Getting the Institutions Right:

Reforms of Banking Sectors in the Czech Republic and Romania

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Abstract:

In this thesis the hypothesis on the path of the institutional reform of the banking sector in transition economy is formulated and tested by the means of comparative case study. I hypothesize that successful reforms proceed in the following sequence: (i) creation of an independent regulator with limited capacities; (ii) gradual introduction of the international regulatory standards; (iii) dealing with the domestic vested interests; and (iv) creating constituency for implementation of evolving best practices (privatization). Focusing on the third stage, I claimed that two factors are instrumental for overcoming the opposition of vested interests: (i) increasing awareness about the unsustainability of high and growing proportion of non-performing assets (threat of banking crisis) and (ii) pressure from the European Union and the World Bank for implementation of the international standards. The empirical case studies of the institutional change in the Romanian and Czech banking sectors are corroborative to the hypothesis, despite substantial differences in the level of economic and political development as well as in economic performance during the transition years. Tentative policy lessons regarding implementation of international standards in transition economies are formulated in conclusion.

Content

List of Exhibits

List of abbreviations

CAR	Capital Asset Ratio
CEE	Central and Eastern Europe
CNB	Czech National Bank
DWL	Deadweight Losses
EBRD	European Bank for Reconstruction and Development
ETR	Economic Theory of Regulation
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFC	International Finance Corporation (part of World Bank Group)
IFI	International Financial Institutions
IMF	International Monetary Fund
NBR	National Bank of Romania
NIE	New Institutional Economics
NPA	Non-performing Assets
PEPR	Political Economy of Policy Reform
SME	Small and Medium Enterprises
SOE	State-owned enterprise
WB	World Bank

INTRODUCTION

Many emerging economies live under looming thread of a banking crisis. Even minor exogenous shock to the economy threatens to destabilize banks and in unfortunate scenario result into full blown crisis wiping out many percentage points of GDP and reverting country's economic development years back[1]. At the beginning of 1990s as well as today domestic banking institutions in emerging countries are plagued by high proportion of non-performing assets (NPA). The most profound example today is China, where the proportion of NPAs steadily increases despite substantial injections of new capital from the government sources (Stephens 2003).

Emerging economies need the institutional framework, which would support efficient and sustainable banking sector. Today these institutions are relatively well described, understood and widely accepted. International standards describing them from the level of general principles to the level of fine technical details are developed, There are various diagnostic tools, which can assist any country implementing the standards and international financial and developmental institutions[2] are ready to provide number of support schemes. Overall, implementation of the institutional reform could seem to be relatively easy exercise.

Existence of internationally accepted and recognized standards has a profound effect on the political economy of reform. Standards define the desired institutional equilibrium to be achieved and the political bargaining concerns only the path how to get there, but not the goal itself. This substantially simplifies the reform process, even more so if the international organizations provide some form of external accountability linked to the progress of reforms. However, even with this simplification the interplay of domestic interests surrounding sectoral reforms remains very complex.

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[1] Levine (1997) reviews theoretical and empirical literature and finds "the first-order relationship between financial development and economic growth" (Levine 1997: 688). From this follows that financial crisis hampers economic development.

[2] Bank for International Settlements (Basel Accord and Principles of Banking supervision), Organization of Economic Cooperation and Development (OECD Principles of Corporate Governance) and World Bank (Reports on Observance of Standard and Codes), International Monetary Fund (Financial Stability Assessment Program). Financial Stability Forum is an overarching structure for most of these activities.

On the general level, this thesis is concerned with constraints on the domestic political markets, which influence the process of institutional change. The general research question fits into the debate on the effects of globalization on the institutional convergence among financial sectors of various countries. The convergence, driven by the need to reduce transaction costs on global financial markets, is hoped to be facilitated by the international standards, which are multiplying every year since the end of 1990s. In most sectors, international standards are relatively recent and still in a process of elementary formulation and refinement. The Basel Accord, introduced already in 1988, is one of the oldest standards and there is some experience with its implementation in many emerging markets.

The empirical review of the implementation experience in the banking sector may provide important lessons, for the implementation of more recent standards and codes. The Central and Eastern European countries over the last fifteen years provide a wealth of the empirical material to be analyzed and generalized into policy lessons. This is the main motivation for this thesis. Its goal is to assess the comparative experience with the reform of institutional framework of banking sectors in Romania and the Czech Republic. The hypothesis claims that despite substantial differences in the level of economic and political development as well as in economic performance during the transition years, the processes of institutional change are similar and follow the same evolutionary path.

The thesis is a part of broader research effort aimed to improve our understanding of the processes of institutional change in transition economies. The two countries, Romania and the Czech Republic, are hardly ever compared to each other as a general sentiment puts them into two separate peer groups – Balkan countries and Visegrad countries. This is well justified on the level of performance and achievements over the whole transition period. After all, the Czech Republic just entered the European Union, whereas Romania struggles to keep its 2007 entry credible (see CSFB 2004). However, if one focuses on the reforms of underlining institutional framework then striking similarities are revealed. The path of institutional change in the two banking sectors correlates tightly, even thought motivation for some reform steps might be different and/or they may take place at different points in time.

The chapter 1 reviews three major strands of academic literature related to policy reform and institutional change, which are complemented by several other theoretical approaches relevant to the process of transition. These theoretical claims are then blended into the research hypotheses on the sequencing of the institutional reform of the banking sector and on the role of international agencies and deadweight losses in constraining the competition among pro- and anti-reform interest groups. Chapter 2 is descriptive. It reviews the banking sector reform experience of Romania and the Czech Republic during the 1990s. Chapter 3 is comparative. It reconciles the experience of the two countries with the research hypothesis to show, that the institutional reform followed the sequence proposed by the hypothesis and that as the constraints became binding, they indeed were instrumental in overcoming the opposition to reform. Conclusion includes some tentative policy lessons regarding implementation of international standards in transition economies.

1. THEORETICAL BACKGROUND AND RESEARCH HYPOTHESIS

This thesis follows the eclectic approach to understanding institutional change, suggested by Harberger (2001). It blends pragmatic insights of experienced professionals in the field of reforms with abstract theories to propose hypotheses of how to implement institutional reforms of the banking sector. The choice of such an approach is determined by the practical considerations. Given the enormous variability of political, economic, social and cultural environments, it proved so far impossible to generate an encompassing generally applicable theory of institutional change or policy reform, despite substantial effort of both theorist and practitioners culminating in mid-1990s (Alston, Eggertsson, North 1996, Rodrik 1996 and Williamson 1994 provide useful reviews). This experience suggests that North (1990) was right to claim that an institutional equivalent of the general equilibrium theory is unlikely without major theoretical breakthrough.

Even though, there is no overarching general theory, there is a number of complementary theories, which allow to develop a (non-formal) partial equilibrium models tailored to the specific reforms. This thesis relies on three major strands of literature:

1. Political economy of policy reform (PEPR), which summarizes the experience of development economists with reforms in various settings,
2. the Economic Theory of Regulation (ETR), which supplies an economic understanding of the interplay of interest groups on the political markets within a set of important constraints, and
3. New Institutional Economics (NIE), which addresses the effects of transaction costs and bounded rationality on political and economic markets and is concerned with remedies to be provided by efficient institutions.

Apart from the above major theoretical fields, there is a set of useful models and theories, which capture some peculiarities of reforms in the polities and economies undergoing the post-communist transition. In this thesis I will draw on the law matters literature and on the research focusing on the role of "external anchor" to the domestic policy, i.e. the role of supranational and international institutions in the transition reforms. The following subsections briefly summarize major findings of the outlined theories and research programmes.

1.1. Political economy of policy reform

Theories in the vein of the Political Economy of Policy Reform are strongly rooted in generalized experience of the key policy-makers and development specialists. In their understanding the institutional change is hardly ever a "green field" project. Institutions can not evolve in historical vacuum, not even the formal institutions. The institutional framework is path dependent and, in the context of economic development, past institutions, more often than not, amount to what Krueger (1993) called a vicious circle.

The starting point of PEPR theories with regard to institutional change is the nexus between policies and institutions[3] (Csaba 2004, Havrylyshyn, van Rooden 2000). Various policies can be used to manipulate at least the formal institutions and influence to some limited extent the informal institutions, which in turn underline the quality of enforcement of formal institutions (Eggertsson 1996). It is recognized that, good policies create good institutions, which in turn help to sustain good policies ("virtuous circle")[4]. On the contrary, bad policies create bad institutions, which support bad policies ("vicious circle")[5]. In this understanding the "good" policies are those that change the formal institutions and their enforcement and induce gradual change of informal institutions so that all these three factors combined create a set of incentives compatible with long term sustainability of and wealth creation in the banking sector operations. On the contrary, "bad" policies are those, which threaten long term sustainability and sooner or later will result into banking sector insolvency. Such insolvency inevitably destroys wealth and places huge financial burden on shareholders, depositors

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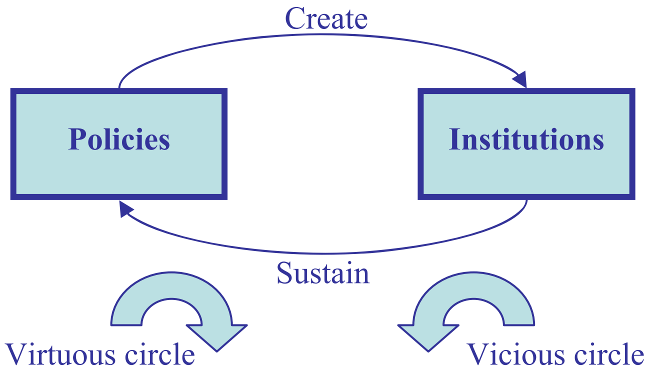
[3] Economists tend to summarize this nexus under the heading "institutions matter but so do policies."

[4] For example, if legislative changes (policy) create an independent banking regulation (institution), the regulator in turn can support future policy improvements such as introduction of internationally recognized standards of prudent banking.

[5] For example, government's support of state owned enterprises via soft loans from state-owned banks (bad policy), which creates an implicit government guarantee for banks deposits (bad institution), which may in a way justify further moral hazard of the bank's management.

and/or taxpayers who, at the end of the day, will have to pay for the gap between the banking sector assets and liabilities.

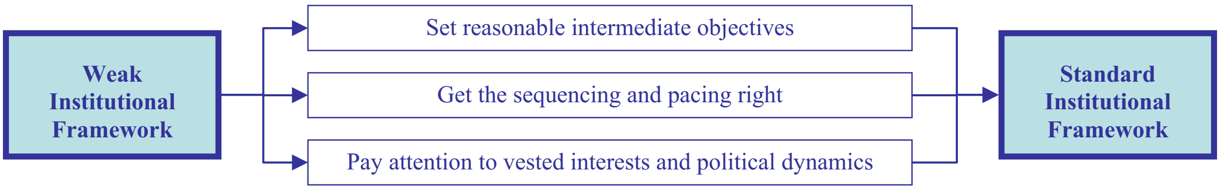
Exhibit 1 Nexus between policies and institutions



The PEPR strives to formulate lessons useful for reform minded politicians and technocrats. It hopes to formulate a policy reform manual, which would be on one hand sufficiently general to allow for compatibility with the best reform practices and at the same time flexible enough to adjust to important particularities of political, economic and social environment of various countries. The work on the reform manual could be also described as a search for answer to the question how can a country attain the right set of institutions supporting long term sustainability of its banking sector. Alternatively, how can an economy break out of the vicious circle of unsustainable policies?

The PEPR literature relies generalized lessons from case studies as well as some models. Formal models are useful for understanding overarching reforms on the macro-social level, but for the purpose of the sectoral reforms the case study approach is more useful, thanks to lower level of abstraction. One of the recent summaries in this vein was provided by Stiglitz (2000), who described the "not-to-dos" in transitional reforms. I try to reformulate Stiglitz's lessons positively (as "to-dos") to fit the context of the sectoral reform. The result is the General procedural hypothesis of banking sector reform depicted in Exhibit 2.

Exhibit 2 Political Economy of Policy Reform: general procedural hypothesis



The procedural hypothesis is almost commonsensical, yet it provides important insights, which, Stiglitz argues, were often ignored in the 1990s' wave of reforms, which often yielded suboptimal outcomes. For the purpose of this research, the general procedural hypothesis is just a stepping stone for the specific procedural hypothesis depicted in Exhibit 5 and justified later in this chapter.

One of the empirical conclusions of the PERP literature is that overcoming the opposition of vested interests is the probing stone of the reformers' commitment, which in turn determines the reform's success[6]. Overcoming the opposition of vested interests, which is present even if the reform is pareto improving (Stiglitz 1998), is a crucial step towards reverting the vicious circle to the virtuous one.

When dealing with anti-reform vested interests any reformist would appreciate most to get good policy recommendations. However, it is also a point where PEPR theories fail. For example, Williamson (1994 as quoted in Rodrik 1996: 33-34) gathered a group of experienced reformists who, from their individual perspective, judged number of the hypotheses of what makes reform feasible and successful *vis-à-vis* opposition of vested interest (listed in Exhibit 3). However, he concluded that "there are no fully robust empirical generalizations; in every case there is at least one partial counterexample" (Williamson 1994: 589). At the same time he suggests that hypotheses are not worthless as at least the following three needs receive strong support: (i) need for a strong political base, (ii) need for a visionary leadership and (iii) need for a coherent economic team.

[6] Rodrik goes even so far as to say "[p]olicy makers who have courageously taken on … interest groups … [become] the heroes of the economics profession" (Rodrik 1996: 9).

Exhibit 3 Hypotheses about reforms

Hypotheses about political economy of policy reforms

1. Policy reforms emerge in response to crisis
2. Strong external support (aid) is an important condition for successful reform
3. Authoritarian regimes are best at carrying out reforms
4. Policy reforms as a right-wing-program
5. Reformers enjoy a "honeymoon period" of support before opposition builds up
6. Reforms are difficult to sustain unless the government has solid base of legislative support
7. A government may compensate for the lack of strong base of support if the opposition is weak and fragmented
8. Social consensus is a powerful factor impelling reform
9. Visionary leadership is important
10. A coherent and united economic team is important
11. Successful reform requires economists in positions of political responsibility
12. Successful reform requires a comprehensive program capable of rapid implementation
13. Reformers should mask their intentions to the general public
14. Reformers should make good use of media
15. Reform becomes easier if losers are compensated
16. Sustainability can be enhanced by accelerating the emergence of winners

Source: Rodrik (1996: 32) on a basis of Williamson (1994).

It is not only puzzling what makes reforms feasible and successful but we do not know enough even about what triggers them. Rodrik (1996: 10) notes that we typically observe a protracted period of collective irrationality when polices, which are clearly unsustainable even in medium term, are pursued and increasingly needed reforms are postponed. Rodrik (1996: 26-29) points out that crisis is understood as a trigger of reforms, yet it is not particularly helpful for analysis and prediction as one can predict neither when will the crisis come nor when it becomes "severe enough" to trigger reforms.

Findings of Williamson (1994) and Rodrik (1996) but also of Stiglitz (2000), Haggard (2000) and Krueger (2000) point to the conclusion that the question of how to deal with the vested interests is essentially an empirical issue and current PEPR theories can at best point out some characteristics one could focus on. This said, however, does not mean that this line of research can not be but fruitless. On the contrary, contributions of leading professionals and scholars in the field point out to the need for well structured comparative case studies of both political economy of reform and the nexus between policies and institutions (Rodrik 1996, Williamson 2000, Shirley 2003, Krueger 2000, Joskow 2003).

1.2. Economic theory of regulation

Economic Theory of Regulation (ETR) was developed by a triumvirate of the Chicago economists – George Stigler, Sam Peltzman and Gary Becker in their articles dated 1971, 1976 and 1983 respectively. The theory or more precisely, the logic of their theory, proved appealing to economists, so it spread quickly throughout the academic as well as policy literature on regulation (see Peltzman 1989 for an early review of its success) and became standard reference for economic understanding of the relationships between economics and politics.

One reason for its appeal is its simplicity. Peltzman (1989: 13) summarized the logic of the ETR into the three statements:

1. "Compact, well-organized groups will tend to benefit more from regulation than broad, diffuse groups. This probably creates a bias in favor of producer groups, because they are usually well organized relative to all consumers. But the dominant coalition usually also includes subset of consumers.
2. Regulatory policy will seek to preserve a politically optimal distribution of rents across this coalition. Thus, over time, the policy will tend to offset changes in this optimal distribution arising from shifts in demand or cost conditions. At any one time, the price structure will cross-subsidize high-cost consumers from rents generated by prices to other groups.
3. Because the political payoff to regulation arises from distributing wealth, the regulatory process is sensitive to deadweight losses. Policies that reduce the total wealth available for distribution will be avoided because, other things being equal, they reduce the political payoff from regulation."

The roots of the ETR, can be traced to Stigler and Friedland (1962) paper, in which they evaluated empirically the regulatory performance in the case of the U.S. electricity suppliers. They found support for the regulatory capture hypothesis, i.e. that the regulation serves to protect producers interests rather than those of consumers. This run contrary to the theories accepted at the time, which justified regulation on the grounds of reduction of welfare losses caused by various market failures. Their results sparked a wave of similar empirical studies, which supported the capture hypothesis, but only in some industries. This was a puzzle: if the effects of the regulation are contrary to theoretical expectations, why does the state engage in regulation?

Stigler provided theoretical explanation in his 1971 paper, which had drawn on studies such as Downs' (1957) concept of rationally ignorant voters, Buchanan and Tullock's work (1962) view of politicians as rational utility maximizers and Olson's analysis of collective actions (1971). Stigler's main innovation was the introduction of the supply and demand framework to regulation. In his view regulators "offer" regulatory measures to interests groups on behalf of politicians in order to strike a mutually advantageous deal, which would maximize utility of the representative politician. Political entrepreneurs may supply subsidies, entry controls, protective tariffs, regulations affecting substitutes and complements, fixed prices and other means of wealth redistribution. In exchange they demand votes and resources, which help them to keep and enhance their power and thus maximize their utility.

As always in meaningful rational choice models, the utility maximization is constrained. Stigler introduces two kinds of constraints: information and organization costs (Peltzman 1989: 7). Interest groups have to organize themselves to deliver both favorable votes and resources, which gives a comparative advantage to groups, which can do it at low costs. This advantage then creates a bias in favor of producers, who have higher stakes in regulation, are less numerous and face lower cost of organization and of avoiding free-riders. They can form compact interest groups more easily and provide politician with more votes and resources than large diffused consumer groups. Stigler (1971: 7) lists also other constraints on the regulatory redistribution, such as oppositions of other firms in the industry, powerful outsiders and procedural safeguards required of the public processes. These constraints are integrated into the general and formalized model of ETR by Peltzman (1976).

While, Stigler spoke of competition among the interest groups, in the background was the capture theory, which in principle allowed for dominance of one single interest group. Peltzman introduced more general framework of optimal distribution of benefits of regulation across the interest groups, which could explain, why regulators in some industries seem to be captured and in others less so. In equilibrium benefits are allocated so that marginal costs in terms of reduced political support due to adverse impact of regulation on certain subsets of electorate are exactly equal to marginal benefits provided by coalition demanding the regulation. Optimization is major contribution of Peltzman (1976) as the rest of his paper formalizes Stigler's concept.

Final step in ETR development was Becker's concept of competition among pressure groups for political influence. Becker climbed higher on the ladder of abstraction and added more general constraint on the regulatory decision making – deadweight losses. Regulation, as every other mean of redistribution, creates welfare losses, which can not go unobserved by voters, who can punish those politicians supporting more than the least inefficient means of redistribution. Becker's analysis "unifies the view that governments correct market failures with the view that they favor politically powerful" (Becker 1983: 371). The former is focused on efficiency, whereas the latter on redistribution and Becker provides the apparatus to balance the trade-off between them.

Becker's set up is the same as Peltzman's but different forces determine the equilibrium at the margin. Peltzman assumed optimal decision making of the politician, whereas Becker presents market based analogy of competition among pressure groups, which try to maximize their share of benefits and minimize their contribution towards paying for benefits of others. In the equilibrium marginal pressures of opposing interests are equal. The deadweight losses become a constraint to redistribution when the balance of pressures moves out of the "efficient" equilibrium. As it moves further, the marginal deadweight losses are increasing, which means that for every dollar of redistribution winners' gains are lower and losers' costs higher. Thus winners have weaker incentive to exert more pressure and, on the contrary, losers face stronger incentives to exert more pressure. From this logic Becker derives a conclusion that if some form of regulation prevails, it must be the most efficient mode available, otherwise competing pressures would exert either less or more pressure and move into a new, more efficient equilibrium[7].

The historical background of the ETR is in the overregulated 1960s and 70s. The redistribution favoring the producer was assumed to hide under the clout of regulation. However, the ETR model is sufficiently general to provide insights for understanding of the redistribution in the opposite case,

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[7] This is somewhat nihilist conclusion from the political economy point of view. It amounts to claiming that any status quo must be in Beckerian sense "efficient", which is difficult to accept *vis-à-vis* some real world cases. For example, the partial deregulation of U.S. trucking industry took longer than 60 years, even though the associated deadweight losses were identified by economists as early as in 1935 (Pelzman 1989: 24). It seems rather perverse to call such a situation efficient in any sense as one would expect that frivolous deadweight losses (Peltzman quotes papers claiming that regulation created 30% wage premium) will induce substantial counter pressures to move to socially more efficient equilibrium.

when the lack of regulatory constraints allows vested interests to enrich themselves at the expense of other stakeholders. Both cases of the overregulation and under regulation were present in the transition countries and institutional change, which is the topic of this thesis, amounts to a process of finding the most efficient equilibrium between the two extremes. It aims to frame the opportunity set so that maximum of perverse incentives are constrained and the most productive ones encouraged.

1.3. New institutional economics

The NIE theory of institutional change is associated predominantly with the work of Douglass North. North (1994: 360) defines institutions as "humanly devised constraints that structure human interaction." North distinguishes formal institutions such as constitution, laws and rules and informal institutions such as norms of behavior and codes of conduct. In North's concept institutions and their enforcement characteristics define the incentive structure of society and consequently of any subset of a society such as banking sector. North (1990) claims that informal and formal institutions shape the opportunity sets, on which agents optimize.

Institutions are thus different from organizations. Organizations are entities set up by the economic and political entrepreneurs to explore incentives created by the institutional framework. There is a close interaction between institutions and organization. When institutions change, the incentives created by the new institutional matrix change as well. Changed incentives may change the perceived pay-offs of alternative entrepreneurial strategies, thus entrepreneurs may restructure their organizations to obtain the highest pay-offs available on the prevailing and expected opportunity set[8]. The amended organizations provide a feedback, which influences prevailing institutions. If political entrepreneurs, who are responsible for introduction of formal institutions, think that another institutional arrangement could deliver higher pay-offs to their constituency and/or to themselves, they

[8] For example, when the institutions forbidding US banks to provide both investment and commercial banking services were abolished, those managers, who expected higher payoffs from the universal banking model, reorganized their banking organizations to provide both types of banking services in-house.

will initiate the change[9]. These interactions are sources of the institutional change according to the NIE literature[10].

A departure to the complex world of institutions creates the need for careful structuring of the thesis and making clear on which level of social analysis one aims to focus (see Eggertsson 1996 and Alston 1996). To this end this thesis will rely on the structuring provided by Williamson (2000: 597 summarized in Exhibit 4), which is generally consistent with approaches of other NIE authors. The separation into different levels of analysis is a useful analytical fiction. In a fully dynamic evolution all levels are tightly interconnected; higher levels impose constraints on lower levels and lower levels provide feedbacks for changes on higher levels.

Exhibit 4 Levels of social analysis

Level	Social analysis	Rate of changes
1	**Embeddedness:** customs, ethics, norms, cognition.	100 – 1000 years
2	**Basic institutional environment:** Property rights, political and legal institutions.	10 – 100 years
3	**Governance:** contract, firms, internal organization, hybrid forms.	1 to 10 years
4	**Resource Allocation:** standard microeconomic theory and agency theory	continuous

Source: Joskow 2003, summarizing Williamson 2000

The Level One is that of social embededness, where "the norms, customs, mores, traditions etc. are located. Religion plays large role at this level" Williamson (2000: 596). This level is researched predominantly by economic historians and sociologist and economists tend to take it as given. This thesis too takes it as exogenous to the model, because with 15 years of transition the feedbacks may have triggered some changes in informal institutions, but they are unlikely to be more than marginal. This is not to deny the impact of Level One institutions on the efficacy of the banking sector institutional framework, but rather to keep the analysis focused and manageable.

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[9] Following on the above example, if the political entrepreneurs perceive that better protection of the risk-averse depositors of the commercial part of universal banks, can bring them increased political pay-offs, they will initiate legal changes tightening the regulations (introducing, for example, Chinese walls between commercial and investment divisions of the universal bank).

[10] In terms of the following discussion, this paragraph is about the interactions between Level Two (formal institutions /external governance institutions) and Lever Three (organizations/internal governance institutions).

The greatest weight in this thesis is put on the Level Two and Level Three of social analysis, where key formal institutions[11] interact with internal institutions of organizations; in our case of banks, bank supervisory authority, commercial and bankruptcy courts, security market supervisor and other bodies. On this level a complex set of incentives and constraints forming an opportunity set on which economic agents more or less rationally optimize according to their preferences (objective functions). Once we have taken the level one as given we can count on stability of preferences and disregard number related of theoretical issues.

The institutional change is defined as a change of the institutional constraints, which frame the incentive structure of the economy. Given the complexity of banking and its importance in the economy these constraints and resulting incentives are numerous and complex as well. From point of view of an individual actively involved with the banking sector the set of constraints includes internal rules of banks as well as the external institutional framework. This thesis focuses more on the external institutional framework (see Section 1.5 for explicit description). The external institutional framework is to the large extent a result of the interest group competition on the political market.

The institutions on Levels One, Two and Three define boundaries of the opportunity set, on which agents optimize in order to satisfy their preferences. The Level Four analysis is typical subject to standard neoclassical microeconomic analysis and the key constraints are budget and technology. In the words of the property rights analysis: economic agents are allocated rights to allocate property rights to valuable assets. The allocation of rights to allocate assets to alternative uses is determined on Level Two and Three. The enforcement of property rights is heavily influenced by the informal institutions of Level One and the allocation of assets takes place on Level Four. Thus it is on the forth level of social analysis where the economic performance of the banking sector is determined. This structuring is rather complex to describe, but analytically very useful. Box provides a brief example of the role of all these institutional structures in the decision-making of a bank loan officer.

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[11] Practitioners tend to call this type of institutions "external governance framework" – see Bokros 2000 or World Bank 2000.

The key claim of the New Institutional Economics is that the economic performance (Level Four) is not determined exclusively by the optimization of the fully rational and fully informed homo oeconomicus, but that it is to also a function of the institutional structures on Levels One to Three.

Example: Bank's loan officer decision making on the credit allocation[12]

What is being allocated:

Bankers typically allocate credits to borrowers and they are charged with finding the delicate balance on the risk-return trade-off to make sure that money is returned at all and reasonable profit is made. Bankers allocate money other people (depositors) entrusted to their bank (deposits). In the logic of contractual and property right economics they give the bank a right to lend the money to the third parties in exchange for a fee (interest rate). The loan officer is then responsible for allocating some of the deposits to borrowers. She has to optimize on the risk-return trade-off to make sure that the loan is repaid in time. Loan officer’s risk-return objective function is optimized on the opportunity set defined by the institutional constraints and their enforcement characteristics. The opportunity set is framed by constraints on different levels, which create various incentives. The following list could be an example of institutions and relationships among them.

Constraints:

Level One: The level of trust prevailing in a given society will influence loan officer's willingness to borrow. The general level of shared values and attitudes to honoring one's debts will influence the level of transaction costs. If the trust is low a loan officer will require higher level of guarantees (more collateral etc.) and higher risk premium. I some cases the transaction cost may be so high that the loan will not be extended. Thus in low trust (i.e. high transaction costs) economies some lending opportunities, which would be realized in high trust economies, are foregone. In this thesis the Level One is exogenous to the analysis and it is assumed to be practically the same in both countries studied.

[12] This Box could be equally well be called author's current understanding of the New Institutional Economics in a nutshell.

Level Two: The rules specified in the banking legislation such as Act on Banks shape constraints on Level Two. For example, it specifies that a loan officer can not lend to the parties related to her or to the bank of which she is the employee. If such a loan is made it must, for example, be based on arm's length relationship and match prevailing market conditions. Moreover, it must be reported to internal auditor, the Supervisory Board and mentioned in the Annual Report. If these rules are vigorously enforced then they will constrain most loan officers, who would not risk their reputation, hefty fines and/or imprisonment for the breach. Number of other important external governance institutions (predominantly specified in the laws and regulatory decrees) is specified on this level – see Section 1.5.

Level Three: Internal governance rules create additional constraints. For example, each and every loan officer in the bank is assigned a limit of the maximum amount of loan she can allocate. Larger loans can be extended only upon approval of credit committee or by a loan officer at higher level of the bank hierarchy, for example. The assigned limit can reflect the experience and seniority of given loan officer. The right to allocate credit only up the limit clearly constrains her decision making. Internal governance systems of banks include risk management, monitoring, internal auditing any many other highly complex procedures, which can, to some extent, substitute for missing external governance procedures. There is a large variety of these systems across banks and countries and their systematic understanding is well beyond the scope of this thesis.

Level Four: Within the above specified constraints, which specify whether the given loan officer can allocate credits at all, to what limit and under what general conditions, the allocation decision takes place. All contractual conditions and covenants are determined on previous levels and strictly speaking only two parameters are left to this level – quantity and price (interest rate). Should the above constraint work perfectly and eliminate all information asymmetries, the decision would be determined by equating marginal product of credit to the interest rate. However, reality is imperfect thus there is some scope for bargaining between the loan officer and borrower even on this level. When the mutually advantageous bargain, reflecting risk return profile of the borrower and opportunity costs of the bank, is found the contract is signed and credit extended.

The role of institutions does not end by the contract signature. Each and every contract is by definition imperfect (nobody can foresee all future states of the world and describe them in a contract) thus there is a scope for ex-post opportunism, on both sides (e.g. bank may deny extending advanced installment or borrower may not be willing to repay in time). The appearance and resolution of these conflicts is also a function of the quality of the institutions.

Moreover, even if parties did not behave opportunistically and agreed on almost perfectly complete contract, which would cover all foreseeable and calculable risks, then still some residual uncertainty would prevail. Uncertainty may bring around a conflict of interests at any time. In general, banks are reasonably sound on estimating and covering risks in stable economies with a long track record. However, they have no good chances to deal with substantial uncertainty, which goes well beyond predictable risks. In fast adapting economies, such as those in transition, the uncertainties are high. This puts higher demand on robust institutions, which help to resolve conflicts, arising from uncertainty, quickly and at low costs (bankruptcy framework is the most prominent institution in these cases).

The role of incentives

The above example provided a description of some institutions constraining the opportunity set on which the loan officer optimizes her objective function[13]. Incentives are the other side of constraints. The institutional matrix creates some opportunities, which are more rewarding then others and thus agents (including loan officers) are more motivated to strive for them; these are the incentives, which allow us to predict the behavior of reasonably rational people (including loan officers in a Box example).

However, as North (1990, 1994), Eggertsson (1990, 1996) and others point out the institutional matrix creates a mixed bag of incentives – some are productive and some are perverse. Productive incentives are those, which, if pursued, create economic growth and development. Perverse are those, which

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[13] The standard economic theory assumes that the take home pay over the long run is the best approximation of the objective function of the loan officer.

merely redistribute or even destroy existing wealth. The distinction obviously needs to be dynamic and contextual as what has been productive yesterday in some context may be perverse today and/or in another context.

Distinction between productive and perverse incentives is far from obvious, but in a given time and context largely possible. Moreover, it is very useful as it gives a normative orientation to the desirable direction of institutional change (within the banking sector or elsewhere). The institutions should evolve so that the perverse incentives are credibly constrained and productive incentives encouraged. This is actually the link between institutions and economic development, as it suggests that countries credibly constraining perverse incentives and encouraging productive ones, will develop faster.

Moreover, this maxim defines the goal for policy makers. They should strive to influence institutions in such a way that the pursuit of perverse incentives is constrained (made less profitable) and is credibly "pushed out" of the opportunity set of economic agents. Consequently, policies should deliver such institutional framework, which makes pursuit of productive incentives least expensive and thus most profitable for all reasonable agents. In another words the pursuit of clearly perverse incentives should be punished and pursuit of clearly productive incentives should be encouraged by measures reducing transaction costs. If it is impossible to distinguish clearly whether some incentives are perverse or productive, than the institutions framing these incentives should be left to political competition to decide the way to adapt them. If a given incentive is considered to encourage perverse strategies of various players, then it should be constrained by a new rule, which would result from the political, legislative and/or judicial action. However, if the political markets in equilibrium conclude that the incentive is more or less productive, then it should be encourage or at least not constrained. In summary, the more are political markets efficient in determining the nature of various incentives, the greater the adaptive efficiency of the economy, the greater is the productivity and thus, ceteris paribus, the faster is the economic development.

The problem for the policy maker is the complex relationship between institutions and policies. It is rather difficult to influence the largely informal institutions of the Level One by direct policy measures[14]. The institutions of the Level Two and to some extent of the Level Three are more prone to be amended by polices. These are predominantly formal institutions, which can be changed by policies introducing new legal regime. The allocation on the Level Four is also beyond the reach of policies in its entirety due to prohibitively complex coordination problems.

However, even if policies can manipulate formal institutions on Level Two and Three to make the institutional framework effective[15] the newly created formal institutions need to be reasonably compatible with the informal institutions on Level One and market logic pertaining on Level Four (Olson (2000) labeled such institutions market augmenting).

The discussion of NIE theory of institutional change enabled yet another specification of the research question (how to attain institutions supportive to development). Only such policies, which are, at the same time, compatible with both the *market logic* and prevailing *informal institutions*, can create formal institutions supporting the virtuous circle. Only such institutions should enable countries to break out of the vicious circle of predatory, wealth-destroying institutions.

1.4. Transition related theories

Transition related literature on the financial sector development is enormous and often refers to the weaknesses in the institutional framework. However, relatively few research programmes, apart from those already mentioned, are relevant to the institutional change. Two strands stand out – the law matters literature and "EU as an external anchor".

The law and finance theory claims that legal institutions are important in explaining international differences in financial development (Beck, Levine 2003 provide recent summary). It makes three assertions. Firstly, in countries where legal systems enforce private property rights, support private contractual arrangements, and protect the legal rights of investors, savers are more willing to finance firms and banks are more likely to flourish. Secondly, the difference between common and civil law or

[14] Unless one wants to resort to highly speculative "awareness raising" campaigns etc.

[15] The term "effective" here is used in a sense of North's (1990) definition as being conducive to growth and development.

more precisely, the legal families that originated in Europe over previous centuries and were spread internationally, help to explain cross-country differences in the efficiency of today's institutions. Thirdly, in emerging countries the gap between the laws on the books and their efficacy is wider (Pistor, Raiser, Gelfer 2000) than in advance countries, which needs to be accounted for when deciding on policies to be implemented.

The EU as and external anchor is an offspring of the debates on the political economy of early transition reforms. At the beginning of 1990s there was a "period of extraordinary politics" (Balcerowicz 1995), which allowed to overcome opposition of vested interests[16] against deep reforms with highly uncertain distributional effects. However, it did not last long enough to facilitate the second stage reforms, including that of banking sector. Fortunately, by the end of 1990s there was a substitute available. As the EU accession became realistic prospect, which was accepted and supported by the overwhelming majority of population and political forces, the pre-accession process created another period of extraordinary politics. The political disputes in many areas were not about what goals to pursue, but about how to implement all measures required by the EU as a prerequisite for membership. This has reduced what Roland (1994) called the ex ante and ex post political constraints to reforms and provided the external anchor to all candidate countries.

1.5. Institutions framing the banking sector

The institutional framework of the banking sector is extremely technical and complex. Fortunately, for the goal of this thesis a very general description is sufficient. The main concern here is with the institutional change so such an abstraction is both reasonable and justified. By the institutional framework of the banking sector is meant a set of formal institutions and their enforcement characteristics. This set contains predominantly regulatory institutions, which are enforced by the supervisory body. On the other hand, the banking sector institutional framework is only a subset of the

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[16] The idea of period of extraordinary politics links well with Olson's (1982) concepts in the Rise and Decline of Nations.

overall institutional framework of the given economy[17], which is also increasingly influenced by international and supranational structures.

Sophisticated financial transactions are backed by some of the most complex contracts in any given economy. Thus to support these contracts various components of the institutional framework should clearly establish rights, responsibilities and liabilities of parties to financial transactions and make these enforceable. The institutional framework of the banking sector thus includes[18]:

- contract laws, capable of defining contractual rights and responsibilities of all parties involved in loan transactions as well as in the purchase and sale of financial instruments;
- private property laws, and in particular provisions relating to the process of creating, registering, prioritizing and enforcing security rights;
- company laws that serve to protect investors, employees and other stakeholders from insider fraud and mismanagement, but at the same time respect the business judgment of the management;
- bankruptcy law, providing failing firms with an orderly means of exit or restructuring and protecting rights of creditors;
- tax laws, which frame some important financial incentives;
- banking laws, clearly defining activities which can be performed exclusively by licensed banks and no other entities and rules on bank licensing, operations, accounting, deposit insurance, supervision etc.;
- accounting and auditing laws, which provide framework for expressing and evaluating the financial performance of banks; and
- banking regulation and supervision rules, which define prudential rules, credit limits, risk management and disclosure requirements, corporate governance structures.

[17] And, in fact of global economy, which renders national borders increasingly irrelevant for financial markets.

[18] The following list is by no means exhaustive, but these laws are among the most important. Given that banking loans are used for financing of everything from holidays to real estates, it could be easily argued, that virtually all laws play a role at some stage.

These formal institutions are embodied in several laws, such as Commercial Code, Act on Banks, Act on Central Bank, Bankruptcy Act and several others. Their enforcement is entrusted, apart from judiciary, to numerous agencies such as Banking Regulator, Securities and Exchange Commission, Deposit Insurance Fund, and Ministry of Finance and also self-regulatory and/or private organizations such as Chamber of Auditors, Banking Associations and many others, depending on specific arrangements in a given country.

The globalization of the financial markets had triggered numerous harmonization processes, which on one hand compete with each other to become standard and on the other hand reduce the transaction cost of financial operations. Number of these projects are run and supported by international financial institutions, such as World Bank, International Monetary Fund, OECD and Basel Committee. The Financial Stability Forum, which roofs many of theses activities currently list 12 standards and codes relevant for financial sector and many more are in the pipeline.

1.6. Research hypothesis

It is generally accepted, that institutions framing banking sectors of transition economies were prone to support crony capitalism rather than competitive one (see Bokros et al. 2000). On one hand, they sustained incentives for financial repression, rent-seeking and other perverse, wealth destroying strategies and on the other hand, they constrained incentives for prudential banking based on fiduciary duty. Nevertheless, the banking sectors and their institutional framework were successfully reformed to facilitate advanced transition reforms, which created an interesting research question: How did countries break out of the vicious circle of predatory institutions and attained institutions creating incentives for productive, wealth enhancing strategies?

Drawing on various strands of literature discussed in previous subsections I devise following hypotheses to be tested by a comparative case study.

1. Sequencing hypothesis: successful banking sector reforms in the transitive economies aspiring to the EU membership proceed in four steps:

(i) creation of an independent regulator with initially limited capacities;

(ii) gradual introduction of the international regulatory standards;

(iii) dealing with the vested interests; and

(iv) creating constituency for implementation of evolving best practices.

The focus of the thesis will be predominantly on the third step, dealing with vested interests. It can provide important lessons, and address questions of what triggers and helps to sustain institutional reform. The claim is that the following factors are instrumental in initiation and sustaining institutional reforms of banking sector.

2. Sustainability hypothesis: two factors play major role for sustaining reforms *vis-à-vis* opposition of vested interests:

(i) Increasing awareness about the unsustainability of high and growing proportion of non-performing assets (threat of banking crisis) and

(ii) Pressure from the European Union and the World Bank for implementation of the international standards.

These two factors constrain the opportunity set on which the domestic interest groups compete and on which the political equilibrium needs to be found[19]. However, on their own they are insufficient to explain what triggers the decisive steps of reforms. This thesis also addresses the issue by formulation of:

3. The trigger puzzle: the literature failed to come up with a theory of reform triggers. Given the inherent complexity it remains an empirical question.

To evaluate the viability of the above hypotheses and to search for their operationalisations, the focus will be on the banking sector reforms in the Czech Republic and Romania. The former is advanced reformer, where the banking sector reforms were successfully concluded prior to its entry to the EU in the first wave of Eastern enlargement. On the contrary, Romania is yet to finish banking sector

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[19] If the equilibrium is not within these constraints, the most likely outcome is the full blown financial crisis, which all candidate countries but Bulgaria managed to avoid. Romania only by a very narrow margin.

reforms and yet to satisfy criteria for EU entry. Choosing these two extreme cases should provide for an initial evaluation of the general applicability of the hypotheses on the cases of all transition economies[20].

The Procedural hypothesis (Exhibit 5) is based on the General procedural hypothesis (see Exhibit 2), which was derived from the lessons formulated by Stiglitz (2000). The individual sequences of institutional change in the banking sector are explained in the following subsections.

Exhibit 5 Procedural hypothesis of banking sector reforms

Policy sequence		Resulting institutions
1. establish an independent regulator	⇒	regulator with initially limited, yet growing capacity
2. introduce standard institutional framework at least on the books	⇒	improving the rules on the books and gradually increasing efficacy of enforcement
3. deal with the vested interests	⇒	separate good and bad parts of banking sector and make institutional reform acceptable
4. create constituency supporting sustainability (privatization)	⇒	private strategic owners bearing residual control rights and supporting prudential operation
∑ Informal institutions will adjust to reformed formal institutional framework so that right set of incentives is in place	⇒	the performance of banking sector is sustainable and further improvements easier to introduce as they evolve

The first sequence: Establish an independent regulator

The starting point of the analysis is around 1989, when soon-to-become transition economies, started to implement perestroika related reforms, including dismantling of the monobank system archetypal for soviet-style planned economies. This had typically created a central bank, several commercial

[20] The transition economies, which could be included in this study are: Estonia, Lithuania, Latvia, Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Slovenia, Croatia, Serbia/Montenegro, Macedonia (FYROM), Albania, Bosnia and Herzegovina and possibly Kosovo. The only condition is existence of a banking sector. These countries are on different stages on their way to EU – some will enter soon, some are in the pre-accession process and some are linked only via aid programmes. At the final stage of empirical testing this set could be contrasted to the banking reform experience of other transition economies, which do not have the "external anchor" in the EU enlargement process (especially fSU and East Asian post-communist countries). In that case there should be enough cases to justify statistical analysis.

banks and consequently a bank regulatory department either in the central bank or one of the ministries.

However, lack of expertise and capacity, left regulators behind turbulent developments of early nineties. Establishing a regulatory body entrusted with increasing capacities and competences was, nevertheless, the important first step of reforms of the banking institutional framework. It allowed for specialization and focus on bank related issues[21]. At the same time mere instituting of a regulator should avoid a direct conflict with vested interests as it did not mean that the regulator would necessarily "bite" straight from the beginning, when constrained by large uncertainty and small capacity.

The second sequence: Introduction of the standard institutional framework on books

Step two is important, but not yet decisive. The regulator is a constituency which, unless badly captured[22] or consisting of uninterested dilettantes, supports a reformist politician's effort. It faces standard bureaucratic/regulatory incentives[23], including expansion of portfolio and introduction of international standards[24], if such standards exist. Typically, there is also some external pressure on implementation of such standards[25]. Yet, the introduction of standards alone is not sufficient condition for their robust enforcement. The law and finance literature (see Section 1.4) provides extensive evidence of the discrepancy between the laws on the books and their efficacy, which characterizes

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[21] Glaeser, Johnson and Shleifer (2000) analyze the reasons for expected improvements of the quality of enforcement of highly complex issues related to banking activities if these are dealt with by specialized enforcement agency as opposed to general courts.

[22] See Stigler (1971) for the concept of regulatory capture and Hellman, Jones and Kaufmann (2000) for empirical analysis of the regulatory and state capture in the transition economies.

[23] See Stigler (1971), Peltzman (1976) and Becker (1976, 1983) for discussion of the economists' view of supply and demand side of regulation.

[24] At this stage I take for granted that the standards are well defined by the codes of best practices endorsed by the Financial Stability Forum and "measurable" by the diagnostic tools developed by the World Bank and IMF, which are published as the Reports on Observance of Standards and Codes. However, there are plenty of problems related to these standards and their measuring and a heated debate, whether complex formal regulatory rules actually improve bank governance of not.

[25] The external pressure and/or incentives to adopt international standards can arise from several sources such as BIS membership, EU enlargement, WB/IMF conditionality on structural adjustment loans, WTO entry conditions (case of China today), pressures of globalizing financial markets and investors etc.

transition countries (Pistor, Raiser, Gelfer 2000, Beck, Levine 2003). This discrepancy serves as likely explanation why not even the step two results in direct conflict with vested interests opposing institutional reform.

The third sequence: Deal with vested interests

Drawing on the Williamson's (1994) list suspect hypotheses (see Exhibit 3) I propose that the role of two factors is especially important for understanding of the crucial step of banking sector reforms (dealing with vested interests):

(i) Increasing awareness about the unsustainability of high and growing proportion of non-performing assets (threat of banking crisis) and

(ii) Pressure from the European Union and the World Bank for implementation of the international standards.

These two factors are hypothesized to be most important constraints on the interplay of the domestic interest groups. They constrain number of potential equilibriums out of the opportunity set on which the domestic interest compete and make them unfeasible, unless the country in question is prepared to accept the exclusion from the international financial markets[26]. This focus also captures the essence of the "benefit of crisis" argument made by PEPR (Rodrik 1996) as well as the increasing relevance of growing deadweight loss argument made by ETR (Becker 1983). Similarly, it captures the "external anchor" argument, which is well rooted in the practices and underlying theories of development currently pursued by international organizations[27].

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[26] The cases recent cases of sovereign defaults in Argentina and Russia, for example, illustrate well the consequence of ignoring external pressure to reform their policies to make them financially sustainable. The equilibrium of domestic interests in the two countries preferred to maintain the prevailing policies in the context of overvalued exchange rate as threat imposed by IMF proved insufficient constrain these strategies credibly out of the opportunity set. The consequences are well known. Romania in 1999 was also on the brink of default on its sovereign bonds, yet chose to accept tough stand-by arrangement and complied with it despite previous history of repeated non-compliance.

[27] For example, EU relies on the harmonization and capacity building during the pre-accession process and IMF employs the concept of conditionality to create incentives for institutional reforms. World Bank is now testing the concept of the Comprehensive development framework, which would provide external anchor and accountability.

The exclusive focus just on these two hypotheses out of the Williamson's list is also justified by the specifics of sectoral reforms. Whereas Williamson deals with overarching economic reforms, where visions, leaders and unique window of opportunities and so on, play substantial role, the sectoral reforms are less encompassing. There is less need to balance priorities among various urgent needs, as banks are typically reformed only after the initial macroeconomic stabilization has been finished. Sectoral reforms are more focused, pragmatic and technocratic. Moreover, they attract less public attention as the important changes take place on highly technical and detailed level, which is not that easy to follow without understanding bank's economics.

The fourth sequence: Achieving long term sustainability prospects

Once the vested interests have been dealt with and the appropriate institutional framework was developed, there is still a need to prevent backsliding, ensure its sustainability and create good prospects for further reforms as the good practice evolves. Arguably the most successful way of achieving sustainability, out of the alternatives pursued by the transition economies in Central and Eastern Europe, is to privatize substantial parts of the banking sector to foreign strategic investors recruited among either regional or global financial groups.

The trigger puzzle

It is not only puzzling what makes reform feasible and successful but we do not know enough even about what triggers them. Findings of Williamson (1994) and Rodrik (1996) but also of Stiglitz (2000), Haggard (2000) and Krueger (2000) boil down to the conclusion that the question of what triggers the third decisive step of reform, when vested interests are dealt with, is essentially an empirical issue. Current PEPR theories can at best point out some characteristics one could focus on. Thus was the trigger puzzle pegged to the hypotheses.

2. COUNTRY CASE STUDIES

2.1. Romania

The process of the political and economic transition started in December 1989 with violent overthrow of the Ceausescu regime. The Exhibit 6 captures the following political developments. It was rather turbulent time as the governments until 1996 elections lacked strong mandate and stability to introduce institutional reforms. Stability of successive governments was also threatened by occasionally authoritative actions of the president Ion Iliescu, who enjoyed strong position within the Romanian system of government.

Exhibit 6 Governments in Romania

Period	Government and its change
Dec 1989	• Ceausescu regime overthrown
May 1990	• National Salvation Front won elections • Petre Roman government established
Nov 1991	• An attempt to introduce wider-ranging market reforms resulted in dismissal of the government following violent demonstrations by miners • Theodor Stolojan government established
Sep 1992	• Social democrats won election and established government supported by ultra-nationalist and neo-communist parties, which resisted major economic changes • Nicolae Vacaroiu prime minister
Nov 1996	• Stabilization achievements from 1994 lost in the pre-election economic expansion, which resulted in high inflation, a devaluation, and price and currency controls • Democratic convention won elections and formed a government headed by Victor Ciorbea • New government introduced radical reforms and made early entry into the EU and NATO the major foreign policy objectives
April 1998	• Living standards tumbled and obsolete industries and institutions resisted reforms • Radu Vasile became new prime minister
Dec 1999	• Limited successes in accelerating the privatization of large firms and banks and in closing down loss-making enterprises in the coal and metallurgical sectors was achieved, however, living standards continued to fall. • Mugur Isarescu, the governor of the NBR, became new prime minister
Nov 2000	• Social Democratic Party won elections • Adrian Nastase head the minority government supported by the party representing Hungarian minority
	Total number of governments in 1990 – 2002: 7

Source: Economist Intelligence Unit

The macroeconomic development during the initial period was mixed. Following the initial fall, the GDP growth was restored already in 1993. Moreover, stabilization policies were successfully implemented in 1994 reducing average annual inflation by 100% between 1993 and 1994 and keeping the current account deficit at reasonable level. However, the political cycle prior to 1996 debilitated these achievements. Fiscal expansion and raising wages resulted in increased, imports, external imbalance and exchange rate problems. Six month before the elections the incumbent government introduced rigid controls on prices and exchange rates, including stripping most banks off foreign exchange licenses (Euromoney, April 1996).

Exhibit 7 Basic macroeconomic indicators for Romania in transition

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
GDP growth	%	-13	-8,8	1,5	3,9	7,1	4,1	-6,1	-4,8	-1,2	1,8	5,3	4,9
Inflation	%	161	210	256	137	32,3	38,8	155	59,2	45,8	45,7	34,5	22,5
Unemployment	%	3	8,2	10,4	10,9	9,5	6,6	8,9	10,3	11,8	10,5	8,8	8,2
Current account	% GDP	-4,5	-7,8	-4,7	-1,7	-4,9	-7,3	-6,2	-6,9	-3,6	-3,6	-5,8	-3,5
Exchange Rate	Lei:$	189	460	1276	1767	2578	4035	8023	10951	18255	25926	31597	33500

Source: EBRD Transition Reports, various issues

The new coalition government elected in 1996 introduced radical market-oriented economic reform, wiped out most of remaining price controls, introduced restrictive monetary and fiscal policy, and the liberalization of the foreign exchange regime. However, these run into troubles when the fragile coalition fell apart in January 1998. The following government tried to continue reforms, yet fell into the same trap as its predecessors: "intra-coalition disagreements; limited administrative capacity; and fear of social unrest lead the government to make concessions on wages that caused an overshooting of macroeconomic targets" (EIU 1998a: 6). The interim government of Mr. Isarescu who was a governor of the central bank, presided over improving macroeconomic conditions until the last elections in November 2000.

The 1990s in Romania were spent struggling with what was latter called first generation reforms, aimed to fulfill the "SLIP" agenda, i.e. macroeconomic stabilization, price and interest rate liberalization, creation of the elementary institutional framework for market economy and initial privatization. The stabilization and liberalization had to be attempted twice, in 1994 and after 1996. This delayed other reforms, including those of the banking sector. Romania began mass privatization in 1992, but it stuck halfway through. The State Ownership Fund (SOF) continued to hold controlling stakes in many large companies until the end of the 1990s. Moreover, the voucher privatization brought in neither fresh capital nor new technologies and most companies did not manage to start any meaningful restructuring (Euromoney, September 1997).

The elementary institutional structure for market economy was created, but it suffered from the flaws typical for most of the countries in transition. The usual bottlenecks included poorly protected property and creditors' rights, malfunctioning bankruptcies, highly inefficient judiciary and corrupt bureaucracy. Such an institutional environment obviously affected the functioning of the banking sector.

2.1.1. Initial structure and institutions of the banking sector

The elementary framework for the market-oriented banking was created in April 1991 when two elementary laws were approved:

- Law on banking Activity No. 33/1991 and
- Law on the Statute of the National Bank of Romania No. 34/1991.

These laws in effect created a two-tier banking system in Romania. The commercial activities of the socialist monobank were carved out predominantly to Banca Comerciala Romana S.A. (BCR) and the National Bank of Romania (NBR) focused exclusively on the central banking functions, including regulation and supervision of the commercial banks. The formal institutional structure introduced by the two laws was at best rudimentary. It lacked the standard measures to introduce prudential banking, which were introduced only gradually until 1998.

Exhibit 8 Initial structure of the banking sector in Romania[28]

Function		Name
Central bank		National Bank of Romania (NBR)
Commercial part of the monobank		Banca Comerciala Romana S.A. (BCR)
Former sectoral banks	(foreign trade)	Banca Romana de Comerc Exterior (Bancorex) S.A.
	(agriculture)	Banca Agricola S.A.
	(investments)	Banca Romana pentru Dezvoltare S.A.
State Saving Bank		Casa de Economii i Consemnatiuni (CEC)[29]

Source: Dancau (2001), Doltu (2002) and NBR (1998)

The initial institutional framework was highly imperfect in an environment hostile to prudential banking and rigorous supervision. The formal framework suffered from many loopholes and failed to constrain plentiful perverse incentives. Paradoxically, some productive incentives, such as provisioning and reserve creation were constrained and discouraged. Moreover, there was persisting problem with enforcement of any rules. In such a situation it is no surprise that market players quite rationally devised number of perverse, wealth destroying strategies, which were most likely beneficial to themselves, but detrimental to general economic development. Some of the typical perverse strategies are listed in the following section.

2.1.2. Perverse bank strategies in Romania

Government ownership of banks. Given the social situation and the level of poverty in Romania there strong pressure on the government to avoid quick restructuring of large loss-making state-owned enterprises (SOEs), which suffered from substantial over-employment. The government gave in to these pressures and the state owned banks were used to channel implicit subsidies, such as (i) soft loans at negative interest rate, (ii) government-guaranteed loans and (iii) other supplies at administratively determined prices (Meyendorff and Thakor 1997: 4).

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[28] Apart from listed banks there were 4 branches of foreign banks and Banca Comercial "Ion Tiriac" S.A., making the total of 10 commercial banks.

[29] Governed by a special Law No. 66/1996. CEC was exempted from the NBR supervision throughout the 1990s.

Insider lending of newly established banks to their owners. Combination of the relatively loose licensing policy, together with absence of the institutional constraints on the related party transactions created perverse incentive for looting. Business and industrial groups could set up the bank in order to legally siphon-off money from depositors and from interbank market to their own coffers. This strategy was used even by the large state owned enterprises and régies autonomes[30] as a source of soft credits. NBR reported that this had affected the stability of Dacia Felix Bank, Credit Bank and Columna Bank (NBR 1999: 80). Insider lending was behind failures of several small, private banks which were established during the 1990s (see Exhibit 14).

Exhibit 9 Number of licensed banks in Romania

	1991	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total	10	20	24	31	33	36	34	33	33	31
Foreign owned	0	3	6	8	11	16	19	21	24	24

Source: EBRD transition report 1997 and 2002; Euromoney April 1996 and NBR 1999

Failed corporate governance left banks dominated by their entrenched management (and/or majority owner[31]) that could pursue its objectives regardless of the shareholder value. In Dacia Felix and Credit banks over 80% of credits were to insiders, executives and large shareholders, which resulted in huge concentration of risks. Moreover, managers in other banks, which were scheduled for privatization opposed the idea of privatization to a single foreign strategic owners, preferring several owners instead. This indicates that there were private benefits of control entrenched managers did not want to forego (Meyendorff and Thakor 1997).

Good money after bad money. Banks were forced to roll over bad loans to their traditional clients not only by the government but also by concern for their own prudential indicators. Their exposure was such that had they disclosed the quality of theses credits in line with international standards, they would become openly insolvent. Entrenched managers obviously had strong incentive to avoid such disclosure, unless all other banks did so as well. Instead, they chose to extend new credit to cover old

[30] Public owned, yet largely autonomous business entities. They are typically utilities.

[31] Government ownership and insider lending strategies are two specific examples of strategies where majority owners dominate.

principal and hoped that the client will be able to pay at least interests (which was relatively easy when lending rates were negative in real terms).

Moral hazard created by indiscriminate bail outs. These have started with the Global Compensation Scheme, which shifted trade arrears to bank balance sheets and ultimately to NBR (Carare, Claessens, Perroti 1999: 10), continued to five successive bailouts of Bancorex (Bokros 2000:15) prior to its liquidation and finished with the pre-privatization bail-outs of virtually all banks privatized and especially of Banca Agricola. Repetitive bail-outs created expectations that the state will help banks out of troubles again and again, which served as an incentive for risky behavior on the side of bank management.

Pyramid game. Insolvent banks, which were starved for liquidity, were willing to offer ever higher interest rates for household deposits to keep their inflow. This has been a problem to the largest Romanian bank Bancorex as well as for several smaller banks (NBR 1999: 85). Similarly, banks were willing to pay a lot higher interest rate at the interbank market to keep themselves afloat. NBR had reported that since late 1998 until the imposition of the conservatorship in Bancorex in March 1999, the bank was willing to borrow at interest rates averaging 265 percent (NBR 2000: 79). Such a thirst for deposits turns a bank to little more than a Ponzi scheme (pyramid game)[32].

Adverse selection and/or corrupt lending. Until 1994 and also in 1996/97 the real interest rates were negative (see Exhibit 10) so banks had to ration credit by other means. Loans were allocated according to the bargaining power and bargains were typically corrupt. When real lending rates turned positive prior to 2000, they were high relative to the rate of return companies in transition. This discouraged serious borrowers and there was an adverse self-selection of borrowers, as predominantly firms that did not intend to repay were seeking new credits.

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[32] See also the discussion of the solvency and liquidity issues in the next section.

Exhibit 10 Lending rates in Romania

		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Lending rate	%	49,5	86,4	61,8	48,6	55,8	63,7	56,9	65,9	53,5	40,6	28,9
Real lending rate[33]	%	-161	-170	-74,9	16,3	17,0	-91,1	-2,3	20,1	7,8	6,1	6,4

Source: EBRD Transition Reports, various issues

Tax and accounting distortions. Loopholes in the accounting and tax system encouraged risky behavior and did not facilitate prudent one. For example, the tax treatment of reserves and provisions discouraged their creation even though they were economically justified. Even more troubling was taxing profits non-adjusted for high inflation and revenues from uncollected interests (NBR 2000:77).

The above list of perverse strategies prevailing in the Romanian banking sector in transition is not exclusive. However, it is sufficient to prove that the institutional constraints on a set of perverse incentives did not exist during the initial phase of transition. The vicious circle has clearly developed. Furthermore, the persistence of the perverse strategies was facilitated by troublesome interactions with the enterprise sector, which underwent slow and difficult restructuring (Meyendorff and Thakor 1997), faced high degree of uncertainty and unpredictability and failed to disclose reliable financial information on its performance. In case of borrowers default the chances of redress were slim as poor protection and enforcement of the creditors rights, malfunctioning bankruptcies and Byzantine court system made it prohibitively expensive both in monetary terms as well as in terms of opportunity costs of time and resources. Last but not least, the banking knowledge and skills of the players, the lack of thereof, proved to be very important factors. The transition (of the banking sector) was learning by doing process, the speed and direction of which also reflected incentives embedded in the institutional matrix (North 1990).

In countries where the banking sector institutional framework evolved beyond the vicious circle the perverse incentives and strategies are constrained by credible legal and supervisory institutions. The Exhibit 11 summarizes what was missing in Romania. Even if some of the important constraints were introduced initially, there was a problem with their enforcement. Meyendorff and Thakor report that

[33] Only very rough estimate calculated as one year average lending rate minus rate of inflation.

"although the prudential bank regulation is well *designed*, problem with implementation remains" (1997: 4, italics in the original). They concluded that by 1997 the formal institutions for the banking supervision were in place and generally in the spirit of the international standards, the enforcement was weak as supervisors focused more on formal compliance rather then on the real risks.

Exhibit 11 Missing constraints

Perverse strategy	Standard constraint
Government ownership of banks	With a few exceptions[34], sale to foreign strategic owners proved to be the only viable strategy for effective privatization.
Insider lending	Limits on exposure to single and connected entities, with special rules on arm's length lending to related parties and reporting of such transactions.
Failed corporate governance	Solution is complex and lies in intersection of (i) strengthening the protection of the minority shareholders' rights, (ii) supervisory of ownership and managerial changes, (iii) strengthening market and supervisory monitoring.
Good money after bad money	Rules on classification of assets, which stipulate the duty to classify new credit in the same category where the worst past credit of given borrower is classified. Banks should be able to exchange such information through a credit registry.
Moral hazard	Best cure for repetitive bail outs proved to be effective privatization preceded by one-off carve out of NPAs.
Adverse selection	Macroeconomic stability, low inflation and competitive banking sector are the best cures for high and volatile interest rates. Corporate information disclosure and good chances of workout in case of default than help even small and medium enterprises to get access to credits at reasonable costs.
Tax distortion	Adoption of the International Accounting Standards and corresponding tax reform is attainable solution even for transition economies.

Clearly many of the standards constraints listed in Exhibit 11 were not attainable to Romania at the time when they were most needed. They could have been introduced only in a context of complex reform sequence. What made most of theses institutional constraints achievable at the beginning of the second decade of transition is a subject to comparative chapter (see Chapter 3).

2.1.3. Romanian banks’ performance

The performance of the Romanian banking sector during 1990s has been dismal. Apart from the above institutional factors encouraging perverse strategies, the macroeconomic environment was hostile to solid banking. Such developments as (i) high volatility of the interest rates, (ii) depreciation and swings in the exchange rate of Lei, and (iii) high inflation (NBR 1999: 77) had their effect of both

[34] Such as OTP Bank in Hungary.

profitability and stability. These effects were leveraged further by the very limited progress with the real sector restructuring.

Exhibit 12 Romanian bank performance in transition

		1994	1995	1996	1997	1998	1999	2000	2001	2002
State owned banks	% assets	80,4	84,3	80,9	80	75,3	50,3	50	45,4	43,6
Non-performing loans	% total	18,5	37,9	48	56,5	58,5	34,5	3,8	3,4	2,3
Credit to private sector	% GDP	n.a.	7,8	11,5	8,4	11,6	8,1	7,2	7,7	8,4

Source: EBRD transition report 1997 and 2002

The Romanian banking sector remained relatively shallow even compared to its central European peers. Total banking assets have risen from around 30% at the beginning of transition to nearly 50% during the short-lived boom in 1996 and then fell again to current level of 32,3% following the banking sector restructuring (BA-CA 2004). Not only was the banking sector shallow, but banks also preferred to lend to clients with either implicit or explicit guarantees of the government, so the amount of credit to private sector rarely exceeded 10%.

These facts indicate that the Romanian banking sector was not quite capable to channel the savings to investments effectively. Moreover, it had plenty of difficulties to avoid outright crisis, which is best illustrated by the amount of NPAs. Despite the lax accounting standards, which were based on the French model, the officially recorded level of the non-performing assets (NPAs) was rising to near 60% of the banking sector balance sheet. Moreover, this figure does not reflect fully the obligations arising from off-balance sheet items. Over 75% of total banking sector NPAs were concentrated in Bancorex, Banca Agricola, Bankcoop and Banca Albina (NBR 2000:77).

Perhaps unsurprisingly, bankers did not remain ignorant and adjusted their strategies to the hostile macroeconomic and institutional environment. After the initial period of naive "lending as usual" at the onset of transition, bankers learnt that it is not sustainable and that there are limits beyond which is nothing but a complete meltdown of their banks. These limits became constraints on their strategies, which in turn created some productive, wealth preserving incentives.

The constraints derive from some inherent specificities of the financial sector in general and banks in particular. Banks produce rather specific product - a promise to repay more then was deposited after certain period of time expires (Caprio and Levine 2002: 10). The key parameter of promise is it credibility - the depositor must judge whether bank will be able to honor its promise in future. However, the credibility is difficult to measure, even more in the absence of good institutional framework that would provide for accounting and other standards, which reduce transaction cost of assessing of bank's health. The measuring difficulty and the flow character of the business give banks extra time, before they are forced to admit insolvency. Even insolvent banks can keep going for years as long as they are able to keep their liquidity (ability to pay out their depositors on demand). However, insolvent bank with a good liquidity is little more than a Ponzi scheme[35]. In any case if the solvency criteria could be suppressed, the liquidity could not be. The bankers had to keep reasonable level of liquidity to keep the bank in operation at least in short run and to prevent the run on the bank.

The liquidity constraint and other emerging regulatory standards, created some incentives for prudent strategies, which were turned into the mix of productive and perverse strategies. By mid 1990s Romanian banks, in their struggle to avoid sinking deeper and deeper into insolvency, stopped extending further soft loans. From the point of view of the corporate sector this was a credit crunch. Only politically powerful companies and those which could immediately threaten the bank regulatory ratios had they ceased repayments (see the "good money after bad money strategy" above), were capable to enforce more soft credits. Banks did not extend loans and invested in save government papers instead (see Exhibit 12) for stagnating proportion of credits to the expanding private sector).

By the mid-1990s, the learning process resulted in the vicious circle when:

1. Further lending to former or still SOEs was needed so they could restructure and become credit worthy.
2. Banks could not lend any further to avoid collapse and recurrent need for government recapitalization.

[35] In theory some banks may even be able to "grow out" of insolvency by paying old losses with current profits. This theory gave many CEE bankers far too much hope as they used it to ex post justification of continuing operation of insolvent banks. The miraculous of return to solvency did not materialize in any major bank in CEE countries.

3. To make the lending sustainable, the emerging regulatory framework would have to be vividly enforced, which would result in immediate forced administration of major Romanian banks, which had to cook the books to fulfill prudential criteria (see NBR 2000: 78)[36].

The bankers' reaction to the hostile environment resulted in excessive risk aversion and the credit crunch, when entrepreneurs had severe difficulties to access credits almost regardless of their creditworthiness. Something had to happen to break out of this vicious circle.

2.1.4. The turning point

The year 1999 was a turning point for the Romanian banking sector. What were previously two irreconcilable worlds – one real banking sector operation and the other the prudential regime – was merged into one. Banks which were not capable of fulfilling prudential criteria were either restructured or liquidated, and the sector remerged as compliant with the regulatory framework.

NBR conducted a thorough analysis and concluded that "share of non-performing loans classified under "doubtful" and "loss" in the total loan portfolio, i.e. 58.51 percent, as well as the ratio of doubtful and overdue claims (net value) to banks' equity, i.e. 253.64 percent. The level of the latter suggested that, should at least half of those claims not have been recovered, the overall banking system would have virtually been bankrupt" (NBR 2000: 77). Under these circumstances the NBR launched a restructuring programme, which was facilitated by upgraded laws approved in 1998[37]. Moreover, the reform minded government elected at the end of 1996 had approved new Board of Governors of NBR, which was determined to bring the banking sector on a firm footing.

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[36] Sweeping claims about the banks' stability are well justified in the next section, which describes the resolution to their problem as well as the proportion of the NPAs.

[37] Law No. 58/1998 – Banking Act, Law No. 101/1998 – The National Bank of Romania Act, and Law No. 83 – The Bank Insolvency Act, which together strengthened the central bank's capacity to take action in the area of banking supervision.

NBR launched the stabilization program[38] with threefold aim: (i) resolve the situation in problem banks, (ii) improving the institutional framework of the banking sector and (iii) stabilizing the deposit guarantee system.

The problem banks were predominantly large, majority state-owned banks, which also presented risk to a systemic stability. To avoid such risks and to allow for swift resolution the Bank Asset Recovery Agency (BARA) was established and all troubled assets transferred to it. Bancorex, the largest bank presented the key threat. Its solvency problems apparent from the 75% of its assets classified as non-performing and off-balance sheet items, which amounted to 80% of the loan portfolio at the end of 1998, turned to open liquidity problems, which triggered run on the bank culmination in February 1999. The run sparked decisive action of NBR, which acted as a lender of last resort, extended emergency loan and placed Bancorex into the forced administration. The bas assets of Bancorex were transferred to BARA, the viable assets and the franchise was taken over by the state-owned Banca Comerciala Romana (BCR). Bancorex was then liquidated.

Less radical approach was taken to restructuring of other banks. The Banca Agricola was put under the auspices of a managing committee overseeing its restructuring, which started already in 1997, and bad assets were transferred to BARA. The bank was further recapitalized by the state in 2001 and in April 2001 sold to the consortium of the Romanian-American Enterprise Fund and Raiffeisen Zentralbank Österreich AG.

The Banking privatization was one of the most important commitments of the Romanian government under the Structural Adjustment Program concluded with the IMF and supported by the World Bank[39]. The first major bank for sale was Banca Romana pentru Dezvoltare S.A. This bank suffered relatively less from the pre-transition legacies and had outward oriented management, which managed to avoid perverse strategies and consistently prepared the bank for the entry of foreign investor (see Euromoney,

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[38] The following description is based on the Annual Reports of the National Bank of Romania for years 1998, 1999 and 2000, Chapter 5.

[39] The conditional financing was made available since early 1990s, however, the conditions were fulfilled only after four failed attempts to disburse all allocated credit.

April 1997). Relatively smaller Banc Post, which was also established after the 1991, went for sale as well at the beginning of 1999 (see Exhibit 13). Since then only the sale of the Banca Agricola was successfully finished. There were two unsuccessful attempts to privatize the largest BCR, which failed twice to attract strategic investors, so the strategy was changed. EBRD and IFC bought together 25% of shares with a view to facilitate sale of 51% government stake to foreign strategic investor by 2006.

Exhibit 13 Privatization of major Romanian banks

Bank	Date	Market share	Investor
Banca Romana pentru Dezvoltare S.A.	1999	14,95	Societe Generale
Banca Agricola S.A	2001	4,78	Raiffeisen Zentralbank
Banca Comerciala Romana S.A.	2003	39,57	EBRD and IFC
Banc Post S.A.	1999	4,09	GE Capital BPI

Source: NBR Annual Reports, BA-CA 2004; (market shares at the end of 1999)

The remaining state-owned bank Casa de Economii si Consemnatiuni (the state savings bank operating under the special law) was bailed out by the state of its obligations arising from disputed backing of the two fraudulent investment companies in 2001. It entered a programme agreed upon with the EU, which should result in its privatization.

The resolution of the small bank crises is summarized in the Exhibit 14. The date of resolution refers to the final decisive step in the crisis resolution process, which was in some cases rather endless. Most extreme example is that of Banca Columna, which was declared insolvent in November 1998. Since then it was out of operation, but the tug of war between NBR and the bank continued until March 2003, when the court finally declared it bankrupt. Following this verdict, the NBR claimed that "[this declaration of bankruptcy] marks the completion of the clean-up of the Romanian banking system. Thus, as of that moment, all banks that were insolvent or had negative net worth have been removed from the system. From this standpoint, it can be asserted that, at present, the operation of the Romanian banking system is based on the principles of a functioning market economy" (NBR 2003: 81).

Exhibit 14 Resolution of small bank crisis in Romania

Bank	Date of resolution	Principal causes	Type of resolution
Dacia Felix (later Eurom Bank)	May 2001	insolvency	bankruptcy filed (1996); restructuring granted and failed; new filing (1998); government bail out; recapitalization; continues operations
Credit Bank	Nov 200	insolvency	bankruptcy filed in 1996, granted by court in 2000; depositors bailed out by the government
Banca Columna	Mar 2003	insolvency	Judicial reorganization (1998); Licence revoked (2000); disputed in court;
Bankcoop	Feb 1999	Bad loans; off balance sheet commitments	Bankruptcy
Banca Internationala a Religiilor	Feb 2000	Bad loans; insufficient provisioning and liquidity	Special supervision and settlement regime; management fined; bankruptcy filed
Banca Comerciala „Unirea"	Jun 2000	Liquidity problems	Special supervision and settlement regime; bankruptcy filed but revoked by the court following capital increase
Banca Turco-Romana	Jul 2002	Run triggered by reports of fraudulent transactions	Stabilization attempts thumbed by the Turkish banking crisis; bankruptcy filed and accepted
Banca Romana de Scont	Apr 2002	Fraud	Special supervision regime; further inspection; management removed; licence revoked; bankruptcy filed and accepted
Banca de Investitii si Dezvoltare	Mar 2002	Fraud	Special supervision regime; further inspection; management removed; licence revoked; dissolved by shareholders

Source: author, Annual Reports of NBR

2.2. The Czech Republic

The process of the political and economic transition in the Czech Republic started in November 1989 with so called Velvet Revolution. The Exhibit 6 captures some of the following political developments. Until 1996 the politics was dominated by the ODS lead by Vaclav Klaus. Since then all governments struggled with minority support in the parliament of with one or two vote narrow majority.

Exhibit 15 Governments in the Czech Republic

Period	Government and its change
Nov 1989	• Communist regime overthrown by velvet revolution
June 1990	• The Civic Forum won elections in both parts of the federation
June 1992	• ODS (Civic Democrats) won elections in the Czech Republic – Klaus's government • HZDS (Movement for democratic Slovakia) won in Slovakia – Meciar's government • No stable coalition could be formed on federal level of Czechoslovakia creating a deadlock for implementation of economic reforms • Political deadlock was resolved by smooth and quick separation of the two republics
January 1993	• The Czech Republic established
June 1996	• ODS lead coalition unexpectedly failed to secure parliamentary majority • Klaus formed a minority government
November 1997	• Revelations of ODS irregular party financing resulted in break up of the coalition, which was undermined by the two fiscal austerity packages • Interim government of Josef Tosovsky, national bank governor, established
June 1998	• Social democrats won elections but failed to secure majority • Milos Zeman's minority government established with conditional support of the ODS based on "opposition agreement" • EU entry was major political goal yet the progress has been rather slow
June 2002	• Social democrats won election and formed a coalition with junior parties from the 1996 coalition • Vladimir Spidla became prime minister
	Total number of governments in 1990 – 2002: 5

Source: Economist Intelligence Unit

The macroeconomic development during the transition period in the Czech Republic was marked by successful stabilization of inflation and low unemployment. Unlike inflation, the low unemployment proved unsustainable. It reflected lack of microeconomic restructuring rather than the flexibility of the labor market. Initially, the growth reappeared already in 1993, however, growing domestic demand, which was not matched by domestic production and exports, triggered substantial external imbalance in 1996 and 1997. The growth proved to be an artificial boom and the sobering policy reaction was inevitable. The CNB and government tightened monetary and fiscal policy respectively and initiated some late efforts to build up the missing institutional framework, which would ensure effective functioning of markets. The economy turned to recession and the government to turmoil. The coalition, lost most of its credibility as it became clear that its transition scenario was not that miraculous after all. When reports of irregular ODS financing were released, the government collapsed.

Exhibit 16 Basic macroeconomic indicators for the Czech Republic in transition

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
GDP growth	%	-12	-3,3	0,6	3,2	5,9	4,3	-0,8	-1	0,5	3,3	3,1	2
Inflation	%	56,6	11,1	20,8	10	9,1	8,8	8,5	10,7	2,1	3,9	4,7	1,8
Unemployment	%	4,1	2,6	3,5	3,2	2,9	3,5	5,2	7,5	9,4	8,8	8,9	9,8
Current account	% GDP	1,2	-1	0,3	-0,1	-2,6	-7,1	-6,7	-2,2	-2,7	-5,3	-5,7	-6,5
Exchange Rate	CZK:$	29,5	28,3	29,2	28,8	26,5	27,1	31,7	32,3	34,6	38,6	38	32,7

Source: EBRD Transition Reports, various issues

The interim government and newly elected social democratic government have at last launched delayed institutional reforms. This triggered restructuring on the microeconomic level, supported by substantial FDI inflow since 1998. The previous distortions caused by the mass privatization within weak institutional framework (see Dyck 2000) resulted in huge accumulation of bad debts in the banking sector balance sheet. This presented a major challenge for the new government, which was successfully challenged as banks were privatized to the hands of foreign strategic owners by the end of the government's first term. Moreover, the economy returned to reasonable growth in 2000.

2.2.1. Initial structure and institutions of banking sector

The elementary framework for the market-oriented banking was approved already in November 1989 as a part of the perestroika related reforms. The laws were little changed when they entered in force by the January 1st, 1990. The two laws laying down the legal base of the banking sector were:

- Law on the State Bank of Czechoslovakia No. 130/1989 and
- Law on Banks and Thrifts No. 158/1989

These laws proved sufficient to create a two-tier banking system in the Czech Republic. The Czech National Bank[40] (CNB) focused exclusively on the central banking functions, including regulation and supervision of the commercial banks. The commercial activities of the socialist monobank were carved out predominantly to Komercni banka, a.s. (KB). The formal institutional structure introduced by the two laws was at best rudimentary.

Exhibit 17 Initial structure of the banking sector in the Czech Republic

New function (original function in the socialist system)		**Name**
Central bank		Czech National Bank
Commercial banks	(commercial part of the monobank)	Komercni banka (KB)
	(foreign trade)	Ceskoslovenska obchodni banka (CSOB)
	(investments)	Investicni a Postovni Banka[41] (IPB)
	(retail savings)	Ceska sporitelna (CS)
	(retail foreign exchange)	Zivnostenska banka (ZB)

Source: Kudrna et al. (2002)

As in Romania, the initial institutional framework was highly imperfect and the transitive environment was hostile to prudential banking and rigorous supervision. The formal framework suffered from number of loopholes and as a result failed to constrain plentiful perverse incentives. Paradoxically, some productive incentives, such as provisioning and reserve creation were discouraged. In its effort the keep the fiscal balance government pressurized state owned banks to postpone reserves and pay taxes instead[42]. Moreover, there was persisting problem with enforcement of any rules. The standard institutional constraints on perverse incentives were missing so the market players quite rationally devised perverse, wealth destroying strategies. These were most likely aimed to benefit managers,

[40] Until Dec 31st, 2002 The State Bank of Czechoslovakia. The Czech and Slovak Republic separated from the beginning of the 1993. For the federal period of post-1989 Czechoslovakia this paper focuses only on what is relevant for the Czech Republic.

[41] Until 1995 merger with the Postovni banka called only Investicni banka.

[42] Snyder, Kormendi (1997:106) report "The bank intended to allocate its [CZK] 3 billion of profits that year to reserves and pay no taxes. The Minister of Finance, Vaclav Klaus, complained to Dr. Salzmann [chairman of KB] about Komercni's plan and the two reached an agreement whereby Komercni banka provisioned half the amount and paid taxes on the balance."

controlling owners or other related parties, at the expense of minority shareholders, depositors, crowded out borrowers and at the end of taxpayers.

Alternative motivation for pursuit of perverse strategies in the later period (after 1995), when the elementary framework was established, was to hide losses and avoid their disclosure. These strategies were not directly beneficial to insiders, but they aimed to cover past mistakes and frauds and get more time to negotiate the way out of losses. Last but not least, substantial proportion of losses is attributable to lack of experience, lack of information and generally high uncertainty during the transition period.

2.2.2. Perverse bank strategies in the Czech Republic

The imperfections in the Czech institutional framework were comparable to those of the Romanian one. Inevitably, the perverse strategies were quite similar to those described in Section 2.1.2 on Romanian banking sector in transition, thus I will only briefly mention their circumstances in the Czech transition. However, there is one more important perverse strategy, which was not present in Romania to comparable extent. Whereas Romanian mass privatization scheme played only marginal role in shaping the opportunity set of bankers, the Czech version had a decisive impact. It had created a whole new set of perverse incentives stemming from owner-creditor dilemma.

This owner-creditor dilemma resulted from the participation of the bank's subsidiaries, investment companies, in the voucher privatization. They have set up and managed investment privatization funds, which gathered vouchers from citizens and invested them in shares of financial and non-financial companies. Indirectly, banks became owners of large stakes in the Czech industrial companies. At the same time, they were their creditors. This has resulted in the specific modification of the "good money after bad money" strategy (see Section 2.1.2).

If the bank's client runs into troubles, as many did during the 1997-1999 recession, the bank, which was its direct creditor and indirect owner at the same time, had to decide where to take the hit. It could either deny new loans, trigger the bankruptcy and suffer the loss in equity portfolio, but avoid further losses in loan portfolio, or, alternatively, it could extend the loan, temporarily preserve its equity portfolio at the expense of future losses in the loan book. There was no good solution to such situations, moreover, some looters learned to misuse it to extract more loans. Malfunctioning and corrupt bankruptcy processes, which lasted for years and hardly ever redressed more then just a few percent of the original value, were hopeless alternative. Thus banks continued financing of non-viable clients.

Continued financing of non-viable enterprises was clearly perverse, wealth destroying strategy, but in the given institutional framework it made sense. Repetitive bail out of state-owned banks and/or enterprises made such gamble a reasonable bet (see Mejstrik et al. 2004 for description). All Czech transition governments were reluctant to let large employers fail; be them banks or large industrial enterprises. The governments had contributed to persistence of vicious circle of perverse financing strategies by effectively encouraging soft loans from state banks to voucher privatized or still state owned enterprises.

Government ownership of banks. The first bank in CEE countries fully privatized to foreign capital was Zivnostenska banka, small bank serving retail operations in foreign currencies during the socialist period, which was sold to the German banks BHF-BANK and IFC in 1991. Allegedly, this privatization experience backfired as the Czech government learnt that privately owned banks stick to prudential lending and are not willing to extend credit to highly risky, state-owned or recently privatized clients.

Insider lending of newly established banks to their owners. Combination of the very loose licensing policy in 1990 to 1993 (Exhibit 18), together with absence of the institutional constraints on the related party transactions created perverse incentive for looting[43]. Business and industrial groups could set up the bank in order to legally siphon-off money from depositors and from interbank market to their own coffers (see Cull, Matesova, Shirley 2001). This strategy brought down majority of the small private banks owned by the Czech capital as briefly described in Exhibit 23.

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[43] Akerlof and Romer (1993) defined looting as borrowing heavily with no intent to repay in order to use the loans for private purposes.

Exhibit 18 Number of licensed banks in the Czech Republic

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total	9	24	37	52	55	55	53	50	45	42	40	38	37
Foreign owned	0	4	11	18	21	23	23	24	25	27	26	26	26

Source: EBRD transition report 1997 and 2002; Euromoney April 1996 and NBR 1999

Failed corporate governance left banks dominated by their entrenched managements (and/or majority owner[44]) that could pursue its objectives regardless of the shareholder value. As their Romanian counterparts[45] the entrenched managers preferred several larger owners instead of single majority holder, who could exercise monitoring and control over their actions much more effectively and strip them of private benefits of control. Arguably, keeping banks' corporate governance in a state of failure was the most damaging strategy of all. Good internal corporate governance practices could substitute for missing external institutional framework and thus constrain the pursuit of all other perverse strategies (Kudrna 2002 developed the argument).

Moral hazard created by repeated bail outs. As has been explained above this government strategy influenced substantially the decision making in the situations of creditor-owner dilemma. The first bail out scheme was introduced in 1991, when the government established Konsolidacni banka and majority of non-performing loans initiated prior to 1990 was transferred from the balance sheets of major banks. This was followed by Consolidation and Stabilization Programmes for small banks in 1995 an 1996. The last wave of bail outs came in between 1998 and 2001 as the four largest banks were stabilized and finally privatized to strategic owners (see Mejstrik et al. 2004).

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[44] Government ownership and insider lending strategies are two specific examples of strategies where majority owners dominate.

[45] In both cases however there were managements oriented towards getting renowned foreign owner as soon as possible. The most profound examples are Banca Romana pentru Dezvoltare in Romania (Euromoney, April 1997) and CSOB in the Czech Republic (Stein 2000). Managements of these banks were entrenched as well but rather then pursuing perverse strategy of maximizing private benefits of control, they worked rather hard to make their bank "salable" to reputable investors. It was not surprising that these managers occupied to management positions even after the privatisation.

Pyramid game. As in Romania the outright pyramid schemes were predominantly problems of non-bank financial institutions, which were rather misleadingly called mutual funds in Romania[46] and credit cooperatives in the Czech Republic. However, as with Bancorex in Romania the IPB in the Czech Republic got dangerously close to becoming little more then pyramid structure in its final year of operation. It was attracting short term deposits by higher interest rates and increased the amounts of loans during the time of recession, when other banks reduced their lending almost to a standstill (Kudrna et al. 2002). This created severe maturity mismatch and reduced its chances to withstand array of bank runs in the first half of 2000.

Adverse selection and/or corrupt lending. With the exception of 1993 the estimated real lending rate was positive. The nominal interest rates were relatively high, especially when compared to rates of return of industrial lenders (World Bank 1999: 168). This discouraged conservative borrowers, who either relied on internally generated resources or on FDIs, and banks ended up financing higher risk projects. These more often then not failed, especially when they were proposed by the Czech "privatizers[47]," who disposed with seemingly liquid, but highly leveraged collateral[48]. Moreover, weak internal controls within the major banks encouraged corrupt lending practices.

Exhibit 19 Lending rates in the Czech Republic

		1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Lending rate	%	13,3	14,1	12,8	12,7	12,5	13,2	12,9	8,7	7,2	7	6,2
Real lending rate[49]	%	2,2	-6,7	2,8	3,6	3,7	4,7	2,2	6,6	3,3	2,3	4,4

Source: EBRD Transition Reports, various issues

[46] The Czech Act of Banks at least prevented and kind of non-licensed institution to call itself bank or savings bank. The Romanian consumers were misled even on this most elementary level.

[47] The Czech equivalent to Russian oligarchs, who, however, come out rather modestly from this comparison.

[48] Typically, they privatized first small firm, used it as collateral for bigger loan to privatize another firm. This recurrent leveraging lasted only until 1997, when these structures started to collapse due to pressures from economic slowdown (see Roberts 2004 for description of credit games in privatization and McDermott 2002 for the insights into emergence, functioning and collapse of these conglomerates).

[49] Only very rough estimate calculated as one year average lending rate minus rate of inflation.

Tax and accounting distortions. As in other CEE countries fictive revenues from uncollected earnings were taxed and relatively strict limits imposed on the tax deductible reserves and provisions[50].

The few perverse strategies listed above provide a brief insight into incentives for and logic of sustaining the vicious circle of wealth-destroying banking sector. The set up of the institutional framework was such that in the resulting opportunity set were many perverse incentives and few clearly productive ones. The missing constraints started to emerge as the actors in banks, CNB and legislature learnt their lessons about negative effects of perverse strategies and about their unsustainability. The learning process was accelerated through interaction with international financial institutions, which helped to identify the weaknesses as compared to the international experience and best practice. The design of the regulatory framework was improving and loopholes were fixed one after the other.

The emergence of the banking supervision in the Czech Republic is briefly described by the following exhibits. It can be meaningfully separated into four periods: (i) emergence of a supervisor, (ii) establishment of rudimentary frameworks, (iii) emergence of consistent banking supervision, and (iv) standardization of the supervisory framework along the international best practices.

Exhibit 20 Emergence of a supervisor

Year	Milestones
1990	• Unclear responsibility for banking supervision • CZK 50 million in capital (which could be refinancing credit), business proposal and several formalities were needed for bank license
1991	• Supervisory department at the central bank was established (8 employees and fast turnover as people with any experience left to private banks) • The rules and methods of supervision were drafted, including licensing rules, accounting rules and prudential requirements. IMF provided support and staff training. • CNB consulted the privatization proposals for banks entering voucher privatization. • "Consolidation program I" of BigFour recapitalization implemented

Source: author, based on CNB (1999)

[50] Initially banks could deduct for reserves only 1,5% of the nominal value of their loan portfolio. In 1993 the limit was raised to 2% of total assets and in 1995 to 3% of total outstanding credit. In 1998 the limit was changed back to 2% again.

Banking supervision was unknown practice in the socialist economy. The hard decisions about allocation of resources and risks were taken within the bargaining structure of the planning hierarchy (Kornai 1992) and banks had mere bookkeeping and monitoring function. There were rules on credit allocation, but if the enterprise needed a credit to fulfill the plan, the extension of loan was quasi-automatic. Bankers were only clerks and had very little power *vis-à-vis* powerful enterprise managers.

When the perestroika reform was prepared nobody thought of adding another layer of regulatory bureaucracy; the order of the day was to abolish these rather then create them. As a result the responsibility for banking supervision and regulation was spread among federal and national ministries of finance, national departments of the central bank and its federal headquarters. Nobody was really responsible. The central bank was supposed to issue licenses, which were more of a formality[51], but it gradually took the responsibility. There were practical reasons such as frequent communication with banks and at least some information about them, which were supplied for monetary purposes (CNB 1999: 9). It was more by chance rather than by constitutional choice, that the central bank became responsible for banking sector supervision.

The first two years were more about learning what should be done in a capacity of the banking regulator and supervisor, then about actually regulating and supervising. The skills, knowledge, capacity and information were of very short supply, despite the urgent needs.

Exhibit 21 Rudimentary regulatory framework

Year	Milestones
1992	• New versions of the two elementary banking laws came to force. The goals of the supervision were defined on the basis of German model. • In retrospect, many loopholes became obvious, such as approvals of shareholder change, changes of key managers, lack of enforcement tools other than licence withdrawal, poorly defined conservatorship etc. • Decrees on capital adequacy, credit limits, foreign currency limits, reserve requirements and increased capital requirements (CZK 300 million) were issued. All applied to new and existing banks. • Classification and provisioning rules introduced. • Rules on bank audit drafted with the support of PHARE.

[51] As the tale of those times goes, it took about 2 hours to get the license and about 2 years to make the bank bankrupt.

1993	• Rules on the annual financial disclosure and reporting drafted. • Some loopholes regarding connected lending and limits on equity risks patched. • Risk management and internal audit rules drafted. • On-site inspections moved beyond the pilot stage and established themselves as useful supervisory tool. Solutions to identified problems remained difficult to enforce. • Separation of the Czech and Slovak banking sector. • Following the first bank failure, rules on access to interbank market were created.

Source: author, based on CNB (1999)

In the next two years the elementary regulatory and supervisory framework was introduced. There was a new set of banking laws, which substituted those from perestroika period. They were considerably more compatible with the market-based banking; however, they failed to constrain wide variety of clearly perverse incentives existing in the transitive institutional matrix. Many unanticipated loopholes created number of perverse incentives. Moreover, new banks spread as a wildfire, as did demand for their services, which the large state-owned banks were not able to meet. It seemingly made sense to ease the entry so that the gains from competition and specialization could be reaped.

On the other hand, the would-be bankers had hardly any clue, what banking business was about[52] and the two years of learning by doing proved sufficient to cause irrecoverable harm to the small banks, which then all failed (see Exhibit 23). Before the bankers and supervisors learnt elementary lessons about banking, the roots of insolvency were so embedded, that none of the small domestic banks could be saved without external help of either the taxpayer or, in a few more fortunate cases, of (foreign) investor. The large domestic banks followed their smaller counterparts in to the trap only with some time lag.

The supervisors realized the risks and started to patch the worst loopholes, which would force the banks to get themselves on the firm footing. For example, they have raised the minimal required capital to 600% of the original, ridiculously low limit. However, there was no capital available to be invested. Domestic shareholders were either too weak or interested only in looting, not stabilizing their bank. Foreign shareholders were too scared by the uncertain unpredictable business environment to

[52] Arguably, in a country of 15 million there were 5 – 10 people with practical experience from market-based banking, which they gained at the London branch of Zivnostenska banka, which was the only Czechoslovak banking institution present on western markets. As opposed to other CEE countries, Czechoslovakia never borrowed on international capital markets, so it was not even marginally connected to them. The only other source of "Czech and Slovak" banking knowledge, were former emigrants, which were not particularly welcome.

take a stake in a troubled small bank[53]. The supervisory effort not only proved insufficient to constrain perverse strategies, but it created incentives for new costly ones. All small banks refinanced their capital increase from loans, which looked like new investment only because they were channeled through complicated structures of related parties.

Exhibit 22 Emergence of banking supervision

Year	Milestones
1994	• Banks were obliged to reach 6,25 % capital asset ratio (CAR). • An amendment of the Act on Banks gives CNB better intermediary enforcement tools (reduction of capital, improved conservatorship, special supervision regime) to deal with prevailing problems, which banks were unable or unwilling to deal with, such as poor performance and frauds. • Deposit insurance fund established. • Minimal capital requirement increased to CZK 500 mil.; applicable to existing banks as well. • New limits on certain types of credits and equity investments introduced to patch more loopholes, including classification and provisioning rules. • The would-be bank's leading managers had to pass the fit and proper examination. • Methodical manuals of the supervision standardized.
1995	• Compulsory disclosure requirements introduced. • Major upgrade of the prudential rules based on the experience from on-site and off-site inspections. • Comprehensive internal rating introduced and intensified on-site supervision. • Consolidation program II was introduced for the sub sector of small banks, which did not fulfill the 8% CAR requirement.
1996	• Notification of suspicious transactions introduced to prevent money laundering. • Further improvements of prudential rules – new rules for bank securities and equity portfolios and related reserves and provisions; improved definitions of key of entities for the purposes of credit limits, new weights for state guaranteed institutions and new liquidity management rules. • Early warning information system introduced. • Consolidation Program II continued and disclosed major problems in 15 out of 18 small domestic banks. • All banks were obliged to reach 8% CAR in line with Basel rules, without exceptions.
1997	• Yet another round of patches of prudential rules on: CAR calculation; more precise limits on certain types of loans and equity investments; rules on securities and equity portfolios and related reserves and provisions; improved loan classification rules. • Stabilization and Consolidation Programs continued.

Source: author, based on CNB (1999)

In the 1994-97 period the banking supervision started to bite. CNB successfully closed increasing number of loopholes and enforcement of increasing number of institutional constraints became credible. Supervisory pressure and economic realities forced small domestic banks to disclose the real extent of their uncovered losses. As they lacked their own deposits and large banks became

[53] Since 1990 foreign banks were allowed to set their subsidiary companies and from 1992 branches. They preferred these two modes of entry.

increasingly wary about lending them on interbank market[54], they were no longer able to hide losses by roll-overs and other perverse strategies.

Exhibit 23 Resolution of small bank crisis in the Czech Republic

Bank	Date of resolution	Principal causes	Type of resolution
Kreditni a prumyslova banka	Apr 1995	Connected party lending	Conservatorship, licence withdrawal; creditors distributed assets in an out-of-court settlement
Banka Bohemia	Jun 1994	Poor credit risk assessment; securities fraud	Conservatorship, liquidation
AB Banka	Feb 1996	Connected party and other fraudulent lending	Bank license suspended; liquidation
Ceska Banka	Dec 1995	Connected party lending, insolvency	Bankruptcy declared
Ekoagrobanka	Jan 1996	Poor credit risk assessment; losses on securities	Conservatorship; stand by loan; new owner found
Prvni Slezska	May 1996	Insolvency; poor credit risk assessment	Conservatorship; take-over by another bank
COOP	Apr 1996	Poor credit risk assessment	Conservatorship; take-over by another bank
Podnikatelska banka	Jun 1996	Fraudulent lending	Conservatorship; freezing of accounts
Kreditni Banka Plzen	Aug 1996	Connected party lending, overvaluing collateral	Bank licence withdrawn
Agrobanka	Sept 1996	Liquidity problems, bad debts	Conservatorship, all obligations guaranteed by CNB; good bank sold, bad bank liquidated
Velkomoravska banka	Jul 1996	Loan losses exceeding capital	Conservatorship; frozen accounts, insured deposits paid out, license withdrawn
Realitbanka	Apr 1997	Loan losses exceeding capital, liquidity problems	Conservatorship; liquidation
Moravia banka	Nov 1999	Loan losses exceeding capital,	Bank license withdrawn; bankruptcy declared
BaSkala	Mar 1997	Loan losses exceeding capital, liquidity problems	Merged with Union bank
Evrobanka	Jun 1997	Loan losses exceeding capital, liquidity problems	Merged with Union bank
Pragobanka	Oct 1998	Loan losses exceeding capital, liquidity problems	Bank license withdrawn; bankruptcy declared
Universla banka	Feb 1999	Loan losses exceeding capital, liquidity problems	Bank license withdrawn; bankruptcy declared
Banka Hana	2000	Loan losses exceeding capital, liquidity problems	Bank license withdrawn

[54] All banks participating on the interbank market were assigned 20% risk weight regardless of their financial standing. This was in line with Basel rules for OECD banks, however, it created perverse incentive predominantly to Ceska Sporitelna, which had abundant deposits as it was originally a state savings bank (Mejstrik et al. 2004: 84). If CS extended credits, it had to create larger reserves to maintain CAR, whereas if it gave a loan to small banks, the requirement was lower, so it seemed cheaper (in terms of opportunity cost of capital) and more profitable to lend to small banks, but only until the first of them failed. Then large banks had to absorb some losses and they abolished the practice.

Plzenska Banka	2003	Insolvency	Bank license withdrawn; bankruptcy declared
Union Banka	2003	Insolvency	Bank license withdrawn; bankruptcy declared

Source: CNB, Mejstrik 2004, author's update

The crisis of the small banks, which together held about 6,5%[55] of the market had potential systemic implications (more to do with the trust of citizens than with the system itself), so the CNB stepped in with the Consolidation program and government complemented that with the Stabilization program. These were designed to provide temporary relief for well behaving small banks, which could be freed of the burden for 7 years and had to repay it only gradually. The success was limited as most banks involved failed anyway and few of them were paid out of the program by new investors.

Exhibit 24 Standardization of banking supervision

Year	Milestones
1998	• Two amendments of key banking laws proposed by CNB were approved. These embedded into law some principles previously contained only in bylaws. Licensing rules were tightened; links between bank and non-financial companies restricted; commercial and investment activities separated by "Chinese wall"; remedial measures tightened; tools to constrain perverse strategies of major shareholders strengthened and there were changes in deposit insurance too. • New regulation stating that if the real estate, which was used as collateral, is not sold within one year after the repayment was due, then the loan is classified as loss and must be fully provisioned regardless of the potential value of the real estate. This was reaction on severe difficulties banks face when sizing, registering and selling real estates. Moreover, expert valuations of real estates were often distorted or simply corrupt as some banks tried to avoid provisions for loss loans. Banks were given 30 months transition period. • Memorandum of understanding signed among CNB, Securities and Exchange Commission and Ministry of Finance (insurance supervision) about regulation of financial conglomerates.
1999	• New regulation: CAR including both credit and market risks; supervision and reporting on consolidated basis. The made qualitative shift to the most advanced forms of banking supervision. • Experts from CNB invited by the Basel Committee to participate on the formulation of new international regulations of CAR and to evaluate the Core Principles of Banking Supervision.

Source: author, based on CNB (1999)

Having dealt with the small banks, the CNB had the gargantuan task to ensure the stability of the large banks. It was clear that the large banks did not manage to avoid perverse strategies, which were on a given opportunity set quite rational at least in the short and medium term. These strategies inevitably had to create a burden on the long term sustainability of the financial health of large banks. It was not

[55] Relates to the situation in 1997. The banks failed in the later period are listed for the sake of completeness.

so apparent until 1996 as the economy was growing and banks had a cushion of cheap deposits to allocate and buffer the impact of non-performing assets on their balance sheets. However, the combined pressure of the regulatory tightening and economic downturn following events of 1997, proved difficult to handle. Instead of growing out of losses, banks faced a real stress testing of the sustainability of their policies, which only CSOB managed to withstand without state involvement.

Until July 1998 the three banks in question – KB, CS and IPB – were able to cope with their NPAs either by provisioning or by creative accounting and other financial transaction, which formally reduced the amount of needed provisions. The quick workout of NPAs was blocked by malfunctioning bankruptcy and resolution framework[56] and by strong incentive for the "Good money after bad money" strategy described above. In July 1998 CNB issued a decree stating that loans guaranteed by real estate collateral and classified as "loss" must be fully provisioned. In other words, banks were given one year since a repayment was due to sell the real estate collateral, otherwise it was regarded worthless.

This was thought and controversial provision, aimed to constrain the largest remaining loophole. The real estate collaterals were troublesome for two reasons.

1. The general institutional framework was malfunctioning – laws made it very difficult for creditors of defaulted debtors to seize the control over the real estate. Originally, they even needed debtor's consent. Moreover, the land registry is one of the most corrupt organizations of the civil service, where surprises happen.

2. Banks were able to artificially increase the reported value of collateral – given that the real estate market was largely illiquid in most areas of the country, the market values were difficult to estimate. The standard procedure was to rely on expert valuations. Not surprisingly, in many cases the value of the collateral was more a function of a fee to the experts than of the value of real estate.

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[56] Despite 20 amendments of the Bankruptcy and Composition Act since its introduction in 1991, the Czech Republic still does not have anything meaningfully comparable to efficient bankruptcies. In international comparisons it compares to African failed states rather than to EU countries (see World Bank Doing Business database at rru.worldbank.org).

The CNB decree inflicted huge provisioning costs on the large banks, which were not prudent enough to avoid this trap. Resolving this issue effectively meant resolving the NPA problem of large banks, which in turn is tantamount to pushing a healthy banking sector into the standard regulatory framework. This has been a start of the third sequence of the procedural hypothesis, when the vested interests had to be dealt with.

By 1999, the regulatory framework evolved from the state of virtual non-existence to status comparable with international best practice in banking regulation and supervision. It took "only" ten years and couple of billions of dollars to evolve[57]. The evolution of the regulatory institutions consistently narrowed down the set of perverse incentives; however, the institutional vicious circle could not be broken without major restructuring of the banking sector, which required to deal with vested interests. Without it the key banks had no chance to comply with ever more demanding regulations.

2.2.3. Czech banks' performance

The performance of the Czech banking sector during 1990s has been troublesome. Despite relatively favorable macroeconomic conditions, the lack of microeconomic restructuring, missing institutions and delayed privatization left a heavy toll of NPAs (see Exhibit 25).

Exhibit 25 Bank performance in transition

		1994	1995	1996	1997	1998	1999	2000	2001	2002
State owned banks[58]	% assets	20,1	17,6	16,6	17,5	18,6	23,1	28,2	3,8	4,6
Non-performing loans	% total	35,8	26,6	21,8	19,9	20,3	21,5	19,3	13,7	9,4
Credit to private sector	% GDP	57,8	46,7	47,2	54,3	47	42,3	36,6	24,3	20

Source: EBRD transition report 1997 and 2002

The level of financial intermediation in the Czech Republic is relatively high compared to other CEE countries. In early 1990s the total banking sector assets stood at around 70% of GDP, it peaked at

[57] Given the wide range of instruments used, including guarantees, favored sales, bail-outs etc., it is difficult to come up with a single figure. Current estimates are between USD 1 and 2 billions.

[58] The EBRD figures exclude Komercni banka and Ceska sporitelna, where the state owned controlling stake, which was however less than 50 percent. These two banks controlled together around 40 percent of the banking sector as measured by assets until they were privatized in 2001 and 2000 respectively.

137% in 2000, falling down to 107% in 2003, after some NPAs were transferred to consolidation agency outside of the sector (BA-CA 2004: 32). Relatively high rates reflect lower levels of inflation, which did not erode value of assets and arguably also the tradition of the developed pre-war banking sector, which somehow survived the communist experiment.

Credit to private sector skyrocketed from zero to the equivalent of 50% of GDP in just 3 years after the beginning of the transition but was falling ever since to current level of around 20%. This reflect increased risk-aversion on the side of bankers, who preferred to allocate assets to risk free T-bills and bonds issued by the government, rather to the more risky corporate loans. As the improving banking experience and regulatory framework built up, there was less scope for careless lending. The reaction to high proportion of NPAs, which were above 20%, was some form of credit crunch and disintermediation.

Tuma[59] (2000) and Mejstrik et al. (2004: 47-48) argued that as a reaction to high levels of NPAs, limited chances of redress and monetary crisis from May 1997, some disintermediation took place. The standard flow of domestic savings channeled to domestic enterprises through domestic banks was abolished. Instead alternative channels of financing developed through:

- Foreign Direct Investment – most investments in the 1997-2000 period derived from this channel; Czech banks even provided financing for foreign investors;
- Corporate bond issues – banks bought corporate bonds of larger companies on capital markets and financed their investments indirectly; development of fairly liquid bond market at the expense of banking channel was a reaction to comparatively better institutional framework of the securities markets, including better disclosure and regulation by SEC;
- Leasing channel – small and medium enterprises financed their investments through leasing arrangements. Better protection of property rights of the lender, created and incentive to use this

[59] Governor of the central bank.

channel instead of the credit one. Major leasing companies were owned and financed by banks, so even this was indirect bank financing of enterprises.

Redirection of intermediation to other channels was a reaction to productive incentives in the banker's opportunity set. Credit crunch was also a productive strategy, as it at least preserved some existing wealth, which could have been lost by further credit expansion. Partial redirection of intermediation channels and FDI inflow cut the banking sector off from the problems of the real sector restructuring. It helped to avoid flow of new non-performing loans, however, the stock problem of a huge pile of NPAs in large bank's balance sheet remained. Three out of four largest banks were so burdened, that in order to keep prudential indicators, they had to engage in more or less perverse strategies in order to hide some losses from the supervisor, which was essentially a wealth destroying exercise. Moreover, alternative channels of intermediation are generally more expensive then direct credit channel, and less accessible for all small and medium enterprises. This was essentially the status of the vicious circle around 1998:

1. The burden of NPAs was incompatible, with increasingly tight regulations[60]. Full disclosure of the real extent of the NPA burden would result into insolvency of the three largest banks.
2. Banks had little chances to resolve it on their own, as the amount of provisioning which was needed was beyond their means, thus they engaged in various wasteful strategies[61] to hide at least some losses and make provisioning manageable.
3. Continued credit crunch put high burden on real sector, which needed working capital and investments to pull itself out of 1997-1999 recessions[62].

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[60] Banks had major problems to comply with the obligation to provision loss loans fully, regardless of the value of real estate collateral.

[61] By this time small banks were out of the game and foreign bank did not have problems to comply. However, KB, CS and IPB were most affected and thus most active players (see Kudrna et al. 2002, chapter 1.5 "Games of CNB and IPB, for examples).

[62] Some FDIs were attracted at firesale prices, as viable Czech enterprises desperate for cash needed to get foreign partners onboard very quickly. This might not be loss to GDP but it is a loss to GNP, which could be thought of as an implicit tax for setting up the business in the Czech Republic, where banking sector failed to function properly.

Relative effective regulation and supervision was not reconcilable with the prevailing situation of the three major banks, which added up to over 50% of the banking sector. It was clear that something had to happen to stabilize the banks in question. Whatever was going it would affect distribution of rents and long run pay-offs of many players in the political economy landscape. There was a complex interplay of vested interests on the way to the new equilibrium.

2.2.4. The turning point

The end of the "wild east" type of banking in the Czech Republic was relatively long and complex process, in which three forces played role of paramount importance: politics, economics and regulation. More specifically, change over of the government and political cycle; worsening financial standings of large bank, which was increasingly disclosed to the government and public through various financial reports and analyses; and tightened supervisory framework, which forced banks not only to disclose the real extent of NPAs but also to deal with the problem.

Domestic political, economic and regulatory factors, together with international influences, framed the opportunity set upon which the opposing interest groups optimized their strategies. This interplay is analyzed in a comparative manner with the Romanian experience in the following chapter. Here it can be stated beforehand, that the reform of the institutional framework of the Czech banking sector was successful, notwithstanding the fact that the success came at high costs.

The privatization started in 1998, when the government sold its minority stake in IPB to Nomura Europe. IPB was subject to the spontaneous privatization and the state's stake was diluted in 1993, when the National Property Fund failed to participate in an equity increase (Kudrna et al. 2002: 38). Since then the bank was effectively controlled by its management. Through middlemen Nomura controlled over 10% of IPB's shares and prior to privatization announced the joint agreement with other shareholders, controlling together 49.4%. State had little other choice then to sell them the rest.

Moreover, in the privatization run up IPB disclosed substantial proportion of its losses[63], so its CAR fell down to less then 4%. The choices faced by the government were either to agree with the imposition of forced administration or to sell to Nomura, non-strategic owner, which was hoped to increase the capital to required level.

The following privatization of the CSOB was a success story. CSOB was a former trade bank, which went effectively bankrupt in 1993, when it was bailed out from the losses inherited from the communist past. Its management adopted and maintained a prudent strategy[64] so it did not generate transition related losses beyond its own means. The stakes of state entities in CSOB were sold to a Belgian bank KBC for EUR 1,2 bn in June 1999.

Privatizations of Ceska sporitelna and Komercni banka followed in 2000 and 2001 respectively. They had to be supported by large cleaning-up operations and several equity increases totaling over CZK 11 bn and some parts of their balance sheet had to be ring-fenced by state guarantees. Ceska sporitelna was sold to Erste Bank Sparkassen and Komercni banka went to Societe Generale. Despite relatively high prices, the total returns on privatization were negative (Hanousek, Nemecek, Hajkova 2002).

The privatization of IPB to non-strategic investor backfired. Bokros (2000: 18) described it as "a textbook case of moral hazard emerged where the private partners were able and allowed to privatize all of the gains and the (new) Czech government finally was obliged to socialize all of the losses." Nomura cherry-picked on IPB's equity portfolio and then let the bank fail in June 2000 under the sever liquidity and solvency crisis. The bank was put to conservatorship and sold to CSOB/KBC over the weekend (see Kudrna et al. 2002).

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[63] Typical behavior described also by Bokros (2000: 14) "Managers of state-owned banks were inclined to under state the true size of their losses before it was too late and then rushed to overstate it once a program of rehabilitation had been announced."

[64] The strategy was supported by the CNB, which held 34% of shares, and National Bank of Slovakia, which controlled 17% and had no interest whatsoever to agree on financing the Czech transition by soft loans.

Exhibit 26 Privatization of major Czech banks

Bank	Date	Market share	Investor
Investicni a postovni banka	1998	15,4	Nomura Europe
Ceskoslovenska obchodni banka	1999	19,1	KBC
Ceska sporitelna	2000	18,2	Erste Bank
Investicni a postovni banka (again)	2000	-	Take over by CSOB/KBC
Komercni banka	2001	12,4	Societe Generale

Source: Kudrna et al. (2002); (market shares as of total assets in CAS at the end of 1999)

As a result of the bank privatization process 94.2 % of total assets of banking sector were directly or indirectly controlled by foreign capital and the Czech banking sector was fully tied in to the multinational financial structures. The bad assets which were carved out of the sector are for sale at 90% discount at the Czech Consolidation Agency, the losses of which are footed by the taxpayers.

3. Reform experience compared

The purpose of this chapter is to evaluate whether the institutional change of the banking sector in Romania and the Czech Republic corroborate with the hypothesis stated in the theoretical chapter. Given that the hypothesis is based on the extensive review of the theoretical literature, this chapter also evaluates the "goodness of fit" of various theories of policy reform with the reform experience of the two countries.

Moreover, the comparison of the Czech and Romanian cases is an interesting test of the potential generality of the proposed hypotheses. The two counties are in respective extremes of the economic development in the CEE peer group. The Romanian GDP is on 24 percent of the EU15 average, whereas the Czech is almost two and half times higher at 59 percent[65]. The Romanian and Czech case differ strikingly also in terms of inflationary and exchange rate performance. Whereas in Romania high rate of inflation and purge of corporate hard currency deposits in 1991 triggered substantial demonetization (Daianu 2000), Czechs had one of the most stable currencies in CEE and experience only one “successfully managed” exchange rate crisis in May 1997 (Dedek 2000). Other major differences could be found by going deeper into the history. Daianu (2000) convincingly argues that the initial conditions in Romania were far worse than in the Visegrad countries and traces some of the differences thought the type of the communist regime all the way to the inter-war economic performance. Romania and the Czech Republic are clearly different in many relevant aspects, thus if the institutional reform in these two transition economies, followed the hypothesized sequence, then there is some chance that it may be relevant even to countries in between the two extreme cases. Two cases are of course far too little to judge, but they can at least provide some indication of whether the hypothesis is worth further research.

The research hypothesis has three essential components. The sequencing hypothesis, which proposes that institutional reform in the transition countries aspiring to EU membership follows the four step sequence; the sustainability hypothesis, which claims that the deadweight losses and EU and/or World

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[65] Measured by the Purchasing Power Standard. Eurostat April 2004.

Bank play a key role in sustaining the reform effort *vis-à-vis* domestic opposition; and a trigger puzzle, which asks what factor had triggered the decisive step of reform. Further discussion in this chapter is structured along the sustainability hypothesis.

3.1. Creation of bank supervisors

The elementary duties of banking supervision and the supervisory body were defined in 1990 and 1991 respectively, when the monobank was dismantled and the two-tier banking sectors established in Czechoslovakia and Romania. As was described in the Czech case the initial allocation of responsibilities was not particularly clear and capacity clearly insufficient.

In both cases it was a central bank, which was assigned the tasks of banking supervision. From today's point of view there were other alternatives, such as separate regulatory body or integrated financial supervision. However, fifteen years ago this kind of debate was not yet anticipated and allocation of duties was primarily driven by the practical purposes. After all, until delimitation of the monobank the new commercial banks were part of its hierarchy, thus the new central bank possessed the best available knowledge, as well as formal and informal communication channels needed for supervision.

Establishment of the supervisory department created a bureaucratic constituency, which supported implementation of regulatory standards as a part of its self-interest[66]. Moreover, international donors were keen to provide technical assistance, expert advice and staff training[67], which helped to start the gradual process of introducing and strengthening of the regulatory framework.

In the early period there was one substantial difference between the standing of the banking supervision in the two countries – the effective independence of respective central banks. The Czech Republic is one of the few countries in the world, which had embedded the central bank independence into their constitution. Moreover, the independence of CNB was fully respected throughout the transition period, despite the fact that after 1996 the close coordination between the government and

[66] Here the rational behavior of a bureau trying to maximize the budget extracted form the sponsor is assumed (Niskanen 1975). Moreover, prospects of travel abroad were attractive in early 1990s for many CEE bureaucrats, thus the supervisory department could be considered even a constituency for adoption of international standards.

[67] See USAID 2001: 3 for Romania and CNB 1999 for the Czech Republic.

central bank, which characterized the first six years of transition, broke down as both sides pursued different priorities, which were not fully consistent[68]. National Bank of Romania was not so fortunate. The Law on its statutes made it formally independent and accountable to parliament only, however, there were several occasions, when NBR clearly gave in to political pressures. Most notably in 1997 the NBR was forced to finance the government quasi-fiscal deficit (Doltu 2002: 287). Also the Commission concluded in its first opinion that the NBR "was subject to a certain degree of interference from the government over exchange-rate management, supervision, licensing and crisis management. It even extended special credits to loss-making state-owned enterprises and agricultural companies" (Commission 1997b: 28).

3.2. Gradual introduction of the international standards

The ever growing number of international standards and codes of best practices started to be implemented as early as in the first sets of laws, which had created the two-tier banking systems. These laws were largely legal transplants modeled on laws of French (Romania) or German (Czechoslovakia) origin. These laws had already reflected Basel Accord principles, which were published prior to transition in 1988.

In the Czech Republic the key principle stating of the 8% ratio of the bank capital to its risk weighted assets, was introduced in 1992. Banks were expected to comply by 1996, which was ambitious goal given that the starting CAR was as low as 1,2% in case of Investicni banka[69]. The principles were introduced early, but it took at least six years of learning by doing, before CNB figured out how to enforce them in a transitive Czech economy. As was described in Exhibit 22 and Exhibit 24 there were at least three major overhauls of the key regulations to patch loopholes and countless adjustments of the fine technical details, which supervisors identified as problematic during the off-site and on-site inspections.

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[68] CNB perceived the loose fiscal policy and growing external imbalance as a threat to the economic stability and to the credibility of its newly introduced inflation targeting. It started to pursue much more restrictive monetary policy, than Klaus's government hoped for.

[69] Annual Report of IB for 1990.

There is less detailed information available for Romania, but some later evaluations suggest that the gap between the laws on the books (international standards) and their enforcement existed in Romania as well. For example, the Commission in its first opinion concluded that "prudential requirements (banking Law No 33/1991 and rules laid down by the BNR) are generally in line with the first Banking Directive and the directives on banks' own funds and solvency" (Commission 1997b: 47). On the other hand, the Commission suggested in the same report that "the viability of the financial sector must be strengthened … by the introduction of effective supervision" (Commission 1997b: 32). In other words, regulations were on books, yet their enforcement was limited.

The important insight into the implementation of the international standards in the environment of the transition economy is that to make the sector compliant more rules than the international standards themselves must be introduced. There must be a separate set of measures to break out of the vicious circle of perverse strategies and to facilitate the transition to institutional framework compliant with the international standards. These measures do are not necessarily compliant with the international standards themselves as they are rather pragmatic reactions on missing institutions.

The prime example of such a measure is the CNB decree from July 1998, which orders full provisioning of loss loans regardless of the value of the linked real estate collateral. Such a rule is absent from the international best practice and indeed in countries with low costs of transacting and liquid real estate markets it would be a perverse, wealth destroying regulatory strategy. Yet in the context of the Czech transition, it constrained major remaining loophole in the institutional framework and forced banks to express their credit risks in their full extent. It had triggered the final changes described in the following subsection, which made the Czech banking sector compliant with the transplanted international standards.

Other examples of non-standard transitory measures are abound; in case of restructuring of Bancorex and Banca Agricola in Romania and of Agrobanka and IPB in the Czech Republic[70]. Practically all

[70] On the other hand, when dealing with bankrupt banks ad hoc measures are more of a rule than exceptions as number of post-1998-crisis East-Asian countries and even United States with their 1990 thrift crisis could witness, thus it can hardly be considered specific to transition economies.

cases of resolution of bank insolvency in transition countries included ad hoc measures, which had to be implemented in order to overcome the problem of absent or malfunctioning institutions. For example, in the Czech Republic there is still no market exit arrangement for banks, which would reflect their specifics *vis-à-vis* non-financial enterprises, despite the fact that more then 20 banks exited the market.

In both countries, to inefficiency of judiciary is one of the key institutional bottlenecks for improved economic development. This made regulators to improvise and include detail provisions into new banking laws, which would limit the discretion of and impose deadlines on the ineffective and corrupt judiciaries. These measures were inconsistent with the international standards and present only the second-best solutions, which may however be more efficient then the first-best solutions dictated by international standards.

3.3. Dealing with vested interests

The interplay of political and economic interests in the process of institutional reforms is a very complex issue, (mis)understanding of which is increasing with the increasing asymmetry of information between the players and external analyst. Thus this section provides only a stylized account of the interest group interplay, in the vain of political-economic models such as those provided for the deregulation of the U.S. banking sector in the 1990s (see Peltzman 1989, Kroszner 1998 and Kroszner and Strahan 1998).

This thesis is based on the theory of institutional change, which is defined as the change in institutional constraints, which reshapes the opportunity set on which economic agents pursue strategies they believe to optimize their individual objective functions. Under this theoretical angle reform means change of incentives. The ideal institutional framework should credibly constrain perverse incentives out of opportunity set, contain the productive incentives within the set and create market and regulatory institutions, which can quickly and at low costs distinguish between the perverse and productive incentives in a dynamic setting. To understand the interplay of interest groups related to institutional change, one needs to focus on the proponents and opponents of changes of the most important formal institutions[71], including their enforcement.

In order to structure the discussion of the interplay of vested interest I have proposed the sustainability hypothesis and posed a trigger puzzle (see Section 1.6). The institutional change of the regulatory framework is hypothesized to be a function of three independent variables (see Exhibit 27):

1. Competition of the domestic pressure groups results in an equilibrium in domestic politics, which determines the extent and quality of the domestic bank regulatory framework on a basis of the relative influence of various interests (see Becker 1983). This competition is assumed to be influenced by the process of learning and prevailing ideologies, i.e. mental models of the key competing players, which evolve through time (North 1990).

2. The competing interest groups are constrained by growing dead-weight losses (DWL), which are increasingly obvious to voters. Voters influence the relative power of competing interests through election process (Becker 1983). In case of banks the dead-weight losses are well proxied by the increasing proportion of NPAs and increasing number of failed banks, which make electorate aware of the problems and thus make it more difficult to political decision-makers to redistribute favors to particular interest groups (see Peltzman (1976) for optimizing behavior of politicians and Olson (1965) for the theory of interest groups). Growing DWLs create internal constraint on the opportunity set on which interest groups optimize their strategies. The improving regulatory framework contributes to appropriate classification and disclosure and thus helps to reveal, which banks are in troubles. In other words, improved regulation makes DWLs more visible to voters and make the DWL related constraint credible for the competing interest groups[72].

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[71] Informal institutions are very hard to manipulate by short and medium term policies, which are available tools of reformist government. Moreover, as has been argued in the section 1.5 the focus of this thesis in on regulatory institutions only.

[72] This assumes at least reasonably functioning democracy.

3. In transition countries with credibly declared EU aspirations, the domestic competition of pressure groups is externally constrained by pre-accession process. The pre-accession process and regular evaluation by the Commission creates external accountability of political decision-makers (Berglöf and Roland 1997), further constraining favors to particular interests. Moreover, almost all transition countries relied[73] on the structural adjustment facilities provided by the World Bank Group. These facilities are subject to ex ante specified conditionality and disbursed only upon its fulfillment. These loans are needed to keep elementary stability, which provides further constraints on the opportunity set of domestic interest groups. The changing perception of probability of severe external macroeconomic imbalances and macroeconomic crisis makes the constraint more or less credible. In case that a country ignores these threats for too long then it may find itself in the midst of crises. That is when the IMF comes into play as lender of last resort and lays down the conditionality requirements, which include structural reforms the country in question tried to postpone or avoid altogether. For Romania this constraint was ever present at all times.

Exhibit 27 The hypothesis summary

Institutional change of the regulatory framework	=	Dynamics of domestic politics	+	Growing dead-weight losses	+	External pressures (EU and WB/IMF)

3.3.1. Domestic politics dynamic

Analyzing the dynamics of domestic politics, in relation to institutional change of the sectoral regulatory framework, moreover in transition economies, is inevitably somewhat speculative. The politics of these countries is far less transparent then in advanced countries and civil society is less developed. Interests are rarely expressed through transparent channels such as hearings of all relevant associations and lobby groups in front of the legislature. Moreover, most of the transition countries are rather small and their governing elites are not numerous, which provides strong incentives for informal

[73] In some cases were forced to rely on IMF/WB support by the macroeconomic imbalances. That was certainly the case of Romania. On the contrary, the Czech Republic avoided borrowing from Breton-Wood institutions.

dealings[74]. Informal deals leave little formal trail for the ex post analysis. Thus this thesis has to rely on observations of the most likely interests of the key stakeholders, which are complemented by the detailed interviews with several knowledgeable insiders in each country[75].

Interest groups opposing reform

The institutional change, which brought the regulatory framework of the banking sector closer to the international best practices, was opposed predominantly by the interests, which had profited from soft lending and rent-seeking opportunities invited by the lack of institutional constraints. These groups include:

- Stakeholders related to the ailing *state-owned enterprises*;
- *Embedded bank managements* with ownership ambitions; and later
- *Domestic tycoons, privatizers* and inward oriented business groups.

All stakeholders related to the ailing *state-owned enterprises* profited from prolonged survival and postponed restructuring (Kreuzbergova 2003, McDermott 2002). Initially this has been large and complex group of supporters ranging from embedded managers, labor unions, local councils and SOEs' suppliers. However, as the reform progressed these groups were weakened.

Initially, even small SOEs were able to acquire soft loans, however, as banks' problems deepened and the heydays of careless lending were over, only the larger SOEs, which were able to exert sufficient pressure retained access to soft loans. Smaller SOEs were either privatized and restructured or went bust. In any case, smaller SOEs faced credit crunch and any meaningful privatization made them to swap side and support banking sector reform. The new owners increasingly aimed to develop the firm,

[74] One could, of course, make the same argument for large countries as well. However, there is still a difference; even if decisions are made by narrow elite, there is still a larger number of professionals capable of challenging the decision on the basis of their highly specialized knowledge and skills. For example, in United States there are thousands of experienced bankers capable of discussing very fine details of banking regulations, whereas in the Czech Republic there are only handful of professionals with comparable knowledge. This makes the Czech discussions more "oligopolistic" rather than "contestable".

[75] Due to unforeseen changes, the interviews in Romania took place only after submitting this version of the thesis. They will be used to refine the argument in the course of future research.

rather then to tunnel it and they were increasingly capable of generating creditworthy projects, especially in export oriented sectors. Inevitably, smaller privatized firms joined to coalition of de novo firms and started to support reforms, which would remove credit crunch and made banks willing to extend new loans.

Each of the two countries opted for mass privatization schemes, which had two features in common: they took some time to implement and they created weak governance structures (Stiglitz 2000 and Coffee 1999). This had left existing enterprises in the hands of incumbent managers, who were under little oversight and monitoring from enterprises' owners. Apart from all kinds of perverse incentives ranging from maximization of private benefits of control to asset stripping and looting, weak governance also created incentive to privatize firms into the hands of incumbent management. Managers often initiated purchases of the company's shares[76]. They used all kinds of furtive schemes (see Roberts 2004) and company's funds to acquire substantial stakes[77]. However, to acquire sufficient controls managers opted for poorly transparent management-buy-outs, financed by highly risky loans. Virtually all these loans were beyond reasonable risks, which prudent bankers would normally undertake[78]. Consequently, in order to pursue their ownership strategy managers needed soft loans, this they were among strong supporters of opposition to the institutional reform of the banking sector.

Some of the more successful managers became local versions of oligarch, tycoons, privatizers or whatever they were called. They managed to build highly leveraged conglomerates, which were often sustained only by the inflow of new borrowings. Initially, banks were willing to finance their expansion as it seemed to be well collateralized by real estate and shares. Later banks ended up only rolling over the debts of these highly leveraged and insolvent conglomerates in order to avoid instant need for full provisioning (perverse strategy of banks described as "Good money after bad money").

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[76] Less in Romania where it took more time to establish the OTC market, which would facilitate such trades.

[77] This process has been sometimes called privatization by incest.

[78] In the U.S. the wave of hostile takeovers in the form of management buyouts in the 1980 was financed by so called "junk bonds", which were highly risky. They did not survive the first economic downturn as companies did not generate sufficient cash-flow to repay them. In any case junk bond is far more appropriate instrument then bank loan.

Not surprisingly, tycoons were most vigorous opponents of reforms, which would make them bankrupt. They were also major sponsors of the political parties of reluctant reformers (Reed 1996).

The interest groups opposing the reform were able to take advantage of deep misunderstandings regarding the role of banks in the economy, which prevailed until at least until 1997 in both countries. The gravest confusion had arisen from impression that banks had a lot of money as it was hardly appreciated that banks' money belongs to other people. As Bokros (2000: 15) points out "it was quite common and publicly acceptable to demand that banks pay high interest on deposits, charge low interest on loans, and still remain profitable in order to maximize dividends after corporatization. Managing risks and liquidity in a prudent manner, keeping growth in check, and optimizing the costs of gaining maximum productivity were concepts largely unheard of or clearly misunderstood."

Similar, misunderstandings were attached to bank privatization. Banks were viewed as "family silver", which ought not to be sold to foreigners. In the Czech case banking privatization during 1992 – 1996 was blocked by the political strategy of ruling party (ODS) heavily supported by the vested interest of the "privatizers". After 1996 the minority government lacked the support needed for decisive reforms so it was only interim government in 1998, which started preparations for strategic privatizations in 1998. The new social democratic government, established in June 1998, originally opposed the idea of bank privatization, but when it recognized the real extent of problems it concluded that there is no real alternative and privatized all banks within next three years. Similarly in Romania, all privatization attempts were blocked in Parliament until a new law on bank privatization was adopted in 1997. The law permitted privatization to both Romanians or foreigners, but "certain provisions such as the provision for the State Ownership Fund to retain 10% of the capital or a golden share permitting it to oppose decisions deemed "contrary to the national interest" or a right of the government to determine "optimal share structure" and the limits on the maximum shareholding, the right to pawn shares, which pose a significant problems" (Commission 1998b: 47). It took another two years of political tug of war, in which external influences play major role, to make meaningful privatizations possible (Euromoney, April 1998).

Moreover, negative sentiments prevailed also on the side of buyers who were initially very reluctant to enter uncertain market. The first Czech privatization in 1991 attracted only quasi-public investors – German public bank and IFC (Mejstrik at al. 2004: 41). The sentiment has changed in the second half of 1990s, when the success of the first foreign entrants became evident. However, even today Romanian largest bank failed twice to find strategic investor so the quasi-public capital form international financial institutions bought some stakes to increase the credibility of the privatization process[79].

Pro-reform interests

Whereas it was relatively easy to identify major groups of opponents to the banking sector reform, the proponents are more heterogeneous and dispersed. They included for example regulatory bodies, outward oriented managerial elite, EU oriented politicians, some SMEs, smaller foreign investors, academic economists and taxpayers aware of costs of soft loans. The heterogeneity and dispersion are not only a problem of academic analysis, but more importantly a severe disadvantage in the competition for influence (Olson 1965 and Becker 1983). More compact and homogenous groups of opponents were had the advantage of clear incentives, lower organization cost and lower cost of controlling free-riders.

The incentives of reform proponents were distorted as the firms would not mind to get soft loans, they only preferred prudent loans to no loans at all. Moreover, as the propones were small and dispersed they were rationally ignorant and avoided cost of supporting a reform with negative net private marginal benefits to themselves. The relative weakness of the pro-reform coalition only highlights the importance of the institutional constraints and of reform politicians and bureaucrats, who have sufficient selective incentives to create and enforce institutions, which create more productive, wealth increasing, incentives.

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[79] IFC and EBRD bought 25% stake to improve the chances of finding a strategic investor.

3.3.2. Growing deadweight losses

The proportion of the non-performing assets on total banking sector assets, can serve as a very good proxy for deadweight losses. As has been demonstrated in the comparative chapters the NPAs were raising until the decisive reforms steps were implemented. In terms of international comparisons both the Czech Republic had some of the highest proportion of NPAs among transition countries (see EBRD Transition reports for comparison). Romania in 1998 was probably the country with the world highest recorded proportion of NPAs, reaching almost 60% of the total banking sector assets.

Exhibit 28 Non-performing loans in Romania and Czech Republic

		1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Republic	% total	35,8	26,6	21,8	19,9	20,3	21,5	19,3	13,7	9,4
Romania	% total	18,5	37,9	48	56,5	58,5	34,5	3,8	3,4	2,3

Source: EBRD Transition Reports

From the point of view of domestic politics it is not the proportion, which plays a crucial role, but rather the economic consequences of high proportion of non-performing loans. The most important one is that it makes banks insolvent so they might not be capable to repay deposits. After a couple of initial bank failure and bank runs, the public learned the lesson and expected that political class will deal with the problem so they would not lose the money in banks. The public expectations created a constraint on further redistribution via soft lending to vested interest and made inaction and postponing of decisive reform step non-viable political strategy. The opportunity set of politicians narrowed down to such extend, that even forces, which previously opposed institutional change, such as social democrats in the Czech Republic, gave in. By 1998 all political strategies avoiding banking sector reforms, would have disastrous consequences before the next elections so even bloodedly rational politician could work out, that reelection after banking crisis was unlikely.

Moreover, the raising number of failing small banks raised the influence of the pro-reform interests. During the transition 8 small banks failed in Romania and 18 in the Czech Republic. As opposed to the large former state-owned banks, they occupied only a small portion of the market, but they failed over the short period of time of three years or so, which had obvious implication of the banking sector credibility in the eyes of depositors. Lack of public trust threatened to have long lasting systemic implications unless reform forced banks to achieve reasonable level of stability.

Alternative proxy variable for the deadweight losses could be inter-enterprise arrears, which were common phenomenon in both countries, albeit much more extensive in Romania. There arrears exceeded equivalent of 20% of GDP already in 1994 and increased to 34% in 1996 (Daianu 2000: 18). In the Czech Republic arrears were oscillating between 5 and 8 percent of GDP (World Bank 1999), are were partially reduced by the government organized netting programme and the first banking consolidation programme. Arrears, however, are more real sector phenomenon.

3.3.3. External constraints

The "return to Europe" has been the overarching political goal of all governments in the Czech Republic since 1991 and in Romania at least since 1996, when prime minister Ciorbea made early entry into the EU and NATO the major foreign policy objectives. Since then the EU functioned as an "external anchor" to both polities and economies. Moreover, since 1997 the Commission was issuing regular evaluations on the progress towards accession, which were widely discussed in media and thus made domestic politicians accountable externally as well as internally.

The first full-fledged formal assessment of the two countries' performance is provided in the Commission Opinions on Application for Membership of the European Union, which were made public in autumn 1997. The financial sector, including banking, was evaluated under the Copenhagen economic criteria[80], to judge whether it is market based and competitive. Commission's regular reports than updated the list of homework for respective domestic governments every year.

[80] "[Membership in the European Union requires] the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union " and "the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union (Commission 1997a: 1)".

The EU evaluations

The Commission concluded that the viability of the Romanian financial sector must be strengthened by further privatization and by the introduction of effective supervision. The goal was to introduce proper monitoring and private sector accountability, which would help to impose financial discipline on the enterprise sector. At the same time, it was hoped to improve access to risk capital for small and medium-sized private enterprises, including medium- to long-term loans, improve. Moreover, Commission suggested, that the effective execution of programmes of enterprise restructuring and financial recovery suffered from the lack of (adoption and implementation of) the necessary legislation. Critical legislation on bank insolvency was yet to be introduced, and prudential and accounting regulations were only in the process of alignment with international standards. More generally, Romania needed to develop a more effective culture of corporate governance, through the creation of a class of managers trained in western methods of management, better supervision by banks and investment funds of their loans and investments, more transparent disclosure of financial information and a less passive involvement of shareholders. The ultimate objective should be to provide an appropriate framework for financial intermediation and to ensure new entry into the sector, both in the form of creation of new enterprises, or through foreign participation.

Similar cure was proposed for the Czechs. The main assets were yet to be privatized and further consolidation and improvement of lending practices was needed for development. Again, increased participation of foreign capital was suggested as a solution at hand, if its hesitancy to enter sparked by the wave of small bank difficulties in 1996, was successfully overcome. Furthermore, legal changes separating commercial and investment banking were needed to deal with significant amount of inter-ownership of banks and cross-ownership between investment funds and banks. The conflict of interest should be addressed by strengthening minority shareholders' rights and disclosure requirements. The bad loans problem for banks ought to improve so the wide spreads between interest rates on credits and on deposits could be reduced to achieve competitiveness. The State may have to intervene to solve the problem of bad loans for some banks. For that matter, more effective supervision was needed to prevent the moral hazard and quick reoccurrence of the bad loan problem.

Exhibit 29 Summary of 1997 homework

Homework	Country
Privatization, preferably to foreign capital to strengthen financial discipline	both
Improvement of legal and regulatory framework, including bankruptcies	both
Improve the standards of corporate governance	both
Introduce "Chinese walls" between commercial and investment banking	Czechs only

The recommended and expected policy mix, according to Commission, ought to get the two countries closer towards fulfillment of the Copenhagen criteria. Consolidation and closures of non-viable banks are presented as measure to deal with the stock problem of bad loans, whereas privatization, improved supervision and dealing with the problems of the real sector is suggested as the best available policy to ensure healthy banking sector and, by the same token, to avoid further growth of non-performing assets. The Commission consistently pressed this agenda throughout the successive annual assessments, until they were implemented in the Czech Republic and most likely until they will be implemented in Romania (see CSFB 2004).

The Commission had regularly presented highly eclectic, yet consistent, analysis, which was very broad and not particularly deep. At the same time it was very efficient in setting the agenda and framing the set of acceptable solutions. As Csaba (2004) points out the assessments from Brussels served as external anchor, which constrained the choice of non-standard and non-viable policy options, which can be observed in some non-candidate transition countries[81].

From the point of view of practical policy making the Commission assessment and subsequent regular reports on progress served the role of a score-card for domestic as well as international audience, according to which the performance of policy-makers was evaluated. It had made the domestic policy makers accountable both internally and externally, given that EU accession was an overriding political priority in all candidate countries transition at least since mid 1990s. The crucial role of these assessments is confirmed by the media frenzy, which followed and still follows in the second wave

[81] Verdier and Roland (2000) even developed the game theoretic model, where EU served the coordination function by choosing the coordination equilibrium to be followed by domestic agent in the law enforcement game.

enlargement countries, the release of each regular report. Commission's assessments found their way into virtually every report made by international agency or company (see Economic Intelligence Unit's Country reports 1998-2003 for examples on both countries). Regular reports clearly played major role in what Csaba (2004)[82] calls "lending institutional credibility" to the candidate countries.

One can also observe an improving quality of reports over time. Whereas the early issues formulations are rather general and various relationships between interrelated problems are rather vague, the later issue were more focused, better illustrated by data and clear about interrelations of various reforms. At the same time reports focused on what should be done, rather then how it should be done, this was left to the domestic decision-makers and the EU influence was channeled through Phare, twinning and other support programmes. Both regular evaluation and support programmes served a very useful function of facilitation the learning-by-doing process on the side of the candidate as well as member states.

Apart from constraining certain perverse strategies, the Commissions reports also supported the pro-reform constituencies and helped it to overcome its own conflict of short term and long term interests (see section on pro-reform interests). Reports created two indirect ways of supporting the reform constituencies[83]. The strong emphasis on the independence of various regulatory bodies helped regulators to withstand political pressures against the reform, and EU requirements could be blamed for unpopular reform steps, which helped to shield of some pressures.

The Breton-Wood institutions and institutional change

The Czech Republic was the only country, which did not rely on the financial support of the IMF and World Bank during the restructuring of its financial sector (Bokros et al. 2000). In the early 1990s the Czech Republic even repaid a loan used to supplement CNB’s reserves prior to price liberalization in advance. Arguably, the reason was an effort of the Czech political class to avoid heavy involvement of

[82] Chapter on transnationalisation, p. 7

[83] There was also a direct support stemming from various projects supported by pre-accession funds.

the Breton-Wood institutions in the reform process. Instead of World Bank, Czechs relied on the loans from less intrusive European Investment Bank.

Situation was different in Romania, which failed to achieve and sustain elementary macroeconomic stability throughout the 1990s. Romania signed stand-by agreement with the IMF, but failed to fulfill the conditions attached five times so it was able to draw less then a half of the allocated credit quota (see IMF 2003: 35). It was only the stand-by agreement approved in August 1999, which became binding. In May and June 1999 the government only narrowly avoided a sovereign default and it desperately needed the stand-by facility to avoid cutting itself off the international financial markets. This gave IMF very strong leverage to enforce the attached conditionality, which are related predominantly to the macroeconomic stability[84]. Consequently, political elites, which were united behind the EU accession aspirations, managed to justify that the painful measures that had to be implemented were necessary not to fall out of the process.

The World Bank was also heavily involved since 1998, when it extended Private Sector Adjustment Loan I (PSAL I), to which number of conditions was assigned. The most important of the Romanian obligations was the restructuring of Bancorex and initiation of privatization of major industrial corporations and numerous smaller units. PSAL I was considered successful and has been thus followed by PSAL II, which is still focused on the sustained privatization, but also expanded to other areas such as health sector and education. Most recently, Romania became a pilot country for a Comprehensive Development Framework, which is a new concept of development designed by the World Bank (World Bank 2001). From the beginning it counts on the low lending and high lending scenario; which one will be adopted depends on the capability of Romania to comply with attached comprehensive set of requirements in virtually all areas of the social and economic areas.

[84] The conditionality is define by a number of targets for monetary aggregates, balance of payment, fiscal policy, privatization, wage policy of SOE, reduction of arrears, business climate improvements and so on.

3.4. Privatized banks and further reforms

Providing that the sequence of creating regulator – introducing standards – dealing with vested interest, results in the virtuous circle of economic development, the country needs to assure that it will be sustained. The hard won institutional change, which had constrained most perverse incentives, encouraged productive incentive and is capable of distinguishing between the two, could be captured unless it continuously evolves. The institutional change is an ongoing process on various margins (North 1990), which is driven by strategies of entrepreneurs on both political and economic markets.

When the institutional framework gets on par with the prevailing international standards, it needs not only to keep up with their evolution, but also to actively contribute to their formulation. In both countries there is a widespread satisfaction with the current status of both institutional framework and performance of their respective banks. The perception is such that banks owned by reputable foreign owners are highly unlikely to run into troubles. However, there are important weaknesses in this thesis. As over 95% and 80% of financial sector assets is controlled by foreign owned banks in the Czech Republic and Romania[85] respectively, number of issues and uncertainties arise regarding the cross-border regulation and supervision. Just at a time, when the national framework is just about to mature, it is to become less relevant as banks enter the EU regime of the Single European Markets. The multilateral European supervisory regime is in its pre-infancy stage, when the banking markets are pan-European. This creates number of challenges supervisors will have to come to terms with.

Fortunately, the vested interests are likely to support the evolution and convergence of regulatory standards. The foreign owners would save considerable amount of money if the regulatory framework is harmonized and they could use one system across all European countries, where there are their branches or subsidiaries. The interest groups competition, in these matters, will shift to Brussels and domestic policy will be constrained by membership obligations towards the EU. Neither of the two countries, can be expected to play major role in standard setting; more so as their financial sectors are easily dwarfed by Luxembourg.

[85] This includes the RCB, quarter of which is owned by IFC and EBRD, which is soon to be privatized.

CONCLUSION

The goal of the thesis was to analyze the comparative experience with the institutional reform of banking sectors in Romania and the Czech Republic, and test whether the comparison fits to the predictions of the research hypothesis. The conclusion is that, despite substantial difference in the level of economic development in general and in banking sector depth in particular, institutional reforms in the two countries followed the same reform sequence. Moreover, the sequence corroborates with the predictions of the Sequencing hypothesis. Given its commonsensical nature it is perhaps not so surprising conclusion. However, the analysis based on the hypothesis derived from eclectic blend of the theories facilitated formulation of several tentative lessons, which are noted below.

The two constraints, international organizations and deadweight losses, were instrumental in overcoming of the opposition of domestic vested interests to reform. This was more the case in Romania, where IMF and WB were given substantial leverage as Romania needed stand-by loans to avoid sovereign default and consequently had to fulfill conditions attached to theses loans. In the Czech Republic deadweight losses were the more important constraint, which forced the opposing interests to give in to reforms. Different relevance of different constraints influenced also the triggers, which forced the government to deal with vested interests and take the decisive step out of the vicious circle.

In Romania these steps on the reform path were triggered by the urgent and overriding need to comply with the IMF and WB conditions and prevent default on sovereign bonds in Spring 1999. In the Czech Republic there was no such acute moment. The build up towards the turn around point was more gradual, starting with the foreign exchange crisis in May 1997, through fall of the Klaus government in November 1997, launch of preparation for banking privatization initiated by the interim government headed by the CNB governor Tosovsky. The final decision came from the new prime minister Zeman, who decided to resolve the situation ones for all[86] and avoid an adverse political consequences of

[86] On this point I had benefited from discussion with Pavel Mertlik, former Deputy Prime Minister and Minister of Finance of the Czech Republic.

potential banking crisis towards the end of the political cycle. Moreover, the Czech decision was taken only at the end of 1998, when there were no more veto players, who would oppose the restructuring and privatization concluding the institutional reform.

In any case, the institutional framework of the two banking sectors is generally sound and reasonably up to international standard. The general expectation is that the current growth of the credit volume is sound and should not result into high proportion of NPAs and repetition of the problems of 1990s neither in Romania (IMF 2003: 13), nor in the Czech Republic (BA 2003:6). However, efficient institutional framework of the sector does not necessarily mean that banks supply the socially optimal amount of credit. The institutional matrix now provides bankers with incentives towards prudent banking in economies with higher risk profiles. Thus banks remain highly risk-averse and invest predominantly in low-risk, low-return government and blue chip papers. Increasingly they focus on the individual retail customers, but the small and medium corporate borrowers still face a credit crunch. The reasons have a lot to do with the general institutional framework, such as malfunctioning bankruptcies, which prevent lending to SMEs.

Tentative[87] lessons on policies enabling institutional change

The following three lessons were derived from the comparative case study. These are somewhat generalized findings, which are worth further attention.

1. *Policies which are compatible with the market logic of voluntary exchange as well as with the informal institutions underlining given society and economy, are more likely to create the virtuous circle of development.*

This is perhaps not particularly original conclusion; nevertheless it is a valuable outcome of the complicated debate about the role of instructions on different levels of social analysis. It also provides valuable criteria for evaluation of chances of various reform proposals to succeed in the context of the economy in question. However, the obvious weakness of the criteria is that economics, including the

[87] The lessons are inevitably tentative because they are based on the analysis of two countries. They are yet to be evaluated as a part of the research project involving at least all candidate transition countries.

NIE, was so far unable to bridge sufficiently the gap between its recommendations and conclusions of other social sciences describing informal institutions.

2. *International standards can define the goal of the reform and international organizations can provide external anchor, however, successful institutional change requires non-standard, homegrown measures to break out of the vicious circle.*

This is a tough lesson as it suggests that the institutional change can not be "imposed" on emerging countries, which would be relatively easy and cheap to do. This seems to be true not only in case of overarching transition reforms, but unfortunately also for more pragmatic and technical sectoral reforms. It takes a lot of local expertise and learning-by-doing to find out the key loophole, which would need to be constrained to serve as a kind of “switch” from vicious to virtuous circle (see end of Section 3.2 for the discussion). The need of local expertise and learning has profound implications on costs of institutional change. Time and human capital are expensive goods, moreover, lack thereof at the onset of reform unleashes plentiful perverse incentives; agents will thus pursue perverse strategies adding to the costs of reform.

3. *Institutional substitutes and second-best solutions are helpful to remedy problems, which given sector faces due to malfunctioning general institutional framework of the economy.*

Since mid 1990s, when economist learned the lesson that institutions matter, every single report on transition country’s economic development includes comments on weak protection of property rights, inefficient judiciary and corruption. None of the transition countries was yet capable of improving enough to prove these comments completely unjustified. However, what is certainly true on general level of the overall economy, may not necessarily be true for particular sectors of that economy. Some transition countries were capable of developing well functioning stock exchanges, bond markets or leasing markets, amidst the general institutional weaknesses. However, these success stories relate usually to the subsectors, which were created on a "green field". Unlike in the banking sector there was no vicious circle to break out from. The success is thus more in avoiding a failure then in implementing successful institutional reforms.

Banking sector started from the vicious circle and banks and regulators developed some interesting institutional substitutes, which helped to remedy effects of the institutional malaise to some extent.

Examples include transfer of some functions typically performed by judiciary to more knowledgeable, technocratic, independent and less corrupt supervisors; or developing indirect lending channels through subsectors, where property rights were more secure (see Section 2.2.3).

An example of the second best solution could be an introduction of separated bank insolvency regime, which on one hand does not allow for bank restructuring, but on the other does not expose insolvent banks to corrupt judiciary. If we assume that Chapter 11[88] type of restructuring, would be the first best solution for the bank insolvency, than not allowing it means that the institutional framework is not compliant to the best international standard. On the other had, if the bankruptcy courts are either captured, corrupt or outright part of the organized crime networks, then allowing for restructuring is actually allowing for tunneling[89]. In such situation, vesting all the right to the hands of creditors would clearly be more efficient solution, despite in general it is only the second-best one.

Another subset of institutional substitutes could be "overshooting" of prudential requirements. For example, the minimum registered capital of a bank in Romania is around 9 million euro and around 17 million euro in the Czech Republic, whereas EU Standards require only 5 million. This "overshooting" corresponds to higher risk profile of the two emerging economies but it also gives owners stronger incentives to monitor bank performance, i.e. if supervision is weaker that in EU, then the stake of market players ought to be higher in order to constrain some perverse strategies.

The above tentative policy lessons will be taken over to the next stage of the research on the institutional reforms of banking sector. I plan to review the reform path of all CEE new member states of EU and add the Bulgarian case to the presented analysis of Romania. The aim of further cases studies will be to formulate a general model unbundling the political economy of processes, which take place between the formulation of international standards and their effective implementation in emerging economies.

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[88] Provision of the U.S. bankruptcy law, which allows the court to protect the insolvent enterprise from its creditors to allow time for remedial action avoiding dissolution of company's assets.

[89] Apart from Capek's robot, tunneling is the second Czech word taken over by English language. It refers to illegal asset-stripping.

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