



THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

*The Politics of Institutional Learning and Creation:
Bank Crises and Supervision in East Central Europe*

By: Gerald A. McDermott

William Davidson Institute Working Paper Number 726
November 2004

**The Politics of Institutional Learning and Creation:
Bank Crises and Supervision in East Central Europe**

Gerald A. McDermott*
Management Department
The Wharton School
University of Pennsylvania
mcdermott@wharton.upenn.edu

September 2004

Abstract

This article examines the political conditions shaping the creation of new institutional capabilities. It analyzes bank sector reforms in the 1990s in three leading postcommunist democracies – Hungary, Poland, and the Czech Republic. It shows how different political approaches to economic transformation can facilitate or hinder the ability of relevant public and private actors to experiment and learn their new roles. With its emphasis on insulating power and rapidly implementing self-enforcing economic incentives, the “depoliticization” approach creates few changes in bank behavior and, indeed impedes investment in new capabilities at the bank and supervisory levels. The “deliberative restructuring” approach fostered innovative, cost-effective monitoring structures for recapitalization, a strong supervisory system, and a stable, expanding banking sector.

Keywords: Institutional change, transition economies, bank crises, bank supervision, learning
JEL Codes: G28, F02, P26, P48, K23

*The author would like to thank the URF of the University of Pennsylvania and the GE Fund/Jones Center for their generous financial support of the research conducted for this article, Mauro Guillen and Chuck Sabel for insightful comments, and Paul Borochin, Alex Klein, Cezary Pietrzak, Anna Pilipienko, Wojciech Rogowski, Kinga Szuly, and Zsuzsanna Vargha for their assistance in this research. The usual exculpations apply.

Introduction

This article examines the political conditions shaping the creation of new institutional capabilities, by analyzing the resolution of bank crises and creation of supervisory institutions in the 1990s in three leading postcommunist market democracies – Hungary, Poland, and the Czech Republic. With the recent financial crises in East Europe, East Asia, and South America, the debate on the development of banking institutions shifted from an emphasis on rapid privatization and optimal incentives to methods of state oversight and adequate supervision.¹ But such discussions simply push one into ongoing debates about the conditions that impede or promote new bank- and supervisory-level capabilities. For instance, recent research on the resolution of bank crises and institutional change is often centered on the trade-offs between more or less constrained governments as well as optimal designs versus socio-political legacies.²

This article attempts to recast the received dichotomies by showing how different political approaches to economic transformation can facilitate or hinder the ability of relevant public and private actors to experiment and learn their new roles. The “depoliticization” approach rests on insulating centralized policymaking power and rapidly implementing new, self-enforcing economic incentives. This approach appears to retard the development of institutional capabilities, as the new incentives are often inapplicable and create strong disincentives to invest in new bank and supervisory capabilities. In contrast, the “deliberative restructuring” approach appears to improve these capabilities by empowering public and private actors to problem solve collectively and monitor one another.

Section I builds on existing research on bank reform and institutional change by showing how it may benefit from recent insights from evolutionary economics and organizational theory. Section II discusses the different approaches Hungary, Poland, the Czech Republic used to address a common postcommunist challenge of simultaneously building new economic governance institutions and resolving solvency crises of their state banks that dominated financial intermediation. (Bonin & Wachtel, 1999) To differing degrees, the Czechs and Hungarians chose to insulate policy-making to promote quick bank reform via a bailout coupled with new incentives (new banking laws and rapid privatization). In contrast the Poles delayed privatization and sought to promote bank and large firm restructuring monitored by various state agencies. Heeding Montinola’s (2003) call for more detailed comparative research on resolutions of bank crises, the analysis here focuses on the interaction between micro-level

institutional changes and macro-level policy making.(Ekiert et al., 2003)³ Moreover, since these three countries were arguably the most advanced democracies and economies of East Central Europe and had little significant experience in market based banking systems, the comparison controls for typical structural explanatory factors.

Section III discusses the outcomes of these approaches by the mid- to late-1990s. The Hungarian and Czech approaches led to costly, multiple bailouts, unstable banks, and delayed supervisory capabilities. The Polish approach led to one of the most cost-effective bad debt resolutions, a stable banking sector with increased lending, and a strong supervisory authority. Section IV argues that these differences can be explained largely by the different political approaches to transformation. The depoliticization approaches of Hungary and the Czech Republic led to separating privatization and restructuring of banks and firms. The reliance on self-enforcing incentives did little change bank behavior and actually retarded the building of new oversight capabilities. In contrast, the Polish form of “deliberative restructuring” came from choosing to combine bank and firm restructuring. The government gave its new public agents the authority to develop monitoring capabilities and experiment with rules that could change private behavior.

Section V concludes the article. By viewing institution building as an experimental process in developing public and private capabilities, one can begin to focus more on how the trade offs between transparency and accountability, on the one hand, and authority and discretion, on the other, can improve the governance of change.

I. Depoliticization, Deliberation and Institution Building

Bank sector reform in general, and banking crisis resolution in particular, in transforming countries centered on resolving the stock of existing bad debt and the flow of future credit, namely to firms. (Glick, Moreno, & Spiegel, 2001) The stock problem is usually resolved by some form of public assistance to the banks – debt restructuring, write-offs, and recapitalizations. The goal is to restore the bank to short term solvency while limiting the moral hazard problems of expectations of further bailouts and adverse selection problems of banks declaring greater aid than needed. The flow problem (with the related concern of soft budget constraints) is a longer term issue and a function of institutional change – ownership and governance of the bank, creditor rights, prudential regulation, etc.

The policy consensus of the early 1990s conceptually and operationally separated the stock and flow problems, in turn bank and debtor firm restructuring. The state would strengthen bank capital one time by a combination of recapitalization and carving out bad loans (i.e., to be written off, transferred to a bank “hospital” or asset management agency for restructuring, etc.). The rapid installation of new incentive systems via rapid privatization, strict banking regulations, strengthened creditor rights, and tough bankruptcy laws focusing on debtor punishment would bring behavioral changes in banks, thus resolving the flow problem.

In the wake of the Asian crisis, students of finance and economics recognized the need to tie together bank and firm restructuring with the development of regulatory institutions. (Barth, Caprio, & Levine, 2001; Caprio & Klingebiel, 1996; Hoelscher & Quintyn, 2003; Klingebiel & Laeven, 2002; Meyendorff & Thakor, 2002) First, bank crisis resolution improved with the conditionality of recapitalization and debt removal – i.e., the state requiring banks to reorganize operations and management as well as initiate work outs or closings of the largest debtor firms. (Aghion, Bolton, & Fries, 2002; Caprio et al., 1996; Zoli, 2001) Second, research highlighted the importance of governments and central banks establishing sound prudential regulatory regimes that made bad debts more readily transparent, insisted on risk-based provisioning, and created independent and capable supervisory agencies.

Such conclusions clearly go beyond reliance on incentives but also open up dilemmas typical of any model of institutional change based on state activism. (Amsden, 1989; Evans, 1995; Johnson, 2001; Moon & Prasad, 1994) Any attempts at strategic privatization, conditionality enforcement, or regulatory supervision would demand the creation of new state capabilities and thus a level of sustained interaction between public and private actors that breaches an insulated state and opens up the door to capture.

An alternative line of inquiry begins by combining research from the political economy of financial restructuring and evolutionary theories of organizations. The former has shown that crises and regime change are moments of extraordinary politics where governments can break up coalitions of entrenched elites and choose policies that profoundly shape the future consolidation and stability of new institutions. (Haggard, Lee, & Maxfield, 1993; Haggard & Maxfield, 1996; Johnson, 2001) The latter highlights stickiness of change and the limitations of relying purely on market signals to guide adjustment, since organizations embody old routines and cognitive templates that screen out alternatives. (Dosi, Nelson, & Winter, 2000; Nelson & Winter, 1982)

So if moments of crisis and regime change provide opportunities to breakup the old interests and routines, then how would policy choices help build new ones? Recent work from the evolutionary camp offers a suggestion in arguing that often new knowledge and capabilities come from empowering groups (within and across organizations) to interact in new, disciplined ways, drawing on one another's experience and engaging in collective problem solving. (Argote & Darr, 2000; Helper, MacDuffie, & Sabel, 2000; Kogut & Zander, 1992; MacDuffie, 1997; Winter, 2003; Zander & Kogut, 1995)

Scholars of comparative politics and sociology coincide with these views by arguing that policy innovations and institutional adaptation begins by embedding the state in professional and inter-organizational networks that provide alternative channels of feedback, resources, and experience. (Evans, 1995; Jacoby, 2001; Stark et al., 1998) To limit problems of self-dealing while accelerating the learning process, deliberative or participatory forms of governance may be helpful. (Evans, 2004; McDermott, 2002; Sabel, 1994) For instance, Sabel (1994) suggests that one should focus on whether governments can initiate policy approaches that merge mutual monitoring and learning by the relevant actors involved in the collective experiment.

This article, in turn, argues that efficient and stable resolution of bank crises and sound development of supervisory capabilities are linked together and depend largely on political approaches that improve the ability of public actors to govern bank and broader institutional experiments. That ability to govern emerges from policies that combine delegation and deliberation: they give public and private actors direct restructuring and oversight authority and provide a legal framework that forces them to continually share information about their related restructuring experiments. Rather than evaluating institutional development in terms of the state versus the market or autonomy versus embeddedness, one may find a more useful set of typologies as approaches that emphasize “depoliticization” versus “deliberative restructuring.”

With its dual aims of insulated power and rapid change, depoliticization eschews deliberations between the state and economic and social actors about the initial policies and their subsequent revisions.⁴ It is achieved when the central state constructs a powerful, insulated “change team” to impose rapidly a new set of rules with self-enforcing economic incentives. Depoliticization would lead governments to avoid legislation on specific reforms and rely heavily on a few rules with self-reinforcing incentives so as maintain insulated and rapid policymaking. Besides solving the stock problem by a recapitalization and/or bailout, immediate

imposition of new market incentives (e.g. mass privatization, capital adequacy rules, bankruptcy as liquidation, etc) to solve the flow problem would effectively treat bank and firm restructuring separately and diminish the importance of the state to impose conditionality and build oversight capabilities. In turn, one would expect to see limited behavioral change in banks, costly repeated bailouts, and retarded development in the capabilities of both banks and supervisory institutions.

Deliberative restructuring begins with the aforementioned principles of delegation and deliberation. One would expect an approach to bank crisis resolution that uses focused legislation that emphasizes the transparency and oversight independence to impose effective conditionality by merging bank and firm restructuring. Subsequently, actors at the bank and government levels would have to develop rules to monitor one another and dedicate resources for the development of the requisite capabilities. In turn, a deliberative restructuring approach would lead to cost efficient bank crisis resolutions, a stable banking sector, and new organizational capabilities in the relevant banks and supervisory institutions.

II. Privatization and Bank Reform in the Czech Republic, Hungary, and Poland

The creation of a two-tier bank system began in 1987 for Hungary, 1989 for Poland and 1990 for the Czech Republic.⁵ The three banking sectors had similar structural problems, such as soft budget constraints and undercapitalization, but varying levels of intermediation. For instance, by 1989 domestic bank debt to GDP was 70% in Czechoslovakia, 44% in Hungary, and 30% in Poland.⁶ Between 1990 and 1992, all three countries initiated reasonably successful general stabilization and liberalization policies; similar basic laws for reform and regulation of the bank sector, with emphasis on universal commercial banking; liberalization of entry, interest rates and product markets; Basel prudential banking regulations, including a requirement for banks to have capital adequacy ratios (CARs) of 8% (immediate for new banks, a few years for state banks); and a central bank whose primary mission is currency strength and stability. While the number of banks (small domestic and foreign owned) increased rapidly, the top five state commercial and savings banks typically accounted for 60-66% of total bank assets, loans, and deposits during 1991-96. (See Table 1.) As the three governments began to sell one or two relatively small, healthy specialized (usually foreign trade) banks to foreigners and hoped to restructure and privatize their banks quickly, the solvency of the sectors came under attack by 1991-92. The collapse of the CMEA, and notably Soviet, markets, the general recessions, and the restrictive monetary and fiscal policies had led to large rapid increases in inter-firm debt and

non-performing loans reaching 25-35% of total outstanding loans (Anderson & Kegels, 1998; Borish, Ding, & Noel, 1996; Borish, Long, & Noel, 1995) (See Figure 1.) But the three countries varied in their policies toward bank crisis resolution and sectoral reform, reflecting differences in their broader approaches to the transformation of economic institutions.⁷

The Czech Republic

By the mid-1990s, the Czech Republic stood out in the region as the leader in rapid, mass privatization and monetary stability. Orthodox communist policies had left the country with a stable macro-economy, low foreign debt, poorly organized social and political groups, and a central government with virtually complete legal control of assets. Vaclav Klaus, first the Minister of Finance and then Prime Minister, ascended to power by building a coalition that used these conditions to construct a strong policy apparatus that cut itself off from potential “rent-seekers,” such as parliament and special interest groups. It weakened workers councils, dissolved administrative regional councils (blocking their re-establishment until 2000), and reduced the powers and resources of fragmented local governments. Armed with broad laws on economic transformation and privatization,⁸ the ascent of Klaus and his allies increasingly put policy control into the hands of team based in the Ministries of Finance and Privatization and allowed for the dominance of the now famous voucher method. This approach to mass privatization enabled the Czechs to privatize over 1,800 firms and four of the five main (beginning with about 50% of equity) in less than four years.

Bank sector reform followed this approach with an independent central bank and high powered economic incentives. The Czech National Bank (Czech National Bank 1999) carried the same governance foundations as the Czechoslovak Central Bank, with the governor appointed by the president and parliament approving him and the bank’s annual report. The Bank Supervision Department (BSD) was first established in mid-1991 within the central bank with primary responsibilities over bank licensing and supervision. The BSD via the CNB came to have extensive formal powers of enforcement over banks, including change management, demand changes in capital and reserves, imposing fines and forced administration, and restricting or revoking the license.

In order to minimize protracted state intervention, the Czechs aimed to resolve the bad debt stock and flow problems by separating limited restructuring from privatization via decree powers and existing privatization legislation. To solve the stock problem, the government

carved out communist era trade loans, placed them with lower interest rates and longer terms in a new state owned “hospital” (Consolidation Bank) and provided a one-time recapitalization of banks in 1991-92.⁹ To solve the flow problem, the government emphasized an abrupt change in incentives, as it continued with voucher privatization and the strict CAR schedule and modified the bankruptcy law in 1992 to focus on liquidation of problem debtors. The combination of a stronger capital base and the new incentives was to propel banks to lead the restructuring of transforming firms and lend prudently.

Hungary

Although the Hungarians used vouchers minimally, their approach to transformation and bank reform began conceptually similar with their emphasis on speed, centralized policy control, and incentives. The experiments in market socialism had left Hungary with significant macroeconomic imbalances, a burgeoning second economy, often decentralized de facto control over assets (with managers creating a myriad of cross-holding among state and quasi-private firms), and several highly organized political parties. Elected in 1990, the Antall government aimed to use privatization of firms and banks to gain revenues quickly and take control of firms from managers.¹⁰ The government had the two subsequent privatization agencies accountable directly to the prime minister and the Minister of Finance with only limited parliamentary oversight. After initial bureaucratic delays in case-by-case sales, Antall was able to use this control structure to change privatization procedures to simplify and accelerate asset sales to both Hungarians and foreigners. (Antal-Mokos, 1998; Mihalyi, 1998; Stark et al., 1998)

The National Bank of Hungary (NBH) and bank supervision were less unified and independent than their counterparts in the Czech Republic. While the governor of the NBH was appointed by the prime minister and only theoretically accountable to parliament, the NBH had to also promote the government’s economic policies. The State Banking Supervision (SBS) was created from a department in the Ministry of Finance in 1987. The SBS had the responsibilities of issuing licenses and supervision, but needed approval of the Banking Supervisory Committee (BSC) to issue any decree or standard and take any strong enforcement actions. The BSC has nine members, including high-ranking officials of the government, NBH, the SBS itself, and relevant experts from the banking community. Moreover, the NBH set up a supervision division in 1993 to perform on-site inspections and ensure compliance for short-term monetary issues (e.g., liquidity requirements, foreign exchange management).

To resolve the stock and flow problems in the banks, the Antall government avoided making bailouts conditional upon specific restructuring steps in the banks and their large debtor firms. Instead, it guaranteed a certain class of communist era loans and also recapitalized the banks via a swap of bad debt for government bonds in 1991-92. In late 1991, the government then enacted a strict bankruptcy law that forced managers with past-due debts (under the threat of criminal prosecution for non-compliance) to enter into bankruptcy negotiations with creditors or the liquidation process. As such the Hungarians believed that while rapid recapitalization would strengthen the banks and the bankruptcy law would lead to debt restructuring, the banks would quickly be ready for sale to foreign institutions.

Poland

Despite its use of “shock therapy” and a fiercely independent central bank to restore monetary stability, Polish privatization soon became viewed as incoherent and slow as well organized groups, such as Solidarity, competed for policy control and used privatization to satisfy multiple goals than simply the rapid delineation of private ownership rights. (European Bank for Reconstruction and Development., 1994; Frydman & Rapaczynski, 1994; Przeworski, 1991; World Bank., 1996) For instance, the 1990 privatization law that allowed workers councils to veto ownership changes effectively delayed a relatively limited but highly regulated Polish version of voucher privatization 1995-96. Besides some sales to foreign owners, gradual ownership change advanced often by empowering stakeholders and local governments, such as through the state-backed restructuring of the shipyards or management-employee lease-buyout options. (McDermott, 2004)

Although the National Bank of Poland (NBP) had to collaborate in implementing the government’s economic policy, its governor was appointed by the president and accountable only to Parliament. The General Inspectorate for Bank Supervision (GINB) was part of the NBP with extensive monitoring and enforcement powers, including the power to issue prudential rules that have the force of law.

Although the government stressed the sale of banks and firms where possible,¹¹ the Polish approach to bank crisis resolution was in stark contrast to the others, as it purposely tied bank restructuring and recapitalization to firm restructuring to solve the stock and flow problems together. (Montes-Negret & Papi, 1997) In 1992, the Ministry of Finance began restricting the entry of foreign banks and ordered the state banks to have international auditors identify the

worst and largest debtors, to refrain from lending to firms with doubtful or unrecoverable loans, and to begin developing loan recovery and debtor restructuring plans. The government aimed to gradually restructure the nine regional commercial banks and two national savings banks prior to privatization while forcing changes in bank operations and bank-firm relations in return for recapitalization funds.¹²

First, in the 1992 legislation for the Enterprise Bank Restructuring Program (EBRP) that became effective in March 1993, the government offered seven of the nine regional banks (which held about 60% of outstanding enterprise debt and each of which became responsible for 200-300 SOE workouts) a one-time recapitalization sufficient to deal with classified debts that originated prior to 1992. In return, the banks had to establish workout departments and had to reach a debt resolution agreement with their main debtors by March 1994, to be fully implemented by March 1996. Such an agreement allowed for 5 paths, including demonstration of full debt servicing (about 40% of the 787 total firms), debt/equity swaps, bankruptcy, liquidation, debt sale, and a new regime called “bank conciliation,” which ended up restructuring 23% of firms and 50% of debt in EBRP. Conciliation was essentially a legal framework facilitating accelerated restructuring negotiations between the firm and the main creditors.

Second, the Ministry of Finance initiated changes in the organization and capabilities of the banks. It hired Polish restructuring specialists, each of whom would direct a new workout unit (of about 15 people) in each of the banks and would receive a seat on the management board of the bank. At the same time, each bank, especially their workout units, received technical assistance from foreign specialists, namely via a twinning program that paired the Polish bank with a reputable foreign bank and via a program supported by the British Know How Fund.

Third, the Ministry of Finance set up a monitoring unit for EBRP. Besides developing relevant data bases, it used regular weekend-long meetings with the directors of the bank restructuring units and representatives of the Ministry, tax authority and the GINB to force an exchange of information, compare one another’s actions, evaluate the steps being taken, and demonstrate best and worst practices.

Table 2 summarizes key distinctions between the three countries with respect to their approaches to resolving the bank crises. Although their details differ, the Czech and Hungarian approaches are quite similar as they relied largely on self-enforcing economic incentives to resolve flow problems but avoided the conditionality of tying state assistance directly to bank

and large debtor firm restructuring. In contrast, Poland tied reorganization conditions to recapitalizations, and thus linked bank and large debtor firm restructuring.

III. Outcomes of the Different Approaches

The outcomes of these different approaches are summarized in Tables 3 and 4. While the Czechs to become the early leaders in transferring ownership of assets to private hands, the Hungarians accelerated the sale of state banks to mainly foreign banks between after 1995, followed by the Poles after 1997. But dramatic differences emerged in terms of costs to the taxpayer, bank stability and performance, and supervision development.

By the end of the 1990s, the fiscal and quasi-fiscal costs of bank restructuring for the Czech Republic were about 30% of GDP, for Hungary about 12.9%, and for Poland only 7.4%. (Tang, Zoli, & Klytchnikova, 2000) Bank sector performance indicators for the 1990s show a similar pattern. For instance, by 1998 non-performing loans remained at about 30% of total loans in the Czech Republic, but dropped to 8% in Hungary and 10% in Poland. (Tang et al., 2000) Zoli's (2001) index on improvements of the banking sector stability and lending for 1991-98 showed that the Polish banking sector significantly out performed all others in the region, followed by the Hungarian and then the Czech banking sectors.¹³ The Czech approach did little to restructure firm-bank relations but fostered an increase in lending in the mid- to late-1990s that ultimately proved unstable. The Hungarian approach did not initially encourage a change in bank operations and bank-firm relations either. A persistent decline in bank lending to firms and subsequent stability came first from the severe, automatic trigger in the bankruptcy law that existed in 1992-93 and then the restrictive lending policies of new foreign owners after 1995. Only in Poland does one see a combination of continued bank sector stability, consistent growth of bank loans to firms (largely mid-and long term loans), and increased confidence in banks (indicated by a consistent decrease in currency to deposit ratios).¹⁴

Despite the lack of systematic, comparable data for the 1990s, the pattern for the development of regulatory and supervisory institutions is similar. Indeed, this may not be so surprising, as Pistor (2001) has shown in her comparative analysis of capital market soundness, the Czechs had significantly weaker investor protection regulations and supervisory institutions than the Hungarians and Poles.¹⁵ In banking, key differences emerged in the development of monitoring activities and enforcement of risk-based provisioning. As can be seen in Table 4, Poland began to invest more rapidly and more extensively than Hungary and especially the

Czech Republic in supervisory personnel and on-site inspections of commercial banks in the early to mid-1990s. By the late 1990s, World Bank estimates showed that Poland had the highest number of professional supervisors per bank of the three. (Barth, Caprio, & Levine, 2002a, Figure 7)

As its own central bank even admitted, the approach of the Czech Republic produced a supervisory agency that was severely understaffed, lacked clear authority toward the large banks, and was late to develop on-site capabilities and off-site information systems. (CNB 1999; Matousek 1998; Pazdernik 2003) For instance, although the Czechs created rules for the classification of non-performing loans, large banks continually underreported bad debts and provisioning until 1998. When it began on-site inspections in earnest in 1994, the supervisory authority focused on weak, small banks rather than problems in the largest banks that presented the greatest risk. By the end of the 1990s, a World Bank analysis showed that the Czech banking sector ranked lower than the Hungarian and Polish sectors in key measurements of the effectiveness capital regulations, loan class stringency, private monitoring, and disclosure. (Barth et al., 2002a) As late as 2001, the IMF concluded that Czech bank supervision was still at a developmental stage. (IMF, 2000)

Hungarian supervision lacked focus, capacity and authority for much of the 1990s. The divided structure of bank supervision described above led to turf battles and a lack of independent authority to force changes in bank behavior and establish adequate information systems for consistent off-site supervision. Moreover, these divisions led the SBS to underdevelop its on-site capabilities, relying often on the NBH staff and external auditors for inspections. (Borish et al 1996, p88-89) Despite reforms triggered by the new banking acts of 1996 and 1998 and the dominance of foreign banks after 1995, weaknesses remained. The SBS had a relatively low number of professional supervisors per bank, had problems retaining trained and experienced supervisors (especially compared to Poland),¹⁶ and could not prevent the collapse in 1998 of Postabank, the second largest retail bank that had substantial private (Hungarian) ownership. (Abel, 2002; Petrick, 2002) While the IMF praised the Hungarian bank sector for its gains in systemic stability and supervisory capabilities in 2001, it noted continued shortcomings in risk assessment and supervisory autonomy. (IMF, 2001a)

Despite their concerns about delayed bank privatization and restricted foreign entry, outside experts have given Poland high marks in its organization of inspections and risk

assessment (IMF, 2001b; Tang et al., 2000), early focus on building the GINB's capacity, and empowerment of the GINB to issue legally binding resolutions to banks. In declaring that the GINB "represents one of the strengths of Poland's overall financial infrastructure and institutional capacity," Michael Borish, a former World Bank analyst, explained in his USAID report on Polish banking that these efforts

[I]ed not only to a better regulatory framework, but the adoption of an increasingly integrated approach to banking supervision, based on comprehensive policy coordination, full-scope and targeted on-site examinations, and off-site surveillance focused on regular reports on areas of greatest risk.... It has avoided the weaknesses found in many other neighboring supervisory agencies, such as inadequate coordination between/among differing authorities, reluctance to use on-site inspections, reluctance to apply enforcement mandates, and inability to retain competent and trained personnel. (Borish 1998, Section 1.3)

Moreover, according to recent World Bank estimates, Poland scored the highest of the three countries in its Private Monitoring Index and disclosure rules, two of the most significant determinants of bank sector development. (Barth et al., 2001, 2002a)

In sum, the Czech approach led to a collapse of the banking sector in the wake of the Russian crisis in the late 1990s and weak regulatory and supervisory institutions. The Hungarian approach led initially to multiple bank bailouts and a continued decline in lending, but bank stability and supervision improved after the sale of bank assets to strategic foreign investors. The Polish approach led to the lowest fiscal cost in the region, a stable bank sector with expanding credit, and sound supervisory institutions.

IV. Explaining the different paths

How can one explain these contrasting outcomes in bank crisis resolutions and prudential bank supervisory capabilities? Typical reference market based incentives, a strong central bank, or prior social conditions may not prove so helpful here. For instance, not only did the Czech use of rapid privatization and liberalization potentially undermine bank governance, but also the Polish bank sector developed stably despite significant state ownership of bank assets. Although the Czech's had an internationally praised central bank, its monetary authority did not translate into investment into regulatory institutions.¹⁷ Despite having by far the most experienced bank professionals of the region prior to 1990, Hungary appeared to mis-manage bank restructuring. (Anderson et al., 1998)

More useful explanatory categories may be depoliticization versus deliberative restructuring. The paths of crisis resolution and institutional development depend largely on the

degree to which political approaches to transformation facilitate or impede the ability of relevant public and private actors to learn from and monitor one another. Depoliticization impedes the development of bank and supervisory capabilities, since the emphasis on speed and insulated policy making power prioritizes the use of rules based on self-enforcing incentives but overrides any interest in imposing conditionality and developing the ability to monitor bank activities. (See Tables 2 and 4.) Deliberative restructuring begins with a suspicion of methods based on bureaucratic directives or arms-length incentives. Conditionality combines incentives with means of acquiring new knowledge and changes in the organization of the bank. The priority is placed on creating adequate monitoring capabilities, which in turn opens up a process of disciplined interaction between public and private actors that enhances learning and investment of resources into the relevant institutions.

The Czech Republic: Extreme Depoliticization

The Czech Republic is the clearest example of the depoliticization approach to transformation. As noted above and elsewhere (McDermott, 2002, 2004), the political rise of Vaclav Klaus and his coalition solidified the model of insulating a powerful group of technocrats focused on macro-economic stability and the rapid implementation of market incentives. A combination of a rapid, mass transfer of ownership rights to private hands, a one-time recapitalization, liberal market entry rules, and a strict bankruptcy law that focused on liquidation were to lead the main banks to restructure or cut off problem firms and reorganize their operations appropriately.

Yet this approach undermined the development of the banks and supervision. First, the so-called incentives for change simply reinforced the reluctance by the main banks to be proactive with the most important firms. The inter-dependence between the main banks and especially troubled manufacturing firms would deepen, but the banks were incapable and unwilling to lead restructuring. Bankruptcy would be a fast track to a wave of liquidations and cripple the banks' stability. (Mitchell, 1998) The main banks chose rather to roll over existing loans. (McDermott 2002, 2004) In the wake of the Russian crisis in 1998, the solvency of the largest manufacturing firms and the banks became increasingly tenuous, leading to their virtual re-nationalization and re-privatization by the newly Social Democrat government in 1999.

Second, the development in bank regulatory supervision suffered. Although the central bank was given strong independence in monetary policy and established legal norms in line with

Basel recommendations, the policies of recapitalization, partial debt removal, and rapid privatization hardly involved the nascent supervisory department and did not compel the government or the central bank to invest in personnel and monitoring resources. The big banks met their 8% CAR by late 1994 and that was sufficient. Until 1994, the main banks even had ample discretion in classifying non-performing loans, as the Ministry of Finance did want the Bank Supervisory Department to interfere and delay bank privatization. When the CNB expanded supervisory activities in 1994, the supervision department focused mainly on smaller banks since resources and trained staff were limited and the weaknesses of the smaller banks were the most visible. At the same time while the CNB demanded uniform classification of non-performing loans, the main banks continued to battle the over-stretched supervisory department over the proper valuation of collateral and proper provisioning. (Czech National Bank 1999; Pazderník, 2003)

Depoliticization had become a double-edged sword, as it retarded investment in institutional capacities and defined the Klausian government's hold on political power. On the one hand, the Czech approach did little to change bank behavior toward firms, other than take defensive strategies, and undermined the supervisory department's ability to confront the greatest systemic risks brewing in the main banks. On the other hand, the Czech approach tied the Klausian's political future to the outward stability of the dominant banks, with their weak assets and mismanaged investment funds. Any new policies would have damaged his government's *raison d'être*, empowered institutions not under Klaus's direct control, and brought parliament back into policymaking and oversight.¹⁸ Indeed, for these reasons, Klaus had blocked new policy initiatives coming out of firm restructuring experiments directed by the Ministry of Industry and Trade and diluted reforms to capital markets regulations and bankruptcy.¹⁹ Only after the Klaus government fell in 1997 did the supervisory department enforce stricter provisioning rules, bringing to light the true fragility of the sector. But even further privatization could not make up for the weak institutions. For instance, although the caretaker government sold its remaining 30% of equity in Investicni Postovni Banka, the second largest bank, to Nomura Securities in early 1998, the bank collapsed as a looted shell in 2000.

Hungary: Moderate Depoliticization

While the Hungarians did not pursue voucher privatization like the Czechs, they did adhere to depoliticization tenets of insulated power and speed. (Stark and Bruszt 1998, Chs. 5 &

6) The Antall government diminished the importance of maximizing revenue and transparency in favor of accelerating privatization. Privatization agencies, the Banking Supervisory Commission, and even the Governor of the NBH came under increased control of Antall's office and his Minister of Finance, while policy toward the banks was a matter of decree rather than legislation.²⁰ Consequently, the Hungarian approach to bank restructuring was much more similar to the Czech approach than to the Polish approach, as can be seen in Table 2. The basic aim of the Hungarian government was to recapitalize the main state commercial and savings banks and then privatize them to foreign investors. A recapitalization would solve the stock problem, while new incentives would solve the flow problems, but without any clear link between bank and firm restructuring.

First, the various bank recapitalizations lacked any effective conditions on banks. The first bailouts were noted for their lack consistent definitions of loans to be guaranteed or swapped and lack of any demands on banks to change operations, management, or relations with firms. (Anderson et al., 1998; Borish et al., 1996) The attempts in 1992-94 to demand that banks generate restructuring plans for problem debtor firms in return for bond swaps resulted in a small number of firms and amount of outstanding debt being restructured. The plans suffered from incoherent guidelines on debt and firm selection as well as consistent efforts by the Antall team to accelerate privatization of non-financial firms. The repeated interventions by different ministries and privatization agencies in firm selection and restructuring negotiations undermined bank interest and the authority of a newly proposed monitoring unit in the Ministry of Finance. (Baer & Gray, 1996; Balassa, 1996; Borish et al., 1996, pp.56-57; Tang et al., 2000)

Second, the government believed the draconian bankruptcy law in 1992 would offer sufficient incentives for the banks to engage in restructuring, yet this was not to be the case. Hardly any banks initiated or participated in actively in bankruptcy procedures, rather only firms did – as debtors and creditors. The most important impact of the law before the automatic trigger was repealed in 1993 was that it had forced a large number of firms into bankruptcy, exacerbated the insolvency of firms and the main commercial banks, and reinforced an existing decline in lending and economic growth.²¹ In turn, the Hungarian approach to bank restructuring only exacerbated moral hazard dilemmas and undermined the change in bank behavior and investment in new capabilities.²²

Hungarian depoliticization also undermined the development of supervisory capabilities. On the one hand, the lack of conditionality for the bailouts limited the involvement of the SBS and even the NBH in defining the terms of debt selection and in monitoring bank activities. On the other hand, the dual focus of accelerating firm privatization and protecting government discretionary power allowed the prime minister and his cabinet to intervene in restructuring issues and exacerbated the already murky authority and mandate of the contending supervisory agents. (Indeed, despite its interest in the bankruptcy regime, the government was slow to invest in relevant judiciary capacity. (Bonin & Shaffer 2002)) Consequently, supervision capabilities in terms of on-site and off-site inspections and skilled personnel suffered. (Borish et al., 1996)

Similar to the Klausians, the Antall government was increasingly constrained by its wedlock to the tenets of speed and insulated policy-making power. Tying bank and firm restructuring as well as investing into supervision would have forced the government to include parliament in new laws and oversight activities, clarify its relationship to the NBH, and alter its privatization goals and timeline. The turning point for Hungarian bank sector development came in 1994-95, namely with the election of a new government led by Gyula Horn. Without anymore funds for further bank restructuring and looking to score points at home and abroad, Horn accelerated the privatization of the banks, which were now recapitalized enough to make them attractive to international investors. The foreign owners effectively stabilized the banks and brought in new risk management and organizational systems. Moreover, once relieved from bank restructuring and under renewed pressure from the new owners, the multi-laterals (with the leverage of needed restructuring loans), and the EU, the government could focus on putting its supervisory and regulatory system in order. The new banking law in 1996 brought important regulatory changes and began a process of consolidating supervisory activities and improving the authority and resources of the SBS.

Poland: Deliberative Restructuring

As can be seen in Table 2, Poland's approach to the bad debt crisis was starkly different, as it consistently scored high marks in terms of transparency and conditionality. As Zoli (2001) points out, Poland tied bank recapitalization and debt removal to restructuring of bank and firm operations as well as broader bank sector institutions. But why was the Polish mode of conditionality so important in changing bank behavior and building regulatory institutions? And why was Poland able to implement it where the others did not or could not?

Bank sector policies should be seen as part of a larger approach to transformation and ownership change. The political set-backs to rapid mass privatization in 1990 perhaps inadvertently led the government to pursue various methods of linking ownership change with restructuring. As analyzed elsewhere (McDermott, 2004), these methods had the common principles of empowering certain public and private actors to restructure assets while providing a framework that facilitated risk sharing and mutual monitoring. For instance, the 1990-91 government began experimenting with restructuring large, distressed firms like in shipbuilding by offering partial financial assistance and property rights to relevant suppliers, creditors, work councils and local governments in exchange for the creation and execution of coherent reorganizational plans. The 1990 law also spurred on one of the most popular and successful methods of ownership change by allowing a majority of employees and managers buy-out their own firms with the help of a low-interest loan. Approval and monitoring of such projects became the responsibilities of the Ministry of Ownership Transformation and the 49 regional administrations (voivodships). These are just two examples whereby the Polish government provided a framework for firms and banks to reorganize their commercial relations and for public actors at the national and regional levels to experiment with new roles in the economy.

Bank crisis resolution followed a similar approach. Stefan Kawalec, the Deputy Finance Minister who spear-headed the reforms, believed that simply using incentives from rapid privatization and bankruptcy laws would do little to change bank behavior and build modern banking skills; centralized administration of bad debts would create a stifling bureaucracy. (Kawalec, Sikora, & Rymaszewski, 1995) Rather, EBRP linked recapitalization with organizational changes in the banks, clear rules and deadlines on debt identification and firm restructuring plans, as well as technical assistance from international experts. In order to evaluate the decentralized actions taken by banks and firms, the Kawalec team established the principles of delegation, multi-party risk sharing, and deliberative or participatory governance. After receiving the restructuring authority and the basic criteria of EBRP, the lead managers of the workout departments of the seven banks met together at least one weekend per month for over a year with relevant representatives of the Finance Ministry, the Privatization Ministry, the Central Bank's supervisory division, and the state auditor. In these meetings, the banks had to reveal how they were and were not making progress in the restructuring of their own balance sheets and the distressed firms.

Notice that by combining delegation and deliberation, in turn learning and monitoring, the government was effectively aiding both the banks and public agents to experiment with new methods and roles of problem solving. The collective, iterative evaluation process created a constant flow of information, which government officials and bank managers used to compare and rate one another's actions over time, detect flaws, limit favoritism, and negotiate updated terms of workouts. The deliberations allowed the banks to learn from one another the pitfalls and benefits of different restructuring methods and the government actors to learn how to improve their own auditing and monitoring techniques.

A similar negotiation process with creditors, firms, and regional public officials took place in the creditor councils for the firms. While some have criticized the uneven impact of EBRP on bank lending and firm restructuring (Bonin & Leven, 2000; Gray & Holle, 1998), the program overall helped banks gain valuable direct experience early on in changing their relationships with key firms (from change management to the privatization of 84 firms) and developing new practices, such as in investment banking, risk management, and small firm lending. (Belka & Krajewska, 1997; Gray et al., 1998; Montes-Negret et al., 1997; Pawlowicz, 1995; Pinto & van Wijnbergen, 1995) For instance, analyses of the turnaround at the state commercial bank in the heavily industrialized region of Lodz (Dornisch 1997, 2000; Lachowski 1997) note that the negotiations between the regional bank, voivodship (as the founder of the firms), the local tax office, and firm management led to new channels of information sharing. As the voivodship learned to forge compromises between the bank and firms, the three parties extended workout negotiations to include the gradual reorganization of supply networks. As a result, the EBRP framework not only helped large firms and their suppliers redefine the terms of their common production lines, but also led the bank to develop new services. The Lodz bank soon developed successful regional equity and venture capital funds out of its workout department and became a model for implementing advanced risk management systems. As Pawlowicz (1995 a, b) shows, Lodz was not the only bank in developing asset management capabilities and actively seeking new strategic owners for previously distressed client firms. This bank and others also developed special write-off provisions in EBRP for small and medium sized firms that were suppliers to the large firms.

The regulatory institutions also benefited. First, by including the banking supervisors and the state auditors in the program and the deliberations, both groups began to learn directly how to

collect off-site inspection information and conduct on-site inspections. For instance, as can be seen in Table 4, the supervision authority began to shift from comprehensive inspections to many narrower inspections. This may have improved the efficient use of resources, and it appears consistent with the notion that innovation and capabilities development under uncertainty can often be best achieved incrementally through frequent smaller experiments than large, time-consuming, incoherent projects. (Argote et al., 2000; Helper et al., 2000; MacDuffie, 1997; Sabel, 1994) Moreover, auditors and supervisors deployed resources both centrally and at the regional level, which improved the use of decentralized knowledge while testing the effectiveness of broader evaluation and feedback methods. (McDermott 2004) Second, by committing itself publicly and legally to bank restructuring with delayed privatizations, the government was forced to invest in relevant personnel and systems early on. The Polish supervisory authority became a leader in the region from the early 1990s by expanding rapidly its staff, implementing extensive training programs, retaining experienced supervisors, publishing guidelines, and having the de jure and de facto authority to enforce new prudential rules. (Borish, 1998; Borish et al., 1996)

In sum, I classify the Polish approach as deliberative restructuring in both the narrow and broad meanings of the term. By imposing conditionality on the banks and their major debtors, the Polish government sought to ensure compliance without interfering in the details. In turn, monitoring via deliberations occurred at two levels – between the government actors and the banks and between the banks and their debtor firms. The monitoring rules forced the frequent exchange of information to promote mutual evaluation, transparency, and learning. At a broader level, Poland did not seek to insulate concentrated government power for rapid changes based on incentives alone, as did the Czech Republic and Hungary. Rather, Poland appears to have been able to achieve some balance of transparency and accountability with operational coherence and discretion. Privatization and bank restructuring programs were authorized by law, making them accountable to Parliament and not simply the Prime Minister’s office. The NBP and supervisory office have relatively strong clear authority in regulating banking activities, but they respond to the Parliament and President. The rules set in EBRP allowed outsiders to track in fairly fine detail the uses of public funds and the measures taken by the banks.²³ These legal foundations indeed may have well been vital in allowing EBRP and the SBS to continue to develop even as governments and coalitions rose and fell.²⁴

Concluding remarks

This article has attempted to show how the structure of policy-making power shapes the development of institutional capabilities. It has argued that institutional development depends largely on whether political approaches to transformation facilitate or impede the ability of public and private actors to experiment with new roles and learn to monitor one another. In doing so, it also has argued for categorizing these approaches as ones of depoliticization versus deliberative restructuring instead of analyzing institution building solely in terms of state versus the market, autonomy versus embeddedness, or passive versus active.

The article has illustrated the relative strengths of this framework in an examination of the policies impacting the resolution of bank crises and the development of banking supervision in Hungary, Poland and the Czech Republic. To different degrees, Hungary and the Czech Republic, typified a depoliticization approach by emphasizing speed and insulated policy-making power, and, in turn, relied largely on rapidly implanting new self-enforcing economic incentives to affect changes in bank behavior. The new incentives alone did not offer the banks a coherent framework of conditionality to facilitate the risk-sharing and information exchange needed to change relations with large firms and build new organizational capabilities. At the same time, relevant public actors were given scant opportunities or resources to gain oversight experience and invest in needed skills.

Poland appears to have followed a path of deliberative restructuring because of the way it combined monitoring and learning in placing significant reorganizational conditions on banks in return for recapitalization. By attempting to resolve the stock and flow problems together, and thus linking bank and large firm restructuring, Poland employed the principles of delegation and deliberation. The government gave relevant bank and public actors the incentives and authority for restructuring and oversight. It also provided a forum for these actors to engage in frequent disciplined deliberations that helped them learn how to develop new capabilities of monitoring and financing. Subsequently, the supervisory body gained valuable experience and invested rapidly in new skills and systems.

By casting institutional development as an experimental process, this article has argued that institutional analysis focus less on ideal policy incentives or on social preconditions and more on the political conditions that would more or less likely advance the governance of institutional learning. A basic conundrum in development is how the process of political

governance can allow public and private actors to develop new capabilities and roles without cycling into bureaucratic suffocation or self-dealing. Deliberative restructuring approaches may have the advantage of micro-level governance structures that combine mutual monitoring and learning. But identification of the background political architecture fostering and stabilizing that approach is less clear. The evidence in this article suggests that that grounding areas of institutional changes in specific legislation may aid the balance of accountability and authoritative discretion. For instance, the reformist governments of Hungary and the Czech Republic avoided specific legislation on bank crises and increasingly sought to insulate their control over relevant policies. This approach may be good for the speed of initial changes, but not in making transparent and informed adjustments. In contrast, Poland had legislation that empowered specific actors and provided a means for oversight of the attendant activities. Such a conclusion would be consistent with recent research on regulation and the political economy of development. (Henisz & Zelner, 2004; Levy & Spiller, 1996; Montinola, 2003) While legislation often enables parliamentary oversight and institutional independence, increased political constraints may indeed facilitate change, even in the face of failures, by improving the likelihood of compromises, transparency, and broad based alliances. (Stark and Bruszt 1998, Montinola 2003) The rub may not be, however, the number of veto points, but rather the *process* that guides interaction among policymakers and stakeholders, thus their ability to develop credible means of mutual monitoring. (Sabel 1996, Stark and Bruszt 1998) Greater emphasis on process indeed coincides with recent research in comparative finance that finds limited significance of typical institutional structural variables in explaining cross-country variation of bank sector performance. (Barth et al., 2001; Barth, Dopico, Nolle, & Wilcox, 2002b; Barth et al., 2003)

Analyzing both political structural and process variables shaping institutional development can also help evaluate the trade-offs and their relative importance on the path initiated. (Kitschelt, 2003) That is, any political approach translates into constraints for a government and commitment to a set of goals. Depoliticization in general can actually be more politically constraining. The more the government becomes identified with rapid, narrow solutions, the more its political identity is damaged with publicly observed adjustments and delays. Moreover, more pragmatic approaches, such as conditionality, would demand investing in new institutional resources and open up a government's hold on power. Adjustment might

only come after another crisis and change in administrations, such as in the Czech Republic, and somewhat in Hungary. On the other hand, deliberative restructuring still has its costs, as certain areas of policy may be delayed. Indeed, as the first set of institutional experiments take root in a fruitful fashion, governments may mistakenly believe that the delayed policy areas may be less important. After taking power in 1993, the socialist government in Poland further delayed bank privatization and removal of previously temporary restrictions on foreign bank entry. Change in these policies came only after strong pressure from the multilaterals and the EU. (Epstein, 2001)

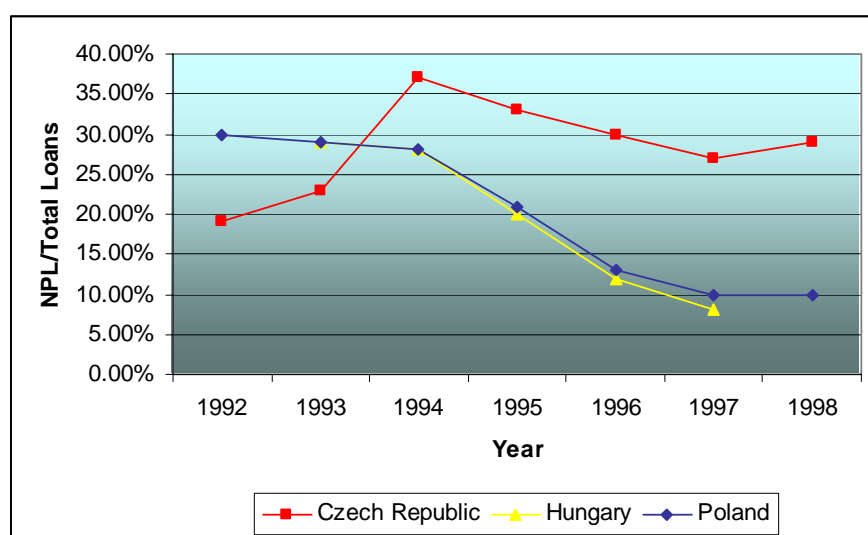
With the ongoing expansion eastward of EU membership, it will again be tempting to consider institutional change as simply a function of ideal designs and the facility to copy them. Whether one is analyzing the collapse Argentine financial institutions or fragility of Chinese banks, the tendency is to frame the problem in terms of the “wrong” design or the lack of will or proper culture to complete the “right” design. This article suggests such approaches are misguided. As Jacoby (2000, 2001) shows, institutional imitation is helpful triggering exploration and locally nested innovations. Students of the history of US finance may not be so surprised either, as recent research has emphasized the evolution of public-private institutions experimenting with better ways to manage the socialization of risk. (Lamoreaux 1994, Moss 2002) Researchers and policymakers alike would therefore be wise to focus on the governance such experiments and the process of institutional learning.

of Table 1. **Number of Banks (excluding cooperative banks) and Bank Intermediation**

		1993	1995	1997
Czech Republic	No. of Banks	45	55	50
Hungary		40	42	41
Poland		104	83	83
Czech Republic	Banks/Mln people	4.4	5.3	4.9
Hungary		3.9	4.1	4
Poland		2.3	2.1	2.1
Czech Republic	M2/GDP	68.4	78.6	69.9
Hungary		55.4	48.4	46.5
Poland		35.9	33.9	37.3

Sources: BIS, Tang et al. (2001), IMF.

Figure 1. Non Performing Loans in Banks



Sources: Tang et al. (2001)

Table 2. Major Differences Between Approaches to Bank Crisis Resolution

	Czech Republic	Hungary	Poland
Specific Law on Bank Crisis	No	No	Yes
Bank restructuring tied to improvements in supervision and regulation	No	No	Yes
Bank restructuring tied to enterprise restructuring	No	No	Yes
Recapitalization/write-offs linked to change of mgmt at banks	No	No	Yes
Recapitalization/write-offs linked to bank operational restructuring	No	No	Yes
Clear demarcation between old and new	Yes	No	Yes
Repeated Recapitalizations b/n 1991 & 1994	No	Yes	No
Inadequate recapitalization/failure to improve liquidity b/n 1991 & 1994	No	Yes	No

Sources: Toli (2001), Borish et al. (1996), Author's interviews.

Table 3: Divergence in Privatization (1995) and Bank Restructuring Costs (2000)

	% of GDP in Private Hands	% of Industrial Output in Private Hands	% of Bank Assets w/in State Banks	Bank Restructuring Costs to Govt & Central Bank (% of GDP)
Czech Republic	70	93	19.5	30.2
Hungary	60	65	62.8	12.9
Poland	60	60	71.1	7.4

Sources: EBRD (1998), Pohl et al. (1997), World Bank (1996), Tang et al. (2000), IMF Reports.

Table 4. Differences in Employment and Inspections at Supervisory Authorities

	1992	1993	1994	1995	1996
No. of Supervisory Employees					
Czech Republic	31	27	60	70	85
Hungary	100	96	101	n.a.	102
Poland	380	447	470	474	473
- o/w at HQ	104	135	143	146	150
- o/w at regional branches*	277	312	327	328	323
No. of Supervisory Employees per bank					
Czech Republic		0.6	1.09	1.27	1.60
Hungary [^]	2.85	2.4	2.35	n.a.	2.49
Poland [^]		5.13	5.73	5.85	5.84
No. of On-site Inspections at Commercial Banks					
Czech Republic	n.a.	n.a.	10	15	8
Hungary - Total	18	7 (+ n.a.)	17	18	26
- o/w Comprehensive	7	7	11	10	n.a.
- o/w Targeted	11	n.a.	6	8	n.a.
Poland - Total	325	n.a.	528	484	181
- o/w Comprehensive	325	n.a.	32	31	12
- o/w Targeted	n.a.	n.a.	496	453	169

Sources: All data from the supervisory authorities of respective countries.

Notes: * - Employees at regional branches also monitor small cooperative banks. [^] No. of banks does not include the many, small agricultural cooperative banks.

References

- Abel, I. 2002. Real Dangers in Banking Crises: Examples of Failed Hungarian Banks. In K. Petrick (Ed.), Banking and financial stability in Central Europe : integrating transition economies into the European Union: 153-175. Cheltenham, UK: Edward Elgar.
- Aghion, P., Bolton, P., & Fries, S. 2002. On the Design of Bank Bailout Policy in Transition Economies. In A. V. Thakor (Ed.), Designing financial systems in transition economies : strategies for reform in Central and Eastern Europe: 37-58. Cambridge, Mass.: MIT Press.
- Amsden, A. H. 1989. Asia's next giant : South Korea and late industrialization. New York: Oxford University Press.
- Anderson, R. W. & Kegels, C. 1998. Transition banking : financial development of Central and Eastern Europe. Oxford, UK: Oxford University Press.
- Antal-Mokos, Z. 1998. Privatisation, politics, and economic performance in Hungary. New York: Cambridge University Press.
- Argote, L. & Darr, E. 2000. Repositories of Knowledge in Franchise Organizations. In S. G. Winter (Ed.), The nature and dynamics of organizational capabilities: 51-68. Oxford ; New York: Oxford University Press.
- Baer, H. L. & Gray, C. W. 1996. Debt as a Control Device in Transitional Economies. In A. Rapaczynski (Ed.), Corporate governance in Central Europe and Russia: 2 v. Budapest: Central European University Press.
- Balassa, A. 1996. A magyar bankrendszer konszolidacioja es jelenlegi helyzete, National Bank of Hungary Working Papers No. 10. Budapest.
- Barth, J. R., Caprio, G., & Levine, R. 2001. Bank regulation and supervision what works best?, Working Paper No. 2725. Washington, D.C.: World Bank Development Research Group Finance and Financial Sector Strategy and Policy Department.
- Barth, J. R., Caprio, G., & Levine, R. 2002a. The regulation and supervision of banks around the world a new database. World Bank, Development Research Group, Finance, and, Financial Sector Strategy and Policy Department, Washington DC.
- Barth, J. R., Dopico, L. G., Nolle, D. E., & Wilcox, J. A. 2002b. An International Comparison and Assessment of the Structure of Bank Supervision. Corporate Finance Review, 6(6): 9-34.
- Barth, J. R., Nolle, D. E., Phumiwasana, T., & Yago, G. 2003. A Cross-Country Analysis of the Bank Supervisory Framework and Bank Performance. Financial Markets, Institutions & Instruments, 12(2): 67-120.

- Belka, M. & Krajewska, A. 1997. The Polish Bank and Enterprise Restructuring Programme: Debt/Equity Swaps Survey Results, CERT Discussion Paper No. 97/14. Edinburgh: Centre for Economic Reform and Transformation.
- Bonin, J. & Wachtel, P. 1999. Toward Market-Oriented Banking in the Economies in Transition. In M. Skreb (Ed.), Financial sector transformation: lessons from economies in transition: 93-131. New York: Cambridge University Press.
- Bonin, J. & Shaffer, M. 2002. Revisiting Hungary's Bankruptcy Episode. In A. V. Thakor (Ed.), Designing financial systems in transition economies : strategies for reform in Central and Eastern Europe: 59-100. Cambridge, Mass.: MIT Press.
- Bonin, J. P. & Leven, B. 2000. Can Banks Promote Enterprise Restructuring?: Evidence From a Polish Bank's Experience, William Davidson Institute. Working Paper No. 294.
- Borish, M. S., Long, M., & Noel, M. 1995. Restructuring banks and enterprises : recent lessons from transition countries. Washington, D.C.: World Bank.
- Borish, M. S., Ding, W., & Noel, M. 1996. On the road to EU accession: financial sector development in Central Europe. Washington, D.C.: The World Bank.
- Borish, M. S. 1998. An Assessment and Rating of the Polish Banking System, United States Agency for International Development/ENI/PER. Washington D.C.
- Caprio, G. & Klingebiel, D. 1996. Bank insolvencies: cross country experience, Policy Research Working Paper 1620: 52. Washington, DC: World Bank Policy Research Dept. Finance and Private Sector Development Division.
- Czech National Bank , C., Prague. 1999. Zpráva o cinnosti bankovního dohledu v České republice, CNB Report for Parliament. Prague.
- Dosi, G., Nelson, R. R., & Winter, S. G. 2000. Introduction: The nature and dynamics of organizational capabilities. In S. G. Winter (Ed.), The nature and dynamics of organizational capabilities. New York: Oxford University Press.
- Ekiert, G. & Hanson, S. E. 2003. Time, Space, and Institutional Change in Central and Eastern Europe. In S. E. Hanson (Ed.), Capitalism and democracy in Central and Eastern Europe: assessing the legacy of Communist rule: xiii, 375. New York: Cambridge University Press.
- Epstein, R. A. 2001. International Institutions and Domestic Policy: Depoliticization and Denationalization in Postcommunist Poland. Cornell University, Ithaca.
- European Bank for Reconstruction and Development. 1994. Transition report. London: European Bank for Reconstruction and Development.

- European Bank for Reconstruction and Development. 2000. Transition report. London . European Bank for Reconstruction and Development.
- Evans, P. 2004. Development as Institutional Change: The Pitfalls of Monocropping and the Potentials of Deliberation. Studies in Comparative International Development, 38(4): 30-52.
- Evans, P. B. 1995. Embedded autonomy : states and industrial transformation. Princeton, N.J.: Princeton University Press.
- Frydman, R. & Rapaczynski, A. 1994. Privatization in Eastern Europe : is the state withering away? Budapest: Central European University Press.
- Glick, R., Moreno, R., & Spiegel, M. M. 2001. Financial crises in emerging markets. New York: Cambridge University Press.
- Gray, C. W. & Holle, A. 1998. Poland's Bank-Led Conciliation Process. In I. Hoshi (Ed.), Enterprise exit processes in transition economies : downsizing, workouts, and liquidation: 249-275. Budapest: Central European University Press.
- Haggard, S., Lee, C. H., & Maxfield, S. 1993. The Politics of finance in developing countries. Ithaca: Cornell University Press.
- Haggard, S. & Maxfield, S. 1996. The Political Economy of Financial Internationalization in the Developing World. International Organization, 50(1): 35-68.
- Helper, S., MacDuffie, J., & Sabel, C. 2000. Pragmatic collaborations: advancing knowledge while controlling opportunism. Industrial & Corporate Change, 9(3): 443.
- Henisz, W. & Zelner, B. 2004. Legitimacy, Interest Group Pressures and Change in Emergent Institutions: The Case of Foreign Investors and Host Country Governments. Academy of Management Review, Forthcoming.
- Hoelscher, D. S. & Quintyn, M. 2003. Managing systemic banking crises. Washington DC: International Monetary Fund.
- IMF. 2000. Czech Republic: Banking Supervision, Report on the Observance of Standards and Codes (ROSC). Washington DC.
- IMF. 2001a. Hungary, Report on the Observance of Standards and Codes. Washington DC.
- IMF. 2001b. Republic of Poland: Financial System Stability Assessment, IMF Country Report No.01/67. Washington DC.
- Jacoby, W. 2000. Imitation and Politics: Redesigning Germany. Ithaca: Cornell University Press.

- Jacoby, W. 2001. The Imitation-Innovation Trade-Off: Does "Borrowing Dull the Edge of Husbandry"? Comparative Political Studies, 34(3): 263-293.
- Johnson, J. 2001. Path Contingency in Postcommunist Transformations. Comparative Politics: 253-274.
- Kawalec, S., Sikora, S., & Rymaszewski, P. 1995. Polish Program of Bank and Enterprise Restructuring: Design and Implementation, 1991-1994. In S. Kawalec (Ed.), Bank rehabilitation and enterprise restructuring: 43-50. Ljubljana, Slovenia: Central and Eastern European Privatization Network.
- Kitschelt, H. 2003. Accounting for postcommunist regime diversity: what counts as a good cause? In S. E. Hanson (Ed.), Capitalism and democracy in Central and Eastern Europe: assessing the legacy of Communist rule: xiii, 375. New York: Cambridge University Press.
- Klingebiel, D. & Laeven, L. (Eds.). 2002. Managing the real and fiscal effects of banking crises. Washington, D.C.: World Bank.
- Kogut, B. & Zander, U. 1992. Knowledge of the Firm, Combinative Capabilities, and the Replication of Technology. Organization Science: A Journal of the Institute of Management Sciences, 3(3): 383.
- Levy, B. & Spiller, P. T. (Eds.). 1996. Regulations, institutions, and commitment : comparative studies of telecommunications. New York: Cambridge University Press.
- MacDuffie, J. P. 1997. The road to `root cause': Shop-floor problem-solving at three auto assembly plants. Management Science, 43(4): 479.
- McDermott, G. A. 2002. Embedded politics: industrial networks and institutional change in postcommunism. Ann Arbor: University of Michigan Press.
- McDermott, G. A. 2004. Institutional Change and Firm Creation in East-Central Europe: An Embedded Politics Approach. Comparative Political Studies, 37(2): 188-217.
- Meyendorff, A. & Thakor, A. V. (Eds.). 2002. Designing financial systems in transition economies : strategies for reform in Central and Eastern Europe. Cambridge, Mass.: MIT Press.
- Mihalyi, P. 1998. A magyar privatizáció krónikája 1989-1997 [The chronicle of privatisation in Hungary 1989-1997]. Budapest: Közgazdasági és Jogi Könyvkiadó.
- Mitchell, J. 1998. Bankruptcy Experience in Hungary and the Czech Republic, William Davidson Institute Working Paper No. 211. Ann Arbor.
- Montes-Negret, F. & Papi, L. 1997. The Polish Experience in Bank and Enterprise Restructuring, Working Paper 1705. World Bank, Washington, D.C.

- Montinola, G. R. 2003. Who Recovers First? Banking Crises Resolution in Developing Countries. Comparative Political Studies, 36(5): 541-574.
- Moon, C. & Prasad, R. 1994. Beyond the Developmental State: Networks, Politics, and Institutions. Governance, 7(4): 360-386.
- Nelson, R. R. & Winter, S. G. 1982. An evolutionary theory of economic change. Cambridge, Mass.: Belknap Press of Harvard University Press.
- Pawlowicz, L. E. 1995. Financial Restructuring of Enterprises and Banks, The Gdansk Institute for Market Economics. Gdansk.
- Pazderník, R. 2003. Banking Supervision in Transition: Czech Experience 1990-2000. Unpublished Diploma Thesis, Charles University, Prague.
- Petrick, K. 2002. Hungarian Banking in Transition. In K. Petrick (Ed.), Banking and financial stability in Central Europe : integrating transition economies into the European Union: 125-149. Northampton, MA: Edward Elgar.
- Pinto, B. & van Wijnbergen, S. 1995. Ownership and Corporate Control in Poland: Why State Firms Defied the Odds, CEPR Discussion Papers: 1273.
- Pistor, K. 2001. Law as a Determinant for Equity Market Development: The Experience of Transition Economies. In P. Murrell (Ed.), Assessing the value of law in transition economies. Ann Arbor: University of Michigan Press.
- Przeworski, A. 1991. Democracy and the market : political and economic reforms in Eastern Europe and Latin America. New York: Cambridge University Press.
- Quinn, D. P. & Inclan, C. 1997. The Origins of Financial Openness: A Study of Current and Capital Account Liberalization. American Journal of Political Science, 41(3): 771-813.
- Sabel, C. 1994. Learning by Monitoring: The Institutions of Economic Development. In R. Swedberg (Ed.), The Handbook of economic sociology. New York: Princeton University Press ; Russell Sage Foundation.
- Stark, D. & Bruszt, L. 1998. Post-Socialist Pathways: Transforming Politics and Property in Eastern Europe. New York: Cambridge University Press.
- Tang, H., Zoli, E., & Klytchnikova, I. 2000. Banking Crises in Transition Economies: Fiscal Costs and Related Issues, World Bank. Washington, D.C.
- Winter, S. G. 2003. The Satisficing Principle in Capability Learning. In C. E. Helfat (Ed.), The SMS Blackwell handbook of organizational capabilities : emergence, development, and change. Malden, MA: Blackwell Pub.

World Bank. 1996. From Plan to Market. New York: Oxford University Press.

World Bank. 1999. Czech Republic : capital market review. Washington, D.C.: World Bank.

World Bank. 2000. Czech Republic : completing the transformation of banks and enterprises. Washington, D.C.: World Bank.

Zander, U. & Kogut, B. 1995. Knowledge and the Speed of the Transfer and Imitation of Organizational Capabilities: An Empirical Test. Organization Science: A Journal of the Institute of Management Sciences, 6(1): 76.

Zoli, E. 2001. Cost and Effectiveness of Banking Sector Restructuring in Transition Economies, IMF Working Paper.

Endnotes

¹ See, for instance, (European Bank for Reconstruction and Development., 1994, 2000; World Bank., 1996, 1999, 2000).

² There is a vast literature here, but see especially, (Ekiert & Hanson, 2003; Jacoby, 2000; Johnson, 2001; McDermott, 2002; Montinola, 2003; Quinn & Inclan, 1997).

³ In addition to secondary and government data sources, this article draws on a series of 15-20 semi-structured interviews I conducted in each country during 2001-2003 with relevant bank manager, supervisory directors, and policymakers.

⁴ See McDermott (McDermott, 2002) for a discussion of depoliticization views as they appear in economics, rational choice, and developmental statism. The critique draws on observations by Mood and Prasad (1994), Grindle (1991), and Murrell (1993). For examples see Shleifer and Vishny (1994), Sachs (1990), and Haggard and Kaufman (1992, 1995).

⁵ Although Czechoslovakia (CSFR) split in January 1993, I focus on the Czech Republic. There was strong continuity in policy for the Czech lands before and after the split, as the main economic policy makers for the CSFR and the Czech Republic remained largely the same. The temporary shared policy control and state ownership by the Czechs and Slovaks of two major banks, Czechoslovak Savings Bank and the Obchodni Banka (for foreign trade), did not dampen the vigor of the Czech policy apparatus's approach to privatization and restructuring.

⁶ The variation in banking intermediation was due to different methods the communist governments used to finance the working and investment capital of state firms as well as the macroeconomic imbalances (fiscal deficits and high inflation) in Hungary and Poland. The persistence of these differences through the 1990s, however, did not necessarily reflect relative strengths in capital markets development for firm finance. For instance, the region's most vibrant and liquid stock, Poland's, did not effectively begin until after 1996.

⁷ Unless cited otherwise, the following description of the reforms of the central banks, bank supervision, and bank crisis policies are from Anderson and Kegels (1998), Borish et. al. (1996), and EBRD (1995).

⁸ I speak mainly about the 1990 law on Economic Transformation and the 1991 law on Large Privatization. For details see McDermott (2002, Ch.3).

⁹ Although the recapitalization occurred in two stages, the method and sources signalled an effort to avoid signalling multiple bailouts. See McDermott (2002, Ch. 3).

¹⁰ Hungary's liberalization in the 1980s had allowed managers to take control of assets through "spontaneous privatization" (often viewed as a form of asset stripping) and to create dense networks of inter-firm equity and debt ties. (Stark and Bruszt 1998)

¹¹ The government actually planned to privatize the banks within 3 to 5 years as a form of incentive to the bank managers and as a concession to the multilaterals to provide funds for the restructuring program, EBRP, to be discussed below. The SLD government, elected in 1993, would, however, delay bank privatization further.

¹² Although EBRP focused on the 7 regional commercial banks, the framework extended with time to the 3 largest national specialized banks. (Borish et al., 1996; Pawlowicz, 1995) The Following also draws on Gray and Holle (1998) and Montes-Negret and Papi (1997).

¹³ Zoli's index is the average of the increase in credit to the private sector, increase in M2-to-GDP ratio, decline in the central bank credit to banks, decline in the currency-to-deposit ratio, decline in M1-to-M2 ratio, decline in the share of non-performing loans following the resolution of banking sector problems. (Zoli 2001, Figure 4)

¹⁴ See, for instance, Anderson and Kegels (1998), Borish, Ding and Noel (1996), Zoli (2001), EBRD (1998), Tang et al. (2000), and Bonin and Shaffer (2002).

¹⁵ Rogowski (2004) notes that officers of the GINB also worked closely with the stock market regulator; and that the GINB prohibited bank supervisors from taking jobs in the regulated banks.

¹⁶ For a critical analysis of the authority and capacity of the Hungarian supervisory structure, see Borish et al 1996. Data on the professional supervisors per bank, supervisor tenure, and the likelihood of a supervisor moving into banking can be found in Barth et al. 2001, Figures 7, 18, and 19. According the Barth et al. 2001 and the CNB, by 2000, average tenure of bank supervisors was: Czech Republic – 6.4 years, Hungary – 5 years, and Poland – 9.5 years.

¹⁷ Indeed, recent research shows little significant impact of central bank independence on banking and regulatory development. (Barth et al., 2001; Barth, Nolle, Phumiwasana, & Yago, 2003)

¹⁸ The general laws on privatization and bank regulation were passed in parliament. Any changes to previously approve regulations and privatization project would demand parliamentary action and oversight. (McDermott 2002)

¹⁹ For fuller discussions of these issues, see McDermott (2002, Chs 4 & 5).

²⁰ While the nine board members came from the NBH, the SBS, the government, bank sector representatives, and outside experts, the prime minister held considerable influence on the appointments. (Borish et al 1996, p. 98)

²¹ The only saving grace of the law was unforeseen: for various legal reasons, the so-called “liquidation” path became the only vehicle for firms to enter into workout negotiations with their creditors that advanced restructuring. Nonetheless, the banks were largely absent. (Bonin & Shaffer, 2002; Mitchell, 1998)

²² For a similar line of reasoning see Stark and Bruszt (1998, pp.149-153). They argue that the assertions of control over assets and policy by the Antall government did little to change bank behaviour or develop institutional capacity.

²³ See for instance the fairly detailed studies on EBRP by the World Bank and Polish institutes. (Gray et al., 1998; Montes-Negret et al., 1997; Pawlowicz, 1995)

²⁴ The SLD government came into power in the late 1993 for four years.

DAVIDSON INSTITUTE WORKING PAPER SERIES - Most Recent Papers

The entire Working Paper Series may be downloaded free of charge at: www.wdi.bus.umich.edu

CURRENT AS OF 11/11/2004

Publication	Authors	Date
No. 726: The Politics of Institutional Learning and Creation: Bank Crises and Supervision in East Central Europe	Gerald A. McDermott	Nov. 2004
No. 725: International Business and Development Economics: A Winning Combination	Tamir Agmon	Nov. 2004
No. 724: Importing High-Risk Capital and Revealing Hidden Comparative Advantages	Tamir Agmon	Oct. 2004
No. 723: Which entrepreneurs expect to expand their businesses? Evidence from survey data in Lithuania	Ruta Aidis and Tomasz Mickiewicz	Oct. 2004
No. 722: Russia from Bust to Boom: Oil, Politics or the Ruble?	Bruno Merlevede and Koen Schoors	Oct. 2004
No. 721: Distance to the Efficiency Frontier and FDI Spillovers	Klara Sabirianova Peter, Jan Svejnar, and Katherine Terrell	Sept. 2004
No. 720: An Analysis of Gender Wage Differentials in Russia from 1996-2002	Rita Hansberry	Sept. 2004
No. 719: Returns to Schooling in Russia and Ukraine: A Semiparametric Approach to Cross-Country Comparative Analysis	Klara Sabirianova Peter and Yuriy Gorodnichenko	Sept 2004
No. 718: The emergence of large shareholders in mass privatized firms: Evidence from Poland and the Czech Republic	Irena Grosfeld and Iraj Hashi	Aug. 2004
No. 717: Wage Determination Under Communism and In Transition: Evidence from Central Europe	Swati Basu, Saul Estrin and Jan Svejnar	Aug. 2004
No. 716: The Evolution of Cross-Region Price Distribution in Russia	Konstantin Gluschenko	July 2004
No. 715: Languages in the European Union: The Quest for Equality and its Cost	Jan Fidrmuc and Victor Ginsburgh	July 2004
No. 714: Voice of the Diaspora: An Analysis of Migrant Voting Behavior	Jan Fidrmuc and Orla Doyle	July 2004
No. 713: International Coercion, Emulation and Policy Diffusion: Market-Oriented Infrastructure Reforms, 1977-1999	Witold J. Henisz and Bennet A. Zelter and Mauro F. Guillen	July 2004
No. 712: Votes and Vetoes: The Political Determinants of Commercial Openness	Witold J. Henisz and Edward D. Mansfield	July 2004
No. 711: Interest Groups, Veto Points and Electricity Infrastructure Deployment	Witold J. Henisz and Bennet A. Zelter	July 2004
No. 710: Firms' Price Markups and Returns to Scale in Imperfect Markets: Bulgaria and Hungary	Rumen Dobrinsky, Gábor Kőrösi, Nikolay Markov, and László Halpern	July 2004
No. 709: The Stability and Growth Pact from the Perspective of the New Member States	Gábor Orbán and György Szapáry	July 2004
No. 708: Contract Violations, Neighborhood Effects, and Wage Arrears in Russia	John S. Earle and Klara Sabirianova Peter	July 2004
No. 707: Determinants of Employment Growth at MNEs: Evidence from Egypt, India, South Africa and Vietnam	Sumon Kumar Bhaumik, Saul Estrin and Klaus Meyer	July 2004
No. 706: Economic Reform in Tanzania and Vietnam: A Comparative Commentary	Brian Van Arkadie and Do Duc Dinh	June 2004
No. 705: Beliefs about Exchange-Rate Stability: Survey Evidence from the Currency Board in Bulgaria	Neven T. Valev and John A. Carlson	June 2004
No. 704: Returns to Schooling in China Under Planning and Reform	Belton M. Fleisher and Xiaojun Wang	June 2004
No. 703: Return to Skills and the Speed of Reforms: Evidence from Central and Eastern Europe, China and Russia	Belton M. Fleisher, Klara Sabirianova Peter, and Xiaojun Wang	June 2004
No. 702: What Makes Small Firms Grow? Finance, Human Capital, Technical Assistance, and the Business Environment in Romania	J. David Brown, John S. Earle and Dana Lup	May 2004
No. 701: The Effects of Multiple Minimum Wages Throughout the Labor Market	T. H. Gindling and Katherine Terrell	May 2004