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INTRODUCTION

The economic, social and political transformations underway in Central European countries have attracted the interest of social scientists from inside and outside the region. This interest has at least two major dimensions - cognitive and applied. The scale of necessary reform has created great demand for theoretical as well as policy-oriented analyses.

The group of Emerging Market Economies (EMEs) is highly diversified. Besides the formerly centrally planned economies of Europe's, it includes such countries as China, India, Malaysia, South Korea, Brazil, Mexico and South Africa. However, the major common features of these economies are reintroduction of market allocation mechanism, deregulation and privatisation.

The most profound changes, in terms of institutional arrangements (*qualitative policy*) and the operation of economic policy instruments (*quantitative policy*) have been introduced in such Central European countries as Hungary, Czech Republic, Poland, Latvia and Estonia. These countries had to rebuild or often establish from scratch, those market institutions and mechanisms which are preconditions for sustainable productivity growth and for improving living standards. Though successful, this transformation process has generated a number of negative side effects. The most acute is high, persistent unemployment. It is visible particularly in countries that were able to initiate deep, microeconomic restructuring.

The scale of the experiment and its side effects has fuelled debate as to the choices of priorities, the timing of reform and instruments of economic policy aimed at stabilisation and transformation. Two main approaches might be distinguished. Proponents of the radical approach, based on the experience of IMF stabilisation programmes implemented in distorted, primarily South American market economies, argued that swift, co-ordinated monetary and fiscal actions are of vital importance in gaining credibility and producing viable results. In contrast, the gradual approach is based on the assumption that the financial and non-financial structures that emerged during the central planning period are rigid.

These structures must be reformed cautiously and progressively if they are to produce sustainable results.

Although simultaneous stabilisation and transformation is a complex, multifaceted process, both approaches indicate that financial reform is a fundamental condition for economic development. Its importance stems from the underdevelopment of EME financial sectors. Despite unquestionable development of EME equity markets, the creation of a sound, efficient banking sector remains crucial for channelling domestic savings, as well as for its role in restructuring and privatising the non-financial sector. Financial sector development is also a prerequisite for effective monetary policy. The pivotal role of financial reform in EMEs has also gained importance due to the rapid technological change and deregulation of this sector in developed market economies. These processes lead to further interdependence and globalisation. They are also accompanied by a redefinition of the role of state and monetary policy in the context of EMU and EU aspirations of European EMEs.

Financial reform, together with sound, transparent solutions in corporate governance should contribute to an increase in foreign direct investment and generate higher levels of domestic savings. The transparency of financial markets is also important for their efficiency. This will decrease uncertainty and help economic agents to form expectations.

The natural complexity of expectation formation mechanisms is even greater in EMEs due to discontinuities of institutional reform, rapid changes in the number of firms and EME market structures. These factors, along with the insufficient quality and quantity of microeconomic and macroeconomic data might hinder quantitative analyses. That is why an integrated, qualitative and quantitative research approach is necessary.

The aim of this book is to present an up-to-date account of theoretical and empirical research on the progress of financial reform in emerging market economies. Although the emphasis is placed on research on Poland and Hungary, other countries and broader theoretical and institutional issues are also analysed. The book comprises chapters based on papers presented at the ACE/Phare Workshop on "Restructuring Financial Institutions in Emerging Market Economies" held at the University of Groningen on 4-6 April 1997 and a number of invited papers by researchers from universities of Aalborg, Bradford, Gothenburg and Poznań. The first part of the book contains three theoretical, background chapters.

Parminder Bahra and **Christopher J. Green** (Loughborough University) and **Victor Murinde** (Birmingham University) analyse the genesis of financial sector reform in EMEs. In this chapter special emphasis is put on policy implications and proposals with regard to banks' bad debt problems. The authors emphasise that at the outset of the transformation there was no blueprint for these economies to follow. They also argue that there is still a lack of general theoretical frameworks suitable for financial sector analysis in EMEs.

In chapter 2 **Niels Hermes** and **Ger Lanjouw** (Groningen University) focus their attention on the role of the exchange rate as a nominal anchor in anti-inflation policies. The theoretical analysis is amended by empirical results of South American countries, Israel and Central and East European countries. The authors note that in the medium and long term a flexible exchange rate system is more appropriate in EMEs due to its greater ability to absorb external shocks.

In chapter 3 **Niels Hermes** and **Robert Lensink** address the problem of deposit insurance and its role in establishing a stable banking system in EMEs. The authors discuss the rationale for implementing such systems and analyse whether they could reduce bank insolvencies in Eastern European countries in the near future. They emphasise the need for introduction of effective and clear-cut supervision of the banking sector before the implementation of deposit insurance scheme.

Deposit insurance is also analysed in chapter 4 by **Jan M. Szambelańczyk** and **Hanna Burmistrzak** (Poznań University of Economics). The authors focus their attention on Poland. They present legal aspects of the deposit guarantee system in Poland and analyse Poland's initial experiences with this new element of its financial infrastructure.

Banking issues are discussed in the following two chapters as well. In chapter 5 **A. Geske Dijkstra** (Institute of Social Studies, The Hague) develops a conceptual framework of financial intermediation and uses it to analyse the development and efficiency of the financial sector in Hungary. Three concepts of efficiency (operational, allocative and dynamic) are used in the chapter. The author argues that financial liberalisation in Hungary has led to a structural competitive loss for state-owned banks. However, this liberalisation has failed to make long-term finance available for the private sector.

In chapter 6 **Vello Vensel** (Tallinn Technical University) analyses the path of development of the Estonian banking system. The author uses a modified DuPont approach and his own matrix method to focus on bank

performance analysis. Vello Vensel argues that the matrix approach has some further applications and advantages over the classical financial ratio analysis.

The next part of the volume is devoted to stock market issues. **Bert Scholtens** (University of Amsterdam) focuses his attention on the way Poland made use of international markets. Using the yield spread of international markets and the efficiency of the Warsaw Stock Exchange, the author analyses foreign appraisal of Poland's equity and debt. In the analysed period the attractiveness of Poland to foreign investors improved.

In chapter 8 **Witold Jurek** (Poznań University of Economics) examines the impact of microeconomic factors on stock prices on the Warsaw Stock Exchange in 1994. It is argued that stock prices were strongly affected by management efficiency. The link between stock prices, liquidity and financing structures was weak.

Qaizar Hussain (Gothenburg University) uses panel data for Malaysia and Korea's 100 largest listed manufacturing firms to examine the sources and nature of variation in these countries' capital structures. These countries belong to the group of upper-middle income EMEs and often serve as a point of reference in analyses of European transition economies. The author argues that the high level of debt-equity ratios in Korea and prevailing domestic equity ownership in Malaysia are results of different policies pursued in these countries.

Chapters 10 and 11 deal with issues of foreign direct investment (FDI). **Wanda Nowara** (Poznań University of Economics) analyses the impact of FDI on balance of payments. Theoretical considerations are exemplified by empirical data on Poland, Hungary, Czech Republic and also Portugal and Spain. The data shows that in most cases, FDI has led to a deterioration of the balance of trade.

Steve Letza and **Bill Neale** (Bradford University) focus their attention on the microeconomic determinants of FDI. The authors analyse motives for FDI and present case studies of joint ventures in Poland and British investments in Hungary. They argue that the success of any joint venture is based not only on foreign investment but rather on the transfer of managerial skills and management methods.

The final part of the book consists of two chapters devoted to macroeconomic and institutional issues. **Wolfgang Zank** (Aalborg University) analyses the economic transfomation of East Germany in 1990-1997. The empirical data is presented against the background of extensive methodological and theoretical analysis. The author focuses on

short-term mistakes that have had long-lasting, macroeconomic consequences. Wolfgang Zank notes that the German government was delayed in realising that Eastern German economic recovery needed large scale government intervention. The author's analysis also suggests that the Eastern German economy is still far from achieving sustainable growth.

Tadeusz Kowalski and **Dorota Hadasik** (Poznań University of Economics) analyse the macroeconomic conditions and institutional arrangements related to bankruptcy in Poland in 1990-1995. The authors argue that beyond maintaining liberal formal entrance rules there is a need to improve both the legal procedures and execution of corporate bankruptcy in Poland. More efficient exit rules and mechanisms will complement market reforms and increase the general efficiency of the Polish economy.

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Tadeusz Kowalski

Poznań University of Economics

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