by high quality analysis. In their detail, however, they have not always given due emphasis to some of the actions necessary to meet the objectives they set. Bank programs focused early and correctly on getting in place the basic legal and regulatory framework required by a market-based financial system, with initial emphasis appropriately on the banking sector. Some adjustment loans were deficient in taking the drafting of acceptable laws or their submission to legislatures as sufficient for loan disbursement, rather than insisting on actual enactment. Also, as noted, some of the laws that were enacted were hastily drafted and had later to be modified or replaced. Earlier emphasis could have been given to the passage of modern laws on collateral and foreclosure and the establishment of the necessary accompanying infrastructure (property and lien registers). These were essential to providing creditors with the confidence needed to make arms-length loans. The most serious shortcomings, however, were not in the laws passed or the specific regulations introduced, but rather in underestimating the time and additional assistance and human resource development required to make them effective.

Accounting and auditing rules, for example, require trained accountants and auditors to put them in practice and an agreed code of professional ethics and oversight to ensure their integrity. Bankruptcy laws are only acts on paper unless there is an adequate body of specialized lawyers, judges, accountants and other professionals necessary to make the highly technical judgments that are involved. Laws can establish the powers and independence of supervisory agencies, but it takes years of training and experience to produce a skilled bank examiner capable of evaluating the risks in the institutions he or she is supervising and taking the actions necessary to manage them. The virtual absence of these skills in the transition economies was well understood and given considerable emphasis in the Bank's policy papers and ESW reports. While highly specific training was provided through technical assistance and investment loans to the staff of project implementation units, financial intermediaries participating in Bank credit lines, and to the restructuring and privatization agencies, assistance programs devoted very few resources to the extended training needed to operate the larger system.[87] Although less complicated to adjudicate, collateral and foreclosure laws require, at a minimum, judges who are aware of and sympathetic to its purposes. It is only in the last couple of years that a concerted effort has been focused on judicial reform, even though its importance was also highlighted early on in policy papers and ESW.[88]

Early adjustment programs were also too optimistic, some would say naïve, in expecting improved enterprise and bank performance to follow quickly from the

[87] The only dedicated training project among those reviewed was the Management and Financial Training Project in Russia, which was limited to a single operation in spite of government requests for follow-up. As one reviewer of an earlier draft of this paper has pointed out, an underlying problem throughout the Region was the failure of government policy-makers to understand the importance of independent regulatory agencies able to pay the salaries required to attract and hold qualified professionals.

[88] Operational attention to the importance of judicial reform has been a recent phenomenon throughout the Bank and is part of the substantially increased importance being attached to governance and the institutional underpinnings of development. Work in the transition economies can probably be given a significant share of the credit for awakening this realization and interest.

formal act of privatization or from the various approaches to supervised commercialization and restructuring. As discussed earlier, too little attention was given to the serious problems of corporate governance and incentives that acted to subvert the assumed responsiveness to market incentives. With the exception of the Enterprise Housing Divestiture Project in Russia, almost no attention was given (at least by those working on financial sector reform) to the social obligations inherited by enterprises that were at least partly responsible for their losses and, hence, also for their demands on, and arrears to, the banking system. A 1996 internal review of policy-based operations carried out in ECA[89] found that these obligations have impeded privatization, reduced enterprise competitiveness, probably resulting in the bankruptcy of some otherwise viable enterprises, and resulted in serious disruptions in the provision of essential social services.

The early attention given in a few country programs to capital market development was premature, and counterproductive to the extent that it drew attention away from more immediate concerns. Without first having a properly functioning banking system, adequate accounting and auditing conditions and effective disclosure requirements, responsible corporate governance and protection for minority shareholders, and with most shares in the hands of individuals with little idea of their meaning and worth, no formal stock market could have played the role the mass privatization proponents had assumed for it. Whatever change and concentration in corporate ownership that was going to occur under the existing circumstances would inevitably be non-transparent, manipulated, and to a large degree fraudulent whether a formal stock market was in place or not. In those countries where relatively advanced markets are now operating—Hungary, Poland, and Slovenia—the Bank was little involved.

Finally, although opening access to credit to under-served sectors, groups, or activities was an eminently relevant objective for Bank assistance programs, many FILs were still carried out without fully considering what was needed to accomplish that objective in a sustainable fashion. Even operations that explicitly asserted the development of sustainable finance as a principal objective were often not well designed for that purpose. It is encouraging in this respect that ECA and the Bank's Financial Sector Board have introduced new procedures to ensure that all such operations are duly reviewed by financial sector staff.

Program Implementation

While programs have, by and large, been relevant, their implementation has varied in a number of important respects. One is struck, for example, by the relatively tight rein kept on the lending to Bulgaria in the face of slow progress in the implementation of reforms, as compared to the continuous high level of support provided to Russia, including major adjustment loans, despite a similarly slow pace of reforms and often frustrating dialogue. In its respective country assistance evaluations, OED praised ECA's decision to keep the Bulgaria FESAL on the back

[89] A brief references to this issue are found in the country strategy for Ukraine and Uzbekistan. It is also mentioned as an obstacle to privatization in the CAE for Kazakhstan and in an internal Bank report for the second FESAC for FYR Macedonia as one of the issues faced by the enterprise restructuring agency.

burner for five years, waiting for tangible progress to justify its approval, while criticizing the large SAL operations in Russia for their weak conditionality and questionable evidence of the authorities' commitment to the reforms being supported. The principal explanation for this disparity of action and of outcome seems to have had more to do with differing levels of external pressure on the Bank to transfer resources than with specific developmental objectives in the financial sector or elsewhere. Similar observations have been made about the "rush to lend" to Poland in the early 1990s and the Bank's support of an IMF program with a large Rehabilitation Loan to Bulgaria in 1996 despite highly unfavorable circumstances.[90] The Bank, as an international institution, cannot be immune to the political interests of its owners (any more than state-owned banks in its member countries can be immune from the political interests of their governments), but in both cases there is need to recognize the consequences for the integrity of the institution's credit allocation role.

Many internal project reports and other review papers have emphasized among the lessons learned the high importance of technical assistance for the institution-building that has been a central concern of the transition process. The Bank and other donors provided large amounts of assistance over the decade for the development of financial sector institutions. One of the lessons drawn from project reviews is the importance of intensive supervision of these activities. Some project reviews accorded high marks to the supervision effort made by Bank staff and gave this effort substantial credit for the success of the project. In a few cases, mostly associated with FILs, supervision was criticized as inadequate and involving the wrong mix of expertise. In general, however, the documents examined do not give a clear view of how adequately supervision has been funded and performed. Conversations with staff suggest that this is an issue deserving a closer look.

Donor Coordination

A large number of external institutions have been involved in assisting the ECA transition economies in their financial sector transformations. Among the IFIs, these have included the IMF, EBRD, ADB, EIB and Islamic Development Bank in addition to the World Bank Group. Other international assistance has come from the EU and a large number of bilateral assistance agencies, central banks, bank supervisory agencies, and finance ministries. Few if any of the transition country governments have been equipped to coordinate these efforts themselves. It is difficult on the basis of documents alone to assess the quality of donor coordination and the World Bank's role in achieving it. Bank CASs and loan documents almost always testify to a high degree of cooperation among the donors and often detail the areas in which each is providing assistance.

In some cases, internal Bank project reviews and OED reviews have given high praise to the success of specific country team efforts to orchestrate and coordinate reforms, frequently using Bank adjustment loans or other flagship lending operations as a vehicle for mobilizing supporting technical assistance, investments, or lines of credit. Among the specific instances that have been singled out was the FSAL in Ukraine, around which all the major donors are reported to have coordinated their efforts in an active and concerted manner.[91] In other cases, however, one finds

[90] See the 1997 Poland CAE.
[91] OED, Ukraine Country Assistance Evaluation, 2000.

problems written "between the lines." Internal project reviews, for example, refer frequently to problems created for the assistance effort when one or another bilateral creditor failed to meet commitments to provide an essential technical assistance component, or the assistance turned out to be of poor quality or at variance with the original terms of reference. Some reviews criticized Bank staff in such instances for not having taken a more proactive oversight role or for not having incorporated the faulty or missing component within the Bank's own operation. The mobilization of external resources to the development support effort is an important aspect of the Bank's role. Where the project elements being financed by other donors are crucial to achieving its objectives, it is essential that task managers be provided the resources necessary to ensure adequate supervision and regular consultation.

Another set of concerns arises from frequent mentions in internal project reviews of other donor agencies' activities that directly conflicted with objectives that the Bank was seeking to achieve. Such instances appear to have been most common in the case of financial intermediary loans. Other donor agencies have frequently funded credit lines with lower interest rates or other conditions at variance with those found in the Bank's loan, often using the same financial intermediaries as the Bank's loan. Similarly, other donors have frequently sponsored narrowly directed credit lines in parallel to Bank efforts to convince governments to phase out the use of directed credit. Even when loan conditions were essentially the same, concerns have been raised that the combined operations might have exceeded the managerial and risk-taking capacities of the intermediary institutions. Casual observation and conversations with task managers suggest that the Bank should have been more proactive in these cases in working with the governments and other donors to resolve such issues.

VI. Some Lessons of Experience

This final section summarizes in bullet-point fashion some of the lessons that can be taken from this review. Few if any of them are new; most have previously appeared in internal project reviews, CAEs or in broader assessments of the Bank's work. The present review serves largely to reconfirm them. Although the magnitude, speed, and complexity of the transition experience have been unique, and few countries remain that are yet to start it, most of its lessons are applicable more broadly across the Bank's country assistance programs. In general terms:

- The transition from a centrally planned economy is necessarily wrenching, complex, and time-consuming. It requires a vast web of interrelated changes in attitudes and concepts as well as laws, policies, and institutions. A carefully crafted external assistance program can help to design and implement these changes and to ameliorate their social costs, but it cannot simplify them. The challenge for assistance strategies is therefore to identify a manageable subset of key measures that, if successfully taken, may induce or "drag along" the other necessary actions.

- That "manageable subset of key measures" will vary from one country setting to another depending, *inter alia*, on the political forces and incentive systems at work as well as on management capacities and the availability of needed human skills. At the start, the Bank, along with many others, took too easily the proposition that privatization and price liberalization were the key first steps that would propel the other necessary changes.

- Given the complexity of the "strategic equation", particularly for an external agency like the World Bank, it is almost assured that initial country assistance strategies will prove wanting and require modification. Moreover, country circumstances inevitably change in accordance with their own internal political-economic dynamic. Perhaps the most important component of a successful strategy for supporting transition is flexibility. The Bank is generally to be applauded for the pragmatic and non-doctrinaire approach that has marked most of its assistance and advice to the transition economies.

- But pragmatism should not connote an absence of judgment. Bank strategies have generally been well thought through in terms of graduating the level and composition of lending to the progress being made in the agreed reforms. In implementation, however, adjustment lending often relied too heavily on preparatory steps rather than on real progress. Regardless of whatever other pressures may be at work, it is rarely helpful to add to a country's unproductive debt.

- The review confirms once again the obvious and often-made point regarding the crucial importance of country "ownership" of the reform program being supported by the Bank's assistance. However well designed the program, the rate of progress will be largely determined by the government's ownership of it and the degree of consensus it is able to mobilize in the society at large.

- The Bank's analytical capacity and accumulated knowledge of international development experience is the greatest asset it has to share with its client members. An effective strategy for the dissemination of this knowledge and for informing the public debate on the difficult and often divisive issues of transition should be an integral part of the overall country assistance strategy.

    - Given their importance to the Bank's country dialogues and to the design of country strategies and projects, ESW products, including informal reports, should be subjected to a more systematic process of review of their quality and impact.

Besides these generalities, a number of more specific operational lessons emerge from the review:

- The constitution of a proper legal framework that clearly defines and effectively protects property rights and that establishes a strong regulatory authority over the decentralized financial institutions and financial markets, is a *sine qua non* for a properly functioning market-based financial sector. Bank assistance programs have been correct in giving early emphasis to putting this framework in place.

  - But the submission of satisfactory laws to the legislature, and even their formal enactment, are not sufficient. The disbursement of adjustment loans should depend instead on tangible progress made in the effective implementation of the legal framework, including the banking and central banking laws as well as the laws governing bankruptcy, collateral and its repossession, and failed bank resolution.

  - Equally important, as one of their highest initial priorities in assisting the transition process, the Bank and other donors should support the intensive training of bankers and bank supervisors, lawyers and judges, accountants and auditors, and the other skilled professionals on which the effectiveness of the legal framework depends.

  - Adjustment lending, therefore, should be accompanied by specific funding for intensive and sustained technical assistance and training. The programmatic structural adjustment loan (PSAL), intended to provide sustained support for medium-term programs of reform may offer a better framework in this regard than the traditional adjustment loan.

- By the same token, a strong regulatory framework, led by an independent supervisory authority, is essential to protect the integrity of the banking system, minimize the systemic risks of bank failures, and maintain the confidence of savers in the system. Bank assistance programs have also given proper early emphasis to putting the framework in place, upgrading prudential regulations and bank accounting practices in accordance with international standards, and strengthening the authority and independence of the bank supervision agencies.

  - But again, early and high priority attention should also be given to the intensive training of bank supervisors. Insofar as possible, formal training should be augmented by opportunities for joint supervision experience with seasoned bank examiners from the advanced industrial countries.

  - Slow progress in upgrading the authority and effectiveness of the bank supervisory agency, including the resolution of failed banks, has been a consistent predictor of poor financial sector performance. Tangible progress in increasing the effectiveness of banking supervision should be treated as an important trigger for continuing financial assistance.

- Inadequate enforcement of accounting standards undercuts the ability of bank managers to know and manage their risks, the ability of bank supervisors to oversee and manage the risks in the system as a whole, and the confidence of savers to entrust their funds to financial institutions or directly to final borrowers.

  - While pressing the adoption of international accounting standards has been a common characteristic of practically all Bank assistance programs for financial sector transition, only a minority of the countries had actually implemented them by the end of the decade. Progress in the effective <u>enforcement</u> of IAS should be viewed as an early indicator of the authorities' determination to push forward with financial sector reforms and an important trigger for Bank financial assistance.

- At the same time, intensive technical assistance and training should be provided from the beginning of the transition programs to make the adoption of IAS feasible.

- Strong, financially sustainable banking institutions are essential to the development of stable financial systems and to the efficient intermediation of financial resources. Bank programs have correctly emphasized the strengthening of banks as a priority objective of country assistance programs in the transition economies.

  - State-owned banks, particularly those emerging from the central planning tradition, have seldom demonstrated good long-term prospects for becoming sound and efficient financial intermediaries.

    - The few exceptions have owed their success to strong (usually new) and independent top management, the elimination of all state subsidies beyond a single recapitalization adequate to meet prudential capital adequacy regulations, and a clear commitment to early privatization to reputable strategic investors.

    - In the meantime, however, given their predominant role in the early transition banking system, however, the state-owned banks cannot be ignored. The traditional state savings banks, in particular, have a continuing medium-term role to play in giving confidence and safe haven for household depositors. While fully commercialized behavior may be an overly optimistic expectation, substantial efforts need still to be made to improve the incentive framework which guides their behavior, through stronger governance, tighter budget constraints, the enforcement of prudential regulations, the divestiture of branches, and restrictions on the scope of their banking licenses.

  - Privately owned banks strongly inter-linked with major borrowing enterprises also make poor candidates for sound and efficient intermediation. Measures are needed early in the transition process to break these ownership linkages and to strictly enforce prudential regulations limiting loan concentration and related-party lending.

    - Bank ownership and governance issues should be given careful scrutiny in determining the eligibility of financial institutions to participate in Bank technical assistance programs and in credit line operations.

  - Institutional development programs for financial institutions should attach highest priority to the strengthening of basic banking skills, including credit policies and procedures, risk management, internal controls and information systems (including accounting standards).

    - Support to the development of sound financial institutions requires a multi-year commitment and is a highly supervision-intensive undertaking. Task managers should be provided sufficient resources to do it properly.

    - Even where the technical assistance is financed by other donors in the context of a broader Bank program or FIL, the Bank should closely monitor the progress and effectiveness of the assistance as crucial to the success of the overall objectives.

    - Apex units, if given strong leadership and substantial autonomy, can assist in project management and take on increasing responsibility over time for program monitoring, but experience shows that close Bank supervision is still required to assure achievement of institutional development objectives.

    - Assessment of the progress being achieved under institutional development programs should be a central consideration when deciding whether to go forward with a follow-up project, and the modifications that may be needed. An internal project review (or other formal review) should be required before approving the follow-up project.

- The size of credit lines channeled through any individual PFI should be carefully limited in accordance with the assessed management and risk-bearing capacity of the PFI. This issue is particularly relevant to newly established microfinance institutions. In making this assessment, the already existing and projected portfolio of the PFI should be taken into account, including any credit lines existing or expected from other donors.

- Many recent Bank operations have supported the start-up of rural and microfinance institutions, which initially depend entirely on government and/or donor funding for their resources. Their eventual independence and self-sustainability requires that they develop the capacity to mobilize savings and, eventually, to attract funds from commercial sources. Moreover, for many rural and poor families, there is greater demand for safe and remunerative savings opportunities than for credit.

  - Greater attention needs to be given in these projects to developing savings services and the consequent supervision requirements.

  - A donor exit strategy, aimed at achieving MFI financial sustainability and possibly involving a series of support operations, should be built in from the start.

- Financial sector staff should systematically be involved in all financial intermediary operations to ensure that all the factors that will determine the sustainability of the financial flows, instruments, and institutions being supported are being adequately taken into account.

    - The question of sustainability should be a central issue in the review of proposed FILs.

- The development of efficient capital markets is an important component of financial sector development. The role the capital markets can play in the early stages of transition to consolidate enterprise ownership in the hands of responsible strategic investors and to provide a goad to sound corporate management should not, however, be exaggerated. The impersonal and largely unsecured nature of financial market transactions requires a very high level of confidence among its participants. The market's growth and deepening depends on reliable accounting, adequate corporate governance structures, and an effective legal framework assuring transparency, information disclosure, and the protection of minority shareholders' rights. It also requires that a strong banking system already be in place and the development of institutional investors, especially contractual savings institutions.

    - In short, promoting the growth of the capital markets does not have the same urgency in the early stages of transition as the attention needed to build a strong banking system.

List of Persons Interviewed

Persons Interviewed for Transition Economy Study

Paul Siegelbaum
Alex Fleming
Roberto Rocha
Gabriella Ferencz
Laura Ard
Robert Liu
Martin Slough
Michael Fuchs
Marie Bakker
Albert Martinez
Hoonae Kim
Gary Fine
Tunc Uyanik

Persons Interviewed Earlier in Context of Background Paper for Russia CAE

William Alexander, IMF
Ken Lay, IBRD
Cesare Calari, IFC
Michael Fuchs, IBRD
Jacques Toureille, IBRD
Paul Siegelbaum, IBRD
Ruben Lamdany, IBRD
Walter Cohn, IFC (Consultant)
Gerhard Pohl, IBRD
*Michael Carter, IBRD
*Lajos Bokros, IBRD
*Ira Lieberman, IBRD

*Interviewed by others, partly on my behalf.

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	World Bank	SAR: Financial Institutions Development Project, Report No. 12707-RU, April 6, 1994.
	World Bank	SAR: Enterprise Support Project, Report No. 12953-RU, June 1, 1994.
	World Bank	SAR: Management and Financial Training Project, Report No. 12987-RU, November 23, 1994.
	World Bank	SAR: Enterprise Housing Divestiture Project, Report No. 15112-RU, April 17, 1996.
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	World Bank	Slovakia: Restructuring for Recovery, Report No. 12282-SK (2 vol.), July 11, 1994.
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Slovenia	World Bank	Slovenia: Economic Transformation and EU Accession (2 vol.), Country Study No. 19020, March 1999.
Ukraine	World Bank	"Ukraine—Risks and Transition: A Review of the Financial Sector," (2 vol.), Report No. 14526-UA, June 30, 1995.
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	World Bank	Country Assistance Strategy, Report No. 20723-UA, August 16, 2000.
	World Bank	SAR: Export Development Project, Report No. 15909-UA, October 25, 1996.
Uzbekistan	World Bank	Country Assistance Strategy, Report No. 23675-UZ, February 22, 2002.

Table A.1: Ratio of Broad Money to GDP, 1991-2001
(Percent)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania				38.4	46.8	55.0	56.1	52.0	57.9	60.8	66.0
Armenia				13.5	7.7	8.2	8.7	10.1	11.1	14.7	13.4
Azerbaijan		38.6	54.8	55.9	12.3	11.3	13.8	10.7	11.7	16.3	13.1
Belarus				39.0	14.8	14.3	15.8	30.9	16.7	17.7	15.2
Bosnia-Herzegovina							22.8	24.5	27.0	27.2	48.8
Bulgaria	71.7	75.8	76.4	77.9	65.4	71.5	33.5	29.6	31.7	37.5	40.9
Croatia			25.6	19.8	24.9	33.9	40.9	41.6	39.4	46.1	62.6
Czech Republic			68.2	73.1	78.6	73.7	69.9	66.0	65.5	72.8	74.5
Estonia	126.9	30.2	27.8	26.4	26.5	28.3	32.0	29.0	34.6	38.8	42.8
Georgia					5.0	6.7	8.0	6.4	7.9	10.5	11.3
Hungary	47.4	51.2	49.6	45.5	48.4	48.1	46.5	45.5	46.7	45.5	46.9
Kazakhstan				13.1	11.0	10.3	10.8	9.0	13.1	14.6	17.2
Kyrgyz Republic					17.2	13.6	13.7	14.5	13.6	11.3	11.1
Latvia			31.6	34.2	23.6	23.4	27.5	26.7	26.7	30.3	33.2
Lithuania			23.1	25.8	23.3	17.2	19.0	19.4	21.0	23.2	26.5
Macedonia, FYR				12.6	12.2	11.6	13.6	14.6	18.0	19.3	25.5
Moldova	70.3	43.5	19.2	15.9	19.2	18.3	21.6	19.3	20.5	22.3	25.5
Poland	32.3	35.8	35.9	36.7	33.9	35.2	37.3	39.9	42.8	43.0	46.9
Romania	63.1	32.6	23.3	21.8	25.6	28.4	24.6	24.8	24.7	23.2	23.6
Russian Federation			23.9	21.2	17.9	16.7	18.4	22.9	20.7	21.4	23.5
Slovak Republic			68.8	67.7	62.1	65.2	62.9	60.4	62.5	66.2	68.0
Slovenia		26.2	30.3	33.8	36.5	39.2	42.5	45.4	46.5	49.7	57.3
Tajikistan				81.7	20.5	8.3	8.6	8.1	7.4	8.8	9.5
Turkmenistan				25.6	18.8	8.1	10.2	14.9	12.7	20.3	18.1
Ukraine		50.1	32.9	26.8	12.7	11.5	13.4	15.2	17.2	18.6	21.9
Uzbekistan				34.7	18.2	21.0	17.5	15.4	13.6	12.4	12.7

Sources: *IMF, International Statistics, January 1999 ar December 2002*
EBRD, Transition Report Update, May 2002.

Table A.2: Ratio of Currency Outside Deposit Money Banks to Broad Money, 1991-2001
(Percent)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania				39.0	39.0	30.9	36.6	28.5	27.8	30.2	30.3
Armenia		23.1	28.9	39.6	61.1	64	53.5	43.1	38.9	39.2	41.1
Azerbaijan		31.9	50.9	31.1	45.9	56.3	53.6	50.2	51.3	35.1	42.7
Belarus				10.7	21.1	22.7	21.3	12.5	17.2	14.8	20.0
Bosnia-Herzegovina							7.6	8.9	22.1	25.4	34.1
Bulgaria	12.2	12.2	10.9	9.4	10.7	10.1	23.1	27.3	27.1	24.9	25.5
Croatia			13.8	15.4	13.7	11.9	10.5	10.0	10.6	9.1	8.0
Czech Republic			8.5	10	9.6	10.3	10.1	10.5	12.7	11.9	11.2
Estonia	9.1	26.2	39.7	39.2	35.0	28.7	22.4	21.3	21.6	18.7	17.0
Georgia					68.1	68.2	64.2	57.5	54.6	50.6	47.3
Hungary	22.0	21.4	21.1	20.7	16.3	15.0	14.2	14.6	16.1	14.8	14.9
Kazakhstan				13.1	11.0	10.3	10.8	9.0	13.1	14.6	17.2
Kyrgyz Republic					69.8	75.8	63.6	57.1	54.0	55.5	60.9
Latvia			32.9	30.5	38.2	40.2	37	35.5	36.4	32.4	30.7
Lithuania					33.9	35.0	34.9	33.6	30.5	25.4	23.0
Macedonia, FYR			6.3	25.9	28.9	31.3	27.1	24.4	22.0	20.8	23.4
Moldova	10.0	11.7	34.2	45.9	51.4	51.1	50.6	48.5	44.5	41.1	37.8
Poland	21.5	19.0	17.8	15.9	18.7	17.2	15.5	13.7	14.5	11.6	11.3
Romania	14.0	23.5	22.5	20.2	20.4	17.4	14.8	12.4	12.9	13.8	13.1
Russian Federation			26.2	26.6	29.3	29.1	28.5	29.9	27.1	26.9	27.5
Slovak Republic			9.9	9.4	9.8	10.6	10.9	10.6	11.0	11.1	12.0
Slovenia	7.7	9.1	7.5	7.6	7.4	6.7	6.3	6.3	7.4	6.0	5.4
Tajikistan											
Turkmenistan											
Ukraine		19.0	26.1	24.7	37.8	43.2	48.9	46.0	43.8	40.5	43.1
Uzbekistan											

Sources: *IMF, International Financial Statistics, January 1999 and December 2002.*

Table A.3: Ratio of Domestic Credit to GDP, 1991-2001
(Percent)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania				51.3	37.2	44.9	52.4	46.7	46.6	47.4	46.1
Armenia				15.3	9.0	9.0	7.9	10.7	10.7	11.5	9.1
Azerbaijan			52.0	44.3	12.5	13.0	13.0	12.9	10.6	9.6	5.3
Belarus				39.8	15.0	15.1	17.0	35.2	19.9	19.2	17.1
Bosnia-Herzegovina							60.5	57.8	48.2	45.7	46.1
Bulgaria	118.2	122.5	131.1	103.4	72.7	115.4	22.0	16.0	16.2	18.9	20.4
Croatia			100.8	49.1	48.8	44.9	45.4	48.6	46.2	45.7	51.9
Czech Republic			72.8	78.2	75.9	72.3	72.3	64.2	59.7	54.5	49.8
Estonia	60.6	11.3	10.5	10.7	14.1	22.2	32.5	32.9	34.8	39.5	44.1
Georgia					5.2	8.3	12.7	13.8	19.6	21.9	20.4
Hungary	74.6	69.9	67.7	64.0	82.3	72.1	65.2	62.9	52.7	54.7	50.0
Kazakhstan				29.1	9.2	8.3	6.8	9.1	9.7	11.8	11.6
Kyrgyz Republic					25.6	25.0	18.0	19.8	14.6	12.0	9.7
Latvia			18.3	22.6	14.6	12.7	15.4	18.5	19.5	25.4	31.2
Lithuania			15.5	19.0	15.3	11.8	13.3	14.0	16.6	15.4	15.8
Macedonia, FYR				78.8	25.7	29.1	29.5	18.8	19.6	14.4	19.2
Moldova	62.8	56.0	25.4	19.7	23.7	23.4	26.0	32.8	28.7	25.2	27.5
Poland	34.9	38.2	40.6	39.2	32.0	33.2	34.1	35.1	37.6	35.5	37.7
Romania	62.5	31.9	21.3	18.4	23.6	28.9	18.7	21.7	17.9	14.1	12.4
Russian Federation			25.9	31.7	41.3	25.1	26.6	40.5	31.2	23.2	24.3
Slovak Republic			79.7	62.5	47.6	55.5	66.2	62.4	58.7	56.4	61.6
Slovenia		22.7	33.6	31.9	36.5	35.9	35.8	40.0	43.3	47.1	49.5
Tajikistan		83.5	30.6	24.2	15.5	14.8	17.1	24.6	25.9	23.8	23.3
Turkmenistan											
Ukraine											
Uzbekistan											

Sources: *IMF, International Financial Statistics, January 1999 and December 2002.*

Table A.4: Deposit Bank Domestic Credit as Share of Total Domestic Credit, 1991-2001
(Percent)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania				27.0	47.7	57.9	50.8	62.9	37.7	68.1	72.1
Armenia			9.7	59.0	70.1	62.2	81.6	88.8	90.5	90.1	88.0
Azerbaijan		68.8	46.1	59.5	29.3	44.7	57.6	62.3	76.2	70.6	142.5
Belarus				61.2	61.7	49.2	35.5	59.3	66.3	78.4	76.8
Bosnia-Herzegovina							91.6	93.5	95.8	96.6	94.2
Bulgaria	81.6	85.5	85.5	87.2	89.7	83.5	99.3	107.1	105.5	90.1	94.7
Croatia			98.0	100.3	99.0	99.7	100.8	97.8	96.7	98.8	99.9
Czech Republic			89.9	96.2	95.5	96.2	95.5	94.9	95.7	98.0	101.1
Estonia	17.9	60.8	70.1	84.1	85.4	79.4	75.9	72.5	74.4	63.1	61.5
Georgia					69.1	30.2	27.9	27.6	29.7	33.6	38.3
Hungary	38.6	46.1	51.8	50.6	37.5	44.8	51.3	54.1	65.7	74.1	87.0
Kazakhstan			59.8	78.9	63.2	54.1	70.3	73.6	82.6	102.3	193.0
Kyrgyz Republic					23.1	34.1	22.6	26.6	28.0	28.4	37.4
Latvia			89.8	82.8	71.3	97.8	81.3	80.0	88.1	86.5	89.6
Lithuania			88.9	96.4	83.2	83.8	88.4	93.7	89.2	99.5	107.4
Macedonia, FYR			97.1	95.9	89.8	90.0	86.5	83.0	98.2	128.1	99.1
Moldova	89.5	47.7	47.1	42.0	47.9	59.7	65.2	46.2	48.3	60.5	63.7
Poland	61.8	64.1	68.7	70.6	83.4	86.0	86.2	88.7	91.7	94.2	93.8
Romania	67.1	69.1	59.6	69.4	67.0	67.5	83.3	79.3	77.0	80.8	91.6
Russian Federation			57.6	56.7	36.4	65.7	66.0	48.6	52.1	71.3	78.8
Slovak Republic			72.8	74.4	79.8	82.4	90.3	88.9	96.5	98.3	100.4
Slovenia	91.2	91.2	93.6	96.0	97.1	98.0	97.8	98.3	96.6	97.2	88.0
Tajikistan											
Turkmenistan											
Ukraine		13.6	42.5	45.5	41.3	43.0	45.5	35.7	35.8	45.8	57.4
Uzbekistan											

Note: Deposit bank domestic claims net of government deposits and claims of central bank on deposit banks.

Sources: IMF, International Financial Statistics, January 1999 and December 2002.

Table A.5: Deposit Money Banks Claims on Enterprises as Share of Total Loans, 1991-2001 (Percent)

Country	***1991***	***1992***	***1993***	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2001***
Albania				**9.2**	**8.0**	**7.4**	**9.7**	**9.2**	**8.8**	**10.5**	**12.6**
o/w private sector				*6.3*	*5.8*	*5.7*	*8.0*	*7.7*	*8.1*	*9.9*	*12.0*
Armenia		**75.0**	**15.6**	**69.1**	**79.0**	**73.0**	**65.4**	**71.5**	**64.8**	**61.0**	**56.5**
Azerbaijan		**77.2**	**69.0**	**52.6**	**66.9**	**73.7**	**75.6**	**84.3**	**75.6**	**52.4**	**59.4**
o/w private sector		*12.2*	*15.2*	*4.8*	*5.5*	*6.2*	*14.5*	*20.4*	*18.5*	*33.0*	*43.2*
Belarus				**61.9**	**77.6**	**74.5**	**69**	**68.7**	**73.6**	**72.3**	**76.7**
o/w private sector				*32.3*	*41.1*	*42.5*	*53.8*	*39.4*	*45.7*	*39.2*	*42.3*
Bosnia-Herzegovina							72.8	76.5	77.9	76.7	73.6
Bulgaria	**56.1**	**55.6**	**47.1**	**39.7**	**48.2**	**4.4**	**24.6**	**35.4**	**40.7**	**39.2**	**42.2**
o/w private sector	*4.9*	*4.3*	*2.6*	*3.0*	*25.8*	*24.3*	*14.3*	*27.0*	*35.1*	*37.0*	*40.3*
Croatia			**43.6**	**52.1**	**55.1**	**53.4**	**60.6**	**68.1**	**65.5**	**60.4**	**58.0**
o/w private sector			*39.7*	*48.0*	*51.9*	*50.3*	*57.8*	*65.4*	*63.4*	*58.0*	*55.4*
Czech Republic			**83.2**	**84.1**	**81.7**	**81.6**	**77.7**	**73.4**	**65.7**	**62.4**	**52.3**
o/w private sector			*57.0*	*62.7*	*81.7*	*81.6*	*77.7*	*73.4*	*65.7*	*62.4*	*52.3*
Estonia	**38.4**	**50.5**	**62.1**	**56.9**	**59.5**	**68.6**	**65.2**	**71.6**	**67.0**	**65.8**	**60.5**
o/w private sector	*23.8*	*30.5*	*52.9*	*52.5*	*56.3*	*66.6*	*64.0*	*70.8*	*65.8*	*65.1*	*60.2*
Georgia											
o/w private sector					*81.2*	*74.2*	*75.8*	*73.9*	*78.1*	*79.9*	*69.7*
Hungary	**77.5**	**70.4**	**56.6**	**58.0**	**58.1**	**55.4**	**58.3**	**56.3**	**59.6**	**67.7**	**64.4**
Kazakhstan			**84.2**	**88.0**	**68.4**	**68.8**	**65.1**	**67.3**	**57.5**	**71.5**	**80.1**
Kyrgyz Republic					**87.0**	**86.7**	**53.3**	**67.2**	**73.8**	**71.4**	**57.6**
Latvia			**29.2**	**44.5**	**31.5**	**23.4**	**26.6**	**41.3**	**39.2**	**36.8**	**41.4**
o/w private sector			*27.4*	*39.8*	*27.8*	*21.5*	*24.6*	*39.5*	*37.3*	*34.6*	*38.6*
Lithuania			**86.9**	**84.3**	**79.5**	**63.7**	**55.5**	**60.9**	**62.0**	**51.4**	**49.4**
o/w private sector			*69.2*	*74.4*	*74.6*	*61.3*	*54.1*	*57.7*	*59.0*	*48.6*	*47.2*
Macedonia, FYR			**37.1**	**53.2**	**72.2**	**74.8**	**74.2**	**64.9**	**63.1**	**54.3**	**44.5**
o/w private sector			*37.1*	*53.2*	*71.2*	*74.6*	*73.9*	*64.4*	*62.7*	*53.6*	*43.7*
Moldova	**46.8**	**57.0**	**63.2**	**79.9**	**86.0**	**86.5**	**87.6**	**73.2**	**63.3**	**64.4**	**68.2**
o/w private sector	*8.6*	*14.5*	*17.2*	*20.9*	*33.1*	*35.7*	*31.1*	*65.7*	*57.5*	*57.8*	*61.7*
Poland	**59.3**	**52.5**	**51.0**	**47.5**	**50.2**	**55.1**	**58.4**	**64.0**	**63.8**	**66.1**	**62.7**
o/w private sector	*27.5*	*27.7*	*29.2*	*28.5*	*32.2*	*38.7*	*42.7*	*49.1*	*51.8*	*56.0*	*54.3*
Romania	**92.9**	**86.6**	**74.1**	**74.0**	**74.3**	**68.1**	**57.9**	**60.3**	**50.2**	**48.8**	**54.6**
o/w private sector	*0*	*0*	*0*	*0*	*0*	*33.2*	*36.1*	*47.4*	*41.5*	*41.1*	*46.1*
Russian Federation			**68.4**	**67.1**	**64.3**	**50.3**	**50.2**	**44.2**	**41.3**	**48.4**	**56.7**
o/w private sector			*38.5*	*40.6*	*43.9*	*34.9*	*44.0*	*40.3*	*37.9*	*44.6*	*53.6*
Slovak Republic			**79.1**	**67.6**	**61.3**	**61.2**	**61.7**	**64.3**	**76.0**	**66.1**	**47.6**
o/w private sector			*40.3*	*36.3*	*43.2*	*42.1*	*46.4*	*50.4*	*50.1*	*39.1*	*31.7*
Slovenia											
o/w private sector	*49.6*	*50.9*	*44.4*	*43.8*	*49.7*	*51.8*	*54.6*	*59.3*	*62.6*	*62.2*	*57.2*
Tajikistan											
Turkmenistan											
Ukraine		**79.8**	**69.9**	**57.5**	**68.2**	**70.4**	**68.2**	**66.9**	**69.8**	**78.1**	**84.2**
o/w private sector		*3.9*	*3.6*	*16.1*	*12.3*	*13.1*	*19.7*	*56.6*	*60.1*	*68.2*	*74.3*
Uzbekistan											

Source: IMF, International Financial Statistics, January 1999 and December 2002.

Table A.6: Deposit Money Bank Claims on Enterprise Sector in Relation to GDP, 1991-2001 (Percent)

Country	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Albania				**5.7**	**5.0**	**5.1**	**4.6**	**3.8**	**3.9**	**4.8**	**6.1**
o/w private sector				*3.9*	*3.6*	*3.9*	*3.8*	*3.2*	*3.6*	*4.5*	*5.9*
Armenia				**11.1**	**7.3**	**5.6**	**6.0**	**8.6**	**9.2**	**10.6**	**8.3**
Azerbaijan		**68.7**	**43.6**	**36.6**	**14.3**	**13.8**	**12.8**	**12.7**	**12.1**	**9.4**	**6.9**
o/w private sector		*10.8*	*9.6*	*3.3*	*1.2*	*1.2*	*2.4*	*3.1*	*3.0*	*5.9*	*5.1*
Belarus				**33.7**	**11.5**	**11.2**	**10.6**	**28.1**	**14.9**	**16.2**	**15.0**
o/w private sector				*17.6*	*6.1*	*6.4*	*8.3*	*16.1*	*9.2*	*8.8*	*8.3*
Bosnia-Herzegovina							58.4	56.4	48.0	45.6	46.6
Bulgaria	**82.6**	**75.9**	**65.5**	**49.2**	**39.4**	**62.0**	**9.8**	**11.0**	**12.6**	**13.2**	**15.0**
o/w private sector	*7.2*	*5.9*	*3.7*	*3.8*	*21.1*	*35.6*	*5.7*	*8.3*	*10.9*	*12.5*	*14.3*
Croatia			**51.9**	**31.0**	**33.1**	**31.1**	**39.0**	**42.8**	**38.2**	**37.6**	**43.2**
o/w private sector			*47.3*	*28.6*	*31.2*	*29.3*	*37.2*	*41.2*	*36.9*	*36.0*	*41.3*
Czech Republic			**72.6**	**79.8**	**75.1**	**74.0**	**74.4**	**64.0**	**57.7**	**51.9**	**42.5**
o/w private sector			*49.8*	*59.5*	*75.1*	*74.0*	*74.4*	*64.0*	*57.7*	*51.9*	*42.5*
Estonia	**29.1**	**12.4**	**12.8**	**14.9**	**15.6**	**19.8**	**26.9**	**25.5**	**26.4**	**26.2**	**27.7**
o/w private sector	*18.0*	*7.5*	*10.9*	*13.8*	*14.6*	*19.2*	*26.4*	*25.5*	*26.0*	*25.9*	*27.5*
Georgia											
o/w private sector					*4.0*	*3.3*	*3.7*	*4.2*	*6.0*	*7.5*	*7.6*
Hungary	**38.7**	**33.1**	**28.1**	**26.1**	**22.5**	**22.1**	**24.3**	**24.2**	**26.0**	**32.3**	**33.8**
Kazakhstan				**26.4**	**6.9**	**5.4**	**5.4**	**6.2**	**7.3**	**10.6**	**20.4**
Kyrgyz Republic					**12.5**	**8.7**	**3.4**	**5.3**	**5.0**	**4.1**	**3.8**
Latvia			**18.5**	**18.4**	**9.0**	**7.9**	**11.4**	**15.5**	**16.5**	**19.7**	**24.8**
o/w private sector			*17.3*	*16.4*	*7.9*	*7.2*	*10.5*	*14.8*	*15.7*	*18.5*	*23.1*
Lithuania			**17.4**	**20.0**	**16.1**	**11.5**	**11.1**	**12.0**	**13.6**	**12.2**	**12.1**
o/w private sector			*13.8*	*17.6*	*15.2*	*11.1*	*10.9*	*11.3*	*13.0*	*11.5*	*11.5*
Macedonia, FYR				**45.3**	**23.4**	**26.6**	**27.4**	**17.9**	**21.0**	**18.1**	**17.7**
o/w private sector				*45.3*	*23.1*	*26.5*	*27.3*	*17.7*	*20.9*	*17.8*	*17.4*
Moldova	**32.1**	**22.9**	**18.4**	**14.1**	**17.4**	**18.6**	**19.5**	**15.5**	**13.0**	**14.1**	**16.3**
o/w private sector	*5.9*	*5.9*	*5.0*	*3.7*	*6.7*	*7.7*	*6.9*	*13.9*	*11.8*	*12.6*	*14.7*
Poland	**23.9**	**21.7**	**21.4**	**19.9**	**18.5**	**20.9**	**22.7**	**24.5**	**27.6**	**28.9**	**29.4**
o/w private sector	*11.1*	*11.4*	*12.2*	*12.0*	*11.9*	*14.7*	*16.6*	*18.8*	*22.4*	*24.5*	*25.5*
Romania	**62.5**	**31.9**	**24.5**	**19.0**	**22.3**	**23.6**	**13.4**	**14.7**	**9.8**	**8.6**	**9.3**
o/w private sector	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*11.5*	*8.4*	*11.6*	*8.1*	*7.2*	*7.8*
Russian Federation			**20.9**	**20.0**	**12.7**	**10.6**	**10.9**	**13.8**	**11.9**	**12.9**	**16.2**
o/w private sector			*11.8*	*12.1*	*8.7*	*7.3*	*9.5*	*12.6*	*10.9*	*11.9*	*15.4*
Slovak Republic			**63.1**	**45.5**	**35.7**	**42.6**	**54.3**	**54.2**	**55.0**	**52.7**	**38.3**
o/w private sector			*32.1*	*24.3*	*25.2*	*29.3*	*40.8*	*42.5*	*36.3*	*30.2*	*25.5*
Slovenia											
o/w private sector		*23.3*	*22.1*	*23.0*	*27.4*	*28.8*	*28.5*	*32.8*	*36.0*	*38.1*	*40.0*
Tajikistan											
Turkmenistan											
Ukraine		**53.3**	**27.7**	**16.5**	**8.2**	**7.4**	**8.4**	**9.1**	**10.1**	**12.2**	**14.2**
o/w private sector		*2.6*	*1.4*	*4.6*	*1.5*	*1.4*	*2.4*	*7.7*	*8.7*	*10.8*	*12.6*
Uzbekistan											

Source: IMF, International Financial Statistics, January 1999 and December 2002.

Table A.7: Interest Rates and Spreads on Domestic Currency Loans and Deposits, 1991-2001
(Percent per annum)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001e/
Albania											
Lending rate a/		20.6	29.6	23.7	19.65	23.96			21.62	22.1	19.65
Deposit rate b/		18.5	27.3	19.8	15.30	16.78	27.28	22.56	12.95	8.3	7.73
Spread		2.1	2.3	3.9	4.35	7.18	n.a.	n.a.	8.67	13.8	11.92
Armenia											
Lending rate c/					111.9	66.4	54.2	48.5	38.9	31.6	26.7
Deposit rate c/					63.2	32.2	26.1	24.9	27.4	18.1	14.9
Spread					48.7	34.2	28.1	23.6	11.5	13.5	11.8
Azerbaijan											
Lending rate d/				406.0	107.0	33.0	21.5	27.7	27.5	27.2	26.1
Deposit rate f/				406.0	90.0	13.0	11.5	10.9	9.9	12.2	12.0
Spread				0.0	17.0	20.0	10.0	16.8	17.6	15.0	14.1
Belarus											
Lending rate g/			71.6	148.5	175.0	62.3	31.8	27.0	51.0	67.7	47.0
Deposit rate g/			65.1	89.6	100.8	32.4	15.6	14.3	23.8	37.6	34.2
Spread			6.5	58.9	74.2	29.9	16.2	12.7	27.2	30.1	12.8
Bosnia-Herz.											
Lending rate z/								73.50	24.29	30.50	
Deposit rate aa/								51.88	9.07	14.67	
Spread								21.62	15.22	15.83	
Bulgaria											
Lending rate h/	48.37	56.67	58.30	72.58	58.98	123.48	83.96	13.30	12.79	11.52	11.11
Deposit rate j/	39.49	45.01	42.56	51.14	35.94	74.68	46.8	3.00	3.21	3.10	2.88
Spread	8.88	11.66	15.74	21.44	23.04	48.80	37.13	10.30	9.58	8.42	8.23
Croatia											
Lending rate k/		1157.8	1443.6	22.91	20.24	22.52	15.47	15.75	14.94	12.07	9.55
Deposit rate k/		658.5	379.3	6.52	5.53	5.59	4.30	4.62	4.31	3.74	3.23
Spread				16.39	14.71	16.93	11.17	11.1	10.63	8.33	6.32
Czech Rep.											
Lending rate k/			14.07	13.12	20.24	22.52	15.47	15.75	14.94	12.07	9.55
Deposit rate k/			7.03	7.07	5.53	5.59	4.30	4.62	4.31	3.74	3.23
Spread			7.04	6.05	14.71	16.93	11.17	11.1	10.63	8.33	6.32
Estonia											
Lending rate ja/		30.5	27.3	23.08	19.01	14.87	11.76	15.06	11.09	7.43	7.78
Deposit rate jb/				11.51	8.74	6.05	6.19	8.07	4.19	3.76	4.03
Spread				11.57	10.27	8.82	5.57	6.99	6.90	3.67	3.75
FYR Macedonia											
Lending rate ma/				159.82	45.95	21.58	21.42	21.03	20.45	18.93	19.35
Deposit rate mb/				117.56	24.07	12.75	11.64	11.68	11.40	11.18	9.97
Spread				42.26	21.88	8.83	9.78	9.35	9.05	7.75	9.38
Georgia											
Lending rate n/					69.8	58.24	50.64	46.00	33.42	32.75	27.25
Deposit rate n/					17.9	31.05	13.73	17.00	14.58	10.17	7.75
Spread					51.9	27.19	36.91	29.00	18.84	22.58	19.50
Hungary											
Lending rate o/	35.1	33.1	25.4	27.4	32.6	27.3	21.8	19.3	16.3	12.6	12.1
Deposit rate o/	30.4	24.4	15.7	20.3	26.1	22.2	18.5	16.2	13.3	9.6	9.3
Spread	4.7	8.7	9.7	7.1	6.5	5.1	3.3	3.1	3.0	3.0	2.8
Kazakhstan											
Lending rate p/					58.3	53.6	22.8	18.4	21.3	19.9	15.4

Deposit rate g/					44.4	29.3	12.0	14.5	13.5	15.6	11.0
Spread					13.9	24.3	10.8	3.9	7.8	4.3	4.4
Kyrgyz Rep.											
Lending rate k/						65.0	49.4	73.4	60.9	51.9	37.3
Deposit rate k/						36.7	39.6	35.8	35.6	18.4	12.5
Spread						28.3	9.8	37.6	25.3	33.5	24.8
Latvia											
Lending rate o/			86.36	55.86	34.56	25.78	15.25	14.29	14.2	11.87	11.17
Deposit rate o/			34.78	31.68	14.79	11.71	5.90	5.33	5.04	4.38	5.24
Spread			51.58	24.18	19.77	14.07	9.35	8.96	9.16	7.49	5.93
Lithuania											
Lending rate k/			91.84	62.3	27.08	21.6	14.39	12.21	13.1	12.1	9.63
Deposit rate r/			88.29	48.43	20.05	13.95	7.89	5.98	4.94	3.86	3.00
Spread			3.55	13.87	7.03	7.61	6.50	6.23	8.15	8.28	6.63
Moldova											
Lending rate g/					41.9	36.7	33.3	30.8	35.5	33.8	28.7
Deposit rate g/					32.5	25.4	23.5	22.0	20.4	17.1	14.2
Spread					9.4	11.3	9.8	8.8	15.1	16.7	14.5
Poland											
Lending rate s/	54.6	39.0	35.3	32.8	33.5	26.1	25.0	24.5	17.0	20.0	18.4
Deposit rate t/	53.5	37.8	34.0	33.4	26.8	20.0	19.4	18.2	11.2	14.2	11.8
Spread	1.1	1.2	1.3	-0.6	6.7	6.1	5.6	6.3	5.8	5.8	6.6
Romania											
Lending rate u/				61.8	48.6	55.8	63.7	56.9	65.9	53.5	40.6
Deposit rate u/				49.5	36.5	38.1	51.6	38.3	45.4	32.7	23.4
Spread				12.3	12.1	17.7	12.1	18.6	20.5	20.8	17.2
Russian Fed.											
Lending rate bb/					320.31	146.81	32.04	41.79	39.72	24.43	17.91
Deposit rate cc/					101.96	55.05	16.77	17.05	13.68	6.51	4.85
Spread					218.35	91.76	15.27	24.74	26.04	17.92	13.06
Slovak Rep.											
Lending rate dd			14.41	14.56	16.85	13.92	18.65	21.17	21.07	14.89	11.24
Deposit rate ee/			8.02	9.32	9.01	9.30	13.44	16.25	14.37	8.45	6.46
Spread			6.39	5.24	7.84	4.62	5.21	4.92	6.7	6.44	4.78
Slovenia											
Lending rate v/	824.56	195.11	48.61	38.87	23.36	22.60	20.02	16.09	12.38	15.77	15.05
Deposit rate w/	682.53	153.02	33.04	28.10	15.38	15.08	13.19	10.54	7.24	10.05	9.81
Spread	142.03	42.09	15.57	10.77	7.98	7.52	6.83	5.55	5.14	5.72	5.24
Tajikistan											
Lending rate x/				30.0	500.0	122.0	74.0	49.7	23.2	18.6	17.3
Deposit rate x/				30.0	100.0	109.0	89.0	15.7	11.4	41.3	33.4
Spread				0.0	400.0	13.0	-15.0	34.0	11.8	-22.7	-16.1
Turkmenistan											
Lending rate y/				300.0	70.0	200.0	52.6	58.6	41.8	11.3	
Deposit rate y/				206.0	80.0	130.0	41.1	24.2	27.1		
Spread				94.0	-10.0	70.0	11.5	34.4	14.7		
Ukraine											
Lending rate k/			184.25	250.28	122.70	79.88	49.12	54.50	54.95	41.53	32.28
Deposit rate k/			148.63	208.63	70.29	33.63	18.21	22.25	20.70	13.72	10.99
Spread				41.65	52.41	46.25	30.91	32.25	34.25	27.81	21.29
Uzbekistan											
Lending rate g/				100.0	105.0	50.0	28.0	33.0	30.0		
Deposit rate g/				60.0	90.0	28.0	15.0	12.0	12.0		
Spread				40.0	15.0	22.0	13.0	21.0	18.0		

Notes: a/ For 1992-95, guideline rate announced by central bank; thereafter, weighted average rate for new 12-month loans of the 3 commercial banks with the highest level of outstanding loans.

b/ For 1992, the minimum rate set by the central bank for 12-month deposits; for 1993-95, guideline minimum rate announced by central bank; thereafter, weighted average rate on new 12-month deposits of the 3 commercial banks with highest level of deposits.

c/ Weighted average rates for maturities of 15 days to less than one year.

d/ For 1994-95, minimum lending rate for private enterprises; thereafter, 3-month lending rate for "bank clients".

e/ Estimate.

f/ For 1994-95, minimum rate for household time deposits; thereafter, 3-month deposit rate for "bank clients".

g/ Rates for 1-year loans and deposits, respectively.

h/ Loans of less than one year.

j/ One-month deposits.

k/ Weighted averages over all maturities.

ja/ Weighted average on short-term bank loans.

jb/Weighted average on bank time deposits.

ma/Midpoint rates for short-term loans to all sectors.

mb/ Lowest reported rate on household deposits of 3-6 months.

n/ Weighted average rates on loans and deposits with 3-month maturities.

o/ Weighted averages for maturities of less than one year.

p/ Weighted average on loans of 1-3 months maturity.

q/ Weighted average on time deposits of 1-3 month maturity.

r/ Weighted average on resident time deposits.

s/ Through 1994, the lowest rate charged to prime borrowers; from 1995, the weighted average rate to prime borrowers.

t/ For 1991-92, the lowest rate offered on 12-month deposits; from 1993, the weighted average rate on household deposits.

u/ Averages.

v/ Short-term working capital.

w/ 31-90 days.

x/ 1-3 month maturities.

y/ Rates before 1996 are the highest in range; from 1996-99, rates are averages for maturities of 3-6 months; From 2000, rates are for 1-year maturities.

z Average of minimum and maximum rates charged by commercial baks on short-term loans to private enterprises.

aa/ Average of minimum and maximum rates offered by commercial banks on time deposits and savings deposits of households.

bb/ For 1995-96, weighted average rate for regional bank loans of up to one year; from 1997, weighted average rate on commercial bank loans of up to one year.

cc/ For 1995-96, prevailing rate for deposits of more than Rub.300,000; from 1997, weighted average rate on household time deposits of up to one year.

dd/ For 1993-94, weighted average rate on all outstanding credits; from 1995, weighted average rate on short-term loans to the private corporate sector.

ee/ For 1993-95, weighted average rate on all deposits; from 1996, weighted average rate on deposits of up to 1-year maturity held by private sector.

Sources: *IMF, International Financial Statistics, January 1999 and December 2002.*
EBRD, Transition Report Update, May 2002.

Table A.8: Market Capitalization, 1994-2000

(Percent of GDP)

Country	1994	1995	1996	1997	1998	1999	March 2000
Albania							
Armenia	0	1	1	1	1	1	1
Azerbaijan	0	0	0	0	0	1	1
Belarus							
Bosnia-Herzegovina							
Bulgaria	0	1	0	1	8	6	5
Croatia	3	3	15	21	15	11	13
Czech Republic	14	30	31	24	21	19	25
Estonia	0	2	10	11	28	31	36
Georgia							
Hungary	3	5	12	33	29	31	34
Kazakhstan	0	0	0	1	1	2	5
Kyrgyz Republic	0	0	1	5	7	3	3
Latvia	0	1	3	6	6	6	8
Lithuania	1	2	11	18	10	12	11
Macedonia, FYR	0	0	0	0	0	1	1
Moldova	0	0	0	2	6	22	19
Poland	3	4	6	8	13	18	21
Romania	0	0	0	2	3	2	2
Russia	2	5	9	8	7	25	19
Slovak Republic	8	7	12	9	5	4	3
Slovenia	4	2	4	9	13	11	12
Tajikistan							
Turkmenistan							
Ukraine	0	0	0	0	2	3	4
Uzbekistan							

Source: Stijn Claessens, Simeon Djankov, and Daniela Klingebiel, "Stock Markets in Transition Economies," in Lajos Bokros, et.al (eds.), Financial Transition in Europe and Central Asia: Challenges of the New Decade, World Bank, 2001.

Table A.9: Stock Market Turnover, 1994-2000

(Percent of Market Capitalization, mid-period)

Country	1994	1995	1996	1997	1998	1999	March 2000
Albania							
Armenia	0	2	2	7	5	15	18
Azerbaijan	0	0	4	12	12	13	10
Belarus							
Bosnia-Herz.							
Bulgaria	0	8	1	1	2	4	6
Croatia	8	8	13	10	5	5	7
Czech Rep.	26	33	50	47	37	61	81
Estonia	0	0	59	78	108	44	21
Georgia							
Hungary	22	17	42	76	112	103	93
Kazakhstan	0	0	0	2	2	2	3
Kyrgyz Rep.	0	2	8	2	6	2	2
Latvia	8	12	15	35	24	21	19
Lithuania	0	37	9	18	16	13	7
Macedonia, FYR	0	0	3	24	41	45	36
Moldova	0	0	12	81	173	81	62
Poland	177	72	85	78	54	62	69
Romania	2	7	72	73	66	58	45
Russian Fed.	367	7	11	20	11	27	40
Slovak Rep.	96	69	134	109	74	48	25
Slovenia	68	71	82	31	35	28	22
Tajikistan							
Turkmenistan							
Ukraine	0	5	11	6	4	12	19
Uzbekistan							

Source: *Stijn Claessens, Simeon Djankov, and Daniela Klingebiel, "Stock Markets in Transition Economies," in Lajos Bokros, et.al.(eds.), Financial Transition in Europe and Central Asia: Challenges of the New Decade World Bank, 2001.*

Table A.10: Index of Banking Reform and Interest Rate Liberalization, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania				2	2		2	2	2	2+	2+
Armenia				1	2		2+	2+	2+	2+	2+
Azerbaijan				1	2		2	2	2	2	2+
Belarus				1	2		1	1	1	1	1
Bosnia-Herz.								2	2+	2+	2+
Bulgaria	1	2-	2	2	2	2	3-	3-	3-	3	3
Croatia				3	3		3-	3-	3	3+	3+
Czech Rep.	2	3	3	3	3	3	3	3	3+	3+	4-
Estonia	1	2	3	3	3	3	3+	3+	4-	4-	4-
FYR Macedonia				2	3		3	3	3	3	3
Georgia				1	2		2+	2+	2+	2-	2+
Hungary	2	2	3	3	3	3	4	4	4	4	4
Kazakhstan				1	2		2+	2+	2+	2+	3-
Kyrgyz Rep.				2	2		3-	3-	2+	2+	2+
Latvia	1	2	2	3	3	3	3	3-	3	3	3+
Lithuania	1	1	2	2	3	3	3	3	3	3	3
Moldova				2	2		2	2+	2+	2+	2+
Poland	2	2	3	3	3	3	3	3+	3+	3+	3+
Romania	1	1	1	2	3	3	3-	2+	3-	3-	3-
Russian Fed.	1	1	1	2	2	2	2+	2	2-	2-	2-
Slovak Rep.	2	3-	3-	3-	3-	3-	3-	3-	3-	3	3+
Slovenia	1	2	3	3	3	3	3	3	3+	3+	3+
Tajikistan				1	1		1	1	1	1	1
Turkmenistan				1	1		1	1	1	1	1
Ukraine	1	1	1	1	2	2	2	2	2	2	2
Uzbekistan				1	2		2-	2-	2-	2-	2-

Note: EBRD Banking Reform Index defined as follows:

1 - Little progress beyond establishment of a two-tier system.

2 - Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.

3 - Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.

4 - Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.

4+ - Standards and performance norms of advanced industrial economies; full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Sources: EBRD, Transition Report, various issues.
Erik Berglof and Patrick Bolton, "The Great Divide and Beyond: Financial Architecture in Transition," Journal of Economic Perspectives, Winter 2002.

Table A.11: Index of Securities Markets and Nonbank Financial Institutions Reform, 1991-2001

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania					1		2-	2-	2-	2-	2-
Armenia					1		1	2	2	2	2
Azerbaijan					1		1	2-	2-	2-	2-
Belarus					2		2	2	2	2	2
Bosnia-Herz.								1	1	1	1
Bulgaria	1	1	1	1	2	2	2	2	2	2	2
Croatia					2		2+	2+	2+	2+	2+
Czech Rep.	1	1	2	3-	3-	3-	3	3	3	3	3
Estonia	1	1	2-	2-	2-	2	3	3	3	3	3
FYR Macedonia					1		1	2-	2-	2-	2-
Georgia					1		1	1	1	2-	2-
Hungary	2	2	2	2	3	3	3+	3+	3+	4-	4-
Kazakhstan					2		2	2	2	2+	2+
Kyrgyz Rep.					2		2	2	2	2	2
Latvia	1	1	1	2	2	2	2+	2+	2+	2+	2+
Lithuania	1	1	2-	2	2	2	2+	2+	3-	3	3
Moldova					2		2	2	2	2	2
Poland	2	2	2	2	3	3	3+	3+	3+	4-	4-
Romania	1	1	1	2	2	2	2	2	2	2	2
Russian Fed.	1	1	2-	2-	2	3	3	2-	2-	2-	2-
Slovak Rep.	1	1	2	3-	3-	3-	2+	2+	2+	2+	2+
Slovenia	2	2	2	3-	3-	3-	3	3	3	3-	3-
Tajikistan					1		1	1	1	1	1
Turkmenistan					1		1	1	1	1	1
Ukraine	1	2-	2-	2-	2	2	2	2	2	2	2
Uzbekistan					2		2	2	2	2	2

Note: EBRD Securities Market and NBFI Reform Index defined as follows:

1 - Little progress.
2 - Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
3 - Substantial issuance of securities by private enterprises; establishment of independent share registries secure clearance and settlement procedures, and some protection of minority shareholders; emergence of nonbank financial institutions (e.g., investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
4 - Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalization; well-functioning nonbank financial institutions and effective regulation.
4+ - Standards and performance norms of advanced industrial economies; full convergence of securities laws and regulations with IOSCO standards; fully developed nonbank intermediation.

Sources: EBRD, Transition Report, various issues
Erik Berglof and Patrick Bolton, "The Great Divide and Beyond: Financial Architecture in Transition," Journal of Economic Perspectives, Winter 2002.

Table A.12: Transition Economy Rates of Inflation, 1991-2002
(Percent per annum)

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001e/	2002p/
Albania	36	226	85	23	8	13	33	21	0.4	0.1	3	4
Armenia	274	1346	1822	4962	176	19	14	9	0.7	-0.8	3	3
Azerbaijan	107	912	1129	1664	412	20	4	-0.8	-9	2	2	3
Belarus	94	971	1190	2221	709	53	64	73	294	169	61	43
Bosnia-Herzegovina												
Federation				780	-4	-25	14	5	-0.3	2	3	2
Rep. Srpska				1061	13	17	-7	2	14	15	11	5
Bulgaria	334	82	73	96	62	123	1082	22	0.7	10	7	8
Croatia	123	666	1518	98	2	4	4	6	4	6	5	3
Czech Republic	52	11	21	10	9	9	8	11	2	4	5	3
Estonia	210	1076	70	48	29	23	11	8	3	4	6	3
Georgia	79	887	3125	15606	163	39	7	4	19	4	5	5
Hungary	35	23	23	19	28	24	18	14	10	10	9	6
Kazakhstan	79	1381	1662	1892	176	39	17	7	8	13	8	5
Kyrgyz Republic	85	855	772	229	41	31	26	12	36	19	7	7
Latvia	172	951	109	36	25	18	8	5	2	3	2	4
Lithuania	225	1020	410	72	40	25	9	5	0.8	1	1	3
Macedonia, FYR	115	1664	338	126	16	2	0.8	2	-1	6	5	4
Moldova	98	1276	788	330	30	24	12	8	39	31	10	10
Poland	70	43	35	32	28	20	15	12	7	10	6	3
Romania	170	210	256	137	32	39	155	59	46	46	34	24
Russian Federation	93	1526	875	311	198	48	15	28	86	21	22	17
Slovak Republic	61	10	23	13	10	6	6	7	11	12	7	4
Slovenia	118	207	33	21	14	10	8	8	6	9	8	7
Tajikistan	112	1157	2195	350	609	418	88	43	28	33	39	14
Turkmenistan	103	493	3102	1748	1005	992	84	17	24	8	12	14
Ukraine	91	1210	4734	891	377	80	16	10	23	28	12	4
Uzbekistan	82	645	534	1568	305	54	59	18	29	24	26	31

Notes: e/ Estimated.
p/ Projected.

Source: EBRD, Transition Report Update, May 2002.