0440

IMF WORKING PAPER

WP/90/120

INTERNATIONAL MONETARY FUND

Central Banking Department

Financial Sector Reform and Central Banking in Centrally Planned Economies

Prepared by V. Sundararajan 1/

December 1990

Abstract

This paper reviews key areas of central banking reform in a sample of centrally planned economies undergoing transition to market-based systems. The discussion draws mainly on the experiences of four countries, Hungary, Poland, Czechoslovakia, and China. Significant efforts have been made, or are under consideration, in all countries to develop a more efficient framework for monetary management, and to provide greater autonomy to central banks in macro stabilization policies. These objectives call for a coordinated approach to strengthening a wide range of central banking functions simultaneously, and require that a core mass of supporting financial sector reforms be implemented to ensure effective transformation and stabilization with minimal transitional costs.

JEL Classification Numbers:

124, 310, 311

1/ The author is grateful to Mr. Douglas A. Scott, Mr. Anupam Basu, Mr. Martin Fetherston, Mr. Mark Swinburne, and Mr. Anton Op de Beke for helpful comments, and Mr. Dawit Makonnen for research assistance. An earlier version of the paper had been distributed for comments to members of the Working Group on the Design of Fund Policy Advice.

Table of Contents

Summary

This paper reviews and compares reforms in central banking in a sample of centrally planned economies undergoing transition to market-based systems, mainly Hungary, Poland, Czechoslovakia, and China.

The transformation of an essentially monobank system to a two-tier banking system called for the resolution of a host of legal, organizational, and technical issues. While this already implied a significant redistribution of power away from the Budget and Plan authorities, further efforts have been made--or are underway--to strengthen the autonomy of the central banks in Hungary, Yugoslavia, Czechoslovakia, and Poland, and balance this autonomy with appropriate arrangements for accountability. Related legal issues have been debated in China. However, the full disengagement from commercial activities by the newly created central banks, has not yet been achieved.

The ability of the newly established commercial banks to compete for deposits and loans is circumscribed owing to the large concentration of the banking industry, the limited network of branches, and various structural and regulatory impediments. While the regulatory environment permits freedom in lending and in a wide range of investment services in Poland and Czechoslovakia, regulated specializations have been continued in China, and for a transitional period in Hungary.

The banking reform has been associated with twp major changes in the mix of instruments for monetary control. However, the technical design and implementation of monetary policy framework has been constrained by the uneven distribution of deposits and credits following institutional reforms and by a variety of other structural impediments.

Progress in banking supervision has been slow due to weaknesses in legislation, the time needed to adapt the traditional accounting concepts to the needs of a market-oriented economy, and the difficulties in building up staff with requisite training.

The lack of adequate clearing and settlement arrangements has created uncertainties in the amount of clearing account balances and have distorted monetary statistics and prudential returns in most countries. New and more efficient clearing and settlement systems are, however, being developed.

I. Introduction

In centrally planned economies (CPEs), economic reforms refer to measures aimed at decentralizing decision making on prices and quantities, and giving market forces a more important role. 1/ The objective of such reforms is to effect a more efficient allocation of resources and a better balance between supply and demand. Since the mid-1980s, financial sector reforms have become important components of this overall process of economic liberalization, and the accompanying stabilization programs.

The accelerating pace of financial sector reforms reflects the consideration that such reforms not only foster broader structural reforms of the nonfinancial sector, but also provide the necessary support for macroeconomic stabilization, which is essential for the success of all structural reforms. For example, the development of commercial banks and other financial institutions that are autonomous, sound, competitive, and profit-oriented would facilitate decentralized decisions on credit allocation and enterprise restructuring in the face of major changes in relative profitability of firms that accompany price liberalization and stabilization policies. At the same time, the development of central banking in CPEs introduces monetary policy as a new dimension of macroeconomic regulation, the rate of interest and the exchange rate as key instruments of stabilization policy and as components of pricing reforms, and prudential regulations as a new approach to fostering sound decisions on credit allocation and managing risk exposure.

A typical initial step of recent financial reforms in CPEs has been the shift from a mono bank system to a two-tier banking system. This has been followed by different degrees of effort--depending on the country--to develop a more efficient framework for monetary management, to provide greater autonomy to central banks in macro-stabilization efforts, to strengthen competition in the banking system, to build up a banking supervision system, to foster money and securities markets, and to streamline the payments system. While such efforts are found in the financial sector reforms of all developing countries, the particular structural features of CPEs at the outset of reforms have posed special challenges in designing the specifics of reform measures and in the sequencing of these measures in coordination with other structural and stabilization policies.

This paper outlines some key aspects of financial sector reforms in the CPEs based mainly on the experiences of four countries, Hungary, Poland,

---

1/ The CPEs in transition from central planning to market-based systems are often referred to as emerging market economies.

Czechoslovakia, and China. 1/ The experience of Yugoslavia is also covered in view of the broad similarities in issues relating to financial sector reforms. The paper is organized as follows. Section II outlines as background the typical financial structure and policies of CPEs prior to the reforms. Section III describes issues in the transformation from a mono bank to a two-tier banking system, and the role of central banks (and commercial banks) that emerged following such transformation. Section IV describes the issues in the design of a new monetary control system after the banking reform. Section V outlines the status of reforms in banking supervision. Section VI describes the efforts to develop money and securities markets. Section VII considers the issues in reforming the payment system. Section VIII offers some concluding remarks.

II. Typical Pre-Reform Financial Structure and Policies in CPEs

In a typical CPE there is a state bank which usually has a significant monopoly over banking and credit. 2/ Under this "mono-type system" there is no significant secondary credit expansion, but the monobank has unlimited capacity to create bank deposits. For example, the Soviet monetary system--emulated by many other CPEs--has been a classic case of managed fiat money whose magnitude is determined directly by the state authority and effectively insulated from outside influences by a state monopoly over foreign exchange transactions. In addition, there are specialized financial institutions that provide banking services to particular sectors, but essentially channel credit to enterprises in these sectors in line with the directives specified by the central authorities.

There are two distinct and separate financial circuits in traditional centrally planned economies. One serves the household sector which receives personal incomes in cash and effects payments for consumption in cash. The other serves enterprises which receive credit from banks and make payments to other enterprises and budget entities via current bank accounts, while paying wages and salaries in cash. Households can deposit funds (mainly in saving accounts) with the bank or banks serving the household sector, which also extend credit to the household sector. However, private citizens cannot invest in, or directly lend to state enterprises, or buy whatever is designated production input from these enterprises. Enterprises cannot

---

1/ The discussion refers to reforms that began around the mid-to-late eighties and does not cover banking reforms that had been introduced in previous years in some of the countries.

2/ In contrast, the pre-reform banking system in Yugoslavia consisted of a large number of banks owned "socially," that is, associations of workers in nonfinancial enterprises joined together to form each bank. In effect, banks were "owned" by enterprises. The state bank--the National Bank of Yugoslavia, and the National Banks of the regions--was a major partner in extending credit to enterprises in selected sectors in the form of co-financing (so-called "refinancing") with individual commercial banks.

acquire anything in retail outlets, with trivial exceptions. Banks (or other entities) serving households do not engage in transactions with state enterprises and vice versa, thus resulting in little competition for funds. 1/

The role of the monetary system is to finance the production plan; in essence the physical plan dictates a financial plan, decomposed into a budget, a credit plan and a cash plan. Monetary policy is exercised through controlling the volume of credit to state enterprises and budget entities, and making available the growth of cash in line with the planned gap between monetary receipts and outlays of the household sector. The state bank has little autonomy, but is charged with monitoring the observance of the central plan by guaranteeing the enterprises the loans needed to carry out planned transactions, and by seeing that these loans and enterprises' own deposits are only used for those transactions. Every transaction of any importance, such as enterprise withdrawals of cash for wage purposes, must be effected through the drawing of a check on the state bank.

Given the reliance placed on the direct allocation of credit in a CPE, interest rates and the exchange rate have virtually no allocative role. Credit is usually extended to enterprises at low fixed interest rates, with no tailoring of interest rate levels to repayment risks and maturities of particular loans. Also, interest rates offered on financial assets held by enterprises have been kept at relatively low levels and in many cases surplus funds have been syphoned off usually by ad hoc agreements with the government, and in some instances by high tax rates. As a result, there has been a strong tendency for enterprises to accumulate real assets (inventories, plant and equipment) as opposed to acquiring financial assets.

Just as the cash plan and credit plan are companions to the physical input and output plans, so too are the foreign exchange and external borrowing and import plans. It is through these plans and attendant administrative controls that the economy is linked to the international economy. The exchange rate was mainly an accounting device to enable conversions between foreign and domestic prices to be made consistently. 2/

The dominance of state enterprises as borrowers from the banking system obscured issues of risk. Bankruptcy was not a relevant event and the ultimate owner of both enterprises and banks was the government. In China

---

1/ This was the case in Poland, Czechoslovakia and Hungary until recently. In China and Yugoslavia, all banks--other than the state bank--were allowed to offer household deposits and limited types of loans to households. In all five countries, the payments system was segmented between households and enterprises by type of payment instruments and settlement arrangements.

2/ The commercial exchange rate often did not suffice to translate foreign prices into domestic prices. Therefore, price equalization schemes were used to adjust transactions (border) prices to domestic prices.

this was the concept of "eating out of one big iron rice bowl." Any surplus of receipts over expenditures in the banking system was transferred to the Government. Similarly, large transfers, including of depreciation funds, were made by enterprises to the Treasury and the state budget was the predominant source of investment funds. Thus, financial policies and the absence of risk and accountability appear to have contributed to the "investment mania" of state enterprises in many CPEs, which has co-existed with a relatively undeveloped network of financial institutions.

III. Banking Reforms--The Emergence of a New Banking Structure

The first important step in the financial sector reforms in CPEs is the transformation of an essentially monobank system to a two-tier banking system. In setting up a two-tier banking system, the state or national bank assumes the traditional central banking functions, focusing on regulating overall credit and interest rates, and divesting itself from deposit and loan transactions with households and enterprises, which are transferred to newly established banks (with existing specialized banks being granted greater autonomy). Examples of the recent creation of a two-tier banking system include China in 1984, 1/ Hungary in 1987, the U.S.S.R. in 1988, Poland in 1989, and Czechoslovakia in 1990

Yugoslavia has also been establishing a new banking system since early 1990, based on new central banking and banking laws which were enacted in mid-1989. The main motivation for the banking reform in Yugoslavia has been to strengthen the autonomy of the central bank, and to change the ownership structure and recapitalize the banking system which carries a large portfolio of nonperforming loans estimated at 15 percent of gross social product.

The creation of a two-tier banking system in CPEs called for the resolution of a host of legal and structural issues, many of which are still being decided. In formulating the new central banking and banking legislation, the authorities had to decide on the permissible banking functions--ranging from specialized to universal--the permissible types of ownership structure for new banks, rules governing entry and exit of banks, the degree to which a central bank should retain autonomy over monetary policy and exercise supervisory functions, and the range of monetary policy instruments

---

1/ Separate specialized banks were established in China in 1979/80, but the transformation of the Peoples Bank of China (PBC) into a separate central bank did not occur until 1984 when new legislation delineating the functions of the PBC and specialized banks was enacted. At that time, all commercial activities, including the collection of household deposits, were transferred to a new bank. In addition, two universal banks were established in 1987.

and prudential regulations. 1/ Even prior to making these decisions, technical questions had to be answered on the number of new banks to be created, their size and regional distribution, the level and sources of capital for new banks, the distribution of weak loans among new banks, the redeployment of erstwhile state bank staff among new banks and their branches, the changes needed in the accounting and payments system arrangements, etc. In preparation for these decisions, most countries began maintaining separate accounts for commercial activities, note issue, and other central banking activities of the monobank for some years prior to the reforms. In Poland, a computer simulation was used, based on three variables (volume of transactions, volume of credits, and number of accounts) to decide on the number of banks and the number and location of branches of each bank, to be formed by regrouping the existing branches of the National Bank of Poland (NBP) into equal-sized banks. In Hungary, enterprises in similar industries were assigned to the same bank, and this led to markedly different credit-deposit ratios among banks, and some banks received a disproportionate share of doubtful loans. In China, the specialized banks were given a monopoly position with different groups of clients, which limited competition among the banks. In Czechoslovakia, two credit banks were created, one in each republic, while some of the long-term credits of the State Bank were shifted to the Investment Bank, which had only very limited credit activity prior to the reform.

The newly formed central banks assumed most of the traditional central banking functions, but certain differences among countries remained reflecting both historical factors and the authorities' preferences. The National Bank of Hungary (NBH) initially retained both commercial and official transactions in foreign exchange, while the National Bank of Poland (NBP) had only a limited role in such transactions, which were handled by a separate state-owned bank, Bank Handlowy. 2/ In China, one of the specialized banks (the Bank of China) has continued to play the dominant role in external debt management and foreign exchange transactions. The banking supervision functions were assumed by the central banks in Poland, Czechoslovakia, Yugoslavia and China, and by the Ministry of Finance in Hungary. The payments processing and settlement functions have been traditionally handled by the central banks in Poland, Czechoslovakia, and Hungary, but a separate institution has continued to perform this function

1/ Many of these decisions have implied a reduction in the traditional dominance of the budget and plan authorities. The emergence of a new central bank and its assumption of the macroeconomic regulating functions has usually meant a redistribution of power which has not always been easy.

2/ The NBH began to decentralize commercial foreign exchange transactions in late 1989. The NBP still maintains a sizeable volume of foreign exchange deposits of individuals, but it did not provide commercial payment and collection services related to foreign trade, as in Hungary.

in Yugoslavia. 1/ The central banks continue to act as government debt managers and fiscal agents in Hungary, China, and Yugoslavia, while the central bank is not involved so far in the management of domestic or external debt in Poland and Czechoslovakia. 2/

In recent years, significant efforts have been made to strengthen the autonomy of the central banks in Hungary, Yugoslavia, Czechoslovakia, and Poland; related legal issues have been debated in China. 3/ The National Bank of Yugoslavia was given significant additional powers to set monetary policy and exercise firm supervision of banks under the new legislation enacted in mid-1989. In Hungary, a new law, still under consideration, strives to strengthen the appointment procedures for the board of management of the NBH, set limits on central bank credit to Government, and make it directly accountable to the Parliament. In Poland, following the political changes in mid-1989, major legal reforms were implemented, inter alia, to limit central bank credit to the Government, reduce the scope of the credit plan, modify the statutory objectives of the NBP, and strengthen the NBP's powers in using indirect instruments of monetary control. In Czechoslovakia, the initial legislation that governed the creation of the two-tier banking system did not provide adequate autonomy to the central bank in setting interest rate policy; the devolution of powers between the center and the republics in various areas--particularly licensing, supervision and representation on the central bank Board--remained to be further developed; and powers of banking supervision and monetary management were inadequate. New legislation under consideration addresses these issues.

Modernization of various functions of the newly formed central banks and the assumption of new functions such as banking supervision and expanded role in foreign exchange operations, 4/ necessarily implied a need for reorganization of the various departments, with attendant shifts in staff

---

1/ This feature is being re-examined in Yugoslavia. In China, the clearing and settlement system is based on the exchange of payment orders through clearing houses organized at different geographic levels. The PBC monitors the clearing houses, but does not handle the paperwork itself.

2/ In Poland, a newly resuscitated state bank--the Bank for National Economy--which is chaired by the Minister of Finance, managed some initial issues of government domestic debt. The NBP is expected to take on a more active role in domestic debt management in due course. External debt in Poland is managed by a separate Foreign Debt Servicing Fund (FOZZ), with Bank Handlowy as executing agent for service payments abroad.

3/ The powers of the Peoples Bank of China (PBC) in regulating the specialized banks remain weak or ambiguous under the current banking legislation which covers both the Peoples Bank and other specialized banks. The PBC has drafted extensive revisions to the regulations with the aim of strengthening the role of the central bank.

4/ For example, in Poland and Czechoslovakia changes in exchange rate arrangements implied a greater role for the central bank in fostering and managing foreign exchange markets, and in managing international reserves.

deployment, administrative arrangements, and information flows. The development of a new organizational structure that will ensure adequate vertical and horizontal communication from an earlier structure that was highly hierarchical has been a challenge that is currently being addressed in all countries. Another key issue in legislative and organizational reforms related to the role of central bank branches, which has become a difficult issue in some countries (Czechoslovakia and China) owing to the attempts to exercise newly granted autonomy by local and republican governments.

As regards the activities of the recently established commercial banks, 1/ their ability to compete for deposits and loans of nonbank entities were somewhat circumscribed owing to the large concentration of the banking industry that emerged, the limited network of branches of many banks, and various regulatory impediments which are being removed only gradually. The large concentration in the banking industry structure reflected mainly the dominance of many specialized banks that existed prior to the reform (Poland, China, Czechoslovakia, and Hungary) and an insufficient number of banks that were formed following the reform (Hungary and Czechoslovakia). 2/ The restriction that an enterprise maintain only one basic account with a specified bank was also a factor limiting competition in the early stages of the reform in some countries. This restriction was eliminated in Poland in July 1989, and in Hungary in 1987.

While the system of specialized banks has continued based on traditions and management inertia, the regulatory environment has been freed to permit freedom in lending, undertake a wide range of investments and services, and to foster a new range of financial institutions. 3/ However, some of the regulated specializations were continued for a transitional period in Hungary. For example, the National Savings Bank, which specialized in household deposits and housing loans, was initially insulated from competition from newly established banks so as to ensure that the Savings Bank would have sufficient funds to continue making housing loans at low and fixed interest rates and to contain the interest subsidies for housing. The competition for household deposits was made open to all banks in 1989, following the transfer of low interest housing loans to a separate agency. 4/ In contrast, the State Savings Bank in Poland and the savings banks in Czechoslovakia had to face competition immediately from other newly established banks for household deposits. However, the ability of others to compete has been limited by the vast network of branches and the dominant

---

1/ Including old banks re-established under a new legal and regulatory framework.

2/ The share of the two largest banks in total assets of all commercial banks was 63 percent in Hungary, 76 percent in China and Poland, and 50 percent in Czechoslovakia.

3/ The specialized banks in China are not allowed to deal in securities, but can act as brokers.

4/ See Section IV for further details.

size of the savings banks. Also, the bank-specific ceilings on credit--which were used while new instruments were being developed--proved to be a disincentive to competition, both in Czechoslovakia and Poland.

In Yugoslavia, the domination of individual banks by enterprise groups, the regional concentration of banks in each associated group, and cartel arrangements until 1989, together limited competition for deposits and loans. Since early 1989, banks have been free to set interest rates, cartel arrangements have been eliminated, and the banking system is being restructured to promote better prudential safeguards and more effective competition. 1/

The newly established commercial banks in the CPEs were technically autonomous in their loan and management decisions and were expected to pursue profits--instead of other nonpecuniary social objectives. Nevertheless, there are many factors--in addition to the highly concentrated banking structure--that continue to hamper the autonomy and competitiveness of commercial banks: the large dependence of banks on central bank funds; the extensive reliance on interest subsidies from the budget or from preferential refinance; the large share of low interest loans, particularly for housing; problem loans to state enterprises; the dominance of large state enterprises in the loan and deposit portfolio; and finally, the state ownership of most banks. 2/ Of course, the relative importance of the above factors differs from country to country. Solutions to partially alleviate these problems are in various stages of formulation and implementation in many countries, as noted in Section IV. The banking industry structure is, however, undergoing rapid transformation in many countries, notably Poland. Reflecting the liberal licensing policies, the number of licensed commercial banks in Poland has increased from 17 in mid-1989 to over 60 in 1990 (including three foreign banks).

IV. Reforms of Monetary Management

The banking reform has been associated with major changes in the monetary policy framework and in the mix of instruments for monetary control. Significant efforts have been undertaken to strengthen the independence of central banks in formulating and implementing monetary policy in many CPEs, with attendant implications for the power of the budgetary and planning authorities. The detailed credit plan and the cash plan are being replaced

---

1/ The number of banks was reduced by half from about 190 in mid-1989 to about 93 in mid-1990, through a process of mergers and bank closures.

2/ Under state ownership, the longer-term goals of building a stronger capital base and strengthening the institutional life of banks may lack operational meaning, unless the state-owned bank is given significant autonomy and is held accountable for clearly specified commercial objectives. Such "corporatization" of state economic activities could be seen as desirable transition phase before full privatization.

by various intermediate and operating targets of monetary policy, supported by appropriate monetary programming techniques. Currently, the instrument mix consists primarily of central bank refinancing quotas, and bank-specific credit ceilings, supplemented as needed by reserve requirements, special deposits with the central bank, and issues of treasury or central bank securities. Also, interest rate policies have been accorded a greater role to influence financial savings and induce more efficient use of capital. In addition, policies have been implemented in Poland and Hungary to replace the system of automatic provision of central bank credit to government (often at zero interest) by a strengthened strategy for domestic debt management. However, the monetary control has been complicated by the uneven structure of the banking system, the growing role of foreign currency deposits in some CPEs, and the interest-inelastic loan demand. 1/ Moreover, the effectiveness of interest rate policy in inducing efficiency has been constrained in the initial stages by weak financial discipline of enterprises, and by major distortions in relative prices due to incomplete price reforms.

The design of monetary policy instruments has been influenced by the structure of the banking industry following institutional reforms in Czechoslovakia, Poland, and Hungary, a structure characterized by an uneven distribution of deposits and credits. This uneven distribution resulted in a large dependence on central bank refinance for many banks, 2/ particularly the new ones and for the system as a whole, large variations among banks in the share of refinance to total liabilities, and the co-existence of a limited number of large surplus banks. The large dependence of the newly created banks on central bank refinance reflected in the first instance the surplus of credits over deposits transferred from the monobank; however, this circumstance derives, in the final analysis, from the lack of well developed interbank markets, the role of the central bank in recycling surplus funds of some banks, and in some cases, simply the excessive creation of credits by the erstwhile monobank.

1/ Interest in elastic loan demand in CPEs in part reflects the continuation of "soft budget" constraint that condones financial indiscipline by firms that cannot go bankrupt. Also, in the absence of realistic exchange and interest rates, burgeoning foreign liabilities and foreign currency deposits of residents create large solvency risks for banks which are realized when a more appropriate exchange rate policy is adopted.

2/ In 1989, claims of the central bank on the deposit money banks formed 39 percent of total credit in Poland, 28 percent in China, and 24 percent in Hungary. For the newly created banks, the share is much higher in all countries. The share of central bank credit to banks was only 11 percent of total bank credit in Czechoslovakia, but this was because the gap between loans and deposits of the newly created banks was closed in part by arranging large interbank deposits from savings banks, with a matching reduction in savings banks' deposits at the central bank. Such interbank deposits constituted 28 percent of total credit of all banks.

These institutional features have implications for the design of monetary policy instruments. Given the structural and uneven dependence on refinance, the refinance policies--the interest rates on refinance, and the method of distributing aggregate refinance among the banks--had a far-reaching impact not only on the effectiveness of monetary control, but also on the structure of the banking industry, and on the evolution of the interbank and money markets. 1/ In Yugoslavia, Hungary and Poland, the refinance policies have emerged as the major instrument to influence market-determined deposit and lending rates and the growth in monetary aggregates. Indeed, incorrect settings of the refinance volume--often based on the projected gap between deposits and credits instead of appropriate reserve money programming--fueled inflationary pressures in the period following the banking reform in Hungary and Poland.

Also, the design of refinance policy, and in particular the procedures for the allocation of refinance among banks has posed difficult questions in part because of weaknesses in interbank markets and other structural factors, as explained below. 2/

In Hungary, the aggregate refinance quota was distributed to individual banks in two tranches (see below) as a multiple of capital, and this allocation did not match the initial gap between deposits and credits of individual banks following the reform. As a result, there were significant pressures to extend special liquidity credits from the central bank, which further weakened monetary control in the initial stages of the reform. The first tranche ("overdrafts") of the short-term refinance quota was accessible automatically at a basic refinance rate, while the size of the second tranche ("supplementary facility") was adjusted from time to time for monetary policy purposes and was available at higher rates. In addition, special "liquidity" loans were introduced in February 1988 to meet structural dependence on refinance. Subsequently, however, active long-term interbank markets and loan syndications emerged, and competition for deposits became intense at times as refinance limits were progressively reduced in 1988. Since early 1989, the second tranche of refinance has been eliminated and consideration is now being given to allocation based on auctions.

In Poland, where the dependence on refinance is much larger than in Hungary, an application of uniform criteria (such as capital or deposits) for allocating refinance quotas (or market-based allocation such as auc-

---

1/ The highly uneven distribution of deposits and credits also influenced the design and operations of reserve requirements and open market-type operations. In particular, it became difficult to adopt a uniform reserve requirement ratio, difficult to adjust the ratio flexibly, and difficult to develop competitive auction markets among banks alone.

2/ The discussion below refers to refinance facilities operated by the central bank for monetary policy purposes, and excludes the selective refinance facilities and facilities to on-lend funds borrowed abroad.

tions) proved difficult to implement because the needed redistribution of funds through the interbank market was regarded as too large for the nascent money market to handle. As a result, the authorities initially relied on bank-specific agreements to distribute refinance according to projected needs. Subsequently, refinance limits for individual banks were reduced on a case-by-case basis in response to the availability of bank reserves from external surpluses. In addition, a payment credit facility was introduced to deal with shortfalls in the clearing accounts of banks, and banks have been offered a bill rediscount facility to encourage a bill market, and a medium-term refinance facility to meet structural needs.

In Yugoslavia, the allocation was based on refinance proportions applied to specific categories of loans, and this served to support regional development, but did not provide adequate control over the total volume of refinance. A reform of this system was introduced in 1990 based on bank-specific refinance quotas (allocated based on historical use) within which applicable refinance proportions could be utilized. Further reforms of this system are under consideration.

In Czechoslovakia, the initial refinance credit--arising from the need to close the gap between deposits (both customer deposits and interbank deposits) and loans of newly created banks--was structured primarily as a long-term loan. However, reserve requirements were imposed at a high enough level to force commercial banks to borrow to meet the reserve requirements. It is planned to meet this borrowing requirement by a short-term refinance facility and a bill rediscount facility, and thereby exert control over interest rates.

While interest rates have been largely liberalized in Yugoslavia and Poland, different degrees of control remain in China, Czechoslovakia and Hungary. As is to be expected, the refinance rate became the key interest rate influencing or guiding the deposit and lending rates in Hungary, Poland, Czechoslovakia and Yugoslavia. As part of stabilization measures, real interest rates were increased substantially, and in some countries to positive real levels (Table 1). The scope for active management of interest rates, and the effectiveness of such management is constrained by both structural and policy factors. First, the level and structure of interest rates has been influenced by the high degree of concentration of the banking structure, by the large share of loans at low and fixed interest rates in most countries, and by the massive volume of nonperforming loans in Yugoslavia. Second, the allocative effects of interest rate policy are weakened by the lack of interest sensitivity of nonbanks (and hence banks' derived demand for refinance) in all countries reflecting financial indiscipline, incomplete price reforms, and slow progress in restructuring enterprises and establishing accountability for profits. Finally, flexible management of interest rates has proved difficult in the absence of market-based instruments of monetary control, which are being developed despite the complexities posed by the above structural constraints.

Table 1. Developments in Interest Rates

CZECHOSLOVAKIA

	1983	1984	1985	1986	1987	1988	1989	1990		
								I	II	III
Rate on central bank credit 1/	5.0	5.0	5.0	5.1	5.1	5.1	5.7	4.0	5.0	5.0
Time deposit rate 2/										
Households	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises	2.5	2.5	2.5	2.5	2.5	2.5	3.0	3.3	2.8	5.0
Memorandum items:										
Annual growth of M2	6.9	6.5	4.4	4.0	5.8	11.6	3.6	6.7 (-3.6)	6.5 (2.2)	3.2 3/ (-0.9)
Inflation	0.9	0.9	2.3	0.5	0.1	0.2	1.4	3.5	3.5	14.1

HUNGARY

	1983	1984	1985	1986	1987				1988				1989			
					I	II	III	IV	I	II	III	IV	I	II	III	IV
Rate on central bank credit 1/	...	...	10.5	9.5	9.5	11.5	11.5	11.5	11.0	11.0	11.0	13.0	14.0	14.0	14.0	14.0
Time deposit rate 2/ Households	3.0	4.0	4.0	4.0	5.5	5.5	5.5	8.5	8.5	8.5	14.0	14.0	14.0	14.0	14.0	14.0
Enterprises	8.0	8.0	9.0	9.0	8-9	8-9	8-9	11-12	14-16 (June 1, 1988)				16.5-19.5 (October 1, 1989)			
Memorandum items:																
Annual growth of M2	2.3	5.1	10.9	8.8	...	...	...	...	...	...	...	3.0	6.9 (3.0)	9.8 (2.3)	10.2 (1.1)	14.3 3/ (7.3)
Inflation	6.4	8.7	7.0	5.3	5.7	8.2	10.2	10.7	17.8	15.3	15.1	15.1	14.3	17.4	17.8	18.3

Note: The bold line in the table indicates the beginning of the reform.
1/ Nonpreferential short-term, end of period.
2/ One-year unless otherwise specified.
3/ Figures in parentheses are percentage growth from the previous quarter

Table 1 (Concluded). Developments in Interest Rates

POLAND

	1983	1984	1985	1986	1987	1988	1989				1990
							I	II	III	IV	I
Rate on central bank credit 1/	3.0	4.0	4.0	4.0	4.0	6.0	44.0	44.0	55.0	140.0	120.0 4/
Time deposit rate 2/											
Households	10.0	10.0	10.0	10.0	10.0	25.0	45.50	45.50	80-90	>140.0	>120.0
Enterprises	6.0	6.0	6.0	6.0	6.0	10.0	45.50	45.50	80-90	>140.0	>120.0
Memorandum items:											
Annual growth of M2	15.0	17.7	22.1	26.7	34.1	63.3	57.0	95.3	164.0	481.8	726.4
							(8.8)	(36.6)	(59.7)	(145.2)	(54.5)
Inflation	22.1	15.0	15.1	17.7	25.2	60.6	75.5 (21.3)	85.0 (28.4)	186.0 (67.3)	550.3 (150.9)	1,110.7 (124.6)

Note: The bold line in the table indicates the beginning of the reform.

1/ Nonpreferential short-term, end of period.

2/ One-year unless otherwise specified.

3/ Figures in parentheses are percentage growth from the previous quarter.

4/ The rate on central bank credit in percent per month was 36.0 for January, 20.0 for February and 10.0 for March.

Many of these constraints are being addressed as part of the on-going program of structural reforms. In particular, the authorities are either implementing or considering various methods to deal with the large volume of loans at low and fixed interest rates in major financial institutions. Similar but more complex problems arise with regard to the large volume of nonperforming loans in all countries, particularly Yugoslavia. 1/

While such problems were being resolved and indirect instruments were being strengthened, it became necessary to retain from time to time some direct controls on both interest rates and credits. For example, in Poland, moral suasion has been applied on the interest rate on current account deposits and on loans to prime customers of state-owned banks--and at times on credit growth--in order to ensure a rapid response to changes in refinance rates and to limit interest margins. Various structural reforms--such as in the clearing system--are under consideration in Czechoslovakia in order to support a more rapid adoption of indirect instruments.

In both Poland and Hungary, the large stock of housing loans of long maturity (30-40 years) at low and fixed nominal rates (1-6 percent) on the books of the savings banks has complicated monetary management and stabilization efforts. The increases in nominal interest rates on deposits for stabilization purposes resulted in either a large increase in budgetary outlays for interest subsidy, or a significant distortion of interest rates on deposits and general loans of the largest banks (with a dominant share in the deposit market) which have carried the low interest housing loan portfolio. A solution to this problem of "old" credits at fixed rates therefore became urgent. For this reason, on January 1, 1989, the Hungarian authorities formed a separate Housing Fund to which the "old" housing credit portfolio has been transferred, relieving the banking system of the burden of such credits and replacing such credits with government-guaranteed securities (issued by the Housing Fund) at negotiated rates. 2/

1/ In Yugoslavia a separate federal government agency has been created to take over and manage problem loans of banks, following detailed portfolio audits of banks.

2/ The deficit of the Housing Fund is to be covered by the budget. The issue of how to finance the losses of the Housing Fund remains to be resolved. Various tax-based solutions with the incidence of the tax targeted to fall primarily on the beneficiaries of housing loans, were under consideration. Simultaneously, all banks were freed to compete for household deposits, but ceilings on household deposit rates were imposed to contain the budgetary impact of interest subsidy on new housing loans. New housing loans carry market-related rates, but a part of the debt service is met through budgetary subsidies.

In Poland, new and substantially higher interest rates were applied to the "old" credits, 1/ but only a part of the interest payments was serviced by the end-users of credit. The remainder was partly met by budgetary subsidies to end-users, and partly by mandated capitalization of interest. For example, in the case of housing loans, 8 percent of interest cost was paid by the household, 32 percent by the Budget, and the remaining 60 percent was added to the principal. This approach served to freeze the sectoral distribution of bank credit, particularly when nominal interest rates were high.

The sharp growth in foreign currency deposits of households (and also enterprises in some countries) in the domestic banking system has posed special challenges to the implementation of monetary policy in Poland and Yugoslavia. A major problem has been the significant short-run shifts in the demand for domestic currency assets and in the national currency money multiplier owing to changes in exchange rate expectations and the consequent substitution between domestic and foreign currency deposits. Also, the sizeable foreign currency exposure of the banking system has led to large losses or reduced profits, and at the same time, currency depreciations have also resulted in large valuation losses, which have the potential to lead to massive monetary expansion. Various approaches to dealing with these problems have figured prominently in the debate on financial sector reforms. 2/ A lasting solution to these problems require financial policies that must ensure that local currency deposits yield more than foreign currency ones on a sustained basis. The approaches to dealing with the prudential aspects of the problem have included the replacement of accumulated foreign exchange losses by income-earning securities issued by the Government (e.g., Yugoslavia), a strengthening of prudential regulations pertaining to foreign exchange transactions, and the imposition of foreign exchange exposure limits.

V. Money and Securities Markets

While unregulated markets in inter-enterprise credits have been a source of disintermediation and prudential risks in most CPE's (and Yugoslavia), attempts to evolve a regulatory framework for short-term money markets have been quite recent. Indeed, until recently money and securities markets were discouraged in the CPEs owing to concerns that such markets would interfere with the credit plan. Some preliminary measures to stimulate money and interbank markets have been implemented in Poland, Hungary, and Yugoslavia. Treasury bills were introduced in Hungary in 1988, and in

---

1/ This required a change in the laws on credit relationships so as to modify the fixed-rate contracts on the "old" credits to preferential sectors.

2/ These problems are not unique to CPEs. Similar problems have been addressed in Ghana, Venezuela and Egypt as part of stabilization and structural reforms.

compliance with regulations based on periodic reports, and audit requirements in some CPEs. 1/ Comprehensive and regular on-site examinations have not been developed, and examination of asset quality and financial analysis of banks remain to be developed in most CPEs. In Hungary, the State Bank Supervision Department of the Ministry of Finance has built up a off-site monitoring system, based on a set of prudential regulations covering capital adequacy, liquidity, loans to large customers, and profitability. Based on additional supervisory powers granted by the new legislation, the National Bank of Yugoslavia has also set up regulations on risk exposure, capital adequacy, investment limits, liquidity, and licensing, and has begun to strengthen banking supervision within the National Bank. In Poland, banking supervision was assigned to a separate body within the National Bank--General Inspectorate of Banks--that reports directly to the President of the NBP. Its initial tasks included the development of a new Chart of Accounts for the commercial banks, establishment of new prudential regulations and reporting systems for banks, and the setting up of financial analysis procedures. Skills in on-site inspection are being developed concurrently. In Czechoslovakia, some prudential regulations have been issued, new chart of accounts for banks is under preparation, and a banking supervision department is being established and staffed. The role of the Peoples Bank of China in the prudential supervision of specialized banks has been fairly limited. The specialized banks have to provide the Peoples Bank of China with information, to set aside reserves for bad debts as determined by the Peoples Bank, and are required to be audited by them to ensure compliance with financial policy regulations.

The implementation of prudential supervision has been complicated by many structural factors, some purely technical. The difficult macroeconomic decisions on how to absorb the losses due to bad loans and foreign exchange exposure, and the inadequacies of loan recovery and bankruptcy laws all complicate prudential controls in many CPEs. The large share of nonperforming loans in total assets of Yugoslav banks has made it difficult to implement prudential rules until the banks and their customers are rehabilitated and recapitalized, as needed, and the concept of ownership has been clarified in the law. Other technical factors that have complicated the application of prudential norms include: the dominance of large loan or deposit customers in many countries, the limited scope for raising capital in most CPEs--other than through budgetary appropriations for state-owned banks--and the absence of reliable accounting standards and loan monitoring systems in commercial banks.

1/ The Peoples Bank of China is legally required to audit all financial institutions. In Yugoslavia, the Social Accounting Service audits and monitors liquidity of both financial and nonfinancial enterprises and reports to the central bank. There are no specific audit requirements in Poland and Czechoslovakia.

VII. Payments System Reforms

The clearing and settlement systems for payments in most CPEs are on a gross (item-by-item) basis, with no netting or sub-clearing arrangements. Even when sub-clearing takes place at regional or provincial levels, the systems as operated are in effect on a gross basis, reflecting the practice of checking the legality of each payment, and could be characterized as continuous settlement systems with no third party guarantees. The payment system is governed by detailed regulations on the use of cash, on the use of payment orders or settlement checks, and on the priorities in payments if an agent has insufficient funds to meet all payments issued by him. The settlement systems in Yugoslavia and Czechoslovakia are technologically sophisticated, involving paperless electronic transfers of payment instructions. Hungary has only recently introduced automation in processing payments. However, both China and Poland still rely on postal or telegraphic services to transmit payment lists. In all countries, except Yugoslavia, the banking reform itself has called for changes in settlement arrangements to reflect the new reserve maintenance rules established for the new banking system, to make further distinctions between inter- and intra-bank transactions, and to handle the increased volume of payment traffic due to greater mobility of funds.

The lack of clearing arrangements, the delays in transmitting information, and the preoccupation of the system with the legality of payments more than the speed of delivery of good funds all have created large uncertainties (float) in the amount of banks' clearing account balances, and have distorted monetary statistics, and prudential returns. The issues in designing new and more efficient clearing systems, e.g., with national and regional clearing houses, in managing settlement risks, and in upgrading technology to speed up payments and to meet new business requirements are being addressed in Poland, Czechoslovakia and China. The3Xdelineationof the precise role of the central bank in the new payments system, given the traditional dominance of the erstwhile monobank on all aspects of the system--clearing, accounting, and technology--has posed complex issues.

VIII. Concluding Remarks

The banking and monetary policy reforms in the CPEs have promoted greater interest rate flexibility and have assigned a more important role to financial policies in macro-stabilization efforts. The initial experiences with these reforms have been generally favorable in fostering greater competition in the banking system, and improving the efficiency of banking services. Nevertheless, significant impediments to competition still remain. Efforts to strengthen the autonomy of central banks in monetary policy formulation and implementation have also gained momentum in many CPEs. While much progress has been made to adapt the new monetary control instruments to the structure of the banking industry, considerable scope remains to develop market-oriented instruments of monetary policy based on active money markets and an efficient settlement system. The development of money and interbank markets and of an efficient settlement system should remain high on the agenda of financial sector reforms, owing to their impact on the effectiveness of monetary policies. The prudential supervision of banks is still in its infancy in most CPEs. The appropriate strategy to develop further this function, including the appropriate balance between supervisory controls and competitive freedom are issues still to be resolved. There is, however, an increasing recognition that key prudential accounting standards can contribute to an effective implementation of adjustment and structural reform policies by fostering sound lending practices and expediting enterprise restructuring.

Financial sector reforms in many CPEs are being implemented in a period of significant instability in the macroeconomic environment, weakness in balance of payments and major distortions in relative prices and investment allocation. The need to implement stabilization policies, financial sector reforms, and other structural reforms raises complex questions regarding the appropriate sequencing of financial sector reforms in coordination with macroeconomic adjustment, price, exchange rate, and enterprise reform policies.

The interactions among policy measures are close. On the one hand, it would seem that since the financial sector reforms are intended, among other things, to create conditions for more effective monetary control and more efficient credit allocation, they should be implemented expeditiously. On the other hand, the achievement of macroeconomic stability supported by parallel reforms in other sectors is essential for the effectiveness of financial sector reforms, particularly for the effectiveness of interest rate policies. For example, a restructuring of weak enterprises--initially at least the major loss makers--would be necessary to ensure that the demand for credit is sufficiently sensitive to interest rates and that interest rate policies prove effective in promoting stability and growth. However, an efficient restructuring of enterprises, based on decentralized decision making by banks and their customers, requires reasonable stability in the macro environment and a realistic structure of relative prices and interest rates. In the course of bringing about stability and relative price adjustments, the banking system gets exposed to much greater risks than would be the case in a more stable environment. Therefore, proper supervision of banks and continued strengthening of their financial condition are needed to preserve the soundness of banking operations and prevent crises.

In view of such close interaction between financial sector reforms, other structural reforms, and adjustment policies, the design of growth oriented stabilization programs should incorporate a package of structural components right at the outset. This package should include, among other things, a minimal program of enterprise restructuring, price (including the exchange rate) reform, and specific reforms in monetary management, money market development and banking supervision, all to be put in motion right at the beginning of the stabilization program. This would set the stage for effective stabilization and facilitate further structural reforms.

Following the initial implementation of such a package, more comprehensive restructuring of banks and enterprises, and further financial system reforms can proceed more effectively. The losses associated with past bad debts, undue risk, and exposure do exist and must be removed as impediments to improved macroeconomic policies. Ultimately, the costs will be born by the general population--the key issue is how to share the burden of the major losses. This issue is best addressed by concentrating weak assets and financial restructuring losses in a single sociopolitical entity where the magnitude of the problems is transparent and burden sharing is addressed as part of fiscal reforms and new political priorities. Such considerations apply to all countries facing macroeconomic instability and significant structural distortions. However, what distinguishes the case of most CPEs is the large onetime adjustments of relative prices, institutional arrangements, and consequential changes in economic values that are being pursued in order to correct the past misallocations sustained through long-term isolation from the international economy.