Japan's Main Bank System

and

The Role of the Banking System in Restructuring and Privatizing State Enterprises in Transitional Socialist Economies

Satoshi Sunumura
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These two papers were prepared by Mr. Satoshi Sunumura while he served as a special advisor to the Vice President of the Cofinancing and Financial Advisory Services (CFS) Vice Presidency of the World Bank. Mr. Sunumura’s career includes positions at a variety of levels in Japan’s commercial banking system and in international banking institutions. In these papers, he draws on these experiences and his insights on how Japan’s commercial banking system helped the industrial sector to respond to the tremendous post-war challenges faced by the country.

The second paper published in this volume attempts to apply these “lessons learned” to formulate a banking sector strategy that may assist the former socialist economies to successfully make the transition to market-oriented economic systems.

As in all World Bank discussion papers, the views expressed by the author are his own and are not intended to reflect those of the institution or its staff, but are intended to provoke thought and exchanges of views on two topics of interest to the international economic development community.

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Japan’s Main Bank System
Introduction

This study analyzes the experience of Japanese main banks in developing their managerial capacity from a practitioner's point of view. It discusses their techniques for enhancing staff quality and coordination, credit risk control, business growth and long-term relationship management techniques. These managerial qualities are shown to be broadly responsive to societal expectations.

A commercial bank, as a licensed financial intermediary, receives deposits from the general public and lends money to creditworthy corporate borrowers at a profit. It therefore deals with multiple tiers of clients, distinguished by credibility and quality of the relationship established with the bank. To cater to the needs of these clients, both “hard” and “soft” infrastructure must be organized. “Hard” aspects include establishing branch networks and computerizing accounting systems; “soft” infrastructure consists of information collection, application of technology, know-how, credit appraisal and consulting. In addition, human and financial resources must be effectively organized by the bank's management in order to meet client requirements and to adapt to changes in the business environment.

Banking is primarily a service industry. As such, its ultimate resources and strengths depend mainly on the people who provide the services. Accountability, quality, profitability and diversity within the banking business can be achieved and facilitated only by developing a competitive managerial capability and culture in bank staff. Moreover, a bank as a going concern under authorized license must comply broadly with economic and social objectives. It does so at three levels: the micro level, the system level, and the macro level. At the micro level, it needs to remain sustainable and competitive by maximizing profit, protecting depositors and fostering prospective firms. At the system level, it needs to organize its operational structure effectively by establishing accountability in its functions, enhancing efficiency in its resource allocation, minimizing risk in its implementation, and promoting credibility in its information services. At the macro level, the bank must be able to respond flexibly to changes in the economic environment by complying with the rules of game, fulfilling social expectations, and conforming to economic policy targets.

The Japanese main bank system, defined simply as well-cultivated practices or concepts in relationship management, developed in the postwar growth period of 1955-1973. It is generally recognized as an effective system for achieving the objectives defined above, and for facilitating industrial as well as corporate growth through allocation of scarce investment funds on a roll-over basis. The system has been found effective in monitoring corporate governance during uncertain economic circumstances and acute capital shortages, conditions that parallel those which currently prevail in developing or transitional economies.

The essential factor for effectively running a banking concern, a service industry, is managerial capacity, since the quality of people involved in main bank operation is the key element. Bank managements must continuously review managerial capacity, upgrading it and building it up at all organizational levels. Ultimately, managerial capacity must fulfill two primary functions: assisting in the sound growth of its corporate clients and complying with social expectations. While banking principles and functions may be universal, differences in resource allocation and management styles
influence overall managerial capacity in terms of accountability, productivity, restructuring capacity and relationship management.

Section I of this study examines the major functions or qualifications of main banks (both explicit and implicit). These functions are interlocking, and it is through them that managerial capacity is most effectively employed. Section II analyzes the normal course of career development within main banks. Staff training should first focus on acquisition of basic skills, then on building managerial capacity in fields of individual aptitude or preference. This method enhances general management’s ability to deal with a variety of corporate clients. Section III examines the implicit aspects of corporate monitoring or restructuring procedures through the standard mode of credit risk appraisal. Monitoring is shown to respond to changes in individual corporate performance. Section IV advocates managing business growth and corporate relationships through overall portfolio review, as well as through proactive responses to fundamental changes within the economic environment. Section V reviews the overall features and implications of managerial capacity at the micro, system and policy levels. Building up management capacity at all three levels enhances general accountability, productivity, and diversity, and is crucial for developing or transitional economies attempting to move towards a market-oriented system.
Section 1

Major Qualifications and Functions of Main Banks

At first glance, the title "main bank" is normally accorded to the largest lending bank that not only maintains a relatively higher share of equity holding on its own, but also exercises effective influence on corporate governance. This influence has traditionally been based upon de facto equity cross-holding among group companies, along with bank representation on the borrower's corporate board. However, whether these entitlements are currently accepted by borrowers is often another story, especially in recent years of ample resource availability and diversification in market instruments. A main bank's qualifications and functions, therefore, must be backed by the ability to undertake restructuring and to accept the ultimate credit risk of clients. Such an undertaking is only possible through extensive credit appraisal and careful monitoring of corporate performance. Indeed, the major qualification the main bank has is its managerial capacity, put into practice in the course of its relationships with clients.

The main bank effectively plays the role of syndication arranger or trustee for raising funds. It explicitly commits the largest share of loans to corporate clients in order to signal its positive attitude to other participating lenders. Specific services, such as provision of credit information or arranging modality of syndication, is extended for various reasons: to obtain the overall merits of foreign exchange business, trustee fees or large deposit balances, or to contain cash flow among major clients within its branch network. In fact, participating lenders can generally save the cost of information gathering, credit analysis (periodic or ad hoc) by relying principally on the main bank's monitoring capacity whenever necessary. The larger the amount and wider the syndicated members, the more transparent the arrangement (with detailed analysis and extensive counter checking). Therefore, the real basis for main bank qualification is its willingness to stand by or act as lender of last resort whenever a borrower faces any difficulty, even if not formally contracted. If borrowers are unable to comply with requests proposed by core bankers within a reasonable time, they could risk their positions by losing the ex-post back-up of the main bank. Disclosure of information in sufficient time, credible information, and ethics of corporate management are the points in question.

Practically speaking, the main bank can be identified generally through six interlocking elements of qualification. While these elements are related, each is important on its own. Three of the elements may be explicit, while the other three are often implicit.

The six elements of qualification are listed from the most cohesive element within the corporate client relationship to the least cohesive element:

- Share of equity holding;
- Whether the bank's commitment to undertake restructuring tasks or to act as lender

1 This includes long-term loans on a roll-over basis, or bonds with mortgages for land and machinery. Other lenders may join the syndication. On agreement with borrowers, a main bank may take only 10% of the lending share in popular deals, yet may be prepared to take on 25-50% in cases of vitally important or confidential projects.

2 The largest lender is not always the main bank and the qualification is often vague.
of last resort is formally or tacitly confirmed;
• Whether the borrower accepts any bank member for its board of auditors;
• The length of time business networking and other overall benefits have arisen from the long-term relationship;
• Whether the main bank is capable of arranging sufficient funds for the borrowers' bank accounts in cost effective ways (even in times of tight credit), and is able to offer lucrative deals and advice on diversification of corporate treasury operations; and
• The availability of widespread and in-depth intelligence service, such as research data on money markets, corporate credit appraisal and technology.

Where all these elements are present, and both bank and firm are satisfied with each other, the position of main bank may be firm on a long-term basis. This is often the case with banks serving the six major Kigyo Shudan company groups. Not all of these functions are necessarily performed, however. In many cases, the relationship is built upon only two or three of these elements. Each case depends on the establishment of the relationship and its performance over the years. The cohesiveness of the relationship may differ from case to case since a bank's commitment to a firm as well as a bank's mandate to a bank do not necessarily cover all these elements. Where the availability of corporate information is limited, a bank's managerial capacity may also be limited. Loose relationships with banks may often be associated with new, rapidly-growing firms, or with firms experiencing a serious credit squeeze. The relationship may change, varying with the depth of coverage of the six elements, and alterations often occur specifically at times of significant change within the credit system and capital markets. The occurrence of mergers, acquisitions and corporate restructurings often provides appropriate times for reviewing the role and function of main banks. Of all the qualification elements, a bank's commitment to act as lender of last resort and the need for such facilities on the part of the firm is indeed the factor most likely to determine the degree of cohesiveness between them.

As firms grow bigger and more successful and financial markets are further deregulated and globalized, corporate borrowers often opt for diversification in their funding programs and not rely to the same degree on main banks. Borrowers can go directly to capital markets to issue public bonds or equity simply by approaching credit rating agencies and securities underwriters. Neither of these entities, however, can replace the role of lender of last resort. Credit rating agencies and securities underwriters are not as dependable in management advising since they cannot assume credit risk on their own accounts. Neither are they endowed with the intensive credit and market information main banks possess. Hence, the main bank's support function is specifically effective in times of capital shortage, uncertain conditions or credit crunches.

While corporate borrowers could loosen their main bank relationships by entering capital markets directly, they rarely do so. Within relationship banking, main bank accounts are rarely replaced with others unless serious distrust arises at the management level of client and bank. From the main bank's point of view, there may be merely a change in the composition of profit and loss items.

While equity holdings and last resort facilities constitute the backbone of the main bank position and qualify the bank to exercise leadership in syndications or corporate governance, other elements can serve as channels of competition with other banks. Often these can lead to changes in the order of relationship positions with particular firms, especially when firms are disappointed with the quality of service or level of commitment in credit undertakings. While equity holding, last resort facilities and board representation must be resolved at the top management level, the extent of routine business relationships, syndication or trustee roles, and quality of intelligence services are functions effectively developed at working levels.

Among the six qualifications, equity holding, board representation and syndication roles are obvious to all the parties concerned and can be explicitly recognized. However, factors such as true availability of last resort facilities, quality of intelligence services, and special arrangements or tacit understandings existing between bank and borrower are not always stated up front. Yet these implicit elements are often instrumental in cultivating main or core bank relationships depending

3 Kigyo-Shudan or Kinyu Keiretsu are closely-knit company groups which appear impenetrable to outsiders. Practically, however, they are groups within which concession, reconciliation or cooperation is more easily obtainable due to long-term relationships.
4 Refer to the examples of Eidai and Daiwa Bank in 1975, or Daishowa Pulp and Sumitomo Bank around 1988.
5 Any creditor can inquire into reasons for changes in lending shares, for example.
on a firm's requirements at a given stage in its business development.

A typical successful relationship is built with small or medium-sized firms at the venture capital stage, like the Matushita, Sony or Honda of forty years ago. These firms were effectively fostered at times of capital shortages by their main or core banks. Their associations with their main banks have never weakened despite the fact that these firms have virtually outgrown their banks in terms of return on investment or manageability of international business. The extent of the main bank relationship is judged by firms based on the six functions. The opportunity for using a wider range of banking services is completely open to Japanese firms in a global setting.6

Equity holding usually relates to restructuring or last resort facilities, board representation and syndication or trustee roles. Board representation often reflects historical relationships, while the fund raising role is closely associated with intelligence services and credit appraisal. During capital shortages, fund raising is considered the most important function of the main bank. This was the case in Japan during the period of about 1955 to 1973.7

It was assumed that Japanese financial markets, groomed under conservative rules of the game over two decades, had created a competitive, efficient and effective commercial banking system. Yet the system had not yet been sufficiently tested in world markets. Banking services offered by foreign banks—intelligence services in overseas bond or equity issues, various forms of credit for overseas project finance, hedging devices for long-term exchange risk, cost-effective arbitrage deals, and in the 1980s swaps, options, derivatives and investment management—were attractions with the potential to turn corporate treasurers' eyes to banks other than traditional main banks. Quality of intelligence services may now be the main means of changing their banks' pecking order in specific deals.8 Commercial banks in Japan have survived over a long period of fierce domestic competition, where rules of the game were relatively simple and strictly followed.9 Banks developed the managerial capacity and sophisticated techniques of merchant bankers in handling corporate clients' overseas deals. Board representation is possible for major shareholders of good reputation, especially if the bank and firm have specifically collaborated in the past on certain symbolic or breakthrough projects. Equity holdings, as well as availability of last resort facilities, may be essential elements for fostering young and prospective firms. If these are fully backed by appropriate management assistance by main banks, small firms can concentrate on investment and development of their own technology on a long term basis.

In sum, main banks have served as effective agents for corporate growth in the development process. Under the deregulated global setting, these relationship threatened by competition if main banks do not sufficiently upgrade their managerial capacity and ensure that their qualifications are sufficient to adequately serve client needs. Main banks must constantly review their portfolio composition while monitoring the quality of all dimensions of their relationships with clients (see Sections III & IV).

6 US investment and British merchant bankers may excel in identifying and arranging attractive overseas packages of M&A or capital market deals, while Japanese main banks may be helpful in appraisal of creditworthiness or scrutinizing hidden loss or profit of targeted firms. Japanese main banks can afford to stand-by or fund the deals (short or long-term); this enables their clients to choose the right timing of such deals.

7 Deregulation advanced after 1964 (when Japan became a member of Article 8 of the IMF) and the market environment by the early seventies enabled Japanese banks to engage more heavily in international transactions, typically in Euromarkets.

8 While the role of syndication for long-term domestic fundraising is primarily derived from the status of large lending or equity holding, quality in intelligence services rendered in overseas deals seems to have challenged main bank positions under a more liberalized banking environment.

9 The scope of operation of licensed banks in Japan has been confined strictly to pure commercial banking. Neither equity underwriting nor brokerage is permitted under Article 65 of the Securities Act. Ceiling rates on deposits are effectively imposed. Foreign exchange control systems had been tightly exercised until 1980. However, no prime underwriter positions were given to bank affiliates operating in the Euromarket. It is argued that over-extended protection for securities companies may have created the privileged positions of securities houses which led to recent scandals.
Section II

Building Managerial Capacity in Organizations

The main bank function can be only fulfilled by qualified banks who, in the eyes of corporate borrowers, are dependable in times of credit squeeze, reliable in management consultation—typically in phases of restructuring, and endowed with the managerial capacity to deal with any type of financial issue. Such capacity must be applied, utilized, practiced and developed in line with sound banking principles, and must meet the specific requirements of corporate clients.

Banking history dates back a few centuries and has taught bankers four sound banking principles:

- Accountability in operation;
- Quality in service;
- Consistent profit making; and
- Portfolio diversification and sophistication.

Such principles are widely recognized, and are acquired through experience and discipline at all levels, from top and mid-level managers down to young working-level officers. Each bank’s overall credibility, management quality and business performance is judged on these principles: human resources, information availability and solid computer systems serve as primary assets. Ultimately, quality of staff is everything in banking.

Let us first examine the general career path of bank staff in a typical Japanese bank, noting what types of skills they are expected to acquire, how they serve clients, and how they comply with banking principles at different levels of responsibility.

Banks recruit candidates direct from schools, and they compete for capable, personable and well-educated students. Upon joining, fresh staff are first placed in intensive training programs organized by the bank’s personnel division for about four weeks. They are then assigned to branches or divisions where their on-the-job training begins. There is not much difference in the treatment of staff at this level in terms of academic career, salary, or gender.

The primary objective at this stage is to provide the employee with the basic knowledge, training and discipline to become a good banker. Deposit taking, accounting or some research work may be a new staff member’s initial posting. The new employee rotates between these sections, then is placed in a specific team of foreign exchange, bond dealings or credit appraisal.

Here, junior officers learn directly from their individual seniors on the job. Care is taken to train young members to be disciplined and credible bankers. On-the-job training will characterize and form the basis for future individual career development in the following four areas:

- Precise accounting practices, asset valuation and cash flow analysis;
- Efficiency in client services, effective and relevant information gathering, deposit and foreign exchange solicitation, and client visitation to facilitate future business expansion;
- Extensive research work on industries or capital markets, or reporting on, perhaps, the production system at client factories or a specific money market; and

10 Competition is fierce, with banks starting to recruit more than one year before graduation. The Japanese Bankers Association does not allow banks to solicit candidates before the summer of their final year.
Preparing credit appraisals or corporate clients prospectus for bond issues or a large syndication.

New employees are expected to learn at least the first three, and desirably all four, within five years' time. Each section is accompanied by extensive manuals that have been compiled over the years by previous employees. These manuals serve not only as textbooks on job specifics, but also as case studies of various deals, containing valuable information and know-how.

Every staff member is expected to contribute new ideas to the content and substance of these manuals. Senior officers are responsible for educating juniors on the job through guidance. New hires move ahead according to individual aptitudes and talents. Some may be chosen for overseas training, for further study—such as MBA degrees—or for training in merchant banking, with decisions based on performance assessments, disposition, potential, and employee goals.

Other staff may be put on secondment for a few years at the treasury offices of corporate clients, or to another research institution or government agency. This allows prospective staff to broaden their basic knowledge and to study subjects from different angles. Secondment at a young age expands workers' capacity to learn, and is meant to enhance their management capability later on in their careers.

During secondment, some highly capable staff members may decide to leave the bank to pursue other academic or professional careers. This generally occurs if the employee becomes discouraged or disappointed with the people, quality or policy of his bank. Periodic formal or private counseling is therefore indispensable at this level.

Whatever the career path of each staff member during the first five years, various prospective courses await them. Employees are generally rotated between different divisions during a period of perhaps ten years. Many incumbent bank board members are not necessarily on elite courses at this stage. Instead, recognition and promotion may come only in ten to twenty years' time.

After approximately ten years, employees often reach the level of section manager. Their assignments are specialized and upgraded, but diversified in dimensions which include budget control, personnel affairs and general matters. Responsibilities usually cover:

- Business performance assessments, client creditworthiness studies, specific investment projects, and medium to long-term business plans and restructuring proposals;
- Surveys on industry and new technology;
- Money and capital market dealings, financial instrument production through specific engineering (swaps, options, derivatives), assets and liabilities management and investment management services;
- Proposals for structured finance, M&A and other deal devices for overall benefit expansion;
- Proactive client management consultations on policy and other issues, or appraising the potential of new business or venture capital; and
- Personnel allocation.

At this mid-level position, duties in the areas of business strategy, operational effectiveness, management efficiency and young officers training are imposed as a major assignment. Knowledge accumulation, hard work, skill building, team work and strategic thinking are all essential to success. Personality and overall credibility are also important. New ideas and creative proposals for promoting business are highly esteemed, while any business failure, if repeated, may be fatal for further promotion. Female staff wishing to pursue professional careers may accept reassignment or transfer to other positions, either domestic or overseas. The quality and complexity of services that such mid-level management provides is evaluated to ascertain the qualification of banks to act as main banks.

Between the tenth and the eighteenth year, comprehensive and objective personal assessment files are completed for each individual. These are based upon accumulation of information from past performance, behavioral patterns, specialties, aptitudes and personality, and these findings influence basic salary scales and future assignments. By this time, bank staff may be broadly categorized into several special fields or divisions for future career development:

- Corporate finance and relationship building (mainly in branches);
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- Credit or project appraisal;
- Money and capital market operation;
- Accounting and treasury;
- Computerization and system control
- Overseas business strategy;
- Research work;
- Personnel affairs; and
- Central planning.

Every staff is given an annual opportunity to express his future career path preference. Any staff member who has achieved high performance and proved his ability is upgraded to the equivalent level of assistant general manager.

Also at this time, certain able staff members may be asked by bank clients—often medium and small size firms—to assist their management in a senior post. These employees must then decide whether to remain with their original bank in light of future career possibilities. Quite often these staff members will initially be transferred through a secondment assignment and, if this role suits them, they will later become actual executives of the client firm. This kind of secondment, with bank employees often moving into client firms, effectively facilitates strong long-term relationships. It is an effective means for transferring management know-how to corporate clients.

After seventeen- to twenty-five years of bank service, some staff reach the general manager level. At this stage, they are assigned the full scope of discretion in their field of responsibility. Their primary task is to take decisions regularly on all fronts with clear vision and leadership. They may, for example, normally conduct dialogue with top management of client firms, attend major outside meetings, such as those of the shareholders, Bankers Association, local authorities, Bank of Japan, or Ministry of Finance. Altogether, fifteen years may be sufficient to raise workers to certain management levels. Thereafter, roughly one-third leave at this stage.

This hierarchical career development system has proven to be a rational and efficient method of operation in the banking industry, where staff members are trained to be generalists. Bank staff regularly rotate jobs, learn multiple skills, and generally improve their abilities in these assignments, as well as developing a sense of coordination with other staff. In such an organization, new information and suggestions for quality improvement and productivity gains move from the bottom up to higher management. Indeed, the very decision-making processes, sanctions, and responsibilities described at the management level are the essential managerial functions of a main bank. These qualities are acquired only through hands-on learning, teamwork, specialization, competition, coordination and discipline at all levels. A main bank only acquire its credentials through exercising quality in corporate governance, and acquisition of managerial skills in accordance with traditional banking principles.

Successful general managers with outstanding performance over a 25-year period may be selected for board membership, if they are not opposed by any incumbent board member. Such a career development scheme inside main banks has been framed by specific elements of the Japanese corporate climate, namely:

- The permanent employment system;
- The policy of promotion from within; and
- The strong seniority element in promotion. These may, however, no longer serve as prerequisites for career development. Moreover, the above elements are not all specific to Japan; rather, they are more or less common to any organization in the world. However, they seem simple policies to follow in the face of other important management issues such as lay-offs, reorganization, personal motivation problems, lack of cooperation and teamwork, declining productivity, and court disputes. Bank management is expected to deal with such problems with discretion and responsibility.

Corporate culture and management style further relate to objectives, principles and philosophy.

13 Nearly forty percent of staff recruited in a given year leave for other firms or professions by their early forties.
14 Bank staff thus trained could be instrumental in assisting, for example, the accounting or treasury divisions of corporate clients, as well as in enhancing their management control system.
15 Admittedly, there may be risks or shortcomings in such a long-term career system. For example, young graduates must determine their life-time profession at an early age, while banks must be selective about new hire potential at the time of employment, and a great deal of time and initial cost may be incurred in providing appropriate training, education, and motivation before each can really contribute much to business development. There may also be some unfairness in treating new hires better than current staff in terms of salary scale, academic career and specific postings.
16 R. Ozaki, Human Capitalism, 1991, Chap.2, pp.26-28 stipulates “nevertheless, conventional economics assumes that labour mobility generally enhances productivity... (However,) the external labour market both inhibits firm-specific skill formation, and discourages cooperative efforts between workers.”
Japanese bankers emphasize quality and long-term relationship management. They know the best way to educate young employees, and how to motivate them to enhance their overall productivity. They are cognizant of their professional responsibilities to society, and to the going concern. Main banks endeavor to build long-term, trustworthy relationships with stable corporate clients. Staff members study hard to acquire specific skills. Only full experiences as generalists at working levels enable bankers to make sophisticated decisions at the mid-level, specifically in group relationships, credit appraisal, fund-raising syndication and intelligence services (which are the core features of daily functions). These lead toward overall leadership in management of corporate governance at the top level. A successful banker should be experienced, mature and quick in decision-making. He should work successfully in groups, and make decisions in line with the sound banking principles. The quality of a main bank will be judged by whether its client relationships are supported by strong human resources at all levels. These elements or programs for enhancing managerial capacity are not at all culture-specific, and perhaps only remain to be proven competitive in the global market.
Section III

Credit Risk Management

The six main bank functions can be effectively managed only by well-trained and experienced bankers. These individuals tend to be shrewd, sensitive, proactive and tough, and their managerial capacity is based on traditional banking principles. For main banks, managerial capacity is assessed with respect to credit risk, business growth, and relationship management. Risk management is implicitly evaluated in terms of credit quality, market exposure, system controls and environmental changes. Let us explore credit risk management.

Loan officers in charge of particular firms are responsible for updating credit information files that contain periodic reports, specific analyses and piles of ad hoc information on corporate performance. Company histories, full descriptions of the careers and characters of board members, quality reports on major products, detailed analyses on B/S and P/L, debt structures, cash flow features, cost and productivity analyses, assessments of unrealized profit or hidden loss, real net worth estimations, and the latest project evaluations are contained in these reports. Most important are reviews of profitability and strategies for relationship management. Any staff member can access these files via his or her chief officer. A loan officer usually manages 10 to 50 firms, depending on the character and depth of the business relationship. Each credit file must be scrutinized by the loan officer's chief, branch manager, and specialist credit officers at the head office (Shinsa-bu). The officer's abilities and talents must be amply demonstrated to his colleagues if he or she wishes to become a general manager in future years.

Abundant data is also available on any listed firm from specialized credit information companies. The credibility of such information must be properly assessed or confirmed, however, through direct dialogue with firm treasurers, interviews with their suppliers and buyers, and scrutinization of detailed financial statements or back-up data not necessarily appearing in audit reports (ie: off-balance-sheet transactions). Any major problems are checked and reconfirmed by the chief, manager, seconded staff and—if necessary—general managers, as well as by board members or auditors.

Each firm may be classified, in order of creditability, into: "Super," "Good," "Ordinary," "Watch" and "Hospital-care" categories. While such classification is necessary to monitor performance and to...

17 Main bank credit risk can be established by considering the largest lending share. While maximum benefit may be obtained by absorbing associated business through main accounts, every effort is made to reduce lending shares through wider syndication. Also, the lending limit for a firm is imposed by prudent regulation; the bank's aggregate assets are controlled by the BIS convention despite each country's differences in taxation systems and accounting practices. Therefore, the quality or substance of those assets is the crucial issue.

18 Apart from credit risk, other areas of risk management are more or less similar in any bank operation. Market risk is due mainly to volatility in rates and should be controlled by a system and against primary capital, unrealized profits (losses) of equity assets, and subordinated debt. System controls relate to hard and soft infrastructure.

19 Japanese loan officers' productivity (ratio of revenue to expenses) and performance (in terms of time and dedication to the bank) is comparatively higher than that of foreign counterparts. See Sakura Sogo Kenkyusho, "Major Banks' Competitiveness (1990)," Economic Report, April 15, 1992, based upon the annual reports of 36 major international banks.
review or determine the extent of the bank’s involvement or credit commitments, other client categorizations may be organized as part of strategies for expanding overall business (see Section IV). Both are integral parts of main bank managerial practice.

Fluctuations in corporate performance by companies in the “Watch” and “Hospital-care” groups will be reflected ex-ante in changes in revenue, terms of bills in receivables and payables, cash flow in the main account and mode of activities. The morale of employees, reputation of the company, and rumors among suppliers and buyers—as well as their competitors—are also likely to be affected. Such effects are easily perceived by loan officers or managers who maintain daily, weekly, or formal contact with key individuals in these companies. Inquiry are widely pursued at various levels to confirm fundamental issues. If the problem is critical, further detailed investigation into the company’s factories, accounting or marketing divisions, clients and employee unions will take place.

At this stage, the chief officer is placed directly in charge of the summary and conclusions for the latest credit appraisal and investigation reports. Normally he can obtain acceptable explanations for performance changes, or can suggest appropriate measures to be taken by the firm. If changes are required, the officer is expected to devise short- and long-term restructuring programs. These require manager and loan specialist sanctions, and are ultimately authorized by the general manager, since they often must comply with firms’ requests for, say, bridge financing. Daily cash flows on accounts are followed by officer and chief. Reassessment of collateral or security may take place confidentially.

In serious cases, confidential meetings are organized at the general manager level to develop more comprehensive measures. Imminent judgment may be required by the main bank to determine whether:

- Quick intermediate rescue packages or bridge financing will be organized through core banks;
- Special stand-by arrangements or overall curtailment of credit commitments may be required to match available security or collateral; or
- More fundamental restructuring is necessary.

For firms which have maintained a long-term relationship with the bank and are in an easily recoverable position, the first choice will likely be made. The second alternative may result when the market share of some of the firms’ major products has substantially dropped, competitive products have emerged, or a firm’s expansion has failed. If the firm has kept regular consultations with the main bank in advance of any potential issues, has diversified its operations reasonably, expects further new products, or is cultivating a new overseas market, the main bank will normally stand-by as lender of last resort with firm support from core banks.

The real question in the third case, which may be considered by dividing it further into three cases:

- Fundamental changes in revenue due to emergence of substitute products or technological progress, compelling the firm to close down its principal production lines, with no scope for shift or diversification into related industries;
- Substantial losses due to speculation in non-principal businesses which inevitably affect normal operation in the principal lines of business; or
- Business failure involving fraud, management ethics or labor disputes.

Even these difficult cases can usually be identified by core banks well in advance of public knowledge. Generally, main banks will have consulted with firm management for some time before any real difficulty occurs. In this context, liquidation announcements are simply confirmations of long consultations, reconciliations or required procedures. If problems are discovered too late for restructuring or reconstruction, all members in charge of the loan commitment will be either relegated or dismissed.

Main bank policy procedure is simple: If identified at the earliest stage, as in the first case, a special rescue team is organized, headed by a task force leader chosen by the main bank’s top management. The utmost effort is made to maintain the business relationship and existing employment levels. To do this, a part-time system or wage-cut will normally be proposed, and lines of obviously unprofitable operations will be closed immediately. Workforces may be rearranged with related companies or their suppliers or buyers. The primary objective is to minimize the size of the loss the main bank may ultimately be obliged to accept. All legal measures will be taken to seize any possible collateral under the banking agreements, since the main bank normally retains first mortgages. The main bank, however, will not use its priority claims simply for loan recovery. Depending on the historical business relationship, lending share, equity holding, and
relationship with major shareholders and other creditors, each case will be carefully evaluated by the main bank’s top management in consideration of the practices, social reputation and specific cost required. This will be done in close consultation with core banks on the shares of final losses. Main banks normally adopt the largest share of write-off to demonstrate their primary responsibility.

The most common type of rescue operation first mitigates debtors’ interest payment burdens in accordance with lending shares among core banks; at worst, it writes off some unrecoverable portion of the loans. The firm may then be sold to others who can afford to take on remaining resources or workable assets including staff, franchise rights, technology patents or R&D institutions. Ultimately, mergers may be the safest way in normal cases.

In the second case, the obvious procedure is to separate non-principal business operations, and transfer or sell them to other reliable firms engaged in the same lines of business.

The third case is the worst. While a main bank rescue or restructuring strategy is simple, team members must undertake long, demanding toil to ensure its success. After the completion of liquidation operations, all members may be amply compensated by special bonuses, or by reassignment to more relaxed and enjoyable posts.

The entire reputation of the main bank may rest on its handling of such cases — for instance, its ability to deal properly with tiers of creditors and debtors in the liquidation process. Remember that there are three primary functions or roles of the main bank: exploring and fostering new prospective clients; expanding and diversifying existing business; and organizing the monitoring team to act as lender of last resort in cases of need.

Skills normally applied to restructuring proposals may be more proactively utilized through M&A deals. In fact, Japanese main bankers experienced as managers or lead-arrangers in project finance and global market syndication are fully equipped to undertake M&A deals. Yet these bankers often encounter one problem in deals involving overseas firms—the depth and coverage of corporate information compiled in the usual prospectus or memorandum. Overseas bankers do not normally stipulate enough information concerning about quality of assets and management attributes of target firms. These points may only be explored at the later stages of a takeover, which has often been identified as a problem in the major deals Japanese firms were invited to bid on in the past. Since Japanese bankers value long-term relationships with clients, they tend to be sensitive to the quality and variety of the products they offer. Main banks would not consider M&A operations to be one-time deals, for example. Rather, the banks look after the firms even after the deal, and expect to develop routine business associations with them.

The heart of main bank managerial capacity rests in well-trained human resources and practical credit appraisal teams with at least three levels of experienced bankers. While corporate information on Japanese firms is widely available, the main bank’s research is extensive in its evaluation of potential client assets and technology. This produces a strong venture capital climate. More than 93% of corporate accounts held with city banks, in fact, are with small and medium size firms. Prior to 1973, the nature of competition among Japanese banks was characterized by the collection of more individual deposits and offering intelligence services; competition was not generally described in terms of rates. Yet with interest rate liberalization, globalization and computerization, competition in the form of rates, innovative ideas, and intelligence services has become fierce.

While unqualified or unsophisticated banks may be doomed to merge with others, top quality banks are now comfortably prepared to compete both with universal banking and investment bankers, once new regulations are enacted and the use of the yen becomes widely prevalent. The world trend appears to be moving from one-shot off-balance sheet transactions toward long-term relationship banking. In the competitive global environment, disparities in performance may lead to major changes in the ranking of world bankers unless relationship banking or niche-playing is fully recognized by management. This is currently happening in Japan. The current real estate crisis, caused by both an environment of easy money and the Japanese mythology surrounding land, has been widely acknowledged due to the transparency of information in Japan. Needless to say, such a failure is a direct consequence of the poor management of non-bank finance companies, yet it is also a failure of main banks, who have not appreciated the changes stemming from interest rate liberalization.

20 See the cases of Fuji Bank’s takeover of Walter Heller and Mitsubishi Bank’s takeover of the Bank of California.

21 Assuming bad loans total ¥14 trillion and that a 30% reduction in the pricing of collateral may be inevitable, this size is still manageable in the current market. At worst, some financial institutions may be taken over.
In addition to individual credit risk control, main bank management is concerned with the prospect of aggregate growth within a 5-10 year span, the quality and profit structure of the bank's business, and the mode of corporate relationships (since clients' positions may change in different economic environments).

Bank profit structure may be analyzed for each item within profit and loss accounts, as well as for the composition of assets and liabilities affecting these items. Usually the accounting division scrutinizes movements in every account and makes regular inquiries to the divisions in charge. These inquiries are based upon the budget plan or specific policy framework authorized by management at the beginning of each financial year. The bank's revenue can be generated broadly from: interest income on loans; various fees and commissions from guarantees, syndication arrangements, custodians, and M&As; trading profit in foreign exchange, bonds, swaps, options, derivatives; and some capital gain in equity and real estate.

Main bank strategy is to build quality portfolios and to raise profitability in the long run. The best ways to achieve this are to:

- Increase the number of main accounts and secure repeated transactions,
- Diversify trading of varieties of new financial instruments with existing growing firms and expand dealings (arbitrage) in markets on their own account,
- Explore new firms in growing industries to foster prospective small and medium size firms, and
- Reappraise the total performance and merits of maturing or matured firms.

These strategies are well-grounded. Since a bank is a financial intermediary, its performance or profitability can be evaluated first by the volume of transactions passing through it. The more depositor and firm accounts a bank handles, the more benefit or profit can be expected. This is especially true in large or main accounts held by existing firms. Here, the interim benefits are usually very large.

As deregulation, securitization, globalization and computerization progress, financial instruments must be diversified. They must be sophisticated, as various interest terms and rates — spot and forward — and currency mixes can be designed. Swaps, options and derivatives are now in fashion everywhere.

One of the prime social roles filled by main banks is the fostering of small and medium size prospective firms. Potentially large, long-run deals

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22 A bank's planning division or industrial research division is normally put in charge of a three-year business plan on a rollover basis. Growth patterns of corporate businesses may be broadly categorized into several groups based, for example, upon turnover growth, cumulative amount of fixed investment, average employee age, and increases in numbers of accounts over a certain time period.

23 In Japanese banking, interest on loans still provides the largest source of income, but the weight of trading profit and fees are increasing fairly rapidly. Some publicly available data indicate that per capita assets, revenue income, number of deposit accounts or corporate clients of major Japanese banks are quite high in relation to overhead costs.

24 Control systems over exposure positions (commitment structure) and volatility (market risk) have been conceived. Netting agreements may be further required to reduce grossly aggregated exposures. More diversification in handling various instruments, as well as more arbitrage, is possible.
can be expected in the future from such prospective firms in terms of new technology, innovative ideas, or venture capital. The most competitive and qualified banks concentrate their relationship strategy on identification of and consultation with such newly emerging firms. Many have innovative products, like the Matsushitas, Sonys or Hondas of the 1950s. Most require start-up funding both in equity and loans, as well as management consultation. Bank appraisals and surveys study technology, product quality, entrepreneurial character, management structure, investment requirements, and potential suppliers, buyers and competitors. In current Japanese banking, finding such promising companies is competitive. After all, the major feature of a main bank is its position as equity holder and lender of the last resort in the development process.25

A main bank protects the interests of its long-time clients, specifically those firms maturing or matured in their performance. The bank uses secondment for management assistance and to present proposals of new market deals, instruments or investment management. The banks also often suggest some useful merger and acquisition deals for the client's further business development.

In bank portfolios, companies at different growth levels are intermingled. Where some may be growing steadily, others may be declining. For our purposes, companies may be broadly grouped into: prospective, steady and secured or maturing or matured. Calling these A, I and P, respectively, the following analysis reveals interesting trends in main bank portfolios.26 For example:

- A>I>P: expansive portfolio (emphasizing future), as in 1950-1973;
- A<I>P: steady and safe in operation, as in 1973-1992;
- A>I<P: facing multi-faceted structural changes.

Incumbent bank management might opt for portfolio positions of the second type, or (more positively) for the first, but the last may prove quite challenging for the main banks with their need for future portfolio reshuffling. Certainly positions where A<P—specifically, where I<A<P—are the worst. Every preemptive effort is made to avoid a case where A<P. In fact, a qualified main bank always strives to maintain the first position by employing all its managerial capacity. Normally, main banks exercise strenuous effort to foster new, prospective firms (A) for which equity holding, credit information, cash flow analysis and assessment of hidden assets (goodwill, new technology, or unrealized profit) are favorable. Steadily growing firms (I) contribute to the core portion of the main bank's repeated business. Networking services, funding and transactional market deals are important strategies in relationship management, and serve to secure stable profit. Regular monitoring or consultation may be desirable for maturing or matured firms (P), who tend to welcome any kind of management advice, restructuring proposals, M&A deals, or networking services. The main bank constantly reviews its portfolio in terms of growth patterns of different groups and corporate relationships, and devises specific strategies for each group.

The managerial capacity of the main bank is acquired through its organization and exercised through its six functions. These have provided the basis for the strength, merit and reputation of main banks. The managerial capacity provided by main banks has been particularly effective during periods of capital shortage, economic uncertainty and confined rules of the game. However, as higher economic growth has been achieved, further changes in the financial sector through deregulation, securitization, globalization and computerization have forced Japanese banks to transform their mode of operations from that which prevailed during the 1980s. Since 1990, the managerial capacity of main banks has been broadly affected on five fronts:

- Two of the six major functions—equity holding27 and last resort facilities28—must be reviewed in light of equity holding costs and social reputation in restructuring measures;
- Major companies have tended to switch funding methods from domestic bank-borrowing to bond issues or overseas equity-related issues due to cost effectiveness;

25 The effort may be costly, requiring time and patience. Yet it is often lucrative when companies succeed.
26 This grouping is possible in terms of business growth as well as in terms of company maturity. Example: A's revenue growth rate may be larger than 12% per annum, I may be 5-12% per annum, and P may be below 5%.
27 Kurosawa (1992) points out that main banks' long-term equity holdings were possible not only through profitability expected on dividends and capital gains, but also through interest income gained through continuous lending opportunities during the high growth period.
28 Main bank loan officers make advance inquiries into possible causes of continuous current account losses, since they can create negative net worth. Officers also offer remedies. If no specific measure is taken by the firm's management, despite prior consultative advice or warning, the main bank may gradually decrease its exposure. This may trigger withdrawals of other banks.
- Banks' lending ability has been curtailed through prudent regulation, including ceilings on lending to individual borrowers, and overall lending limits on weighted risk assets under the BIS convention (defined against Tier 1 capital);
- Off-balance-sheet transactions offer new business opportunities for banks active in markets to achieve better returns on equity, (i.e. yen-dollar swaps for medium term note issues or yen-yen swaps between fixed and floating rates); and
- Banks are now permitted to move effectively into universal banking through their subsidiaries of securities and trust banks.

Managerial capacity groomed under traditional credit risk control systems or restructuring management can be directly utilized for M&A deals. During the period of the internationalization of banking (1974 to 1989), overseas subsidiaries could be readily applied to corporate equity-related or medium-term note issues. Now, competition for swaps and derivatives is fierce and increasingly sophisticated among the Japanese market makers. New financial products—suited to individual client tastes—may be forthcoming. In order to execute all client functions, main banks are reorganizing their strategies through subsidiaries to cope with paradigm changes and deregulated rules of the game. This kind of response—or transformation—is only possible with high-quality staff trained and sophisticated in their career development. While there are a growing number of cases where banks wish to terminate involvement with poor management or where clients grow to the point of independently managing their treasury operations, perhaps a new balance will emerge where banks become more selective and less committed to acting as main bank for the category below “Ordinary.” At the very least, perhaps banks will implicitly retain the role of lender of last resort.

In any case, judging a main bank's commitment only from lending amounts or explicit elements is often misleading. The main bank's primary role is to foster new prospective firms. Once firms outgrow the need for a main bank's back-up facilities, the relationship must be judged on its merits, though most main bank accounts will remain intact.

Main banks should be able to compete in terms of rates and services on the same footing with other banks. Insofar as main banks continue to properly train staff and constantly review relationships and portfolios, they should be able to manage any difficulty. Ultimately, it is strong managerial capacity that enables banks or firms to manage their problems in a new environment.
Managerial capacity within main banks can be effectively exercised through their six major functions. These major activities, in implementation, may seem on the surface to be nothing new in relation to ordinary commercial banking or investment banking. Differences in effect may arise from the way individual staff are educated and organized, as well as from the principles and emphasis behind management development programs.

There are four distinct features of Japanese management that contrast with Western management styles:

- Bank stakeholders are multi-tiered—client firms, employees, shareholders, community and society, the central bank and the Ministry of Finance. Not only shareholders exercise corporate governance—employees and client firms with long-term interests may often be the most vocal stakeholders. One cannot ignore strong influence from the central bank, Ministry of Finance, or society. A typical case is employment policy. Management may not move immediately for lay-offs, but may opt for wage-cuts, part-time systems or job reassignment;
- Career development programs are designed for the long-term, in line with the banking principles of transparency and equity. Management competes through quality services rather than through price;
- While the ultimate rationale for running a bank may be profit maximization, Japan prepares for the education, employment and welfare of its people on a long-term basis. In contrast, Western business tends to pay wages primarily for the job that must be done. The Japanese firmly believe it is a banker’s social responsibility to foster prospective firms which have potential but generally lack funding, management know-how or information; and
- While career development may be organized to acquire all-around experience, this may not necessarily be the normal practice or strategy of Western business.

It is important to realize that these four features are not culture-specific. They can be implemented in any organization in any country. It is more or less a question of management philosophy or, in particular, investment cost for each employee. Lifetime employment, as well the seniority system, are not the essential conditions here. Instead, initial training and discipline for the first four years, and appropriate rotations of eight to ten years, are integral to acquiring the fundamental qualities relevant to main bank functions.

Overall, the implications for main bank managerial capacity may be identified at the three levels: micro management, institutional setting and macro policy implementation. At the micro level, special emphasis is placed on fostering talent from within on long-term basis. This is done at three levels. Every staff member gains experience in deposits, business promotion, and credit appraisal. Other features and specialties are pursued through the employee’s own motivations and talents if he remains in the banks.

Every effort is made to maximize the merits of long-term relationships with prospective client firms. Staff is rotated through different sections and branches throughout a two to four year period. Workers are never put in charge of the same clients
for at least ten years. Fair personnel files are com-
plied throughout a ten to fifteen year period on
ability, aptitude, personality and behavioral pat-
terns, with an eye to future assignments.

Prospective enterprises are fostered by holding
equity, providing credits and last resort facilities
and offering useful management advice. This is the
key role of main banks as going concerns in society.
Ensuring proactive communication, sound moti-
vation, credible relationships, effective allocation
of resources and flexible responses to changes in the
environment is the key area of management re-
sponsibility.

At the institutional level, networking of corpo-
rate information and provision of consulting advice
to concerned parties may be broadly expected of
main banks. Banks in Japan compete with each
other to offer seminars or training programs for
basic skills. Cross checking of management inform-
ation and modes of operation is possible among
syndicated members through main banks or spe-
cialist banks in the field.29 New practices or rules of
the game can be easily implemented in a cooperat-
eive and competitive manner. Asymmetric inform-
cation can be easily rectified through multilateral
dialogue or channels in such an institutional set-
ting, saving agency costs.

Efficiency and creditability in payment mecha-
nisms are the primary function and responsibility
of all licensed banks. Their costs must be shared.
Consensus on system building, adjustment or orga-
nized action may be readily taken by the incumbent
chairman of the Japanese Bankers Association.
Close dialogue and representation of banking group
interests is made to regulatory authorities through
the Japanese Bankers Association. Discussion is on
rules of the game, practices, system supports, legal
considerations, taxation rates, advertisements and
compliance.

At the macro level, an equitable control system
or guidelines for credit allocation may be organized
by the central bank through dialogue with each
main bank. An effective market operation can be
implemented by identifying the position of major
banks. Accountability in policy implementation is
enhanced as every bank can equitably share inform-
ation on markets and policy guidelines in a
transparent way. Managerial capacity, developed
through such a main bank system, is instrumental in
enhancing accountability, effectiveness, efficiency
and equitableness at these three levels.

There may be, therefore, a significant case for
developing such managerial capacity in banking
within developing or transitional economies. This
is true on four fronts:

- Bank credit may be the major source of
corporate finance due to shortages of sup-
plying funds against potential investment
demand and lack of local capital markets.
Central bank rediscount facilities for qual-
ified trade bills or short-term government
bonds, even at lower rates of interest, may
not be sufficient. Syndication efforts by
main banks on a short-term roll-over basis
may be appropriate ways to support pro-
spective corporate finance. This also en-
courages participation of other financiers;
- Basic skills for prudent banking are more
easily acquired under the simple rules of
commercial banking than under global or
universal banking systems, at least until
basic market mechanisms or financial asset
growth or maturities are ascertained. Spe-
cifically, active inter-bank money markets,
competitive (narrow margin) foreign ex-
change dealings, as well as some kinds of
medium-term notes or equity issues may
well be confirmed before full deregulation
or interest rate liberalization could be taken.
A standard case of operation may be demon-
strated by major banks or their securities
subsidiaries, perhaps initially under tech-
nical assistance by teams of bankers, accoun-
tants or consultants;
- Accountability and effectiveness under
micro and system management may be
crucial objectives for major banks, not only
for twinning programs but for long-term
career development and enhancement of
managerial capacity. Participation of many
institutions for financing new projects un-
der initiative arrangements of main banks
facilitates competition, transparency and
accountability; and
- Interlocking relationships between state
enterprises and state banks due to their
inherited debt—or the privatization pro-

29 In the post-war period, certain specialized banks played
unique roles in their individual fields, delivering useful
information on projects and know-how in arrangements,
and contributing much to enhanced managerial capacity
of participating banks in Japan. These specialized banks
could be called main banks in their special fields. Their
professional functions and equitable contributions have
been significant in the development process, and are
highly regarded by current competitors.
cess—may be rectified through prudent regulation exercised over licensed commercial banks. Portfolio clean-up efforts can be openly implemented by main banks, even under the environment of principal agent problems. Major state enterprises will have to be split into several corporations due to limited bank lending to one borrower. Some debt must be replaced with equity or government bonds, which may then be sold as appropriate in markets. Other units may have to be liquidated. Main bank managerial capacity can be instrumental in restructuring state enterprises. Technical assistance may be indispensable at first.

**Conclusion**

Economic systems may be largely determined by non-economic factors such as history, community values and demographic mentality. Management styles in banking will likewise be determined not only by relevant stakeholders, but also by awareness of social responsibility, long or short-term costs to career development, and price or quality competition. In addition, under the prevailing circumstances in developing or transforming economies, some realistic guidance must be offered in terms of whether growth is preferred to stability, or whether bank credits or security issues can be the major sources of funding for new investments.

The managerial capacity of main banks, the multifarious functions they exercise, their training of human resources, their fostering of corporate growth through relationship management, and their internal competition within government guidelines, are the salient features of the main bank system. Their basic know-how may be adopted universally if managerial capacity, human resources, quality in services, and long-term productivity are considered key competitive banking elements in the development process. The effectiveness of such managerial capacity can be best proved in the global market, despite differences in language, currencies and management styles. As one Japanese banker states, “Money is our business. Insofar as our clients trust us and are clean in business ethics, we will stand by as the lender of last resort. We wish to grow together with our clients. Together we aspire to achieve our goals, as well as prosperity, in society for long years to come, as going concerns. Our duty and responsibility rests together with our society.”
References


The Role of the Banking System in Transitional Socialist Economies
Introduction

Extensive debate has surrounded the restructuring and privatization programs of Transitional Socialist Economies (TSEs). Over the past three years, questions have revolved around the appropriate methods for shifting to market-oriented systems and restructuring enterprise debt. Prescriptions have ranged from shock therapy to gradualism, from budget deficit reduction and the opening of trade systems, to the liberalization of prices and interest rates. Due to the efforts of liberal economists and free-market technocrats, significant progress is being achieved.

All prescriptions aside, however, the prospects are not entirely satisfactory to host countries. The G-7 nations are either hesitant to undertake politically risky actions, or are saddled with their own budgetary constraints. International financial institutions (IFIs) believe that both liberalization and democracy require at least a decade more to take effect. Practically no development agency is willing to offer assistance beyond the broad structural adjustment loans which come with prerequisite macro-economic conditions (such as controlling budget deficits and inflation rates). These conditions, however, pose difficulties, including how to maintain employment while restructuring state enterprises; how to sustain the social safety net in transition; how to increase production to combat anticipated inflation while maintaining tight fiscal and monetary policy; and how to reorganize the old system within a new environment.

Historically, the main issues of inherited debt and privatization programs of major state enterprises and banks have either been handled inadequately or tackled ineffectively. During the transition from a centrally planned economy to a market one, the liberalization of trade, prices, and interest rates without directives, incentives, or management assistance would certainly have many costs. Specifically, such liberalization is known to cause inflation, speculation and political intervention, not to mention social costs and time loss. Resources are wasted due to bottlenecks, lack of knowledge or experience, scarce money and goods, vested interests, and the unfairness stemming from the lack of property law or prudent banking regulation.

To avoid these pitfalls of liberalization, four main steps should be followed to create an economic system in a relatively short span of time. These measures comply with the rules of the game prevailing in the global market, and allow for liberalization or transformation efforts to be sustainable and successful within a decade. Otherwise, the TSEs may be plagued by hyperinflation, social unrest or repetition of autocracy.

The four essential measures are: 1) the establishment and adoption of a new constitution for democracy; 2) the creation of an anti monopoly act to dissolve inherited or military complex monopolies and to restructure them into industries meeting current market needs; 3) the establishment of a socially receptive economic system for macro-economic adjustment, which will serve its own economic and social targets; and 4) the development of a sound, accountable and effective banking system. The earlier these four measures are applied to the transition, the faster and easier the implementation of macro-economic adjustment, and the less the waste of resources, time and cost.  

Even if only three of these four measures can be implemented, the desired effect can still be achieved by effective enforcement of them. Implementation problems, of course, come from entrenched interest groups, which understandably resist loss of power or influence.
The first and second measures are especially important, as they are the prerequisites for social reform and reflect the will of the people. The third measure may be implemented at the discretion of the government, and will likely remain controversial (since it reflects the country's historical, cultural, and demographic values). The fourth measure, creation of a commercial banking system, is fairly standardized and has been common practice for over two centuries. Banking systems are global in nature, and remain the key element for shifting to the market mechanism. There is not much room for political intervention in terms of prudent banking regulations and general accounting and auditing practices. In fact, a sound and accountable commercial banking system will help resolve pending economic issues within transitional economies in a more market-oriented manner.

During the postwar economic recovery of Japan, the first and second measures were enforced by government headquarters. Also during this time, labor unions were legitimized and a new educational system was adopted. The Ministry of International Trade and Industry (MITI) vigorously pursued the third measure (despite scarce resources and capital during the initial 15 years), and the Ministry of Finance organized an efficient and equitable banking system (complete with prudent regulation) which allowed for effective allocation of scarce credits for industries. In practice, this system served MITI's guidelines for strategic industries as expressed in its five year (roll-over) economic plan. The guidelines, however, were not compulsory, and some were rejected by the management of several companies involved in the new investment of the 1950s and 1960s.

Transitional Socialist Economies (TSEs) possess features and problems similar to those present in post-war Japan. The military complex of the TSE must be converted into a civilian production system, and state enterprises must be released from the inherited debt to state banks. Budget deficits must be reduced to combat inflation, and acute capital shortages must be relieved to promote new investment. In such transitional economies, a basic framework must be established before liberalization takes place.

This paper emphasizes the important role played by the banking system in facilitating market orientation, as well as in restructuring and privatizing state enterprises in TSEs. The author examines basic financial sector issues regarding the effective restructuring of state enterprises and banks in Bulgaria, China, Hungary, Myanmar, Poland, Romania, Russia, Czechoslovakia, Ukraine, Vietnam and Yugoslavia. The principal strategy suggested here may be broadly applicable to any transforming or developing country.

Whatever economic system or political design may be desired, an effective and equitable market can only be built on a sound and accountable commercial (not universal) banking system.

Section I addresses the economic systems appropriate to different countries. The major factors affecting policy framework are explored. Section II emphasizes the need to build institutional systems which facilitate the resolution of macroeconomic and micro-management policy problems. Section III examines the core role of the banking system in handling new investment financing, inherited debt, enterprise restructuring, equity investment, and local financial market development. Section IV describes a general course of privatization which may be pursued whatever specific schemes are designed or implemented by government. Section V addresses controversial aspects of industrial policy. Effective policy is essential to the reshaping of a country's economic structure within a short span of time (5 to 8 years).

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2 In light of the other three measures, however, this country-specific policy may not unduly affect the macroeconomic adjustment or the primary objectives of economic reform.
3 Refer to Table 2 for a summary of the similarities and differences between postwar Japan and, perhaps, Russia.
4 Industrial policy issues, when effectively addressed, can shorten transition time to 5 to 8 years, as opposed to the 15 to 20 year time period which results when economies are not specifically guided, but left to a purely invisible hand.
Seven fundamental macro factors must be considered in determining the direction and speed of economic reform and real growth in transition. These are, inter alia:

- constitutional framework;
- non-economic and cultural factors;
- features in the budget structure;
- remaining influences still exercised by the previous monopolistic system;
- basic supply systems of foodstuffs, money and foreign exchange;
- economic bottlenecks and hardware and software infrastructure conditions; and
- international relationships with ODA agents, international financial institutions and commercial creditors.

Assuming that economic movement towards a market-oriented system is intended under a new constitution after revolution (with new democratic representatives in the parliament), then the broad economic framework of any specific country may be largely determined by non-economic factors.

These factors include:

- historical and cultural background;
- religious and community values; and
- demographics or international relations affecting management decision making.

The differences and similarities between Europe, the U.S. and Japan in these respects are symbolically illustrated in Figure 1 and Table 1. As shown, the U.S. and Europe maintain common social values of community and religion; Europe and Japan identify and appreciate each others’ unique history and culture; and Japan shares a diplomatic policy—often termed isolationist—with the U.S. These cultural factors underlie modes of

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**Figure 1: Economic System Determinants**

**Table 1: Preferred Management Styles**

<table>
<thead>
<tr>
<th>Major Areas of Operation</th>
<th>Choice</th>
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<tbody>
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<td>Corporate Strategy</td>
<td>(a) Longer-Term</td>
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<td>Social Importance</td>
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<td>Business Priority</td>
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<td>Competition Mode</td>
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economic systems, laws, regulations, policy and management styles. The elements greatly influence social acceptability, efficiency, welfare, quality of life and survival rules within society. Additional determining factors for an economic system are: the mode of the budget structure (both on revenue and expenditure sides), tax collection system and rates and, in particular, the weight of social welfare vis-a-vis public investment. If International Financial Institutions (IFIs) choose to ignore these factors in their implementation of economic assistance, not only will economic efficiency be eroded (in terms of cost, resources, allocation, and time), but morale and social justice systems may be severely affected.

If we contrast the management styles of each zone with respect to major areas of operation, some interesting areas of common ground emerge. For example, corporate strategy in Japan is characterized by long-term relationships rather than short-term return on investment. Management in TSEs may place more importance on maintenance of employment rather than on higher profit-seeking. American and Japanese managements generally target growth and enlargement in market share rather than stability or preservation of the status quo. Japanese managements may give priority to group welfare rather than individual wealth. Competition in Japan is based more on service and quality than on wages and prices. Investment funds in the development process are raised through the banking system in Japan rather than through the securities market, as commonly takes place in the U.S. It is a challenging task to identify the most appropriate economic system for each of the TSEs, in light of the many differences in management styles in these examples alone.

Arguably, TSEs may prefer the European system over that of the U.S., just as, for instance, Hungary moved toward universal banking in lieu of commercial banking. The Poles, in contrast, appear to focus on the conflict of interest usually associated with a bank's equity underwriting, and may guide their banks toward engaging in the securities business only through subsidiary securities companies, as is the case in the U.S. or Japan. More generally, TSEs might recognize similarities and merits in the development of the Japanese system during the postwar recovery period (see Table 2). This is especially true if TSE governments choose to pursue growth rather than stability, and consider bank credits as more realistic, accountable methods of scarce capital allocation than new securities issues, which are volatile and slow in reflecting corporate creditability in equitable capital market ratings.

It may be argued that socialist economies collapsed due to excessive expenditures in support of military complexes, or investment spending disproportionate to GDP. Undoubtedly, TSEs are characterized by undiversified production and neglect of public needs for consumption. Yet the old

| Table 2: TSEs: Similarities and Differences with Postwar Japan |
|-----------------|-----------------|
| **Similarities** | **Differences** |
| Hyper-inflation and reduction in production | Less serious food supply conditions |
| Credit allocation required | Production capacity remains (though obsolete) |
| Military complex must be converted to civil manufacturing | Rich in natural resources |
| Decayed infrastructure | No enforcement power regarding decentralization and restructuring of monopolistic entities |
| No capital markets, with bank credit as the main funding source | Little market experience |
| Priority given to long-term relationships, community and connections in society | Interest and exchange rates totally liberalized |
| Corporate management is responsible for employee welfare | Government guidelines effective, essential and helpful in transition |
industrial complexes still tend to rely on budget and debt subsidies from state banks, since they cannot expect to generate enough revenue from the traditional production systems. Conditions and pressures of the new market environment create additional constraints leading to their inability to retain their existing employees. Any sovereign government must establish a firm and equitable tax collection system, one with progressive rates based on the source of income.

In TSEs, a social safety net may be established by interim socio-capitalist means, rather than through the purely socialist method of general subsidy. Cuts in wage rates and adoption of part time or flexible time employment, combined with the provision of basic food supplies at relatively low prices, may be necessary adjustments. While economic bottlenecks—such as those in infrastructure—may be overcome by some ODA, it is essential to split up large industrial complexes and to resolve bank debt. Only when this takes place can TSEs transform traditional budget structures into sustainable ones, and provide their economic systems with a new market orientation.

It is obvious by now that the existing monopolistic system must be dissolved. The quicker this occurs the better, since the system is not only burdensome for the budget, but is also delaying the decision-making necessary for economic reform. Any large individual complex producing more than 25 percent of similar products should be split into several manageable units which can compete in terms of quality and price within a new market environment. Incompetent, incumbent management should be replaced with professionals by shareholders and labor unions. This includes government, local authorities, private firms, banks, and the like. These are absolute conditions for economic reform and democratization, as is the privatization of production means in transitional economies.

An adequate supply of basic foodstuffs, money and foreign exchange are fundamental to any economy. Each economy—whether it is in transition, requires transformation, or is pursuing specific development courses or faster growth—must first consider three fundamental factors.5

The first key factor is the agricultural industry, the second is the banking system, and the third is the cultural exchange system, including tourism earning foreign exchange, and an understanding of the country's values and diplomatic ability. Until these factors are firmly established, neither public welfare nor economic well-being may be expected. Agriculture provides essential food for people to survive, banking plays the role of the blood system in an economy, and cultural exchange allows for trade and investment relationships with other countries, which provides foreign currency and technical assistance. Neither agriculture nor cultural exchange can be ignored in policy debate regarding the transforming economy, but banking may work more effectively under confined rules of the game, specifically when an economy is in transition.

Where aristocracy, autocracy, monopoly or corruption dictate any aspect of agriculture, banking, or cultural exchange, further economic development and living standard improvements will be severely hampered. Moreover, corruption in agriculture, banking, or cultural exchange greatly impairs the transition to a global, market-oriented system. Efforts to maintain accountable systems or to improve productivity in agriculture, foodstuff distribution, banking (deposit and credit approval), or overseas capital transaction controls, therefore, should not be eroded by the discretion of a minority interest group. Particular care must be taken of the agricultural, banking, and cultural exchange systems if public welfare and equity is to be maintained. Without reasonable control over these, as well as over the competitive pricing mechanism in the commercial banking and foreign exchange markets, effective policy dialogue cannot take place. In fact, the key to macro-economic issues such as wage rates, subsidies, investment, inflation, the budget deficit, exports, and industrial development is commercial (not universal) banking during the economic transition.

The speed and effectiveness of governments in resolving economic bottlenecks and providing hard and soft infrastructure determines the rate and amount of new investments—including foreign direct investment—and speculation. Telecommunications, electricity, and pipelines or transport facilities, for example, are essential to new industrial development. Investment bankers and consultants point to the lack of property law and local capital (securities) markets as impediments to their professional services and new investment.

While the latter may be resolved by an effective banking system, the former may need to be legislated—as rapidly as possible. One caveat, however, is

5 This should be done before applying any aspect of orthodox economic theory prevailing in developed countries.
that private ownership of property should be permitted to proceed phase by phase. Quick and harsh overall liberalization will only encourage excessive speculation over office buildings in major cities and selected sites in the regions, specifically where interest rates are negative and nominal prices low. Support for this observation can be found in the hyperinflation and devaluation taking place in countries such as Poland and Russia.

Three points should be taken into account in the interim period. First, individual households should be given priority to purchase pieces of land or real estate up to certain sizes for residential purposes. Second, firms with new investment programs should be allowed to purchase real estate for corporate use, and to use it as collateral for bank borrowing or bond issues. Specifically, large industrial complexes that have prepared restructuring programs may be given priority to select appropriate sites, on condition that they split existing production lines into several management units and privatize them within perhaps three years’ time. Third, foreign investors should initially be encouraged to invest in specified industrial estate zones to achieve reasonable regional development or to restructure bankrupt companies.

The status of international relationships with ODA agents, IFIs and commercial creditors will certainly affect the speed of reform, types of initial investment, laws and regulations, allowances for imports, and speculation on overseas capital transactions. These will be affected more seriously in the medium term.⁶

Obviously, foreign exchange policy will not only affect industrial structures in the medium-term, but will also determine the pace of inflation and allowances for income policy. Various country experiences support the effectiveness of the adjustable peg system—perhaps combined with the crawling peg for some emergency measures—to deal with imminent macroeconomic issues in terms of medium-term guidance. This includes industrial as well as wage policy in transition, if intended by the government and supported by TSEs. The key currency to which the exchange rate should be pegged may be a matter of argument for development economists, but the practical solution is to peg it to a basket of three or four major currencies in the world capital markets, possibly to those of major trading partners.⁷

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⁶ Interesting comparisons can be made between the negotiation styles, implementation procedures, and management modes of Brazil or Russia vis-a-vis China, India or Indonesia.

⁷ It would have been wiser, for example, if the trouble zones (or some payment or clearing union among the Former Soviet Union) could have been maintained at the outset. This would have minimized overall foreign exchange costs and residents’ capital flight, while fostering prospective private enterprises in transition.
Section II

Institutional Systems For Handling Macro and Micro Issues

Whatever the economic system preferred, all TSEs must undertake daunting tasks during the transition period. These tasks occur at the level of macro-economic policy, system building, and micro management.

Issues to be tackled range from fiscal and monetary policy (in terms of budget deficit and control over money supply), capital market development (in dealing with inherited debt and equity holding), privatization program mobilization (state enterprise restructuring and management assistance) and labor market issues (employment and wage policy). All of these issues were previously interlocked with each other at all levels by central planning agencies. They must be separated, to make each of them more responsive to market forces. This is possible through proper deregulation and transformation into assessable business forms. The interlocking situation in TSEs moving toward the market system is illustrated in Figure 2 below.

Figure 2: Transforming Socialist Economies

![Diagram](image)
Ex-Socialist economies were doomed to collapse due to rigidities firmly entrenched in macro-economic policy, system workability and micro-management capabilities. The following numbers correspond to Figure 2: (1) Budget policy is not disciplined, the deficit is enlarged, and society still pays social costs or wages for (3) State enterprises which rely on (1) Subsidy and (5) Debt due to state banks to keep their (7) Employment. (1), (3), (5) (7) are closely interlocked in TSEs. In order to shift to a market system, financial discipline and market valuation are essential at all three levels. This may be reflected in appropriate market instruments, management quality or labor productivity.

Ongoing macro-economic assistance is not sufficient; instead, effective system advice must be given on how financial discipline can be introduced to fit into each circumstance, how effective market valuation should be organized, how management quality can be enhanced or enforced, and how wages and employment should be maintained.

Money supply (2) must be kept under control, with flexible but stern discipline. State enterprises must be gradually cut off from subsidy, outstanding debt restructured with new equity or bonds (4), or with temporary government recapitalized bonds. Perhaps a certain amount of outstanding debt could be effectively converted into equity. This equity can then be disposed of or sold privately or publicly in the market, facilitating the pace of market-based privatization (6). Employment (7) in TSEs may be reasonably maintained by wage control (8) vis-a-vis productivity and quality under new ownership structure and able management. The direction toward (2), (4), (6), and (8) should be objectively and mechanically encouraged and consistently pursued.

Under this basic design and structure, a prudent banking system constitutes a core function in all respects. First, it works as a cushion for financial discipline (though it may delay processing the shift or erode public savings). Second, it facilitates restructuring and privatization of state enterprises, and serves as economic and business lever for rejecting political intervention (while ousting incompetent, incumbent managements). Third, it fosters local capital market development through bank portfolio clean-ups and securitization (while this may reveal the actual net worth of enterprises as lower than formerly perceived, it may stimulate private investment). And fourth, it facilitates mobilization of monetary and human resources (which may contain costs by reducing effective wage rates).

The disintegration of rigid TSEs is relatively controllable, and can be facilitated through the banking system without political intervention. Disintegration should be based upon prudent commercial banking regulations which are universally accepted.

While more technical measures are discussed in Section II above, four additional factors have been shown to facilitate shifts to the market mechanism. These factors tend to eliminate the rigidity, distortion or corruption often inherent in TSEs. These include:

- At the macro policy level, efficient and accountable channels of dialogue are essential for policy makers and central banks and allow for an equitable credit system, allocation or control of total credit, delivery of policy guidelines, and transparency of official information;
- Established rules of business and implementation of the market mechanism through an effective banking system, specifically during periods of capital shortage, economic uncertainty, and lack of information;
- Transparency, accountability, and an information orientation tend to sidestep any principal agent problems. State banks may be the main banks for state enterprises. Asymmetric information flow can be easily rectified through multilateral dialogues throughout banks or syndication.
- Once prudent banking regulation is established, agency costs will be minimized. If corruption is equal to monopoly plus direction minus accountability, then these factors can be largely eliminated through the accountable banking system; and
- Availability of information is crucial, including individual corporate credit ratings, investment information; market surveys, industry and technology updates, seminars, consulting work, and audits or accounting functions. Banking is an information industry, and these information flows effectively foster growth of small and medium-sized firms in periods of economic transition.

At any level of macro-economic policy, institutional setting or micro organizational management, strategic design and policy implementation should be approached with short, medium, and
long-term concerns in mind. Figure 3 illustrates how the banking system (established over two centuries) can be effective in dealing with the social issues inherent in the transitional period. Specifically, it is illuminating in terms of resource allocation, subsidization, and speculation (see Figure 3).

If one denotes the TSE banking system, either in terms of TB (i.e. treasury banks for state enterprises, which only transfer subsidy as instructed by the government and lend as requested by their enterprises), or as UB (i.e. universal banks, engaging simply in speculation in foreign exchanges, commodities or real estate and not acting as proper financial intermediaries in the true sense), then traditional banks licensed by governments as commercial banks under prudent banking regulation may be expressed as CB in Figure 3. TSE banking, not operating under the normal prudent banking regulation or rules of the game, may either transfer the rigidity from the previous regime into its new economic environment, or engage purely in speculation.

Neither TB nor UB are transparent in operation, nor do they serve as traditional financial intermediaries. Once standard prudent banking regulation is introduced, those banks would be obliged to comply with the rules of the game prescribed for them; that is, either to operate under commercial banking license or as finance companies or securities brokers. Then, many of the allowances under the old loose rules in dealing with special entities may be taken away, hence reducing subsidization, speculation and waste. Figure 3 symbolizes the degree to which the commercial banking system (CB) will improve effective resource allocation over that achieved with TB or UB, under the standard rules of banking license.

The banking system holds the key in facilitating TSE shifts to true market-oriented economies. Any effective, efficient and equitable commercial banking system provides an accountable and diversified basis for transformation. It plays the role of societal buffer in terms of management systems, social welfare, and employment and wages; it acts as societal anchor in maintaining credit order, efficient settlements and the market mechanism. The banking system also serves as a stimulus for flexible inflation adjustment, investment and production.

Figure 3: Illustrative Difference In Effectiveness in Banking System
An Accountable, Effective Banking System

The banking system can facilitate effective handling of many macro-economic issues inherent in TSEs. If enforced in a competitive manner, it can allocate resources with little political intervention, based upon well-defined rules of the game. Commercial banking forms the basis for all accountable and effective business within both developing and transforming economies. Starting with the primary functions of commercial banks, this section describes specific aspects of prudent banking regulation, the functions of a central bank, the need for clean up of bank portfolios, and local market financing of new investments.

Primary Function of Commercial Banks

The primary function of commercial banks as financial intermediaries is the acceptance of deposits from the general public and the lending of those deposits to specific clients (borrowers). The clients are those appraised as creditworthy in terms of their ability to pay interest and principal on due dates as contracted. The bank’s management will readily provide trade credits to those clients whose primary lines of business and credit history are familiar to them and confirmed in advance. Examples here are suppliers of raw materials and usual buyers of their products. Some borrowers may be able to provide certain kinds of security as collateral, or guarantees from some creditworthy third parties or licensed banks to supplement their creditworthiness. In cases of TB or UB, these functions and principles are neglected and financial viabilities are lost.

In normal trade transactions, buyers request their suppliers to allow a certain period of time for cash payments (usance for sales). For confirmation of sales of raw materials or products, buyers either issue promissory notes (PNs) to pay on agreed dates, or sellers issue bills of exchange (BEs) addressed to buyers to pay on agreed dates. For example, if the bank’s client buys some materials on 30 days’ usance and sell its products on 90 days’ usance, this client usually requires trade financing for 60 days (unless the client has sufficient funding of its own). The bank generally provides the financing for such underlying trade transactions, or discounts the buyer’s PN or client’s BE (accepted or endorsed by the buyer or his banker at relatively lower short-term interest rates). The bank has no problem with providing trade or bridge financing for underlying payables or receivables. To facilitate such normal trade financing, the Central Bank’s rediscount facility is usually available at a favorable rate for licensed banks and their qualified PNs and BEs.

Business transactions, however, may be more diversified in their payment terms and conditions. Bank financing instruments vary according to credit risk involved, information or knowledge of commodities as well as market trends, length of payment period and complexity of handling such transactions:

- Cash finance or discount facilities are readily available for routine (confirmed) business transactions for established clients;
- Documentary letters of credit issued by creditworthy banks may normally be required for discounting the bills of exchange for parties whose credit information is not altogether established or reliable (especially in overseas business);
- Some banks or trading companies may be willing to purchase (in lump sum) commodities or products in packages with relevant documents (BL, invoices, BE)
appraised as salable on their own assessment and risk. These can be purchased at reasonably profitable levels, if the banks are equipped with market knowledge and trading capacities on their own accounts;

* Some durable or capital goods may require payment in installments. Hire purchase can be conceived (for cars and durables) if the mode of transaction and conditions of installment payments are clearly defined and contracted between sellers and buyers, and all PNs are submitted together with a certain amount of down payment (usually 10 to 25%). Banks may be able to discount such PNs provided by sellers (banks' clients) under appropriate agreement (often with some kind of comfort letter, guarantee or with recourse conditionalities); and

* Leasing is financing in-kind. It is generally the provision of equipment or plant (capital goods, large in sum, usable for long term) for which fees composed of interest, amortization and handling charges are included. A main difference between this and a hire purchase is that the ownership of leasing goods rests in the hands of providers (lessors) and not with users (lessees). Leasing may look a bit expensive, but still be attractive for the lessee in terms of requirements for funding, collateral and coping with technological changes.

Any financing instrument backed by real, underlying transactions are normally bankable. The question is whether the obligors (borrowers, buyers, or lessees) are creditworthy from the banker's point of view, and engage in substantially profitable business. Normally, cash flow and management capabilities are the points in question. While any of above financing should be possible in transitional economic systems where uncertainty prevails, discounting facilities, letters of credit, or leasing may be more widely used. Creditworthy and established companies dealing with sound bankers should not have the problem of arrears currently facing some TSEs in the inter-company market. All credits should reflect normal trade transactions, and investments or remittances should be carried through efficient settlement systems of qualified banks to creditworthy business counterparts.

### Prudent Banking Regulation

If a creditable and accountable system is to be established, the standard Banking Act (with supporting regulations and legislation) should be introduced to implement, inter alia, GAAP, BIS (capital ratios, liquidity requirements, ALM, provisions of reserve for bad assets, ceilings on lending to one borrower and equity holding relative to capital base. Banking license is normally given only to those reputable institutions who can comply with such rules of the game.

Some existing TSE local banks, however, are not really qualified for banking licenses. But, so as not to discourage their strong desire to run private banks, the Central Bank should perhaps be prepared to open the door for re application once these banks fulfill the necessary requirements. More important guidance is normally prescribed by the Central Bank or by presidential decrees in the following areas, in order to rectify inherent problems, eliminate the speculative climate prevailing among banks, or to reduce national resource waste:

* The foreign exchange positions of licensed banks (long or short, as well as the maximum ratio of assets in foreign currency) may be defined relative to the bank's real capital base. Residents' capital flight overseas could be legally contained, say at $50,000, with the remainder of investment allowed only with domestic banks or national bonds;

* The extent of banks' involvement in real estate and securities investment may be prescribed, subject to capital base and valuation of collateral, to perhaps 60%;

* Off-balance transactions or contingent liabilities (including derivatives and guarantees) may be required to be specified in annual reports, and should be restricted relative to either capital base or corresponding assets;

* Equity underwriting should be permitted only through authorized securities companies (including subsidiaries) independent from the banks' own accounts, to avoid any insider trading, market manipulations, or conflict of interest, and also to protect depositors;

* The establishment of banks' new subsidiaries (including overseas) should be screened by the Central Bank in advance through approval, consultation, registration or reporting. This should take place in relation to principal lines of business, ratio of equity
The Role of the Banking System in Transitional Socialist Economies

holding, relationship with other partners, management structure and corporate governance in order to identify the extent of the bank’s other commitments, and to keep track of all activities of the banking group (and preempt any mismanagement); and

- Board members and directors of licensed banks should not be allowed to borrow from their own banks or associated companies, or to deal in the securities of their clients on their own accounts.

Functions of the Central Bank

The Central Bank should aim at: price stability, facilitating financing wherever and whenever required; and maintaining the order of the credit system. This should be done through issuance of notes; as a banker of banks (lender of last resort); and as an agent for the government.

Therefore, the central bank and supervisory authorities will need to guard against the bankruptcy of individual banks, which could quickly destabilize the financial system during the transitional phase. Bankruptcy can be envisioned through four scenarios:

- Large defaults by major clients mainly due to poor credit appraisal or undiversified portfolio lending;
- Liquidity or cash shortages triggered by borrowing short and lending long (poor asset and liability management or ALM);
- Speculative dealing in foreign exchange, or investment in concentrated ranges of stocks, shares, or real estate relative to the bank’s management or capital base; and
- Cases specific to certain clients, particularly those overseas.

These are the classic cases that lead to banking failure. They are often observed at times of credit squeezes, or during rapid changes in the financial system. Normally, however, experienced bankers are accustomed to organizing and controlling their operations. The best course of action during the transitional period discussed here is to exercise control and supervision over the bank’s range of activities.

The goal is to discourage the bank from engaging in excessive equity or real estate investment, expanding contingent liabilities, or setting up overseas subsidiaries until it has established a solid track record in domestic commercial banking.

Experience in postwar Japan provides several parallels to the challenges facing TSE policy-makers. In the 1950s Japan had high inflation, a highly concentrated industrial sector, capital shortages and high budget deficits.

The government wanted to diversify the industrial base, as well as to encourage savings and private investment. After the stringent budget-balancing measures recommended by Mr. Dodge, as well as the introduction of a single exchange rate policy, the policy which emerged (through consultation and consensus) had the following characteristics:

- Effective use of commercial banks and the postal system to encourage savings;
- Reliance on the banking system for scarce savings allocation and credit provision for funding priority investment, as opposed to using universal banks or capital markets;
- Maintenance of tight monetary policies to reduce inflation, mainly through the banking system, by credit allocation of the Central Bank;
- Targeting credit to strategic industries, such as steel and coal; and
- Taxing income at the source, thereby reducing the potential for tax evasion.

While some may recommend that the TSEs create universal banks, such a move is premature in terms of soundness, efficiency and future growth. At their current stages of development, TSEs should focus on developing a simple but competitive commercial banking system. Developing efficient payment systems, competitive services for depositors, and effective corporate lending and trade facilities should be primary goals. Since nearly all TSEs face severe capital shortages, high priority should be given to deposit mobilization at this stage.

Competition should be encouraged within confined rules of the game in order to minimize overhead costs and improve the services rendered. Financial maturity is gradually achieved through active competition in deposit-taking, a competitive inter-bank market, competitive margins on lending and foreign exchange deals, quality in credit appraisal, as well as a steady stream of private investment and export growth.

Many existing state banks will need technical assistance to establish a sound and competitive banking base. This could be accomplished through the use of management contracts for periods of, say, 5 years. Further diversification of operations should
only occur after success has been achieved in the provision of "plain vanilla" banking services. Banks in transition should refrain from underwriting equity and investing excessively into real estate on their own accounts, so as to avoid overburdening their capital base and contaminating otherwise sound portfolios.

At the same time, policy-makers should ensure that the banks have an appropriate regulatory and legal framework for their operations. A strong foundation—the use of generally accepted accounting principles, the development of a regulatory and supervisory body, and a strong legal basis for the banking system—will facilitate the move toward a more competitive system. Ultimately, it will reduce the need for direction from the central bank or government. Since bank managers in TSEs are largely inexperienced and the banks' capital bases inadequate, regulators will need to exercise greater caution than would be necessary in more sophisticated environments.

**Need to Clean-up Bank Portfolios**

State banks in TSEs face enormous challenges. Under prudent banking regulation they must restructure and diversify their existing or inherited portfolios, and learn to survive in a market-based economy. They must help restructure state enterprises in ways that foster growth, while maintaining the health of the banking system. Moreover, they are expected to conform broadly to their government's social, economic and industrial policies. Because of the large overhang of inherited portfolios, it will be difficult for state banks to play meaningful roles in promoting new investments until the issues of state enterprise debts are resolved. Thus, the restructuring of inherited debt and restructuring of state enterprises are high priority tasks for state banks.

Some TSEs have adopted mass privatization programs using vouchers or coupons to transfer ownership from state to individuals. These schemes may be significant in building wealth but may not be the most appropriate method of ownership transfer. Voucher or coupon systems ignore the viability of enterprises, and lack the means to evaluate performance in the marketplace. The systems have the potential to disappoint individual investors and undermine any existing government industrial policy. Also, such methods do not take into consideration the need for skilled management and effective banking systems in most cases.

State banks can deal with non-performing loans through five different channels:

- Reduction of loan asset value through inflation;
- Writing off bad loans, transferring them to a liquidation trust fund, or selling loans or equity;
- Replacement of bad loans with government bonds, or backing them with guarantees (thus effectively reducing the portfolio risk weight);
- Restructuring enterprises and introducing new management to improve productivity;
- Conversion of major loan portions into equity (despite possible adverse tax consequences).

While inflation is not recommended as a viable channel for reducing debt in TSEs, banks may use varying combinations of the above. As a first step, large state enterprises must be divided into several manageable units such as product base, factory or enterprise division; then they must be corporatized. Only after this occurs can state banks (similar to their main bank counterparts in Japan) begin to design restructuring programs for potentially viable units and liquidate those which are not viable.

Main banks in Japan have played a pivotal role in providing financing, advice and restructuring know-how in response to corporate development needs. During the post-war period, these banks provided long-term investment financing to strategic industries and promoted the growth of small and medium-scale enterprises through equity holdings, provision of market information and management assistance.

The major qualifications for determining "main bank" status in Japan can be described in terms of six dimensions:

- The ability to hold equity in firms;
- The presence of board representation with key clients;
- The provision of last resort facilities;
- The maintenance of historical relationships with certain groups of enterprises;
- The development of long term fund raising or trustee roles; and
- The offering of specific intelligence services.

After World War II, the enterprises involved in military production were obliged to convert their production systems to civilian operations, such as
the manufacture of capital goods, transport, shipbuilding and machinery. Main banks guided enterprises through this transformation. Figure 4 illustrates the various functions carried out by the main banks.

In tackling their portfolios, state banks should classify their loan portfolios broadly into four categories, using performance (increasing revenue or declining income) and net worth (assets versus liabilities) as primary benchmarks (see Figure 5). Sectoral analysis, showing per capita productivity, revenues, overheads and profitability will aid in splitting large enterprises into manageable units. Experienced consultants or accountants can assist the banks in classifying enterprises into four categories, described below:

Figure 4: Major Qualifications of Main Banks

<table>
<thead>
<tr>
<th>1. Equity Holding, Long-term Merits</th>
<th>2. Last Resort Restructuring Facilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Auditing, Board Representation &amp; Monitoring</td>
<td>6. Intelligence Services, Credit Appraisal</td>
</tr>
<tr>
<td>4. Networking, M&amp;A, or Historical Relationship</td>
<td></td>
</tr>
</tbody>
</table>

Explicit | Implicit

1. Good
Divide and sell

2. Prospective
Debt to equity or
Divide and improve

3. Partially viable
Divide and improve

4. Doubtful
Liquidate or write-off
(Sell any residuals under RTC)

Figure 5: Performance versus Net Worth

Net Worth

1. Good
Divide and sell

2. Prospective
Debt to equity or
Divide and improve

3. Partially viable
Divide and improve

4. Doubtful
Liquidate or write-off
(Sell any residuals under RTC)
industries of comparative advantages or utilities and other public services may fall into this category. Figure 6 illustrates the general criteria for governments in making these considerations. While governments in TSEs presumably want to sell as much as possible, some consideration of social welfare policy is appropriate. Units may be sold, for example, through regulatory arrangement or specific leasing contracts (see Figure 7). In many cases, enterprises in this category may be restructured into viable form by a split into several entities and conversion of debt into equity. The major question may be how to replace the incumbent management with an able one, or with an effective contract supported by the ministries in charge.

Partially viable enterprises must be subdivided and given management assistance in order to improve their performance. These firms should have positive net worth, but accumulating debt and declining revenues are cutting into their viability. Government bonds or guarantees may be necessary to preserve their viability in the short-term.

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**Figure 6: Industrial Policy versus Return on Investment (ROI)**

![Diagram showing the relationship between ROI and investment in various sectors such as private business, telecom, electricity, mining, and water supply.](image)

**Figure 7: Social Welfare versus Productivity**

![Diagram showing policy objectives with high and low productivity and high and low social welfare.](image)
Bad enterprises are those firms must be liquidated and written off. Assets to be liquidated can be transferred to a liquidation trust fund (see Section IV) to facilitate the recovery effort.

Credit evaluations and restructuring can best be initiated by state banks (main banks) as part of their portfolio clean ups under prudent banking regulation, inter alia, provisions for bad assets, lending limits and capital requirements. This can take place with the support of the Central Bank, Ministry of Finance and Ministry of Industry, and should be strictly enforced (see Section V).

**Financing Long-term Industrial and Corporate Investment**

Under current TSE inflation levels, interest rate volatility, and uncertainty in economic prospects and legislation, it is extremely difficult for any new investor to appraise and undertake projects or raise long term funds in the market at a reasonable cost in the medium term. With every financial institution engaged in short-term speculation, there is virtually no market for funding industrial financing at the moment. Even the monopolistic Russian Savings Bank is busy with housing loans and inter bank market operations.

Long-term financing under such uncertain conditions, however, may be mobilized if reasonable interest rate structures can be established (perhaps following the example of postwar Japan). The following channels apply:

- **Treasury or local authority bond issues** (initially in short-term) can be underwritten by savings banks or licensed commercial banks. Longer term government bonds may be undertaken by a pension fund.

- **Main banks for state enterprises** could arrange syndicated loans (say, from 2-7 years) on a roll-over basis (perhaps 3-6 months in step-up rates) through commercial banks to finance revenue-generating projects.

- **Equity investment funds**, venture funds, trust funds, reconstruction corporations, or privatization funds, may be managed after state enterprises' restructuring, corporatization, and establishment of ownership rights.

- **Some creditworthy banks or enterprises** may issue debentures of medium-term maturities (2-5 years), with appropriate collateral (such as guarantees or real estate) provided to trustees.

- **Some high yield bank assets** may be securitized (backed by underlying transactions), to be sold in the secondary market.

- **Foreign borrowing** may be the major source of long-term financing for export related projects.

These steps will prove helpful for regional development, investment, or long-term credit banks in their pursuit of positive industrial investment financing (including domestic resources and foreign direct investment).

Assuming a principal agent problem exists in TSEs, four major principles are applicable to the development bank:

- The joint venture bank, owned by domestic partners, can own a majority share (say 60%). Governmental sources should not own a majority, but could maintain a 30% to 49% share; domestic private institutions could own up to, perhaps, 20%. This shareholding structure is critically important in light of current creditability and prevailing practices. It ensures transparency in governance and decision making, as maintains the check-and-balance system of management responsibility.

- The single largest government shareholder (owning approximately 25-30%) should be available to act as a sponsor of last resort for a joint venture. Regional authorities are essential partners in identification, implementation and supervision of projects, with shares of between 10 and 30%. Still, all government shareholders together should not exceed the majority of between 30 and 49%.

- **Foreign institutions** are indispensable partners for bringing in management know-how, widespread human resources and long-term funds. Both semi official agents and private institutions may be invited to participate to diversify the operation. Perhaps some type of option clause should be required for partners to review total performances after 5-7 years.

- **A channel for consultation with independent experts**, such as independent investment management boards, may be necessary depending upon management structure or available expertise (see Section IV).
Section IV

Privatization Programs through the Banking System

TSEs have been deluged with Western advice on reform and privatization of state enterprises. Additionally, it has been difficult for merchant bankers to implement their usual approach of undertaking privatization programs, due to the absence of property law and the undeveloped condition of local capital markets.

Because of these facts, IFIs or IFCs should be able to assist TSEs as well as investment bankers. The ongoing mass privatization programs (including voucher schemes) appear equitable in promoting private ownership for small shops and restaurants.

Yet what is really required is promotion of sound corporate development and new industrial investment. Large enterprises which have technology or market share advantages may have already been partially sold to Western European investors.

The general difficulty may lie with large industrial or military complexes, or with state enterprises still practicing some form of subsidy. Problems lie in: producing salable products in the new world environment, financing new investment, shedding inherited debt, and perhaps replacing old management.

Privatization programs should be commensurate with the viability of enterprises, since potential investors or entrepreneurs may be discouraged by nominal privatization or corporatization. While some aspects of privatization may be controversial, governments and state banks can take several non-controversial steps that will help pave the way for the ultimate state enterprise privatization.

Comprehensive restructuring and privatization should be based on five principles:

- Restructuring should be enforced through portfolio clean-up held by state or main banks in the prudent commercial banking system (see Section III).
- The centralized production systems of enterprises should be broken into several manageable units and allowed to compete for new markets.
- Inherited debt should be handled through securitized instruments and replaced with government recapitalized bonds, equity or convertible bonds. The market should be allowed to determine the value of those debts.
- Enterprises should contract with independent consultants to agree on restructuring and privatization programs with their state or main banks.
- Governments may set broad guidelines on industrial development in the medium term.

These implementation programs should be enforceable under the new constitution and antimonopoly laws, as well as under prudent banking regulations.

Banks should first classify their existing loans broadly into four categories (see Section III). Due to capital base constraints, insufficient provision for bad loans can be made, and some of the loans may exceed the lending limit under regulation. Bad loans must either be written off, replaced with government recapitalized bonds, or transferred to a liquidation trust fund. The rest of the loans may be substantially converted into straight or convertible
bonds or equity. Selling convertibles or equity in the market is virtually the process of privatizing the enterprises.

Two alternatives may be considered. One is to change the loans into some preferential form of convertible bond (CB), possibly collateralized with enterprise fixed assets. The other means is to transfer excessive equity (that beyond net worth) to the management of an independent equity holding company. Here, associated banks keep minority shares on their own undertaking, together with governments and/or interested group funds or companies (see Table 3 and Figure 8).

Thus, large debt may be divided into smaller units in terms of either bonds or equity, so that markets can deal in both instruments. Various terms may be conceivable for convertible bonds, but bond and equity will be their form. CBs may be convertible into equity either when the price of the equity reaches a certain level, or after a certain amount of time has elapsed (say 5 years). The life of a CB may be up to 12 years, and carry a coupon rate of perhaps 5 to 18% per annum (as local circumstances permit). CBs can be issued at two tiers:

- Issues by state banks to government (an equity holding corporation) or the Central Bank; or
- Issues by enterprises to their main banks.

The terms and conditions of both CBs may basically be the same, but flexible consider-

Table 3: Ownership/Management
A Case for Mixed Economy

<table>
<thead>
<tr>
<th>Management</th>
<th>Ownership</th>
<th>Management contract</th>
<th>Guarantee (Tariff)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Government Control</td>
<td>Fully Government-Owned</td>
<td>Public sector (State enterprises)</td>
<td>Management contract (Partial sales)</td>
</tr>
<tr>
<td>Indirect Control</td>
<td>Party Government-Owned</td>
<td>Public corporation (Management contract)</td>
<td>(Special JV enterprises) Under regulatory arrangement</td>
</tr>
<tr>
<td>Private Control</td>
<td>Privately Owned</td>
<td>Management contract (Fee)</td>
<td>(JV investment (Non-commercial risk sharing)) Private enterprise</td>
</tr>
</tbody>
</table>

Figure 8: Roles of Banks in Restructuring Enterprises
ation may be given to certain prospective enterprises on applying progressive rates of interest, starting at perhaps 5 to 7% per annum, and ending at 12 to 18%, unless converted into equity in the meantime. Time of conversion should rest on the judgment of bond holders depending on market interest rates, prospective performances of enterprises or their own ALM positions.

Indeed, CBs can be considered the best market instruments (both as bonds or as equity), since their prices are quoted to reflect relative asset values, market interest rates and performance. While pricing may occasionally induce arbitrage, on the whole it indicates a fairly appropriate measure of local market values, despite the potential technical difficulty of enterprises involved.

By converting debt into equity or CBs, cost on enterprises may be minimized, while restructuring time is gained. Debt of a special nature (such as external debt or senior claims) may either be swapped into property or replaced with short-term IOUs from the Central Bank, if this is considered appropriate from a monetary point of view. It would be effective if some ODA or IFIs could extend credits of say, 10 to 15 years to TSE governments (or the Central Bank), in order to facilitate conversion of debt into equity at a two-tiered level.

For reasons of social justice, the national burden or social cost inherited from the previous regime must be borne widely by the economy as a whole. De facto inflation or devaluation is obviously one means for doing this, and allowing markets, potential entrepreneurs, or foreigners to undertake it may be another. Still further, devices for enhancing the value of existing productive capacity (perhaps under new, professional management) is definitely the right course of action; this should be quickly implemented. Any of these channels or devices can be organized so as to produce a cost minimizing effect in tackling inherited debt, but this is only possible through market functioning, as well as an effective, efficient and equitable banking system.

In view of the lack of managerial capacity and corporate governance faced by TSEs, these economies should consider creating investment management advisory boards composed of expert financiers, industrialists, consultants, accountants and entrepreneurs. Many multilateral and/or foreign advisors should be included to provide outside expertise and objective perspectives. The board could advise on macro as well as on micro issues, providing guidance for each enterprise. The boards should have the power to authorize, guide or facilitate viable investments. They should be constituted even prior to the enactment of the legislative framework for investment (investment code, contract law, company law). The boards should not only provide individual investors with micro management assistance in making their investment programs workable, but should also play macro strategic roles. They could aid, for example, in establishing appropriate industrial zones, in conceiving investment incentive schemes in export industries, or in providing intelligence services to diversify treasury operations. They could assist in marketing or in introducing technology or equity partners, as well as in assisting with mergers and acquisitions. In short, the boards could minimize all dimensions of business infrastructure constraints on TSEs.

Such draft schemes of restructuring programs for all enterprises may initially be produced by bank management as main banks or representative creditors. First, they should be discussed with the management of enterprises to identify the units divisible in the existing production systems. Based upon feedback from enterprise management, banks should then submit the plans with feasible balance sheets for each unit to the government (or some form of independent restructuring authority composed of members of the ministries in charge) for broad and general agreement. Such balance sheets will be worked out objectively by independent qualified accountants.

Consolidation of such balance sheets should reconcile with the audited balance sheets of the total complex. The government or restructuring committee is expected, in point of principle, not to modify the proposed plans agreed upon by the concerned parties, except in cases where a specific industrial policy consideration is affected.

Based upon state banks' restructuring proposals, governments can obtain a strong sense of the status quo of each state enterprise. Governments should establish and state their positions clearly. They should be committed to:

- Adopting a broad view of industrial and welfare policy, and publicly specifying the degree to which the government may remain as stockholder;
- Dividing complex enterprises into as many economically-viable units as possible, then privatizing (or selling) them with the aim of enhancing competition and efficiency
The Role of the Banking System in Transitional Socialist Economies

(44) The Role of the Banking System in Transitional Socialist Economies

• Resolving the actual allocation of work forces to each of the salable units prior to each unit’s sale. This should be based upon practical judgment, and conducted under the advice of an independent professional team (such as the investment board);

• Concentrating on enhancing the efficiency and profitability of production units through leasing, management contracts, or recapitalization, in view of the overall lack of domestic capital stock. This should take place until potential investors emerge, perhaps in the form of corporations (joint stock companies), or as other salable instruments such as convertible bonds;

• Supporting the public sector through the social safety net (services). This will be maintained through stockholding, recapitalization, bonding, guarantees or regulatory arrangements;

• Relegating bad enterprises or doubtful assets to a special independent liquidation trust fund. It is more transparent and less costly if such doubtful assets are concentrated under the same umbrella, rather than split between several entities;

• Streamlining shareholdings in enterprises (since debt overhang is so substantial), via either state banks or public equity holding companies (see Figure 8). This will facilitate moves away from an interlocked system, and maintain the option of selling banking equity in the market when appropriate opportunities arise.

A few additional technical points:

• Dividing huge production complexes of state enterprises into many independent corporatized units not only helps promote the sale of assets and privatization at better prices, but also assists in the diversification of portfolios as state banks themselves are divided into smaller units. This enhances the banks’ ability to convert long-term loans into equity, and enables them to gain new equity.

• Banks should take this opportunity to diversify their portfolios more broadly, from the Asset and Liability Management (ALM) point of view. On the asset side, some long-term loans may be changed to short term loans, if necessary, on a roll-over basis. Some loans may be securitized, say to convertible bonds or collateralized straight bonds. Fairly large portions of banks’ equity holdings may be shifted to independent management companies, possibly via joint ventures with other pension funds, or to foreign partners.

Additional sell down of assets may be possible in securitized forms. On the liability side, recapitalization of enterprises may be possible through issuing convertible bonds. Medium term swap arrangements may be conceivable through foreign financial institutions, which potentially wish to make local investments without incurring exchange risk.

More attractions can be attached to deposit taking or networking of cheap fund-raising in money markets. Opportunities exist for enhancing stability and balancing assets and liabilities. This leads to improved profitability for banks.

• Conflict may arise between creditors regarding the seniority of claims. These should be irrespective of the nature of the claims (working capital, bridging finance, accounts payable) by replacing them with, for example, convertible bonds of different maturities.

• For asset sales, the following points should be given priority consideration:
  - It is appropriate to set floor prices and guide the market to bid higher.
  - Since governments ideally should handle the reallocation of work forces to each unit, and given that employees normally work harder if sharing in company ownership, shareholding (albeit minor) should be offered to employees at preferential fixed prices (slightly below the floor price).
  - Potential entrepreneurs or management candidates normally feel more confident investing in or running companies if core portions of shareholdings are in the hands of reputable groups or specific private parties. Hence, sales to core private parties by auction stimulates bidding and often results in success.
- If wider ownership or public holdings are preferred, fixed price offerings are more desirable than conventional or Dutch auctions.

- To stimulate interest or turnover in secondary markets and enhance the consciousness of management over performance, various marketable instruments should be employed to reflect wider evaluation in the market (see Section III).

- It is essential that every independent unit (across the board) be corporatized.

The amounts which will be privatized thereafter depend on prospective profitability, pricing, viability, and market conditions, and should not be of primary concern. The immediate government focus should be the rationalization of each unit, in order to enhance efficiency and profitability. In many cases, this can be achieved through lease or management contracts, or by some regulatory arrangements including tariffs and fees. As in any capitalist country, the TSE will face a variety of ownership and management forms. While some are unique, most fall into nine basic categories (see Table 3 above). These categories depend on the degree of government ownership and control that must be exercised, either from a public welfare or industrial policy point of view. Indeed, there is a good case for the mixed economy. However, constant review is encouraged to examine performances within those categories, specifically in cases of partial ownership and indirect control. These should be sold into private hands in 3-5 year programs.
Section V

Industrial Policy Considerations

In order to facilitate the shift to market orientation, some form of industrial policy is effective in guiding new long term private investment. Under the transitional period of hyper inflation, no investor can venture to undertake new investment. Three major motivations may promote new investment: first, increasing the supply of foodstuffs and consumer goods to combat inflation and maintain the social safety net; second, overcoming economic bottlenecks in infrastructure elements such as telecommunications, electricity and transportation; and; third, channelling scarce resources into prospective industries rather than into foreign exchange or real estate speculation.

Specifically, industrial policy for transitional economies should address issues of:

- Return on investment vis-a-vis private business prospects;
- Social welfare factors vis-a-vis productivity in the public sector; and
- Maintaining creditworthiness in dealing with external outstanding debt, since this may promote foreign direct investment.

Some state enterprises will require screening in light of the government's industrial policy versus return on investment (ROI). Figure 6 (above) may clarify this point. Utility enterprises may be supported by regulatory arrangements and/or government bonds which allow them to run as going concerns.

Those units of enterprises with high ROIs or ROAs may be divided and sold, and units with lower returns required to improve efficiency, perhaps under professional management contracts. Enterprises still endowed with positive net worth but with accumulating debt should be divided into viable units and unprofitable units.

Viable units may be put under professional management contract for further performance improvement. For partially viable enterprises, some social welfare policy considerations may be required vis-a-vis productivity.

Government bonds or guarantees may also be required to make them sustainable. Figure 7 (above) may provide a general guideline. Units with high productivity should be sold, while those with low productivity and lower policy significance should be liquidated and written off.

It may be interesting to compare the differences between prospective new investment, productivity and coverage in military state enterprises, centrally supported enterprises, guided multi-enterprises, and free enterprises within a centrally planned unit.

The most likely result is that ranges of investment in military state enterprises would be confined to the traditional areas of steel, chemical, oil and gas. Investment in centrally supported enterprises would center around shops, finance and food processing; in free enterprises within a centrally planned unit, the applicable industries would be real estate, foreign exchange, and commodities. Either may be lower in productivity.

In contrast, in guided multi-enterprise with diversified investment one would expect a wider range of industries, where competition would enforce efficiency and raise productivity. Such differences in growth rates and competitiveness would...
provide strong incentives to potential private investors. See Figure 9 for a comparison of the prospects of military state enterprises, centrally supported enterprises, guided multi-enterprises, and free enterprises within a centrally planned unit.

External debt may receive somewhat different treatment, as it involves relationships with many important overseas creditors. In terms of scarce foreign exchange and the creditworthiness of the country in capital markets, TSEs should adhere to the following guidelines when resolving external debts:

- Early and decisive action is necessary before a crisis occurs. Countries should maintain close relationships with reliable institutions which may offer last resort facilities, such as standby facilities or note issuance facilities (NIFs);
- The timing of refinancing and rescheduling arrangements must be reviewed continuously in consultation with major key institutions;
- Arrears or delayed payments should be avoided, as these will endanger the country’s sovereign credit standing in international markets;
- Rescheduling negotiations should go through one window, such as the Paris Club or bank advisory committees;
- If debt and debt service reduction operations are necessary, the country should make all efforts to maintain and restore its creditworthiness in international markets;
- All possible options should be made available in dealing with the different positions of various creditors;

Figure 9: Illustrative Prospects on Productivity/Production
In a worst case scenario, it may be necessary to convert external debt to equity;

- Avoid using secondary market prices for sequestering and discounting one's own debt. These markets are marginal, and use multiple counting by using the same debt to bid down the price of the debt. Officially accepting these prices could lower the debtor's level of creditworthiness, and put "friendly" creditors in awkward positions;

- Interest capitalization should also be avoided, as it implies an inability to control one's monetary affairs; meanwhile, debt continues to accumulate. If this option becomes unavoidable, the interest capitalized could be converted into short-term convertible bonds, perhaps due to state enterprises or state banks.

- Most importantly, any sovereign borrower should be able to repay its debts in its own currency. Some creditors may be willing to convert their loans into local equity or property if appropriate incentives are attached. Payment in local currency is desirable at face value to preserve the sovereign integrity of the government. In addition, it may be possible to link repayments in local currency with the provision of new money by the same creditors. This debt-to-equity conversion could be quite attractive to friendly creditors, and to investors (who anticipate strong prospects in these economies once debt overhang is reduced). Debt equity conversions may be limited, however, by the government's fiscal and monetary position.

The core problem for TSEs is the substantial state enterprise debt due to their state banks. This debt was inherited under the central planning policy of the previous regime. A centralized approach is essential to rectifying such systemic problems as policy guidelines, managerial capacity and the market mechanism. The distribution of vouchers to private citizens, or the use of mutual funds, may be useful in promoting small private ownership. However, the main objective is to tackle large state enterprises by making them viable units, to enhance market competition, and to foster the managerial capacity which lays the groundwork for the move to the market system.

State banks, as financial intermediaries acting as main banks, are in key positions to resolve these issues (under professional assistance). These banks can initiate the classification of outstanding loans based upon objective credit appraisal, corporate performance, and net worth. They can further propose methods for restructuring industrial complexes into economically viable units. They can adopt specific measures to replace debt overhang, mostly with equity. Governments must indicate broad guidelines, and announce their willingness to promote such restructuring and privatization under broad industrial and social welfare policy. Banks should take this opportunity to improve their own asset and liability management, and to become efficient and competitive in their role as financial intermediaries facilitating private investment in the new environment.

**Conclusion**

From a historical or cultural point of view, TSEs may prefer the European or Japanese style of economic system over the American brand of liberal capitalism. Moreover, TSEs may find the Japanese model of enterprises, guided industrial policy, medium term planning, and socialistic welfare in net income distribution more palatable than the American system.

Following the adoption of a new constitution, antimonopoly, private ownership and property laws should be enacted as quickly as possible to discourage any form of political intervention.

Pure commercial banking systems may be more advantageous than universal banking at the initial, 5 to 10 year stage. The former discourages resource waste, as well as excessive speculation. Lower interest rate policy, equitable taxation systems. And sensible foreign exchange control (such as that practiced in postwar Japan) are recommended. This will establish a business system characterized by accountability, competition, and fairness.

The banking system can serve as the core of information and competition within corporate business development. For this to succeed, banks must properly train management, obtain the equity of venture capital, arrange for cofinancing and facilitate efficient computerization programs.

The protection of depositors and the enhancement of employee welfare is essential, as is the development of managerial capacity.

Foreign banking licenses may be dispersed into the region and utilized to promote joint ventures, perhaps using the conversion of debt into equity.

Certain well-structured regional investment banks may hold the key to promoting new invest-
ment under industrial policy guided by the central government.

Corporate governance will be effectively enhanced through banks, auditing arrangements, structuring of boards and creation of independent investment advisory groups.

IFIs and ODA agents have many avenues for assisting developing or transforming economies. Macro policy, institutional setting and micro management provide the foundation for strong and steady growth (see Table 4). While this paper has offered much advice on common denominators, it is important to emphasize again the importance of institutional settings on the economic environment.

The banking system plays a key role in economic development worldwide, and is instrumental to any movement toward a market-oriented system. Its efficiency, effectiveness, and equitability will vary country by country, reflecting the management and cultural influences organized at the macro policy level.

In fact, the banking system may be rendered ineffective, inefficient or unacceptable to the society within which it operated if these macro and management issues are ignored in the pursuit of economic development.

A market-oriented system within transitional socialist economies can be facilitated by recognizing the role of commercial banking, organizing an effective accountability system, and restructuring state enterprises. The time has come to move beyond simple liberalization policy.

### Table 4: Major Factors Affecting the Economic System

<table>
<thead>
<tr>
<th>Common Denominators</th>
<th>Focus</th>
<th>Culture</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro policy</strong></td>
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<tr>
<td>Macroeconomic</td>
<td>Comparative advantage</td>
<td>Social safety net</td>
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<tr>
<td>adjustment,</td>
<td>Economic planning</td>
<td>Value concept</td>
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<tr>
<td>Foreign exchange</td>
<td>Technology</td>
<td>Mentality</td>
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<td>Investment</td>
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<tr>
<td><strong>Institutional setting</strong></td>
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<tr>
<td>Banking system,</td>
<td>Coordination</td>
<td>Laws &amp; Regulations</td>
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<tr>
<td>Market mechanism</td>
<td>Competition</td>
<td>Market maturity</td>
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<tr>
<td>Information</td>
<td>Incentives</td>
<td>Workers’ welfare</td>
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<tr>
<td><strong>Management Style</strong></td>
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<tr>
<td>GAAP</td>
<td>Profitability</td>
<td>Ownership</td>
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<tr>
<td>Efficiency</td>
<td>Quality skill</td>
<td>Motivation</td>
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<tr>
<td>Experiences</td>
<td>Training</td>
<td>Practices</td>
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