Reform in Eastern Europe: Creating a Capital Market

By Lawrence J. Brainard

What role should the reform of financial markets play in the economic transformation of Eastern Europe into market economies?

This essay argues that the revival of economic growth in Eastern Europe requires the creation of a viable market for capital. A capital market is an essential prerequisite for successful privatization and increased efficiency of resource use.

The introduction of a capital market requires that the balance sheets of the enterprises and banks be cleaned up. Unrealized losses on enterprise balance sheets should be addressed through bankruptcy, rehabilitation of viable enterprises, and privatization. The balance sheet losses of the state-owned commercial banks should be solved by means of recapitalization of the banks. The recapitalization of the banks is also an essential requirement to enforcing "hard budget" constraints on enterprises.

Because these reforms come with significant fiscal costs, governments should employ a comprehensive fiscal framework and clear priorities in order to prevent a hemorrhaging of the fiscal accounts.

What role should the reform of financial markets play in the economic transformation of Eastern Europe into market economic systems? Two perspectives are essential in addressing this question: 1) What is the fundamental goal of the transformation process and how does financial market reform contribute to achieving that goal? 2) Where are we today in the reform process and what has to be done in order to move toward that goal?

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Where Economic Transformation Should Lead

It may be commonplace to remark that economic growth is the goal of the transformation process, but many seem to forget that the marketization of these economies is not an end unto itself. The challenge is to create economic systems in Eastern Europe that will generate self-sustaining economic growth under conditions of stable prices. Growth is central to the political legitimacy of the reform efforts; a failure to boost growth, and with it personal incomes, would seriously undermine popular support for the new democratic regimes. Furthermore, growth should be the yardstick against which alternative adjustment strategies are evaluated. Any viable adjustment strategy must spell out a feasible process that leads to the revival of growth and investment in these economies.

The creation of a real market for capital, where resources are allocated efficiently, is an essential component of the economic transformation. The payoff from stabilization and economic reform will not be forthcoming unless capital is allocated efficiently. The most important institutional element of the capital market is the banking system. Markets for equities and government bonds could play an increasingly important role in the development of capital markets in Eastern Europe, but in the near term and the medium term, the bulk of savings will flow through the banking system. The issue of banking system reform, therefore, is central to efforts to improve the efficiency of resource use.

A second requirement for ensuring efficient allocation of resources is that the users of investment capital should be responsible for its effective application. This implies the privatization of ownership of much of the capital in these countries, and effective disciplines on those firms remaining under state management. In other words, privatization, improved financial discipline and banking reform are related aspects of the same resource efficiency goal.

Enterprise restructuring, privatization, and banking reform must go forward together. Privatization without banking reform would fail to ensure that capital is allocated to the firms that can use the resources most effectively. This will only hamper the hoped-for supply-side response essential for increased economic growth. Furthermore, firms will not face effective financial disciplines until the banking system can refuse to provide additional credit to given borrowers, i.e. banks must be able to enforce the "hard budget" constraint. A banking reform without enterprise restructuring and privatization, in turn, would only perpetuate the accumulation of bad loans in the portfolios of the banks.

The success of privatization and financial disciplines for state firms, therefore, is tied to the creation of banks that are capable of exercising independent credit judgments. This is not going to happen unless banks are forced to protect their own capital position against credit losses. Banks cannot defend their own capital until their existing balance sheets are cleaned up to identify what those capital positions are. Banking reform, therefore, should focus on the restructuring of the existing commercial banks to achieve this end.

This point is also relevant to western efforts to increase flows of new credits to support reform efforts in Eastern Europe. Unless the existing banks are restructured, the new western resources going into the country will likely be misused, thus perpetuating the power of the nomenclature and the influence of the existing economic structure over resource allocation.

A second goal of banking reform is to create the institutional framework for effective control of the money supply by the central bank. This is more than a technical question of reserve requirements or instruments for open-market operations. One necessary change is to free the banks—both the central bank and the commercial banks—from their traditional roles as financiers of the fiscal deficit and of the losses of the state-owned enterprises. This change is obviously closely related to the reforms discussed in the preceding paragraph.

A further aspect of monetary control involves bringing Eastern Europe's burgeoning informal credit markets under effective supervision. Inter-enterprise credit markets have emerged in recent years in response to central bank efforts to tighten credit conditions. Such disintermediation of credit flows is a major factor acting to weaken the effectiveness of monetary policy.

Where Does the Reform Effort Stand Today?

Many efforts to reform Eastern European economies have been launched over the past decade, but most have shown little in the way of results. A relevant question, therefore, is why effective reform has been so hard to achieve.

It is obvious that economic structures in Eastern European countries are seriously distorted, giving rise to the wastage of economic resources on a massive scale. Some of these resource losses are easily identified; for example, irrational relative prices and budget subsidies to loss-making enterprises. The sensible policy here is to introduce economic stabilization policies, such as balancing the budget, freeing prices, and increasing competitive forces in the economy.

If economic stabilization were the only concern, the task of economic transformation would at least be clearly outlined, even if still hard to achieve. But the evidence suggests otherwise. Efforts at economic stabilization over the past decade in Yugoslavia, Poland, and Hungary have not been successful largely because these efforts have neglected serious economic imbalances imbedded in the structure of these economic systems. In order to address these problems, countries must move beyond conventional stabilization programs to implement comprehensive structural reforms.

Serious structural imbalances in these countries today are lodged in their banks, which have been the repository of decades of accumulated losses of state-owned firms. Socialist banks are engaged in a misallocation of resources of massive proportions, and most of these losses do not find reflection in conventional measures of the government's fiscal deficit.

Some data will serve to highlight the dimensions of the problem. In 1987 in Yugoslavia, for example, the government's fiscal accounts showed a small surplus, but losses recorded by the National Bank of Yugoslavia (NBY) amounted to a staggering 8.5 percent of GDP. The NBY losses resulted from the redistribution of resources to loss-making enterprises through the banking system by means of negative real rates of interest on outstanding loans.[1] In Poland, the World Bank estimated that interest rate subsidies provided to state enterprises through the banking system totaled 10 percent of GDP in 1988.[2]

Another less-than-evident source of such resource wastage through the banking system derives from the massive portfolio of bad loans held by commercial banks in Eastern European countries. Faced by the refusal and inability of loss-making enterprises to service existing credits, the banks have simply refinanced such loans and provided new ones on top of the old ones in order to pay the interest. Neither the banks nor the government have been willing to push companies into bankruptcy.

In Yugoslavia, for example, the National Bank estimates that troubled loans account for over 40 percent of the loan portfolio of the commercial banks, with potential losses totaling as much as 25 percent of loans ($7-9 billion), far in excess of the banks' capital.[3] Accurate data on bad loans in other countries is unavailable, but potential losses are of similar magnitude.

Questionable accounting and supervisory practices have also helped obscure these hidden losses. In Hungary, for example, the three major commercial banks inherited a substantial portfolio of troubled loans when they were set up by the National Bank in 1987. These banks have capitalized interest due payments and accrued interest as income on nonperforming loans, with the result that the banks' published income statements depart substantially from generally accepted accounting procedures (GAAP) in the West. Although the banks have consistently reported profitable operations, their loan portfolios have, until recently, not been audited for collectibility and reserve funds for doubtful loans are inadequate.[4]

Stabilization and Structural Reform—the Polish Model

Experience with failed reform programs in Eastern Europe since 1980 suggests that economic stabilization and structural reform are both essential components of a viable economic transformation strategy. The key issue is the sequencing of stabilization and structural reforms. Should stabilization efforts move forward, while the ground is being prepared for structural reforms? Or do stabilization and structural reform need to be synchronized in some way? A discussion of the recent Polish economic shock program will serve to highlight the dimensions of the sequencing issue.

The Polish economic program introduced on January 1, 1990, is predicated on decisive and rapid change in economic policy. The initial policy shock is focused on economic stabilization measures such as:

1. a balanced fiscal budget, tight credit ceilings and controls on wage-setting in state enterprises;
2. the freeing of most prices to find their market-clearing levels;
3. removal of bureaucratic restrictions on the private sector; and
4. increased competition by means of a sharp devaluation followed by the pegging of the zloty at a competitive rate.

The Polish shock program foresees a phased introduction of structural changes, though the importance of a rapid introduction of such changes is clearly recognized. Jeffrey Sachs, who advised the Poles drawing up the program, explained that "Poland's goal is to establish the economic, legal, and institutional basis for a private-sector market economy in just one year."[5] But the introduction of comprehensive stabilization measures was not held up pending the introduction of structural reforms. The basic Polish strategy, therefore, is rapid and severe economic stabilization, followed by a phased introduction of structural changes.

In assessing the Polish Program, several concerns deserve emphasis. One is that the stabilization measures imply a severe, immediate reduction of real incomes, but without a clear identification of where or how the hoped-for supply response is to be achieved. There are certainly efficiencies to be gained through the creation of unregulated markets, but most potential market participants lack the resources to respond to the opportunities such unfettered markets offer. The hoped-for supply response depends primarily on structural reforms of the markets for labor and capital, not on stabilization. The Polish Program has little to say on how factor markets are to be created.[6]

The sequencing of the Polish Program—harsh stabilization, followed by phased reform—also introduced a volatile element of political instability into the reform effort. Workers are unlikely to accept substantial reductions in real incomes without going on strike, unless tangible benefits of their sacrifices become evident in fairly short order. In the first four months of the shock program the average Polish standard of living declined over 30 percent in real terms.[7] The policymakers' political vulnerability to workers' protests, in turn, puts at risk the delayed structural reforms.

In this regard, the announcement by the Polish government in mid-1990 of an easing of the austerity program appears to suggest that Polish leaders were having second thoughts about the viability of the original strategy.[8] The official press release announced that the switch to a free market economy was completed in just five months, but this cannot be seen as credible. None of the critical structural reforms promised in January have been achieved; indeed, the new law on privatization, which had been promised by no later than March, was not passed by the Parliament until the end of July.

It is too early to say how much the easing of austerity will slow down efforts to introduce structural reforms. It does suggest, however, that the over-riding, initial emphasis on radical stabilization moves was misplaced. It acted to slow progress on the different structural reform measures by focusing the attention of key policymakers elsewhere. The shock program also reflected a naive optimism about the reinvigoration of growth through the free play of market forces, while missing the fact that structural impediments in the markets for labor and capital remained largely untouched.

An initial judgment about shock programs, such as the Polish one, is that it is a mistake to launch a radical economic stabilization until key structural reforms are ready to be implemented. Stabilization efforts are obviously unavoidable in the context of hyperinflation and serious price distortions: greater priority, however, must be accorded efforts to accelerate the structural reforms and to achieve a closer synchronization between reform and stabilization.

A second concern about the Polish Program is that its agenda of structural reforms seems to be limited to privatization. In his lengthy exposition of the Polish model in *The Economist*, Sachs devotes considerable attention to problems of privatization, but he ignores problems of the banking system and the need to create a real capital market in Poland.[9]

There are two key reasons why banking reforms are essential to strategies of economies transformation in Eastern Europe. One is that privatization cannot succeed without a capital market. And a capital market cannot be created unless a thorough reform of the banking system is enacted. Privatization and banking system reform, therefore, must go together.

The second reason is that the banking system is a serious source of economic disequilibrium in each of these countries. As the Yugoslav case cited earlier illustrated, it is possible for the government's fiscal budget to be in balance at the same time that huge deficits are piling up in the banks.

As we will explore in more detail in the next section, there are two distinct aspects to banking reform. Banks must not be allowed to continue making bad loans; enterprise restructuring through privatization and moving loss-making firms into bankruptcy and tighter prudential supervision on the banks' loan portfolios are essential steps here. But reforms must go beyond such measures. For banks to make a positive contribution to the efficient allocation of capital resources, it will be necessary to clean up the banks' balance sheets by writing off troubled loans and by injecting new capital. We turn now to a detailed look at the state of Eastern Europe's banking systems.

The Condition of Socialist Banking and Finance

The traditional banking model in Eastern Europe consisted of a central bank and several special-purpose banks, one dealing with individuals' savings and other banking needs and the other focused on foreign financial activities. The central bank provided most of the commercial banking needs of enterprises in addition to the usual functions of a central bank.

In recent years, Eastern European countries have modified this structure by carving out all of the commercial banking activities of the central bank and transferring them to new commercial banks. In most countries the new banks were set up along industry lines, while in Poland the banks were set up on a regional basis. The creation of these new banks is relatively recent:

Country	Date	New state-owned banks
Bulgaria	1987	7
Czechoslovakia	1990	2
GDR	1990	1
Hungary	1987	3
Poland	1988	9

Although a number of small *de novo* banks were also allowed, mainly in Poland and Hungary, the new state-owned commercial banks controlled the bulk of the financial transactions of the enterprise sector.[10]

What is important to understand about these banks is that they were created by transferring existing loans from the portfolio of the central bank to the new institutions. The banks, thus, started life with an inherited overhang of troubled assets, in most cases highly concentrated by enterprise and industry. Furthermore, competition was restricted because the banks were not allowed to deal with enterprises other than those assigned to them.

Hobbled with such handicaps, these new banks simply cannot play a role in the allocation of capital that is similar to the role played by sound banking institutions active in western capital markets. They do not have their own capital resources because their loan assets are not carried on their balance sheets at realistic values. In extending new loans, therefore, the bank is not putting its own capital resources at risk, since any potential losses will accrue in one way or another to the central bank or Ministry of Finance—either the government must inject new capital from the budget to cover such losses, or, more probably, the losses will be covered up by the authorities agreeing with the bank not to recognize such bad loans. The fact that the losses are not recognized, implies an accumulation of contingent liabilities on the account of the government's fiscal budget, since the government will have to cover such losses sooner or later out of budgetary resources.[11]

The new state-owned commercial banks should be viewed more as fiscal agents of the Treasury than as banks in their own right. They collect a large part of the government's inflation tax on enterprise cash balances and redistribute resources to enterprises through interest rate subsidies (i.e. negative real rates) and additional loans to cover interest due.[12] Furthermore, the banks have limited leverage over their borrowers. If the firm does not have the money, it simply refuses to pay. The bank is forced to extend a new loan to recognize the nonpayment. Unless the government is willing to throw a firm into bankruptcy—so far a very rare occurrence—the bank cannot pursue an active credit policy. The existing banking structure, therefore, is acting as a fiscal "black hole," misallocating capital to cover the losses of the state-owned enterprises.

A substantial volume of losses is also booked on the balance sheets of the central banks of these countries. These losses have resulted from the periodic devaluations of each country's currency. In most countries the foreign debt is carried as a liability on the central bank's books.[13] Devaluation increases the local currency value of total liabilities; to balance this rise in liabilities, a corresponding asset entry is made, usually identified as a "valuation adjustment." In reality, of course, there are no resources behind such an "asset," since the enterprises have been relieved of any exchange rate risk.

The size of valuation losses carried by central banks from devaluations is staggering.

In Hungary, recent estimates put the stock of National Bank losses at about 30 percent of GDP, or about $7 billion.[14] In Yugoslavia, the valuation losses carried on the consolidated balance sheet of the National Bank are over 60 percent of total assets.[15]

Approaches to Financial Market Reforms

Attempts to improve financial sector performance have been included in all Eastern European country programs of the IMF and World Bank in recent years. The meager results of such reform efforts serve to highlight why financial reforms are so difficult to implement.

Starting with Yugoslavia in 1983, financial reform has focused on eliminating financial losses associated with credit flows. The primary policy measures included the introduction of positive real rates of interest on deposits and loans and the tightening of credit conditions by imposing credit ceilings.

The typical result of such tight credit policies was a rapid growth in payment arrears between firms. In the context of relatively monopolized market structures, few firms could afford to cut off an important buyer of a given product, so they tolerated such arrears. In any case, the country's legal systems did not furnish the creditor enterprises strong legal means to force repayment. As a result the practice of inter-enterprise credit spread throughout the economy.

The disintermediation of credit flows through the growth in inter-enterprise credit has now reached significant proportions. In Yugoslavia, the share of inter-enterprise credits in total credit increased from 26 percent in 1980 to 39 percent in 1987.[16] In Hungary, the so-called "credit queues" rose dramatically in 1988-89, when the National Bank implemented a tight monetary policy as part of its IMF standby. Information on inter-enterprise payment arrears in Poland is sketchy, but it appears that such arrears have risen dramatically since the implementation of the shock program in January.

There are reasons to believe that the disintermediation of credit flows has increased since the implementation in 1990 of stabilization programs in Poland, Hungary, and Yugoslavia. These developments are worrisome because they act to reduce the effectiveness of restrictive monetary policies on aggregate demand—the growth of inter-enterprise credits has so far escaped such controls. And since such credits are inadequately captured in the credit data, the central bank's ability to gauge the tightness of monetary policy is hampered. The danger is that monetary policy will appear much more restrictive than it really is.

New Perspectives on Financial Reforms

The stock answer in every reform proposal to Eastern Europe's financial market ills has always been the same—to increase the financial disciplines in the system. The reason why such efforts have so far failed to produce acceptable results is that none of these reform efforts has yet addressed the balance sheet losses which lie at the heart of the problem. Banks and governments have been unwilling to push firms into bankruptcy—the banks fear the financial impact on their balance sheets, and the governments fear the unemployment consequences. As a result, firms have never had to pay the ultimate price for their misdeeds.

The only effective way to implement financial discipline is to go beyond the current measures, which focus on subsidies and credit flows, to clean up the balance sheets of enterprises and banks. The reform must seek to allocate the unrealized losses on the balance sheets of enterprises and banks. Financial discipline (hard budget constraints) must be translated into balance sheet realities for each firm.

The issue for policymakers, therefore, is how to allocate such losses among the workers, the creditors, and the government's budget (i.e. society at large).

For enterprises, the mechanisms for sanitizing balance sheets include bankruptcy, rehabilitation, and/or privatization. Bankruptcy implies losses for the workers—through unemployment—and the liquidation of financial claims on the enterprise, i.e. losses for the creditors, which may in turn be covered out of the fiscal budget. The rehabilitation of enterprises with reasonable prospects of profitable operation would likely require wage sacrifices from workers and partial debt relief from creditor banks. Privatization, properly managed and implemented, may be viewed as an alternative way for the state to translate firms' balance sheets to current values, since any sale should yield a cash benefit to the government's fiscal budget equal to the firm's net worth.[17]

Viewing the issue of financial discipline in such a balance sheet perspective serves to underscore the need for a comprehensive fiscal framework and a set of clear priorities for action as a prerequisite for structural reform. The restructuring will undoubtedly be costly, and the authorities need to monitor costs carefully. Otherwise, the natural tendency to push most of these losses in an unplanned and piecemeal fashion onto the account of the fiscal budget will quickly swamp the ability of the government to balance the fiscal accounts, thus reigniting inflationary pressures. This perspective also highlights the urgent need for credible balance sheet valuations, which require the implementation of western accounting principles and practices. Finally, privatization may be seen as the logical outcome of a set of comprehensive measures to clean up enterprise balance sheets; it is not the sole structural goal of the reform. Many discussions focus exclusively on the techniques of privatization, without adequate attention to broader fiscal reform goals.

Cleaning up the balance sheets of the banks poses a separate set of issues. It should be obvious that a thorough restructuring of enterprise balance sheets will contribute much to eliminating bank losses from ongoing credit activities. Restructuring of enterprises and banks should, therefore, proceed together. But the losses in the banks' loan portfolios raise a slightly different set of problems. There is little social value in pushing any of the state-owned banks into bankruptcy, given their pivotal role in the financial system. The only viable option is to restructure the banks.

The best way to do this is to recapitalize the banks by first lifting the bad loans out of their portfolios and then providing a mechanism for injecting new capital. One approach used in Chile in the mid-1980s and now being implemented in Yugoslavia is for the government to "purchase" the banks' bad loans (identified by means of a special portfolio audit) with long-term bonds paying a positive interest spread over the banks' cost of funds. The capital of the banks would grow over time, thanks to the elimination of problem loans and the positive net income flow from the government bonds.

Given improved accounting practices and effective prudential supervision, the banks could be transformed into profitable institutions, hopefully in a relatively short time. Such institutions could then form the core of an emergent capital market structure. The persistent foreign exchange losses of the central banks should be controlled by holding the enterprises accountable for the foreign risk on new external borrowings.

The government would have to absorb the losses on the bad loans and transfer new resources to the banks via interest payments on the bonds. These actions could prove costly to the fiscal budget, but removing such losses in a one-step operation with fiscal costs spread over the life of the bonds is likely to be less costly than doing nothing.[18] This action is essential to eliminate the misallocation of resources by the banks and to facilitate the creation of a capital market. It should also discourage the disintermediation of credit flows outside the banking system, thus improving the central bank's ability to control monetary conditions.

An alternative approach would be for the government to assist in spinning off a bank's bad loans into a separate entity, managed by a special work-out team from the bank. This would create a "good" bank and a "bad" bank; special incentives could be provided to the management team to help maximize value from the work-out process. The "good" bank would then provide the focus of new capital market activity.[19]

Whatever structure is chosen, the important goal is to create viable institutions quickly to provide the impetus for the development of a real capital market. This can only be done if the existing overhang of bad loans is removed from the banks' portfolios.

Strategies for Economic Transformation—a Summing Up

It is time to bring together the various elements touched on in this paper that outline a possible strategy for the economic transformation of Eastern European economies:

1. The revival of economic growth in Eastern Europe requires the creation of factor markets, especially a market for capital.
2. Financial market reform is central to efforts to improve the efficiency of resource allocation; successful privatization requires a functioning capital market.
3. The introduction of structural reforms should be synchronized as much as possible with major economic stabilization efforts; it is a mistake to undertake radical economic stabilization until key structural reforms are ready to be implemented.
4. The key structural reforms involve cleaning up the balance sheets of the enterprises and banks; these reforms must go forward together.
5. The unrealized enterprise balance sheet losses should be addressed through bankruptcy, rehabilitation of viable enterprises, and privatization; the balance sheet losses of the commercial banks should be addressed by means of a recapitalization of the banks.
6. The recapitalization of the commercial banks is an essential step in the creation of a capital market and in the improvement of the effectiveness of monetary policy.
7. The above-mentioned reforms come with significant fiscal costs; governments should employ a comprehensive fiscal framework and clear priorities to prevent a hemorrhaging of the fiscal accounts.

A final consideration is the potential contribution that foreign capital may make to the success of the above strategy, especially in accelerating the creation of new capital market institutions.

Western banks opening new branches or subsidiaries in Eastern Europe are likely to perceive substantial risks in any domestic lending activity during the transition to market-based economies. The banks' caution could rule out a substantial near-term role for foreign private banks in efforts to recast the existing banking system. Although the new financial sector investments undertaken by western banks will have clear positive benefits, these ventures will not come close in the aggregate to matching the existing scope of the state-owned commercial banking system.

The rapid creation of a modern commercial banking system is feasible only if human skills and knowhow can be transferred quickly and on a significant scale. This seems unlikely unless countries are willing to grant interested foreign banks a significant domestic banking franchise without the legacy of past bad corporate debts.

This suggests that financial market restructuring in Eastern Europe could be viewed as a necessary precondition for the successful and rapid transfer of western capital into commercial banking in these economies.

Whether such a role for foreign capital in the banking industry is desirable or not is up to the individual countries to decide. What is important is that East European authorities initiate the restructuring process as soon as clear priorities can be determined.

Endnotes

[1] Roberto de Rezende Rocha, "Structural Adjustment and Inflation in Yugoslavia," World Bank, EMTTF Division, May 26, 1989, p. 6.

[2] Fernando Saldanha, "Interest Rate Subsidies and Monetization in Poland," World Bank, EMTTF Division, April 1989, p. 2.

[3] Data cited by Mitja Gaspari, Deputy Governor, National Bank of Yugoslavia in a private meeting with commercial bankers in New York.

[4] The National Bank of Hungary is currently addressing these problems in the context of a financial sector modernization loan from the World Bank. The NBH is conducting audits of all the commercial banks according to GAAP and there are plans to send a new banking law to Parliament by the end of 1990.

[5] Jeffrey Sachs, "What Is to Be Done?" *The Economist*, January 13, 1990.

[6] In his article Sachs does not even address the problem of setting up functioning markets for labor and capital.

[7] Statement by the Polish Finance Minister Leszek Balcerowicz at The Council of Foreign Relations, New York, September 28, 1990.

[8] "Poland Says Free Market Reached, Austerity to Ease," *Reuters*, June 6, 1990.

[9] Sachs, "What Is to Be Done?" pp. 21-25.

[10] The Hungarian government reduced its share holding in its three large commercial banks to just over 50 percent by selling off bank shares to enterprises. The banks in other countries remain wholly state-owned.

[11] There is a close parallel in this regard with the savings and loan crisis in the United States. It was possible for the Reagan administration to paper over such losses for quite a long time. But when a decision was made by President Bush to deal with the problem, the accumulated losses had to be covered with real resources from the budget. Most experts believe the U. S. Treasury paid a much higher price because a solution to the problem was deferred for so long. It is also true that it is very difficult to estimate the scope of potential losses in such a situation until the assets in question are sold off or written down to actual value. There is a strong political inclination to understate the actual losses likely to be realized.

[12] I fully agree with this characterization of the banks outlined by Manuel Hinds in his paper, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," World Bank, EMTTF Division, March 1990, p. 11.

[13] In Poland, the debt is carried on the books of the Bank Handlowy, while in Yugoslavia, the debt is carried both by the commercial banks and the National Bank. In Bulgaria, most of the debt is carried by the Bulgarian Foreign Trade Bank.

[14] Hinds, "Issues," p. 14.

[15] Rocha, "Structural Adjustment," p. 6.

[16] Rocha, "Structural Adjustment," p. 31.

[17] Any decision to socialize a portion of a firm's losses prior to privatization should be transparent in the sense that the social costs and benefits of such actions should be made public and be subject to review by competent authorities.

[18] Hinds, "Issues," p. 57. Hinds provides an excellent discussion of the reasons why bank recapitalizations are desirable.

[19] This option was recommended by the Blue Ribbon Commission, which prepared an "Action Program" for Hungary's new democratic government: *Hungary—In Transformation to Freedom and Prosperity: Economic Program Proposals of the Joint Hungarian-International Blue Ribbon Commission*, Indianapolis: Hudson Institute, Inc., April 1990, pp. 28-29.

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