Financial Market Reform in the Czech Republic, 1991-1994: The Revival of Repression? *

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Abstract

In 1991 the Czech and Slovak Federal Republic embarked on the rapid liberalization of its financial markets under tight monetary policy. This involved the creation of a functioning capital market through a program of mass privatization, along with the establishment of a universal banking system. In these respects, the Czech Republic is considered one of the most successful examples of post-socialist reform. But evidence from the former CSFR and the Czech Republic between 1991 and 1994 also shows that some of the main institutions created to oversee industrial-financial reform have been converted into instruments of indirect, selective credit-allocation, due largely to the leverage of economically non-viable firms and their large-bank creditors, together with the unwillingness of reformers to re-organize fundamentally the economic bureaucracy. How can we explain the formation of these institutions by which reforming governments intervene in financial markets, even in the relatively successful case of the Czech Republic? In a system of financial repression, governmental authorities maintain substantial control over the allocation of credit, which is often granted at below-market interest rates to favored enterprises. This paper suggests that financial repression has political sources. In the economies of the former East Bloc, privatizing firms whose subsidies have been cut off want cheap credit. Old state banks whose portfolios are tied up in bad loans want substantial debt relief. The executive bureaucracies, finally, need to acquire the expertise and information in order to replace centralized command structures with broad financial regulation. So it is in the Czech Republic that reformers, fearing that bankruptcies of the largest firms will send unemployment figures soaring and strengthen the hand of the opposition, are led to design institutional structures which allocate credit to vital industries, which swap bank debt for equity in these firms, and which generally enable some governmental discretion in corporate finance.

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Abstrakt

V roce 1991 Česká a Slovenská Federativní Republika zahájila rychlou liberalizaci finančních trhů za přísné monetární politiky. Program masové privatizace spolu s ustavením univerzálního bankovního systému pak umožnil vznik fungujícího kapitálového trhu. V tomto ohledu je Česká Republika považována za jeden z nejúspěšnějších vzorů post-socialistické reformy. Avšak svědectví z bývalé ČSFR a České Republiky z období 1991 - 1994 také ukazuje, že některé z hlavních institucí vzniklých za účelem kontroly průmyslově-finanční reformy byly přeměněny v nástroje nepřímé selektivní alokace úvěrů, což bylo většinou způsobeno finanční sílou ("leverage") ekonomicky neschopných firem a jejich velkobankovních věřitelů spolu s neochotou reformátorů fundamentálně reorganizovat ekonomickou byrokracii. Jak můžeme vysvětlit vznik těchto institucí, kterými vlády reformních zemí intervenují na finančních trzích, a to i v relativně úspěšném případě České Republiky? V systému finanční represe si vládní úřady zachovávají podstatnou kontrolu nad alokací úvěrů, které jsou často poskytovány privilegovaným firmám za úrokovou míru, která je nižší než tržní. Tento článek naznačuje, že finanční represe má politický zdroj. V ekonomikách bývalého východního bloku privatizující firmy, jimž byly zastaveny dotace, chtějí levné úvěry. Původní státní banky, jejichž portfolia jsou svázány špatnými půjčkami, chtějí podstatnou úlevu dluhů. Výkonné byrokracie nakonec potřebují získat expertizu a informace, aby mohly nahradit centralizované příkazové struktury širokou finanční regulací. Tak je tomu v České Republice, kde reformátoři, kteří se obávají, že bankroty velkých firem prudce zvýší nezaměstnanost a posílí opozici, jsou vedeni k tomu, aby navrhli institucionální struktury, které alokují úvěry důležitým odvětvím, vyměňují bankovní dluh za vlastnický podíl v těchto firmách, a zpravidla dávají vládě jistou volnost jednání při financování podniků.

LIST OF ABBREVIATIONS

CR -	Czech Republic
CSFR -	Czech and Slovak Federal Republic
ČMZRB -	Czechomoravian Guarantee and Development Bank *(Českomoravská Záruční a Rozvojovná Banka)*
ČNB -	Czech National Bank *(Česká Národní Banka)*
ČS -	Czech Savings *(Česká Spořitelna)*
ČSOB -	Czechoslovak Trade Bank *(Československá Obchodní Banka)*
FNM -	National Property Fund *(Fond Národního Majetku)*
IB -	Investment Bank *(Investiční Banka)*
IC -	investment company
IPB -	Investment and Postal Bank *(Investiční a Poštovní Banka)*
IPF -	investment privatization fund
KB -	Commercial Bank *(Komerční Banka)*
KOB -	Consolidation Bank *(Konsolidační Banka)*
MPO -	Ministry of Industry and Trade *(Ministerstvo Průmyslu a Obchodu)*
MSNMP -	Ministry for Privatization *(Ministerstvo Spravu Národního Majetku a jeho Privatizace)*
ODA -	Civic Democratic Alliance *(Občanská Demokratická Aliance)*
ODS -	Civic Democratic Party (*Občanská Demokratická Strana)*
PSE -	Prague Stock Exchange
RM-S -	over-the counter exchange *(Registrační Mista System)*
SBČS -	State Bank of Czechoslovakia *(Státní Banka Československa)*
SOE -	state-owned enterprise
TOZ -	perpetually revolving inventories *(trvale obracející se zásoby)*
VHJ -	industrial-economic unit *(výrobní hospodářský jednotek)*
VÚB -	General Credit Bank of Slovakia *(Všeobecná Úvěrová Banka)*

Introduction

A basic dilemma for emerging markets is that the institutions required to secure greater productivity are sources of power; they distribute the costs and benefits of growth. For this reason their design and creation are deeply political matters, as they will shape the struggles over resources in a society for years to come. Where property rights remain vague, unstable, or weakly-enforced, institutional choices are made according to how public authority is wielded, as much as according to efficiency and transaction-cost considerations. Financial-system development is the proto-typical case where applied welfare analysis seems fruitful. At least since Gerschenkron, the formation of capital market- vs. bank-based financial systems has been seen as, more or less, an efficient response to the scarcity of capital and the "lateness" of industrialization. Across the lands of the former East Bloc, Gerschenkron's famous inference finds much well-known evidence: universal banking, credit-based financial systems, bank-led restructuring, and thin or non-existent securities markets. Is this an "optimal" solution to cost-of-capital-problems?

Too much faith in efficiency, however, ignores a fact well understood by students of politics, but ignored in work on corporate finance: that financial systems are bargaining regimes which determine the income sources for economic groups. They are public goods, but they can also be exploited by larger, more powerful groups. In short, financial systems are sources of political power. The empirical centerpiece of this paper is the formation of an *integrated credit-based adjustment mechanism*. By "adjustment mechanism", I refer to an institution which defines a collection of instruments by which assets and liabilities of individual firms are reallocated in response to external pressures. An "integrated," "credit-based" adjustment mechanism, then, is a system of business finance having three distinct traits: (1) funds are provided to firms for new investments mainly through loan-contracting, (2) credit markets are dominated by a few large banks which hold both debt and equity in industries, and (3) the allocation of these new funds occurs through the influence and administrative discretion of governmental authorities. These instruments appeared in the Czech Republic (CR)[1] between 1990 and 1993.

The Czech financial system therefore represents, in a sense, a hybrid of the French "price-administered" and the German "oligopolistic" credit systems. [Zysman, 1983: 71-73] Drawing upon evidence from the Czech Republic

[1] I deal specifically with the development of financial markets in the Czech lands. Unless otherwise specified, however, the years 1989-1992 refer to the whole former Czech and Slovak Federal Republic (CSFR), the years 1993- to the Czech Republic (CR).

(perhaps the only country to "plan" the wholesale creation of a capital market through its voucher privatization program), I argue that the eventual appearance of a credit-based adjustment mechanism was as much a consequence of efforts by key actors to minimize their contribution to the total costs of institutional reform in post-communist Czechoslovakia, as it was to capital-market failures. The bargaining regime which this adjustment mechanism represents has in turn granted political expression to certain economic interests, perhaps at the expense of progress in adjustment.

1. Capital Scarcity and Endogenous Institutions

How can we explain the formation of institutions by which governments operate in financial markets? Until recently, institutional analysis did not receive much attention in work on finance, which relied heavily on neo-classical assumptions. How financial markets affect non-market institutions, however, is at the heart of a political economy of development.[2] The best-known arguments consider financial systems to be optimal solutions to failures in capital markets. There is, however, another dimension to the problem: financial systems distribute the costs and benefits of economic adjustment. They are therefore hotly disputed, and represent a compromise among powerful interests with different objectives.

Capital scarcity, high interest and discount rates represent a potentially high gain to be made from the corruption and plundering of common resources, and thus contribute substantially to market volatility. [Soskice, Bates & Epstein, 1992] Bates [1990] argues that suppliers and demanders of capital are strongly motivated to form arrangements which reduce risks and hold-ups in capital markets, particularly in developing areas where the marginal returns on new investments are especially high. According to the Modigliani-Miller theorem, however, this should not be the case; the cost of capital should have nothing to do with institutions. Under the strict requirements of the Modigliani-Miller world, financial and investment decisions are made separately. The stock-market valuation of the firm is based entirely on the "real" economy of how well a firm performs, its profitability, productivity, etc. An investor selects a portfolio of investments regardless of a firm's capital structure. The cost of capital, then, does not influence investment, and thus will have no effect on any institutional arrangements. But upon the introduction of taxation, the potential for bankruptcy, and positive transaction costs, a firm will select an optimal

[2] On financial policy in developing countries, see Fry, 1988; Haggard, Lee & Maxfield, 1993; Maxfield, 1990 (Mexico); Woo, 1991 (S. Korea). On the industrialized nations, see Zysman, 1983 (U.K., Germany, France); Rosenbluth, 1989 (Japan); Lukauskas, 1994 (Spain).

capital structure to maximize the stock-market valuation of a firm. In other words, under more realistic assumptions, capital scarcity affects institutions.

Credit-based adjustment, financial repression, and universal banking, it is argued, are optimal responses to the imperatives of costly capital. As I will argue below, *politics* explains the formation of these institutions more accurately than the advantages of efficiency. In brief: capital scarcity affects different economic groups in different ways. Firms in "late-industrializing" nations lack the accumulated capital stocks in the form of retained earnings which are available to those industries in nations which industrialized at a time when existing technologies were far less capital-intensive. Capital scarcity, even in Gerschenkron's interpretation, is a firm-level phenomenon, referring to the inability of firms to raise finances through internal means. The most capital-intensive manufacturing industries requiring the largest infusions, must turn to external sources of funding. Banks, on the other hand, are the main intermediaries capable of converting savings into usable funds, and thus are in a position to capture substantial (potential) distributional gains. Capital scarcity defines economic interest, and credit-based adjustment may be seen as the result of attempts by these interests to acquire control over financial markets. The development of an integrated credit-based adjustment mechanism, then, may be better explained by the interests of creditor banks and debtor industries, shaped by a preference for external financing, and mediated through the activities of governmental agencies involved in the tasks of industrial reform.

1.1. Banks and Market Failure

Why should the provision of outside funds to industry require the involvement of banks and/or the government? The short answer is: because capital (equity) markets fail. Early analyses argued that frictionless Arrow-Debreu markets could not exist where diversification and pooling of risks were restricted. Under direct financial arrangements, firms would finance themselves by issuing demand deposits, insurance policies, or savings accounts. But in that case both consumers and companies would be subject to very high, concentrated risk. [Gurley & Shaw, 1960] Diversification (one company issuing small demand deposits to millions of customers; investors holding a portfolio of policies or deposits) and risk-pooling (several companies or investors coordinating financial stocks) under such an arrangement would be prohibitively costly. [Hellwig, 1991: 43] Thus, in the language of transaction-cost economics, in steps a financial intermediary placing upstream (deposit issuing) and downstream (bonds and share holding) functions under a single hierarchical authority.

Arguments since have tended to identify the higher agency costs associated with equity markets, particularly in developing areas. To be sure, equity markets have the advantage of no fixed commitment to repay the equity-holder, and there is no threat that equity-holders can force a firm into bankruptcy. In post-communist countries, equity markets are often the best way to evaluate the worth of privatizing firms. Equity markets, however, can generate serious incentive problems. According to Stiglitz, a publicly-held corporation is a public good to its shareholders, and is therefore plagued by chronic free-riding: "no rational shareholder should expend the resources required to vote intelligently." [1985: 136] Banks, on the other hand, provide possible solutions to the failure of arms-length "control mechanisms" by loan contracting, under which the lender has the right to intervene, under proscribed circumstances, in the activities of the firm. [Ibid.: 143]

Because of this corporate monitoring and control capability, banks reduce or eliminate moral hazards and information asymmetries between firms and financiers. Under normal circumstances, managers' marginal utility and the value-maximization of the firm diverge, leading to high agency costs and a lower net return to the shareholders' investment. [Jensen & Meckling, 1976] Monitoring of firms by financiers, moreover, is made all the more costly when ownership is dispersed. Banks, on the other hand, are well-situated to capture increasing returns to monitoring, as they can control a firm as effectively and more cheaply than thousands of shareholders. [Diamond, 1984] *Ex ante* monitoring reduces the potential for loan default, while *ex post* monitoring improves firm performance, and both are accomplished with the gains exceeding the various technical costs. [Hellwig, 1991: 47-48] Finally, bank intermediation provides a commitment to a long-term relationship and to the provision of long-term finance. [Mayer, 1988][3]

These arguments are clear enough; the empirical evidence, however, is not overwhelmingly supportive. It is by no means clear that banks and close bank-firm relations are the best solutions to failures in capital markets, nor that bank-centered financial systems push developing economies to their Pareto frontier. Recent research on the two "models" of bank-based corporate finance — the Japanese and the German — have found that there is no positive relation between firms' reliance on large banks and superior performance. Indeed, some studies have found a *negative* relationship: main-bank clients tend to have lower

[3] It is interesting to note that Mayer considers the bank-dependent relationships of German industries not a result of economic backwardness, as much a he considers the market-based systems of the U.K. and the U.S. a sign of the structural weakness of those systems.

profits, and tend to grow more slowly than "emancipated" firms. Studies of Japanese firms in the 1980's, when financial liberalization and de-regulation of equity markets allowed companies to raise equity more easily in domestic and foreign markets, have found evidence supporting the same conclusion. [Nakatani, 1984] Weinstein and Yafeh [1994: 18-19], examining bank-firm relations in Japan over two decades, argue that Japanese banks, as major debt-holders, were more risk-averse than other equity holders. More importantly, banks, in return for providing long-term capital, were able to extract rents from clients with higher-than-average-interest payments on debt. Similar studies of German bank-firm relations have revealed that banks have likewise abandoned their traditional role of monitor, as firms have become more self-financing, and managers more independent, in spite of relatively high levels of debt financing and bank-held equity. [Edwards & Fischer, 1994] These findings raise the possibility that there are, in the long run, limits to bank-based systems of corporate governance.

In addition to restricting investment and siphoning profits, bank-based financial systems have their own moral hazards and adverse-selection problems. First, one bank-one firm relationships may prevent banks from disciplining clients, and banks may take to rolling over loans and other means of avoiding foreclosures on their clients. Second, if the results of monitoring are not readily observable, each bank may fear that their clients are the ones rejected by other banks as bad credit risks — the so-called winner's curse — laying the basis for severe credit shortages where the financial sector is dominated by a few large banks. [Broecker, 1990] Third, where a few banks monitor several firms in the same industry, as is often the legacy of state-socialist central banking, there may be a tendency for banks to cartellize the industry in order to increase the aggregate gross returns earned by the industry. [Yanelle, 1989] Finally, concentrated banking systems can expose firms to substantial abuses of power. Hellwig notes that exclusivity in bank-firm relations may contribute to banks' willingness to renege on *ex ante* commitments due to various "unforeseen circumstances". If there were competition among financiers, the threat to renege would be ineffective. Lacking competition, however, the firm has no choice but to give in. [1991: 56] Those contractual commitments are less likely to be legally enforceable where there are few, large, universal banks.

The conclusion to be drawn is that credit-based systems are *not* necessarily the best solutions to capital-market failures, and that capital market-failure is *not a sufficient* condition — it may not even be necessary — for the development of large-bank based systems of finance. Those arguments omit the fact that there is additionally a very close connection between distributional struggles in markets and in politics. A financial system is not simply the locus of decisions made by banks and firms, but also proscribes the capacity of the government to intervene in markets.

1.2. The Political Sources of Financial Repression

Economic liberalization simply represents the elimination of preferential, industry- or firm-specific credit policies in favor of "horizontal," broad-based instruments of fiscal and monetary management, and the consequent reduction of governmental involvement. Yet liberalizing economies may also perpetuate financial repression by other means. This is primarily what an integrated credit-based financial system does; to repeat, it allows governmental involvement in distributing the costs and gains of liberalization. The previous section mentioned the well-known argument that credit shortages mean that potential borrowers face a severe threat of financial repression, and thus financial repression is endemic to developing, capital-scarce markets. But financial repression may also emerge as a result of predatory interests attempting to reduce their exposure to the costs of reform while securing as much of the benefits as possible.

Economic adjustment goes hand in hand with the structural choices involved in governmental-bureaucratic reform. In post-communist states, the scope of public authority be fundamentally altered. Planning commissions, "line" ministries, and industrial directorates must be dismantled, and direct state manipulation of production comes must be replaced by "general" commercial regulation. Thus adjustment represents a public good, requiring an exercise of public authority to be put to work. Moe [1989] argues that this "right of exercise" of authority should be considered a *political* property right, which by definition is continually in flux. The reform of public agencies, then, consists of a process of *structural choice* whereby those in possession of political property rights will impose their will on their opponents. The prime political task for a group involved in public agency or design is to find some structure which will both protect "their" agency from control by opponents, and in the event that it does fall into the hand of the opposition, will protect their group from the misuse of that public agency. The result is often a series of organizational structures which hedge against changes in political property rights, bring about policies preferred by more powerful groups, and to no small extent, incapacitate opponents. [Moe, 1989; 1984] Even in transition economies, where institutions are often created for the express purpose of increasing overall welfare, the potential for groups to collect economic rents by redistributing the costs and gains of transition in their favor compels institutional formation. This governmental-bureaucratic component of economic reform can create special privileges for special firms in the form of monopoly rights, licensing restrictions, and other market barriers. While adjustment is a public good, it is also a source of artificial profit.

Adjustment mechanisms have particular distributional consequences for the three main constituencies in post-communist states: privatizing manufacturers, the financial sector, and the former economic bureaucracy. Manufacturing industries normally have a strict preference for self-reliance for funds, since the only cost incurred is the opportunity cost of re-investing retained earnings. Where internal finance cannot be found, firm preferences become more complicated. The costs of information, agency, signalling, etc. may lead firms to seek different corporate debt structures. Recent empirical work on developing nations indicates that firms choose different forms of finance on the basis of mainly firm-level variables: product characteristics, capital intensity, size, ratio of tangible to intangible assets (labor skill, etc.), income volatility, rate of growth of tangible assets, and profitability. [Singh & Hamed, 1992] There are costs for both equity and debt financing, and for debt financing through both bond and credit markets. In developing economies, however, capital is scarce, long-term capital markets are thin, and thus the manufacturing sector demands cheap credit pure and simple. Some SOEs can benefit substantially from financial repression *via* below-market interest rates, loan guarantees, and regulations which extend cheap credit to preferred firms. During financial-system liberalization, we can expect that manufacturing firms will attempt to sustain these methods of subsidization.

The interests of the financial sector are less easily identified, depending on the diversity of financial organizations. Financial systems in which credit-based allocation dominates tend to redistribute resources away from manufacturing to banks. Evidence from Germany [Neuburger & Stokes, 1974], Japan [Caves & Uekusa, 1976] as well as more recent work on Latin America [Frieden, 1991] supports the finding that the financial sector benefits at the expense of manufacturing industries where capital markets are underdeveloped and where the banking sector is concentrated. If we accept this premise, we can expect that large commercial banks will have an incentive to force the rationing of the capital market, as well as restrictions on the entry of new banks, through various market and extra-market means. Large banks will also, quite obviously, have an incentive to continue providing loans to the large SOEs which dominate their loan portfolios.

Finally, the "interests" of bureaucrats and decision-makers in the government are important for the reason that they affect the capacity of the existing political order to "supply" economic adjustment. I have already mentioned the need for former directorates and planning agencies to be replaced by general instruments of market regulation. A major part of liberalization requires reform of the public sector — the prime source of inflation-fueling deficits — and bad international credit-worthiness. This is costly, and the costs are often hidden. Whether public-sector reform involves liquidating, privatizing, or restructuring state-owned enterprises (SOEs), the relationships between SOEs and the former planning bureaucracies are likely to be very tight, and very resistant to drastic realignments, since they are the main elements of powerful coalitions with well-established claims to credit and public resources. [Waterbury, 1992] But these relations, while being routinized, are also likely to be valuable to reformers, for these central economic *bureaux* maintain a monopoly on technical (economic) and administrative expertise and information required to implement a new, effective system of property rights, economic competition, and market oversight. Whether or not it is beneficial to adjustment, reformers will tend to make substantial use of existing agencies rather than design completely new ones at higher cost.

In attempting to explain the formation of a credit-based financial system in which governmental agencies and large banks together allocate investment funds to industries, the argument thus far may be summarized as follows:

1. Capital market failures are a possible, though by no means sufficient condition for credit-based financial systems. What is more likely is that the scarcity of capital contributes to the set of circumstances which define and shape the interests of key actors.
2. A credit-based mechanism, like any financial system, represents a bargaining regime through which the government, banks, and firms negotiate over "who will pay" for economic adjustment. A bargaining regime may be used to create artificial privileges through restrictions in the marketplace.
3. All three groups aim to pay as little as they can of the total price of economic transformation, and at the same time, create institutions which will hedge against the future, insulate them from their opponents, and prevent their opposition from extracting greater contributions in the future.

Financial mechanisms for economic adjustment, then, represent political demand as much as they do economic necessity. Section 2 outlines the financial aspects of economic reform in the CSFR/CR, surveying both capital and credit market effects. Section 3 demonstrates how reform affected the financial position of the largest banks and prevented the disciplining of loss-making industries. Section 4 then analyzes the "supply-side" of the equation: how instruments of broad regulation were converted into instruments of financial repression as policy-making bodies came to rely more and more on these instruments to prevent bankruptcies. Section 5 summarizes the argument and offers some preliminary conclusions.

2. Financial Transition in former Czechoslovakia: an Overview

Financial reform in the former CSFR may be traced to the triumph of monetarist-based reform in early 1990, subsequently enacted in two stages: (1) deregulation and macroeconomic stabilization, lasting from January, 1990 until the end of 1991, and (2) deepening of institutional reform, beginning in mid-1991. Briefly, in the first stage, reformers seized opportunities presented by the rather rapid collapse of Communist-Party rule in the so-called "Velvet Revolution" of November-December, 1989. The absence of a prolonged economic crisis, a relatively low external debt, and low inflation gave the CSFR a relatively advantageous starting position compared to other economies in East-Central Europe. In the first year of reform, initial steps were taken towards the abolition of administrative pricing. In July, 1990, price supports which created the most blatant distortions, typically for foodstuffs, were removed.[4] Further price liberalization that year equilibrated prices for oil and fuels with world prices. The following year, price controls for most industrial goods were completely lifted, giving the Czechs their highest inflation to date (58%). Second, the Czechoslovak Crown *(Koruna)* was devalued, pegged to a basket of currencies (mainly the U.S. dollar and German mark), and limited internal-account convertibility was established. Third, all foreign-trade monopoly licenses were cancelled, and foreign economic relations were similarly liberalized. Between 1989 and 1992, GDP fell by 23% in real terms, industrial production by 34.4%.

The nominal money supply was to be the anchor for stabilization in the first years. Reformers, in collaboration with the IMF, elaborated five monetary targets for 1990-1991: the volume of domestic credits, the domestic assets of the banking system, credits to the government, reserves in convertible currencies, and credits to foreign borrowers. Changes in all of these indicators were to be within -2% to +1% of the previous year. The upper limits were relaxed to +2.6% in mid 1991, after price liberalization made adherence to the earlier target impossible. Discount-rate ceilings — set at 13%, raised to 24%, and brought back down to 17% — were also held in place between October,

[4] Subsidies to food products amounted to over 3% of GDP in 1990. With the removal of price supports, retail food prices rose 25%. To compensate, residents were paid a monthly "contribution" of Kč140 (about 5% of an average salary). [Guba & Skolková, 1993].

1990 and April, 1992. Due to the impending separation of the Czech and Slovak republics, however, the central bank continued to hold interest ceilings in place for the largest banks until the beginning of 1993.

The second stage began the institutional changes in earnest which are the concern of the rest of the paper. The two elements of broad-based, long-term institutional transformation were first, the removal of state control over property, and second, the separation of the monetary and commercial functions in the banking system. In the remainder of this section we shall see how fiscal and monetary reform in Czechoslovakia and later the Czech Republic, while creating functioning capital markets, came to depend on the critical role of banks in adjusting the economy.

2.1. Privatization and the Formation of Securities Markets

The massive transfer of the largest state industries to private hands in the CR has attracted tremendous notice internationally, largely due to the prominent role given to voucher distributions. A short summary of the mechanics of the program will suffice here:[5] managers were given six months to submit a privatization project for their firm. The "project" essentially consisted of one part description of technical and financial characteristics, one part privatization method, one part longer-term business plan. Competing projects could be submitted by any citizen or group of citizens, and could be quite varied in intent and result. A project could select any single method for privatization, or a combination of direct sale, public auction, public tender, free transfer to municipalities, restitution, foreign participation, or conversion to a joint-stock company; projects could propose that firms be privatized in whole or in part; they could recommend breaking up large firms and they could outline different methods or different combinations of methods for different firm divisions. Competing projects were submitted to the "founding ministry" which had some discretion over choosing final projects. The final decision, however, was in the hands of the Ministries for Privatization for each republic. Upon selection, a project would be delivered to the republic-level National Property Fund (FNM) for implementation. The FNM would then act as the sole overseer of the state's share of a privatizing firm.

But it is the voucher portion of the program which has grabbed the most

[5] The relevant law is the Large Privatization Act no. 92/1991, passed by the Federal Assembly in February, 1991. For overviews of Czechoslovak privatization, see Frydman, Rapaczynski, & Earle, *et al*., 1993: 38-92, Burger & Mejstřík, 1993.

attention. For the joint-stock companies to be established, a decision was made as to what portion of shares to remain permanently or temporarily in the FNM, what portion to be sold to foreign buyers, and what portion to be sold for vouchers. The distribution of company shares by vouchers to citizens was designed (1) to remove state control rapidly while momentum and support for reform was high, (2) to allow as much fairness as possible, and (3) to create a *functioning capital market*. Of over 2000 firms approved for conversion to joint-stock companies in the first wave of privatization, representing Kč465.3 billion[6], some 1230 firms representing Kč258.8 bil., or 49.9% of the total book-value of all property approved for privatization, 55.9% of the total value of companies approved for joint-stock conversion, allocated on average 62% of their shares to voucher privatization.[7] For the first wave, lasting between May and December, 1992, approximately 8.56 mil. (three-fourths of the eligible population) Czech and Slovak citizens bid for vouchers in these companies over five rounds, directly or indirectly through one of 429 investment privatization funds (IPFs) registered in both republics.[8]

On April 6, 1993, four months after the end of the first wave and the split of the Federation into two independent republics, the Prague Stock Exchange (PSE) opened. Approximately 1,000 companies had access to the unlisted market. Until June, 1993, nine shares were traded on the unlisted market on any given trading day (once per week). By the end of 1993, the number had jumped to 300, and trading had switched to twice weekly. As of April, 1994, one year after it's opening, 450 companies, on average, have issued shares traded per day, and trading is now three times weekly.[9] In July, 1993, the RM-S (*Registrační Mista System*), a separate over-the-counter exchange opened. The RM-S was essentially a continuation of the registration-office infrastructure which supported voucher-bidding. In 1994, RM-S moved to continuous auctions.

In spite of an operating market with greater capitalization than any in East-Central Europe (see Table 1), the Czech securities market has not provided the sort of discipline firms require in order to adjust. First there are significant problems of market rigidity. Initially there were over 1,000 firms listed, but

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[6] \$1(US) = Kč29.

[7] Figures are for the CSFR provided by the Federal Ministry for Privatization; see also Laštovička, Marcinčin & Mejstřík [1994].

[8] For the CR, the figures are: 5.95 mil. citizens bid for 987 firms; 72% of these bidders allowed portfolios to be managed by one of 260 IPFs. [Mejstřík & Burger, 1992]

[9] [Matesová & Seďa, 1994]

only ten of them accounted for three-fourths of the total trading volume in 1993. That shortage meant that demand would outstrip supply and share prices would be highly overvalued. Indeed, prices in the RM-S, which initially valued stocks according to the price of the issue settled upon during the voucher-bidding rounds, were consistently lower than identical issues on the PSE. Overvaluing on the PSE has also been attributed to the tendencies of larger investment funds to sit on their shareholdings, and wait for prices to rise in order to increase their portfolio value. RM-S prices in the latter half of 1993 plummeted, while prices on the stock exchange rose. [Laštovička, Marcinčin & Mejstřík, 1994] The RM-S was meant to alleviate problems of access, as any individual could trade shares at any of several branch offices around the country. Still, large investors have not been attracted to the system because of higher commissions, and the length of time (ten days) required for transactions to clear. More importantly, however, The RM-S works on a peculiar price-fixing mechanism, the details of which are not thoroughly understood. To most observers, RM-S price-fixing is rigid and unresponsive to market fluctuations. This combination of flaws has kept RM-S volume low: by the time buy and sell offers are matched and the transaction cleared, the price has changed.

Table 1: *Stock-Market Performance in East-Central Europe, 1993-1994*

	Growth in index, 1993 (in $ terms)	No. of stocks trading as of January, 1994	Estimated market value, April, 1994	Market capitalization as % of GDP	Approx. weekly turnover
Prague	+288%[a]	1001 (996)[b]	$18bn	56.9	$30m
Bratislava	No index	507 (496)	n.a.	n.a.	$1.5m
Warsaw	+717%	22 (0)	$4bn	6.4	$5m
Budapest	+28%	28 (18)	$1bn	2.8	$150m

a. Annualized figure (index started in September, 1993).
b. Figures in parentheses refer to unlisted stocks.
Sources: *Business Central Europe* 2, 9 (1994): 53-45; *Euromoney Guide to World Equity Markets* (suppl., June 1994); IMF, *International Financial Statistics* (September 1994); author's calculations.

Second, large distortions persist along with resulting agency costs, due in part to the behavior of the main players in the equities markets: investment funds. As mentioned above, some 429 IPFs bid for voucher points distributed to citizens. Single investment companies (ICs), however, often founded several funds. The largest ICs, moreover, were subsidiaries of the largest commercial banks — a point to which we return below. The funds of the largest ICs, backed by the largest banks, carried a substantial advantage to the market for voucher points. In the end, the funds of the 13 largest ICs collected 77.6% of all investment points allocated to funds; the six largest ICs took 65% of these points, and the largest alone took 16%![10] As mentioned above, ICs have been reluctant traders. Where they have traded, much of it has been in collaboration with other fund managers, thus smoothing over price fluctuations.[11] Since the markets opened, stocks of a few large companies and banks have dominated trade volumes, and now account for a major portion of the increase in market capitalization; these tend to be the most overvalued stocks on the PSE. The general fear, then, is that divestment will bring about a sharp drop in share values.

ICs have also, therefore, been unwilling or unable to use market valuations of firms in their portfolios to monitor and discipline firm managers. Though individual funds were restricted to 20% of the shares of a single firm (the parent ICs are restricted to 25%), the investment funds have come to hold effective, controlling shares of companies. Of the 842 companies which offered more than 50% of their shares to voucher privatization in the first wave, ICs hold a 50%-or-greater share in 334 firms or approximately 40% of all voucher-privatized companies. In many cases, two or three ICs owning 10% each is enough to give the IC effective ownership, since the remainder is typically dispersed over thousands of individual shareholders.[12] ICs, then, were especially well situated to take on the burden of adjustment. Nonetheless, ICs have not taken the initiative to restructure companies. ICs elected their own representatives to supervisory boards of the firms they controlled, but these members were usually forced to defer to the judgement of managers, limiting themselves to encouraging current managers to improve operations, rather than

[10] On IC-IPF concentration, see Laštovička, Marcinčin & Mejstřík, 1994: 15-17; Brom & Orenstein, 1993: 22-24.

[11] *Respekt*, April 19-25, 1993: 8-9. For reviews of insider-trading problems see Deděk (1994).

[12] The only exception is where the National Property Fund holds a greater share than all funds combined — not atypical.

firing them. [Anderson, 1994: 13-14; 17] The main problem for IC representatives is the monopoly of relevant information held by enterprise managers. In the first wave in the Czech Republic, an average of 4 privatization projects were submitted for every firm. Only one of those was typically submitted by management. Yet managers' projects accounted for over 80% of all projects approved by the Czech Ministry for Privatization (MSNMP). [Buchtiková & Čapek, 1993] Managers continue to hoard vital information about their firms, and continue to resist organizational changes sought by the largest shareholders. The opacity of information has now been made worse by new enterprise-secrecy laws by which government agencies withhold any firm-level data until the completion of the second wave of privatization. Speed in privatization was obtained, to some extent, at the expense of effective enterprise control.[13]

2.2. Banking-Sector Reform

Universal banking, occurring at about the same time as the Czechoslovak privatization program was being designed, was meant to establish a more efficient basis for economic adjustment. In early 1990, the socialist "monobank" was dissolved in place of a two-tiered banking system clearly separating commercial from monetary functions. Seven commercial, state-owned banks were hived off the commercial, investment, savings, and foreign-trade operations of the now-independent State Bank of Czechoslovakia (SBČS).[14] These seven banks inherited the debts, assets, reserves, and branches of the monobank; this advantage, together with their relationships to SOEs, would form the crux of an eventual credit-centered financial system. The next step was to privatize these banks.

State authorities, in the case of banks however, temporarily abandoned their insistence that "restructuring be left to private owners". Communist banking practices had left these banks in poor shape. We will return to these problems

[13] There is a burgeoning literature on the problems of corporate governance in transition economies and in the Czech Republic in particular in the aftermath of privatization. See Frydman & Rapaczynski (1993), Singer & Švejnar (1992), Mládek (1994) and the references contained therein.

[14] In the C.R.: *Komerční Banka* (Commercial Bank), *Investiční Banka* (Investment Bank), *Česká Spořitelna* (Czech Savings), and *Živnostenská Banka* (Merchant Bank); in Slovakia: *Všeobecná Úvěrová Banka* (General Credit Bank), and *Slovenská Spořitelna* (Slovak Savings); finally *Československá Obchodní Banka* (Czechoslovak Trade Bank), jointly-owned by both republics.

later, but will list them briefly here. First, they were severely under-capitalized: their average capital-asset ratio a mere 0.85%. Second, the loan portfolios inherited by these banks were replete with heavily-indebted firms. Bank loans to industry in 1989 comprised 70% of GDP in Czechoslovakia, compared to 50% in Hungary and 30% in Poland.[15] Thirdly, main bank clients — manufacturing industries — continued to sell inputs to each other on credit as a way of avoiding insolvency. Thus inter-firm debt spiraled between 1990 and 1991. Fourth, there was no framework of any kind for dealing with bankruptcies; indeed there was no recent *example* of a bankruptcy.

Several steps were taken in 1991 to prepare banks for privatization. First, the FNM provided the (still state-owned) commercial banks with Kč50 billion worth of five-year bonds worth approximately 8% of all bank credits to enterprises. A portion was allotted for recapitalization (Kč12 billion), while the rest was to be used to write off non-performing loans through debt-for-bond swaps (Kč38 billion).[16] The debt write-offs were to be directed at firms which "had a chance to be profitable". The banks themselves were to select "viable" firms", in cooperation with an advisory committee consisting of members from the FNM, SBČS, and ministries. [Hrnčíř, 1993: 313] This consortium of banks and government agencies formed the nucleus of the bargaining regime which would coordinate credit-based adjustment. Unfortunately, the FNM-financed mass debt write-off did not accomplish its aim, as banks were unwilling to concentrate scare resources on particular firms in order to give them the full force of the capital infusion. [Keroš, 1993] The money was spread far too thinly to have a palpable effect on the growing problem of insolvency.

Second, the Consolidation Bank (KOB), a "hospital" for non-performing loans, was set up by governmental decree as a state financial institution under the supervision of the Ministry of Finance. Its main purpose was to purchase the so-called credits for "permanently revolving inventories", which were the main method by which banks financed industry.[17] KOB was to purchase these

[15] *The Central European*, February, 1994, p. 20.

[16] For loan write-off: Kč22.2 bil. for the C.R., Kč15.8 for Slovakia; for re-capitalization: Kč7.8 bil. for the C.R., Kč4.2 bil. for Slovakia.

[17] Beginning in the early 1970's, the state seized special pre-tax reserves used by firms special loans to finance inventories and operating expenses. In their place, industries received loans for "TOZ"--*trvale obracející se zásoby*, or "permanently revolving inventories". These were unsecured, automatically rolled-over loans with interest rates initially set at 3%, later raised to 6%. Enterprises would then take these loans to re-lend them to the government, which was facing a severe cash-shortage. In 1989, interest rates on TOZ shot up to some

perpetual credits in the amount of Kč110 billion, almost a fifth of all credits to enterprises then. All of the initial loans were purchased from the banks which were responsible for the TOZ, and which in 1991 held two-thirds of all loans to industry: the Czech Commercial Bank (KB) and Slovak General Credit Bank (VÚB). The funds for these purchases came from the SBČS, which KOB was to pay back at a *real interest rate of negative 3%*. KOB also borrowed from other Czech and Slovak Banks, primarily Czech Savings (ČS), and paid an average interest rate of 11% for these funds in 1992 — a -1% real rate. Additionally, KOB purchased Kč15 billion in "bad loans" from the largest banks. [Charap & Zemplinerová, 1993] KOB was initially given a temporary license to operate for 125 days, which was later extended to 6 months. In 1992, KOB became a permanent fixture of the Czech banking system, and moved into regular banking activities, commercial and inter-bank lending, deposit taking, and shareholding.

Third, a bankruptcy law was enacted. The law passed by the Federal Assembly, however, included an article effectively blocking anyone from initiating bankruptcy. Arrears were classified according to "overhang" of total overdue debts minus receivables, or "primary" insolvency, and according to the extent to which the remaining overdue debts could be covered by overdue credits, or "secondary" insolvency. Bankruptcy proceedings could only be brought against firms facing primary insolvency, that is, the inability to sell goods. The rationale behind these requirements was that secondary insolvency, caused by customers' failure to pay bill, should not be cause for liquidation, since the firm might still be profitable. But any bankruptcy proceeding had to go through the republic-level Ministry of Industry, which could extend proceedings for a year. [McElveen, 1992] The law, under pressure from firms and banks, was postponed twice, revised, and finally enacted in April, 1993.

Finally, universal banking and the heavy dependence on banks for adjustment was was codified in the passage of the Banking Act in December, 1991.[18] In addition to payment services and credit granting, the Banking Act allowed banks

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23%, pushed by inflation, and began to threaten huge budget deficits (the reason that TOZ were established in the first place). To decide the amount of recapitalization, banks were asked how much of the TOZ loans they wanted removed. [Thorne, 1992] In 1991, KOB purchased these loans from the largest Czech and Slovak commercial banks for 80% of their nominal value, effectively taking over a large portion of loan collection from bank clients at a 13% interest rate (to be changed according to fluctuations in the discount rate).

[18] Banking Act, No. 21/1992, along with the Act on the Czechoslovak State Bank No. 22/1992.

to: (1) found investment companies, (2) trade in currency, futures, options, and securities markets, and (3) underwrite new stock issues. The largest banks have since plunged into all of these activities, and have become the main actors in reforming the Czech economy. Chief responsibility for supervision of the banking system was given to SBČS, now established as a fully independent monetary authority, given powers to license banks (in consultation with the Ministry of Finance), establish rules regarding bank portfolios, and all relevant banking practices. SBČS would also insure the deposits of the state-owned banks. Bank privatization was accomplished in the regular first-wave in 1992. Between 37% and 53% of banks' shares were distributed through vouchers, while 40-45% remained in the FNM.[19] The huge demand for bank shares indicated that the voucher-holding public was well aware of these banks' worth.

Table 2: *Cumulative Ownership in the Czechoslovak Voucher Market, 1992*

	No. of voucher points acquired[a]	Percent of total voucher points	Percent of fund-held points	No. of total shares held[a]	Percent of total shares held	Percent of fund-held shares
Individuals	2453.8	29.0	—	101.7	37.0	—
Largest IC	950.4	11.1	15.6	21.4	7.7	12.2
Largest 5	3279.2	38.0	69.0	74.1	27.0	42.0
Largest 13	4744.3	55.4	77.6	119.1	43.0	67.7
All funds	6111.8	71.0	100.0	176.0	63.0	100.0
Bank funds[b]	3771.8	44.0	62.0	96.3	35.0	55.0
TOTAL	8565.6	100.0	—	277.7	100.0	—

a. Millions.
b. 11 largest funds bank-owned funds: 6 Czech, 4 Slovak, 1 Austrian.
Source: Laštovička, Marcinčin & Mejstřík, 1994.

Under the Banking Act, banks were permitted to hold shares in corporations

[19] The exception is the Merchant Bank, 100% of which was sold to foreign, private investors.

under the restriction that no more than 10% of a company's capital should be acquired by a bank, and no more than 25% of a bank's capital should consist of stakes in any single "non-financial institution," without the approval of SBČS. Together with the Act on Investment Companies and Investment Funds[20], the Banking Act ensured a critical role for banks in the reforming Czech economy. Investment funds collected 71% of all voucher points in the first wave. Of the 13 ICs operating over 50 funds which acquired 77.6% of these points, 11 of them were founded by banks.[21] Ownership figures in Table 2 show that the 11 bank-owned largest ICs acquired 44% of all voucher points, 62% of all voucher points given to funds. This translated into 35% of all shares, 55% of all shares held by funds. It is important to note that investment funds in the first wave were established as joint-stock company funds, requiring a founder. Voucher holders who entrusted their points to IPFs received shares in the founding investment company. The fund would then invest those points in the shares of companies being privatized.[22] Moreover, in certain cases, banks which held old debts in companies would exchange it for equity which the bank would in turn manage directly. Thus bank equity ownership of firms, either directly or indirectly, allowed substantial participation in enterprise operations and supervisory boards.

A schema of the basic capital structure involving the FNM, KOB, and the typical main bank-one firm relationship is presented in Figure 1. To simplify, individual investors are not included. The FNM maintains an equity stake in (a) privatizing firms, (b) privatizing banks, and sometimes (c) ICs set up as joint-stock companies. ICs, in turn, are (d) subsidiaries of banks which, via IPF funds, own up to 20% of a joint-stock corporation (e). The bank itself may hold direct equity stakes in a firm (f). Banks have also transferred portions of loans

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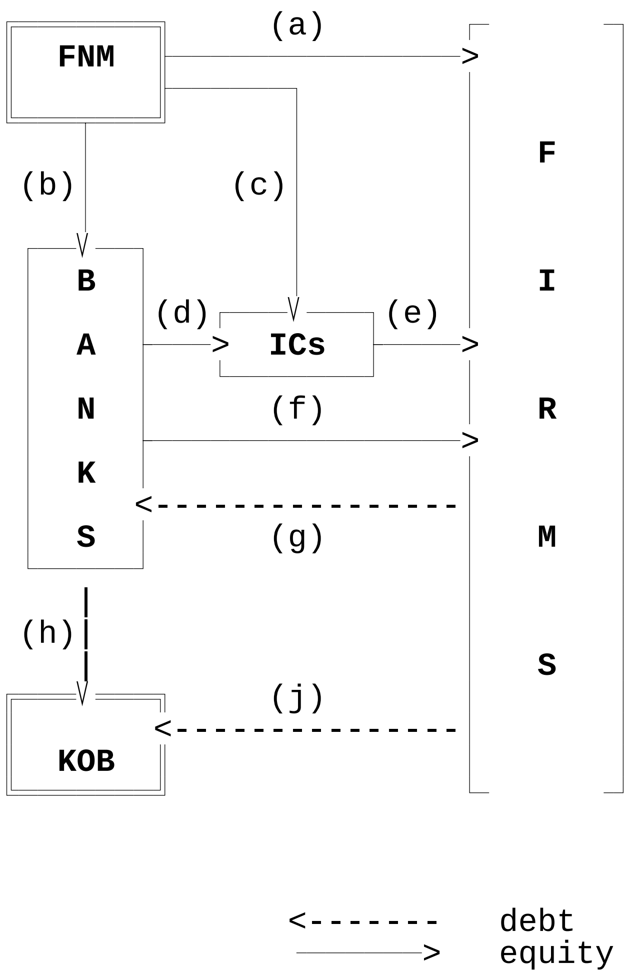
[20] Law No. 248/1992, passed April, 1992. Conditions for ICs and IPFs were first legislated by government decree 383/1991 of Sept. 1991. Initially, they were quite loosely regulated, but later amendments restricted an IPF from investing more than 10% of its own capital in any single company, or from acquiring more than a 20% stake in any single company. [Tříska, 1993] In 1991, a group of IPFs owned by the same IC could together hold up to 40% of a company. This limit was lowered to 20% by the Act on Investment Companies and Investment Funds. For a description of the legal issues, see Dědič, 1992; Brom & Orenstein, 1993: 19-21; Parker, 1993: 25-27.

[21] Of the remaining two, one was owned by the Harvard Capital & Consulting company, the other by *Česká Pojišťovná*, the former state insurance company.

[22] IPFs no longer required to be managed by ICs. Additionally, ICs can now establish "unit funds" which gives shares to voucher holders in exchange for points, but no voting rights. [Anderson, 1994: 4]

to KOB, but may also owe debt to KOB stemming from KOB's new loan activities to large commercial banks (h). Firms, finally, are indebted to both banks (g) and now KOB (j).

***Figure 1**: Capital Structures for Industries in the C.R., 1993*



All of the actors depicted in the diagram — the government, financial, and manufacturing sectors — are a necessary part of economic adjustment. But economic adjustment is a public good, and therefore creates constituencies with incentives to minimize their individual contributions. The next section shows how banks, as well as the largest industries, used their influence to maintain a repressed financial system and thus avoid insolvency.

3. The Evolution of Control in a Bank-Based System

Early recommendations to Eastern European reformers urged the adoption of universal banking laws. Banks, it was argued, were strategically positioned to be agents of change, to monitor, discipline and prod loss-making enterprises into new growth. Their long-established links to firms would allow the government to step back as the principal restructurer, and enable banks to take the lead in converting old debts, finding foreign equity partners, creating any sort of "optimal" capital structure. [Saunders & Walters, 1991; Corbett & Mayer, 1991] Most of these suggestions, however, came with the stipulation that the banking system itself be substantially reformed, that the balance sheets of banks be cleared while still in state hands, and that prudent regulation and supervision be enacted *prior* to privatization, such that automatic loan-renewal could be prevented, and that the establishment of new banks and banking competition would be encouraged.[23] The advantage of post-communist states, as compared to other developing economies, was that debtors and creditors were both still state-owned, so the problem of reforming the financial system could be solved within the public sector, and the effect on the aggregate balance sheets would be minimized. [Begg & Portes, 1992] Banking sector reforms in Czechoslovakia, however, did not substantively alter bank behavior.

Although the number of banks in the Czech Republic has grown from four in 1990 to 47 in mid 1993 to about 60 today, new domestic banks face large designed and unintentional barriers to entry. Of the 60 or so banks currently operating today, about five of them control approximately 70% of all banking assets. The "big four" — ČS, KB, the Investment Bank (IB),[24] and the Czechoslovak Trade Bank (ČSOB) — together control about 85% of all household deposits (ČS alone controls 80%), 65% of the loan market, and employ 80% of the banking work-force. If one takes into consideration the

[23] See Saunders, 1992 (EBRD); Thorne, 1992 (World Bank); van Wijnbergen, 1993 (World Bank); Kemme, 1993; OECD, 1993.

[24] IB, in early 1994, merged with the Postal bank to form the Czech Investment and Postal Bank (IPB).

transfer of credits for inventories to KOB in 1991, little has changed in loan markets in the Czech Republic. Despite a law on the protection of competition,[25] heavy concentration in the financial sector persists.

The old banks have inherited the advantage of vast networks of regional branches, and the accompanying name recognition. Second, SBČS and its Czech successor, the Czech National Bank (ČNB), requires that any bank established after January 1, 1991 comply with the Bank for International Settlements' minimum capital-to-assets ratio of 8%. Since the large banks' capital adequacy ratios fell far short, as noted above, they were allowed to reach the 8% target incrementally,[26] and to comply by the end of 1996. [Hrnčíř, 1992] Third, resources required for loans are available only at high cost. The Czechoslovak financial system has become one of the most segmented in Eastern Europe, with the commercial banks relying heavily on the deposits of the main savings bank ČS for funds to, in turn, lend out. Where there is clear segmentation, there is less inter-bank competition, since borrower banks depend on lender banks for funds. [Thorne, 1993] All banks are faced with the problem of covering risky credits, which they can only do by increasing reserves and loan-loss provisions. But while the big four have easier access to cheaper resources (their own deposits), new banks must depend entirely on either (1) the refinancing operations of the ČNB, or (2) the inter-bank market. The importance of refinancing credits (obtained at the discount rate) is considerably more important for smaller banks which rely on it for about 60% of their sources. [Hrnčíř & Klacek, 1993: 24] The inter-bank market, on the other hand, is dominated by the former state saving bank, ČS. The universal banking laws do not help, as formerly specialized banks like ČS are now diversifying their activities — moving into credit markets, establishing pension funds, and financing foreign trade[27] — and consequently distributing fewer assets on the inter-bank market.

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[25] Law no. 63/1991, together with the Banking Act 21/1991, defines "dominant" or "monopoly" market position to be a 30%-or-greater share of any relevant market held by a bank. Banks were given three years with which to comply with the law.

[26] The targets were as follows: ratio of capital base to risk-weighted assets to be 4.5% until the end of 1991; 6.25% until the end of 1993; 8% not later than the end of 1996.

[27] The director of ČS outlines, in addition to these activities, three new lending targets: individual households, small and medium-sized enterprises, and most significantly, municipalities, to which the bank expects to distribute 20% of its shares. While 50% of ČS's assets are lent out to other banks, new lending activities will undoubtedly cut into inter-bank capital. Reported in *La Tribune de Prague* 6 (April/May 1994): 38-39.

In these ways, the strategic advantage of the big four is maintained. With few exceptions, new banks have not been able to offer as many products, nor access the funds for loaning out, as easily as the old banks. New banks are typically forced to resort to raising capital either through equity funds from a limited number of shareholders (usually private firms), or by venturing into international borrowing markets. For inexperienced bankers, both options are treacherous. The dilemma of small banks was underscored in early 1994 by three well-publicized bank failures: the Industrial Credit Bank, AB Bank, and the Bank of Bohemia, all of which had licenses revoked and have been placed under National Bank supervision. The first two succumbed to pressures from shareholders to provide *them* with favorable credits, while the third — the country's seventh-largest bank — fell prey to international securities fraud.

The problem might have been somewhat alleviated had the central banking authorities taken a more forceful approach to breaking up large banks during the first year of reform. The central bank, however, was concerned much more with credit restraint and banking-system stability, and feared that breaking up the large banks at a time when there was an enormous demand for banking services would be prohibitively costly. A demonopolization proposal was made, but was naturally resisted by the banks controlling 99.5% of the market, if only for the official reason that the operations of these newly-independent banks would collapse under the logistical pressures bound to arise from splitting up networks.[28]

3.1. The Benefits of Bad Debt

In the Czech economy, as in much of East-Central Europe, there are the usual strong incentives for creditor passivity on the part of banks and firms. Banks, it is argued, fear that initiating foreclosures may make transparent the real extent of their insolvency; banks have also come to expect that, if no action is taken, government intervention will be inevitable.[29] In the Czech Republic there are two additional problems complicating the chance for reform. First, due to the heavy concentration of the banking sector, the largest banks have inherited regionally and sectorally undiversified portfolios, and these credit portfolios have been poorly managed. But second and more importantly, banks manage many of the funds that own shares in the debtor clients of the banks themselves. Most

[28] Interview with Mr. Miroslav Kerouš, Vice Governor of SBČS, 1989-92, June 1, 1994.

[29] These issues are discussed in Mitchell, 1992; Begg & Portes, 1992; and Phelps, *et al*., 1993.

of the largest banks' loan portfolios are tied up in the largest privatizing firms, and thus banks threatened their own existence by foreclosing. As a result, most of the so-called "bad debts" have accrued since 1991. Table 3 shows that the percentage of total credit comprised of "risk credits" has increased since the end of 1991. The percentage devoted to reserves and loan-loss provisions for the largest banks has declined slightly, while the same for the smallest banks has fallen by half, in spite of a widening loan-deposit interest rate spread. The share of short-term borrowing to total credit, too, has increased by 12%, while long-term loans have fallen 32% over the same figures at the end of 1991. These last two indicators demonstrate the two strategies taken by banks to protect themselves: bigger interest rate differences, and greater focus on loans with maturities of less than one year.

Table 3: *Borrowing Trends in the C.R., 1991-93*

	Dec-91	Jun-92	Dec-92	Jun-93	Dec-93	Δ in %
Risk credits[a] as % of total borrowing	2.4	3.9	19.2	21.7	23.8	+892
Reserves[b] and loan-loss provisions as % of risk credits	n.a.	n.a.	51.5	47.1	48.5	-6
-for large banks:	n.a.	n.a.	24.1	28.2	45.0	+87
-for small banks:	n.a.	n.a.	36.5	16.2	16.8	-54
% Short-term credit	39.5	40.3	37.4	41.8	44.1[c]	+12
% Medium-term credit	18.2	20.9	26.7	28.2	27.2[c]	+5
% Long-term credit	42.3	38.8	35.9	30.0	28.7[c]	-32
Interest rate spread	5.9	6.7	6.9	7.8	6.8[d]	+15

a. Refers to temporarily illiquid claims and badly-performing loans.
b. Including reserve funds from profits and reserves against losses.
c. Figures for Oct-1993.
d. Figures for Sep-1993.
Sources: Hrnčíř, 1994; Buchtiková & Čapek, 1994.

The largest banks, being the most threatened by foreclosure on delinquent industries, had powerful incentives to lobby for a credit-based system which would push the burden of adjustment from the large banks towards the smaller. Main-bank bargaining power was strengthened by the degree of concentration of assets among a few large banks, by the universal banking laws which effectively made banks the linchpin of the financial system, and by the lack of other alternatives for converting savings into investments.

3.2. Industrial Lobbying

Like banks, the largest firms attempted to avoid incurring real costs of reform. Like banks, they benefitted heavily from the toleration of inter-enterprise debts. Begg and Portes [1992] note that, when price of bank credit is high, firms try to compromise on this expensive commodity; those enterprises with liquid assets are likely to extend credits to their own customers rather than press for delivery of payment. Where there is creditor passivity by banks, inter-firm debts are likely to rise. In former Czechoslovakia, primary and secondary inter-firm insolvency rose by, in real terms, 607% in 1990, 203% in 1991, and was essentially unchanged in 1992. By the end of 1992, inter-firm debts amounted to one-fourth of all outstanding bank credit, and approximately two-thirds of GDP for the CSFR [Hrnčíř, 1993] Financial resources of firms had all but vanished between 1990 and the end of 1991. Price liberalization and expectations of inflation forced many to hoard their inventories as a reserve against the declining value of producer goods. [Holman, 1991: 9-11] State subsidies were removed and, with the collapse of COMECON, the main markets for the heaviest industries evaporated. By increasing supplier-to-customer credits, firms could both shield themselves from the effects of producer-price increases, and avoid the lay-offs which would be necessary to cut costs.[30]

Lending in the Czech Republic continues to shy away from the viable private sector. Lending figures of the ČNB are simply divided into "public sector" and "private sector" categories, and thus the data naturally indicate a rise in private-sector lending. "Private sector", however, includes both new firms and

[30] There was plenty of pressure on both firms and politicians to avoid lay-offs. A peculiar aspect of Czech industry--perhaps more than any other Eastern European state--are the strong community-firm relationships built from autarkic patterns of industrialization. [On the issues of community-firm relations, see Illner, 1992 and McDermott, 1993: 11-13 and the citations given therein.] The number of one-industry towns is enormous for a country as small as the Czech Republic. The biggest firms, to this day, are identified by the city in which they are located as much as by their own name: Poldi-"Kladno", Tatra-"Kopřivnice", Škoda-"Plzeň", etc.

privatizing SOEs, and the lack of distinction hides the fact that most of the funds still flow to the same firms with which banks have long-established ties. Other types of evidence show this indirectly. For example, from data provided by the Ministry of Industry covering 1325 enterprises "supervised" by the ministry, it is clear that the most profitable industrial sectors are not receiving the most credit. Table 4 ranks six selected industries according to (1) percent of total new bank credit to total equity, (2) percent of total bad debt to total equity, and (3) profit-to-equity ratios, all for 1992. The first measure is used rather than the usual indicator of leverage — long term debt-to equity — in order to measure the proportion of bank credit received. The results show that there is a *negative* relationship between profitability and new borrowing: bank credit flowed to loss-making industries. The electrical materials and the paper & pulp industries, for example, were the two least profitable, but received the most proportionate credit. The electrical materials industry, moreover, had the highest proportion of bad debt. On the other hand, the two most profitable industries in 1992, chemicals & rubber and glass & ceramics, also had the least amount of bad debt, but received the least new bank credit.

Table 4: *Rankings for Lending to, and Performance of, Selected Industries in the C.R., 1992*

	Credit/equity	Bad debt/equity	Profit/equity
Iron & Steel	4	2	3
Chemicals & Rubber	5	4	1
Electrical Material	1	1	6
Paper & Pulp	3	4	5
Glass & Ceramics	6	5	2
Textiles	2	3	4

Source: Author's calculations based on data from Ministry of Industry and Trade, C.R., 1993

Privatization was meant to end this "skewness" of old debt endowments, where technically insolvent industries were sometimes quite profitable, and allow the most profitable industries to recover from the burden of past debts. Preliminary evidence demonstrates that this has not happened to the extent it was expected. That privatization may not have been fully successful towards this end may have been less a problem of defining property rights than it was a problem of *delimiting the exercise of public authority*. Specifically, the relationships of the Federal and Republic ministries with the various industries they had supervised were left more or less intact, and the fundamental questions of government control in a reforming economy, were all left unanswered.

4. Government Agencies and Preferential Credit Policies

In the first two years of reform relationships between elected and newly-appointed officials and industry were quite unclear, quite varied. Most of the debates, quite naturally, focused on the appropriate sequence, timing, and method for privatization. Certain economist-cum-politicians, including the Finance and Privatization Ministers, insisted at every opportunity that the government would be the worst-possible agent for restructuring, and that the duty of government was to lower the obstacles to free entry and exit, and to let the market do the rest; rapid privatization, allowing different methods of transferring state property to private hands, was their solution. Mildly opposed to them was a second group, also made up largely of economists. They argued that, given the legacies of Czech industrialization, the economy would not reform successfully without some form of selective government assistance, for example, in searching aggressively for foreign partners or promoting investment in export-oriented industries. Vouchers, then, would merely privatize firms while leaving them dangerously cash-starved. Without extra, initial help, Czech industry could not be competitive.

Towards the elections of 1992, these contending perspectives obtained some expression in different political parties. For our purposes, it is useful to focus on two of them. The Civic Democratic Party (ODS), a right-of-center splinter off the Civic Forum party which had carried the anti-communist victory of the 1990 elections, became the chief advocate of laissez-faire market reforms. The Civic Democratic Alliance (ODA), on the other hand, was a pre-1989 dissident movement that became a political party. While it supported much of the same platform of the ODS, it also attracted members with more interventionist sympathies, and those who were, above all, concerned with keeping the manufacturing base of the country alive, lest the Czechs become a nation of "street traders, barmen, and souvenir sellers".[31] After the June, 1992 elections, the ODS and ODA both entered the new coalition government: the new Prime Minister (former Federal Finance Minister Václav Klaus) was an ODS member, while other ODS representatives took control of the Ministry of the Economy and Ministry of Finance. ODA members came to be in charge of the MSNMP, FNM, and the Ministry for Industry and Trade (MPO). Thus the cabinet setting by mid 1992 had the ODS in charge of the broad "regulatory" ministries, while the ODA came to control the special governmental agencies involved with the day-to-day business of privatizing and reforming industries, and protecting the state's equity holdings. These agencies, along with KOB, formed the governmental part of the state-banks-firms bargaining regime. I will concentrate on the three agencies with special roles in economic adjustment.

4.1. The Ministry for Industry and Trade (MPO)

The MPO was the Czech successor to the Federal Ministry of Industry, itself formed from the consolidation of the numerous "industrial" ministries of the Czechoslovak Socialist Republic. These former ministries, the product of efforts to effectively centralize the planning mechanism, composed the main part of the economic-bureaucratic apparatus. Annual, 3-year, and 5-year plans drawn up by the State Planning Commission with set targets for investment and production for all industries, were passed to the ministries responsible for each industry, which in turn, would implement the plans in cooperation with the general directorates and "industrial-economic units" (VHJs) under ministerial authority.[32] In a series of reforms between 1958 and 1974, the number of industry-controlling ministries was reduced from sixteen to nine, including two separate republic-level Ministries of Industry. [Rosický, 1980] The Federal Ministry formed in 1989, as well the Czech MPO formed in 1993, both contained "divisions" comparable to the earlier ministries. The new divisions

[31] See Myant, 1993: 218.

[32] VHJs were set up to further centralize industrial control. A 1958 law on enterprises reduced the number of enterprise from 1445 to 929, which were to be under the control of 383 newly-established VHJs. [Kališová & Gregus, 1991: 8] These were to act as monopolist-conglomerates, coordinating internal upstream-downstream relations, investment demands, research and development, COMECON and trade relations, and "social" or "cultural" needs of workers, of all the firms under their command. Initially, most of the plan elaboration was done in tight coordination with the central ministries, but a 1974 law established three distinct types of organizations: (1) Divisional Firm, (2) Trusts, comprising the general directorate and associated state firms, and (3) Concerns, or the actual VHJs, which were to coordinate production with greater independence. [Pavlátová, 1982: 81-82]

for energy & fuels, construction, "general" machinery, engineering, light industry, and so on, took the place of whole former ministries. Many of the same officials who had previously worked in the various industrial ministries, general directorates, and VHJs now worked under newly-formed divisions of the same name within the MPO. These individuals were typically engineers or others with technical training and experience with applications in their industrial specialty. Among these ranks, ailing firms found technocrats with intimate knowledge of their industrial sector who, at the same time, were now involved with advising the Minister for Industry on various matters.

But little effort was made, even after the June 1992 elections, to clarify the duties of the MPO and its relations with other agencies. Lacking delimited spheres of authority, the MPO extended its activities into three new roles. First, recall that under the privatization program, projects approved by the MSNMP were to be transferred to the FNM for implementation. The MPO was the "founding" ministry for most enterprises, and thus had the right of first-review of privatization projects. In passing the proposals along to the MSNMP, the MPO was to submit a recommendation, choosing among competing proposals. Although, the final decision was technically in the hands of the MSNMP, the MPO had substantial discretionary power, for example, in rejecting some proposals out of hand, or in requesting revisions, etc. MSNMP officials tended to defer to the expertise of the MPO committees in approving privatization projects.[33] For second wave privatization projects, the MPO committees have taken an even more active role in project evaluation. Second, the MPO has recently acquired from the FNM voting rights in 46 of the largest firms, and is now the holder of state equity in these firms. For most of these voting-rights transfers, again the issue is expertise; FNM officials have formally deferred to the MPO, and MPO representatives have taken their place on supervisory boards.

But third and more importantly, the MPO has started taking back projects for which something has "gone wrong": if the FNM cannot distribute shares according to plan, if direct buyers cannot be found, if debt problems cannot be resolved, if joint-venture negotiations run into delays or break down, or even if authorities realize that successful completion of the privatization project would lead to troubles, e.g., unemployment, environmental problems, production complications upon breaking up a firm, etc. If this happens, the project is now transferred back to the MPO for further evaluation. In consultation with the

[33] Interview with Mr. Tomáš Polák, Director for Large Privatization, MSNMP, April 20, 1994.

MSNMP and the FNM, (along with various bank creditors, firm owners and management) a revised "Report on the Current Situation of Firm X and Proposed Solutions" is submitted to the Minister for Industry who presents the recommendation to the Council of Economic Minsters[34] for a vote. In the past year, the recommendations reaching the Council and later implemented have been, among others: government-guaranteed credits for Nová Huť, Vítkovice, and Třínecké Železárny, three steel mills in Northern Moravia; a bailout for Škoda-Plzeň, an engineering firm; a debt-equity swap for Aero, an aircraft maker, with its main creditor IPB; the merger of Plženské Pivovary with Pražské Pivovary, two of the largest breweries; supports for subcontractors to Tatra, a truckmaker. The number of firms whose privatization projects have not worked, and have later successfully sought some sort of government assistance is not small, and most of them tend to be the largest value-added industries.

In the halls of the MPO, there is talk of the need for "industrial policy". The Minister for Industry, an ODA member, has supported the idea of promoting exports and providing assistance to industries in purchasing higher-end technologies, in public statements. At cabinet meetings, the loud talk quickly turns to whispers, since industrial policy is something to which Klaus and the ODS members are firmly opposed. Nevertheless, the MPO has established itself an instrument of a *de facto* industrial policy, involved primarily with selective industrial guidance and credit arrangements for industries in distress.

4.2. The National Property Fund (FNM)

The Fund was created as a quasi-autonomous state agency on the basis of a 1991 law on the administration of privatizing properties,[35] making it sole "owner" of state assets. For the first two years, the FNM used most of the revenues raised from privatization to stabilize the credit-granting institutions of

[34] The Council of Economic Ministers consisted of the Prime Minister and the ministers representing the Industry, Economy, Finance, Agriculture, Transport and Privatization ministries, along with the Chairman of the FNM Executive Committee.

[35] No. 171/1991. The FNM, according to the statutes, was a legal entity an entered as an "enterprise" in the Commercial Register (*Podnikový rejstřík)*. It was solely responsible for the formal conversion of SOEs to joint-stock companies, and was to take over and administer the property, shares, or securities of the privatizing firm, participate in the management of the business unit, and exercise all rights involved with such ownership, including the right to sell shares or property, rent facilities, issue bonds, close contracts upon the sale on enterprise, and to be entitled to an equitable share of the value of a liquidated firm according to share of ownership. See Klvačová (1993).

the financial system. It was noted above that, in the Czech lands, the Fund in 1991 offered to make Kč22.2 billion available to relieve the debt burdens of "viable" firms, and Kč7.8 billion to recapitalize banks. In 1992, the Fund paid out Kč22.1 billion in bonds to write off bad debts, and Kč1.5 billion to pay off the interest associated with these debts. Also in 1992, the FNM issued Kč23.2 billion worth of bonds to strengthen the capital base of the two main creditors to industry, KB (Kč 13 bil.) and IB (Kč10.2 bil.). The money raised from the sale of these bonds was redeposited in the two banks to increase their capital-assets ratios.[36] By the end of 1992, 95% of all expenditures of the FNM since its beginning had gone to banks.

These duties of the FNM were extensively specified under the provision that resources should be used to strengthen banks and settle obligations of firms. Relationships with other agencies and the limits on Fund activities, however, were less clear. Throughout 1993 various other governmental authorities frequently turned to the FNM as a source of liquidity to cover a variety of expenses, mainly to provide assurances against the specter of bankruptcies. In 1993, Kč15.7 billion in bonds was transferred to KOB to increase provisions against loan loss. As the state budget was, by law, limited to providing no more than 10% of total revenue in the form of credit guarantees,[37] the government began using revenues from the FNM to provide cheap credit and "emergency" funds to large enterprises in distress — Škoda-Plzeň, the transport engineering firm ČKD Praha, the chemical company Chemické Závody-Sokolov, in addition to the three Moravian steel mills. In this way, industries could receive necessary funds, and the government could continue to boast of budget surpluses.

As a distinct legal entity, the FNM was to maintain separate accounts, and its revenues were not to be included in the balance sheets of the regular state budget. The FNM battled with the Finance Ministry on this subject of budgetary independence. Legislation in 1993 was designed to make it easier for other governmental agencies to access FNM funds and direct FNM expenditures, while the FNM resisted these attempts to exert control. The Finance Ministry wanted the FNM to pay off partially its foreign debt borne by the old trade bank ČSOB in the amount of Kč6.5 billion, as well as Kč18 billion interest on the

[36] All but Kč2 billion of these funds have been paid back. Interview with Mr. Jan Princ, First Deputy Chairman of the Executive Committee, FNM, May 24, 1994. All figures from *Výroční zpráva Fondu národního majetku za rok 1992* (Praha: FNM, 1993), pp. 16-17; 21.

[37] Most of the guarantees for 1993-94 were taken up with two projects: the construction of the Ingolstadt pipeline from Germany, and the construction of a controversial nuclear power plant in Temelín on the Austrian border.

national debt. Second, the budget office had promised a Kč1 billion deposit into the government-established Czechomoravian Guarantee and Development Bank (ČMZRB) — a bank set up for the purpose of guaranteeing credits for small and medium-sized enterprises — and now wanted to pull the funds from the FNM. Third, Kč2 billion was owed by the state to ČS and IB to cover losses from loans to housing construction, which the FNM was also asked to pay. To date, approximately Kč8 billion has been transferred to the state budget. The Chairman of the FNM at the time,[38] an ODA member, argued that these budgetary demands would siphon away funds needed for enterprise recovery. In revealingly blunt language, he stated that the priority of the FNM should be to: "save the healthy economic tissue and isolate the sick cells which are [destined] to vanish. . . to ensure that the dying cells do not propagate their infection," and not to serve as the government's debt fixer. [Ježek, 1992: 6]

4.3. The Consolidation Bank (KOB)

KOB began as a short-term solution to the problems of bad debt devised by the Finance Ministry and central bank. Within a single year, however, its temporary license was extended twice, finally made permanent. The original activities were to consist entirely of purchasing sub-standard loans from banks, and then "doing" something with them, such as exchanging them for equity, trading them domestically or internationally. To a certain extent, KOB was singly responsible for relieving banks of the severe burden of inherited bad loans. As a result, KOB is now a creditor to approximately 4000 firms in the CR, 2000 in Slovakia — the vast majority of all medium and large enterprises. As with the FNM, KOB has become an instrument for strategic industrial and financial assistance. The position of KOB as universal creditor allows its representatives a place on the committees which decide methods for reviving or liquidating firms under the revised bankruptcy law. This allows the governmental agencies with regulatory powers over KOB (mainly the Finance Ministry) numerous opportunities for involvement in bankruptcy proceedings which it would not otherwise have.

As with the other agencies, there was much debate surrounding the new role for KOB. One role emerging seems to be that of a permanent debt-alleviation agency. KOB continues to purchase loans from the large commercial banks. The original purchases of loans for enterprise inventories were completed to clear up bank balance sheets by removing credits which, due to inflation and

[38] Tomáš Ježek, Chairman of the FNM, resigned in June, 1994 amid allegations of several improper sales of company shares. He was replaced by the First Deputy Minister for Privatization, also an ODA member.

high interest rates, threatened large industries uniformly. Yet in 1992, KOB purchased and additional Kč15.1 billion in loans from KB (Kč9.7 bil.) and IB (Kč5.4 bil.) at 80% of their nominal value. These were loans made before 1990; KOB, not the banks, chose the loans to be bought, on the advice of auditors. Original loan purchases by KOB were meant to remove long-term obligations to companies which had some potential profitability. The second-round purchases, on the other hand, simply diluted firms payment discipline. Unlike the inventory loans, of which 80%-90% of the firms now pay on time, KOB has had much less success with its recent activity. Of the Kč15.1 billion original purchase, the 1992 annual report notes that the firms remain behind on Kč12 billion in payment.[39] Again in early 1994, KOB proposed to use the proceeds given by the FNM to again purchase the payables of insolvent firms at between 50%-60% of their nominal value, in order to prevent the "domino effect" of growing bankruptcies just as the implementation of the refurbished bankruptcy law began.[40] This would require an additional subsidy from the FNM in the amount of Kč9-10 billion, and would grant governmental agencies, through the KOB, numerous discretionary powers to decide the fate of firms.

A second role for KOB seems to be that of a development bank. Under pressure from the MPO, a program has been proposed for the KOB to provide credits for exporters and firms involved with infrastructure projects — telecommunications, transport, utilities — to be guaranteed by the government (FNM). So far, Kč3 billion in loans have been made for these purposes.

5. Conclusion: The Politics of Credit-Based Adjustment

The imperatives of holding unemployment down and preventing massive bankruptcies has opened the door to both rent-seeking by industry and government intervention in support of favored companies performing badly. The FNM and KOB have become the main inoculations against insolvency, as well as the instruments by which artificially cheap credit is provided, either directly through FNM guarantees or loans from KOB, or indirectly through the relief of previous debt obligations. Consequently, financial preference has been extended to some firms and restricted to others.

The capital structure which emerged for Czech industry between 1990 and 1993,

[39] *Výroční zpráva Konsolidační banky za rok 1992* (Praha: KOB, 1993), p. 11.

[40] Odbor konkursů a likvidací Konsolidační banky, *Směrnice pro odkupování pohledávek za upádci* (Praha: KOB, 1994).

to some extent, is a result of the failure of the ambitious voucher-privatization program to provide the liquidity and flexibility which firms required. Yet the capital market was also squeezed by the countervailing effects of universal banking laws which granted banks powers to manage investment funds which owned the lion's share of privatizing firms. Due to the influence of the large banks spun off of the unitary, communist banking system, little effort was taken to force the break-up of these financial conglomerates. Thus the fledgling capital market created in 1993 was dominated by banking power, and remained highly vulnerable to collusion, price fixing through artificial bidding-up of share prices, and volatility due to fluctuations in prices of single issues.

The failure of capital markets, then, established certain conditions which affected the incentives and perceptions of the main players. Under-investment in the real private sector and in profitable firms due to various distributional struggles has been the unfortunate result. Banks, for their own part, simply wanted to be assured that the unreliability of old and new debt holdings would not threaten their present survival. As is characteristic of countries undergoing the rapid, uncontrolled growth of a highly concentrated banking sector in need of recapitalization, there was substantial pressure to keep interest margins spread wide, and to move away from long-term debt contracts. Because of the capital structures which had emerged, banks also had powerful incentives not to enforce their debt contracts with "important" industries. Bankruptcy laws did not provide the incentives for banks to initiate proceedings against the loss-making firms which were using up scarce credit, since the costs of liquidation were much higher than any benefit any creditors could expect to receive. Firms, on the other hand, especially those whose disposable incomes depended heavily on state subsidies, naturally demanded cheap credit. Banks and firms turned to the government for solutions. Against this background, the bargaining regime by which credit came to be "delegated" appeared.

The main flaw in the program of the reformers was that they concentrated too much on the distribution of economic property rights while ignoring the "political" ones (to use Moe's language). Like the banks and firms, governmental bodies involved with directing economic reform, too, wanted to minimize the costs of institutional reform which they would have to bear. For certain ministries such as the MPO, this meant avoiding drastic reorganization, and perpetuating the strong interdependencies between bureaucratic units and industries. For the government as a whole, this meant letting various agencies improvise relationships with each other. In the MPO, and the ODA party which controlled it, ailing industry found sympathetic ears. The Finance Ministry and the state budget office were, above all, afraid of running large deficits which might frighten foreign investors away. These ministries turned to the two "liquid" institutions in the country, the FNM and KOB, to rescusitate failing industries and provide a bulwark against large numbers of bankruptcies. The institutional arrangement which subsequently emerged was a financial system which depended almost entirely on credit markets to convert savings into investment, and relied on the collaborative decision-making of governmental bodies and banks to allocate funds. This arrangement constituted the ultimate political expression of powerful economic interests, and at the same time, provided an "insulation" of sorts for politicians and the current government.

The arguments, along with the evidence presented here, suggest that credit based systems should be recommended to transitional and developing economies only with a great deal of caution. There is the danger in all cases that certain interests will come to enforce their positions through the creation of extra-market arrangements, that credit markets will just as easily fail, and that vital savings urgently needed for economic development will be wasted.

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