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Financial and Enterprise Restructuring in Emerging Market Economies

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Abstract

This paper examines alternative approaches to building sound financial structures in emerging market economies. The foremost task is to resolve the bad loan problem and to recapitalize insolvent state banks. By restoring an incentive for banks to price accurately the risks of new lending, this effort would be an important first step in strengthening financial control. However, we argue that this endeavor is only part of the task at hand; the remainder is to provide financing that facilitates the economic restructuring of SOEs. A comprehensive strategy may involve combining discipline derived from enforcing existing loans to SOEs with adequate funding for new forms of ownership, including financing for enterprise sell-offs and leasing.

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Building sound financial systems is key to developing viable market economies where central planning once prevailed. In a market economy, it is the financial system that channels savings among alternative uses; and accompanying this provision of financing are various forms of control over the use of capital. Within the discipline thereby imposed, a market economy permits a large degree of decentralization. The transformation from a centrally planned to a market economy thus involves, in large measure, a shift from bureaucratic administration to financial control.

Financial restructuring in emerging market economies is not limited to building a sound financial system that implements effective control over the use of capital, however. The economic and financial structure of state-owned enterprises (SOEs), including their privatization, is also of crucial importance. For the transformation to a market economy to enhance efficiency, it must involve the paring down of large SOEs to reduce their often vast scale and scope and to create less concentrated market structures, as well as the liquidating of chronic loss-making enterprises. In the void created by the breakdown of bureaucratic administration, strengthening of financial control can be an important means to achieve this economic restructuring.

However, the legacy of bad loans from the passive role of finance under central planning and the early transition period, as well as the excessive scale and scope of large SOEs, impose significant obstacles to the successful transition from central planning to a market-based economy. The overhang of debt creates several potential pitfalls to this transition: (1) insolvencies pose moral hazard problems with respect to both creditors and debtors; (2) moral hazard problems enlarge the fiscal cost of the bailout that will eventually be needed; and (3) insolvencies prevent the privatization of banks and SOEs. Moreover, large SOEs tend to be of inefficient scale and scope; and failure to restructure them before privatization risks perpetuation of concentrated market structures.

This paper examines how the above problems can be tackled within the fiscal constraints faced by reform governments. Priority is given to restoring the solvency of banks because of the important roles that they could play in strengthening financial control and in providing finance for enterprise restructuring. One way to restore soundness to the banking system is to undertake a case-by-case exchange of bad loans for government debt. A centralized agency could then undertake to resolve the bad loans with the SOEs. Moreover, the centralized agency could use these loans as leverage to pry productive assets away from SOEs. For this effort to succeed, however, financing must be available for the acquisition of enterprise assets. This could involve the provision of new bank loans and equity purchases by insiders. Sources of outside equity would in all likelihood be more difficult to tap initially. Governments could retain equity stakes in enterprise sell-offs to achieve some diversification of risks. Leasing could also play an important role in transferring productive enterprise assets to new private firms.

I. Introduction

Building sound financial systems is key to developing viable market economies where central planning once prevailed. In a market economy, it is the financial system that channels savings among alternative uses, either through competing intermediaries or in markets, guiding the composition of economic activity and its rate of expansion. Accompanying this provision of financing are various forms of control over the use of capital--the voting rights of shareholders, restrictive covenants in lending agreements, and shifts in control associated with bankruptcy. Within the discipline thereby imposed, a market economy permits a large degree of decentralization. The transformation from a centrally planned to a market economy thus involves, in large measure, a shift from bureaucratic administration to financial control.

Financial restructuring in emerging market economies is not limited to building a sound financial system that implements effective control over the use of capital, however. The economic and financial structure of state-owned enterprises (SOEs), including their privatization, is also of crucial importance. For the transformation to a market economy to enhance efficiency, it must involve changes in the organization and deployment of productive resources, including the paring down of large SOEs to reduce their often vast scale and scope and the liquidating of chronic loss-making enterprises. In the void created by the breakdown of bureaucratic administration, strengthening of financial control can be an important means to achieve this economic restructuring. The enforcing of existing debts can be used to force the shedding of physical assets by inefficient SOEs, while the provision of new financing to support enterprise sell-offs and leasing can facilitate the transfer of productive assets into the nascent private sector. However, the financial structure of new private firms, which shape the incentives faced by their owners, creditors, and managers, should reflect their preferences rather than those of a central authority.

Because of both the discipline imposed by a sound financial system in a market economy and the need to provide finance for economic restructuring, an overhaul of the financial systems in emerging market economies is of pressing importance. This involves not only an upgrading of the physical and human capital of banks and other financial institutions, but a fundamental shift from finance as the passive record-keeping mechanism under central planning to finance as the primary instrument of control over the use of capital.

The legacy of bad loans from the era of central planning and the early period of transition to a market economy, however, imposes a significant obstacle to the overhaul of both state banks and SOEs in some emerging market economies. These doubtful loans are mostly to SOEs by state banks; in some cases, they constitute substantial proportions of both state bank assets and enterprise liabilities. State banks are also hampered by the sectoral and geographical concentration of their loans that resulted from their typical origins as either regional offices of monobanks or as specialized financing agencies for particular industries. 1/

In this paper, we examine alternative approaches to building sound financial structures in some emerging market economies. The foremost task is to resolve the bad loan problem and to recapitalize insolvent state banks. By restoring an incentive for banks to price accurately the risks of new lending, the resolution of bad loans would be an important first step in strengthening financial control. However, we argue that this endeavor is only part of the task at hand; the remainder is to provide financing that facilitates the economic restructuring of SOEs. A comprehensive strategy may involve combining discipline derived from enforcing existing loans to SOEs with adequate funding for new forms of ownership, including financing for enterprise sell-offs and leasing.

II. Origins of the Bad Loan Problem

While loan defaults did not occur under central planning, origins of the current bad loan problem in some emerging market economies can nevertheless be traced to the old system. Under the monobank structure, a single bank performed both commercial and central banking functions. With regard to commercial banking, a monobank typically played a passive role, providing book-entry credit to SOEs for all investment projects approved under the central plan and disbursing cash for payment of wages. An attempt was usually made to maintain a strict separation between cash and credit money, the former being used for wages and household consumption and the latter being restricted to inter-enterprise transactions. 2/ Since credit money could not be spent without the planners' approval, and credit could be created automatically with the planners' approval, the lending decisions of the monobank were not guided by the opportunity cost of funds or by the ability to repay. Therefore, the concept of bad debt was irrelevant. Since the enterprise sector as a whole was typically solvent, being the main source of revenue for the government, the credit-worthiness of individual SOEs was not of primary concern to planners.

In many of the centrally planned countries, the initial reform efforts involved the scaling back of central planning and the granting of more autonomy to SOEs. At the same time, more banks were created. In some countries, such as Poland, the monobank's commercial banking functions were devolved into newly-created commercial banks; while in others, such as Russia, many new banks were established. However, bank operations were slow to adapt to the greater degree of decentralization.

1/ An extreme case is that of the "pocket banks" in the former Soviet Union, which were established largely to channel funds--usually central bank credit--to particular state enterprises.

2/ Credit money essentially formed a closed circuit on the books of the monobank.

Absent both constraints imposed by central planning and effective financial control, SOEs stepped up their borrowing. In some countries, sharply negative real interest rates gave them a further incentive to accumulate debts. Moreover, where high real interest rate prevailed, adverse selection may have impeded the efficient allocation of credit. Since banks had not begun to discriminate among borrowers on the basis of credit-worthiness, high interest rates may have discouraged borrowing by solvent enterprises whose managers and workers expected to have a stake in the firm, whereas those SOEs whose debt far exceeded their assets may have been undeterred, never expecting to service the new lending (see Dooley and Isard, 1992). 1/ Restrictive credit policies, compounded by shortcomings in credit and payment systems may also have contributed to the overall deterioration of the enterprise sector in some countries (Calvo and Coricelli, 1992 and 1993).

The large shocks to which SOEs in Central and Eastern Europe were subjected in the early 1990s were another source of the bad loan problem. First, price and trade liberalization worked to undermine the profitability of the enterprise sector: SOEs that had produced goods subject to shortages, purchasing inputs at controlled prices and selling their output under conditions of excess demand, suddenly hit the demand constraint. Many enterprises faced a significant contraction in demand, and were unable to adapt to altered market conditions (Blanchard et al., 1991; and Borensztein, Demekas, and Ostry, 1993). 2/

Second, the breakdown of trade among the former CMEA countries and among the countries of the former Soviet Union exacerbated the plight of enterprise sector (Rodrik, 1992). This breakdown was intensified by deep distrust among some of these countries, and by the fact that the previous pattern of trade had been, to some extent, artificially promoted in the interest of fraternal relations among the socialist countries (Wolf, 1990). The shocks affecting the enterprises, together with the banking system's failure to discriminate according to credit-worthiness, contributed to substantial further accumulations of bad debt after the inception of some reform programs.

The pattern of lending in the initial period of reform illustrates three aspects of the lack of financial control. Many SOEs were confronted with permanent changes to their economic setting--to their input prices and markets for their outputs--that would not permit survival in their present form. Nevertheless, these SOEs continued to receive bank credit that

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1/ Moreover, in some countries, such as Poland, official policy sanctioned interest capitalization.

2/ In some cases--notably Poland in 1990--rapid inflation early in the reform programs boosted the profitability of SOEs, as they earned profits on inventories and foreign-currency deposits, and as real (product) wages fell due to the incomes policy. These profits were subsequently reversed, however. See Lane (1992).

enabled them to perpetuate chronic loss-making activities. 1/ Some enterprise managers may have used their access to credit to buy industrial peace through higher wages (Coricelli and Lane, 1993) or to further their own interests, expecting that the debts would be serviced by someone else. 2/ In addition, in some cases there was an explosive growth in inter-enterprise arrears. 3/ (Clifton and Khan, 1992; and Ickes and Ryterman, 1993).

Why did banks not implement a greater degree of financial control after the initiation of reforms? First, banks had no clear-cut incentive to maximize profits, since they remained under state ownership. Even where their profits were shared with employees, uncertainty about how long this arrangement would last may have given them a very short-term perspective. Second, those banks that were themselves insolvent had no incentive to withhold credit from unworthy borrowers. 4/ Under these circumstances, lending to enable insolvent debtors to service their obligations could be rational, since this would enable the troubled banks to report the loans as performing, and thereby postpone the day of reckoning (Mitchell, 1993). Third, the quality of information on outstanding debts was very poor, since little factual basis existed on which to assess the long-term viability of SOEs, or even the quality of their receivables from other enterprises. Finally, the strength of insider networks and customary relationships may have perpetuated lending patterns established under the era of central planning.

The bad loans in emerging market economies constitute a serious problem because they distort the incentives of both creditors and debtors. Banks whose bad loans are so large that they are insolvent do not make efficient lending decisions, since at the margin no incentive exists to price accurately the risks of new loans. Under these circumstances, a serious moral hazard problem could arise as managers of state-owned banks would see little benefit in prudent lending relative a high-risk gamble that could keep them in business. Moreover, as long as banks are saddled with such a large proportion of nonperforming assets that they have negative net worth, they cannot be privatized. Bad loans also pose a similar moral hazard

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1/ Hughes and Hare (1991) estimate that between one-quarter and one-third of SOEs in Bulgaria, Czechoslovakia, Hungary, and Poland were producing negative value added at world prices.

2/ The diversion of credit to personal used was not limited to SOEs, as Poland's 1991 Art B scandal demonstrates (Folkerts-Landau, Garber, and Lane, 1993). This scandal is a reminder that in addition to the incentive problems of SOEs, there is the danger of outright fraud which existing supervisory structures may be inadequate to prevent.

3/ Some expansion of inter-enterprise credit may have reflected tax evasion, the normal extension of trade credit, or disintermediation due to inappropriate pricing of bank lending.

4/ For instance, a World Bank study released in May 1993 reported that the two largest banks in Hungary were technically insolvent.

problem for insolvent SOEs, destroying the incentive for maximization of enterprise profits. They may therefore be a significant impediment to their privatization (Levin and Scott, 1993).

III. Fiscal Constraints in Emerging Market Economies

With the aims of quickly eliminating the moral hazard problem associated with the debt overhang and of paving the way for privatization, sweeping solutions to the bad loan problem have been suggested. These involve either debt cancellation--eliminating claims of state banks on SOEs and of SOEs on one another--or debt socialization--replacing existing bank loans to SOEs with claims on the government's budget (Calvo and Frenkel, 1991; Begg and Portes, 1993; Calvo and Kumar, 1993; and Levine and Scott, 1993). However, any such solution to the bad debt problem must take into account its impact on the government's fiscal position. This impact arises largely from the extent to which the government implicitly guarantees deposits in state banks, which usually account for the bulk of the private sector's claims on the public sector. The government's ability to raise revenues with which to fund a bailout of depositors may thus constrain the extent of debt reduction that is feasible.

In emerging market economies, revenues are largely derived from the enterprise sectors, the profitability which has been squeezed by initial reform efforts (Tanzi, 1991 and 1993). Steps have been taken in some countries to move toward new tax bases--such as personal income tax and value added taxes--but new forms of taxation often take time to yield much revenue. 1/ In parts of the former Soviet Union, this problem may be exacerbated by disagreements on the right to tax the enterprises, and on the ambiguity of property rights in general (Shleifer and Vishny, 1993). This suggests that, if a debt write-off or socialization further reduces a government's ability to derive revenues, including debt service payments, from the enterprise sector, a heavier burden would fall on those forms of taxation that can be most readily collected, including the inflation tax (Lipton and Sachs, 1990).

The fiscal constraint would be less binding, if there were well-developed markets for government securities (bills and bonds). Such financing opportunities would permit the government to achieve its desired intertemporal distribution of the tax burden. The appropriate choice of intertemporal tax incidence would then depend on anticipated improvements in tax collection and increases in income that would be expected over the long haul, in order to minimize the deadweight losses from the taxation. This choice could also take into account intergenerational equity considerations,

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1/ For instance, Hungary introduced a personal income tax and value-added tax in 1988, while Poland and the former Czechoslovakia introduced a value added taxes in 1993. In each case, administrative and other start-up costs were substantial.

possibly shifting to future generations some of the costs of the economic transformation from which they will likely benefit in the form of higher incomes. However, in many emerging market economies, the absence of well developed money and securities markets limits the amount of government debt that could be sold to finance the cancellation of old loans.

The debt socialization proposal aims to avoid large-scale sales of government debt into under-developed markets by swapping these obligations for the claims of banks on SOEs. As a first approximation, debt socialization means substituting an explicit liability of the government for the contingent liability that an official guarantee of deposits entails. There are two key differences that would make debt socialization preferable, however. Debt socialization is more transparent, in recognizing the transaction as a financing item in the government's budget rather than as a contingent liability. It also paves the way for solving the moral hazard problem associated with insolvent banks and SOEs.

If the debt socialization approach is followed, however, how much debt should be socialized and what should a government do with the claims that it obtains on the SOEs? As a starting point, it is assumed that the state banks are to be privatized. If this privatization were to take place by selling shares in a liquid equity market, the net fiscal cost of any debt socialization would be limited to the negative net assets of the bank, since the government would recoup the amount of any excessive the debt socialization through increased privatization revenues (Begg and Portes, 1993). However, if--as seems more realistic--banks will be sold in relatively illiquid equity markets, or if they are given away to the public via some kind of voucher scheme, the benefits of excessive debt socialization are unlikely to be fully reflected in share prices, and thus to some extent would accrue to the new owners of the banks.

With respect to the claims on SOEs that governments would receive from banks, such debts could be retained at least in part to impose financial control over the managements of SOEs and to bolster government revenues. Provided that these debt contracts can be enforced, they could be used as means of prying productive resources away from inefficient SOEs. If financing for enterprise restructuring is available, the existing debts of SOEs could be used to mop up free cash flows that may be generated by the sale of productive assets (Jensen, 1986). Moreover, with respect to profitable SOEs, the existing debts could limit the discretion of managers over the use of operating profits. In both cases, the existing debts of SOEs could also provide the government with a source of revenue. However, the fiscal benefits of enforcing the existing debts of SOEs must be counterbalanced against the adverse incentives faced by the managers of insolvent SOEs.

A blanket solution to bad loan problem in emerging market economies, such as a generalized debt socialization or write down, is unlikely to strike the appropriate balance between quickly restoring solvency to banks and SOEs and limiting the fiscal impact of a bailout. Moreover, an indiscriminate bailout would not promote the restructuring of SOEs that is needed to achieve more efficient deployment of productive resources and more competitive market structures. Rather, to resolve the bad loan problem, a case-by-case approach is necessary.

IV. Resolving the Bad Loan Problem of State Banks

In formulating a case-by-case approach to resolving the bad loan problem in an emerging market economies, its is perhaps better to begin with the state banks, since the provision of new, high quality loans and other services is key to strengthening financial control and to restructuring the enterprise sector. With respect to the banking overhaul, several important issues must be addressed. First, the responsibility for undertaking the resolution must be assigned. Two alternative approaches are a decentralized route, in which responsibility for resolving the problem rests with the banks themselves, versus a centralized approach implemented through a specialized agency. The second issue is whether the banks should be recapitalized and, if so, how this should be accomplished. Finally, as with any bailout, the moral hazard problem must be combatted, which in this case requires the privatization of banks.

1. Decentralization versus a centralized resolution strategy

One approach to administering the resolution of the bad loan problem is to leave the individual banks that are so burdened to sort out the problem, as in the decentralized strategy recently adopted in Poland to address the bad loans of its nine major commercial banks. In this case, a certain portion of the banks' doubtful loans have been segregated in their balance sheets and subjected to special monitoring. This approach has also been used in Argentina, Malaysia, South Korea, Thailand, and the United Kingdom (during the secondary banking crisis). An alternative approach is to carve out bad loans from the banks' balance sheets and to transfer them to a centralized agency created by the government (or banks) for the purpose of resolving the bad loan problem. Recent examples of this approach are the creation of the Resolution Trust Corporation in the United States, the Cooperative Credit Purchasing Company in Japan, and the Spanish Guarantee Fund. This approach has also been used in Chile, the Philippines, and Uruguay.

The experience in industrial and developing countries reveals that the choice of a decentralized or centralized strategy for resolving the bad loan problem often reflects a number of factors. Foremost among them appears to be the size and scope of the problem (Saunders and Sommariva, 1992). In banking crises that involve a large number of problem banks with a significant proportion of the banking system's loans, the doubtful assets are often transferred to a restructuring agency. In the other cases, a more decentralized approach is typically used in which individual institutions retain responsibility for the resolving the bad loan problem. 1/ By both official and unofficial accounts, the number of troubled banks and the proportion of doubtful loans in some emerging market economies are very large, pointing to the use of a centralized solution.

Beyond the above consideration, a number of unique factors have a bearing on the appropriate choice of a resolution strategy in an emerging market economy, some of which also weigh in favor of the centralized approach (Blommestein and Lange, 1993). First, this approach decouples the banking overhaul from enterprise restructuring and may help to sever the symbiotic relationship between banks and SOEs. Since the restructuring and privatization of large SOEs is likely to be protracted, the retaining of bad loans to SOEs on the balance sheets of banks may impede their overhaul. The relatively quick rehabilitation of banks' balance sheets afforded by the centralized approach would allow the management of these institutions to turn to the business of making new, high quality loans. Moreover, the substantial reduction of banks' credit exposure to loss-making SOEs would be an important first step in breaking the spiral of bank lending to support these troubled enterprises. If banks are adequately recapitalized when the bad loans are removed from their books, these institutions would no longer be compelled to roll over old loans to maintain the pretense of solvency. However, regulations to curb new bank lending to SOEs--for example, rules pertaining to large exposures--are likely necessary to establish an arms-length relationship between banks and SOEs and to encourage the formation of broadly diversified loan portfolios.

In contrast, if the bad loans were retained on the balance sheets of banks, their close relationship with SOEs would most likely be preserved, as would be the banks' concentrated credit exposures. While in principle banks could be recapitalized sufficiently to enable them to charge off the nonperforming loans, the resolution of the bad loans could require the banks to become closely involved with the managements of SOEs. Moreover, this involvement would not be limited to isolated business failures, but rather it would be pervasive given the financial condition of the enterprise sector. The extensive commingling of banking and commercial activities has been resisted throughout much of the history of Anglo-Saxon banking (Corrigan, 1991). Two main concerns have been about conflicts of interest and concentrations of economic power. The delegation of enterprise restructuring to banks may thus impede the paring down of large SOEs. However, in other countries, such as Germany, the cartelization of banking and industry has been viewed as an engine of development (Hellwig, 1991).

The second consideration that favors a centralized approach is the pace at which bank privatization could proceed. The cleaning up of banks'

1/ This empirical regularity suggests that there may be some economies of scale in undertaking bad loan resolutions. However the precise source of these gains is difficult to pinpoint (e.g., administrative cost savings versus greater control over the disposition of assets).

balance sheets would make possible their more precise valuation and reduce the time required for due-diligence investigations prior to their sale. Moreover, privatization in this manner is likely to be more enduring because it makes a clear break with the past. The government could credibly argue that any losses on loans are in the first instance the responsibility of banks' private owners and managers (Levin and Scott, 1993).

Third, a centralized resolution agency may facilitate the restructuring of SOEs. One impediment to their restructuring is the diffuse control of SOEs with the loss of central government authority after the collapse of communist regimes. Workers, incumbent managers, and local governments now vie for dominant positions in these enterprises (Dinopoulos and Lane, 1992; van Wijnbergen, 1992; and Shleifer and Vishny, 1993). In bargaining with these various stakeholders, an agency backed by the government may have greater authority and leverage than banks. In principle, the agency must devise a resolution strategy that combines enough "carrots and sticks" to prevent these stakeholders from blocking the restructuring of enterprises. One possible incentive is the transfer of shares in privatized enterprises as needed to one or more of these groups (van Wijnbergen, 1992), while channeling new bank loans away from chronic loss-making SOEs toward enterprise restructuring is a potential way to discourage obstruction (Perotti, 1992).

The main argument against adopting the centralized approach is that the administrative demands of this solution would be difficult to satisfy in many emerging market economies, where such expertise is in short supply. This, in fact, was the main reason why the Polish Government opted for a decentralized approach to resolving the bad loan problem of its nine largest banks (Kawalec, 1993). A centralized agency may also become a focal point for rent seeking activities that could undermine its efforts to restructure enterprises--although individual banks would also not be immune to such pressures.

2. <u>Bank recapitalization</u>

Given an assignment of administrative responsibility for resolving the bad loan problem, the issues of whether and, if so, how to recapitalize the banks must addressed. The case for recapitalizing insolvent banks rests upon several considerations, including the desirability of building confidence in the banking system and preparing for the privatization of state banks. Failure to protect depositors would risk financial instability and jeopardize the attempt to impose market discipline through financial control. At the same time, recapitalization is a necessary first step for the sale of banks to private investors that would help combat the moral hazard problem associated with a bailout of depositors. Concern over the fiscal impact of the bailout, however, could lead to the imposition of losses on depositors, especially through high inflation and negative real deposit rates. It could also lead to the adoption of inefficient schemes in the attempt to hide its true cost.

Many industrial countries experienced periods of financial instability, particularly in the 1930s and in periods surrounding major wars, that involved widespread failures of financial institutions, sharp declines in asset prices, and disruptions to payments systems and credit intermediation. The view that this instability contributed to significant declines in real activity and employment have led most industrial countries to adopt financial policies aimed at promoting financial stability and containing the spill-over effects from financial crises onto the real economy. These policies include extensive explicit and implicit guarantees of bank deposits.

The official safety net for banks and other financial institutions in industrial countries consists primarily of the central banks' authority to act as lender of last resort, typically on the basis of collateral, and explicit deposit insurance schemes. The structure of these schemes differs widely, however, in terms of the extent of their coverage, the institutions allowed or obligated to participate, the relative roles of private and public insurance, and the extent to which insurance funds have been used. Nevertheless, in instances of financial instability, authorities typically have come quickly to the rescue of troubled institutions, mobilizing both public and industry resources. In the case of troubled banks, preserving confidence in the system has usually necessitated providing enough liquidity to protect depositors and to provide time until the situation could be fully assessed and an orderly resolution put in place (Corrigan, 1990).

In emerging market economies, the potential for financial instability is significant. Initial reform efforts have seriously impaired the financial position of many SOEs and, in turn, that of their creditor banks. Moreover, owing to a lack of reliable accounts and financial disclosures, the distribution losses within banking systems is largely unknown to depositors. To maintain financial stability and to lay the foundation for the shift to financial control over the use of capital, many governments overseeing the transition to a market economy have pursued a policy of de facto guaranteeing 100 percent of deposits in major state banks in nominal terms, although in many cases they have lost much of their real value through inflation. 1/

The choice of recapitalization method often reflects the trade-off among conflicting objectives, in particular the maintenance of financial stability versus minimization of fiscal costs. In industrial countries, attempts to strike a balance between these goals have sometimes led to efforts aimed at concealing the true cost of recapitalizations, which often raise their ultimate costs. For example, in some cases, governments can sufficiently restrict competition among banks, allowing them to earn

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1/ A combination of inflation and wide interest rate margins increased banks net worth dramatically in Poland in the early 1990s, although this solution was probably unintended and provided only temporary relief from banks' solvency problems (Lane 1992).

extraordinary profits from wide net interest margins that can be used to rebuild their capital. This approach, while keeping the recapitalization costs off the government's books, imposes the equivalent of distortionary taxes on consumers of banking services to fund the recapitalizations. This is not in general an efficient way to distribute the tax burden. Another method, found for instance in the early stages of the U.S. savings and loan crisis, is for the deposit insurance agency to resort to the widespread use of loan guarantees to avoid making cash outlays. These guarantees weaken the incentive to collect on problem loans, and, as found in this instance, may ultimately prove very costly.

In emerging market economies, the status quo of allowing banks with negative net assets to continue operating with the benefit of a de facto 100 percent guarantee of deposits has the appeal of postponing the awful day when the cost of bank recapitalization needs to be confronted. In such circumstances, the government effectively borrows by having state banks issue deposits and using the proceeds to fund the negative net assets of banks. The status quo has appeal also because the interest on this borrowing is paid by creating additional bank deposits, rather than by using government revenues. However, allowing banks with negative net assets to continue their operations involves the danger of escalating the bad loan problem, because there is little incentive to collect on old loans or to price the risks of new lending accurately.

Any effort to recapitalize banks in emerging market economies thus must overturn the appeal of the status quo. One way to tip the balance in favor of explicit recapitalization is to craft a plan that to some extent replicates the present situation. Since both the banks and SOEs fall within the public sector, recapitalization of banks can be achieved by the government exchanging its debt for bank claims on the SOEs. This balance sheet operation does not affect the consolidated net worth of the government, taking into account its commitment to depositors. Thus, in effect, this method of recapitalizing banks simply substitutes explicit government borrowing for its implicit borrowing in the form of bank deposits.

While it is possible to craft recapitalization plans that to a large extent replicate the status quo, any explicit recapitalization of banks would make the costs transparent. This transparency could have political disadvantages for the government, and run afoul of attempts to achieve targets for benchmark levels of the fiscal deficit--which is of particular concern to international financial institutions. Nevertheless, an explicit recapitalization would allow the authorities to establish accountability for keeping these costs at a minimum.

3. Moral hazard and bank privatization

In most official efforts to recapitalize troubled banks, the government's aim of preserving financial stability cuts against the need to maintain market discipline for banks, since the losses are not confined to their shareholders and private creditors. Indeed, the fundamental dilemma is that, while official assistance can limit the impact of financial instability on real activity and employment, the expectation that such assistance will be forthcoming may alter the behavior of banks' managers, shareholders, and unguaranteed creditors in such a way as to make instability more likely in the future (Lane, 1993).

In industrial countries, the moral hazard problem associated with the official safety net for banks is combatted in several ways. First, a precondition for official assistance to a troubled institution is typically the replacement of the bank's management. Second, the shareholders' claims on the bank are substantially diluted or written-off in return for government assistance. Thus, the management and shareholders of a troubled bank bear the costs of failure to the fullest extent that is possible. Third, to minimize the likelihood of failure, governments implement comprehensive systems of banking regulation, including capital requirements, limits on concentrated credit exposures, and prudential examination.

The present banking troubles in emerging market economies do not, in the first instance, pose precisely the same moral hazard problem as those in industrial countries, since the government is the principle shareholder of the banks. By virtue of the de facto 100 percent deposit guarantee, the government is essentially a shareholder with unlimited liability and, thus, internalizes fully the costs of the banking troubles. However, bank managers in emerging market economies may not have acted entirely in the interests of the government. Establishing accountability at the level of bank management is also hampered by the short supply of capable managers.

The first line of defense against future banking troubles in emerging market economies is thus privatization of the banks and a credible government commitment not to protect the private shareholders. The most effective preventative measure against future troubles is placing private capital truly at risk in the banking system. With private capital at stake, the banks' owners would have an incentive to ensure that risks of new lending are appropriately priced and that risk management procedures are adequate. Moreover, if future losses are sustained, the private capital would serve as an initial buffer to absorb these costs, before recourse is made to public funds. The government's commitment not to protect bank shareholders in the event of future losses would be made more credible by removing the bad loans to SOEs from the banks' balance sheets prior to their sale (Levine and Scott, 1993).

V. Overhauling State-Owned Enterprises

The other side of the bad loan problem in emerging market economies is the restructuring or liquidation of SOEs that cannot service their debts. Whichever approach to bad enterprise debts is adopted, the final concern is not to protect the narrow interests of the creditors, but to find the most efficient way of structuring economic activities afterwards, as well as to create the appropriate incentives for lending in the future. These concerns are especially pressing in economies in transition. If prevailing structures of large SOEs, with their extensive vertical and horizontal integration, were left intact, productivity gains from a more efficient deployment of productive resources would be foregone and the risks of monopoly abuses would be high (Carlin and Mayer, 1992). 1/ Another issue is the unemployment consequences of enterprises restructuring which are often serious because of the provision of housing and other social services by SOEs and prolonged due to the relative immobility of workers (Dooley and Isard, 1992).

In principle, a bad loan can be restructured to reduce its principal amount or present value of its interest payments. This approach typically enables the borrower to continue operating as a going concern at the expense of bank profitability over time. Alternatively, the operations of the borrower can be wound up, with the proceeds from the disposition of assets accruing to the creditor. The unpaid loan balances must then be charged off. Moreover, these two types of resolutions are sometimes undertaken simultaneously, in which case partial asset sales are used to pay off some debts, while others are restructured in a way that reduces their net present value.

While formal bankruptcy proceedings provide one forum for resolving bad loans, restructurings and liquidations (or combinations thereof) can also be achieved, often at lower cost, through bargaining between creditors and debtors. However, the credible threat of enforcing the loan agreement (by seizing collateral) or risk of bankruptcy often underpins such negotiations (Huberman and Kahn, 1988; Hart and Moore, 1989). The reform of bankruptcy and related laws would thus facilitate the overhaul of SOEs (Aghion, Hart, and Moore, 1993; Mitchell, 1993). However, passing legislation and building the relevant administrative capabilities are time consuming. A centralized resolution agency could perform some of the functions of bankruptcy proceedings, as well as allow for the social benefits and costs associated with enterprise restructuring.

1. Restructuring versus liquidation

Evidence from industrial countries, while limited, confirms the general preconception that firms filing to restructure their liabilities in bankruptcy tends to be larger and in better financial condition than those seeking to liquidate. However, the net assets of both types of firms are on

1/ An important lesson from the experience with privatization in industrial countries is that pro-competitive restructurings should precede privatization (Vickers and Yarrow, 1988). Moreover, Kornai (1990) cautions against pseudo-reforms that do not fundamentally alter the organization and conduct of the enterprise sector.

average significantly negative. 1/ A study conducted for the U.S. Department of Justice found that the average ratio of total assets to liabilities of firms that file for Chapter 11 bankruptcy was 0.71, while that of firms that filed for Chapter 7 bankruptcy was 0.14 (Ames et al., 1983, as reported in White, 1989). The ratio of assets to secured liabilities of these two type of firms was 1.67 and 1.0, respectively.

One reason that loss-making firms may seek to restructure their liabilities is the ability to generate an adequate stream of profits with a lighter debt burden (Fries, Miller, and Perraudin, 1993). Such a restructuring also preserves the firm's value as a going concern (Jensen, 1989). However, if the firm's losses are large enough, debt restructuring may not sufficiently improve the outlook for profits, in which case the firms are liquidated.

The choice between informal debt restructuring and bankruptcy proceedings appears to be influenced significantly by the presence of a dominant creditor. In the United States, private negotiations over debt restructuring are more likely to succeed if banks are the primary creditors and less likely to succeed if there a number of distinct creditor groups (Gilson, Kose, and Lang, 1990). Moreover, its is widely believed among practitioners that costs of informal debt restructuring tend be less than those of bankruptcy. Similarly, in Japan, where informal debt restructurings are not uncommon, a distressed firm with close ties to a main bank tends to perform better than a distressed firm with no such ties (Hoshi, Kashyap, and Scharfstein, 1990). One interpretation of these facts is that a dominant creditor can effectively serve to keep the costs of financial distress to a minimum.

The restructuring or liquidation of SOEs is subject to several constraints, however. First, the absence of well functioning bankruptcy procedures would limit the number of restructurings or liquidations that could be undertaken through the courts. Bankruptcy laws in emerging market economies are relatively new and untested, with Hungary, Poland, and the former Czechoslovakia enacting such legislation in 1990-91 (Aghion, 1992). Only in Hungary, where the bankruptcy law came into effect at the beginning of 1992, has there been a significant number of bankruptcy petitions. By the end of 1992, the Hungarian courts had registered 3,658 restructuring and 7,062 liquidation applications (nine percent of enterprises with 33 percent

1/ The latter result contrast with the prevalent notion in the economics literature that a firm with negative net assets should be closed promptly. However, the option to put the assets of the firm onto its creditors associated with limited liability of shareholders can at least in part compensate them for the negative net assets of their firm. See Fries, Miller, and Perraudin (1993).

of GDP). 1/ However, only 27 percent of these cases have been completed, owing to limited court capacity.

Finally, the lack effective recourse to bankruptcy undermines the ability of banks and SOEs to reach an informal agreement over the resolution of bad loans. The absence of restrictive loan covenants that could give creditors leverage by threatening to seize collateral or to restrict in other ways enterprise operations also undermines the bargaining position of state banks. 2/

2. A resolution agency's role in enterprise restructuring

The considerations that have been discussed--creditors with little leverage to restructure debt outside of the courts, nonexistent or poorly functioning bankruptcy procedures, and significant social benefits and costs to restructuring--argue for a resolution approach that does not conform precisely to approaches typically followed in industrial countries. The Treuhandanstalt, a government agency charged with responsibility for restructuring and privatizing East German SOEs, provides an example of an alternative. The view behind this approach is that a government agency can compensate for shortcomings in the legal framework, including corporate governance, and allow for social benefits and costs (Carlin and Mayer, 1992).

The Treuhand has among its main functions evaluating the balance sheets of SOEs and writing off their old debts, reorganizing and closing enterprises, and setting employment and investment targets. The Treuhand called upon a team of West German managers to analyze the potential viability and balance sheets of East German SOEs. Its evaluation of viability was based on whether SOEs had marketable products, capable managements, and links with West German firms. To mitigate the initial arbitrary conditions imposed on SOEs by their inherited debts, the liabilities to the state bank of the former East German regime were written down to the point at which their equity was in line with that of comparable West German firms. 3/ The Treuhand's power to restructure enterprises stems from a 1991 law that allows it to carve out parts of SOEs for sale. If necessary, the Treuhand can use dismissal, or the threat thereof, to override management opposition to restructuring. Finally, while the net worth on the adjusted balance sheets of SOEs serve as benchmarks, the Treuhand adjusts sale prices in privatizations according to the investments that the buyers guarantee to undertake and the number of jobs that they preserve.

1/ The vast majority of the liquidations are thought to involve small firms, but precise data are not available.

2/ Uncertainty about ownership claims in emerging market economies has made it difficult to offer property as collateral.

3/ The Treuhand estimates that about 70 percent of the old debts will be written off.

While the majority of enterprises will be restructured and privatized, recent estimates indicate that between 20 and 30 percent of East German SOEs will be liquidated. The industries slated for the greatest share of enterprise closures are mining, metal goods, leatherware, synthetics, textiles, electronics, and chemicals--all tradable goods. In contrast, enterprise restructuring and privatization is proceeding most rapidly in the construction, services, and distribution sectors. The closure of firms may be by liquidation under the auspices of the Treuhand or a more formal court liquidation. The Treuhand's liquidations tend to preserve where possible the going-concern value of enterprises by carving out those parts that are viable and negotiating their sale to new investors. In formal bankruptcy proceedings, the Treuhand looses the power to dispose of assets and the narrow interests of creditors tend to prevail. As a result, more jobs are preserved in Treuhand liquidations (33 percent) than in formal bankruptcy liquidations (23 percent).

The Treuhand's emphasis on the preservation of enterprise employment, however, may impede the reallocation of labor to more productive sectors, and may not be feasible in other emerging market economies. 1/ The criteria adopted by the Treuhand have no doubt been appropriate in eastern Germany, where the social safety net makes unemployment very costly from a fiscal standpoint, while the tax base of Germany as a whole is large enough to support an expensive bailout of SOEs. The massive increase in the costs of the Treuhand's restructuring efforts relative to initial expectations may nevertheless point to one of the drawbacks of a centralized resolution agency. It may face considerable political pressure not to liquidate chronic loss-making enterprises, even when they face little prospect for returning to profitability. However, as pointed out above, individual banks may be subject to much the same pressure under a decentralized approach.

Other aspects of the Treuhand's approach, while suitable for eastern Germany, may also be less applicable to other emerging market economies. These include the heavy reliance on expertise from western Germany and the introduction of the established legal system from western Germany. Such an extensive use of outsiders, let alone the wholesale introduction of laws and law enforcement procedures from outside, would not likely be possible nor political acceptable in other countries in transition.

The above considerations suggest that, in other emerging market economies, a resolution agency may adopt a more narrowly focused and less costly approach than that of the Treuhand. For example, such a government agency, as the holder of claims on SOEs after a debt socialization, could concentrate on enforcing these debts. This could involve selling off viable parts of SOEs as going concerns and using the proceeds to pay off the outstanding debts of the SOEs. Enterprise assets could also be sold to private firms either directly or by selling the assets to leasing

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1/ Burda (1991) examines the extent to which the private sector can absorb displaced workers in the former Czechoslovakia and eastern Germany.

companies. Provided that these sales and leasings are based on accurate valuations of the structure and capital equipment, this approach would effect the writing down of outstanding enterprise debt to its market value and, at the same time, would boost productivity and foster more competitive market structures. Moreover, implementation of the strategy could be tailored to the agency's administrative capacity, provided that tight controls can be imposed on SOEs that were awaiting restructuring.

VI. Financing for Enterprise Restructuring

While a resolution agency could play an important role in reducing the inefficient scale and scope of large SOEs and in creating more competitive market structures, such restructuring would also require financing for the acquisition of productive assets from the SOEs. In principle, the stock of private savings could be used to fund the purchase of these divested assets. However, their value may well outstrip the amount of private wealth, both domestic and foreign, that could be mobilized in the short run for this purpose (Aghion and Burgess, 1992). This constraint on asset sales could be eased if the government accepted claims on the cash flows generated by the assets (Bolton and Roland, 1992).

To the extent that individual wealth is mobilized to fund the acquisition of assets from SOEs, asset sales may sort potential buyers by their wealth rather than their ability to use the assets efficiently (Bolton and Roland, 1992). If the relevant abilities are not strongly positively correlated with wealth, asset sales to the private sector may not achieve the maximum possible efficiency gains from redeploying enterprise assets. The wealth constraint could be eased in several ways. In the first instance, it is important to note that restructuring of SOEs prior to their sale would lessen the amount of wealth required to control a particular set of enterprise assets. Another approach would be to provide private investors with financing to purchase assets sold in the course of restructuring. Finally, acceptance by the government of non-cash bids (claims on cash flows) for enterprise assets could provide purchasers with an alternative source of financing-although it would also leave government as a major creditor of these enterprises.

What is the appropriate financial structure to support sell-offs from SOEs? The answer depends in part on the relationship between the new firm's owners and its managers. In an owner-managed firm, management decisions are taken in the owner's interest, but at the expense of a potential exposure to firm-specific risks. If ownership extends beyond the firm's managers to include outside shareholders, a greater diversification of risk is achieved, but the managers must be given a stronger incentive to act in the owners' interests. Mechanisms that serve to combat this incentive problem include managerial compensation contracts based on (noisy) measures of performance, monitoring by boards of directors, and shifts in control associated with hostile takeovers or bankruptcy.

The problems of constructing incentive contracts and monitoring mechanisms are particularly difficult for firms operating under highly uncertain conditions (Tirole, 1992). This consideration is particularly important in emerging market economies, in which demand and cost conditions are often volatile. For example, highly sensitive performance contracts may expose managers to significant risks beyond their control, while ex post monitoring of whether a firm lost money because of an adverse shift in market conditions or because of poor managerial performance could be difficult. One solution to the incentive versus risk-sharing problem appears to lie with having an inside shareholder group, which may involve a majority stake to solve the incentive problem, and outside equity investors to spread the risks (Demsetz and Lehn, 1985). Moreover, high leverage in face of great uncertainty carries the danger of frequent bankruptcies that do not necessarily reflect managerial performance.

The provision of outside equity, even in industrial countries, is a difficult and costly endeavor, especially for new firms. Initial public offerings (IPOs) in a number of industrial countries are on average priced at substantial discounts to their post-offering prices (Smith, 1986; Jenkinson, 1990). This under pricing of IPOs reflects at least in part the limited information that investors and underwriters have about the prospects of firms tapping the equity market for the first time. This problem is likely to be more severe in emerging market economies. One solution is for the government to retain equity stakes in divested companies to achieve some spreading of risks during the initial high risk period. 1/ These holdings could then be sold in tranches to develop a liquid market for the shares and to maximize the revenues from the sale to private investors. Public offerings of equities that are already traded on markets tend to be priced near prevailing secondary market prices (Smith, 1986). Given the severe fiscal constraints to which governments in many emerging market economies are subject, such methods of increasing the revenues from privatization might be considered--although they would have to be set against the distortions associated with prolonging direct government involvement in productive activity.

In addition to sell-offs, the shifting economic activity to a smaller scale can be achieved through leasing productive assets either by bank affiliates or the government. Leasing is in part an alternative to collateralized borrowing that has the advantage of economizing on the amount of financing needed by the lessee (Smith and Wakeman, 1985). A lease involves financing for only the amount of the productive asset that is depreciated while in the lessee's possession. Moreover, a lease has desirable incentive effects to the extent that the lessee pays a fixed amount for use of the asset and receives at the margin the benefits from its

1/ The retention of minority equity claims on the SOEs would also provide the government with a source of revenue, from which would have to be subtracted the interest cost of postponing sales. See Blanchard et al. (1991) and Borensztein and Kumar (1991).

efficient use. However, leasing has certain adverse effects not associated with outright ownership of an asset. With leasing, the lessee has less of an incentive to invest in maintenance and improvement of the assets relative to that with ownership. In cases where it difficult to specify contractually such responsibilities, there may be a moral hazard problem in which either the lessor or lessee may refrain from undertaking investments that would be beneficial.

In emerging market economies, short-term leases have the desirable property that they tend to lessen the need for both buyer and seller to have information about the value of the asset being leased (Flath, 1980). With outright sales, it would be necessary to produce considerable information about the value of the assets. In a period of rapid economic transition, when any valuation is highly speculative, this information be very costly, if not impossible, to produce. With a short-term lease, the lessee only agrees to rent the assets' services for a limited period; therefore, less is at stake in the initial valuation. The assets can be sold outright at a later date when there is a sounder basis on which to value them.

VII. Conclusion

The legacy of bad loans from the passive role of finance under central planning and early transition period, as well as the excessive scale and scope of large SOEs, impose significant obstacles to the successful transition from central planning to a market-based economy. The overhang of debt create several potential pitfalls to this transition: insolvencies pose moral hazard problems with respect to both creditors and debtors; moral hazard problems enlarge the fiscal cost of the bailout that will eventually be needed; and insolvencies prevent the privatization of banks and SOEs. Moreover, large SOEs tend to be of inefficient scale and scope and failure to restructure them before privatization risks creation of concentrated market structures.

This paper examines how the above problems can be tackled within the fiscal constraints faced by reform governments. Priority is given to restoring the solvency of banks because of the important roles that they could play in strengthening financial control and in providing finance for enterprise restructuring. One way to restore soundness to the banking system is to undertake a case by case exchange of bad loans for government debt. A centralized agency could then undertake to resolve the bad loans with the SOEs. Moreover, the centralized agency could use these loans as leverage to pry productive assets away from SOEs. For this effort to succeed, however, financing must be available for the acquisition of enterprise assets. This could involve the provision of new bank loans and equity purchases by insiders. Sources of outside equity would in all likelihood be difficult more to tap initially; and governments could retain equity stakes in enterprise sell-offs to achieve some diversification of risks. Leasing could also play an important role in transferring productive enterprise assets to new private firms.

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