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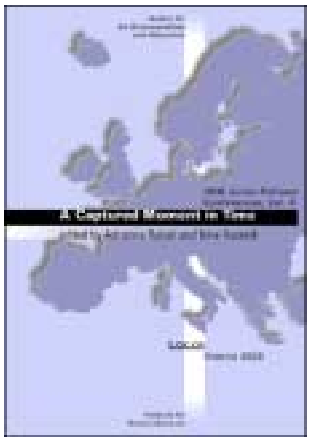

Ideological Content of the East European Financial Sector Reform

Gallina Andronova

Neoliberalism was envisioned as the leading ideology to drive the development of Central and Eastern Europe (CEE) from a communist to market-oriented economy at the beginning of transformation. Politicians and reformers embraced the ideas of democracy, competition, individual rights and private property, and propagated them passionately. It was the "West" – open and inviting – which was held in absolute awe in contrast to the failed socialism and its economic damages. The never-brought-to-fruition "reformed" socialism of the 1980s accelerated the ideological shift in CEE. The strongest reform proponents received attention and power, and their voices were heard. Balcerowicz, Bokros, Klaus and Gaidar were among the reformers given a chance to match their neoliberal rhetoric with actual policies.

Neoliberalism easily won the ideological battle: "The decade of the nineties started with many hopes. (…) The liberty and free markets were on the winning side; both 'hard' and 'soft' variants of socialism (or communism) were visibly in retreat."[1] It was in the years to come that the hard part of establishing and executing market-oriented reforms faced serious difficulties, which in certain cases look like pure deviations from the underlining ideas. Did the policy makers betray the new ideology? Or did they ever undertake it?

Searching for useable concepts, researchers have been increasingly taking recourse to conduct studies of episodes of financial development, and evaluating them against some economic indicators in order to capture the factors that affect policy choices in the process of financial development. There are concerns about the validity of this approach, however, which is grounded on an ex-post assessment of policies. In addition, the observed choices ultimately reflect not only the decision of the policy makers and their motivations, but also may have been the product of various factors such as crisis situation, international pressure, interest groups or different political initiatives.[2] While not denying the importance of the study of reform episodes, I will concentrate on the ideological substance behind the design of the reforms in the financial sector in CEE. As this piece argues, even though the guiding idea behind the post-1989 financial sector reforms was to establish a competitive market environment for efficient financial intermediation, the implementation of the reformers' original market-driven blueprint for the development of finance ran into massive obstacles. Looking at the viability of the neoliberal ideas, this study inquires as to why it happened this way.

This paper provides an analysis of the financial sector development in CEE by considering the ideological inclination and its actual translation into policies undertaken in the financial sector after the fall of the communist regime. The objective is to understand the ideological patterns of financial development in CEE, the resulting changes in the countries' financial architecture, and the implications for their economies. From this perspective, I conclude that financial reforms in the CEE countries follow what may be called an initial uniform path of development based on the idea of markets as they move out of their infant status: breaking from the mono-banks system, creating independent central banks and commercial banks, and establishing the foundations of a modern financial sector. The differences occurred in the way particular processes like privatization, recapitalization, consolida-

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1 Klaus, Vaclav. 1999. "Liberty and the Rule of Law." CERN Web Note # 7. http://www.ceip.org/programs/polecoms/cernpn6.htm

2 Haggard, Stephan and Sylvia Maxfield. 1993. "The Political Economy of Capital Account Liberalization." In *Financial Opening*. Helmut Peisen and Bernhard Fischer (eds.) Paris: OECD.

tion, regulation and others were tackled in these countries. However, once reforms were undertaken, the countries searched for new opportunities in response to diverse domestic and international conditions by making endogenous policy choices in their finance.

Financial development efforts frequently focus either on the state or the market as the engine of reforms. However, as we see in this paper, financial development does not necessarily follow the prescription of a single ideology. Understanding the context in which policy ideas are translated into policy action may provide an explanation for why governments do not follow the logical sequence of policies based on their respective ideologies. This paper runs a check on neoliberalism in CEE's early transition context, based on its political, institutional and economic viability.

In the outlined framework I expect to see a few tendencies peculiar for the transition countries from CEE, which I formulate as hypotheses, and investigate them in the sections to follow. First, neoliberal ideas stay behind the vision of CEE transition development on both political and economic fronts. Looking at the financial sector experience in CEE, however, I argue that the execution of market-oriented reforms has not been sufficient to actually bring about a market-based financial sector. Second, when the financial markets are "thin" and unstable, the institutional configuration is determined more by the network of interest than by the exigencies of the market, thus explaining the reluctance of policy makers in shifting their right over financial sector management, allocation, and ownership to the market.

The paper is structured as follows: I first review neoliberal ideas for the development of CEE finance to define the meaning of the market-based reforms for the financial sector. After presenting the targeted shape of the sector by the policy makers, I run viability checks in Hall's framework on neoliberal proposition for the financial reforms in the context of CEE environment, and discuss the difficulties translating neoliberal ideas into policies.[3] To illustrate my argument, I bring examples from the privatization, recapitalization, regulation and the consolidation of the banking sector in the region. Finally, I briefly summarize by considering the implications of neoliberalism for the development of the financial sector in CEE.

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3 Hall, Peter (ed.). 1989. *The Political Power of Economic Ideas: Keynesianism Across nations*. Princeton: Princeton University Press.

Neoliberalism and the CEE Financial Development

The neoliberal approach to economic development in CEE has been propagated by policy makers, development economists and international organizations. This widely spread package of reform ideas is based on the following principles, as outlined by Nonneman:[4]

(i) The functioning of even imperfect markets is better than imperfect states.
(ii) Short-term efficiency is increased by free-markets, and consequently results in long-term improved economic performance.
(iii) The smaller the state the better. Bigger states are detrimental to development.
(iv) Private is better than public.

The neoliberal approach to reforms has been very attractive to the countries in CEE. The ideological content of neoliberalism calls for openness and liberalization. It introduces the market mechanisms as a main force driving the exchange behavior among market agents, and at the same time de-politicizes their interactions. And even though neoliberals are not asserting perfection in markets, they strongly advocate that market mechanisms do allocate resources better and in a more efficient way than states.[5]

On a grand basis, soon after the fall of the communist regime, the CEE countries had initiated and carried out market-oriented policies to a different extent. It appeared that the neoliberals had won the ideological debate in that region. Backed by the international community and organizations, CEE transition countries "rapidly liberalized their internal markets, foreign trade, and the process of new private business."[6] But, how truly committed were East European policy makers to implement radical neoliberal reforms in already recessive early years of transition?

Janos expresses some reservation concerning neoliberalism in CEE, and claims that policy makers' "rhetorical commitment to the market economy is weakened by their not altogether irrational fears that unleashing the market mechanism would

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4 Nonneman, Gerd (ed.).1996. *Political and Economic Liberalization: Dynamics and Linkages in Comparative Perspective.* London: Lynne Rienner Publisher. p.16.

5 See for example Colclough and Manor. (eds.). 1991. *States or Markets? Neoliberalism and the Development Policy Debate*. Oxford: Clarendon Press, or Shand. 1984. *The Capitalist Alternative: An Introduction to Neo-Austrian Economics*. NYU Press.

6 Greskovits, Bela. 1998. *The Political Economy of Protest and Patience: East European and Latin American Transformations Compared.* Budapest: CEU Press.

have catastrophic results for their weak economies."[7] Here, I would call for even more caution when labeling reforms in CEE. Just because policy intentions have been market-oriented, one should not rush to characterize the reform episodes as typically neoliberal. In the beginning of transition, CEE was like a wire-fenced field, and any policy that removed parts of this barrier might be described as liberalizing. Indeed, in their unique development, CEE countries experienced political liberalization and democratization before liberal economic reforms were initiated and carried out. In fact, there was no doubt that the former communist countries would embrace political liberalization after the fall of the regime. There was more uncertainty about which road the economic transformation would take.

Moreover, it is not solely the ideas that make policy outcomes; it is their implementation, long-term consistency and horizon that translate policy ideas into results. Additionally, networks of interest groups as well as institutions influence the transformation of policy ideas into policy outcomes. In this regard, one should be concerned about whether new democratic governments indeed possess the capacity to carry out consistent developmental reforms in CEE following the liberal propositions. The concerns that emerge from there allow us to formulate the questions that this paper itself will seek to answer: Did the neoliberal approach to financial policies make some countries more advanced than others in CEE? If so, why do policymakers deviate from the neoliberal "recipe" if it provides for sustainable economic development? Was it really possible and viable to launch it during CEE transition?

The Vision

Before turning to these questions let us shift the neoliberal approach to the grounds of financial development, and summarize the vision of the financial reform and the environment in which it was coined. The CEE transition authorities began reforms in the financial sector under the alarming conditions of macroeconomic instability and recession. On of the leading problems in policy agendas in this system of transformation was the question what kind of financial sector will evolve. What was the vision of the financial sector and on what principles was it built?

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7 Janos, Andrew. 1995. "Continuity and Change in Eastern Europe: Strategies for Post-Communist Politics." In *Markets, States, and Democracy The Political Economy of Post-Communist Transformation*. Beverly Crawford (ed.). Bouder-San Francisco-Oxford: Westview Press. p.64.

Two extremes could contour alternatives to finance. The first was an interventionist system with heavy state participation in allocation of investment resources decisions, while the second was a highly liberal and unrestricted system. At the time when the socialists' principles of economic development were breaking up, the envisioned financial sector in CEE aimed to rest upon the liberal aspirations of private ownership, competition and market rules. Liberal transition economy, market mechanism of coordination, diminishment of the state's role, and depolitization of finance were the leading elements in the reforms' rhetoric across CEE.[8] In line with the market reforms in finance, introducing financial markets was regarded as "… a quick means of making visible reforms that would improve the efficiency of resource allocation."[9] Moreover, it was believed that launching a financial system based on market-driven principles would contribute to the development of CEE countries and enhance their economic growth.

And although specific reasons for financial reforms may vary among countries, in general, the efficiency gains that result from a deepening of the financial sector further facilitate economic development. Financial systems that provide efficient intermediation of funds are fully integrated entities with the rest of the economy, and are able to actively encompass a range of activities from generating deposits to channeling funds towards perspective investors. The forces of market competition prepare the emergence of new economic dynamics in finance, and, are, supposedly, based on more accurate signals coming from the market. Private ownership is introduced in the financial sector, which stimulates the development of private commercial banks and non-bank financial intermediaries. Also, financial liberalization is undertaken, ensuring that the input of resources from domestic liquidity and investments would not remain unemployed. The main idea behind the financial liberalization is that "the opening up to not only domestic but also to international competition would sharpen competitive skills and thus reinforce the entire process and promote growth."[10]

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8 See Klaus, Vaclav and Tomas Jezek. 1991. "Social Criticism, False Liberalism, and Recent Changes in Czechoslovakia." *East European Politics and Societies.* Vol. 5(1): 26-40, and Balcerowicz, Leszek. 1995. *Socialism, Capitalism, Transformation.* Budapest: Central European University Press.

9 Caprio, Gerard Jr., Izak Atiyas, and James A. Hanson (eds.) 1994. *Financial Reform. Theory and Experience.* Cambridge University Press.

10 Nonneman. 1996. p.5.

The view about the ultimate shape of the financial sector impinges on creating a system of financial intermediation to ensure efficient transformation of savings into productive investments; agglomerate capital; choose and invest into the most promising projects; effectively monitor its borrowers; diversify risks and engage in profitable inter-temporal transactions. In achieving this, the early reformers' guide list of policy actions was clear (see Table 1).

Table 1: What does the financial sector reform in CEE consist of?

POLICY INITIATIVES	POLICY CONTENT
1. Reorganization of the central bank:	Breaking from the monobank system.
2. Restructuring financial intermediaries:	Introducing commercial and private banking.
3. Credit allocation and monetary policy tools:	Distancing government involvement.
4. Interest rates:	Liberalized.
5. Foreign banks:	Participation allowed.
6. Domestic equity markets:	Evolving stock market.

From the brief summary of the market-based propositions for financial development, the objectives of the reform with reference to CEE can be described as a transmission process *from* a highly controlled environment *to* a market-oriented financial environment. Neoliberals postulate that, first, the financial sector should make the process of financial intermediation transparent and credible. Second, it should be able to mobilize efforts to ensure the use and thorough implementation of rules and regulation with respect to financial intermediation. Third, the financial system should serve as a bridge to international integration through facilitating transactions, capital flows and investments.

But what is the driving force urging these changes? It seems that the logic of the market-oriented development appealed to the CEE reformers, but that there was reluctance in execution. Development functions were assigned to two actors, respectively. The state was to minimize the control of the bureaucratic system over prices and the allocation of financial transfers, while the market was to provide a suitable financial environment to achieve efficiency in intermediating funds by allowing market forces to exert greater influence on financial transfers. [11]

11 Cole, D. C. and B. F. Slade. 1991. "Reform of Financial Systems." In *Reforming Economic Systems in Developing Countries*. Dwight H. Perkins and M. Roemer (eds.). Cambridge, MA: Harvard University Press. p.331-340.

But once again, how exactly are market forces allowed to "exert greater influence" over financial transfers when the state is the governor, owner and monitor of the overall financial system and, further, is reluctant to transfer these roles to the market?

Just removing the state would not have solved the issue. An underlying principle of the introduced market-driven ideas in finance is the decreasing role of the state as both owner and manager of financial intermediation. Decreasing the participation of the state should not necessarily imply its elimination because the state does play a decisive role in the development of the financial sector in CEE. Privatizing, abolishing the administrative control in the process of allocating financial funds, ensuring liberal basis for new intermediaries, products and services to enter the market while allowing failed products and banks to exit, and letting private ownership to play a major incentive role would all provide for flexibility and soundness of the evolving financial system. It would also give the state a chance to create the adequate regulatory framework of its financial system.

The vision did not translate into practice although it was in line with the market-driven liberal ideas. Once in office, the CEE reformers saw themselves as the agents of *creating* the market, justifying it with the claim that until the market is not in place the state's only decision is to provide the conditions and assist its genesis.[12] And inevitably state intervention became the way reform initiatives were executed in finance. Confronting policies and practices illustrate this paradox. For example, credit ceilings, bailing out of banks and other interventionist policies lasted for years after the first reform governments, regardless of the propagated depolitization of credit allocation and monetary policy tools. The Bulgarian banking system crashed in 1996 after a continuous delay in the introduction of market reforms such as privatization, cleaning up the bad loans and keeping the sector closed. Enormous capital flows straight from the state budget were directed towards consolidation and capitalization of banks everywhere in CEE. In just one of many such cases, the Posta Bank bailout cost the Hungarian government 56.2 million USD in 1998.

The envisioned financial sector was very liberal in intention, but there was always a justified reason to alter the market-driven reforms. As a result, neoliberalism became anchored only in the policy papers and speeches of the reformers. The target

12 Kovacs, Janos M. 1992. "Engineers of the Transition (Interventionist temptations in East European economic thought)." *Acta Oeconomica,* Vol.44 (1-2):37-52.

of establishing efficient system of financial intermediation based on market-driven criteria was present, but the policy road undertaken somehow did not lead there. Why was it so?

Which Road Do We Take from Here?

Neoliberals advocate "hands-off" domestic policy in finance, suggesting that the government should play an almost inactive role when addressing the process of financial development. Government tinkering with financial management/ intermediation is inefficient, possibly even counterproductive, and as the CEE transition experience shows, it fails to effectively govern the financial intermediation system. Thus, according to the neoclassical view, the government should be distanced from the financial sector as soon as possible.[13]

Neoliberalism is associated with narrow-mindedness by its opponents. They claim that the "pre-packaged" solutions installed by governments under the auspices of international organizations cannot be an optimal policy choice. Nonneman characterizes neoliberalism as "too dogmatic in its insistence on simplistic policy prescriptions regardless of the individual country's circumstances."[14] The opponents of neoliberalism - structuralists, interventionists or neointerventionists - stress a much broader approach to policy design and emphasize the importance of initial conditions, national resources, size of the country, and relations with the external world. They claim that all these factors influence the balance and content of policies. But even when all these reasons hold nothing justifies the delay of major reforms such as privatizing banks or exposing state banks to competition in the transformation of the CEE financial sectors.

Proponents of non-liberal approaches to financial development answer with traditional arguments that rapid liberalization and marketization impose harmful effects on certain groups of the society. The commonly expressed concerns point out that the hardship of the reforms increases the chances of financial crisis where mac-

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13 See for example Hayak, F. A. 1994. *The Road to Serfdom.* University of Chicago Press; Hayek, F. A. 1990. *New Studies in Philosophy, Politics, Economics and the History of Ideas.* London: Roudledge; von Mises, Ludwig. 1985. *Liberalism: In the Classical Tradition.* Irvington-on-Hudson, NY and San Francisco, CA: The Foundation for Economic Education, Inc., or Shand, Alexander H. 1984. *The Capitalist Alternative: An Introduction to Neo-Austrian Economics.* New York and London: The NYU Press.

14 Nonneman. 1996. p.17.

roeconomic weaknesses prevail.[15] However, the advocates of a more decisive market reforms ask, "What are the costs of delaying reforms?" As much as the state-led financial development approach was favored in CEE, the costs of intervention have proved certainly to be much higher than expected. In this regard, cost repeated bailouts, capital injections into the banking system, bad loans recapitalization, and consolidation were among the main expense-incurring items on the reformers' agendas for years.

Voices against rapid liberal reforms say that the financial sector of every country is "special." Thus, it is too important to be handed over to market forces all at once because the financial sector intermediates most transactions in an economy: commercial banks are expected to facilitate the process of development and provide loans to projects in need. In a sense, national financial systems are strategic because they execute the transmission of monetary policy to the economy. These reasons are often cited in justifying huge domestic ownership, clumsy regulation, misallocating credits to non-profitable (often state-owned firms), and not rarely crediting the state budget. All these cited reasons for keeping the financial sector under the state's control and ownership do not provide solid justification for its preference over private ownership.

Neointerventionists, however, insist that strong economies require strong states and that the content of the state's strength is not static. Interestingly, they do not disregard the power of the market in the same way that neoliberals do not disregard the state. The former determine the state's strength by its capacity to govern the markets.[16] The latter define the state's role through its capacity to provide the conditions for the flourishing of the market. Haggard and Lee pick on the advocates of intervention in financial markets and point that there is a problem with their implicit assumption of the existence of "a competent, informed, and 'strong' government whose motives were to maximize social welfare by offsetting and correcting market imperfections."[17] Rent-seeking and abuse of the government system is so widespread, especially in developing and transition countries, that the idea of a benevolent and competent government, leading reforms for the better well-being of

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15 Goldfarb, Jeffrey C. 1990. "Post-Totalitarian Politics: Ideology Ends Again." *Social Research.* Vol. 57(3).

16 Weiss and Hobson. 1995. *States and Economic Development: A Comparative Historical Analysis.* Cambridge: Polity Press.

17 Haggard, Stephen, Chung H. Lee, and Sylvia Maxfield (eds.). 1993. *The Politics of Finance in Developing Countries.* Ithaca: Cornell University Press. p.3.

its citizens, seems inadequate. Misdirecting funds through the banking system has proven to be a "specialty" of reform-minded policy makers in the CEE region. Negative allocative effects and perverse political incentives grew so evident in CEE that such arguments for intervention and control over the financial intermediation did not turn sound. "Big" states and excessive constructivism, which were legacies from the past carried over to the transition period, proved to be even more harmful by bringing "clan"-style networks in the financial sector. Deformed market practices spread across CEE under the label of liberal policies. Insider bank privatization, avenues for cross-ownership and inefficiencies of the Czech voucher privatization, for example, well illustrate this position. The clientalistic privatization favored in Slovakia brings further evidence. The Bulgarian banking sector, which was closed to outsiders and foreigners prior to 1997, falls in there as well.

However, what are we left with in CEE financial transition if the government is excluded as a major actor in financial sector development? In an ideal liberal world, the immediate answer would be the market. The neoliberal approach nicely outskirts the state propagating market principles, private ownership, and financial liberalization. Hayek and the Austrian tradition fit here with their judgment that only free markets provide the necessary information of time and place in the pursuit of optimal/rational economic policy. Therefore, market flexibility and the ability to instantaneously adjust cannot be replaced by any kind of government involvement.[18]

In a not-so-ideal liberal world of systemic change, however, one could seek reasons for having precisely the state as the agent of reform (Keynes or Gerschenkron). At least the post-World War II development of states demonstrated the power of this proposition. But CEE of the 1990s is not Germany in post-World War II years. There are two main differences: there is no Marshall Plan aid for its reconstruction and development, and second, at least forty years lay in between, which place these countries in an entirely different international environment of more financial liberalization, technological advances and appreciation of liberties.

However, the experience of the developing economies across the world shows that market solutions to policy problems are mainly popular in literature, particularly offered by libertarians, classical liberals and neoliberals. It is hard to locate absolute examples, especially among development policies. Moreover, even when the experiences of the Southern Cone countries (Chile, Argentina and Uruguay) whose neoliberal reforms are quoted most often, it should be pointed out that these

18 Hayek. 1994.

neoliberal reforms are quoted most often, it should be pointed out that these countries have been quite interventionist in their financial policies. Restrictions on capital flows and other regulations were important government tools in these development episodes.[19]

At the same time, it is equally hard to convey justification for the other extreme of heavy-state involvement and intervention in CEE, given the fact that these countries strive to distance themselves from the world of command economy. The financial boom of the East Asian economies, often quoted before the collapse of their financial markets in 1998, did not seem appealing thereafter. The complicated ownership configuration between businesses and the state in these countries as well as lack of clear rules in lending decisions and low transparency in intermediation backfired against the proponents of state-led development.

On the other hand, liberal financial system do exist, both in the developed world and in to a less extent in the developing countries, ranging from the more liberal financial system of the US and England to the less-liberal ones of Germany or Japan, for example. Moreover, even transition countries like Estonia or to some extent Hungary, seem to have advanced more by developing their financial industry following market-driven policies and quicker bank privatization in comparison to the rest of the CEE countries.

Thus, there may be something more that just to propagate either *laissez-faire* or state *dirigism*. And even though the unification of these two paradigms may not be possible on the side of the ideological grounding of the financial reform in Eastern Europe, viewing the transition as a process of creating institutional order for initiating market-driven reforms aimed at the development of efficient financial intermediation is an ambitious, but achievable task, that combines the best of the two worlds. The Chilean, Korean and/or Japanese experience of financial reforms clearly conveys an important message that sole reform initiatives like privatization could not bring the desired market outcomes without the supporting principles of complementarity of institutional and regulatory environment with the rest of the development initiatives in the financial sector. And maybe, exactly there, is the solution how to unbundle the puzzle of advancing the CEE financial sector in a time of systemic transformation and instability.

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19 See for example the essay by Hastings in Haggard, Lee and Maxfield (eds.). 1993.

The Failed To-Be-Implemented Neoliberalism

1. The Political Side of the Neoliberal Appeal in Finance

Neoliberalism had good chances of becoming a policy of the reformist governments in CEE because of the appeal it offered to the politicians at the time. Interestingly, various CEE governments, regardless of their basic political ideology, embraced neoliberal ideas: from the strong liberal aspiration of Klaus to the communist sentiments of Meciar's government, neoliberal intentions, at least, were abundantly clear. Why did they not become proponents of some other ideological school for their *planed marketization* but instead chose exactly liberalism? That, which opposed the discontented-with-socialism economic thought, I claim, was the most attractive concept for the rhetoric of the development of dismal post-socialist economies at the launch of transition process in CEE. The propagated new, or rather rediscovered, ideas within the mainstream paradigm of markets, democracy and capitalism appeared more than attractive to politicians and policy makers in contrast to the planned and collective-interest driven society from which they were exiting.

Neoliberalism was attractive politically to the early reformers of CEE because of the fear of reversal to communism. There were two main grounds for this allure. On the one hand, neoliberalism was used to legitimize and define the reform-minded politicians from the region. And, on the other hand, it offered an appealing alternative to the very fragile political environment after the fall of the communism, establishing the principles of free and democratic society in a *period of extraordinary politics*.[20] Referring to Poland, but valid for all transition countries in CEE, Szacki observed that, "liberalism had become popular in our country not because some advantages of that ideology have been discovered but because people have realized the defects of the political and economic system, which is the fullest denial of all the values and achievements of liberalism."[21]

Radical, *market-based*, *neoliberal*, and *decisive* were the descriptions given by the CEE policy makers to the reforms in the financial sectors in the region. They needed strong adjectives to differentiate the future from everything which resembled the remains of the "defects" of the socialist finance with its predominant state

20 Balcerowicz, 1995. p.161.

21 Szacki, Jerzy. 1990. "A Revival of Liberalism in Poland." *Social Research.* Vol. 57(2). p.467.

ownership, poor incentive and managerial structure, political crediting, non-efficiency based project evaluation, and unskilled personnel.

To be sure, the ideologically popular market-oriented reforms were not politically attractive to implement, regardless of the wholeheartedly propagated liberal ideas. Across CEE, there was a clear understanding that a government committed to market reforms and the introduction of tough economic measures would lose popularity and find itself under strong political pressure to slow down reforms.[22] This becomes true especially in the area of financial reforms where market-based policies would have affected a large share of the economic agents at the moment of their implementation. The state would be on the losing side. It would abandon control over ownership and allocative decisions in finance, as well as the unrestructured state-owned enterprises (SOEs). In a market environment, the SOEs are forced to function without the protection of the state in a market environment and cut employment. On the winning side are the depositors, entrepreneurs, and potentially the economy as a whole. Their interest, however, is not organized to push for such reforms.

And indeed, until 1995 the market-oriented financial sector reformers did not deliver on their main promises. The progress of several reform governments in the CEE countries boiled down to the minimum: introducing a two-tiered banking system and inadequate re-regulation providing conditions for "mushrooming" of commercial banks. To illustrate with an example, in 1991 Bulgaria had 75 commercial banks, which provided only 7.2 percent of GDP in the form of a credit to the private sector; bank privatization was not even discussed. The situation across the other CEE countries was similar, showing that the state kept control over domestic financial systems and introduced only partial reforms, which meant the benefits behind the neoliberal propositions were not really actualized.

2. Economic Viability

The economic viability of ideas in the Hall's framework examines their "capacity to resolve a relevant set of economic problems."[23] With respect to the financial sector development in CEE, the "relevant set" of problems was the entire introduction of a functioning system of financial intermediation, which could efficient satisfy the

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22 Rosati, Dariusz K. 1993. "Poland: Glass Half Empty." In *Economic Transformation in Central Europe: Progress Report.* Portes, Richard (ed.). London: CEPR. p.259-261

23 Hall. 1989. p.371.

demand from both borrowers and depositors. In assessing the viability of the market-based reforms, a check on their suitability to deal with some of the more acute economic problems in the financial sector is interesting to run.

The Bad Loans Problem

To start, let us take the problem of bad loans. A leading objective of market-based financial intermediation is the efficient allocation of resources. The existence of chronic bad loans *per se* runs against this aim, however. But they were there, in every country, and in every bank. For example in Poland, a strong increase in the proportion of loans regarded as under- or non-performing at the end of 1991 found that "about one-third of all state enterprises are no longer considered creditworthy by banks, and loans to state enterprises represent about 90 percent of the loan portfolio of the commercial banks."[24] The reformers had no other choice but to find a viable solution how to deal with them.

In dealing with the bad loans, which corrupt the balance sheets of the commercial banks, governments have basically two options: to try to restructure the loans and then to offer the banks for privatization; or to sell them with the existing bad loans right away. Everywhere in CEE, governments chose the first option and trapped themselves in expensive recapitalization and restructuring. They explained their choice along the lines that a more radical market solution was not viable since the entire real sector was structurally connected to the commercial banks through the loans. By giving in the control on such decisions to support the real sector via financial resources, these economies may not stabilize and restructure their industries.

Moreover, reformers were concerned with the revenue side of potential bank privatization. Their calculations in this area showed their hope for receiving higher price for banks that are freed from the bad loans on their balance sheets, rather than for a potential sale of non-recapitalized bank. Such reasoning was sound, except for the fact that this implied time and resources issuest. Consistent data on the funds spent for restructuring, consolidation, recapitalization, bailouts of banks, and other related repeated expenses for the financial stabilization of the governments of CEE is not available. But the Czech example is rather representative of the rest of the transition economies: during ten years of transition the amount of direct state bail-

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24 Gomulka, Stanislaw. 1993. "Poland: Glass Half Full." In *Economic Transformation in Central Europe: Progress Report*. Portes, Richard (ed.). London: CEPR. p.199.

outs is Kc 225 billion (around USD 8 billion).[25] To illustrate with more examples, the Hungarian government for the 1990-1994 period channeled 3 billion USD (about 10% of its GDP) through the banking system to clean up the banks' balance sheets.[26]

Accumulation of bad loans after the first attempts for consolidation and recapitalization continued, however. The policies of financing the loss-making SOEs were backed politically, mainly because of the undesired losses of workers and managers, and of employment in general, if the state support were terminated. The resulting effect was a bias against the funding of new, more profitable ventures. The reason behind such irrationality was the assurance that banks' previous debts will be repaid through the injected capital and guarantees coming from the state. Instead of stimulating an environment of financial discipline and competition, the political decision about the way funds were allocated brought failure to the reformers' intention to terminate subsidized financing of loss-making SOEs.

Such policies, typical for the transition economies, were in absolute contrast with the propositions of market-based financial intermediation. Already early in the transition, it became apparent that market-based solutions to structural problems like the bad loans were not inspiring to the reformers. Banks and enterprises were left to operate under soft budget constraints, which further deepened the difficulties to reform the sector.

The State Ownership Problem

Urgent privatization was the only durable answer to insolvency and inefficiency of the public enterprises and banks.[27] While for the majority of economists privatization is the means to raise efficiency and the allocation of resources at the microeconomic level, for CEE politicians propagating privatization it brings political support.[28] In turn, privatization of the financial sector was massively delayed, or in the

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25 *Prague Business Journal,* 22/05/2000

26 Frydman, Kenneth, Murphy and Rapaczynski. 1998. *Capitalism with a Comrade's Face.* Budapest: CEU Press. p.139

27 Balnchard, Dornbusch, Krugman, Layard, and Summers 1992. Balnchard, Olivier, Rudiger Dornbusch, Paul Krugman, Richard Layard, Lawrence Summers. 1992. *Reform in Eastern Europe.* Cambridge, MA and London: MIT Press pp.32, 54

28 See Rosati 1993, Klaus and Jezek 1991.

the best case, executed in a very state-involved way.[29] The privatization story in the financial sector in CEE seems deformed and paradoxical, and even less liberal when looking at the way the benefits from the market and private ownership were supplemented by heavy control and intervention. Popular among reformers were views that in the absence of competitive financial markets, the state would guarantee the intermediation of funds.

"Reform"- minded policy makers were trying to reason along the lines that the delay in bank privatization would indeed work in favor of the commercial banks, once their borrowers restructure and improve their financial positions and are able to repay their obligations. This way banks indirectly would improve their portfolios and credit only "good" projects. Political crediting, however, never stopped to certain "strategic" sectors and borrowers in these countries. Cases of political credit and favors in acquiring position within the financial sector were typical for the transition countries. Multigroup in Bulgaria is an example of how organized vest interest connected to government officials materializes into assets acquisition through privatization. Between 1990-1994 the holding company took stakes in different industries, including the financial sector through connections with, at that time, ruling Socialist party.[30] Another example is the allegation that former Hungarian Prime Minister Bokros was biased when he used public funds in the form of capital injections for the recapitalization of the Budapest Bank prior to its privatization.[31] Examples of this sort can be found everywhere in CEE.[32]

3. Institutional Transformation

The institutional changes, which the regulation in transition banking aimed to achieve, were grandiose: it was envisioned as a financial system free of the features from the socialist past, transformed to implement the criteria of credit-worthiness of borrowers as a major factor in lending decisions. Developing proper accounting standards and disclosure requirements were to be the major information source about creditors and borrowers, which would neutralize the existing information asymmetries, such as the practices of adverse selections and the moral hazard behav-

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29 For example, the share of state-owned banks, 1993: in Poland was 86.3 %, in Hungary 74.9%. Data from the EBRD Transition Report 1999.

30 EBRD Transition Report 1999.

31 *Budapest Business Journal* 1995.

32 See for example The EBRD Transition Report 1999.

ior. Moreover, developing a prudent regulation required prompt corrective actions in the cases of low net worth of financial institutions in order to halt the practices of shielding problem banks and enterprises.[33] Establishing the conditions for a financial sector based on market principles intended mainly to separate politics from financial sector decisions. Did the reformers have the capacity to implement such systemic transformation, however?

Even though the institutional changes advocated the introduction of prudent regulation in the banking system - through which fair competition would be encouraged, the banking structure improved, capital markets set up, and financial operations liberalized - these market-based measures to improve the institutional environment of the financial sector did not bring about the desired outcomes. The enterprises' and banks' insolvency and under-performance remained the norm of economic behavior in the transition environment. Liberalization itself could not contribute to the conditions for sound and efficient banking; capital markets could not effectively intermediate funds in an environment guided by the state allocation of funds and soft budget constraints on loans.

It was clear to the reformers that only ground institutional changes could back up reforms and facilitate the evolvement of a sound financial sector in the transition economies of CEE. Two main obstacles, however, prevented them from boosting the development of a market-based institutional environment in the financial sector, in addition to the fact that the transition period came with the former institutional structures of the socialist regime. It meant that there was a lack of institutional framework to constraint the involvement of the state into the financial intermediation. The state had to initiate institutional reforms for its own retreat. The second obstacle spread beyond the state; it was the formation of powerful politically-centered interest that took advantage of this institutional "vacuum" in the financial sector. Concretely, delaying the introduction of prudent regulation and supervision allowed misusing the state.

Even though, the major aim in developing prudential banking regulation relies on the premises that efficient banking protects depositors, guarantees the stability of the industry and the payment mechanism, CEE reformers were not that keen to apply these principles in banking. The regulation was designed in a way that could

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33 Mishkin, Frederick S.. 1996. "Understanding Financial Crises: A Developing Country Perspective." in *Annual World Bank Conference on Development Economics 1996.* Michael Bruno and Boris Pleskovic (eds.). Washington: The World Bank. pp.56-57.

oversee the solvency and portfolio risk measures. It resulted in extended government guarantees to the banks as well as enterprise and banks' bailouts. "Correcting" the regulation rules was easily coined and introduced to suit particular interest.

Overall, the idea that regulation would ensure banking performed in a manner that would guarantee independence on investment decisions while acting in depositors' interest, carries the liberal message of minimizing the political decision-making on a bank level. Apparently, this was not that easy to translate into policy in an environment where the authority feared that deregulation over financial intermediation would facilitate financial independence and result in a banking policy out of political control. The interventionist nature of the reforms in the financial sector suggests a variance between the reformers' intentions to regulate in accordance to the market ideas and the resulting re-regulation of the sector.

It should be emphasized here that the underlying message is not only the need to withdraw the state from the financial decisions and the micromanagement of the banking industry, but rather that its role should be centered around building institutions and regulations that facilitate the intermediation process. Liberal economic ideas postulate that the new institutional order prefers privately-owned commercial banks and competition over state ownership and interference. This is partially because of profit-maximization, greater efficiency and productive employment of resources, and partially because of the distance of privately-owned institutions from political pressure. The institutional environment, however, needs credible and adequate regulation if financial intermediation is to be efficient.

Conclusion

After this account of the incompatibility between ideological and policy content of neoliberal propositions for financial sector reforms, one must wonder whether it is really worth experimenting with neoliberalism in the financial sector in Eastern Europe when the rhetoric only partly resembles the aspirations towards efficiency and markets. It was the kind of reformist propositions, shaping the development of the financial sectors across Eastern Europe in a very interventionist manner, which distance the market-driven ideas of competition and minimal state involvement from the development of the financial sector. And maybe Kovacs rightly remarked that "from an economic point of view the puzzle called 'transition' may have no lib-

liberal solution, let alone a radical liberal one."[34] Yet, looking behind the viability of neoliberal ideas for the development of the financial sector in CEE is useful. The early reformers had the targeted vision and the model of a functioning financial system from the industrial countries. But even though market ideas for the development of the financial sector were a decisive part of the reformers' rhetoric, they were never a serious part of the government programs for financial sector development. It was not viable politically and economically, and it did not materialize institutionally. It was just rhetorically attractive to describe the reform in the financial sector as one fully dismantling the socialist principles and moving towards a capitalist system of financial intermediation.

The glitches appeared because the reformers from the region were greatly concerned with the "engineering" of the reform.[35] The initiated reforms were labeled as "neoliberal;" nevertheless, they hardly had a neoliberal content. The reformers' penchant for being the actor that dismantles the socialist past distances them greatly from the neoliberal propositions. Treating financial transition as a process of exiting from one order and entering to capitalist, private based, market-driven financial intermediation with the navigation from the state, may certainly be advancing the society to some kind of capitalism, but should definitely not be labeled with the neoliberal tag.[36] Szacki critically observes the early post-communist reality. He states the apparent discrepancy between the liberal ideas and what is being labeled as such in CEE and points that "liberalism is colored by a 'constructivism' which the classical liberal thinkers most energetically fought against."[37]

Certainly, radical solutions would not have worked in CEE. Behind both the *laissez-faire* and *dirigism* remain just ideologies. Moreover, it is not the neoliberal approach to financial policies that made some countries more advanced than others in financial development in CEE. In fact, we find neither a pure implementation of neoliberal strategies in the region to judge; nor, on a larger international scale, is there enough proof to claim that neoliberal policies always work. Nevertheless, understanding the motivations behind following certain set of reforms by govern-

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34 Kovacs. 1992. p.39.

35 *Ibid.*

36 For assertion of the transition in Easter Europe see for example Galbraith 1990, or Klaus 1991, among many others.

37 Szacki (1992, p.491) uses the term with reference to Hayekian "constructivist rationalism," which here refers to state interventionism. See Hayek (1990).

ments is helpful in clarifying the bigger picture of the financial transition. Over the course of time, as the financial institutions become better functioning and integrated, one may find that certain policy mix had worked for Eastern European financial development. For now, the dominating neoliberal or, on the other extreme, interventionist programs, do not seem to fit the peculiarities of the CEE environment. It should be emphasized, however, that the policy stance in the transformational scene in Eastern Europe requires a credible institutional and regulatory environment, which will ensure the shift from socialist financial order to a capitalist environment, where the principles of markets and private property enable the efficiency of financial intermediation. The success of these reform measures largely depends on a variety of factors, but particularly on the interest involved in their actual execution.