REFORMS OF THE BANKING SECTOR IN POLAND 1989-1995

BY

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A Thesis/Practicum submitted to the Faculty of Graduate Studies of The University of Manitoba in partial fulfillment of the requirements of the degree

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ABSTRACT

The Polish Socialist Central Planning System was abolished in 1989 to be replaced with a Capitalist Market System. In 1993 Poland embarked upon a comprehensive restructuring programme, which combined restructuring of formerly state owned banks with that of their most prominent clients, state owned enterprises. In terms of its objectives of transferring capital from inefficient uses to more efficient uses, the programme seems to have been quite successful. The standard according to which progress is measured are much to high, however. Furthrmore, the objectives of the programme did not take into consideration social complications such as increased unemployment resulting from restructuring of banks and enterprises.

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CHAPTER 1

INTRODUCTION

In the past seven years, Poland, along with all other countries of Central and Eastern Europe has been undergoing major economic changes. Since 1989, an official attempt has been made to replace the former socialist central planning system with a market based capitalist system. With the involvement of the IMF, the World Bank, and other international financial institutions, as well as the assistance of Western governments. Poland has embarked upon the process of economic transition. The IMF prescriptions for Poland's reform, attached to financial aid from that institution, are of the usual sort. They include the liberalization of prices and the removal of subsidies, the devaluation of the Polish zloty, a decrease in government expenditures, with the goal of decreasing the budget deficit, along with a tight monetary policy. The process is quite lengthy and involves not only the overthrowing of old principles of operation and adapting new market based instruments and signals, but also the incorporation of a wide range of institutional changes, as well as the creation of a new legal framework. The long term goal is to privatize all those economic institutions owned by the state, with the hope of creating a market based capitalist system.

Thus three areas of reform can be identified within the transformation process. The dismantling of controls, the adjustment of macroeconomic imbalances, and the

building of institutions. In the last area, we can again distinguish between reforms in the enterprise sector, the restructuring of fiscal institutions, and reforms in the financial sector. Great emphasis must be placed on reforming institutional structures if any of the other goals. in particular macroeconomic stability and a well functioning market, are to be achieved.

It is the purpose of this study to focus on reforms in the banking sector, which in a socialist economy comprises the financial sector, and in the economy in transition, the bulk of the financial sector. The objective is to see, what changes individual banks need to make and what reforms the system as a whole requires in order to be able to service a market based economy. Furthermore, the argument is made that one of the most crucial aspects of institutional changes in formerly centrally planned economies is the training and teaching of staff and management, as well as a gradual adaptation of new behaviours by economic agents. This can be a lengthy process and hence sufficient time must be allowed, before any inferences about its success can be made.

The banking system of a socialist economy, as described in chapter two, operated on the basis of a whole set of principles which did not correspond to market principles. The banking sector, a state owned monobank, was an extension of the central planning agency. Its principal function was to ensure that enough money and credit were provided to finance the central plan of physical production. Banks did not assess their clients in terms of risk or entrepreneurial promise, nor were they particularly concerned with their

own financial standing. They did not have a minimum required capital adequacy ratio, nor did they base their decisions on the profitability of any venture. Furthermore, economic agents in the economy regarded banks either as a source of guaranteed credit, a means of transferring of funds, or a place in which to deposit savings. Loans were not expected by, nor by and large were they extended to, the private sector. The rates of interest paid on deposits and charged on loans were set administratively and by no means reflected the opportunity cost of capital. Savings were, however, placed in banks as there was a huge shortage of physical goods available for purchase.

The banking system of the socialist economy could not service the needs of a capitalist market. Along with the entire economic system, the banking sector had to undergo major reforms in behaviour and guiding principles as well as institutional structures. Unreformed banks, as well as unreformed enterprises did not know how to respond to market signals such as the rate of interest. State owned banks continued lending to state owned enterprises on the basis of old principles. This resulted in large financial losses.

During the transformation process, which includes the privatization of the industrial and service sector as well as the banking sector, an environment must be created which allows small and medium sized private enterprises to prosper and to create employment opportunities. New job openings are important, since the reform of state owned enterprises in an attempt to eliminate inefficiencies inevitably produces

unemployment. The development of banks can facilitate the process of creating a favourable environment for private small and medium sized firms through the release of capital from inefficient uses in state owned enterprises. A further task for the banks is the redistribution of this capital among more efficient projects as brought forth by private firms. Banks must learn new behaviour and adapt new rules and regulations in order to be able to preform their functions efficiently.

Issues of the banking sector in transition are addressed in chapter three. Problems faced by commercial banks and the central bank, which adopted balance sheets from the previous system are described. As well, the poor situation of banks' clients - enterprises is explained. A catalogue of solutions to those problems is provided, from which Poland could choose whichever were considered most effective. Also issues of institutional framework reforms are brought to light along with proposals of how to create the appropriate framework. A financial sector of a centrally planned economy did not have a regulatory and supervisory framework sufficient to serve a market based banking system. Also legal structures supporting private property were not developed. The chapter further focuses on questions of central bank independence and monetary policy goals and instruments. The degree of central bank independence influences the central bank's ability to exercise policy independently from political considerations of the governments. Also the central bank's role in the regulation and supervision of the commercial banking sector is described.

Poland's actual experience with reforms in the banking sphere is summarized in chapter four. There again, reforms and changes have been geared toward the goal of privatization. The situation of banks at the onset of reform was quite poor and thus banks were not attractive for privatization. The objective of reform has been to create banking institutions which will attract new potential owners. After several years of disintegrated attempts at reform, which led to little improvement in the situations and operations of banks, Poland decided to embark upon a more comprehensive programme of joint enterprise and bank restructuring. Thus some issues of enterprise restructuring are touched upon in this chapter, which also describes the successful privatization of several state owned banks. Furthermore, issues of commercial bank supervision and regulation are explored, as well as the degree of central bank independence and the central bank's choice of monetary policy instruments.

The results of the enterprise and bank restructuring programme as of 1995 are described in chapter five. It is important to see, whether the objectives of the programme have been realized and if they have not yet been, what the prospects are for their realization. Remaining problems, to be focussed upon in future economic reform initiatives, will be pointed out.

It is, however, equally important to question the validity of the reform objectives themselves, as well as the criteria on which basis bank performance is evaluated. The enterprise and bank restructuring programme resulted in many job losses, and even if

unintended, this effect was certainly not a desirable one. The discontent of the public was expressed through the desperate re-election of a communist government, which many worked so hard to overthrow. Chapter five will attempt to explore, whether a milder approach could have prevented social dissatisfaction.

Chapter six will provide a brief summary as well as some concluding remarks.

CHAPTER 2

THE BANKING SECTOR IN SOCIALIST POLAND

Presently, People's Poland is undergoing a fundamental economic transformation. The goal is to move away from a socialist centrally planned economy and towards a capitalist market economy. One of the sectors of the Polish economy which requires major structural and functional changes is the banking sector.

The purpose of this chapter is to provide the reader with an understanding of the ideological framework and the structure of the formerly socialist banking system in Poland. It is crucial to provide a detailed account of the former banking system in order to be able to identify which areas of the banking sphere are being targeted by policy, how they are changing and why some areas are more problematic than others. A description of the past will provide some insights into the present situation.

1. Banking in Socialism

Ideally, a communist economy, towards which all socialist economies were striving, would operate without the use of money. As envisioned by Marx, in a moneyless society, each individual would put into society and take from society equal shares of

goods and services, without anyone having more than others.

Lenin recognized, that the banking system was the foundation of a capitalist economy, and thus a sector that had to be changed first. He did not dispose of the idea of money, since that seemed too hard to implement in practice. Instead. he believed, that the socialist banking system would act as a skeleton of the socialist economy, and be used in the realization of national plans as the distributor of information and the enforcer.

The centrally planned economy of Poland was created after the image of the Soviet Union. where Lenin's ideas served as guidelines. In this economy all production and distribution was to take place only as specified by the central plan designed by the planning authorities. The financial situation of the economy did not influence real quantities of output. Money had no autonomous purchasing power. it was merely an accounting unit. a numeraire. It did not influence real processes in the economy, since these were planned; money only accommodated and made possible the fulfilment of national plans.

It must be kept in mind, that not all socialist systems and their banking systems operated along the same regulations and functions of the banking system differed slightly between countries. It is safe to say, however, that the principles governing the economies and their banking systems were quite similar. In this chapter, these principles will be outlined. It will also be seen that principles and their applications did not always fall in

line.

Crudely, the difference between a socialist system and a capitalist system, is the destination of surplus value created in the production process. The value of a commodity is the sum of the cost of its production and the surplus value. The capitalist society allows private individuals to hold and dispose of the surplus value. In a socialist system, any surplus value is to be passed on to the hands of the state, and expended on specific services such as health care, education and national defence. Although over time, increasingly more control over surplus value was given to enterprises, to some degree its uses have always been supervised directly by the state and indirectly through state owned enterprises. The role of a banking system in a socialist society is to represent the state's interest to the enterprise sector, and to monitor and direct the uses of surplus value created in the production process. [Zwass, 1979] The enterprise sector was of course state owned, and thus also representative of the state's interests. But managers of enterprises could deviate from the plan if left unsupervised. The main purpose of the banking system was therefore to keep in check the actions of the management and the staff of enterprises. To a smaller degree, the bank sector also exercised control over the private sector.

In a planned economy, the primary objective was to fulfil the national plan, and the banking system served as a means to facilitate this process. Thus any action, or policy exercised by any part of the banking sector was always geared toward the realization of the plan objectives. In other words, it must be kept in mind, that the rules that govern the

behaviour of capitalist banks differ greatly from those that governed the socialist banks, in that they were always secondary in the latter system. Recovery of credit, the most profitable allocation of credit, recovery of costs, were all objectives, which were at times followed by the polish banks, but have always been subordinate to the real goals of the economic plan.

It is clear then, that we cannot think of the former state bank or any of the former specialty banks as a separate entity acting in pursuit of its own interest, but rather as another part of the whole network of organizations pursuing the interests of the entire nation (or at least those of the planning authorities). This is very crucial to understanding why banks acted the way they did, even if their actions created many situations that in the present time of transition pose problems to the polish economy.

2. Structure of the Polish Banking System

One of the first steps in the transformation of Poland's economy from a market economy into a centrally planned economy was the nationalization of the banking sector. All commercial banks were amalgamated with the central bank to form one entity. This step was taken first by the Soviet Union and later by all other countries pursuing the goal of socialism. Over the course of history the nationalized banking sectors of the Soviet Union and all socialist countries of Eastern Europe developed similar characteristics.

Poland's banking sector, as that of most other socialist countries, consisted of what has been termed a monobank. The core of the system was the National Bank of Poland, a socialist central bank. Aside from the NBP, several other types of banks existed. An Investment Bank, an Agricultural Bank, a Foreign Trade Bank, and a Savings Bank, all described in the paragraphs following.

The Polish banking sector underwent two periods of reform, the first around 1954 and the second around 1973. The changes implemented were centred around the idea of lessening the degree of centralization of the decision making process.

3. Types of Banks in Socialist Poland

3.1. The National Bank of Poland or State Bank

Originally, the head of the state bank was the Deputy Minister of Finance. The relationship between the NBP and the Ministry of Finance was somewhat loosened in the course of development, but remained close knit nonetheless. Around the second decade after the war, the State Bank became responsible to the Council of Ministers. The head of the State Bank was appointed by the supreme political authority, and often had no previous banking experience. Working with the head was a managing board of directors, and a council representing a cross section of economic administrators. [Garvy, 1966]

The National Bank of Poland consisted of one large head quarters in Warsaw, and numerous smaller branches scattered across the entire country. Local offices had the duty to supervise each enterprise individually, and report to regional offices, which would report to headquarters.

Within the Bank, five departments could be identified: a policy department, a credit department, an operating department, a control department and a staff department.

The National Bank of Poland was a central bank in the sense that it was the only institution credited with the ability to issue bank notes and release them into circulation. Aside from being the bank of issue, the NBP acted as a centre for settlements and clearing of payments between enterprises, as well as the accumulation and redistribution in the form of credit of the economy's money stock. It was thus able to exercise financial control over the activities of socialist economic institutions. One of its main tasks was to ensure that enterprises kept their expenditures within the limit of the plan and that they met their financial obligations to the bank.

Not only did the state bank exercise control over enterprise behaviour, its books served as a tight monitoring device. The bank's books kept track of all production and distribution in the economy, as measured by one common denomination, namely money. Thus any unforeseen changes in the levels of production or distribution were instantly and in great detail reflected in the bank's books. This allowed the authorities to supervise the performance of individual enterprises and check whether the whole of the economy was

moving in line with the plan. In this sense, the NBP was a key part in the administrative apparatus of the economy. [Garvy, 1966]

The National Bank of Poland was a bank to the government as well as the enterprise sector. Although the line between state owned enterprises and the government is quite fine, the separate function of budgetary accounting can be identified within the state bank.

Originally, all banks other than the state bank were to perform only technical tasks and act as transmitters of information between the state bank and the rest of the economy. [Garvy, 1966] They were regarded as generally economically passive institutions. In the late 1060's some discussion emerged about making individual banks more active and increasing their ability to influence the economic process. [Huszti, 1981]. Some changes were introduced hand in hand with changes in the degree of autonomy of enterprises.

3.2. The Investment Bank

The Investment Bank acted as an administrative organization for the disbursement of budget funds, which were granted on a non-return basis. Budget transfers to enterprises were restricted to financing large long term investment and were originally the only source of finance for long term investment. The funds granted to enterprises can simply be thought of as budget subsidies to be used for specific purposes laid out in the national

plan.

The Investment Bank was obligated to keep accounts with the National Bank of Poland. In later years, around the early seventies, the Investment Bank became obsolete. The sharp separation of short term and long term credit was relaxed and banks were allowed to extend credit for the purposes of long term investment. Thus there was no longer a need for a separate institution dealing specifically with long term investment funds, and the Investment Bank was amalgamated with the State Bank. [Garvy, 1966]

3.3. The Agricultural Bank

The Agricultural Bank was designed to serve the needs of the agricultural sector. In Poland, roughly 10% of the agricultural sector was nationalized, a small percentage when compared to other socialist economies. The Agricultural Bank financed projects of cooperative farms, and also extended credit to private farmers, where warranted by the national plan. [Garvy, 1966] Also the Agricultural Bank was responsible to and obligated to keep account with the NBP.

3.4. Foreign Trade Bank

The Foreign Trade Bank was an institution designed to oversee all of foreign trade, and foreign exchange needs. It acted as a correspondent to foreign banks of

socialist countries and some capitalist countries. Its main task was to administer bilateral trade payments and to maintain foreign exchange reserves for tourists and for diplomats. [Garvy, 1966] Foreign trade and exchange arrangements in the former Soviet Union and the Eastern Bloc deserve a separate discussion, as they were quite interesting, but such discussion is not within the scope of this chapter.

3.5. Savings Bank

The Savings Bank was the banking institution available to the population at large [Garvy, 1966]. Private individuals deposited their savings with the savings bank, and on rare occasions were granted loans. The savings of individuals were often involuntary, forced by shortages in the supply of goods and services. The limitations in the supply of output were a form of controlling private sector expenditures. The only alternative to placing excess cash in the savings bank was the hoarding of money. The rate of interest paid on savings deposits, often of minimal value, was designed to discourage the hoarding of money by individuals, since savings deposits are much easier to control.

4. The Circulation of Money

In the centrally planned economy of Poland, money was circulated through two circuits, a cash circuit, and a non-cash circuit. Most of the operations of the private sector, as well as the payment of wages and salaries to private individuals by enterprises flowed

through the cash or currency circuit (private money). The non-cash circuit was used for payments between the government and enterprises, and payments between state owned enterprises (enterprise money). All non-cash operations had to go through the state bank, which resulted in excessive amounts of paper work. Each transaction was recorded in the books of the buyer and the supplier, and each transaction was entered separately in a bilateral system. This payment system was not very speedy nor efficient.

4.1. The theory of money

According to Garvy, money in a socialist economy "represents a classic case of fiat money." The value of money, which was said to be backed by gold, was administratively determined. The actual amount of gold held in reserve to back money was never publicised. Money was also not exchangeable for other currencies, especially not those of capitalist countries. To purchase currencies of other socialist countries, a number of exchange rates were set. These would vary with the purpose of purchasing foreign currency and with the origin of that currency. In other words, exchange rates were by no means prices of currency as determined by a foreign exchange market.

Money in a centrally planned economy did not fit into traditional monetary theory. Functions and use of money were greatly constricted, as a result of the early attempts to abolish money from the economy. [Zwass, 1979]

The three functions of money in conventional monetary theory are to serve as a means of payment, a unit of account, and a store of value. In a planned economy, as well as in a market economy, money did serve as a unit of account. Although often production and distribution plans were set in physical quantities, money served as a numeraire in the monitoring of implementation of plans. This was especially the case when it was banks who monitored and controlled the execution of production and distribution plans. According to Garvy, money in a socialist economy had two function: to serve as a means of payment, and to be used as a tool of administrative control. [Garvy, 1966]

Money was used as a means of payment in the purchasing of labour from individuals, and in the purchasing of consumer goods by individuals. Currency was one type of payment, which was used in the cash circuit. In the non cash circuit of the economy, payments between enterprises and the government and payments among enterprises were made by means of book entries and deductions.

Money cannot be said to have served as a store of value in the same sense as it does in a market economy. In a planned economy, money did not give its holder anonymous purchasing power. Money did not allow its holder to buy everything, since supply was restricted by economic plans, nor did it allow holders to acquire means of production, since these were generally owned by the state. Thus money in a planned economy did not embody the same kind of value as it does in a market economy. The value of money in a planned economy was very much tied to the real quantities specified

by the economic plan. In a sense then one could argue that goods served as a store of value, particularly given the low rates of inflation prior to the 1980's. The functions of money in the case of Hungary may have been slightly different, as availability of goods was higher and property rights were not typical for the Centrally Planned economies of Eastern Europe and the Soviet Union.

Zwass believes, that money, although originally thought to be unnecessary in a planned economy, did serve important functions. Money, since it was used for wage payments, may have been an incentive for workers to increase labour productivity, and an incentive for enterprises to increase efficiency. [Zwass, 1979]. But money could only have been an incentive to the degree that it had some autonomous value. If increases in money wages or money profits did not allow its holder to purchase anything, then the mere holding of money would have created little incentive. The degree of autonomy of money had increased through the years, with consecutive reforms, and money had increasingly more purchasing power. Thus, over time, monetary remuneration could have been used as an incentive, as Zwass suggests, to stimulate efficiency and labour productivity.

4.2. Monetary Policy in a Socialist Economy

On the aggregate money did not have the ability to influence socialist economic activity. Monetary policies were never used to stimulate or to contract the economy, they

were used only within the framework of production and distribution as specified by the planning authorities. The quantity of money released into circulation, as well as the quantity of credit extended in any given year were specified in the national plan. Thus the National Bank of Poland did not engage in active monetary policy geared to the stimulation or contraction of the economy, as do Central Banks in capitalist economies. The size and the rate of growth of the economy was determined by the national plan, the monetary and credit plans only accommodated physical plans. The only active role of the state bank was to ensure that the necessary amount of money and credit be available for the execution of the national plan.

The amount of total supply of money in the economy, as opposed to the amount of currency in circulation was not a policy objective in the socialist system. Changes in the total money supply were never used to influence the real economy, since the size of the economy was to be determined by the plan. Data on the money supply were never published, since there was no analytical significance attached to that economic variable. In a socialist economy, it did not serve as an economic indicator.

The total money supply in a centrally planned economy could be divided into private money, circulated through the cash circuit, and enterprise money, circulated through the non-cash circuit. The two forms of money had to be managed separately and differently, since they differed in their functioning.

Private money could be spent freely, as each zloty was not tied to a specific purchase. Thus real demand could not be controlled through the allocation of money in the private sector. In order to control demand, production had to be restricted to those goods and services which the national plan designated for consumption. Thus the supply of private money could potentially create inflationary pressures, but these were instead transformed into shortages of goods and services and never termed "inflation". Queuing or rationing was the preferred approach and hence, with fixed prices, inflation remained repressed.

Enterprise money was always tied to a specific purpose. For the most part it originated from bank credit or budget grants, the difference between which is only in name and destination, since all banks were state owned. Any zloty that was used in the non-cash circuit of enterprise money was supposed to be accounted for in the national plan. Thus the management of the supply of enterprise money was a lot simpler than that of private money, since the bank could directly influence the amount of money each enterprise used. Inflationary pressures were of much smaller concern in this circuit.

However, in practice, as will be seen , the extension of credit occurred more or less automatically, and a considerable part of it was not planned, but occurred due to inevitable discrepancies between plan and practice. Planned production often created a mismatch between supply and demand in the real economy, and resulted in large piles of inventories and at the same time shortages. Banks were obligated to finance this kind of

activity. In that sense, the control over enterprise money was not quite perfect either.

4.3. Credit in a Socialist Economy

Credit in the centrally planned economy was to be granted only by the bank sector. There was not supposed to be any credit extended between individual enterprises, nor was it to be granted by the vendor to the buyer. In a sense the state held a monopoly on credit allocation, which of course was meant to allow total control over the amount and destination of credit in the economy.

All credit was to be extended following the five principles of socialist credit, that emerged in the early 1930's in the Soviet Union, and were adopted by all other socialist countries. They required that credit be planned, specific, secured, repayable and fixed in maturity. Following these principles was supposed to render credit non-inflationary.

Credit had to be specified by the Central Bank's credit plan, which would allow the allocation of credit to be kept in line with planned material values. No credit could ever be granted if the purpose of the production was contrary to the plans of the national economy. Credit could only be extended to promote the realization of such economic objectives that were in accordance with the national economic plan. [Mezerics, 1968] All

credit was thus to be tied to specific working assets and was not to be granted any anonymous purchasing power. The upper limit of aggregate credit was set by the Cental Bank. If credit was not secured with a working asset, it was to be repaid immediately, even if the maturity date agreed upon at the time of the credit contract had not been reached. Generally, credit could be extended only for purposes that would allow for the repayment of credit in the future. The repayment period allowed, or the maturity date, was to be set no further than a year from the day credit was granted. [Zwass, 1979]. These principles aimed at providing a basis for using administrative controls, but they did not in any way allow the use of credit policy as a means of controlling aggregate demand in the economy, as is often done in capitalist economies. The need for aggregate demand management did not exist, since the level of output was by no means demand determined, but rather planned by political authorities. Excess demand would not be translated into inflation, since prices were administratively set, but would rather find expression in persistent shortages of supply. [Garvy, 1966]

Although the five principles of credit were officially to be followed at all times, in order to facilitate control, throughout the three decades of socialism in Poland it became increasingly clear, that in practice, the principles were not kept. Even the hardest lending terms could not prevent discrepancies between planning and plan fulfilment. Almost every year unplanned credit had to be extended to accommodate enterprise working capital needs, and soon provisions for unplanned credit were made part of the national plan. [Garvy, 1966]

The purpose of credit in a planned economy was to be able to exercise control over financial resources in the economy, such that distribution within the economy was in line with the plan. The banking system pooled together all funds of the national economy and unspent incomes, and redistributed them to economic organizations and individuals in the form of credit. Because bank credit was always temporary, and always to be repaid, it did not alter the proportions in the distribution of national income, nor the actual distribution of funds.

Originally, bank credit was to be used only to supplement enterprises' own fund used for non investment purposes. It was to finance seasonal pileups of inventory, and to assist enterprises with temporary short term needs.

The alternative to bank credit and enterprise internal capital were subsidies extended by the budget. Although at times termed long term credit, funds granted by the government did not have to be repaid. They were extended for purposes of long term investment as planned by the national planning authorities.

Because of the practical difficulties of sticking to the five principles, much more liberal concepts of credit began to emerge. In a 1954 reform, authorities agreed to loosen lending terms for prospering enterprises, yet to exercise extremely stiff lending terms over enterprises with poor performance, or operating at a loss. In the same reform period, enterprises' position in the economy changed from being a mere executor of the national

economic plan. to becoming a self financing entity, with a much smaller reliance on budget subsidies.

In 1973 it was decided that even those enterprises operating at a loss should face loose credit terms. At the same time, enterprises, or large economic organisations (wielkie organizacje gospodarcze) were declared to be the pillars of the economic system and economic management. The underlying idea was that by allowing capital investment projects to be financed out of enterprises' own funds, the implementation of decisions made at the macroeconomic level would speed up considerably. [Zwass, 1979]

With time it became increasingly harder to keep the sharp distinction between working capital or seasonal needs of enterprises and longer term investment needs. The clear line between production and investment activities became hazy. Also, enterprises were given a higher degree of control over their own funds, and the requirement that all surplus value be passed on to the budget and from there redistributed was relaxed. A certain portion of enterprises profits could be disposed of by the enterprise itself. Profits were still to be used within the limitations of the national plan, but compliance with this rule was of course much harder to enforce. Often enterprises in Poland used their own capital for purposes not approved by the national plan, and obtained bank credit for those approved. [Zwass, 1979]

The gradual replacement of budget subsidies with enterprises own funds and bank

credit to finance investment rendered the Investment Bank obsolete. Its function, to allocate state funds for investment purposes among enterprises, was no longer required. This led to the fusion of the Investment Bank with the National Bank of Poland in the early 1970's. [Zwass, 1979]

Although credit terms were specified, more strictly in the earlier years, the actual extension of credit by socialist banks to enterprises was more less automatic. When granting credit, considerations such as profitability of the enterprise, the risk involved in the project to be financed, or the credit history of the enterprise were never of paramount importance. The enterprise, which produced socially desirable output and strived toward meeting national goals, was granted credit without regard to its financial situation. In effect, many enterprises operating at a loss were continued to be extended credit, which would allow them to continue operations as well as service their debts. The amount of credit outstanding could therefore no longer be controlled, and increasingly more enterprises started to operate at a loss, knowing that they would not face a great penalty. The banks attempted to use the rate of interest as a disciplinary measure and charged higher interest rates on overdue loans. But the effectiveness of this measure was very low, since there was no real threat to the enterprises of losing access to credit. The automatic extension of credit in the socialist economy created one of the greater problems with which the Polish economy is faced today. The next chapter will deal with the problem of enterprises operating at a loss and banks repeatedly rolling over their debts in more detail. For now it suffices to emphasize the difference in the rules of granting credit between

socialist banks. where the primary criterion is the compliance with the national plan, and capitalist banks. which are interested only in their clients own financial situation.

5. Interest Rates

In the early stages of the development of socialist banking in Poland, the rate of interest was thought of as merely a means to recover costs of banking services. It has been kept at a very low level, 1-2 % annually and 3% for overdue credit. The rate of interest could not be considered to be the price of credit or the price of money in the market sense, because money or capital markets did not exist. If we think of it as the administered price of credit, it must be kept in mind, that clearly it could not act as a market clearing signal and would not equilibrate demand for and supply of credit. The rate of interest was never reflective of the availability of credit.

With changes in the structure of the banking system, the importance of manipulation of the rate of interest became increasingly more important. Banks came to rely on the rate of interest as an instrument of credit policy, which would allow them to influence enterprise behaviour.

As Zwass says: *" In a planned economy interest is no more than an accounting parameter of banks. It has become respectable not, however, as the market price of money, but as an instrument of banks for influencing their relations with enterprises." [Zwass, 1979]*

Interest rates were to create an incentive to comply with the national plan. They were meant to ensure the safe utilization of national funds temporarily placed at the enterprises disposal. Interest was also used to cover the overhead expenses of the bank. The interest rate could only work as an incentive, however, if it was great enough to influence net income of the enterprises, and if the managers of the enterprise were personally motivated to meet the target level of net income. [Mezerics, 1968]

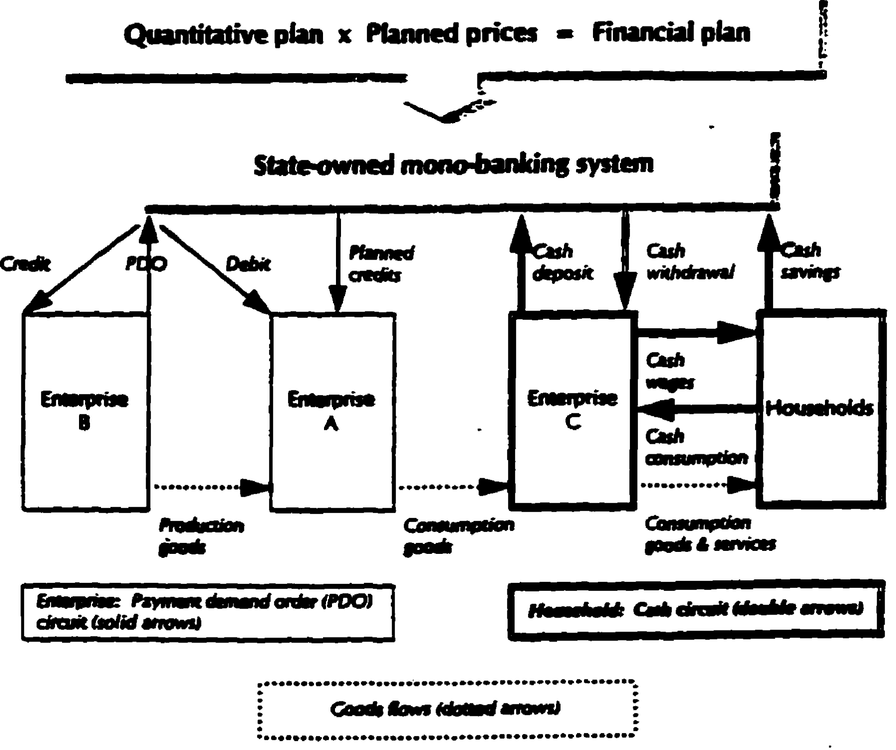
6. Was the monobank system the best choice for a Centrally Planned Economy?

The structure of the banking system in Poland was subject to debate over the years. Many times did policy makers propose to implement changes. The proposal to change the system from a monobank system to a two tier system with an orthodox central bank and separate commercial banks was debated continuously. On the basis of theoretical considerations as well as other countries' practical experiences, the authorities came to the conclusion that the monobank system was best suited for a centrally planned economy. Although steps were taken toward a decentralization of decision making, and enterprises were given a somewhat higher degree of autonomy in that respect, the basic framework of a one level banking system remained in place until the mid 1980's. A monobank system in a socialist economy ensured a smooth functioning of the economy, and facilitated the implementation of the macroeconomic plan. Since only one bank was utilized, the distribution of funds required for the fulfilment of the national plan was uniform. The one tier system also allowed for greater control over the production process

and the allocation of funds, although it was not the optimally effective means of control, either. The monobank system was justified in vast amounts of literature as being the best suited for a centrally planned economy, but its effectiveness in terms of ensuring compliance with the plan could have been improved. [Huszti, 1981]

Appendix 1

The following diagram illustrates the separation of as well as the connection between the cash and the non-cash circuits.



Enterprises use these credits to purchase physical capital for investment, to purchase intermediate goods from other enterprises to be used in the production process, and to purchase labour.

When enterprises make wage payments to labour, they withdraw cash and the cash circuit is initiated. The cash circuit is used by the household sector to purchase goods and services from the enterprise sector. The cash circuit can only be monitored through controlling flow of goods and services. [Sato, Humphrey, 1995]

CHAPTER 3

FINANCIAL REFORM IN THE TRANSITION; THEORY, PRINCIPLES AND PROBLEMS

A. Banks and Enterprises

1. The McKinnon-Shaw Framework

1.1. Financial Repression

Governments intervene in the financial system when market imperfections, such as bank monopolies appear. The purpose is to prohibit nominal rates of interest from becoming too high. Low nominal interest rates are believed to encourage investment, and redistribute income. [World Bank Development Report 1989] Fry terms the existence of interest ceilings and credit rationing imposed by governments on private financial claims "financial restriction". The coexistence of financial restriction and accelerating inflation produces financial repression. [Fry, 1995] Financial repression usually takes the form of interest rate controls, credit rationing and exchange rate controls. Under socialism, the banking sector was entirely owned by the government. Interest rates were set arbitrarily, and credit was distributed in accordance with the national plan. After the abolition of the socialist system, a large part of the banking sector in economies in transition is government owned, at least until it can be

privatized, which takes time and resources. Old habits cannot be broken overnight, and credit is often extended to priority sectors of the economy at interest rates that deviate from competitive market equilibrium levels.

Low nominal interest rates will have the desired stimulating effect on investment only when certain requirements are met. Firstly, the supply of loanable funds must not be limited, so that an increased demand for loanable funds at the low nominal interest rates can be accommodated. Secondly, rates of inflation must be low and under control. If inflation rates are high, and interest rates are kept low and not allowed to adjust, real interest rates turn negative. [Gillis, Perkins 1996]. Even if positive, real rates of interest set below the opportunity cost of capital discourage the public from saving in the form of domestic financial assets. In transitional economies, rates of inflation are neither low nor stable, since prices are undergoing an adjustment process to the new market environment. Real rates of interest often become negative and the supply of loanable funds is limited, since the public refrains from saving in the form of financial assets. Indeed, savers often look for better opportunities abroad, inducing capital flight. This is only true to the extent that savings are mobilized by way of the interest rate paid on deposits. It must be noted that in formerly planned economies, savings were mobilized by force through the elimination of all other alternatives. Goods were in shortage and no financial assets other than bank savings accounts existed. Investment abroad was not allowed. Only in the beginning of the transformation process did people start withdrawing their savings from banks in order to invest

elsewhere or because they lacked confidence in the banking system. At this point rates of interest became important as an incentive to save.

On the other hand, to the extent that investment depends on rates of interest also during the transformation, the demand for loanable funds increases when real rates are low. This reinforces the shortage of capital. Not all investors, who would have been able to obtain credit for their investment if the market was free, are able to when the market is repressed. Though some are able to finance their investment internally and some may obtain credit from informal financial markets, many marginal investment projects will simply not be undertaken. Thus investment falls, particularly marginal, high risk, high yield long term investment, which is often sorely needed in the economy. Official credit has to be rationed, and selection is often made on criteria other than optimal efficiency of investment. Credit is often extended to priority sectors of the economy, whose growth the government deems socially desirable. Administrative rationing of credit also creates the opportunity for fraud and favouritism. It is believed that administrative rationing of credit does not lead to as high a degree of efficiency in investment as would market allocation of credit. This implies that rates of growth in output of a financially repressed economy could be higher than they often are. [Meier, 1995]

It is "the combination of rigid ceilings on nominal interest rates and inflation that impedes financial development and ultimately retards income growth". [Gillis,

Perkins 1996]

1.2. Financial Strategies

Since financial repression retards economic growth, McKinnon and Shaw suggest removing factors which are financially repressing the economy. The solution is financial liberalization, where the government steps back and allows market forces to set interest rates at a competitive market clearing level. Financial Liberalization is part of what is often referred to as financial deepening, and its objectives are to:

- mobilize a larger volume of financial savings in the economy (increasing savings to GDP ratio) ,
- enhance the accessibility of savings to all types of investors,
- secure a more efficient allocation of investment throughout the economy,
- permit the financial process to mobilize and allocate savings efficiently, without relying on fiscal policy, inflation or foreign aid. [Gillis, Perkins 1996]

In other words, financial liberalization is said to result in an improvement in the performance of all basic functions of the banking sector in an economy.
Once interest rate ceilings are removed, the rate of interest should rise to its market equilibrium level. Savings in financial form will increase, as they are positively related to the rate of interest, thereby increasing the supply of loanable funds. All investors wanting to borrow money at the market rate of interest will be extended credit, and will

be willing to invest. Overall investment levels will rise and, as a result, the rate of growth of output will increase. [McKinnon 1973, Shaw 1973] This, at least, is the theory put forward by the advocates of financial liberalization.

1.3. Weaknesses of and amendments to financial liberalization

When in 1973 McKinnon and Shaw introduced the theory of financial repression to development economics, and suggested financial liberalization to policy makers, many followed that advice. Policy makers of the IMF and the World Bank quickly adopted the idea of financial liberalization in their policy design. Many countries, primarily in Latin America and Southern Asia, decided to liberalize their banking sectors. The results of financial liberalization policies have been mixed. Southern Asian countries have benefited in many respects, in that their banking sectors often increased in size and efficiency. [Fry, 1995] The experience with financial liberalization of Latin American countries on the other hand has been quite disappointing. As nominal interest rates were allowed to rise, rates of inflation suddenly decreased, leading to extremely high real rates of interest. The latter are just as undesirable as negative real interest rates, since they cause distress among borrowers. Domestic financial sectors faced a large number of bankruptcies. The government had to intervene and many private institutions were nationalized. The expected increase in domestic savings did not occur. On the contrary, savings generally declined, even though interest rates rose to very high levels. Nonetheless foreign

savings did rise, contributing to the debt crisis of the 1980's. Those Latin American countries that underwent financial liberalization did not see the desired increases in capital accumulation and output. [Diaz-Alejandro 1985]

The experimentation with financial liberalization in developing countries showed that the policy cannot be prescribed as an across the board solution. General economic conditions, as well as the sequencing of reform seemed to have made a great difference in the performance of the banking sector after financial liberalization.

Poor actual results led to amendments to the theory by McKinnon himself, as well as to theoretical critique from others. McKinnon explained that financial liberalization, as had been implemented in Latin America, was too abrupt. He revised the theory to say firstly that the financial system cannot be viewed as a separate entity, but rather as integrated into the whole economy. Since financial markets by their unique nature adjust much quicker than do goods or labour markets, the former's liberalization must be paced in accordance to the speed of adjustment of the latter two. Secondly, since any policy can work only in the appropriate environment, financial liberalization can be successful only if seen as a credible and consistent policy. Actors in the economy cannot suspect a change or reversal thereof, or else they will fail to respond to the new market signals as they should according to neoclassical theory.

Thus the comments brought forth by McKinnon, a representative of the

neoclassical school of thought, addressed factors that may have been a hindrance to the success of financial liberalization policy. No question was raised as to the appropriateness of the goal of the policy, which is to completely remove government regulation from the financial sector, but some critique seems in place. Firstly, financial markets, even though they adjust quickly, are not perfect, particularly in the sphere of information. Sequencing liberalization policy may not be enough, some more fundamental changes may have to be made. Secondly, McKinnon would argue that to have more credibility, economic policy must be founded on neoclassical theory, since in his view, it is only this approach to theory that can achieve the desired results. In other words, McKinnon does not seem to be open to alternative suggestions. [Grabel 1994]

Another perspective from which financial liberalization is criticized is the neostructuralist school. The basic assumption underlying this critique is the existence of financial curb markets alongside formal markets in a financially repressed economy. Curb markets, as they operate outside the formal market, do not face reserve requirements and other regulations. Thus, it is believed that curb markets are more efficient in the creation of loans. When savers shift assets from the curb market to the formal market, as a result of financial liberalization, the supply of loanable funds actually decreases, as formal financial institutions face reserve requirements. The desired effect of financial liberalization, an increase in overall investment financing, does not necessarily take place.

Where this observation may undoubtedly be correct, the neostructuralist critique does not, however, provide an alternative solution to a freely operating financial market, and therefore does not offer much help to the policy maker. [Grabel 1994].

Aside from theoretical shortcomings, we must also consider the practical side of financial liberalization. Governments may choose to repress the financial sector because this practice is of benefit to them. Governments in many countries are net debtors. They run a sustained deficit in order to meet their social obligations. When expenditures are high, but revenues low, governments often resort to what is called "inflationary revenues" or "inflationary tax". New money is printed to pay for expenditures. This creates inflation. Inflation reduces the size of the government deficit, as it shifts wealth from debtors (government) to creditors (public). Inflationary taxation as a policy works only if the nominal rate of interest is not allowed to change. By repressing the financial system, the government is able to keep the lid on the nominal rate of interest, thereby ensuring easy revenue for itself.

An alternative strategy of the government to raise funds can be the government trying to make the holding of private debt less attractive to lenders, by keeping interest rates paid on private debt low. Lenders will then choose to hold public debt in the form of government bonds, since these do not face interest rate restrictions and thus pay a higher yield. In this way governments ensure that available funds from domestic

financial savings are channelled to them and not the private sector.

Furthermore, repression allows the government to control the direction of credit and subsidization of the public sector, even if the latter does not offer most efficient investment opportunities. [Roubini, Sala-i-Martin 1992] and [Bencivenga, Smith 1992]. Governments subsidize investment in priority sectors of their economy, or even direct credit to those sectors, which may be believed to be socially more desirable than other, private sector investment. For these reasons governments may be reluctant to implement financial liberalization.

The debate over the appropriate extent and sequence of financial liberalization is far from finished. Nonetheless, development of an effective financial system is propagated by policy makers, as it is believed that a financial system has the ability to increase efficiency. More efficiency contributes to development and growth. The World Bank, one of the world's biggest policy designers, stresses the importance of the financial system in successful economic development in the World Development Report of 1989.

1.4. Financial Liberalization in Transitional Economies

It is not only true that financial liberalization or any other financial sector policy must take place within the context of the rest of the economy, it must also be

recognized that such policy cannot be limited to the removal of government intervention. It is important to recognize the problems that financial institutions may be faced with during the process of liberalization. It is hard to speak of a repressed financial market in Eastern Europe, since a "market" did not really exist. We cannot assume that market forces will kick in as soon as distorting government intervention is eliminated, as neoclassical theory predicts. There do not exist repressed banks just waiting to be allowed to finally operate according to the laws of the free market. In formerly centrally planned economies financial markets are not developing, but rather evolving. Any policy aimed at a creation of freely operating financial markets must not overlook the problems of financial institutions inherited from the past.

> *" Improved financial intermediation involves more than just the removal of discriminatory taxes and interest rate distortions. First, macroeconomic stability is essential. Second, a sound regulatory framework and effective bank supervision are imperative. Third, some institutional reforms are urgently needed ..."* *[Fry, 1995]*

In the case of reforming the banking systems of formerly socialist economies several measures must be taken aside from the removal of interest rate setting by the government. Free market behaviour, particularly from the institutional point of view, does not come naturally, but rather must be learned over time and conditions must be

ripe. As the functions and objectives of the banking sector change, old behaviour must be replaced by new behaviour. This entails much more than the removal of administrative interest rate ceilings.

Firstly, old problems, to be discussed below, which have come to light during the transition must be resolved, as they prevent banks from becoming competitive free market institutions. Secondly, an environment must be created which enables banks to operate under free market conditions effectively. Thirdly, the Central Banks must be reorganized in order to be able to perform all functions of a central bank in a capitalist economy. And fourthly, governments must commit themselves to bank reform policy and not engage in any activity which might conflict with policy objectives.

2. The need for financial restructuring

In a market based economic system, the financial sector has to perform several important functions. Because the majority of financial institutions in Poland are banks, they must be restructured so as to be able to execute these functions. Banks must be able to collect newly generated and voluntary savings and to allocate them towards various uses on the basis of risk return criteria. Savings must be voluntary as opposed to forced, which was predominant in the former economic system. Banks must also be able to monitor and control the existing stock of savings and to implement sanctions whenever risk-return criteria are not met. The third main task of banks is to manage a

market oriented clearing and payment settlement system. [OECD, 1992]

In a microeconomic sense, banks must effectively intermediate funds between savers and investors. From the macroeconomic point of view, banks must channel savings in such a way that all resources in the economy are used efficiently.

An efficient banking system in the economy in transition is necessary in order to provide enterprises with a source of external funds. During the transition process, banks must not only mobilize savings and channel them to the most productive uses, and provide payment services, they must also make available a large amount of capital to the private sector which may be used for the acquisition of state owned firms. After state owned enterprises are privatized, banks must be available to aid with the restructuring of enterprises. For lack of other financial institutions, it may have to be banks which play the role of corporate governance. Banks may have to be prepared to impose financial discipline on their borrowers, the enterprises. [OECD, 1994]

3. Obstacles in the Way of Restructuring

3.1. Banks

3.1.1. Undercapitalization

Due to the deterioration of enterprises' financial situations and thus the banks' portfolios, banks in Poland, and other formerly planned economies were faced with the problem of capital inadequacy. An adequate capitalization as specified by the BIS Basel Guidelines for Prudential Regulation should be 8% of equity to assets ratio [Abel, Bonin, Siklos, 1994]. Old state owned banks are generally undercapitalized, some newly created small private banks are financially viable. [Borish, Long, Noel, 1994]

3.1.2. Insufficient Competition

Although many new small commercial banks were created in Poland, and thus the degree of competition in the banking sector may be stronger than in many other transition economies, effective competition between banks is still weaker than it could be. Newly created banks are essentially much too small to rival the large state owned banks. A lack of competition prevailed in Poland because banks were organized on a regional basis, and thus had to interact relatively little with each other. There also exists very little competition from non-bank financial intermediaries.

The consequence of insufficient competition is that the development of the banking system is impeded. Firstly, banks have little incentive to improve the efficiency of their operations or increase the range of services they offer. Secondly, banks may create excessive spreads between deposit and loan rates, which would be quite discouraging to capital investment. High spreads are often a sign of monopoly power. And thirdly, the shallowness of the financial market could stand in the way of effective monetary policy.

3.1.3. Lack of Experience and Staff

Perhaps one of the most pressing problems in the way of a quick and speedy transformation is the fact that people who work in the banking sector and those who are meant to use banking services lack knowledge and experience. Underlying all aspects of the economic reform is the need to change attitudes and behaviours of all agents on the economy. This is not an easy task. Those who provide services must learn to follow rules of the market, and also those who use services must learn to accept the rules of the market. It is a long term process.

3.2. Enterprises

3.2.1. Bad Assets from the Past

In the centrally planned system, the objective of enterprises was not the maximization of profits, but rather the fulfilment of the physical plan as well as the provision of employment. During the early stages of the transition period it became clear that many of the old state owned enterprises were not profitable and in terms of market standards essentially bankrupt. The monobank of the former system did not make its decisions about lending to those enterprises on the basis of profitability and risk return, but rather extended credit as was required by the enterprises to fulfil their objectives.

The division of banks into commercial banks and a central bank revealed that many loans extended to the enterprises during the planning period were non performing. The nine newly formed commercial banks thus inherited a stock of bad assets from the previous system. It is worth emphasizing that at the time of the planned economy these loans were not classified as "bad". Banks at the time were not closing their eyes to the unprofitability of enterprises, but the latter was simply not a criterion for lending decisions. Thus in the case of inherited non performing loans, one cannot maker assertions about the state of the macro economy. Whereas often bad loans are a consequence of unsustainable expansionary policies, terms of trade shocks, technical

failures of bank management, over extension of credit or poor risk assessment, supervisory failure or fraud [OECD, 1992], old inherited bad loans are largely a result of the particular functions performed by the former financial system.

3.2.2. Post Reform Creation of Bad Assets

In the early stages of reform, the situation of enterprises worsened. If they were not already so, many enterprises became unprofitable and loss making. Several factors contributed to the deterioration of enterprise performance:

- collapse of the Soviet Union and with it a collapse of the CMEA export markets,

- the liberalization of Polish foreign trade in 1989, which generated strong and sudden import competition. A corresponding increase in Polish exports did not occur due to the backwardness of many Polish products,

- the domestic shock therapy which attempted to keep real interest rates positive increased the cost of servicing debt for enterprises,

- the reduction and often elimination of government subsidies, on which enterprises had learned to rely. [Pawlowicz, 1994], [Dittus, 1994]

The poor situation of enterprises greatly influenced the balance sheets of the banks. The above mentioned factors led to enterprises being unable to service their debts with the banking sector. Banks then found themselves with an even greater

number of non performing loans on the asset side of their portfolios. In many case this meant a negative net worth for the banks. [Dittus, 1994]

A negative net worth led banks to less than prudential behaviour. Often the incentive existed to invest in high risk projects in order to recover lost worth. Bank managers and directors could also engage in activities which may have benefited them, but only at the expense of the depositors. [Dittus, 1994]

Also enterprises responded in various ways to their debt overhang. At best, they focussed on the debt, often at the expense of giving enough attention to efficient production and staying alive in the new market environment. Their old stock of debt made it difficult to obtain new funds for clearly profitable projects. Enterprises also often engaged in high risk activities, as they expected to be recapitalized by banks or the government. [Dittus, 1994]

Some state owned enterprises looked to servicing other financial obligations first, such as wage bills or payments to suppliers. They would simply disregard banks. State owned enterprises are often strong enough politically that they know they will not be liquidated in case of defaulting on their bank debt. Other state enterprises did not survive the harsh conditions of the transition and went out of business. And yet another group of enterprises had been privatized, in which case neither the new owners nor the government were willing to assume responsibility for old debt. [Borish, Long, Noel,

1994]

3.2.3. Interenterprise Arrears

It was often hard for banks to distinguish between good and bad enterprises. Firstly, due to a lack of adequate accounting and auditing standards and personnel trained for their enforcement, banks were unable to properly assess credit worthiness. Lending to poorly performing enterprises was not stopped as soon as these problems were discovered, because of the lack of information about enterprises' credibility and also because of old ties between enterprises and banks. Enterprises expected an automatic extension of credit and banks were often prompted by the government to continue lending so as not to jeopardize large enterprises, which gave employment to many people.

Secondly, a quickly spreading web of credit extension between enterprises (often involuntary) also made it difficult for banks to properly assess enterprise viability. Very high interest rates (up to 60% monthly) at the beginning of 1990 resulted in enterprises with large debts becoming insolvent in a short period of time. Banks rolled over debt or added penalty interest. Enterprises fell into a debt trap. [Pawlowicz, 1994] They were unable to pay their suppliers, which were other enterprises, and interenterprise arrears were developed and spread quickly. [Dittus, 1994] Interenterprise debt affected also those enterprises which did not fall into a debt

trap. Banks were not capable of determining which enterprise was profitable but victim to the interfirm arrears problem, and which enterprise was unprofitable in its basic operations.

What is clear is that a deterioration of the financial situation of enterprises led to the worsening of bank portfolios. [Pawlowicz, 1994] The interdependence between enterprises created a network of financially fragile entities. A shock to any one enterprise could easily spread across all enterprises and thus become system wide. The financial fragility along with a lack of reliable information about enterprises added greatly to the risk, a systemic risk of lending to those enterprises. The result of this was that short term, lower risk investment was at all times preferred to long term higher risk investment, even though the latter may have been socially more desirable. Economic growth was thus impeded by interfirm debt and the bad assets of banks and the problem had to be addressed as one of the main issues of bank reform. [Calvo, Frankel, 1991]

3.2.4. Microeconomic Implications of Non-Performing Loans

The inherited stock of non-performing loans, the newly created non-performing loans as well as interenterprise debt, are obstacles in the improvement of efficiency of the banking sector as well as efficiency in the allocation of credit. Banks are preoccupied with the resolution of old problems and with staying afloat and as a result

often pay insufficient attention to learning skills necessary for survival in a market environment.

Furthermore, even if audits and regulations were prescribed, large state owned loss making enterprises as well as banks cannot simply be shut down due to inefficiency. Large state owned enterprises are providers of employment to many workers and political pressures prevent the liquidation of such enterprises.

Non-performing loans also pose a problem when it comes to privatization of banks. Banks with unhealthy balance sheets are not very attractive to private owners. The poor state of banks balance sheets might prompt new private owners, if such are found, to quickly liquidate the banks, or to engage in high risk activities. [Caprio, Levine, 1994]

3.2.5. Macroeconomic Implications of Non-Performing Loans

The problems of the state owned banks, which are connected to the poor situations of state owned enterprises are often believed to be the responsibility of government. Pressures exist on the government to capitalize state owned banks as well as to subsidize state owned enterprises. These distort the proper functioning of a market signal system. The government may also resort to such measures as printing new money in order to monetize its obligations. This in turn creates high levels of inflation.

If monetization is decided against, governments may attempt to raise higher revenue by increasing taxes. The easiest tax to extract is a tax on financial market activities. The extraction of tax lowers the ability of the financial system to develop speedily and efficiently. A lack of confidence in the banking sector creates uncertainty and leads to less productive investment.
[Caprio, Levine, 1994]

3.3. Institutional Arrangements

3.3.1. Inadequate Regulatory and Supervisory Structure

In this area, several problems may be identified. Legal and regulatory frameworks are inadequate. Supervisory staff is inexperienced, and institutional capacity as well as financial sector infrastructure are insufficient. [Borish, Long, Noel, 1994]

Bank supervision is impeded by several factors. Reliable information about banks' portfolios as well as the financial situations of their clients is not available. There exists only limited experience with risk analysis. Generally, there is a shortage of experienced supervisors and auditors. Tax regimes are not adequate for loan loss provisions and prudential regulations as they exist are not always in line with international standards.

3.3.2. Lack of Clearing and Payment Settlement System

Even though Poland is among those formerly planned economies who have made the most progress in the area of clearing and payment settlements, the capability of Polish banks to process information quickly is still not in line with Western standards. An efficient settlement system for payments is beneficial as it lowers the required working capital within the banking system, it reduces transaction costs and it provides the framework for an active policy of assets and liabilities management. In other words, a well functioning payment settlement system allows for a more efficient use of time and resources.

4. The financial restructuring of enterprises and commercial banks

The restructuring of the banking sector has to be one of the priorities of reform for obvious reasons. However, due to the complexities described in the above section, restructuring banks alone would be a futile process. Unless enterprises are restructured along with banks, the latter will immediately face the same problems with the former and accumulate bad assets again. It is thus important, that banks and enterprises be restructured at the same time. Furthermore, any existing enterprise ownership of banks needs to be severed in order to break up ownership and management conflicts and eliminate the possibility of enterprises pressuring banks into extending loans. [Borish, Long, Noel, 1994]

The restructuring of the banking system is crucial, since the major bulk of savings of the economy is to be entrusted to it. Furthermore, a sound banking system is a basis for the development of any other financial market, for example the securities market. A well functioning banking sector is also required for the development and functioning of indirect monetary policy instruments. [OECD, 1992]

Cleaning up the balance sheets of banks also requires a simultaneous improvement in the information system as well as improvements in the legal system. As already said, a clear specification of property rights must precede any measures to retrieve debt from enterprises or to change terms of debt in any way.

4.1. Solving the undercapitalization problem

Several approaches can may be followed in order to establish and maintain capital adequacy of commercial banks.

Firstly, troubled banks with poor balance sheets may simply be liquidated. This approach is of course quite costly, and may result in the liquidation of banks which could have been restructured and their viability restored. It is not easy to determine which banks should and which should not be liquidated, since the appropriate accounting and auditing procedures do not exist. As well, the measurement of the exact financial situation of banks is complicated by the fact, that banks may hide their losses.

The problem of interenterprise debt, described below, adds to the difficulty of assessing the viability of banks.

A second approach may be termed "growing into strength". State owned banks can be encouraged to build up loan loss reserves, as soon as they can. They may do so by permitting generous deductions of provisions from profits before tax. The drawback to this approach is that it may encourage financially weak banks to take excessive risk. Since the capital position of banks in Poland was stronger at the onset of reforms relatively to that of banks in for example Hungary or the Czech and Slovak Republics, Poland may chose this option of recapitalization, since it is not very strenuous on the state budget.

A third option is that banks simply be recapitalized. Banks may be injected with a capital grant from the state budget, with the restriction that this be a one time recapitalization and not to be counted on by banks in the future. The purpose of recapitalization is to restore banks' solvency and to create conditions for competition and viability. Thus, recapitalization should be accompanied by changes in the banks' incentive structures, in order to prevent moral hazard, as well as a recurrence of the problem. The advantages of recapitalization are that it decreases the risk of banks rolling over debt and/or capitalizing interest (where the amount of interest payments due are turned into part of the principal). Also, excess risk taking by banks is reduced, provided that it is clear that recapitalization is a one time deal. Furthermore,

recapitalization, unlike liquidation, allows stability in the banking system to be preserved during the period of transition. Overall, recapitalization should lead to improved allocation and management of financial resources. [Borish, Long, Noel, 1995]

Some disadvantages to recapitalization include the high fiscal cost, the failure to liquidate those banks that really should be wound up, as well as the fact that inexperienced government involvement in the banking sector is increased. [Borish, Long, Noel]

In extension to the above, banks and borrowers, in this case large state owned enterprises may be restructured simultaneously, in order to ensure that recapitalization never be needed again. [OECD, 1992] A restructuring of the balance sheets of banks will be discussed later in greater detail.

4.2. Solving the Problem of Insufficient Competition

To stimulate competition in the banking sector, other problematic areas must be addressed. It is important to develop a regulatory and legal framework, which will allow banks to know their limits and rights and provide some incentive to change scope of operations. Also, a decrease in the barriers to entry into the market could prove beneficial in terms of increasing competition. What is furthermore crucial is trained and

experienced personnel, with the ability to improve a bank's operations and increase the range of services offered, as well as financial resources to fund such changes. Thus solving problems of undercapitalization, lack of experienced staff and the lack of a legal and regulatory framework should take care of the problem of insufficient competition.

4.3. Solving the problem of insufficient experience

Rudka suggests that a two track training system should be implemented. It separates most urgent training from more comprehensive training. Most urgent skills can be taught in a summary training program, and a more comprehensive approach can be followed in a model training program. The summary training program should take around two weeks, whereas the model training program should be a full university course focussing on monetary problems and market economy systems in general. [Rudka, 1991]

Whatever approach, teaching appropriate skills to staff is of great importance in attempting to solve the problem under discussion. Thus much attention should be devoted to the education of the banking sector personnel. The time it requires to learn skills and to change behaviour is one of the main reasons why removing of government intervention in the banking system will not immediately result in a system of competitive market oriented banking institutions.

4.4. Solving the bad debt problem

A main objective of banks and enterprise restructuring is to firstly clear all problem loans and bad assets which banks already have on their balance sheets. Secondly, it is important that doubtful or unrecoverable loans be minimized in the future. This can only happen if banks adopt proper risk assessment procedures in order to determine their clients' credit worthiness, and if enterprises become solvent, such that they no longer have the need to take loans which they cannot service. All this should be accomplished with as little cost to the budget as possible. It is also important to create the appropriate incentive structure, and not allow either banks or enterprises to expect to be bailed out in the future. [Calvo, Frankel, 1991]

4.4.1. Debt Cancellation

Several options exist with respect to taking care of banks balance sheets. Doubtful and unrecoverable loans can firstly be cancelled. A cancellation of the debt can easily create a moral hazard problem, where enterprises come to believe that debt is cancellable and expect future debt to be forgiven, as well. Thus it must always be stressed that a debt cancellation is a one time deal and not to be counted on in the future. Furthermore, debt forgiveness may reduce the availability of capital to all firms, including creditor firms, as banks net assets will decline. Some of those enterprises may well be efficient and in need of working capital. [Calvo, Frankel, 1991] Therefore debt

cancellation should be a purely bookkeeping procedure.

4.4.2. Debt Socialization

Another possible approach to the bad debt problem is the socialization of debt. In a sense, debt is swapped for debt. Claims which are held against enterprises by other enterprises as well as banks are exchanged for Treasury bills or other government securities. This allows a recapitalization of banks, who now hold government obligations in place of non performing loans on the asset side of their portfolios. Calvo and Frankel believe this to be a reasonable approach, since non performing loans, especially those made prior to economic reforms, were extended by state banks to state enterprises at the disposal of the government and in place of government subsidies. Thus these loans are obligations of the government and should be taken care of by the government. [Calvo, Frankel, 1991]

4.4.3. Special Reserve Fund

Abel, Bonin and Siklos suggest another option for the cleaning up of balance sheets. They suggest that banks should deposit all tax funds, which would be paid to the government into a specially created reserve fund. This fund would be held against non performing loans, and could be held in the form of government subsidies. After several years banks should accumulate enough funds to recapitalize bad loans. At the same

time, a disincentive or penalty structure should be imposed on banks to prevent them from extending any more non performing loans. [Abel, Bonin, Siklos, 1994]

4.4.4. Work-Out Units

A more comprehensive approach is the establishment of work-out units within banks. These concentrate their efforts on the recovery of problem loans. The definite advantage to this approach is that banks are forced to develop banking expertise in terms of the appropriate classification of loans and acquire skills to evaluate credit risk. Thus internal bank systems are improved. The obstacles to an effective functioning of work-out units is the lack of experience on the part of banks. Also there are insufficient legal and regulatory norms for an efficient recovery of loans and as stated above, often local pressures exist for banks to roll over debts of politically important enterprises. [Borish, Long, Noel, 1994]

4.4.5. Good Bank/Bad Bank

A similar approach allows banks to separate their problem loans from their balance sheet and pass them on to one bank, created specially for that purpose. This may be the consolidation bank, a "bad bank", whose task it is to collect problem loans. In a sense it becomes a collection agency.

4.4.6. Debt/Equity Swaps

Debt to equity swaps are also an option when dealing with non-performing loan. Banks come to own parts of the debtor enterprise in exchange for its debt. This gives banks greater control over the operations of the enterprise, thus there is more room for corporate governance. However, it also creates an environment in which banks may take on higher risk, and in which there is greater chance of corruption and bribery of bank managers. [Borish, Long, Noel, 1994]

This approach also raises the question of the desirability of banks being involved in enterprise management and in industries in which they may have no expertise.

4.4.7. Bank Restructuring and Rehabilitation Agencies (BRA's)

Special agencies may be created with the objective of restructuring and rehabilitating banks. Their primary responsibilities include: a) a liquidation of non-solvent banks, those who have a negative goodwill in the market, b) a merging of viable portions of poorly performing banks with other banks, c) the taking over of troubled banks, whose worse debt may be written off and the rest may be merged with that of other acquired banks. The advantage to BRA's is that the banking system is reconfigured rather than maintaining its status quo, such that "hopeless" banks are eliminated. This approach is also quite fast, and thus allows for the development of a private banking sector to occur sooner. The problem once again is the lack of

experienced staff to operate the BRA's. [Borish, Long, Noel, 1994]

4.4.8. Case-by-Case Restructuring

The last option is a case by case restructuring of debtor enterprises. This is quite similar to a work-out unit proposal except that restructuring is organized and conducted on an individual basis. Therefore a bank client relationship is reinforced, which allows the enterprise to maintain its reputation. At the same time, loans remain part of the banks assets. The approach is not always effective as banks are often too lenient. For instance they might choose to roll over debts, an approach often used in western cases of loan restructuring, while at the same time capitalizing interest, which has the effect of inflating the asset side of banks portfolios. Banks capital liquidity is reduced and more viable private borrowers may lose access to credit. Case by case restructuring must be monitored and regulated closely. [Borish, Long, Noel, 1994]

4.5. Improving Institutional Arrangements

4.5.1. Regulatory and Supervisory Structure

Training of staff to perform audits and to supervise banking activity seems to be one of the most crucial steps to improving regulatory and supervisory structure. Furthermore, after the balance sheets of banks have been cleaned up, the monitoring of

banks should become much easier, and information should be more reliable. The introduction of adequate prudential regulation is a legal matter, for which a legal framework must be developed, however the enforcement of rules must again lie in the hands of supervisory staff.

The lack of a legal framework is a great obstacle to the cleaning up of banks balance sheets. A sound set of property rights must be specified in order to allow the banks to put any claims on their debtors. So far the legal rights of creditors and debtors are very unclear, and no standard procedure for the improvement in the situation of banks and enterprises can be set. Some economies do not yet have a clear legal separation of central banking, commercial banking and other financial institutions' functions.

Once supervision and regulation are improved, the confidence in the banking and the entire financial system should improve.

4.5.2. Clearing and Payment Settlement System

A payments system is well functioning when it exhibits the following attributes: acceptability, timeliness, and reliability to serve all household and enterprise needs. As well as safety, efficiency and ease of use. [Sato, Humphrey, 1995]

A payments system which displays inefficiencies in the form of delays in bank transfers, verifications or settlements, creates many problems in the banking sector. It leads to unnecessary delays in completing transactions. It also puts customer deposits at risk as it undermines customer confidence in the banking sector, thereby encouraging financial disintermediation. Furthermore, it limits business expansion, for similar reasons. Thus an inefficient payments system poses a critical constraint to the development of a modern banking and financial sector. [Borish, Long, Noel, 1994].

Several issues need to be addressed during the transformation process. Sato and Humprey [1995] believe that these problems need to be solved simultaneously.

First, the legal structure of the payments system must be expanded in order to accommodate private ownership and private payments. Second, the time sensitivity of payments needs to be improved. Processing and settlement of existing paper based payments need to be sped up. Eventually, an electronic payment and communication infrastructure should be developed to facilitate enterprise payments. The degree of future atomisation and centralization of the banking system should be determined. Third, same day or next day settlement must be developed and restricted to enterprise and large value international payments. Fourth, credit risk assessment must be improved. [Sato, Humphrey, 1995].

Economies in transformation must make some choices as to the design of their

payments systems. First, they must decide between a centralized or a decentralized system of savings supply and payments services. An example of a centralized system is the Western European post office savings and GIRO system, which contrasts with the US decentralized system. Second, the choice between paper and electronic payments must be made. This choice corresponds with the first question, since electronic payment services are much easier to implement in a centralized system. Also related is the third question, whether non bank competition in supplying payment services should be allowed, for instance from the post office. The fourth choice is in the splitting up of payment system tasks between commercial banks and the central bank. These include user interface, clearing, settlement and regulation. In principle, all functions can be performed by either the central bank or commercial banks. In practice however, the most common distribution of duties is that the commercial banks focus on the user interface function as well as the transformation of information needed to process, clear and account for payments. Central Banks generally take care of final settlements of interbank payments as well as the majority of the regulatory function. This division seems appropriate, since Central Banks generally lack profit incentive and should be limited to providing settlements. Commercial banks or other private institutions on the other hand have profit incentive and can take care of clearing and processing. [Sato, Humphrey, 1995]. This is also the usual division of labour in industrialized countries

A more complete list of issues which need to be addressed and choices which have to be made in the transformation of the payments system may be found in

appendix 2.

5. Financial Assistance

The road to enforcement of financial discipline in enterprises by banks is longer than envisioned earlier. Banks balance sheets must be rehabilitated and adequate skills must be developed by banks before they can supervise and ensure appropriate financial behaviour of enterprises. [Schroeder, 1995]

The speed with which banks can clean up their balance sheets depends primarily on the pace at which bad debts are written off and banks are privatized, as well as the proper implementation of bankruptcy laws. Since the financial resources of banks in transition are not sufficient to fund the above mentioned process, financial assistance from the state, foreign governments and international institutions is crucial. [Schroeder, 1995].

6. Macroeconomic Stability

Aside from the internal restructuring of banking institutions and the improvement of their financial situation, it is also important to create an economic environment which will facilitate the efficient operation of the banking system. A stable microeconomic environment must be a key policy objective if newly restructured and

privatized banks and enterprises are to function effectively. A stable macroeconomic environment would include a low and stable rate of inflation, positive real rates of interest and equilibrium levels of real exchange rates. A stable macroeconomic environment is crucial as it would substantially reduce risk and uncertainty, decrease the prevailing asymmetry of information, lower transaction costs as well as increase overall confidence in the emerging financial system.

At the same time, a non inflationary rate of economic growth requires that the banking system function effectively. Thus there exists an interdependence between the stability of the banking system, and the stability of macroeconomic performance.

The link between the banking sector and the macro economy is the Central Bank. The Central Bank regulates and supervises the financial sector, and at the same time is in charge of designing and implementing policies aimed at macroeconomic stability. It is therefore to the consideration of issues involved in creating an effective central bank that we now turn.

B. The Central Bank

Although the general trend around the world is to privatize industry and services and free them of all intervention such that they may operate according to market forces, the banking sector is viewed in a slightly different light. Some regulation of the banking

sector is considered necessary in order to guarantee the safety and soundness of the banking system as well as to provide an institutional structure for macroeconomic monetary policy. [Udell, Wachtel, 1994]. Many aspects of this structure can be, and in developed economies most often are, performed by the central bank. This section will examine the extent to which a central bank should be involved in the regulation of the banking system and what that means for economies in transition.

1. Safety and Soundness Regulatory Structure

As mentioned above, the banking systems in formerly planned economies lack a well functioning safety and soundness regulatory structure. Four facets of the structure include:

a) development of the payments system

b) bank examination and adequacy regulation

c) deposit insurance

d) lender of last resort facility

All of these functions can be performed by the Central Bank, some may be performed by private institutions.

As already discussed, the development of a speedy and safe payments system is crucial in the formerly planned economy. Quite often, interbank credits and debits are cleared through their accounts held at the central bank. In this case the central bank has

the responsibility of ensuring safe and sound banking procedures. The function of clearing payments may also be adopted by a private clearing house, in which case all members are jointly responsible for the actions of the entire system. This may require more experience than is available to banks in transformation.

To make its role of ensuring safety and soundness, the central bank may restrict access to the payments system to only those banks and other financial institutions which comply with safety and soundness regulations. [Udell, Wachtel, 1994]

To ensure the safety of the entire banking system it is also important to examine individual banks and to ensure that they have adequate capital to meet requirements. Once banks have more or less healthy balance sheets, capital adequacy regulations can be imposed and enforced through bank examination. In formerly planned economies, it is important to restructure banks balance sheets and bring them up to par prior to imposing capital adequacy regulations. [Udell, Wachtel, 1994]. Various approaches to the restructuring of banks balance sheets have been described above.

Another approach to making the banking system safer is the establishment of deposit insurance. Deposit insurance may be provided by the government, where all deposits have an implicit government guarantee, such that the government ultimately bears all risk. The second option is to create a private institution which would provide insurance on a system of risk pricing, and in the end assume all risk. Pricing risk accurately may be difficult in formerly planned economies, since information may not

always be available. In any case, deposit insurance is important to establish a trusting relationship between borrowers and lenders. It makes it easier for banks to attract deposits and transfer them to viable borrowers. [Udell, Wachtel, 1994]

In terms of its safety and soundness regulatory function, the central bank should also act as a lender of last resort to the banking system. This is meant to provide liquidity to those banks and other financial institution who suffer from temporary illiquidity problems, but are not insolvent. The distinction is not easy, and often the lender of last resort facility is misused. The result is that banks who are no longer viable are sustained longer than they should, and furthermore, the control over monetary expansion is lost. [Udell, Wachtel, 1994] Thus the lender of last resort facility must have experienced staff who will be able to distinguish between illiquid and insolvent banks as far as possible, and who will keep the lid on excessive monetary expansion. Once again, to train such staff and to enforce all regulations takes time and cannot happen overnight.

2. Credit Policy

According to Udell and Wachtel [1994], it is inevitable to have some government involvement in credit allocation in the economy in transformation. The question then is. to what degree governments should have control over the pricing and allocation of credit. Extensive controls may impede the development of the banking

system in that they create too large distortions and encourage disintermediation. The extreme case is of course a centrally planned economy, in which banks have no role other than channel funds to designated areas. This is what economies in transition try to move away from.

A middle ground between no government intervention and excessive intervention is the establishment of a development bank or an investment bank, who is responsible for competitive allocation of capital, usually foreign capital [Udell, Wachtel, 1994]. There is some room for selection criteria other than competitive market forces and thus some control over the direction of the economy. This does not solve the problem of excessive government intervention, since such institutions can easily be corrupted by politics.

It would seem that free competitive credit markets are a feasible long term goal toward which economies in transition should be moving. Although at this point in time the experience and training may not exist, both may be acquired over time. It is not clear, why some degree of government involvement should be inevitable.

3. Monetary Policy

Udell and Wachtel believe that the choice of monetary policy goals is straightforward and should include price stability and real growth. Also the instruments

used should consist of the conventional interest rates, exchange rates and monetary aggregates or any combination thereof. These may be used through direct control in the form of credit or interest rate ceilings, or through open market operations. The main concern in economies in transformation is the degree of independence of the central bank, which determines its strength and ability to follow its objectives. A discussion of central bank independence will follow shortly.

A choice of instruments of monetary policy which affect interest rates and bank liquidity includes central bank lending or discounting to commercial banks, open market operations on the primary and open market operations on the secondary market for government securities. According to Udell and Wachtel, the optimal monetary policy instrument are open market operations using the secondary market for government securities. The reasons are that open market operations are free from pressure to lend to banks, as happens with central bank lending or discounting. The instrument is also free from pressure to finance the government deficit, as would happen if the primary market for government securities was used. Therefore open market operations do not lead to extensive monetary growth. This choice of monetary instrument also encourages the development of an interbank money market and a secondary market for government securities.

Other options of monetary policy include ceilings on interest rate and credit availability. Those of course fall under the category of financial repression and are not

greatly desirable.

4. Central Bank Independence

The notion of independence or autonomy of the central bank from the government and from the financial sector has been a controversial issue for several decades. There is debate about the definition of central bank independence as well as the desired degree thereof.

First, it is important to explore what is meant by central bank independence. There may exist three types of independence. 1. A central bank can be politically independent. This implies that the central bank is free to choose its policy goal and pursue it without having to obtain permission. 2. A central bank can be economically independent, in which case it may decide on the policy instrument to use in order to achieve a goal. Political and economic independence have been found to be positively correlated. Political independence depends on who runs the government and who runs the central bank. The degree of economic independence is determined by how much control the government has over financial decision, such as the amount of credit extended or the rate of interest. 3. The third type of independence is legal. It may be measured using regulations specified in a central bank charter, or any other document which specifies for instance the term of office of central bank officials or procedures to be followed. [Wojtyna, 1994]

There also should prevail an independence of the central bank from the financial sector, where the central banks lender of last resort facility cannot be overused as a result of commercial banks influence on cental bank activity. [Udell, Wachtel, 1994]

4.1. Central Bank Independence in Economic Theory

Mainstream economic theory gives little attention to institutional or structural factors or political problems which may be important in the restructuring of the banking system in a transitional economy. Mainstream theory does however point out two problems which may be of interest. Firstly it directs attention to the problem of reputation and credibility of any policy making body, and thus also a central bank. Secondly, it points out the problem of time inconsistency in policy making, where the optimal policy to be followed at on time may differ from the optimal policy option at a later time.

In order to increase credibility it is suggested that the policy maker may chose one of three options. She may either "tie her hands" through legislation, which will not allow policy direction to change at the policy makers discretion. She may also increase the clarity of regulations which govern the policy makers' actions, so as to decrease the asymmetry of information. The third option is simply to build reputation and credibility through good behaviour over time. [Wojtyna, 1994]

4.2. Game Theory and Central Bank Independence

A game theoretical approach has often been used to explore some of the issues surrounding central bank autonomy.
Firstly, policy making can be thought of as a game between two players, the central bank and society. The central bank has two options, to either aim for low inflation or high inflation. Society may expect either low or high inflation. Thus there are four outcomes, low or high inflation with the correct or the incorrect expectations. The outcome turns out to be least socially desirable, when there is no coordination between central bank actions and society's expectations. It then follows that it is important that the central bank communicate its intentions clearly. [Wojtyna, 1994].

Secondly, the game can be thought of as taking plays between the central bank and the government, which may either cooperate with one another, or not. If there is no cooperation, the result is a Nash equilibrium, in which neither side can improve their situation on their own. The other result may be a so called Stackelberg game, where each side tries to make the other give in and make the first move, leading to a try of powers between the central bank and the government, a game of chicken. Whoever gives up first, the confidence in the system is undermined by playing the game and inflationary expectations increase. [Wojtyna, 1994] Again this points to the notion, that cooperation between the central bank and the government is desirable.

4.3. Other approaches to Central Bank Independence

A quite pessimistic view of central bank autonomy comes from Sargent and Wallace, who call the interaction between government and central bank an "unfriendly monetary arithmetic". They believe that the government can have such a budget deficit policy that even a restrictive monetary policy will not prevent high inflation. If the government decides to levy an inflation tax, the central bank will not be able to fulfil its obligations of stopping inflation, no matter how independent it is. Thus the central bank has no power, anyway. [Wojtyna, 1994]

It is also often pointed out, that there exists a trade off between central bank credibility and flexibility. If an autonomous central bank is committed to an anti-inflationary policy, then it no longer has the flexibility to respond to external economic shocks at its discretion. Thus price stability may be a trade off for real stability. This of course depends on the ability of monetary policy to influence real phenomena.

4.4. Central Bank Independence in the Economy in Transition

The questions remain, whether the central bank in a transitional economy should be independent, to what degree it should be independent and what position it should strive toward in the future.

The central bank cannot be trusted to know exactly what to do and when. Central bank staff must be trained much like any other staff. The ability to conduct monetary policy well comes with experience, which former monobanks do not have. It is not natural for a central bank to behave in any predictable or preconceived way, it must **learn** to take appropriate action in any given circumstance.

The central bank should not necessarily be independent of government and of the banking system in the process of transformation. Since structural change is taking place, all policy makers and other actors must coordinate their plans in order to develop one structurally sound system. For that reason, the central bank as well as the government should communicate not only with each other, but also with those who have experience. For instance the central banks of other countries, or international institutions. This is not to say that the central bank or the government should avoid responsibility for decision making in their own economy, rather that they would be well advised to listen to and take into account suggestions of those with more experience.

Appendix 2

Box 9: Poland's Experience With "Commercialization" and "Conciliation"

Restructuring Requirements: In exchange for debt restructuring and rescheduling, Poland's out-of-court "conciliation" has involved a series of enterprise changes intended to prevent a recurrence of non-performing loans, including:

- Conversion of the enterprise to a joint stock company, with a supervisory board to scrutinize management performance. This sometimes involves a change in the distribution of share ownership, and is designed to shift the company's decision-making influence to management and improve corporate governance.
- Dissolution of Workers' Councils (WCs), de-linkage of wage settlement requirements regarding government and State enterprise employees, and elimination of the requirement of WC legal consent to privatize an enterprise. These measures are intended to reduce employee influence in management decision-making, and lower the cost structure of troubled enterprises.
- Divestiture of SOE social services (water, heating, housing, day care, health) and other non-core assets[41]. Banks try to get enterprises to focus on their competitive advantages for sustainable growth and creditworthiness. Sales of non-core assets sometimes provide cash for loan repayment and interest arrears.

Preliminary Results: It is too early to tell how successful out-of-court conciliation procedures and other methods will be in restructuring SOEs and transforming them into creditworthy firms. Initial results in Poland have been favourable, at least insofar as *stabilization* is concerned. Within 15 months of EPSAL effectiveness, recapitalized Polish SOCBs had resolved approximately 90 percent of their bad debt problems through restructuring, bankruptcy/liquidation, swaps, sales and repayment. In most cases, this occurred through liquidation of non-viable enterprises. Questions remain about whether this approach can be applied universally given the weakness of bank governance in many transition countries. It has also been argued that significant restructuring has been taking place in many SOEs by themselves without being a part of the conciliation process. However, this is largely due to incentives tied to their privatization program. With regard to Poland, strengthened bankruptcy procedures may be needed for future debt resolution if the Ministry of Finance plans to be less involved in encouraging the resolution of creditor-debtor disputes.

CHAPTER 4

THE REFORM PROGRAM IN POLAND

A. BANKS AND ENTERPRISES

1. General Economic Reforms in the Early Stages

Throughout the 1980's it was becoming clear that the banking system required reforms. In 1989 the Solidarity Workers' Union was elected leader of the government and introduced a radical program of economic stabilization and reconstruction for the whole of the economy.

Transformations started with a stabilization programme agreed upon with the IMF. The programme included tight fiscal and monetary policy and the maintaining of a positive real rate of interest with the main goal being the containment of hyperinflation. This shock treatment of the economy, designed to stabilize the economy while at the same time pushing the economy towards transformation, was introduced in January 1990 under the name of "Balcerowicz Plan", or "Balcerowicz Programme" (after the Finance Minister Leszek Balcerowicz). It was implemented under the neoliberal government of Prime Minister Tadeusz Mazowiecki. The programme was aimed at the Polish economy's most predominant problems:

- hyperinflation,

- shortages in the supply of goods and services,
- a high budget deficit,
- a great loss of value of the zloty,
- a large foreign debt and
- low economic efficiency in production.

The most important measures of the Balcerowicz Programme included the liberalization of prices, the liberalization of foreign trade, the introduction of a new, and undervalued exchange rate and the introduction of internal convertibility of the zloty. The attempt to eliminate price and income subsidies and to balance the budget resulted in a very restrictive fiscal policy. Also monetary policy was kept tight with the goal of curbing the extremely high rates of inflation. Monetary policy tools used included the regulation of the supply of money and rates of interest as well as credit limits. [Adam, 1994] The effectiveness of the instruments used of course depended greatly on the structure and the proper functioning of the banking system.

The Polish government took an active role in setting up a stabilization scheme for enterprises, since a stable financial position of enterprises was beneficial to the government. Large state owned enterprises were the main source of budgetary revenue, and their stability allowed for a predictable and stable source of budget revenues. [Boguszewski, Czulno, Prokop, 1991]

At this point, reforming the banking system became more urgent than ever. [Rudka, 1991] Improvement in the capital allocation mechanism was crucial for the further development of the Polish economy. The banking systems role in this mechanism was the efficient transformation of savings into investment. [Pawlowicz, 1994] Aside from ensuring that savings are gathered and channelled toward the most productive uses, a second function of the banking system was also to create a link between macroeconomic stability and microeconomic financial discipline of banks and enterprises. [Schroeder, 1995]

The long range goal of the banking system reforms in Poland was and still is to create private banks, which will be in competition with each other, have little bad or doubtful debts and have healthy balance sheets. Alongside competitive banks, a sound regulatory structure is envisioned, with some degree of state supervision. [Schroeder, 1995].

2. Reforms of Commercial Banks

2.1. Creating a multi-tier banking system

The first goal in the reform of the banking system was to create a two tier banking system with a fully fledged central bank and a second tier of independent profit oriented commercial banks. [Rudka, 1991]

The establishment of a two tier banking system with an independent central bank was designed to aid the transformation of the Polish economy.[Pawlowicz, 1994] The main task that was to be accomplished by the division of functions of a central bank and commercial banks was to deregulate the process of capital distribution in the economy. [Schroeder, 1995]

Three steps can be identified in the process of creating a multi tiered banking system. The first entails the division of the monobank into a two tier banking system with an independent central bank and market based commercial banks. The second step involves the development of commercial banks with greater autonomy to make lending decisions on the basis of commercial criteria. Commercial banks may be either the already existing large state owned banks, or newly created small private banks. The third step involves providing the central bank with the means to conduct monetary policy and supervise banks. These steps are not to be taken in succession. The improvement of the commercial banking system and the central bank should take place at the same time.

The banking system is often thought of as a two tier system, with the central bank being the first tier and commercial banks being the second tier. Commercial banks may also be though of as having two separate and quite different categories. In that case the second tier includes already existing large state owned banks, and a third tier consists of newly created small privately owned banks. [Mullineux, 1995a]

Nine state owned banks (treasury commercial banks) were established in April 1988 on a regional basis and took over the deposit and credit activities of the NBP in January 1989, (see appendix 3). Enterprises could now choose the bank they wanted to deal with. I was in 1989, however, that official large changes in the banking sphere began. On January 31 of that year a new commercial banking law was introduced along with a new central bank charter. On February 15, 1989 new regulations on foreign currency came into effect.

2.2. New commercial banking laws

The development of the Polish banking system may be divided into three phases. A liberalization phase during the year of 1990. A second phase lasting from 1991-1993 during which first attempts at bank privatization were made and which was marked by a financial crisis of the banking system. And a third phase, beginning in 1993, when the Enterprise and Bank Restructuring Programme was introduced.

During the 1990 liberalization phase, when a two tier banking system was legally established, the basis for emergence of new banks was created. The period was characterized by a strong emphasis on the creation of new banks while the issue of restructuring the already existing large state owned banks was put aside. The belief was that newly created banks would generate enough competition to force state owned banks to adopt competitive market behaviour. Accordingly, licensing policy for new banks was

highly liberal and capital requirements were quite low. [Polanski, 1994] This resulted in very fast growth of small banks in Poland. By the end of 1990, one year after the reform, 75 banks were created, 30 of which were private. [Pawlowicz, 1994]. The positive outcome of such quick liberalization was a decrease in the high sectoral and regional segmentation of the banking system as existed before. However, speedy liberalization also had quite a negative impact on the stability of the financial system in subsequent years.

As the mushrooming of new small banks did not seem to enhance competition in the banking sector, a new approach was adopted. During the 1991-1993 period emphasis was shifted from the creation of new banks to the restructuring of already existing state owned banks, as well as their preparation for privatization. Licensing requirements were tightened, and regulations imposed on banks were made more stringent. [Polanski, 1994]

In February 1991 a Polish Development Bank was established to fill the gap left by the reluctance of banks to lend to small and medium sized enterprises. The tasks of the Development Bank included, the financing of fledging companies, financial assistance to restructuring state owned enterprises, and the channelling of funds from international institutions to special projects. [Mullineux, 1995a]

Furthermore, the nine state owned commercial banks were instructed by the Ministry of Finance, their owner, to establish debt work-out departments and assign bad

debts to them. These departments were to evaluate all delinquent enterprises and classify their debts into good, substandard, doubtful and unrecoverable. This classification scheme was designed to prevent banks from concealing non-performing loans. Banks had an incentive not to admit to having problem loans, so as to preserve the trust of their clients. Banks were to stop lending to those enterprises with doubtful and unrecoverable debt. The Ministry of Finance created a monitoring unit to ensure the smooth implementation of these measures.

When problem loans were carried over from the previous system they were easily identifiable, due to their low rates of interest or their inconvertibility. It was preferred to pass these loans on to special agencies other than banks themselves. If loans were not easily classified as bad, because they were made after the reform, Poland preferred to recapitalize banks and allow them to deal with those problem loans themselves. [Dittus, 1994] In that sense the state took responsibility of those loans which were made as part of the requirements of the old system. Previously, loans made to state enterprises were in a sense loans to the government or made in place of government subsidies and thus it made sense that the state rather than banks themselves should deal with them.

Secondly, banks were obliged to provision for non-performing loans. They were allowed to do so out of pre-tax income. Provisions on different classes of loans were determined according to international standards. Thirdly, accounting rules and standards were tightened in an attempt to move closer to International Accounting Standards (IAS).

Fourthly, minimum capital requirements were increased in order to put a stop to the creation of a large number of small undercapitalized banks. Fifthly, exposure rules were introduced, which would not allow banks to hide bankruptcies of their large customers. [Dittus, 1995]

These measures, however were not enough to prevent a deep crisis of the Polish banking system between 1991 and 1993. The crisis was a result of several conditions, such as a too speedy liberalization of the banking sector, a slow reform of state owned enterprises, initial weaknesses in supervision and a lack of a strategy to clean up banks balance sheets and break old ties between state owned banks and state owned enterprises. [Polanski, 1994]

Overall bank lending to enterprises declined during the early 1990's. In 1990, Poland, along with the rest of Eastern Europe, faced a substantial credit crunch. Total domestic credit to the non-government sector fell from 44.4 percent of GDP in 1987 to as little as 12.5 percent of GDP in 1990. [Calvo, Kumar, 1993] This may be attributed to tightened lending regulation, but may also have been a result of banks lending more to the government, which offered attractive rates on T-bills due to budgetary needs. [Dittus, 1994] Of course the financial situation of banks and the fact that their poor portfolio suddenly mattered may have simply rendered banks reluctant to lend to any enterprises at all, since they did not yet posses the ability to distinguish between viable and insolvent enterprises.

In 1992, it became clear that despite all reforms introduced in the banking sector, the banking system did not resemble the competitive market clearing system that was envisioned. Several problems could still be identified. Firstly, the supply of banking services was still insufficient as compared to the demand for them, thereby granting banks some monopoly power. Secondly, the banking services available were still quite low in quality and were of little variety. This was primarily due to a lack of experienced staff and a poorly developed infrastructure. Thirdly, a money market had not yet been developed. Fourthly, banks were still financially weak. [Rudka, 1991]

Furthermore, the problem of bad loans and interenterprise debt was not disappearing, This was attributable to mainly two reasons. Banks did not wish to expose their own insolvency, and thus tried to cover up the extent to which their balance sheets were plagued by bad debt. They did not enforce strict rules on themselves or their clients. As well, the bankruptcy of insolvent enterprises, which would have been necessary in order to stop the creation of interenterprise debt, was socially undesirable. State owned enterprises employed a large part of the labour force and their closure would create vast unemployment.

By the end of 1992 the authorities realized that the financial troubles of banks were closely linked to the poor situation of enterprises. Cleaning up of banks' balance sheets and their recapitalization made little sense if they continued to lend to unrestructured enterprises. At the same time, banks had more information available than

anyone else on the financial situations of enterprises. Thus it became evident that the restructuring of banks and enterprises had to be tackled simultaneously.

3. The financial restructuring of enterprises and commercial banks

In 1993 a Law on Financial Restructuring of Banks and Enterprises was introduced, which permitted a number of restructuring options, such as partial forgiveness of debt by commercial banks, the rescheduling of debt repayments, and debt for equity swaps. [Mullineux, 1995a]

Around the same time, the World Bank extended to Poland an Enterprise and Financial Sector Adjustment Loan (EFSAL) in the amount of $450 million. The World Banks recommendation was that banking and enterprise problems must be jointly resolved, and since banks know their clients best, they may be the most effective in supervising enterprise restructuring. Some of the World Bank's loan would also be directed towards the financing of the Mass Privatization Program in Poland. In fact, part of loan conditionality was that the attempt be made to privatize state owned banks. [Wallich, 1995]

The new law as well as the EFSAL provided the legal and financial foundation for the introduction of an Enterprise and Bank Restructuring Programme to the Polish economy. The objective of this was to reverse the negative tendencies of interrelated

structural crisis of enterprises and inter enterprise debts and the stability of the banking system. The distorted lending patterns of banks would be improved through the reduction of bad loan portfolios, incentives to restructure debt, the recapitalisation of state owned banks through the infusion of new money and the restructuring of bad enterprises. The programme was designed for state owned banks who had a problem with old enterprise debt, not for newly created privately owned banks, which did not have long standing ties and obligations with state owned enterprises. [Pawlowicz, 1994]

The program was designed by the Ministry of Finance, which had a choice between a centralized and a decentralized approach to the restructuring of banks and enterprises. If the former was chosen, a central agency would be placed in charge of the restructuring of both the bank and the enterprise sectors. Poland chose the latter, which meant that the main task of financial restructuring of bank and enterprises was assigned to banks themselves. The state's involvement was limited to a strengthening of the capital bases of banks involved in the restructuring programme, as well as to some direct control over the restructuring of state owned enterprises. [Kunik, Parfinowicz, Zebrowski, 1995]

Goals of the restructuring programme focussed on the situations of both banks and enterprises. In terms of banks, the objective was to clean up the credit portfolios of banks, solve the problem of bad loans, and improve capital bases of banks so as to make banks attractive for future privatization. In the enterprise sector, the programme was designed to accelerate the restructuring of enterprises. This included strengthening of those

enterprises deemed by banks to be able to survive in a market environment, as well as the elimination of those enterprises, which the banks found unable to adapt to market conditions. The elimination of unfit enterprises was expected to substantially decrease the amount of inter-enterprise arrears. [Dittus, 1994], [Kunik, Parfinowicz, Zebrowski, 1995]

The responsibilities of banks included a separation of doubtful and bad assets and the establishment of work-out units, which were charged with the preparation of debt management strategy. [Pawlowicz, 1994] In the end, banks were to be able to divide their debtors into two categories: those who had potential to survive in a market environment (group 1) and those who did not (group 2). The actions of banks toward each of these groups would be quite different. [Kunik, Parfinowicz, Zebrowski, 1995]

Banks were to assist enterprises in group one in changes which would allow them to better function in the market system. Measures to facilitate enterprise restructuring were to include changes in the terms of debt agreements, such as debt reduction, conversion of short term into long term debt or the granting of a grace period. Also banks could choose to engage in debt to equity swaps, which would make them directly involved in the enterprises' operations. Such conciliatory agreements were to lighten the enterprises' financial burden and allow them to focus on the adaptation of competitive market behaviour. [Pawlowicz, 1994]

Enterprises in group two were to be eliminated through the restructuring

programme, and banks were to focus on the recovery of as large a portion of their debt as possible. Group two enterprises were to either be liquidated, or their debt could be sold publicly. The consent of debtors was not required to implement either measure and the banks' secrecy laws were no longer binding. Debt could be sold neither to the debtor, nor to any of its affiliates. If debt was not paid within 30 days, the new holder had the option to convert this debt into equity at a very attractive rate. [Pawlowicz, 1994] This was done with the overall goal of privatization in mind, in the hope that new owners and new management might be able to revive enterprises in financial trouble.

The short time period and the methods used by banks, such as debt-equity swaps and sales of debt were very successful in that they forced banks to undertake investment activity and introduced market mechanisms based on the distinction between creditor and debtor.

Enterprises on the other hand were forced to seek professional advice from the outside in order to clear up their financial situation and regain credit worthiness. This was a very positive aspect in terms of introducing market forces into the operations of the enterprises. [Pawlowicz, 1994]

Also important was the change in the relations between banks and enterprises and the resulting change in their attitudes. Enterprises could no longer expect automatic extension of credit, nor did banks have to grant them. This became very clear during the restructuring programme. In some instances enterprises attempted to use political

pressure, but were rarely successful. Government bodies were not allowed to interfere in the restructuring programme. The ministry of finance was limited in its role to supervision of the banks (as their owner) and the interpretation of the law in case of lack of clarity. [Pawlowicz, 1994]

4. Mass Privatization Programme

The first step to privatization of banks was taken in May 1991, when the previously established nine large commercial banks were transformed into single owner partnership (with the state being the owner). By June 1991, the decision was made to privatize at least five of the nine state owned commercial banks within the following year. [Rudka, 1991] The privatization of nine regional state owned banks in Poland began in 1993 and was planned to be completed by the end of 1996.

Generally, the definition of privatization includes a shift of activity from the public to the private sector. In the case of Polish commercial banks, initially only some portion of ownership was to be transferred from the government to the private sector. More specifically, during the privatization of a state owned bank in Poland, the Treasury was to retain 30% of total shares of the banks with, however, only limited voting rights. Bank employees were offered 20% of shares on preferential terms. The rest of the shares was then to be sold to the public in two tranches; a small investors tranche and a large investors tranche. [Bonin, 1994].

In 1992 a Polish Bank Privatization Fund was created as a result of several donor countries shifting their contributions to the new fund from a previously established stabilization fund for the zloty, which was never used. The Bank Privatization Fund was to create an incentive to the government to privatize banks. Conditional upon an IMF standby program and an IBRD Enterprise and Financial Sector Adjustment Loan, the fund was to service the Treasury bonds issued to banks as they were privatized. [Dittus, 1994]

The benefits of privatization include an injection of fresh capital, an upgrading of technical and management skills and access to lower cost funding through economies of scale. [Bonin, 1994]

Polish state owned banks were privatized in the following order. The first was the Wielkopolski Bank Kredytowy (WBK.S.A.), which offered its shares to the public on March 15, 1993. The first day on which its shares were traded on the Warsaw Stock Exchange (WSE) was June 22, 1993. The second bank to be privatized was Bank Slaski S.A. W Katowicach, whose shares were offered to the public in October, 1993. They were first traded on the WSE in January 25, 1994. It turned out that the Initial Public Offer Price of Bank Slaski was 13.5 times lower than the price offered on the WSE. The third bank to be privatized was the Bank Przemyslowo-Handlowy S.A in Krakow, to be followed by Bank Handlowy [Bonin, 1994]

The Mass Privatization Programme was aimed at privatizing large state owned

banks. To facilitate the process, 15 National Investment Funds were created in order to manage the shares issued in the privatization programme. The programme was voucher based and allowed holders of vouchers to buy shares of large state owned banks at one of the 15 National Investment Funds. All 25 million adult citizens of Poland were eligible to participate in the privatization programme. They could apply for vouchers and after paying a nominal price, obtain them in early 1995. [Mullineux. 1995a].

In 1995, the Polish banking system still consisted primarily of state owned banks. although a large portion has been privatized. The efforts at privatization of all large state owned banks remain in place. [Mullineux, 1995a]

5. Institutional Arrangements

5.1. Clearing and Payments System

Prior to reform, bank branches held their current accounts with regional branches of the NBP. Since the clearing and payments system was paper-based and quite disintegrated, settlement between banks took anywhere from three to fourteen days. This was far too slow for the purposes of a market economy, and often invited fraudulent behaviour. In 1992, the National Bank of Poland began consolidating the current accounts of banks, allowing only head quarters of banks to hold reserves with the NBP. This centralized clearing and payment operations to some degree.

A fundamental reform of the clearing and payments system was undertaken only in 1993. Key points of the reform included the establishment of a National Clearing House, as well as a concentration of bank reserve balances in the NBP headquarters in Warszawa. [Osinski, Slawinski, 1994]

A National Clearing House (Krajowy Instytut Rozliczeniowy) was established in 1993. It replaced the existing system of interbank payments. It was created in the form of a joint stock company with primarily large state owned banks as owners. Smaller private banks must apply for membership. Applications are reviewed by the National Bank of Poland and fees are decided with the individual banks financial situation in mind. [Mullineux, 1995a]

Two settlement systems were introduces into the Polish system. The first was SYBIR, a paper based system, which was started in April 1993, and allowed foe settlement within two days. The second system was called ELIXIR, and was book entry based. It was started in 1994 and designed mostly for large "wholesale" transactions. [Osinski, Slawinski, 1994]

5.2 Regulatory and Supervisory Framework

5.2.1. Bank Supervision

In the Act of 1989, bank supervision was entrusted to the governor of the NBP. To relieve the governor of this duty, a General Inspectorate of Banking Supervision was created, after long discussion, which started in November of 1988. It began operations in the summer of 1990. Rules to be followed by the Inspectorate were modelled after standards of the European Union. This was partially, because Poland lacked its own experience on the basis of which regulations could be set, and partially because both the World Bank and the EU required that EU standards be applied. [Polanski, 1994]

5.2.2. Prudential Regulation

The first guidelines to prudential regulation were set in the form of "recommendations" from the NBP issued in August 1990. In 1991, the National Bank of Poland introduced a new Banking Chart of Accounts, which provided the banking system with accounting standards. Once again these were based on EU guidelines. By 1993, it turned out, that prudential regulation in Poland was more restrictive than in many other EU countries. [Polanski, 1994]

Financial Assistance

Poland received financial assistance from international financial institutions throughout the development of its reform programme. Poland had Stand-by-Agreements with the IMF in 1990, which were renewed in March and then again October of 1994. In 1991, Poland received a Compensatory and Contingency Financing Facility , as well as an Extended Fund Facility. By the end of 1994, Poland's overall debt to the IMF was 918.6 billion SDR. [NBP report, 1994]

The World Bank extended many loans for specific purposes, such as for instance the development of roads or the development of the agricultural industry. The most important in terms of this study was the EFSAL, extended in 1993 in the amount of 450 million US$. [NBP reports, 1993, 1994, 1995]

Furthermore, Poland was given help by the EBRD (European Bank of Reconstruction and Development) as well as the EIB (European Investment Bank). Help by these institutions was given in order to support the private sector through provision of credit, to finance investment projects which exhibit a great degree of innovation, to support the development of institutions necessary in a market environment and to finance the expansion of the NBP headquarters in Warsaw to allow for more effective functioning. [NBP report, 1995]

The Polish Bank Privatization Fund was a collection of donations from Sweden, Australia, Island, Finland, Great Britain and Japan. The amount of the fund toward at the end of 1994 was US$ 425.3 million. The first use of the fund was made in January, 1995. Prior to that date, several conditions attached to the fund had not been fulfilled. [NBP report, 1994]

Overall, Poland received financial assistance from many sources, not all of which have been mentioned in the above paragraph. Most funds available to finance Polish reforms came with many conditions attaches, which had to be met before the funds could be used. For the most part, these conditions consisted of meeting deadlines for the cleaning up of banks' balance sheets and the privatization of banks and enterprises were imposed, and "recommendations" were also made for the regulation of banks and the setting of performance requirements.

B. The Central Bank

In February 1989 a New Central Bank Charter was introduced. It defined the functions of the National Bank of Poland as being: to function as a central bank of the state, as an issuing bank, and a banker for banks. The new Central Bank charter gave the NBP broad powers to execute monetary policy without the obligation of submitting a detailed credit plan to the parliament for approval. [Pawlowicz, 1994]. However, the NBP is still obligated to cooperate with the government and ensure that its goals are

coordinated with the governments overall economic policy. [Wyczanski, Golajewska, 1995]

NBP became a central bank of a market economy, whose primary objective was to strengthen the Polish zloty. The NBP's main tasks included

- management of monetary and foreign exchange policies
- control over the Polish banking system
- licensing of bank activities
- granting of foreign exchange permits

1. Independence

Independence of the NBP from the government is particularly important during the transition period, when governments tend to change rapidly and the political situation tends to be highly unstable. [Kaszubski, 1994]

To strengthen the independence of the NBP from the government, a regulation was introduced granting a six year term to the governor of the Central Bank. The governor was to be called by the Seym after a proposal had been made by the president of Rzeczpospolita Polska [Kaszubski, 1994] The governor could be removed only due to resignation, illness preventing her from performing her duties, or a criminal charge.

[Wyczanski, Golajewska, 1995]

Even though the NBP was obligated to present its plans to the Seym and discuss monetary policy measures, the NBP alone set the assumptions underlying its goal and the means to achieve them. The Seym or any other government bodies cannot impose the direction of monetary policy on the NBP. Monetary policy must, however, be in accordance with general economic policy, particularly with financial policy and the budget. [Wyczanski, Golajewska, 1995]

2. Institutional Framework

2.1 Learning Skills

In order to give the National Bank of Poland skills which would be required by a market economy, Western Nations decided to extend their expertise and offered technical assistance. Each function of the Central Bank was closely monitored by a Central Bank of one Western Nation. The Bank of England assisted the NBP with monetary management and money market development. The Netherlands Bank shared its knowledge about monetary and balance of payments analysis. The Bank of France helped with establishing commercial bank supervision. The Austrian National Bank provided insights into central bank accounting. The Bundesbank helped pave the way for foreign exchange operations. And finally, the US Federal Reserve System aided in the upgrading

of the payments system [Rudka, 1991]

2.2 Supervision and Regulation

Originally, the governor of the Central Bank was obliged to undertake commercial bank supervision and regulation. To relieve the governor of this function, a General Inspectorate of Banking Supervision (GIBS) was created in 1990, as part of the NBP organizational structure. The Inspectorate was a department of the NBP, whose director was directly responsible to the governor of the Central Bank.

The tasks of the GIBS were to prepare a proposal as to prudential regulations; to define concepts such as bank capital, assets, risk, and to find a uniform method to calculate liquidity; to decide on allowable levels of bank risk and to prepare and introduce an auditing system, as well as an accounting plan for banks. [Kaszubski, 1994]

Commercial bank supervision was realized through analysis of quarterly bank reports as well as through on-site inspection, to ensure that banks have sufficient liquidity, that they extend credit and loans within guidelines of regulations, that there exist guarantees on repayment of credits and loans, and that the general financial situation of banks is intact. The goal of such inspection was to ensure the security of savings and deposits and bank behaviour within prudential guidelines. [Kaszubski, 1994]

Should the bank act against regulations, the GIBS had the power to direct the appropriate department of the bank to replace the director, manager or whoever was responsible for the bank's wrong doing. The GIBS could also limit the banks activities. [Kaszubski, 1994]

It is important to understand the precise nature of the NBP's supervisory function. It is crucial to keep in mind that commercial banks are now separate legal entities, who alone are responsible for their actions and thus also their failures. The NBP cannot be held responsible for failures of individual banks; its task is to focus on the stability of the banking system as a whole. Only if deposits are endangered or if a bank breaks the Banking Law, can the NBP intervene. Commercial banks thus cannot expect the NBP to assume responsibility for their losses.

3. Instruments

In the initial stages of transformation, the NBP relied on supervisory and control methods which were taken over from the planning system, such as credit plans, credit ceilings and interest rate ceilings. Over time the use of these has decreased, but they were kept as alternative tools in case monetary policy goals could not be achieved through other, indirect means. Gradually the NBP withdrew from using administrative controls and began to rely increasingly on instruments adapted to a market economy. The only administrative tool used are reserve requirements placed on commercial banks.

[Pawlowicz, 1994]

In 1989 the use of reserve requirements was quite popular. Reserve requirements were getting increasingly higher during that year. The side effects of this monetary policy tool were increased costs of operation for banks, which translated into higher costs of credit and higher bank spreads. [Kaszubski, 1994] In 1990 reserve requirements were used as one way of absorbing excess liquidity in the system. To begin with, a split reserve requirement was introduced. Later, the requirement was unified. Reserve requirements were subsequently increased to higher levels, and once again split requirements were instituted, where the required reserve rate on time deposits was lower than that required on chequing accounts. [Calvo, Kumar, 1993]

In order to restrict excessive credit expansion, the National Bank of Poland tried to use moral suasion in the first half of 1990. The response of commercial banks was not satisfactory so bank by bank credit ceilings were implemented in the second half of the year and they have been used since. [Calvo, Kumar, 1993]

In 1990, refinancing credit became popular as a policy instrument. Toward the middle of the year, the NBP shifted from refinancing credit to long term credit (which would have to be repaid in 1995), as well as rediscount and lombard credit. [Kaszubski, 1994]

In terms of the determination of interest rates, banks were allowed to set their own rates. The National Bank of Poland influenced some of the spreads between deposit and loan rates, however. [Calvo, Kumar, 1 993] For a long time, it was the rate on refinancing credit which commercial banks used as a reference rate, It took a while before they started looking at the rediscount rate as being the Bank Rate.

In mid 1990, the NBP began introducing instruments of monetary policy, which took effect fully through the market. The NBP started using open market operations. At a weekly auction, the NBP would sell short term securities of the NBP, and a short time later open the possibility of selling them back to the NBP. In 1991, the NBP securities were replaced by government Treasury Bills, primarily in order to cover the budget deficit. [Kaszubski, 1994]

4. Monetary Policy

Under central planning, the policy of the central bank was termed monetary and credit policy. Its name was changed to simply monetary policy at the onset of reform. The name change of course reflected an underlying desire to move away from credit planning and toward a monetary policy which relied on market instruments.

While the long term goal of monetary policy, similarly to the entire economic reform programme was the curbing of the rate of inflation and economic stabilization, the

immediate means to achieve this long term goal was primarily the control of the supply of money. Monetary policy was for the most part quite restrictive, although it was often loosened through commercial banks readiness to extend credit to state owned enterprises. Interest rate policy was geared towards ensuring positive real rates of interest.

In terms of its exchange rate policy, the NBP decided to fix the Polish zloty to the US$, in order to provide a nominal anchor and to counteract possible inflation. This was possible only through the stabilization of prices of imported goods, as well as the containment of inflationary expectations

This programme, although designed by Polish economists, was essentially the same as an IMF prescribed adjustment programme in terms of its assumptions and its logic. Both the creation as well as the realization of the programme were monitored and evaluated by the IMF. [Wyczanski, Golajewska, 1995]

Appendix 3

Names of the nine commercial banks that were branched off from the NBP:

1. Bank Gdanski in Gdansk
2. Bank Slaski in Katowice
3. Bank Przemyslowo-Handlowy in Krakow
4. Bank Depozytowo-Kredytowy in Lublin
5. Powszechny Bank Gospodarczy in Lodz
6. Wielkopolski Bank Kredytowy in Poznan
7. Pomorski Bank Kredytowy in Szczecin
8. Panstwowy Bank Kredytowy in Warszawa
9. Bank Zachodni in Wroclaw

CHAPTER 5

EVALUATION OF POLISH BANKING SYSTEM REFORMS

This chapter attempts to analyse the results of Polish banking sector reforms. Since problems with reforms prior to the implementation of the Enterprise and Bank Restructuring Programme have been discussed in the previous chapter, this chapter will focus on the restructuring programme itself, its success in terms of achieving its objectives, as well as some of its shortcomings. The Polish approach to bank reform is briefly compared with other approaches to see whether a different route may have been more appropriate.

A. Banks and Enterprises

1. Enterprise and Bank Restructuring Programme

The programme was designed to simultaneously target the problems of enterprise indebtedness to banks and to other enterprises and the consequent bad asset portfolio of banks. Its goal was to create a sound banking system, which would be able to free up capital used inefficiently in the public sector and channel it toward efficient uses in the private sector. The next section will analyse whether the restructuring programme was successful in its implementation.

2. Banks

2.1. Competition

One crucial feature of a sound financial system is a sufficient degree of competition. which we know did not exist prior to the restructuring programme. An increase in competition should lead to an increase in the range of financial services available, as well as a decrease in the spread between deposit and lending rates offered by banks.

Thus measuring the size of the spread to see whether it is falling should give us an indication of whether the degree of competition is rising. This measure is not perfect. It must be kept in mind that spreads are also affected by the size of reserve requirements. The higher are reserve requirements, the higher are costs to banks and the higher will be the difference between the rate at which banks lend money and the rate at which banks borrow money.

Reserve requirements have been held fairly constant at 10% of demand deposits throughout the years and should not have affected spreads to any great extent. Nonetheless, caution must be exercised when examining the spread between lending and deposit rates as an indicator of changes in the degree of competition.

Table 1

Deposit Rates, Lending Rates and the Spread

Year	Deposit Rate (%)	Lending Rate (%)	Spread (%age points)
1989	104	64	-40
1990	41.7	504.2	462.5
1991	53.5	54.6	1.1
1992	37.8	39.0	1.2
1993	34.0	35.3	1.3
1994	33.4	32.8	-0.6
1995	26.8	33.5	6.7

[IMF International Financial Statistics, 1996]

In reference to table 1 and graph 1 we can see that in 1989, the spread between lending and deposit rates was negative at -40%. Spreads seem to have peaked in 1990 at as high as 462.5 %. This figure can be attributed to the extremely high lending rate of 504.2%. Real interest rates after inflation are discussed on pages 122 and 130 of this chapter.

Between 1991 and 1993 spreads stabilized at around a low of 1%. Immediately after the implementation of the Enterprise and Bank Restructuring Programme, the spread turned negative again. This indicates that the deposit rate paid out by banks was higher than the lending rate charged by banks. It is hardly attributable to an increased degree of competition, since this situation would lead to banks being unable to cover their costs of operation. Hardly a situation enforced by an increase in free market forces. An increase

in competition may induce losses in individual banks, but should not lead to a negative spread in banks on the aggregate. The spread then rises again to 6.7% in 1995, due to an increase in the lending rate and a decrease in the deposit rate.

Overall it does not seem that measuring changes in the spread between deposit and lending rates can provide us with reliable insights into the growth of competitiveness between Polish commercial banks. We may also inspect the range of services offered by banks to various types of clients.

Table 2

Types of services offered by banks by client

Services/ Clients	Deposits	Credits	Domestic Accounts	Foreign Accounts	Mortgage Services	Leasing Services
Government		commercial 9 BH, BIG, PeKaO.S.A.		BH		
Financial Institutions	interbank money market participants	PBR, interbank money mkt participants	BGZ, GBW, GBPZ, BUG	Reiffeisen Centrobank		Central Leasing Associati on
Foreign Enterprises	foreign banks	foreign banks	BH, commercial 9 BRE, foreign banks	foreign banks		
Large Enterprises	commercial 9 BH	commercial 9 BH	commercial 9 BH	commercial 9 BH, foreign banks		Central Leasing Associati on

Small and Medium Sized Enterprises	BRF. BIG, Kredyt Bank, PeKaO.S.A., private banks, commercial 9	BRE, BIG, Kredyt Bank, PeKaO.S.A, private banks, commercial 9	BRE, BIG, Kredyt Bank, PeKaO.S.A., private banks, commercial 9	BRE, BIG, Kredyt Bank, PeKaO.S.A .		BEL Leasing, EFL, BRE Services, Kredyt Lease, Carcade, Nywig
High Income Individuals	BIG, Creditanstalt, Amerbank			Creditansta lt, Amerbank, PeKaO.S.A .	Creditans talt, BRE	
General Public	PKO BP, PeKaO.S.A., Invest Bank, PKBI, BBK, BIG Bank, commercial 9	PKO BP, Invest Bank, PKBL, Agrobank, WBC, BBB, BBK, Kredyt Bank, BOS, BPH	PKO BP, commercial 9	PeKaO.S.A .	PKO BP, PeKaO.S. A., BRE. commerci al 9	

[Auda, 1994]

Although table 2 does not provide us with a comparison of availability of banking services through time, it is nonetheless provides some useful insight.

Firstly, if we assume, that increased competition is reflected in an increased number of banks engaged in a particular type of activity, we can see that the degree of competition varies greatly with the sector of the economy being serviced.

The highest number of bank services is catering to the private market for the general public as well as small and medium sized enterprises. Activities are concentrated on deposit taking from and lending to the general public and small and medium sized

enterprises, and payments settlements between small and medium sized enterprises. Most banks participate in these areas, including the nine large commercial banks (formerly all state owned). Note that the latter do not extend credit to the general public.

Large, predominantly state owned enterprises are serviced by the nine large commercial banks. Ties between them have apparently not been broken and may even have been strengthened by the restructuring programme. Mullineux [1995] believes that inspite of the restructuring programme, state owned banks are still reluctant to lend to small and medium sized private enterprises. Instead, they remain tied to state owned enterprises. This he attributes largely to the nature of the restructuring programme, which required cooperation between large state owned banks and state owned enterprises. The solution to the problem of unbroken ties may be full commercialization and privatization of state owned banks under the Mass Privatization Programme. As will be discussed in more detail, privatization is progressing much more slowly than expected and was not yet fully under way in 1995.

Competition in this area has not increased. If we assume that large state owned enterprises comprise the bulk of business of the nine large commercial banks, we can conclude that the degree of competition between these banks is still low. We know that competition among them is limited due to their regional structure, and competition from other banks does not seem to have increased. As previously noted, the newly created private banks are often too small to pose any kind of competition to large formerly state

owned banks.

The fact that activities vary between the nine large commercial banks and other small commercial banks may have contributed to the situation of negative spreads. Large banks may have been able to offer lower lending rates of higher deposit rates than could small banks. An uneven distribution of activities may have resulted in an average negative spread. Unfortunately, detailed data on differences between rates offered by various banks are not available to the author.

2.2. Experience

It seems quite impossible to find a measure of experience. which would allow us to assess the performance of banking staff prior to and after the restructuring. It is not unreasonable. however, to assume that banking staff was forced to acquire and use new skills, while implementing the restructuring programme. An overall assessment of the programme's performance will, in a sense, tell us whether the people responsible for its administration performed well. We can then assume that skills have improved, and continue to improve. If the restructuring programme was not successful in its objectives. then it may partly be due to a lack of increase in experience and expertise on the part of the banking staff.

It is also clear from the previous chapter that extensive efforts were put into

training of current staff, as well as future staff. The amount of banking education which took place during the years of the reform will certainly result in increased knowledge and expertise to some degree.

3. Enterprises

3.1. Bad Debt of Enterprises

Table 3

Share of irregular credits in total credits of commercial banks

Month	Below standard credits	Doubtful credits	Unrecoverable credits	Total of bad credits
Dec 1994	6.0	4.0	17.3	28.3
Dec 1995	5.0	3.4	13.1	21.5
Mar 1996	4.5	2.8	12.0	19.2
Jun 1996	4.3	2.0	10.9	17.3
Aug 1996	3.9	1.7	9.5	15.1

[NBP Report on Inflation, 1996]

Table 3 and graph 2 show us, that the share of all types of bad credits have been decreasing, and thus have the number of total irregular credits as a share of total credits in the years following the restructuring programme. In the two years after the implementation of the programme, irregular credits have fallen from 28.3% to 15.1% of total credits. which constitutes a 13.2 percentage point drop. It is obvious, that banks

credit portfolios have been continuously improving after the restructuring programme. This may be attributed to improvements in the financial situation of enterprises. As the Polish Central Statistical Office (GUS) tells us in table 4, there has been an increase in the net financial position of enterprises.

Table 4

Net Financial Position of Enterprises

Year	Net Financial Position of Enterprises (revenues - costs) millions (old zloty), hundreds (new zloty)
1992	- 3619.7
1993	- 1566.5
1994	4896.6

[GUS, 1995]

As a result of the improvements in the financial position of enterprises and consequent improvements in the portfolios of banks, banks' credit activity has increased in 1995. As can be seen in more detail in the discussion of monetary policy during the years of the restructuring programme, credits to the non financial sector accounted for 55.9 % of money creation in early 1996, as compared to only 25.8 % in 1992. Credits to enterprises fell during 1992, due to the poor financial records of enterprises and reluctancy of banks to lend to those enterprises, and possibly due to increased borrowing by the government. The steady increase in credit activity towards the enterprise sector, as well as to the private sector, can safely be attributed to an increased confidence in that

sector by banks.

The fact that credit to the non-financial sector increased does not per se show, whether capital has been freed from inefficient uses in the public sector and channelled toward efficient uses in the private sector. No distinction is made between credit to public and credit to private enterprises. In an attempt to evaluate the effectiveness of the restructuring programme in terms of channelling capital from inefficient to efficient uses. the following data may be used.

Table 5

Allocation of Credit between Sectors
Commercial Bank Credit

year	Credit to the Government	% of total	Credit to Public Non-Fin Enterprises	% of total	Credit to the Private Sector	% of total
1989	403	11	3061	84	199	5
1990	1321	10	10105	77	1719	13
1991	7445	28	10379	39	8979	33
1992	12037	33	11770	32	13111	36
1993	19278	37	14252	27	19022	36
1994	27402	40	16757	24	25165	36
1995	39299	41	20342	21	36700	38

Table 5a.
Central Bank Credit

Year	Credit to the Government	Credit to Public Non-Fin. Enterprises	Credit to the Private Sector
1989	595		
1990	601		
1991	4365	51	5
1992	12170	8	15
1993	15729	6	21
1994	19530	3	20
1995	11534	3	19

[International Financial Statistics, 1996]
Note that beginning Dec 1991, financial data are based on a new system of accounts and an improved reporting system.

From Tables 5 and 5a, as well as graphs 3 and 3a, we can see that commercial bank credit to all three sectors has been rising up until 1995. Central bank credit to the government started to decline only in 1995. Central bank credit to public enterprises has been falling throughout the period between 1992 and 1995, and credit to the private sector was rising until 1993 and fell in the following two years. Central Bank lending to the enterprise and the private sectors is negligible and largely irrelevant to the analysis.

As a percentage of the total credit extended, credit to the government has been rising throughout. Credit to enterprises as a percentage of total credit feel sharply in 1991 and has been declining thereafter. Credit to the private sector has been increasing, but at a decreasing rate, with almost no change between 1992 and 1995

In terms of channelling financial resources from public to private uses, we can conclude that the restructuring programme has been successful. Credit to non financial public enterprises by commercial banks decreased. Also , the proportion of credit extended to the private sector definitely increased. If overall domestic credit must increase due to inflationary pressures as well as overall economic growth, then it is a good sign that the proportion of private credit is increasing. It is possible that credit to the private sector could have increased even more, and did not at the expense of government borrowing. Nonetheless, the share of credit to private enterprises increased . and in that sense, resources are being reallocated from the public to the private sector. This is a desired result if we assume that the private sector makes more efficient use of credit than does the public sector.

Central bank lending to enterprises, both public and private is not one of the functions of the central bank. We can see that central banks lending to those two sectors has been negligible. Lending to the government is generally included in the catalogue of central bank activities. The fact that lending to the government both by the central bank and by commercial banks has been steadily increasing, except for central bank credit in 1995, arouses the suspicion that credit to the private sector may have been crowded out.

This set of data seems to indicate, that the programme was successful in terms of freeing up resources for more efficient uses. Schroeder does not agree. He believes that state owned banks continue to lend to inefficient enterprises in order to prevent a

financial disaster of their own. Thus capital, which could be used productively by small or medium sized enterprises is used for non productive purposes instead. Private investment projects, as well as the creation of small and medium sized enterprises is discouraged through the lack of capital. [Schroeder, 1995] Although Schroeder does not provide an alternative set of data, he nonetheless instills doubt about the success of the restructuring programme.

3.2. Enterprise Selection

Two other objectives of the Enterprise and Bank Restructuring Programme were to restructure those enterprises, that were found to be able to survive in a competitive environment and to eliminate those enterprises unable to survive.

The elimination of inefficient enterprises included bankruptcies. 38% of which were of state owned enterprises and public debt sales. Banks put on sale the debts of 378 enterprises. over 200 of which were state owned. It turned out that debt sales allowed for recovery of more money than did bankruptcies. They also required small financial resources and were quite a fast procedure. Thus the elimination of unwanted enterprises took place fast and efficiently. In this respect, the restructuring programme can be evaluated as having been successful.

However. the over 200 state owned eliminated enterprises were estimated to give

employment to more than half a million workers. [Dittus, 1994] Thus the bankruptcy or liquidation of enterprises, which had been taught to rely on a continuous flow of credit as a form of budgetary subsidy, translated into a large number of jobs lost. The effects of the restructuring programme on unemployment were thus far from positive. On the contrary, a large amount of unemployment was created. Increased unemployment is not only undesirable from the point of view of the unemployed, but also from the point of view of the budget. An increased number of jobless citizens means a higher strain on the budget in terms of unemployment insurance and other forms of social assistance and reduced tax receipts. This may be one of the reasons for the observed increase in credit extended to the government, although as will be discussed later, government borrowing began to decline in the years following the restructuring programme.

A successful restructuring of viable enterprises would be reflected in an improved financial standing of existing enterprises, as well as in a fall of interenterprise credits. Tables 3 and 4 show us, that the amount of bad credit to enterprises has fallen, and that the financial situation of enterprises has indeed improved between 1992 and 1994, respectively.

3.3. Interenterprise Credit

A third objective of the restructuring programme was the limitation of interenterprise arrears. Some growth of interenterprise credit is said to be inevitable and

quite natural to a market economy. Its level appears to increase in times of economic slowdown. The degree of interenterprise indebtedness, however, should be held within limits. [Mullineux, 1995]

There seems to be a general agreement, that interenterprise credits have decreased since the onset of the restructuring programme. Although Pawlowicz believes that it is too early to make a final judgement about this, Dittus, on the other hand contends that the programme was in fact successful in terms of imposing prudent behaviour on enterprises and limiting arrears between them. The situation could easily have been different, if banks decreased credit to enterprises as they did. but banks refused to behave more prudently. Interenterprise arrears would have increased in that case.

4. Mass Privatization Programme

As already mentioned, the progress of the privatization programme is going much slower than was anticipated. Three state owned banks have been fully privatized so far, and a fourth is in the process. Their privatization did not go smoothly, as discussed in the previous chapter, and several problems surfaced. One may say that without errors, Poland would not learn, or that learning by doing cannot ever be frictionless. However, in the area of privatization, it seems that much remains to be learned. The small number of privatized banks is witness to this.

The particular case of privatization of Bank Slaski is quite controversial. Some believe that it was a great success, others contend it was a complete failure. The peculiar circumstances surrounding the privatization may explain this lack of agreement. The fact that Bank Slaski attracted a new foreign partner, ING, is regarded as a strong affirmation of positive future prospects, and thus an indication of success. [Bonin, 1993] The highly underpriced shares, on the other hand are often cited as an indication of failure. Bank Slaski is one of the very few banks that actually underwent privatization, others did not even make it that far.

It may well be that Polish state owned banks are not very attractive to potential new owners, since they are not yet fully efficient. We have seen that they display a lack of competition and that the range of services they offer is quite limited. Also, although decreasing, irregular loans still do plague their portfolios. And finally, the unstable situation of the Polish economy, which is described in later sections, may deter potential new owners. They may be waiting for stability and thus a larger degree of certainty before they decide to acquire large state owned banks. and make fit them for the market.

5. Regulatory and Supervisory Structure

Improvements in the financial positions of commercial banks, as well as the positive results of the restructuring programme in terms of interenterprise debt and bad debt with banks, are indicative of a well functioning regulatory and supervisory structure.

Without effective regulation, a comprehensive restructuring programme would not have been possible.

There are however some shortcomings to the new regulations. The imposition on Eastern European economies in transition of prudential regulation laws which were modelled after laws designed for advanced Western European economies, created problems. Often banks were unable to comply with the new regulations and were forced into bankruptcy.

If banks cannot comply with new regulations, because of the large gap between old and new standards, then supervisors have two choices. Either they can close banks, as threatened, or they can forbear. The first option is unattractive, because it is quite costly to the banking system. The more banks have trouble keeping up with new regulations, the less attractive is bankruptcy as a solution. The second option becomes relatively more attractive, when a large number of banks are unable to comply. However, forbearance may lead to a loss of credibility of supervisors and a loss of confidence in the entire programme. It may also create a moral hazard problem, if banks no longer feel that accepting and following the new high standards is crucial to their survival.

But a moral hazard problem may be created even if supervisors do not forbear. Banks may attempt to hide losses in order to avoid forced bankruptcy. This problem is increased the tougher are the regulations. The new regulations were originally designed

for Western economies with mature capitalist banks. Adoption of strict standards makes the task of supervision more difficult. The higher is the incentive for banks to cheat the higher is the cost of supervision and enforcement to authorities. When the supervisory structure itself is in the process of developing it may not be wise to increase the difficulty of its tasks.

Understanding this is crucial in terms of the performance evaluation of banks in transition. If standards are set too high, then a restructuring programme is setting itself up for failure. The high standards were chosen not because they were proven to be effective in transitional economies, but rather because they were recommended by the IMF as well as the EU, which Poland wants to join.

6. Clearing and Payments Settlement System

The characteristics of a well functioning clearing and payments system include timeliness, reliability, safety, efficiency and ease of use. The increase in timeliness from a week to two days, as in the case of the Polish system is a definite indication of substantial improvement. This may be an indication that experience in this area has increased. An effectiveness of the clearing and payments settlement system will also allow for more efficient transactions processing. The system is an underlying structure. which is necessary but not sufficient for the creation of a sound banking system.

B. Central Bank

1. Monetary Policy

One of the necessary conditions for the economy in which a banking and enterprise restructuring is supposed to be successful is macro economic stability. Monetary policy action is one of the major determinants of stability. Thus it is important to look at the direction of monetary policy in the years of the restructuring programme and thereafter. It is important to note that monetary policy action is more successful the more independence the Central Bank has from other agents in the economy in terms of pursuing monetary goals. It is thus important to inspect both the path of the money supply, as an indicator of monetary policy processes, as well as the determinants of money creation in the economy.

The path of the money supply can be seen in graph 4 whose figures are given in the following table:

Table 6

Money Supply Growth and Inflation

Year	Money Growth	CPI Inflation
1989	253.6	247.7
1990	401.1	553
1991	14.4	76.7
1992	38.8	45.3
1993	31.3	36.9
1994	39.7	33.3
1995	36.4	26.8

[International Financial Statistics, 1995]

In reference to table 6 and graph 4 we can see, that the growth of money supply was trailed by the inflation rate. That prices and money supply move hand in hand is to be expected, the question is which causes which. The sharp drop in the inflation rate in 1990-1991, which occurred along with the introduction of a strongly restrictive monetary policy may demonstrate that in fact monetary growth preceded inflation. We can then speculate that monetary policy was successful in containing hyperinflation in the early 1990's. It was not however, successful enough to bring inflation down much below 30 %, which is still quite a high rate of inflation. The reasons for insufficient tightness of monetary policy may be found by looking at the sources of money creation.

2. Sources of Money Supply Creation

In terms of its major determinants, including not only domestic but also foreign factors, the creation of money can be divided into three phases. Phase One was 1992-1994, when the main source of money creation was credit extension to the budget. Phase Two was 1995, when the main determinant of money creation seemed to be the inflow of foreign capital. In Phase Three, 1996, credit to the non-financial sector including enterprises and private individuals was the primary source of monetary expansion.

Table 7

Sources of Money Creation (in %)

	1992	1993	1994	1995	1996 (a)
Total	100.0	100.0	100.0	100.0	100.0
Net Foreign Assets	25.9	17.5	32.9	58.5	33.3
Net Budget Indebtedness	48.3	47.1	37.2	3.7	10.8
Credit to Non-Fin. Sector	25.8	35.4	29.9	37.8	55.9
a. enterprises	23.5	30.9	26.0	31.9	41.4
b. private individuals	2.3	4.5	3.9	5.9	14.5

(a) January - October
[NBP Report on Inflation, 1996]
Also refer to graph 5.

2.1. Phase One: Credit to the Budget

Along with the increase in government borrowing came a substantial decrease in

credit to the non-financial sector. It was already mentioned that in 1992, enterprises were faced with a credit crunch. It is now possible to identify increases in government borrowing as being one of the causes of the credit crunch, along with the increase in enterprises' bad assets which led to banks' reluctance to lend to enterprises. During 1993, the problem of bad enterprise assets in banks' portfolios began to diminish, and lending to the private sector started to rise.

Government borrowing during that period may have also partially been caused by the lack of credit to enterprises. Enterprises were for the most part state owned and the government may have felt responsible for their survival, thus extending subsidies. Also, bankruptcies of some enterprises contributed to the number of unemployed people, who required unemployment insurance or other forms of social assistance from the government. Thus the causation may run both ways. Increased government borrowing may have crowded out the enterprise sector, while on the other hand, the poor financial situation of enterprises may have contributed to increased government borrowing.

Government borrowing began to decrease in 1994. This may be attributed to reforms in the tax system and structure, which allowed for higher and more stable revenues to the government. Also expenditures were cut, especially those on unemployment insurance, pensions, family allowances and disability insurance. By 1995, credit to the budget ceased to dominate monetary creation.

2.2. Phase Two: Net Foreign Assets

Between 1992 and 1996, credits to the non-financial sector have been on the rise, although they did not account for the bulk of money creation, although they did account for close to 40% of money creation in 1995. In that year, credit to the budget decreased substantially, to 3.7% of total monetary expansion, as a result of the demand for government securities by domestic as well as foreign investors increasing greatly, which also meant a greater role for the banking sector in the managing of the budget deficit. Net increase in foreign assets were responsible for the remaining 58 percent of money creation.

Increased interest in Polish government bonds on the part of foreign investors greatly facilitated the financing of government budget, yet at the same time hampered anti-inflationary monetary policy. The resulting inflow of foreign capital into the country accounted for a major part of money creation., and made it harder for authorities to keep monetary expansion under control.

Alongside an increased demand for Polish government securities, both domestically and abroad, came increases in the demand for Polish goods and services in foreign markets. Foreign capital inflow increased as a result of these developments, and Polish production increased at a phenomenal 7% in 1995.

Table 8

Nominal GDP and nominal GDP growth

Year	Nominal GDP, millions (old zloty), 100's (new zloty)	Nominal GDP growth
1989	11832	299
1990	56027	373
1991	80883	44
1992	114944	42
1993	155780	36
1994	210377	35

[IMF International Financial Statistics, 1996]

Note that beginning in 1990, data have been revised significantly. Therefore caution is advised when comparing pre 1990 to post 1990 data.

It may be more useful to look at the growth of the real GDP as opposed to its nominal values. Problems with data availability, however, present some difficulties. Table 8a includes the authors own calculation of real GDP values done on the basis of nominal GDP values as reported bu the IMF International Financial Statistics and a GDP deflator, as reported by the Polish Central Statistical Office (GUS). The GDP deflator is available for the years 1990-1994 only.

Table 8a

Real GDP and real GDP growth

Year	GDP deflator (1990=100)	Real GDP	Real GDP growth (%)
1990	100	56027	
1991	155.3	52081.7	-7.04
1992	215.1	53437.5	2.60
1993	280.7	55496.9	3.85
1994	360.4	58373.2	4.92

[IMF International Financial Statistics and GUS]

The increase in demand for exports may be in part explained by the relative situations of Poland and her neighbours. Relative to the west, significant differences prevailed between prices of goods and services, despite attempts to increase Polish price levels to western levels. To the East, the lack of goods and services in countries of the former Soviet Union may have contributed to their increased imports from Poland.

The effects of an increased demand for Polish exports of goods and services and for Polish bonds on the net foreign assets situation were amplified by a "crawling peg" regime on the foreign exchange market. All this posed serious obstacles in the pursuit of monetary policy goals of reducing inflation.

2.3 Phase Three: Credit to the Non-Financial Sector

In 1996 the role of net foreign assets in terms of money creation fell, government borrowing increased again and for the first time since the implementation of the Enterprise and Bank Restructuring Programme credit to the non-financial sector accounted for the bulk of monetary expansion.

Foreign capital inflows may have decreased due to the Central Bank putting an end to portfolio investors' expectations of an appreciation of the Polish zloty. The National Bank of Poland announced that it planned on keeping the zloty stable in real terms. Portfolio investors began to leave the Polish securities market soon after this announcement.

From the point of view of money creation the key phenomenon in 1996 was the increase in credits to the non financial sector, which started in 1995. Between January and October 1996 non-financial sector credits increased nominally by 25.5%, while credits to private individuals rose nominally by 67.2% and to enterprises by 21%. The NBP estimates that the **real** increase in lending to the non-financial sector during the first three quarters of 1996 was 4.% in the first, 6.0% in the second and 8.5% in the third quarter (using the producer price index as the deflator).

Thus since 1994, visible increases in commercial bank credit activity can be

attributed primarily to the improvements in the banks' financial standings. Referring back to table 3 we can see that the share of irregular credits in total credits of commercial banks fell and thus the credit portfolios of banks became much cleaner.

3. Central Bank Independence

The degree of independence of the Central Bank is difficult to measure. We can, however, infer from developments described in previous sections that the NBP's autonomy in terms of monetary policy could have been higher.

During all three phases of post-restructuring programme monetary policy, different sectors of the economy exerted great influence over the direction of monetary policy. The level of credit expansion was not exogenously determined by the NBP but rather influenced by endogenous factors within the economy. The budget demanded credit during Phase One, foreign capital inflows resulted in increased money creation in Phase Two and the non-financial sector, including enterprises and private individuals demanded credit in Phase Three.

Thus during that time the NBP was never really independent in terms of being able to pursue anti inflationary goals of monetary policy. Instead of being able to restrict money creation, the NBP had to respond to the need of various economic agents. This greatly hampered its independence.

What needs to be improved in the operations of monetary authorities is the use of open market operations. It has been mentioned before that open market operations are the best available monetary policy instrument, as they do not interfere with the market. However, in order to prevent excessive expansion of the money supply, open market operations should take place on the secondary market. Unfortunately, a secondary market for government securities has not yet fully developed in Poland. and open market operations make use primarily of the primary market. A well functioning secondary market is soarly needed if monetary policy is to contain monetary growth in an attempt to reduce inflation.

4. Macroeconomic Stability

Requirements for macroeconomic stability are the persistence of a low and stable rate of inflation as well as positive real rates of interest and equilibrium levels of exchange rates. We can inspect inflationary processes during the years of transformation to see whether the inflation situation has been improving. Furthermore, we can use the refinancing rate along with the rate of inflation to see whether real rates of interest have been positive.

Table 9

Inflation and Real Interest Rates

Year	CPI Inflation	Real Lending Rate	Real Deposit Rate
1989	247.7	-183.7	-147.7
1990	553	-48.8	-511.3
1991	76.7	-22.1	-23.4
1992	45.3	-6.3	-7.5
1993	36.9	-1.6	-2.9
1994	33.3	-0.5	0.1
1995	26.8	6.7	0

[International Financial Statistics, 1996]

From the table 9 as well as graph 4 it is apparent that inflation in the Polish economy is still quite high . Although it has been brought down from its highest levels of 247.7% in 1989 and 553% in 1990, it is nonetheless still around 30%. It seems however, that the rate of inflation has been consistently falling since 1990, which may be attributed to restrictive monetary policy, and possibly to other factors, such as increases in production levels.

The situation with real interest rates is far from being satisfactory (also refer to graph 6). Real interest rates remained negative throughout these years. Deposit rates became positive in 1994, at a very low 0.1 % and dropped to zero in 1995. Lending rates moved to the positive side in 1995. Data are not sufficient to predict positive interest rates in the years following 1995. Negative or very low real interest rates could indicate that government involvement in the financial sector is still too high and that interest rate

ceilings and other restrictions remain in place. The problem could also be attributed to the fact that the National Bank of Poland has been unable to contain inflation sufficiently, probably due to other obligations of monetary policy. Thus the lack of central bank independence may have been a large hindrance in the pursuit of anti-inflationary policy, enough to prevent it from being successful. Another possibility is that the banking sector has not developed enough to be able to properly channel monetary policy throughout the economy. This would then indicate that the restructuring programme has failed to produce an efficient banking sector capable of transmitting monetary policy signals.

The requirements for macroeconomic stability of a low and stable rate of inflation and positive real rates of interest have not been met. In an unstable environment it is even harder for new private banks and enterprises to survive, and for previously state owned banks to fully rely on the forces of the market. The creation of a sound and efficient banking system is made more difficult when the rate of inflation is high and real rates of interest are negative. Conversely, the effectiveness of monetary policy is decreased when the banking sector cannot channel policy signals properly, and thus the achievement of macro economic stability is made more difficult. This is the same circle of problems that Poland had been faced with since the onset of reform. It seems that progress is being made, since definite improvements in the situation can be identified. Although the economy is still not stable, it is more so than it was in 1989, and the banking sector has increased in efficiency since that time. Thus although there is a long way to go yet, efforts have been fruitful and progress is being made.

5. Foreign Assistance

Poland received very large amounts of financial assistance both financial and technical. Loans were extended from the IMF and the Word Bank, the EBRD, the EU and many other organizations and grant assistance was also offered and help was provided with restructuring tasks at hand. Generally, Poland's performance in terms of the macro economy is judged quite well, as her rates of growth of output exceed those of other countries in transition. But problems remain with relatively high rates of inflation and unemployment.

Foreign financial assistance is usually accompanied with technical advice. In fact, loans from the international financial institutions have attached a set of policy measures upon whose implementation the loans are conditional. Also in the case of Poland, the IMF and World Bank prescribed a set of policies similar to those usually prescribed in developing countries of various regions of the world. Poland was asked to implement restrictive monetary and fiscal policies, to devalue exchange rates, to liberalize trade and prices and to remove government subsidies. These policies were in fact implemented, and generally claimed to have been chosen by Poland herself.

Also in the area of banking reforms, international financial institutions as well as the European Union had their say. The general push was towards financial liberalization in the form of removing interest rate distortions, as well as privatization of commercial

banks. The strategy was followed, only to discover that mere liberalization of interest rates and removal of government involvement was not enough to do the trick. Problems carried over from the previous era emerged, such as a stock of bad debts in banks' balance sheets and a large amount of interenterprise arrears. It became clear that bank reform cannot be divorced from enterprise reform. As well, it became apparent that major institutional changes were required, payments systems were inadequate, regulation and supervision were too disorganized and banking personnel needed to be trained.

Foreign helpers did not give up, but instead designed an Enterprise and Bank Restructuring Programme, aimed to address the financial troubles of banks and enterprises simultaneously. Or perhaps it was the Polish Minister of Finance who officially designed the programme, which just happened to coincide with the World Bank's own ideas enough that it was heavily funded by the institution? In any case, programme design required extensive knowledge of the situation of individual Polish banks and enterprises and the workings of the financial system as a whole. Supervision of the programme called for close monitoring of banks, their balance sheets and their relations to enterprises, other banks and the central bank. In other words, foreign involvement allowed international financial institutions, as well as members of the EU, to inspect Poland's finances throughly.

The National Bank of Poland was not spared good advice. All departments of the Polish central bank came under close inspection of the central banks of one Western

country. Thus for instance England gained extensive knowledge of the NBP's monetary management and money market situation. Germany became an expert on Polish foreign exchange operations. Others were given access to the records of other NBP departments. The reward for advice extended was a detailed familiarization with Polish central bank operations, commercial banks structure, financial standing and future prospects. The Polish financial system became an open book, with no secrets and thus no possible surprises. What better way of controlling a potential competitor than keeping a finger on her finances?

6. Problems with the Restructuring Programme

The Enterprise and Bank Restructuring Programme is generally seen as a success, especially in terms of its objectives, which were those suggested by foreign advisors. What is mentioned less often are the ridiculously high standards and though regulations that were set and the very short time given to individual banks to comply with them . As already discussed, standards set too high cause problems.

Also, the fact that enterprise restructuring has put many people out of work without necessarily providing them with an alternative is generally not addressed. The implicit assumption is that once funds are freed from inefficient uses in old state owned enterprises, they will be channelled toward the newly emerging private sector and used efficiently. Thus any unemployment created during the process of restructuring old state

owned enterprises should easily be absorbed by the new private sector. However, all workers, much like banking staff and policy makers, may not have the training and skills necessary to fit into the private sector. Also they must be taught new forms of behaviour and learn how to survive in a market environment. A person who was pushed through the polish socialist education system and placed in a job for the next thirty years, performing a task which was either productive or completely redundant, cannot be expected to suddenly be able to look and successfully find an alternative job. Much less will these persons skills be up to date and required in newly created businesses and firms. Bank reforms, which pulled along reforms of enterprises paid no attention to the problem of unemployment which the general public would be faced with.

Table 10

Unemployment

Year	Total # of unemployed (1000's)	Rate of unemployment
1990	1226.1	6.3
1991	2155.6	11.8
1992	2509.3	13.6
1993	2889.6	16.4
1994	2838.0	16.0

[International Labour Statistics Yearbook, 1995]

The rate of unemployment has increased into the double digits in 1991 and has remained high thereafter. Caution is advised when working with data on unemployment as it is a self reported type of data. Only those who report themselves as unemployed are

counted. Reports usually take the form of applications for assistance on the basis of being out of work and looking for work. Thus the proportion of those unemployed who do report themselves will be greater, the greater the incentive to apply for assistance, or the greater the amount of available assistance. Polish unemployment insurance and other forms of social assistance are quite low, and may not provide much of an incentive for reporting. Thus unemployment data may well be underestimated.

It is hard to say whether unemployment has indeed increased as a direct result of the restructuring programme, since data are available only up to 1994, one year after the implementation of the programme. But we can see that unemployment is a great problem in the Polish economy; it was ignored by the restructuring programme and may have even been increased by it.

7. Future Prospects

The Polish decentralized approach to enterprise and bank restructuring is most often compared with the Hungarian approach. Hungary opted for gradualism in their overall economic reform, as opposed to the Polish "Big Bang" approach. In terms of banking reforms, Hungary adopted a centralized restructuring programme, which is often said to have had little success.

In Poland a comprehensive approach to enterprise and bank restructuring was not

adopted until 1993. Prior to that time, some initial steps were taken in the right direction, and some in the wrong direction. Generally, it was a period of experimentation, and measures taken were not organized and focussed on specific goals.

Only in 1993 did Poland develop a detailed plan with specific objectives and guidelines to be followed. It would then seem that the evaluation of progress should begin at that time and not prior to 1993.

Evaluation should not be too harsh, keeping in mind the ridiculously high standards. Standards should in fact be lowered in the beginning stages of reform, and then gradually increased, as banks clean up their balance sheets, smooth out their operations, and acquire market survival skills. The acquisition of skills takes time and this should be allowed for.

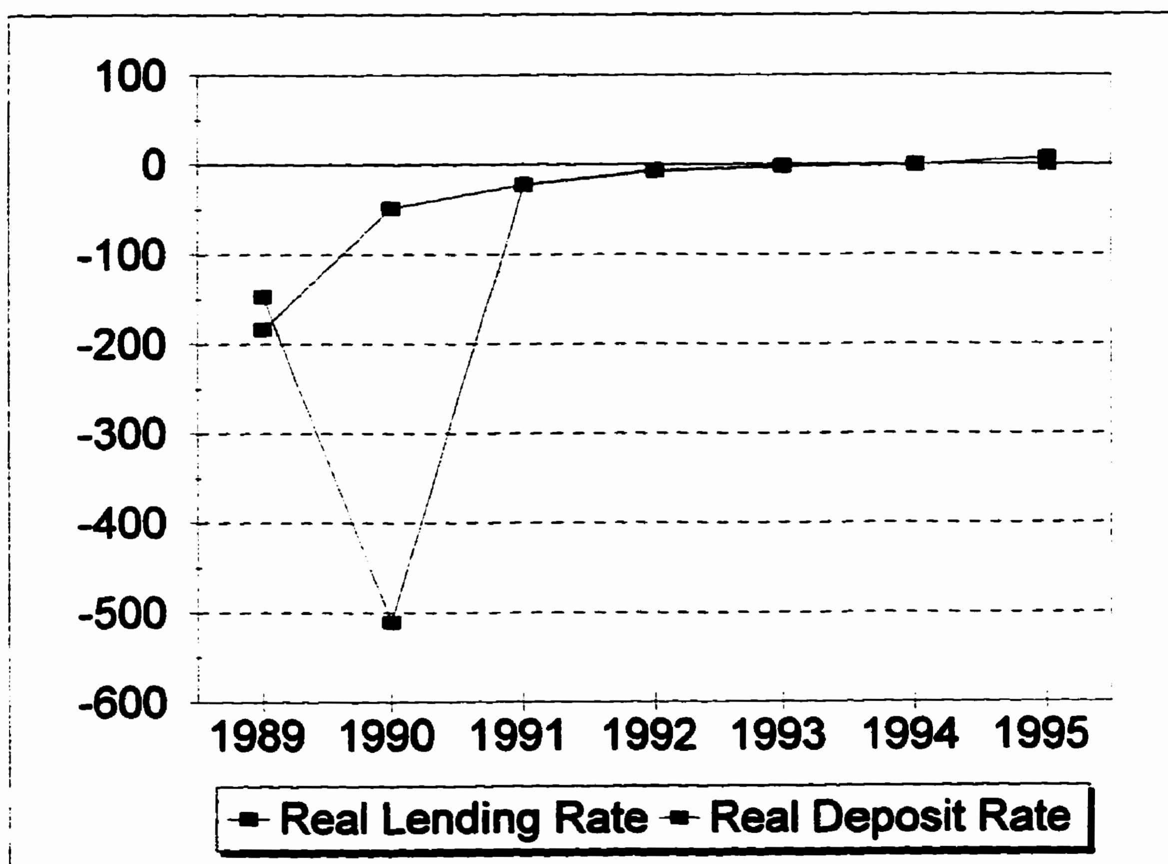
Only four years have passed since the reform properly started, a period just sufficient to fully educate new banking system employees, managers and directors. During this time, those employed by banks partaking in the restructuring programme, and those supervising the pogramme's implementation were in the process of learning and acquiring new skills. They were forced to take crash courses and do most of their learning by doing. Some employees and supervisors were foreigners, and only a few anticipated a growing demand for banking specialises and began acquiring their education prior to 1993, in the few schools available at the time.

1996 may thus have marked the year in which a new push was given to banking reforms. With the fresh influx of educated human capital, reforms should speed up.

The direction of reforms should be changed slightly in order to incorporate concerns about the growing number of unemployed people, maybe through a more gradual approach. Also those people, who lose jobs as a result of enterprise restructuring should be allowed sufficient time to retrain and look for new employment. Thus reforms should be patient. Enterprise restructuring should not be a slash and burn process, but rather opt for a gradual elimination of redundant employment positions. More time is required in order for reforms to be more successful, and more time should be allowed.

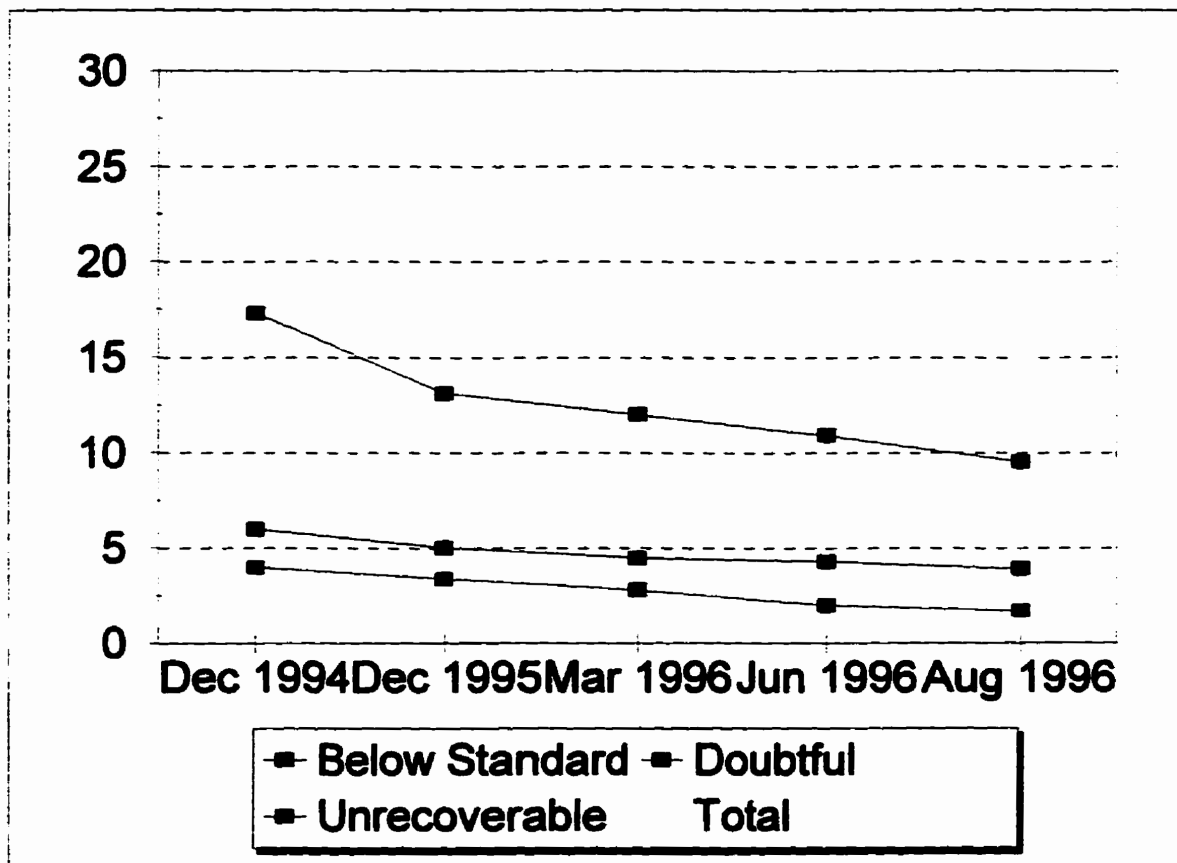
Graph 1

Deposit Rates, Lending Rates and the Spread



Graph 2

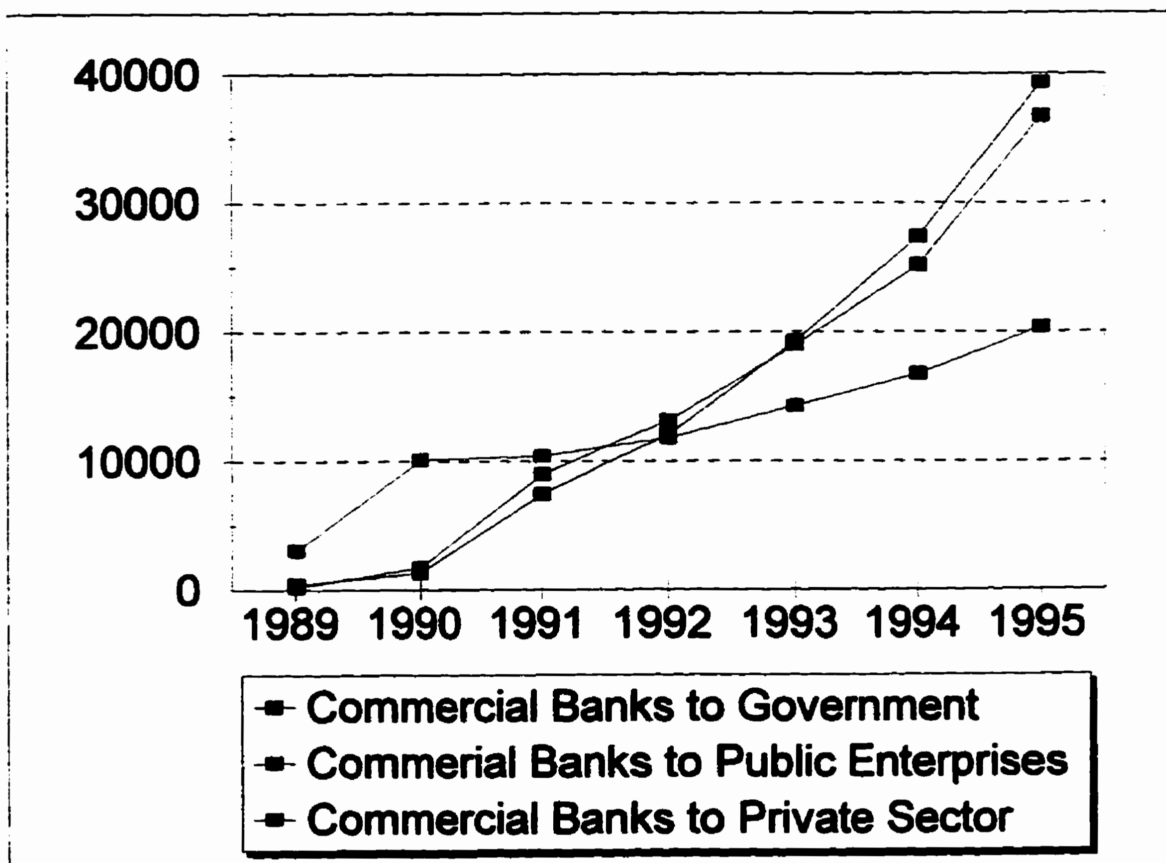
Share of Irregular Credits in Total Credits of Commercial Banks



Graph 3

Allocation of Credit Between Sectors

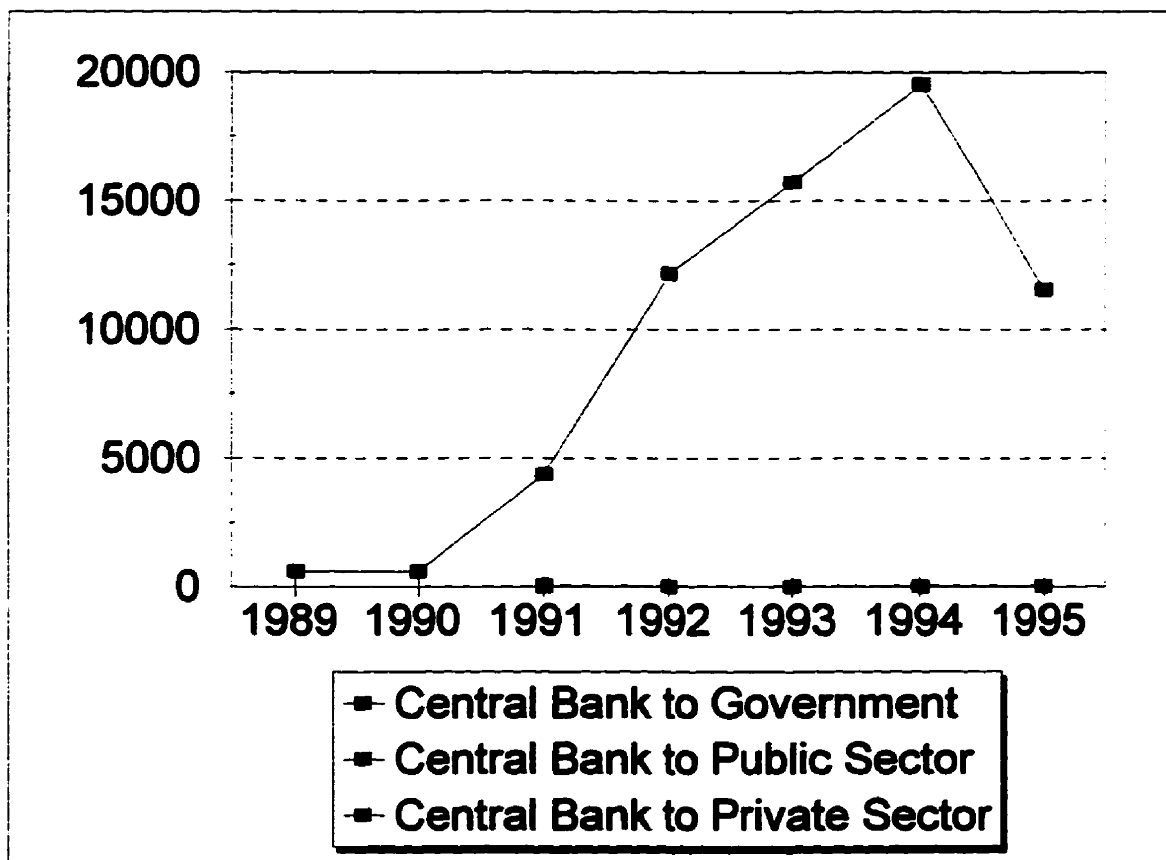
Commercial Bank Credit



Graph 3a

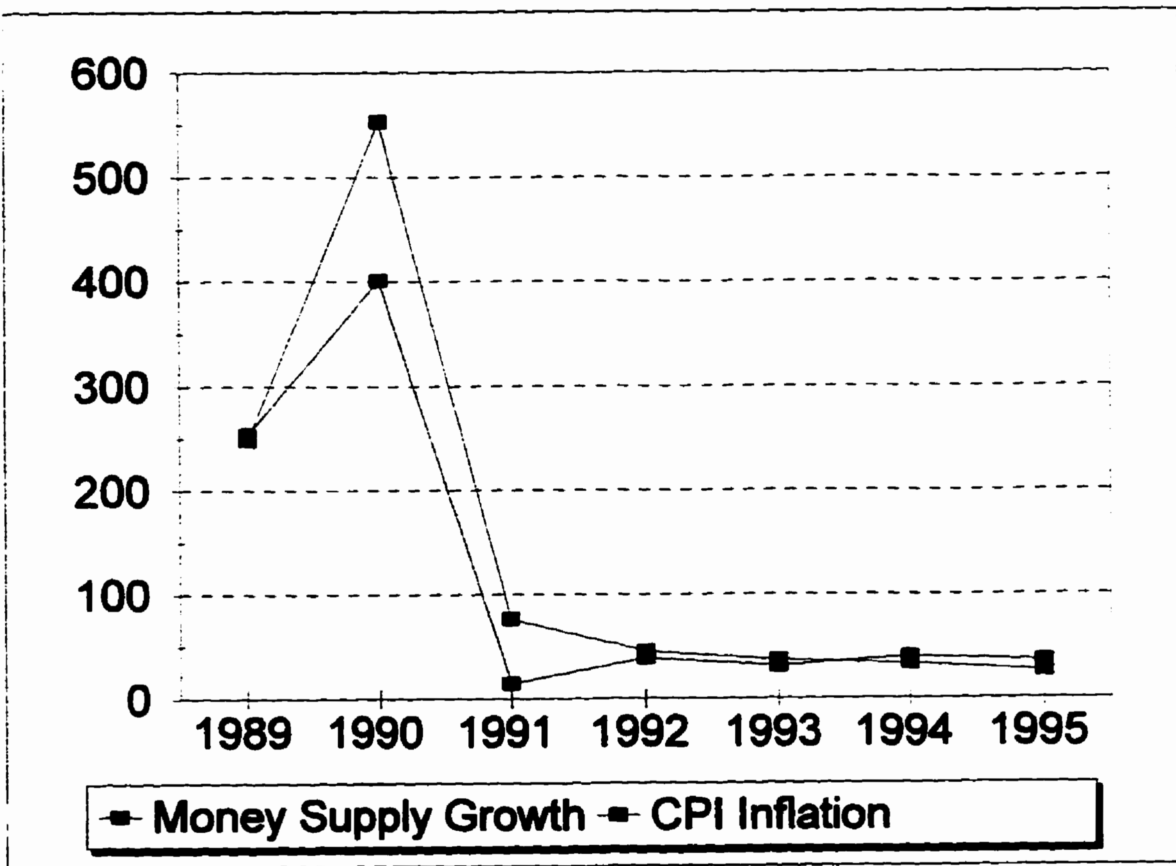
Allocation of Credit Between Sectors

Central Bank Credit



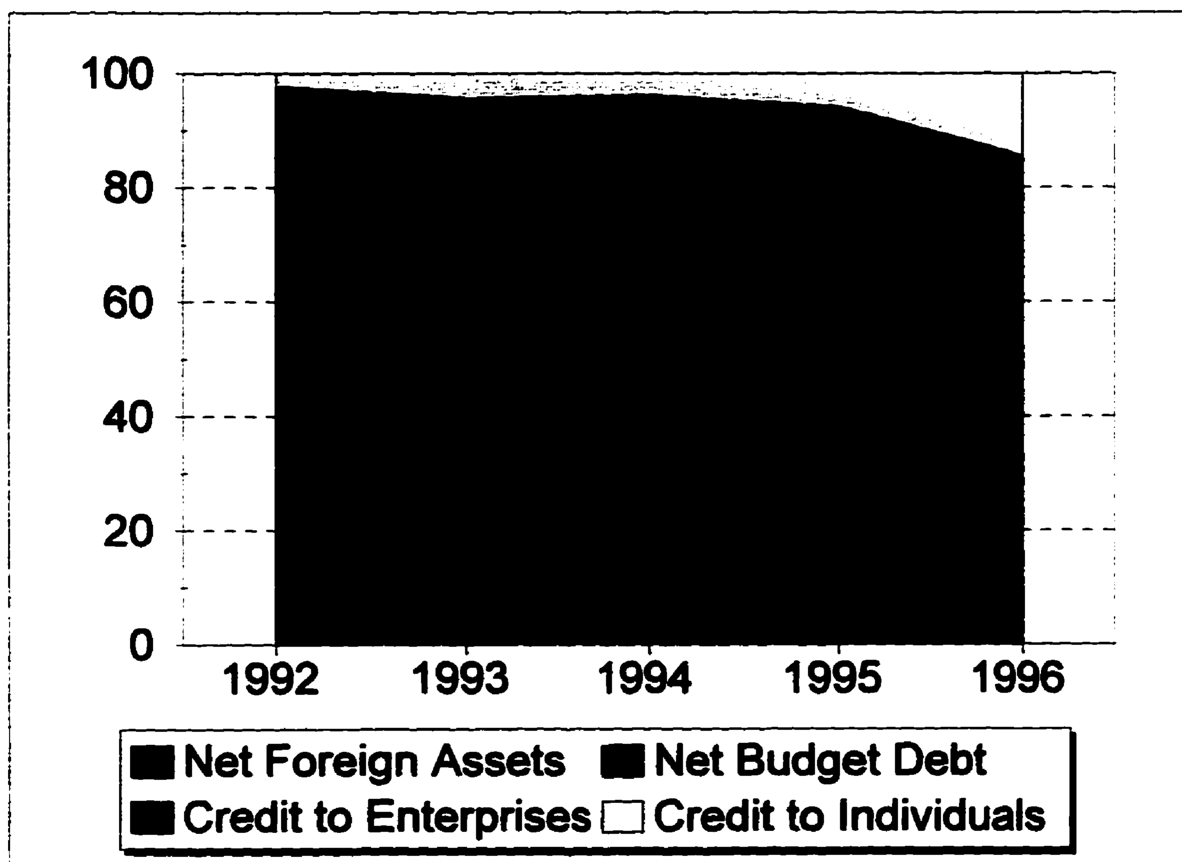
Graph 4

Money Supply Growth and Inflation



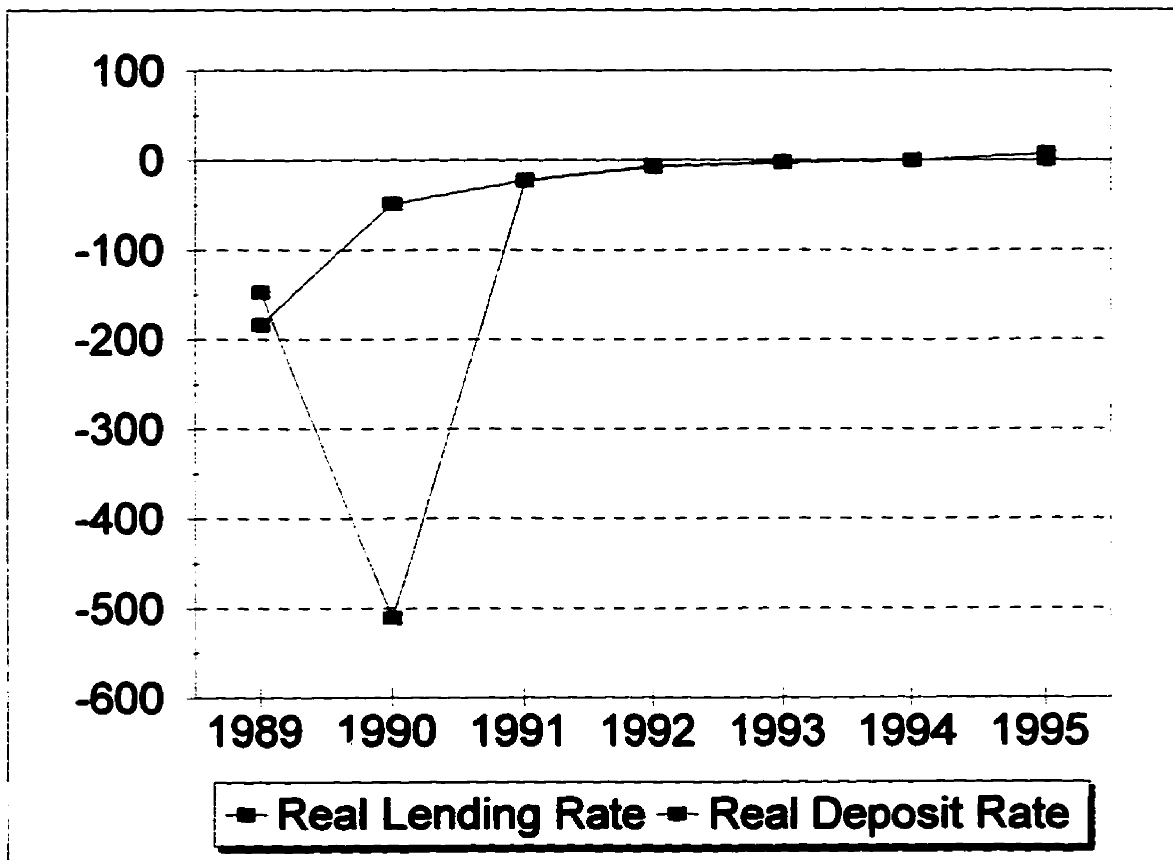
Graph 5

Sources of Money Creation



Graph 6

Real Lending and Real Deposit Rates



CHAPTER 6

Concluding Remarks

Competition between formerly state owned large commercial banks, as well as the rest of the banking sector has not increased greatly. Commercial bank lending to public non financial enterprises did not decrease, on the contrary, it continued to grow. Only the share of lending to private enterprise increased. Real interest rates were negative until 1995, when they reached positive but low levels. Yet the Polish enterprise and bank restructuring programme is generally considered to have been quite successful. It did improve the financial situation of enterprises and thus provided cleaner balance sheets for banks. It also equipped banks with better skills and experience in terms of evaluating potential borrowers and lending in a market economy.

Even though the Polish approach to banking reforms was more less successful in terms of its objectives, it seems that these objectives may have been chosen incorrectly. Increased competition between banks, and the preparation of commercial banks and at the same time enterprises for privatization, as well as a financial deepening of the banking sector are important goals. It seems however, that expectations for speedy improvements in these areas were too high. Standards which were to be met by banks and enterprises were set ridiculously high creating harsh conditions for both banks and enterprises. Harsh conditions for enterprises translated into harsh conditions for workers, many of whom

ultimately lost their jobs.

It also seems that the trust placed in foreign institutions was unreasonably high. Although western advisors certainly had better experience and knowledge in terms of the functioning of a market economy and the banking system within such an economy, a transition from a socialist to a capitalist system has not been experienced before. Thus knowledge about the appropriate procedures. as well as appropriate guidelines was not available even to western advisors. The result of too much foreign interference in the Polish reform programme was that standards were set much too high, setting many possibly viable institutions up for failure. Also, foreign advisors gained extensive insight into the functioning and the progress of the Polish system

It may have been wiser to soften standards and regulations and allow banks and enterprises to gradually work their way up to Western standards. It should not be forgotten that restructuring of any institution, be it a bank or an enterprise, involves teaching new skills and new forms of behaviour to people, who may require a long time to acquire new skills as well as change their attitudes toward certain aspects of an economic system.

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