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Corporate Governance
in Transition Economies
The Theory and Its Policy Implications

Erik Berglöf

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Foreword

This EDI Working Paper will be published as one of 12 chapters in a forthcoming book entitled: *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* edited by Masahiko Aoki and Hyung-Ki Kim. The book will have three parts:

Part 1: Generic and Comparative Issues: Theory and Policy Implications (chapters 1–3)

Part 2: Country Studies in Comparative Perspectives (chapters 4–8)

Part 3: Relevance and Lessons of the Japanese and German Experience (chapters 9–12)

A list of titles is provided on the inside back cover of this paper.

The book presents the results of a research project on corporate governance issues in transitional economies from a new perspective based on comparative institutional analysis. A concern with three issues—the emergent phenomena of insider control, the possible role of banks in corporate governance, and the desirability of the comparative analytic approach—sets the common ground for the research presented in this volume.

The coexistence of the alternative models of corporate control in the developed countries suggests that the possible "lessons" for the transitional economies may not be so obvious. It makes little sense to judge the merits of each corporate governance model and its applicability to the transitional economies without taking into account a country's stage of development and the history of its institutions and conventions. In designing corporate governance structures for the transitional economies, economists are required to identify the specific conditions under which each corporate control model (or combination of models) works, the availability of these conditions in the transitional economies, and the most efficient approach to achieve these conditions. By pooling rich individual country studies and cross-examining and comparing their implications, we may be able to avoid premature generalizations or theorizing based on the observation of a single economy. By comparing the workings of diverse systems, we may also be able to uncover latent factors that are conducive to, or constrain, the workability of particular governance structures. Comparative analysis may thus serve in the social sciences as a kind of proxy for laboratory experiments.

This work was prepared as part of EDI's multiyear *Program for the Study of the Japanese Development Management Experience* which is financed by the Policy and Human Resources Development Trust Fund established at the World Bank by the Government of Japan. The Program is managed by the Studies and Training Design Division of the World Bank's Economic Development Institute.

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Corporate Governance in Transition Economies: The Theory and Its Policy Implications

Erik Berglöf

There is general agreement that production in the transition economies of Eastern Europe and the former Soviet Union must be fundamentally reoriented and enterprises thoroughly restructured. After the demise and final collapse of central planning, control over most of these strategic decisions is effectively in the hands of managers of firms; privatization has done little to change this. The strong insider control is reinforced by the weakness of financial institutions and the poor enforcement of property rights. In the absence of strong outside investors and an institutional framework supporting corporate governance, managers are unable to raise the capital needed for investments in new technologies and capacity.

The central question addressed here is what kind of corporate governance institutions are best suited for the transition economies. Governments in these countries have looked both east and west for advice and models to emulate. Even when they were not looking, outside consultants and academics alike have offered their own favorite recipes. Much of the debate has concerned the role of stock markets in corporate governance and the choice between mutual funds and commercial banks as instruments of such governance. What has been lacking is a basic conceptual framework in which to describe and analyze existing models and proposals. The purpose of this chapter is to suggest such a framework based on a survey of the recent theoretical literature on corporate governance. Although this literature is still in its infancy and policy implications must be treated with caution, it provides a much better guide to understanding corporate governance than the traditional finance literature. In particular, through its emphasis on the institutional aspects of finance, this framework is more helpful in analyzing the transition economies.

This chapter will briefly characterize the present situation in Russia and the four Visegrad countries—the Czech Republic, Hungary, Poland, and Slovakia. While there are important differences in degree and in nature, the basic problem of insider control is pervasive throughout most of the region. The problem of insider control has been at the heart of an active recent literature on corporate governance discussed in the third section of the chapter. This literature provides a number of concepts useful for describing and analyzing the choice among different forms of corporate governance and governance institutions. The fourth section makes use of the basic conceptual framework to draw a number of lessons for policymakers. The analysis strongly suggests that commercial banks will come to play an important role in corporate governance in transition economies. These conclusions are worrying given the present state of the banking sector in most countries. The fifth section asks what we can expect from banks in transition economies and discusses what has been and what can be done to improve how they function.

Corporate Governance in Transition

With the growing interest in the issue of corporate governance in transition economies, the empirical evidence is mounting. Case studies and, increasingly, systematic surveys have forced us to change many of our preconceptions about how firms are controlled and how managers behave during transition. To

provide a basis for the discussion of the conceptual framework and its policy implications, this section identifies the basic corporate governance issues in Russia and the four Visegrad countries.

;bInsider Control and Credit Constraints

The predominant feature of corporate governance in large and medium-size enterprises throughout Eastern Europe and the former Soviet Union is the strong control exerted by insiders, primarily by managers (for a survey of the empirical studies, see Aghion and Carlin 1994). In Russia, the shift of bargaining power toward insiders started with the enterprise reforms during the late 1980s, but the trend was reinforced by the collapse of the Soviet state. The new government has been unable to reassert its nominal property rights over state-owned assets, which still represent the bulk of large enterprises. For the most part, the privatization program has merely legitimized the de facto distribution of control. Most large enterprises have been privatized by transferring ownership rights to incumbent managers and workers. Through lock-in arrangements workers are prevented from selling their equity-holdings. Insider control is mirrored in boards and shareholder meetings captured by management, and with few external directors.

The picture in the Visegrad countries is similar, with some variations. For historical reasons, workers in Poland, and probably in Hungary, seem to have more influence over strategic decisions than Russian workers (Fan and Shaffer 1994). In the Czech Republic and Slovakia, the state—before the separation—managed to reassert its property rights, at least to some extent. Consequently, insider control is less pronounced, especially in the Czech Republic, where voucher privatization and the subsequent emergence of the investment privatization funds have led to a strong concentration of nominal ownership rights with outside institutions. In the average firm, the leading investment fund holds 14 percent, and in 25 percent of the firms privatized in this fashion the largest funds own more than half of the investment points (Earle, Frydman, and Rapaczynski 1993). Even though no single fund or group of jointly managed funds is allowed to vote for more than 20 percent of the outstanding shares, there appear to be ample opportunities for funds to circumvent these rules. There are few signs, however, of these control blocks being translated into active corporate governance.

The strong position of enterprise managers in the transition economies is reinforced by the weakness of the financial systems. Reforms to separate central and commercial banking have been undertaken in all the countries, but financial institutions are still rudimentary and financial intermediation is limited. The degree of intermediation and decentralization of credit allocation also vary substantially across countries. In Russia, where reforms are relatively recent, decision-making is still more centralized (Belyanova and Rozinsky, in this volume; Pohl and Claessen 1994). Money creation is dominated by outside money, with the central bank channeling considerable funds to state enterprises through the largest commercial banks. These so-called direct credit programs account for the bulk of loans from the banking sector. Under these programs finance is essentially passive, although banks have exercised some monitoring since the last years of the Soviet period.

Much of the Russian banking sector has effectively been captured by enterprises. Most of the large number of new banks have been created by enterprises or former ministries. In essence these institutions are little more than corporate treasuries that handle the cash flows of individual enterprises and to some extent reshuffle liquidity among affiliated firms; most credits are short term, typically two to three months. Enterprise ownership of banks has perpetuated connected and inside lending; enterprise deposits are, after central bank contributions, the most important source of funds for commercial banks. To an increasing extent banks also hold equity in borrowing firms and in voucher investment funds.

The financial systems in the four Visegrad countries have evolved further and decisionmaking has been decentralized (Dittus 1994). Banks are more independent from both the central banks and firms, and they play a more active role in managing their portfolios. Consequently, bank incentives matter more than

in Russia. This is significant because most banks have been saddled with bad loans from prereform years, rendering the average quality of loan portfolios very poor. A number of recapitalizations have been undertaken with varying results, but most banks still suffer from low capital adequacy ratios. Commercial banks have become important owners in many enterprises, particularly in the Czech Republic and Hungary. Czech banks directly control more than 40 percent of the investment points in the first wave of privatization, and estimates suggest that the figure would rise to 60 percent if indirect holdings were included (Stern 1993). Three of the top four investment funds are controlled by banks. In Hungary, bank ownership is largely a result of conversion of old loans into equityholdings.

Enterprises in the transition economies are establishing links among themselves through the widespread use of trade credits and, to an increasing extent, crossholdings of equity. The widely reported rise in enterprise credits in Russia followed attempts by the government to cut subsidies. In the absence of alternative external sources of finance, trade credits may offer temporary relief from the effects of fiscal tightening. Initially the expansion of interenterprise lending and the potential consequences of accumulating arrears on these credits put strong pressure on the central bank, forcing it to bail out firms on several occasions. The growth in trade credits in Russian enterprises now seems to have leveled off, because many firms only accept cash payments (Fan and Shaffer 1994). Interenterprise credits have not been as important in the Visegrad countries, and they appear to have stabilized at a reasonable level. In Hungary, however, crossholding of equity has spread quickly and resulted in a complicated and nontransparent web of ownership that largely serves to protect insiders against outside intervention.

The strong insider control in the transition economies of Eastern Europe and Russia also stems from the poor enforcement of property rights. While the role of formal legal codes in economic transition probably should not be overemphasized, the general ambiguity about existing property rights is harmful. This ambiguity arises partly from weaknesses in the legal environment, but more important is the volatile macroeconomic situation and the fragility of the political system. The problem is particularly severe in the emerging private sector and recently privatized firms that want to raise external funds. The high uncertainty also increases the option value of waiting to invest and reinforces the corporate governance problem by contaminating the signals generated by increasing market competition.

The strong insider control, the ambiguity about property rights, and the high general uncertainty have made the legal buying and selling of corporate assets more difficult. The illiquidity of assets is particularly severe for real estate, where the details of the legal framework often have not been worked out yet through legislation and case law. The absence of a market for corporate assets severely impedes the possibilities of enterprises to raise outside funds.

What Do Insiders Do?

What kind of behavior should we expect from enterprises controlled by managers in what is, in effect, a corporate governance vacuum? First, while there are some spectacular examples to the contrary, widespread asset stripping is unlikely. Managers are de facto, and in Russia and Poland increasingly de jure, owners of the enterprises and thus we should expect them to maximize the surplus generated by corporate assets. In highly liquid asset markets, liquidated assets sell at a large discount, and managers consequently prefer to keep the firm as a going concern. Furthermore, as managerial labor markets develop, short-term behavior is increasingly likely to be penalized. Scant empirical evidence also suggests that asset stripping has been less widespread than often is believed (see, for example, Pinto, Belka, and Krajewski 1993; Estrin, Shaffer, and Singh 1993; Fan and Shaffer 1994).

Second, it is not clear that firms controlled by managers will completely abstain from labor shedding and liquidation of unprofitable production units. Without access to external finance, cutting costs may be the only way to increase the surplus generated internally. While there undoubtedly are a number

enterprises where management and labor have joined forces, surveys indicate that such collusion is not the general picture (Estrin, Shaffer, and Singh 1993; Fan and Shaffer 1994). On the contrary, insider-controlled enterprises have reduced their work force substantially and closed down loss-making activities. Even in Poland, where worker control plays an important role, firms fire employees and liquidate inefficient units.

Third, while Russian managers do seem to cut costs, they are not investing sufficiently in new technology and capacity. The level of investments in Russia has fallen more than production since the dissolution of the Soviet state; the current level is only 50 percent of that in 1990. At least to some extent, the disproportionate fall in investment activity can be explained by the lack of external funds. The fundamental dilemma of insiders is that their strong control over assets makes them unable to convince outsiders to contribute capital. In the Visegrad countries external finance does seem to play a larger role, and investment has not fallen as much as production.

The picture of corporate governance that emerges in the transition economies is a scattered one; in Russia many enterprises still have direct channels to the central bank or the state budget, but the bulk of industry is severely constrained by lack of corporate governance and subsequent problems in obtaining outside finance. If macrostabilization is to be successful, the budget constraint for the first group must harden, and viable firms need to find new sources of funds. For the second group, the external finance constraint will become increasingly severe as competition increases and internally generated funds decrease further. In the Visegrad countries the budget constraints have hardened significantly following stricter banking regulation and increasing competition among banks, but strong insider control and a weak legal framework still limit the possibilities of many firms to obtain outside finance (Dittus 1994). Mounting evidence also suggests that many of the soft financing practices of the prereform period persist (for a study of credit flows in Poland, see Anderson 1994).

Corporate Governance and Finance—A Conceptual Framework

To many observers the significance of corporate governance to the transformation process is of fairly recent origin; privatization and market liberalization were supposed to be sufficient. As the need for governance has become increasingly urgent, a heated discussion has evolved around the choice among institutional arrangements. To make this choice we need a conceptual framework that allows us to describe and analyze different kinds of corporate governance institutions and different forms of corporate governance. Furthermore, in order for us to evaluate the feasibility of particular governance arrangements in the transition economies, such a framework should say something about the conditions under which particular arrangements will emerge. A framework must therefore show how the different aspects of a corporate governance arrangement relate to each other, to other aspects of the financial system, and to the rest of the economy.

This section briefly surveys the recent literature on corporate governance and extracts some basic concepts that can provide building blocks in such a framework. These concepts distinguish the basic forms of external finance, and they allow us to classify existing and potential financial institutions and financial systems. This article certainly is not the first to present such a framework (see, for example, Rybczinski 1984; Zysman 1985; Mayer 1993). What distinguishes the framework advanced here is that it is derived directly from an explicit theory of corporate finance. Thus, the first step is to understand the basic problems facing a firm seeking to raise external finance.

The Basic Finance Problem: The Insiders' Dilemma

While it may be expressed to extremes in the transition economies, the insiders' dilemma, in essence, is nothing but the agency problem at the core of recent literature on corporate governance in finance. An entrepreneur, or the management of a firm, has ideas but insufficient internal funds to realize these ideas. The firm must then ask investors to contribute capital against promises of being paid back out of future revenues. To reduce the costs of external finance, or sometimes to obtain funds at all, promises to use invested capital in particular ways and to pay investors back must be made credible. The insiders' dilemma is that to improve credibility they must either issue contingent ownership rights to assets and cash flows of the firm (for example, by providing collateral) or give up some control over investment decisions. These options—here called arm's-length and control-oriented finance—represent two generic solutions to the basic problem of corporate finance.

The choice of terminology is somewhat arbitrary. Holmström (1992) and Holmström and Tirole (1993) use the terms “intermediated,” “monitored,” and “informed” interchangeably for what is here called control-oriented finance, and “uninformed” and “unmonitored” for arm's-length finance. None of these terms is ideal. Monitoring is just one form of financial intermediation. The dichotomy “uninformed-informed” highlights the information available to investors, whereas the crucial distinction here is whether or not investors influence investment decisions; “monitoring” is also often used to denote the collection of information. Furthermore, “uninformed” and “unmonitored” suggest that assessing collateral requires no information. On the contrary, arm's-length finance requires information verifiable by courts; under control-oriented finance only the information of controlling investors matters.

Before discussing these generic forms of external finance, two points should be made. First, the relative importance of external finance, and consequently of corporate governance, depend on a firm's ability to generate funds internally. As this ability varies across firms and industries and over the business cycle, so does the role of external finance. Second, the finance decision—that is, the choice between internal and external finance and among sources of external finance—may itself be subject to agency problems. For example, even though a firm has profitable investment opportunities, a manager may decide not to raise funds externally, because he would have to give up some control rights. This seems to be the prevailing attitude among many managers in the transition economies at the moment.

;bArm's-Length Finance: “Governance by Objective”

The literature on arm's-length finance has focused on the problem of getting the firm to pay out at all. Loosely speaking, arm's-length finance is “corporate governance by objective”; investors do not interfere directly in strategic decisions as long as they are paid according to contract. This, in a sense, is the extreme case of insider control. Arm's-length finance does not rule out intervention. Nevertheless, the initial investors rely on the external mechanisms such as the market for corporate control or bankruptcy courts to achieve such intervention.

While investors do not intervene in the investment decision itself, they can, when the firm fails to pay out, foreclose, or at least threaten to foreclose, on assets or cash flows specified in the financial contract. The scope for external finance is here limited by what is credibly contractable—that is, what can be enforced in court. Whereas cash flows in a firm may be difficult to use as the basis for a contract, physical assets, in particular buildings and land, but also machines, may be more easily valued. The use of such collateral reduces the downside risk for the investor, but it also affects the ex post bargaining situation between the firm and its investors (Hart and Moore 1989, 1991). If the collateralized assets are important to the future earnings capacity of the firm, a threat to take possession can be used to extract funds when the firm refuses to pay out. Giving an outside investor such liquidation rights ex post can make a commitment to pay out credible ex ante.

The problem with the threat to liquidate is that this also hurts investors if they have long-term interests, such as equity or long-term debt, in the firm. To make the threat more effective, and thus strengthen commitment *ex ante*, investors can separate their claims over time (Berglöf and von Thadden, forthcoming). When an investor with collateral only holds short-term claims, the liquidation threat becomes more credible. Thus, arm's-length finance helps explain why firms often have both long-term and short-term investors, why their financial claims differ in security interests and priority, and why they specialize in particular claims. The relative bargaining power of the firm may also depend on the number of investors involved in bargaining and the allocation of security interests among them (Bolton and Scharfstein 1992); theoretical and empirical evidence suggests that more complicated capital structures with large number of investors holding different kinds of claims may make the firm weaker in *ex post* bargaining. When investors are dispersed and have conflicting interests, it may be more difficult for them to agree to reschedule their claims.

It should be emphasized that a firm relying on arm's-length finance does not only raise external finance in the form of secured debt. In Berglöf and von Thadden (forthcoming), the firm issues both secured short-term debt and equity, and sometimes bonds. In most cases some of the firm's cash flows are also verifiable, that is, enforceable in court, and can thus be contracted credibly in the form of equity or unsecured debt. The extent of verifiability of assets and cash flows depends on a broad range of factors, such as the nature of the firm's business, auditing requirements, the sophistication of outside analysts, whether the firm is publically listed or not, and the capability of the legal system.

Under arm's-length finance there is a strong connection between the nature of a firm's assets and its finance capacity—the more liquid its assets are, the more, or the cheaper, capital it can raise. This may help explain why small, medium-size firms, and new firms, for which less information is publically available, are more dependent on expensive short-term bank finance than larger and older, relatively better-known, firms. By the logic of arm's-length finance it is in a firm's interest to seek secured short-term finance from “tough” bargainers, such as banks with large resources and a reputation at stake in other credit relationships; this further improves the commitment power of security interests.

The scope for arm's-length finance is strongly affected by the general state of the economy. The threat to liquidate is more effective, and arm's-length finance consequently more attractive, when liquidation values are high—that is, when asset markets are liquid and assets are not specialized (Shleifer and Vishny 1992). When asset values are depressed—for example, in a recession or after demand has fallen in an industry—investors will demand more collateral and previously unconstrained firms may have problems raising funds. The need for collateralizable assets—and cash flows—can thus also help explain why the effects of economic downturns on financing conditions differ across firms of different sizes and across industries, and why in a recovery credit constraints loosen faster for some firms than for others.

In the transition economies the illiquidity of asset markets is further reinforced by the ambiguity of property rights and the prohibitions against transfers of certain assets. The extreme situation of insider control studied in the literature on arm's-length finance is not extreme enough—in many enterprises in the transition economies there may be few, if any, assets that can be contracted. In such an environment, control-oriented finance may be the only option open to firms.

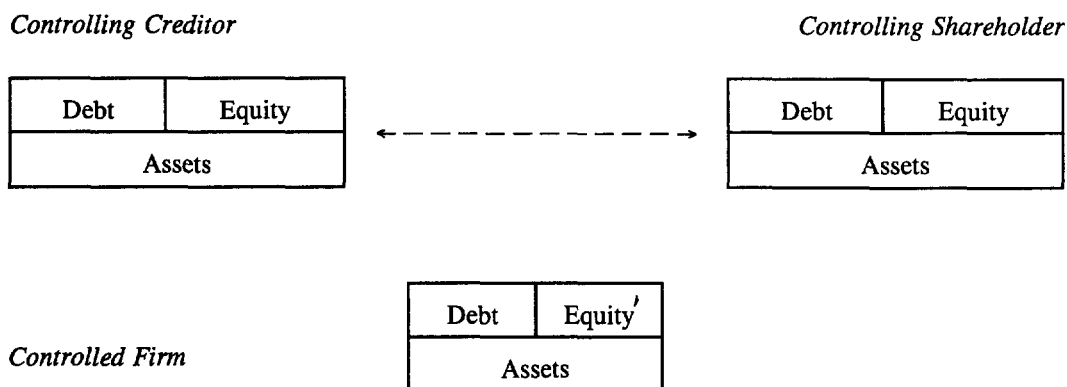
Control-Oriented Finance: “Governance by Intervention”

Under control-oriented finance investors take it upon themselves to reduce agency problems by monitoring the firm's investment decisions (Holmström and Tirole 1993). If arm's-length finance implies “governance by objective,” then control-oriented finance is “governance by intervention.” The exercise of control can take many forms, such as vetoing inefficient decisions or using control rights to force the

implementation of efficient decisions. Replacing management when it undertakes certain actions, or fails to undertake others, is a similar way of affecting investment decisions.

As illustrated by figure 3-1, the nature of control is affected by the kind of claims held by the investor and by her capital structure. If the investor only holds debt in the firm, control rights are state-contingent in the sense that they are exercised primarily in bad states of nature when the firm cannot meet its payment obligation (Aghion and Bolton 1992). If the intermediary only holds equity, control is confined to non-default states. In many firms debt and equity control are performed by different investors. In some cases the investor holds both debt and equity claims on the same firm, and the exercise of control could occur across all states, with the nature of intervention changing as the firm comes into financial difficulties.

Figure 3-1. Different Forms of Control and the Balance Sheet of Controlling Investors



Debt and equity control also differ because of the different return schedules associated with these instruments. The fixed payment with no share in upside returns makes the monitor tough—that is, more likely to favor less risky actions, such as a discontinuation of particular projects or of the entire firm (Dewatripont and Tirole, forthcoming). Equity, in contrast, is soft, with a bias in favor of incumbent management and continued operation of the firm. Thus, while debt and equity control complement each other, it is more doubtful whether they can serve as substitutes for one another.

The optimal form of control depends on the nature of the agency problem between the firm and its investor—that is, whether the firm is likely to under- or overinvest and whether conflicts are state-contingent or not. If the firm is inclined to excessively risky actions, the bias of debt could serve as a counterbalance to management. If potential underinvestment is the problem, debt may reinforce the agency problem. Similarly, if management is more likely to behave inefficiently when the firm is doing poorly—for example, by refraining from shedding labor or by gambling for resurrection—state-contingent, or debt, control may be preferable. If the main agency problem is to prevent managers from building empires in otherwise healthy companies, we should expect to observe equity control (under arms-length finance the same objective would be achieved by issuing debt; see Jensen 1986). The difference in nature between debt and equity control suggests that a specialization

among controlling entities may be preferable. Liquidation and restructuring in bad states of nature also require quite different skills from those needed to constrain a management inclined to empire building in a firm that is doing well.

Control can be exercised directly by an individual investor, but also by an intermediary with liquid claims (for example, short-term deposits and listed equity) on the liability side of the balance sheet and illiquid claims (such as debt and equity holdings in client firms) on the asset side; intermediation transforms illiquid claims into liquid ones. It is the combination of the information collected and the control rights exercised that allow such intermediation.

Thus, to understand the nature of monitoring we have to study not only the type of instruments held by the controlling entity but also the concentration of these holdings in its portfolio and the incentives provided by its balance sheet. Two useful distinctions can be made between portfolio-oriented and control-oriented investors, and between well-capitalized and heavily leveraged investors. A portfolio-oriented investor emphasizes diversification of risk and has little incentive to exercise control, and thus typically purchases arms-length instruments. A control-oriented investor foregoes diversification opportunities to exercise control, or at least to have the potential of doing so. For a control-oriented investor the composition of the balance sheet may affect incentives to monitor. A poorly capitalized bank, or a bank that is explicitly or implicitly insured against downside risks, may support riskier investments than desirable, or it may shirk in the exercise of control. High leverage where default leads to dire consequences for management may also provide incentives for monitoring.

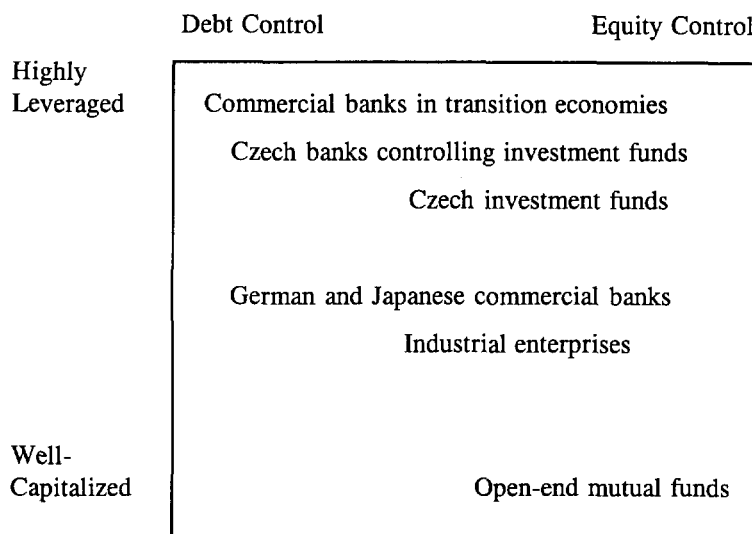
The control-oriented investor's costs of monitoring are the diversification opportunities foregone and the expenses in collecting information and influencing strategic decisions. Because holding large control blocks involves fixed costs, control-oriented financial arrangements are typically long term, and control blocks of equity and bank debt tend to be less liquid than minority equity and bonds. In addition, when resources available for the exercise of control are scarce (for example, in an economy undergoing transition and where existing institutions are still in embryonic form), state-contingent debt control may economize on controlling costs by allowing financial distress to serve as a screening device—as long as the firm is doing fine the intermediary basically remains passive, and its control is only activated when a firm enters into distress. Debt control thus offers a screening device that allows investors to identify the firms most in need of monitoring.

A wide range of institutions—not only banks, but also investment companies, mutual funds, and even other enterprises—may exercise control. Figure 3-2 classifies existing and potential control-oriented investors according to capitalization and kind of control. These basic concepts clarify the debate concerning the choice between different control-oriented intermediaries, such as mutual funds as opposed to commercial banks. In the terminology used here, the mutual funds put forth in the debate are well capitalized (basically all-equity) intermediaries exercising governance through controlling blocks of equity. Commercial banks are less well-capitalized, particularly in the transition economies, and control is primarily based on large debt holdings, but possibly on holdings of equity as well. In the popular debate the two kinds of intermediaries are often treated as mutually exclusive. The corporate governance literature suggests, however, that mutual funds and commercial banks complement each other not only in the financial system as a whole, but also in the individual firm.

The conceptual framework also throws some light on the emerging intermediaries in the transition economies. Figure 3-1 suggests that the juxtaposition of mutual funds and commercial banks is misleading. Calling the Czech investment privatization funds “mutual” is a misnomer. These intermediaries have complex capital structures, with equity holdings by banks and private individuals, and debt claims held by the original voucher holders. Viewed in this way, many of the funds are heavily leveraged and vulnerable to systemic shocks in much the same way as banks. Many of the so-called investment funds emerging from voucher privatization in the Czech Republic and Russia are strongly affiliated with commercial banks. Thus, for the purposes of governance, the two intermediaries form part

of a single state-contingent corporate governance arrangement where control shifts from equity to debt when firms come into financial distress.

Figure 3-2. Control-Oriented Investors by Capitalization and Kind of Control



Intermediaries can also control each other through mutual arrangements, and one intermediary can specialize in controlling other intermediaries. Ultimately, however, the question of intermediary incentives raises the perennial issue of “who controls the controllers,” and the credibility of the government in disciplining failing institutions—an issue of acute importance in the transition economies addressed in the final section of the chapter.

The Firm’s Capital Structure and the Financial System

Whereas these two forms of finance are distinct in theory, in reality they may be more difficult to discern. For example, claims originally issued as arm’s-length finance can later turn into control-oriented finance. For example, a portfolio-oriented investor may change strategy and decide to take over control of the firm by increasing her stake. Similarly, it is not uncommon for a bank, even though it was not control-oriented initially, to purchase the claims of other creditors when a debtor firm enters into financial distress. In their ambition to hold the market portfolio, certain large, portfolio-oriented investors—for example, some pension funds in the United States—also have come to hold such large stakes in individual firms that they are more or less forced to exercise control. Of course, a control-oriented investor may later divest his controlling share, as is common in venture capital finance, for example.

Arm’s-length and control-oriented finance may also be difficult to distinguish because many, if not most, firms raise funds through both arm’s-length and control-oriented finance; the two forms of finance complement rather than substitute for each other. For example, the contingent liquidation rights associated with secured debt may serve to increase the effectiveness of monitoring. Effective monitoring may also

reduce the uncertainty about underlying assets, thus increasing the firm's capacity to raise arm's-length finance. Similarly, the guarantees implied by the presence of a main bank may make other investors more willing to commit to arm's-length finance. Indeed, the importance of commercial banks in most countries derives to some extent from the ability of these institutions to provide both kinds of finance. The combination of seats on the board, votes in the general shareholders' meetings, and security interests in crucial buildings or machinery should increase the likelihood of monitoring being effective.

The two forms of finance also complement each other because they are influenced by different factors. For arm's-length finance, the nature of a firm's assets plays an important role. This form of finance also strongly relies on the liquidity of markets for corporate assets, and consequently on the extent of enforcement of property rights and general business conditions. The conditions for control-oriented finance are less well understood, but establishing and maintaining monitoring relationships is costly; control-oriented finance should be expected to be more long term and less vulnerable to short-term fluctuations. In addition, while the exercise of control requires sophisticated institutions, control-oriented finance may be less dependent on the formal legal framework.

The relative importance of arm's-length and control-oriented finance should vary not only across firms and industries, but also across countries. Unfortunately, traditional financial statistics do not distinguish between arm's-length and control-oriented finance; equity finance can be both arm's-length and control-oriented, as can bank debt. In addition, differences in accounting and statistical methods make reliable international comparisons of patterns of finance across countries difficult. The evidence suggests, however, that internal finance is by far the most important source of finance, and debt finance the most important external source, in all the major industrialized countries (Mayer 1990). There appear to be significant international variations in the degree and nature of intermediation within economies, across industries, and across firms of different sizes, as well as across countries, depending on level of development and institutional arrangements.

While the dominance of internal funds in total finance and bank loans in external finance is virtually universal, there appear to be significant international variations in the degree and nature of control orientation within economies, across industries, across firms of different sizes, and across countries, depending on level of development and institutional arrangements. The clustering of these arrangements suggests a strong interconnectedness among different aspects of the financial systems. For example, countries with strong commercial banks tend to have a higher share of control-oriented finance, more concentrated ownership of debt and equity, less turnover in control positions, and less liquid markets for equity and debt. Attempts have been made to understand these patterns by classifying financial systems into broad categories such as bank-oriented and market-oriented, or market-based and credit-based. Table 3-1 shows one, necessarily simplistic, classification. To make clear the link between the basic form of finance and the financial system, and avoid some of the misleading associations of the previous typologies, the terms arm's-length and control-oriented financial systems are used here.

Some of the interdependencies in table 3-1 are self-explanatory, even tautological. It is obvious, at least given the argument pursued here, that a financial system dependent on control-oriented finance requires more control-oriented intermediaries, more concentrated capital structures, and will have lower turnover of large blocks of debt and equity. High ratios of bank credits to total liabilities and extensive interfirm shareholdings are also expressions of the significance of control-oriented finance. The existence of close control relationships may reduce the incentives to incur the costs of going public and prevent firms from going from closely held to widely held. When firms are not widely held, the market for corporate control can play little role in disciplining management; a hostile bid is only possible if the controlling owner has less than a majority of the outstanding shares.

The list of attributes of the financial systems in table 3-1 is by no means exhaustive, and there is reason to believe that there are more interesting interrelationships within the financial system, and between the financial system and the rest of the economic system. Aoki (1984, 1994), for example, in

his discussion of the Japanese firm, notes a strong complementarity between external control systems and the internal organization and operation of firms. In particular, financial and employee interests complement each other in influencing managerial decisions. Given the tradition of worker influence in many of the transition economies, similar patterns are likely to emerge. Wymeersch (1994) argues convincingly for a relationship among the financial system, firm organization, and the legal framework. He distinguishes between company-based legal codes that focus on the contractual relationship between the firm and its investors and enterprise-based legal codes emphasizing the firm as a productive entity and the role of codetermination.

The distinction between arm's-length and control-oriented financial systems suggests two fundamentally different models of capitalism—one where ownership and control have become strongly separated and one where this separation is much less important. That ownership and control are more closely associated does not imply that this holds for the ultimate distribution of wealth and control over enterprises. While family ownership seems to play a more important role in large enterprises in control-oriented systems, indirect ownership through intermediary institutions also is more common; this helps explain the many layers of ownership observed in, for example, German enterprises by Franks and Mayer (1992). It is likely that we will see similar patterns emerging in the transition economies of Eastern Europe and the former Soviet Union.

The conceptual framework of table 3-1 places the corporate governance discussion in the larger context of the financial system. The classification is based on observations of developed capitalist economies, but it allows us to speculate about where the transition economies are heading. There are a number of signs that these systems, sometimes despite government policy, are becoming increasingly control-oriented. Even in countries that have followed equity-based voucher privatizations, such as the Czech Republic and Russia, banks seem to emerge as the most important outside investors, in some cases by investing directly in firms, but often indirectly by buying into investment funds. The observation that these financial systems are becoming control-oriented has implications not only for intermediation, but also for the evolution of equity and bond markets and financial regulation. Before suggesting the main lessons for policy, however, the framework is illustrated using a particular governance arrangement that combines different forms of finance and intermediation.

;bAn Example: The Japanese Main Bank System and the Financial Keiretsu

A first indication of the usefulness of a conceptual framework is given by its ability to characterize existing governance arrangements. This section describes corporate governance in Japan, focusing on the main bank system and the closely associated financial keiretsu. These arrangements have been put forth as models for transition economies (for example, in Bardhan and Roemer 1992). Extensive research in recent years has provided detailed information on their structure and behavior (for a recent characterization, see Aoki, Patrick, and Sheard 1994). The example of corporate governance in Japan also yields further insights into how the different forms of finance complement each other and how the different aspects of governance arrangements are related.

Table 3-1. Financial Systems and Capital Structure

Item	Type of financial system	
	Control-oriented	Arm's-length
<i>General characteristic</i>		
Share of control-oriented finance	High	Low
Depth and width of financial markets	Low	High
Bank assets as a share of total financial assets held by financial institutions	High	Low
Control-oriented intermediaries	High	Low
Likelihood of going public	Low	High
Importance of market for corporate control	Low	High
<i>Creditor structure</i>		
Degree of concentration	High	Low
Bank credits to total liabilities	High	Low
Bonds to total liabilities	Low	High
Turnover of holdings	Low	High
<i>Shareholder structure</i>		
Degree of concentration	High	Low
Bank shareholdings	High	Low
Interfirm shareholdings	High	Low
Turnover of control blocks	Low	High

The main bank system and the financial keiretsu are essentially two different, but overlapping and complementary, corporate governance arrangements. The main bank system combines relationships between banks and firms, among banks, and between banks and regulatory institutions. Almost all Japanese firms have close links to one particular bank. These relationships involve loans, but also assistance in bond issues, shareholdings, payment settlement accounts, and various informational and managerial services. Many, mostly larger, firms also have relationships among themselves, denoted financial keiretsu. These interfirm links include crossholdings of equity and debt (through trade credit), trade in goods and services, and, for core firms, membership in Presidents' Clubs. The main bank can be viewed as the foundation, and the financial keiretsu reinforces this foundation. Core firms are more closely tied together, while peripheral firms form much looser relationships. There is also variation in the tightness of these linkages among the financial keiretsu (Hoshi and Ito 1991). For simplicity, this section focuses on the situation in firms that have both a main bank relationship and are affiliated with one of the large, more cohesive financial keiretsu.

The exercise of control in the financial keiretsu is state-contingent. As long as payment obligations are met, largely passive mutual equity monitoring among affiliated firms dominates. But when a firm gets into financial distress, the governance mode shifts to active intervention, generally led by the main bank. To obtain early warnings of potential problems and to facilitate coordination, the bank guarantees trade credits among keiretsu firms. If a firm defaults on one of its trade creditors, the claim is transferred to

the bank, which then decides on the form of intervention. Such state-contingent control allows the bank to focus on restructuring in financial distress. Empirical evidence also shows that when profits fall in a member firm, both the main bank and the shareholders send directors to the ailing firm, but if there are liquidity problems, only the main bank sends directors (Kaplan and Minton, forthcoming).

Thus, the main bank arrangement with the associated financial keiretsu is a dynamic relationship that changes in response to the conditions of the individual firm and the general state of the economy. For firms that are doing well, the state-contingency feature plays little or no role, whereas in firms with liquidity problems the possibility of transferring control to the main bank is crucial. In the era of rapid growth in the Japanese economy, most firms relied heavily on the main bank relationship, but in the 1980s the importance of the bank lessened considerably.

An arrangement based on crossholdings of debt and equity could be used to entrench incumbent managers of banks and firms from the pressures of the marketplace. One reason that such “low-effort” equilibria are not observed may be found in the capital structure of the main bank. The bank is heavily leveraged, with most of its liabilities in short-term deposits. If the bank were to shirk in monitoring, it would be the first to suffer. Given the implicit and explicit government guarantees in case of bank failures, however, leverage may not provide sufficient incentives and may potentially make the bank take larger risks than desirable. Sheard (forthcoming) shows that these incentive problems can be mitigated through delegated monitoring among main banks. While the group bank is the largest lender in member firms, the lending relationship is not exclusive; a firm typically also borrows from main banks of other groups. These banks monitor each other and delegate to each group’s main bank the responsibility of restructuring member firms in financial distress. The group bank’s status as the largest lender, and in addition that it has guaranteed much of the outstanding trade credits, provides it with strong incentives to act on its promise.

The empirical evidence suggests that keiretsu firms, at least during certain periods, have been less profitable than independent firms (Nakatani 1984). The relatively high wage levels in keiretsu firms and the high interest rates paid to group banks indicate that this may reflect a distribution of output in favor of insiders at the expense of outside shareholders and creditors. More important, from an efficiency point of view, recent research by Hoshi, Kashyap, and Scharfstein (1990a, 1991a) shows that firms affiliated with a financial keiretsu and a main bank are less sensitive to liquidity fluctuations than independent firms. In other words, a keiretsu firm is less likely to have to reduce investments or shed labor in the event of a shortfall in liquidity; the main bank relationship provides insulation against the effects of cash shortages.

As evidenced by the pressure put on banks by the recent decline in real estate prices, arms-length finance, although seldom mentioned, also plays an important role in main bank financing in Japan. The main bank usually has at least part of its debt collateralized in prime assets. While the bank appears willing to make concessions outside of formal bankruptcy, it seems to pursue its security interests vigorously once a firm has ended up in court (Packer and Ryzer 1992).

The financial keiretsu thus illustrates how arms-length and control-oriented finance, along with debt and equity monitoring, can be combined into a state-contingent monitoring mechanism, with a critical role played by a heavily leveraged, control-oriented intermediary. The nature of the exercise of control changes from passive mutual monitoring based on equityholdings among firms to active intervention by a control-oriented intermediary holding debt claims. The example, however, also shows how the concepts provided by the framework only capture part of the complexity of the relationships between the bank and the firm and among firms. In particular, the analysis focuses only on the formal aspects of the relationships—the holdings of equity and debt—but does not include the informational and other services performed by the bank. The interfirm relationships within the financial keiretsu also involve the exchange of goods and services that are generally outside the analysis. Furthermore, the framework does not consider the role of the government in monitoring intermediaries. Finally, by focusing on the

relationships between the firm and investors, this literature does not consider the interaction between these relationships and the internal organization of the firm. All these limitations should be kept in mind in considering the policy implications.

Some Lessons for Transition Economies

The research on corporate governance is still in its infancy, but the literature provides a basic framework for description and analysis. This framework suggests some preliminary lessons for corporate governance in transition economies.

- *Internally generated funds will be by far the most important source of finance.* This is true in all industrialized countries, but the costs of external finance are likely to be particularly high in the transition economies given the weak outside institutions and legal framework.
- *Most of the external funding will have to come from control-oriented finance.* The markets for real assets will remain illiquid, at least in the medium term, because of strong insider control and poor enforcement of property rights. Efforts to privatize and facilitate transfer of real estate are particularly important for arm's-length finance to develop.
- *Stock and bond markets are not going to play a major role in the provision of funds during early phases of economic transition.* Promoting the liquidity of stock and bond markets is of second order compared with the promotion of liquidity in markets for real assets. Raising funds through minority equity is likely to be particularly difficult given the strong insider control and poor protection of minority interests. Nevertheless, equity markets may gradually come to play a role in facilitating ownership transfer, particularly if workers start to sell their shares, and ultimately also in generating information about the performance of companies. There may be a tradeoff, however, between the liquidity of stock markets and the incentives to take control positions and exercise control; investors may choose "exit" rather than "voice" as a means of expressing their dissatisfaction with incumbent management.
- *Holdings of debt and equity will be concentrated, with little turnover in control blocks.* The corollary of illiquid stock and bond markets is highly concentrated and stable ownership structures. Patterns of ownership and control established at early stages of transition are likely to persist over long periods of time. In general, intermediaries should be prone to control-orientation in transition economies given the limited diversification opportunities open to them.
- *Control-oriented intermediaries will use both debt and equity monitoring.* Debt and equity control complement each other; both are needed. Given the nature of the corporate governance problem, however, with severe agency problems in poorly performing firms and the need for drastic restructurings, the kind of control exercised through debt holdings is likely to be particularly important. The scarcity of monitoring resources also suggests some that state-contingent monitoring will dominate.
- *Both mutual funds and commercial banks will be needed, but banks are likely to be more important in corporate governance.* The two control-oriented intermediaries can complement, compete with, and monitor each other. Given the need for debt monitoring, however, commercial banks should play the most important role, and their ability to provide several kinds of finance may prove valuable.
- *The functional specialization associated with some Western financial systems may not be feasible in the transition economies.* The exercise of control typically implies functional overlap; control-oriented intermediaries are closely involved in all stages of financial relationships. Many of the countries in Eastern Europe have already opted for legislation allowing banks to play such a role. Such broader banks may be the only feasible solution in situations where boundaries between

different banking activities are by necessity going to be fluid. Allowing banks to hold equity and to take equity as collateral (debt is then transferred into equity in financial distress) may facilitate industrial restructuring.

- *The initial choice of a privatization scheme may not be decisive in determining the evolution of the financial system.* Whereas the initial distribution of property rights in privatization may affect which institutions come to exercise control, the choice of the basic form of finance and kind of control-oriented finance is determined by fundamental characteristics of the institutional environment and the governance problem at hand. In particular, “giveaway” schemes, as shown in the Czech Republic and Russia, do not guarantee that arm’s-length systems will emerge. In the Czech case, the dispersed holdings of vouchers rapidly became concentrated with the emergence of the so-called mutual funds, and the strengthening of ties between these institutions and the commercial banks suggests that the financial system is becoming increasingly control-oriented. The equity purchases by Russian banks in investment funds indicate that this country is heading in a similar direction.

;aWhat Can We Expect from Banks?

The corporate governance literature emphasizes the need for strong independent institutions capable of monitoring investment decisions in industrial enterprises. The discussion so far has suggested that commercial banks have an important role to play in the exercise of corporate governance in the transition economies. This section asks whether existing banks can be expected to play this role. The emphasis is on understanding the banks’ incentives in monitoring firms in these countries.

Even someone sympathetic to the general approach of the corporate governance literature could question its applicability to the countries in transition. Bank monitoring may be desirable, the critic may argue, but the present state of the banking sector simply does not make this a feasible option. The large commercial banks in these countries are simply products of the old monobank system populated by thoroughly corrupt bureaucrats with limited understanding of finance in a market economy. Even if these banks and their staff were reformable, the analysis overlooks the fragility of the banking sector. Macroeconomic instability and the financial heritage from the old system is likely to give rise to repeated bank insolvencies, and subsequent bailouts by the government. Under such circumstances it is questionable whether banks have the right incentives to monitor firms.

;bDo Bank Incentives Matter and What Are They?

A first question is, of course, whether incentives matter, or whether they are sufficient to change managerial behavior. In its extreme form, the corruption argument says that incentives will not make a difference when they are applied in the old institutional structures. When a group of managers decides to leave their old bank to set up shop next door, however, they will behave efficiently. At the other extreme, only incentives matter; with the appropriate reward and punishment structures, any manager can be expected to behave efficiently to the best of his ability. An intermediate view, and the one taken here, is that while institutions are important, much can be gained by getting incentives right. The skills and information necessary for effective monitoring are in short supply, and the problem is to determine where these resources are used most efficiently. In any case, from a policy point of view the debate over the choice between new and old banks appears to be dead; most countries have opted for policies that involve both new and old institutions. Early evidence suggests that competition in banking is increasing, and that new banks are gaining market shares (Dittus 1994). The issue addressed here is how these institutions—new or old—can be given the right incentives.

There is, however, a second reason why incentives, at least the incentives provided by the banks' balance sheets, would not matter: the banks may not be making the lending decisions. In the first phase of financial transition, at the stage of Russia at the moment, the banking system is still dominated by the large funds channeled from the Central Bank to state-owned enterprises. Most decisions in the financial systems remain centralized, and the incentives provided by the composition of bank portfolios, and potential future bailouts, thus play a limited role. In the second phase, where we find the most advanced transition economies of Poland, Hungary, and the Czech Republic, decisionmaking has become more decentralized. The incentives facing financial institutions, and commercial banks in particular, then become important. Banks that have inherited poor loan portfolios may not feel motivated to monitor clients, not even new customers. It is not until the financial system has entered into this second phase of transition that the fragility of the banking system has an important impact on banks' incentives.

How bad are existing bank portfolios? There is no easy answer to this question. A thorough study by Dittus (1994), however, suggests that the problem may have been exaggerated. Indeed, while the situation is still serious, and capital adequacy ratios low by Western standards, available evidence indicates that the problem is close to a solution in the Czech Republic and of manageable proportions in Hungary. In Poland, the poor quality of bank portfolios remains an important problem, and further recapitalizations will be needed. No reliable information is available for Slovakia after the separation, but earlier figures point to a situation somewhere in between those of the Czech Republic and Poland. In Russia the high inflation has drastically reduced the value of financial claims, eliminating the problem of bad loans, but leaving a very small and fragmented banking sector.

What, then, are the consequences of bad portfolios on the incentives of banks to take control positions and exercise control? The stance most often taken is that banks with poor portfolios will be soft in lending and negligent in monitoring enterprises; managers know that they are going to be bailed out, or that things are over no matter what. Surprisingly to many, recent survey evidence from Poland suggests that the effects of the poor quality of banks' loan portfolios on corporate governance is much weaker than expected (Estrin, Shaffer, and Singh 1993). Even banks with large amounts of bad loans seem to monitor new credits in a satisfactory way, and they do not throw good money after bad to the extent expected. The Dittus study reinforces this impression. In 1992 enterprises in the four Visegrad countries paid more in interest than they received in new loans. In Hungary, enterprises even paid back part of their loans. He also shows convincingly that the fall in bank lending does not reflect lower demand by enterprises. His findings raise the question of whether banking regulation may have become too strict too quickly; all the countries experienced a severe credit crunch in 1992, with potentially large costs in profitable investments foregone. Judging from the Dittus study, banks, if anything, seem to be too tough. A possible interpretation supported by other casual evidence is that while banks tend to be soft on old loans, they are hard on new lending.

One explanation for why the relationship between stocks and flows of loans may be weaker than previously thought is that the incentives facing a bank manager may have been conceived too narrowly. Managerial decision may, for example, also be influenced by an emerging market for bank managers and increasing competition in the banking sector. In addition, bank managers may take into account the expected consequences for management of government bailouts. A number of bailouts of banks have already taken place in Eastern Europe, and more must be expected. There is no question that across-the-board bailouts are bad for incentives; bad banks are rewarded whereas good banks are penalized. If bad banking can be distinguished from good ex post, however, at least to some extent, the government may be able to influence incentives ex ante. The experience from bank bailouts—for example, in Scandinavia—shows that the government, by default, has wide discretion after a bank failure has occurred. Regulators have used this discretion to, among other things, replace and fine managers and directors, force bank mergers, close unprofitable operations, undertake training programs, and alter lending routines. If bank managers know that, even though depositors are protected, they themselves are

not, government guarantees may be less harmful to incentives. Indeed, bank bailouts, although costly and undesirable, have proven to be useful tools for restructuring the banking sector and correcting managerial failure.

Even if banks could be expected to monitor firms effectively in a fragile financial system, having banks heavily involved in the manufacturing sector could have negative consequences for the stability of banking and the entire financial system. The “corporate governance” view of banking does not address this second, systemic, effect of fragility. Mounting empirical evidence suggests that a collapse in the credit system, and ultimately in the payment system, can be very costly, in particular for small and medium-size firms. It seems to be these effects of fragility, rather than the weakened monitoring incentives, that has been on regulators’ minds in many Western countries. Any discussion of the role of banks in corporate governance in transition economies must take these systemwide effects into account. The analysis thus suggests a tradeoff between gains from improved corporate governance and the costs of a more fragile financial system.

;bWhat Can Be Done to Reduce the Fragility of the Banking Sector?

Much of the fragility of the banking sector in the transition economies stems from bad loans incurred prior to or in early phases of economic reform. These bad loans represent claims on enterprises in need of restructuring and sometimes complete liquidation. The corporate governance literature suggests that recapitalization and corporate restructuring must go hand in hand; the balance sheets of the banks should, as far as possible, be cleared up without destroying the incentives for firms to restructure and for banks to monitor such restructuring. A number of measures have been undertaken to improve banks’ balance sheets, and others have been proposed. This section briefly describes the most important experiences and how they can be understood in the framework of this paper.

The Visegrad countries have tried several ways of recapitalizing banks. The choice of form has been motivated largely by whether loans were incurred before or after reforms started and whether problem loans were easily identifiable, but also by the preferences of the individual government (Dittus 1994). In former Czechoslovakia and in Hungary, where the stocks of old loans with low interest were reasonably well defined, the authorities chose to provide interest subsidies to make the loans yield market-related rates of return. When problem loans were clearly defined, these loans were transferred to special government agencies. In Poland old loans were generally wiped out by hyperinflation. When loans had been incurred after economic reforms, Czechoslovakia and Poland have chosen to recapitalize banks and leave them to reach workout agreements with debtor firms. Hungary initially preferred to transfer these loans as well to a government agency, but later decided to recapitalize. None of the countries, with the exception of a brief experiment in Hungary, has attempted to use government guarantees to clean up bank portfolios.

The Polish restructuring scheme illustrates well how incentives can be maintained throughout the process. After a major recapitalization early in 1993, the authorities deliberately involved the banks in the restructuring process; 3,000 enterprises with substandard loans have been allocated to special workout departments in nine “target” banks. The banks and the debtor firms were supposed to have struck agreements on their loans by March 31, 1994, or the firms would face liquidation. Some 200 enterprises were granted reprieves with gradually declining subsidies. The government could play an important role in restructuring (van Wijnbergen 1993). In most firms government is both the largest owner and the senior creditor because of tax liabilities. To achieve agreements among the involved parties, the government usually has to both extinguish its old equity and to give up its senior claim status. In addition, the government has matched debt reductions by other creditors and participated in the conversion of debt into new equity.

;bWhat Can We Expect from the Government?

A commercial banking sector involved in monitoring manufacturing firms clearly relies on the government playing an active role in maintaining the stability of the financial system. Is it realistic to expect the government to play this role in the transition economies? Without addressing this issue directly, we will indicate some factors that complicate state involvement in the financial system.

First, however, it may be useful to distinguish the role of the state in the two initial phases of transition of the financial system. In the first phase, the main preoccupation of the government is to resist the strong collusive pressure to continue its role as provider of outside money to enterprises through the banking system. The government has accumulated little credibility capital, and thus has little to lose from bailing out failing banks and continuing to subsidize ailing firms. This reinforces the weakness of the government in the bargaining process. As intermediation deepens and the linkages between firms and banks are weakened, conflicts are introduced into the system between different commercial banks and between banks and firms. In this phase, the emphasis should be on promoting competition among intermediaries and severing the ties between banks and enterprises. When banks are mere extensions of enterprises, intermediation will not develop. Under these circumstances providing insurance to banks is not necessary—banks take deposits primarily from enterprises that can closely monitor their use. Indeed, insuring banks closely affiliated with a single firm could be particularly harmful for incentives.

With improved regulation and increasing competition the collusive pressure should subside. In this second phase, the government worries about the incentive distortions from poor banking portfolios and the risk of systemwide crises. As the government determination to resist outside money creation becomes more credible, however, the cost of bailouts in lost credibility increases. Under favorable circumstances the government may embark on a virtuous spiral of gradual credibility building, and a transition from a “weak” to a “strong” state. There is also, however, the nonnegligible risk of a relapse into the first phase, with increasing institutional pressures to refinance ailing firms. In this more pessimistic scenario, the strengthening of the state may never come about.

Ironically, the transition from “weak” to “strong” hinges on the ability of the government to withdraw from direct involvement in economic activities. Needless to say, this process will prove difficult. First, a sizable number of “basket cases” is likely to be impossible to privatize or to entice banks into restructuring. Second, the links between the government and firms seldom disappear completely with privatization. In many cases the government retains a minority position, and in an even larger number of enterprises state-owned banks remain important creditors. In addition, when privatization is financed through government loans, default is likely to send firms back into the state-controlled sector. Even completely privatized firms may be too many and too large to fail. Third, the government is unlikely to be able, or willing, to fully withdraw its ownership interest from the banking sector in most countries, and recurrent systemic shocks may force the government to take over privatized and new private banks. Recent recapitalizations have in some cases forced the government to increase its ownership stake. To expect the government to also play the role of restructuring the financial system may be expecting too much.

Ultimately, however, the commercial banking sector and other potentially control-oriented intermediaries must develop the capacities necessary to hold and exercise control. If they do not, the pressure will mount on the government to force the banks to extend arm’s-length finance beyond the collateral base of debtor firms. Under these conditions the financial system may regress into the first phase, where the influence over credit allocation is centralized and budget constraints of firms are softened. This is one possible interpretation of recent developments in Hungary, where bank portfolios have worsened considerably in the last two years, and where the government has been forced into repeated bailouts of insolvent banks.

The discussion here has assumed that the government in a transition economy has at least some agenda-setting power. In a more pessimistic view, the state is inherently weak and merely the prey of different groups struggling over the appropriation of rents in society (Roland, in this volume). In such a world, few normative conclusions can be drawn. In a slightly more optimistic perspective, however, the government, or the original framers of the constitution, can influence where in society rents are appropriated. Under these conditions the discussion in this chapter suggests that these rents initially should be allowed to accumulate in the commercial banking sector to ensure effective corporate governance and reduce the fragility of the financial system.

;aSome Implications for Banking Reform

The basic conceptual framework suggests that reforming the banking system is necessary for effective corporate governance; banks with bad portfolios cannot be expected to exercise control effectively. Depending on the circumstances, banks will either be unwilling to provide finance without full collateral or too willing to extend credit, but lax in the exercise of control. This section summarizes the most important lessons for banking reform in the transition economies.

- *Corporate restructuring and the cleaning up of bank portfolios should actively involve the concerned parties.* Banks and debtor firms should be forced to renegotiate their relationships before banks are recapitalized. Bankruptcy courts should only be used as a last resort. Forcing firms into formal court proceedings according to some rigid criteria, as done in Hungary, only slows down the restructuring process.
- *The government has an important role to play in both corporate restructuring and banking reform.* Whether we like it or not, and often by default, the government has to get involved, as an important owner of debtor firms and creditor banks, and as a senior creditor through its tax claims. To achieve restructuring, the government should be willing to concede its claims, but only conditional on restructuring. When banks fail, the government has no alternative but to intervene, either by recapitalizing the bank or by closing it down.
- *Financial regulation is crucial, but must be phased in with care.* Without regulation, abuse will be widespread, and corporate governance ineffective. When capital adequacy requirements are introduced too rapidly, however, credit crunches are likely; banks with bad portfolios will be too tough rather than too soft. Regulatory authorities will also be forced to exercise considerable discretion in the implementation of specific regulations. If used in a responsible way, this discretion can offset the distortions of financially weak banks.
- *Restricting competition in the banking sector may be necessary if banks are to play a constructive role in corporate governance.* This strategy has been followed by many governments in Western Europe since World War II. The rents accumulated in this way could help reduce the fragility of a banking system heavily involved corporate governance.

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Footnotes-Chapter 3

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