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# **Challenges of Financial System Development in Transition Economies**

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## Challenges of Financial System Development in Transition Economies

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# "CHALLENGES OF FINANCIAL SYSTEM DEVELOPMENT IN TRANSITION ECONOMIES"

Stefan Kawalec and Krzysztof Kluza

## ABSTRACT

The paper looks at three segments of the financial sector: banks, corporate debt market, and equity market. The main conclusions could be summarized as follows:

- *Transition economies have much smaller financial sectors than developed economies. However, there are dramatic differences in the relative size of the financial sector among transition countries.*
- *The very small relative size of the financial sector in transition economies coincides with:*
  - *Very high cumulative inflation over the past 10 years;*
  - *High cumulative GDP contraction over the past 10 years;*
  - *Weak legal and institutional financial sector infrastructure;*
  - *low GDP per capita.*
- *Financial sector structure in transition economies differs from that in developed countries:*
  - *Banking sectors, although relatively small, usually dominate financial sector in transition economies as other financial sector segments are even less developed.*
  - *Compared to developed economies, stock market capitalization in transition economies is lower in relation to GDP and in most cases, also in relation to the aggregated financial sector size. However, there are countries where market capitalization is quite significant.*
  - *Corporate debt markets in transition economies are hugely underdeveloped and in most countries they hardly exist.*
- *Transition economies with the biggest financial systems do not always have the healthiest and most efficient system:*
  - *Countries with relatively the biggest banking sectors overburden their banks with a stubbornly high share of non-performing loans.*
  - *Although in some countries stock market capitalization is quite impressive as a result of "coupon privatization," the effective ability to raise capital through share issues in transition economies is limited.*

- *Except for a few countries in transition economies, there is a lack of trusted and appropriate savings/investment instruments for individuals. It hinders the growth of financial systems, hampers economic development and constitutes a source of instability for transition economies.*
- *Actions in several fields are necessary to build confidence in a domestic financial system:*
  - *Accounting and auditing standards should be brought fully in line with international standards.*
  - *Creditor and investor rights should be adequately protected.*
  - *Tax rules should be clear-cut without room for discretion for tax administration. Tax authorities should not have excessive privileges over other creditors.*
  - *Independent, strong and decisive financial sector supervision is a must.*
  - *Macroeconomic policies should sound and stable.*
  - *Unresolved banking crises should be dealt with decisively and in a way inspiring confidence.*
  - *Banks should be privatized and separated from politics and government influence.*
- *Reform of the pension system through the creation of privately managed pension funds may have a substantial impact on capital market development and thus contribute to the improvement of the financial sector structure.*

## INTRODUCTION

Transition economies are the economies of the former socialist countries, and states of the former Soviet Union, that in the early 1990s started the transformation of their economies from a socialist to a market system. Building a market type financial sector constituted a key element in these transformation efforts. However, after a decade of these transitions, the results and the experience is mixed. Most transition economies still have a long way to go to built a robust and efficient financial system.

This paper tries to assess the present situation of the financial sector in transition economies and discusses what are, and how to face, the challenges that lie ahead. We look at three segments of the financial sector: banks, corporate debt market, and equity market. Based on the experience of developed countries we formulate some observations as to the role of these segments in the financial sector and the economy as a whole. Then we discuss the actual role of these segments in transition economies and future challenges. Findings are formulated in the form of twenty concise observations, some of which are supported by statistical analysis presented in the form of charts.

It should be underlined that our observations mostly describe the prevailing features of the financial sectors in the whole group of 28 transition countries in Europe and Central Asia. Some of these observations may not apply to a few central European countries that have the most robust financial sectors.

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## I. FINANCIAL SYSTEM IN MARKET ECONOMIES – BANK DOMINATED VERSUS CAPITAL MARKET ORIENTED SYSTEMS

A healthy financial system should:

- generate an adequate level of population's savings;
- allocate these savings to efficient uses;
- provide efficient tools of corporate control.

We can distinguish two main patterns of financial sector structure in developed economies.

- Bank dominated financial sector—individuals predominately keep their savings in banks which are the main source of external financing for the corporate sector. Banks are also the dominant investors in equity and corporate debt markets since stocks, bonds and commercial papers function as bank products, supplementary to loans.
- Capital market oriented financial sector—bank deposits are not the dominant savings/investment instruments for individuals. Individuals invest directly in the capital market buying stocks and corporate debt instruments, and to a growing extent, invest through non-bank intermediaries like pension funds or investment funds. Accordingly, banks play a smaller role in financing the corporate sector than capital and corporate debt markets dominated by non-bank investors<sup>1/</sup>.

For years many observers praised the advantages of the bank dominated model. However, the flaws of this model were widely acknowledged in the nineties. There is also growing evidence that underdevelopment of the stock market may hamper an economy's ability to restructure in response to technological changes<sup>2/</sup>.

We may easily risk the views formulated in the following observations:

### **Observation 1**

*Banking sector, corporate debt market and equity market play an important role in the financial sector. None of these segments should be discriminated or underdeveloped.*

### **Observation 2**

*For healthy development of equity and corporate debt markets, it is advisable that banks do not dominate these markets. To achieve this goal, non-bank financial intermediaries are necessary, as well as a broad group of individual investors.*

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<sup>1</sup> /Mellyn and Saal (1998)

<sup>2</sup> /Hale (2000)

## **II. GOALS IN FINANCIAL SECTOR REFORMS AT THE START OF TRANSFORMATION FROM A SOCIALIST TO A MARKET SYSTEM**

Bank deposits were the only officially available savings/investment instruments for individuals in socialist economies. The exclusive source of external financing for the enterprise sector was bank credit, provided on the basis of investment and production decisions by central planning bodies. Banks themselves did not take credit allocation decisions and did not need to evaluate credit risk. Thus, there were no equity and corporate markets and although institutions called banks existed, they were rather government agencies having little to do with modern commercial banking institutions. We can note the following observation:

### **Observation 3**

*At the start of the transformation, goals in the financial sector could be summarized as follows:*

- replace the monobank system with a genuine banking system,
- create equity and corporate debt markets from scratch.

Over the past 10 years financial systems in transition countries have undergone dramatic changes as a result of the successes and failures of macro- and micro-economic reforms and changes in the institutional framework. Today, the shape of financial sectors in transition economies varies significantly as far as relative size, structure, health and efficiency are concerned.

## **III. THE PRESENT SHAPE OF FINANCIAL SYSTEMS IN TRANSITION ECONOMIES: SIZE, STRUCTURE, HEALTH AND EFFICIENCY**

We distinguish three segments of the financial sector: banks, corporate debt market, and equity market. As indicators of the size of these segments we take accordingly:

- value of bank deposits,
- value of outstanding corporate debt instruments (corporate bonds and commercial papers)
- stock market capitalization.

The aggregated sum of these three components can be regarded as a proxy for the size of the financial system. We will compare financial sector structure and its relative size (in relation to GDP) in transition economies and selected developed economies, and we will discuss the health and efficiency of the financial sector in transition economies.

### **3.1. Financial sector relative size**

The financial sector relative size as a percentage of GDP in OECD countries and in transition economies is presented accordingly on Charts 1 and 2. While the non-weighted average for the financial sector size in OECD economies is 198%, this relation for transition economies is 34%. The relative size of the financial sector in OECD economies ranges from 100% to 450% the only exception of Mexico having about 50%. The range for transition economies is from 2% to 89%.

#### **Observation 4**

*In transition economies the relative size of the financial sector is on average much smaller than in developed economies.*

#### **Observation 5**

*There are dramatic differences in the relative size of the financial sector among transition countries.*

Chart 3 illustrates the relation between the relative size of the financial sector in transition economies in 1998 and the cumulative inflation in 1989-1998. The trend line drawn shows that the higher cumulative inflation coincides with the smaller financial sector's relative size. The coefficient of 0.77 indicates a strong statistical relation.

Chart 4 illustrates the relation between the size of the financial sector in 1998 and the cumulative GDP change in 1989-1998. The trend line drawn shows that the higher the cumulative GDP contraction the smaller the financial sector's relative size. The coefficient of 0.57 indicates a moderate statistical relation. On this chart, the primary privatization method for each country is indicated as depicted by EBRD<sup>3</sup>/. It is worth noting that out of nine countries with dominance of voucher privatization, all but one have their financial sectors bigger than implied by the trend (located on the right side of the trend line on the chart). On the other hand, most of the countries with dominance of other privatization methods (direct sale or management/employee buy-outs) have their financial sectors smaller than implied by the trend. It may be interpreted that *ceteris paribus* voucher privatization contributes to a bigger size of the financial sector.

The statistical relation with cumulative GDP change is stronger when we focus on a key component of the financial sector i.e. the banking sector which is shown on Chart 5. The trend line drawn shows that the higher the cumulative GDP contraction the smaller the banking sector's relative size. The coefficient of 0.71 indicates a strong statistical relation.

Chart 6 illustrates the relation in 1998 between the relative size of the financial sector and the average EBRD grade of progress of reforms in the financial sector<sup>4</sup>/. The trend line drawn shows that the smaller the progress in financial sector reforms the smaller the financial sector's relative size. The coefficient of 0.58 indicates a moderate statistical relation.

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<sup>3</sup> / European Bank for Reconstruction and Development (1999)

<sup>4</sup> / Op. Cit.

Chart 7 illustrates the relation between the relative size of the financial sector in 1998 and the level of economic development in the same year, measured by GDP per capita. The trend line drawn shows that the smaller the level of economic development the smaller the financial sector's relative size. The coefficient of 0.48 indicates moderate statistical relation. The relation becomes stronger when we focus on a key component of the financial sector i.e. the banking sector which is shown on Chart 8. The trend line drawn shows that the smaller the level of economic development, the smaller the banking sector's relative size. The coefficient of 0.66 indicates strong statistical relation.

We may then formulate the following observation.

### **Observation 6**

*The very small relative size of the financial sector in transition economies in 1998 usually coincides with:*

- (a) very high cumulative inflation over the preceding 10 year period;
- (b) high cumulative GDP negative change over the preceding 10 year period;
- (c) weak legal and institutional financial sector infrastructure;
- (d) low GDP per capita.

Observation 6 describes statistical relations which in themselves do not explain the cause-effect relation.

In general, we may assume that the small size of the financial sector is rather an effect than a cause of inflation, GDP decline, weak institutional framework and low GDP per capita. One may also say that circumstances (such as economic policies, external shocks and civil wars) that constituted the cause of continuing high inflation and prolonging economic decline, triggered escape from domestic currency, and did not create a climate for the development of equity and debt capital markets.

Very often deep the GDP decline is a reflection of a significant shift from official to unofficial ("gray") economy where funds are neither kept in, nor transferred through banks within the reach of the government or the tax authorities. An example of such a situation is Ukraine, where in 1998 official GDP in real terms account for 37% of 1989 level, the relative size of "gray" economy is reported to be extremely high and bank deposits constitute barely 8% of GDP<sup>5</sup>.

In some cases however, sudden financial sector contraction causes a surge of inflation and a severe GDP decline. In Bulgaria, in 1996, a mounting bad debt problem undermined confidence in the banking system and led to a run on banks and escape from domestic currency. Inflation skyrocketed, domestic currency money declined in real terms to less than one sixth of the pre-crisis level. Real GDP dropped cumulatively by 18% over two years 1996 and 1997.

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<sup>5</sup> / See: Sultan and Mishev (1999)

### 3.2. Financial sector structure

#### Observation 7

- *Compared to developed economies, transition economies usually have banking sectors smaller in relation to GDP. However, these small banking sectors usually dominate the financial sector in transition economies as other financial sector segments are even less developed.*
- *Compared to developed economies, stock market capitalization in transition economies is lower in relation to GDP and in most cases, also in relation to the aggregated financial sector size. However, there are countries where market capitalization is quite significant.*
- *Corporate debt markets in transition economies are hugely underdeveloped and in most countries they hardly exist.*

Chart 9 illustrates that in developed economies all three financial sector segments play significant roles. Bank deposits account on average for 35% of financial sector size, 49% for stock market capitalization and 16% for corporate debt.

Chart 10 shows that in most transition economies the financial sector is dominated by bank deposits which account, on average, for 63% of the financial sector size. Stock market capitalization account on average for 35%. There are, however, several countries (Moldova, Lithuania, Kazakhstan and the Kyrgyz Republic) where stock market capitalization represents 60-80% of the financial sector size. Corporate debt markets are noticeable in only a few countries and on average have a rather marginal share of 2% of the total financial sector size.

### 3.3. Financial sector health and efficiency

The size of the financial sector and its particular segments is not always a good indicator of its contribution to the economic growth. Looking at the financial system's health and efficiency we will analyze separately the banking sector and the equity market. We will not discuss the corporate debt market because of its marginal significance in the transition economies.

#### Observation 8

*The shapes of banking sectors differ dramatically among transition countries and three typical groups can be distinguished.*

- (a) *The first group, composed mostly of former CIS<sup>6</sup>/ countries exemplified by Russia and Ukraine, has extremely small banking sectors as the result of the deep deterioration of banking balance sheets. There is a lack of confidence in banks and their role as financial intermediaries is very limited. The fundamentals for efficient banking sector have yet to be created in these countries.*
- (b) *The second group exemplified by the Czech Republic and Slovakia consists of countries with the most sizable but unhealthy banking sectors, where banks are overburdened with a stubbornly high share of bad debts. However, stable macroeconomic policies and firm government support to the banking sector in these countries have made it possible to maintain confidence in banks and avoid system destabilization. The intermediary role of banks in these countries is very significant although with negative effects on efficiency: banks allocate savings to non-efficient uses and provide non-efficient tools of corporate control.*
- (c) *The third group exemplified by Hungary, Poland, and Estonia consists of countries that have relatively small banking systems but that are healthy and growing. These countries overcame banking crisis in the first half of 1990s, without undermining the confidence in banks. They created healthy fundamentals for the banking systems and privatized the bulk of banking assets with the participation of foreign strategic investors.*

#### **Observation 9**

*In some transition economies stock market capitalization is quite significant. However, this indicator may be misleading. In part of the countries stock market capitalization is inflated as a result of voucher privatization. In some countries, strategic holdings, mostly by foreign investors or state treasury, represent the bulk of market capitalization. The actual role of the stock market as a source of capital for domestic companies is very limited.*

Unfortunately, we do not have comparable data on the amount of capital (as percentage of GDP) raised by companies through new share issues—which would be an important indicator to judge the stock market contribution to economic growth. Fragmented evidence indicates that ability to raise capital through primary share offering for companies in transition economies is very limited—much lower than data on market capitalization would suggest.

#### **Observation 10**

*Except for a few countries in transition there is a lack of trusted and appropriate savings/investment instruments for individuals. It hinders the growth of financial systems, hampers economic development and constitutes a source of instability for transition economies.*

Except for a few countries in the Central European and the Baltic region, banks and capital markets in transition economies dramatically lack public confidence. People feel that the official financial sector does

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<sup>6</sup> / CIS - Commonwealth of Independent States includes former republics of the Soviet Union except the Baltic States (Estonia, Latvia and Lithuania).

not offer them any trusted and appropriate savings/investment instruments. In shortage of such instruments, individuals may follow several strategies:

- to increase spending - which on a macroeconomic level translates into higher consumption and lower savings rate;
- to invest abroad - which translates into capital flight and less domestic savings available to finance investments in country;
- to invest in gray economy - which translates into less saving available to finance investment in the official economy;
- to keep money under mattresses - which translates into less savings available for investments in the country.

All in all, a lack of an appropriate savings/investment instrument hinders the growth of the financial system and results in less savings available for financing investments in official economy which has a negative impact on the official GDP growth.

In cases where foreign capital inflows substantially compensate for low domestic savings as a source of financing for corporate and government sector, the small size of the domestic financial systems in relation to foreign flows, makes the economies vulnerable to financial and currency crisis.

## **IV. CHALLENGES FOR FUTURE DEVELOPMENT**

After 10 years of transformation, most transition economies still have a long way to go to create a robust and efficient financial system. Actions in several fields should be vigorously implemented to build long-term confidence in domestic financial system.

### **4.1. Accounting and auditing standards**

A number of transition economies made great progress in bringing their national accounting and auditing standards broadly in line with International Accounting Standards (IAS), and International Standards on Auditing (ISA). There are, however, still material differences between national and international standards.

#### *Consolidated basis*

A very important weakness of prudential regulations, reporting and auditing standards in transition countries is the lack or insufficient level of consolidation requirements. This makes it difficult for banking supervision to supervise on a fully consolidated basis and some problems may be swept away by banks

into their affiliates<sup>7</sup>/. Without full consolidation not only the public and supervisors may be misled, but also bank management may not properly understand the risks borne by their institutions.

#### *Application of "substance over form" rule*

One of the most important shortcomings of the accounting regulations in transition countries is the precedence of the legal form of a transaction over its commercial substance.<sup>8</sup>/. The application of "substance over form" rule is one of the most important tools against unfair reporting practices. This tool is unavailable to auditors in most transition countries<sup>9</sup>/.

The introduction of the "substance over form" rule is getting more urgent as transactions become more complicated and their economic substance is being changed by derivative instruments. Presentation of accounts based on the legal form of transactions may often be misleading. In these circumstances banking supervisors, who may always have difficulties catching up with innovations in the commercial sector, would find it difficult to assure adequate enforcement of *the substance* of prudential regulations.

#### *Application of "truth and fairness" principle*

Auditing regulations in transition economies emphasize compliance with regulations and do not provide the auditor with an overriding principle of "truth and fairness" which is key in ISA, and constitutes an important tool to counter practices which formally comply with, but are against the spirit of the regulations.

### **Observation 11**

*Accounting and auditing standards should be brought fully in line with international standards: companies should be obliged to present fully consolidated accounts; the "substance over form" rule as well as an overriding "truth and fairness" principle should be applied.*

## **4.2. Legal framework**

### *Protection creditor rights*

In order to carry out their business banks need to have the ability to secure their loans with various types of collateral and be able to quickly seize the collateral in case of loan default. Bankruptcy procedures

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<sup>7</sup> / "...the implementation of these regulations on solo rather than a consolidated basis enables banks to bypass the spirit whilst operating within the 'letter of the law' should they so choose." FITCH IBCA (1998), p.2.

<sup>8</sup>/ Cunningham (1998).

<sup>9</sup> / Concept of "substance over form" left out of accounting legislation is usually recognized in tax legislation, see: op. cit.

should allow creditors to effectively recover loans through liquidation. In addition to the proper legal framework, there is a need for efficient courts and other institutions to assure that creditors' rights are effectively exercised.

### *Protection of shareholders rights*

Shareholders need adequate information about the company's standing and they should have an effective possibility to put their representatives as non-executive directors (supervisory board members) and to change management. Any privileged transactions, transferring value to insiders (dominant shareholders, management or employees) at the expense of the company's shareholder value, should be properly disclosed and pre-approved by shareholders. Minority shareholders' rights should be protected from abuse by dominant shareholders.

The EBRD survey on corporate governance in transition economies supports the view that while many laws in the region theoretically provide a sound basis for protection of shareholders' rights, the implementation and enforcement of these laws is lagging<sup>10/</sup>.

### *Excessive privileges of tax authorities*

Effective tax collection is a prerequisite of macroeconomic stability and a level playing field in business activity. However, excessive privileges of tax authorities should not be treated as an easy substitute for an efficient tax system and an effective tax administration.

When banks act as tax collectors and any transfers coming into bank accounts are automatically taken over for payments of any tax or wage arrears, than firms tend to avoid transacting through banks<sup>11/</sup>. If the tax authorities have priority over secured creditors, the value of secured loans is undermined.

Long term investors' confidence can hardly be build if companies' financial situations may be unexpectedly affected by discretionary actions by tax authorities.

#### **Observation 12**

*Laws and law enforcement institutions should protect adequately creditor and investor rights.*

#### **Observation 13**

*Tax rules should be clear-cut without room for discretion for tax administration. Tax authorities should not have excessive privileges over other creditors. In case of dispute with tax authorities taxpayers should have an effective possibility to appeal to court.*

### **4.3. Financial sector supervision**

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<sup>10/</sup> / Ramasastry, Slavova and Bernstein (1999).

<sup>11/</sup> See: Sultan and Mishev (1999).

Independent, strong and decisive supervision is a necessary condition for building confidence in the financial sector. The growth of the relative size of the financial sector further increases the macroeconomic risk of a financial sector crisis and thus increases requirements for proper regulation and effective supervision.

#### **Observation 14**

- (a) Independent strong and decisive supervision is a necessary condition for building confidence in the financial sector.*
- (b) In order to become more effective the financial sector supervision should be very focused, putting as much responsibilities as possible on the private sector and market discipline; public disclosure requirements should be strengthened and responsibilities of auditors expanded<sup>12</sup>.*
- (c) Interdependency among various financial sector segments calls for organizational integration under one roof of regulatory institutions, in order to make regulation more consistent and effective, as well as diminish industry's cost of dealing with regulators.*
- (d) Financial sector supervision needs very good professional staff which has to be adequately remunerated. To enable this, financial sector supervision could be financed by special fees paid by the financial industry.*

#### **4.4. Macroeconomic stability**

In case of high inflation financial assets are likely to lose part of their real value. When unsound macroeconomic policies result in currency crisis and/or default of government domestic debt, (as happened in Russia in 1998), losses incurred by capital market investors as well as bank depositors may be very severe. Once the confidence is lost it requires years to rebuild it.

#### **Observation 15**

*Long term growth of the financial sector requires sound and stable macroeconomic policies.*

#### **4.5. Dealing with unresolved banking crises**

For most transition countries, the priority is to lay down institutional fundamentals to allow the development of banking sectors and their growth from an exceptionally small relative size.

For some countries a pressing need is to deal with the banking crisis which means the situation where the high share of non-performing assets threatens the liquidity or solvency of a significant part of the banking sector. A banking crisis especially constitutes an acute problem if it happens in a country with a relatively sizable banking sector, like the Czech Republic, Slovakia, Croatia or Romania<sup>13</sup>.

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<sup>12</sup> / See: Kawalec (1999) p. 33-34.

<sup>13</sup> / See: Kawalec (1999) and *Banka* (2000).

A banking crisis affects the economy in various ways. It undermines overall confidence in the economy and causes misallocation of resources. It may result in a major banking destabilization when major banks lose liquidity and/or there is a bank panic resulting in downsizing of the banking sector's balance sheet. Such destabilization is likely to be connected with a drop in GDP (as in Bulgaria in 1996 and 1997). Even if a one-off destabilization is avoided, an unresolved banking crisis undermining the confidence in banks and threatening their liquidity, may contribute to the systematic erosion of banking balance sheet (as it happened in Romania). A prolonged banking crisis, even if it neither destabilizes nor erodes banking sector, is likely to ultimately have a deep negative impact on economic growth as in the Czech Republic and Japan. If a banking crisis is dealt with both decisively and in a way that inspires confidence, the disruptive impact on economic growth may be minimized. The recapitalization of banks, however, usually requires significant budgetary resources<sup>14/</sup>.

#### **Observation 16**

*For a group of countries facing banking crises, the pressing need is to deal with these crises both decisively and in a way that supports not undermines confidence.*

#### **4.6. Bank privatization**

Political influence in the selection of the management and in credit and investment decisions adversely affect bank efficiency, assets quality and confidence in banks. Governments should withdraw themselves as owners and must not influence bank business decisions. In a shortage of decent domestic investors understanding banking business, involvement of reputable foreign banks as shareholder in local banks in transition economies is warranted.

#### **Observation 17**

*Banks should be privatized and separated from politics and government influence. The key objective of bank privatization should be to create the best conditions for long term development, soundness and efficiency of the privatized institution.*

#### **Observation 18**

*A specific task still not carried out in a number of transition economies is restructuring and privatization of former specialized savings banks.*

#### **4.7. Pension system reform – opportunities and risks for the capital markets**

All transition countries face the challenge of developing capital markets which would play a significant role in providing funds to the corporate sector and constitute an effective instrument of corporate control. A pension system reform—of the type introduced in Chile in the 1980s or in Poland in 1999—creates a stream of mandatory savings which is channeled into specially created privately managed pension funds.

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<sup>14/</sup> / Opinions on various ways of bank recapitalization and restructuring are presented in: Kawalec (1999) p.30-31, and Simoneti, Kawalec (1995).

This might constitute a substantial cure for weak domestic investors base and for a lack of long term portfolio investors<sup>15</sup>/. Pension funds may soon become very significant investors, increasing dramatically the domestic capital market capacity to absorb new issues. Pension reform creates tremendous opportunities for the capital market development. There are however, associated risks.

- A risk concerns an introduction of pension reform when legal and institutional framework for capital markets is too weak. If investors' rights are not protected and there is a lack of transparency, and a lack of effective supervision, then widespread fraud might undermine realizable value of pension funds' investments. As a result, confidence of the pension fund members could be destroyed and it may lead to dangerous frustration.
- A negative return from pension funds' investments may also be caused by high inflation or a financial crisis as a consequence of unsound macroeconomic policies.
- Another risk concerns the possibility of a stock market price "bubble" if growing investments of pension funds constitute too big a part of stock market free float. Stock prices might rocket up dramatically exceeding any conceivable estimates of the fundamental value connected with future earnings. Sooner or later a price "bubble" has to end with a market crash, meaning a dramatic loss of the value of the investments.

In order to diminish the risk of a price bubble, there is a need for the growing availability of assets in which pension funds would be eligible to invest. Technically the easiest way would be to increase the percentage of the pension funds' assets that may be invested abroad and limit the percentage that may be invested in the domestic market. However, in case of transition countries that have domestic savings deficiency and huge domestic investment needs, it does not seem to be rational to create a force saving scheme in order to export capital. Another easy solution would be to force pension funds to invest the bulk of their assets in the government debt. This would, however, dilute the macroeconomic sense and diminish benefits of the pension fund reform. Thus other solutions should be preferred.

Privatization policy may contribute to the growth of the stock market free float, through more privatization transactions and preferences to IPO as opposed to direct sales or employee buy-outs.

It is also critical to increase the availability of eligible attractive debt instruments. It requires adequate regulations concerning commercial papers, corporate bonds and municipal bonds, as well as mortgage securities and other asset based securities. On the other side it requires an adequate regulatory policy allowing pension funds to invest a substantial portion of their assets into various non-government debt instruments.

### **Observation 19**

*Reform of the pension system through the creation of privately managed pension funds may have a substantial impact on capital market development and thus, contribute to the improvement of financial sector structure. However introduction of pension reform when legal and institutional*

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<sup>15</sup> / Introduction of funded pension schemes was presented as "Single most important decision Baltic governments can make to support equity culture", Hansabank Markets (2000), p.9.

*framework for capital markets is too weak and/or macroeconomic policies are unsound may result in an embarrassing failure.*

**Observation 20**

*Pension reform, creating a growing stream of force savings channeled into capital market, may contribute to a stock market price “bubble”. To diminish this risk there is a need for growing availability of assets eligible for pension funds to invest in. To this end, privatization polices should aim at increasing stock market free float. It is also critical to increase the availability of eligible attractive debt instruments.*

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