



Center for Social & Economic Research

**COMPARING
FINANCIAL SYSTEMS**
PROBLEMS OF INFORMATION AND CONTROL IN
ECONOMIES IN TRANSITION

by

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1. Introduction

An important literature is growing on financial reforms in the countries in transition : it is widely understood that putting in place well designed financial systems is a crucial element of structural reforms. The Central and East European Countries (CEEC) are painfully leaving behind the caricature of a Modigliani-Miller world: in the absence of capital market the performance of enterprises was determined by real variables, financial flows being adjusted to real flows. The lack of a full fledged financial system has often been identified as one of the main weaknesses of centrally planned economies.

Modern theories of finance, having taken into account imperfections in the capital market and transaction costs, have put in the centre of their analysis the relationship between investment decisions and financing decisions. The importance of financial systems is also documented by a number of empirical studies which have shown the positive impact of financial development on economic growth and development. ¹

Looking for an appropriate model of a financial system the managers of transition are inevitably confronted with the diversity of contemporary institutional arrangements in this domain. Therefore, echoing western discussion there is a budding debate in CEEC about the relative role of the stock market and of the banking system in financing investment and controlling management.

According to early declarations of intentions by Central and East European governments there was some eagerness in these countries about quickly establishing and heavily relying on the stock market: often seen as the symbol of capitalism, it was considered as the ultimate confirmation of international respectability and sometimes even as the real goal of privatization.

Such enthusiasm has provoked severe criticism of a number of western economists (Corbett and Mayer (1992), Mayhew and Seabright (1993)) arguing that instead of following the Anglo-Saxon model with widely held equity and an active market for corporate control the CEE countries should rather adopt the German system with a stable core of majority equity owners exercising directly control on management. Several other papers on financial reforms in CEECs have argued (Tirole (1990), Wijnbergen (1992), Frydman et al. (1993)) that a German type model with strong universal banks should be considered as a desirable pattern. We shall analyze the arguments that may be used in favour of such solution (or have been used although not always in a rigorous way) and then discuss them, taking into account

empirical evidence (based on the experience of developed and developing countries) and recent developments in economic theory.

We shall then look at the particular situation of the countries in transition in order to draw some conclusions about the desirability and feasibility of different institutional arrangements. Finally, we shall present the actual evolution of financial systems in CEEC from the viewpoint of the relationship between banks and industry: it seems indeed that banks are playing an increasingly important role and that very close links are developing between the banking and the industrial sectors. The arguments *pro* and *con* such involvement will be discussed not in terms of an "optimal" model, which remains obscure, but from the viewpoint of the medium term objectives of transformation. Our main point is that introducing (or not breaking up) early in the process strong links between banks and enterprises may hinder the injection of contestability (i.e. potential competition) in the industrial sector : a bank dominated system may fail to create incentives for the generation of information about different investment opportunities. The value of such information creation for the economy as a whole is particularly high in CEEC because of the scope of the needed reallocation of resources: unusually large amount of resources should be liberated from their entrenched uses and moved to their highest value use. The crucial issue is how to identify the directions of such reorientation.

2. Stylized characteristics of the two financial systems.

The differences among two models of financial systems can be captured under several dimensions. For the purpose of this paper we shall distinguish between three aspects: financing, information and control, that may be considered as three functions any financial system is supposed to perform. Let us define them briefly.

1. ***Financing***. Creating channels of financing is the first and the most obvious role of any financial system: in order to transform savings into investment it has to create opportunities for savers (including the possibility of risk sharing and providing insurance).

2. ***Information***. Generating information on the value of firms and on various investment opportunities (pricing the risk) and ensuring that resources are efficiently allocated.

3. ***Control***. Imposing a discipline on corporate managers ²:

- a/ information collecting about the borrowers'/managers' characteristics (competence, creditworthiness) before the contract is agreed (Hellwig, 1990), i.e. screening of borrowers (i.e. mitigating adverse selection)
- b/ monitoring of managers under an incentive contract (including the transfer of control from shareholders towards creditors in the case of default (i.e. mitigating moral hazard)
- c/ active participation in the creation, transformation and expansion of borrowers .

All these functions but one (i.e. 3 c) are fulfilled by any financial institutions but the importance of these various roles varies from one system to another. The last point which may seem a bit unusual, has been suggested by economic historians (Gerschenkron, 1962 ; Cameron, 1972): they have shown that in the case of underdeveloped and developing countries banks had often taken initiative of actively seeking out and exploiting profitable opportunities in manufacturing, commerce, etc.

We present (see **table**) a very stylized description of two models of financial systems. It goes without saying that the actually existing systems are more complex and that in most developed countries we can observe a mixture of these 'ideal types'.

It is not always easy to separate different functions of financial systems and in what follows we shall not be able to strictly stick to this analytical approach. Close interrelationships between the problems of finance, information and control notwithstanding, we shall concentrate on the aspects of information and control mentioning only occasionally the issue of finance. This might surprise as the usual discussion on enterprise restructuring in CEEC focuses on the problem of the lack of capital as the fundamental impediment to successful market adjustment. It is obviously important for firms to be able to raise finance externally but, according to our understanding, what firms primarily need at the first stage of restructuring characterized by pervasive uncertainties, is good judgement about alternative investment opportunities. This is why information generation and the issue of corporate control take a paramount importance.

The Anglo-Saxon system

Savings move from households to industry through securities markets. Banks provide mostly short-term loans to corporations. Long-term finance takes the form of equity capital. Financial institutions have been either deliberately fragmented (as in the US, where Glass-Steagall Act of 1934 imposed the separation of commercial banking and investment banking) or remained specialized even in the absence of special legal barriers (as in the UK). Pension funds and insurance companies play an important role.

The information on firms is widely and easily available : investment opportunities are publicly assessed. A great number of companies are listed on the stock exchange (more than 2000 corporations are listed in the UK, almost 7000 in the US). The anti-insider trading law ensures that all traders have equal access to information : it is not allowed to trade shares on the basis of confidential information. Financial markets are very liquid which creates incentives for information analysts to permanently estimate the firms' value ³ and to discover potential synergies. The information about investment prospects is rapidly incorporated into stock prices.

Corporate ownership is split between non-bank financial institutions and a minority of individual shareholders. The power of individuals is negligible, that of institutional investors is rarely exercised : they use *exit* rather than *voice*. Having diversified across a wide range of shares (because of various laws and regulations) they change constantly their portfolio in order to maximize returns to their own shareholders. Boards of directors are dominated by management (and non-executive officers appointed by management) which remains weakly accountable to shareholders. Because shareholders rarely act to change the management the latter is dismissed if there is change in ownership : takeovers, buy-outs, buy-ins.⁴

The German system

Finance

The financial system is dominated by a few universal banks involved in both commercial and investment banking, and maintaining close links with industry. Banks provide typically long term loans, but also the whole range of financial services, including the issuing of securities. Industrial firms own shares of each other. Private pension funds and mutual funds are almost inexistent : pensions are financed through a pay-as-you-go system.

Information

Little information on the value of securities is publicly available : information can be obtained through close relationship. Most firms are privately owned. A small number of shares are listed on the stock exchange (about 600 in Germany), in many of which banks own big stakes (more than 25 per cent of equity). Banks have a privileged access to information. Accounting information is limited.

Control

Ownership is concentrated (companies own substantial stakes in each other), acquisition by an outside investor is difficult, stock market does not play an important role as a market for corporate control. There are almost no hostile takeovers. Banks have extensive relationships with corporate customers : sit on supervisory boards, hold concentrated blocks of stocks ⁵, act as stock brokers, actively participate in restructuring of firms. Banks control large blocks of equity voting rights. ⁶ The company law based on the two-tier system makes the management board accountable to the supervisory board. A member of the management board cannot sit on the supervisory board. Companies are legally obliged to consult all important decisions with labor representatives. ⁷

3. Is there a case for a bank based financial system ?

In the literature a mixture of theoretical and empirical arguments have been used in favour of the German type financial system.

Empirical argument

The case for a German type system has been supported most eloquently by Colin Mayer. According to him "the distinctive feature of successful financial systems is their close involvement in industry" (Mayer, 1988). Mayer shows that in the seventies and in the eighties countries with strong industrial performance were those with close relationships between the banking and the industrial sectors. On the other hand, where takeovers play an important role, the performance is weaker. Additionally, in terms of financing investment Franks and Mayer (1990) have shown that in developed countries stock markets provide a negligible amount of funds for financing investment.

Consequently, it has been argued (notably by Corbett and Mayer (1992)) that a German-type financial system has an absolute advantage over an Anglo-Saxon one, and that CEEC should move towards the former and not towards the latter.

A slightly weaker version of this argument would be to claim that although a main bank relationship may not have an absolute advantage over direct finance, at least at some stages of economic development banks can and did play a crucial role. For instance, as Gerschenkron (1962) argued, in the middle of the nineteenth century universal banks, i.e. a combination of commercial banks (serving as a source of short-term capital) and investment banks (designed to finance the long run investment needs of the economy), strongly contributed to the industrialization of Germany: they not only provided capital, but also entrepreneurial talent and guidance, actively participating in shaping major decisions of enterprises.⁸

The first and perhaps too obvious problem with the empirical argument is that a particular shape of the financial system alone can hardly explain national economic growth, during some period of time, of an economy. There are so many other intervening factors - macroeconomic policy, legal framework and regulatory history⁹, path of economic development, social structure and political forces, cultural specificity - that we are unable to extract the influence of institutional arrangements concerning the financial system. In the nineties it is becoming increasingly clear, for instance, that what was considered as the

strength of the German or Japanese economies, and notably the strong ties between banks and industry, is now often viewed as an obstacle to rapid adjustment in a changing economic environment. Recent empirical work (Weinstein and Yafeh, 1994) suggests that in the case of Japan firms with close ties to a bank did not grow faster or perform better than other firms.¹⁰

More importantly, the Gerschenkron story has been severely questioned by economic historians having carefully looked at empirical evidence. In Austria, for instance, which had the same banking structure as Germany, banks did not behave like the German banks with their "from cradle to grave" fidelity : they preferred lending to well established and profitable firms, avoiding the painful and risky working out of long-term plans and providing entrepreneurial expertise (Cameron, 1972). On the other hand in countries in which strong links between the industrial and financial sectors have been established, the results were not always positive.¹¹

As far as investment financing is concerned, it is indeed striking that in advanced countries stock markets play a negligible role: retentions strongly dominate all other sources of finance and if corporations use external finance, this is largely debt, not equity.¹² However, CEE countries should look not only at the experience of developed countries. More relevant may be the pattern of financing in developing countries which is quite different: corporate growth is due much more than in developed countries to external finance and new equity issues play an important role.¹³ So securities markets contribute more to industrial financing in developing countries than in mature economies. Also, the data on the financing of American firms since the beginning of the twentieth century show that the importance of new equity issues is diminishing with time (Taggart (1985) quoted in Singh and Hamid (1992)). This suggests that the German nineteenth century development cannot be generalized and should be considered rather an exception than a rule.

Additionally, the whole debate on the relative superiority of one system over another seems somehow anachronistic if we look at recent evolution in different countries: there is a growing awareness that both systems are not working well any more and the process of adaptation clearly shows signs of convergence. On the one hand, in the US, there is a lot of talk about two problems linked to the separation of ownership and control: one is the alleged passivity of shareholders¹⁴ and the resulting undermonitoring of managers, another is the distortion of managerial incentives by takeovers. It is largely understood that takeovers alone, that have been notably criticized for short termism and are considered as costly and imperfect, cannot be relied upon to monitor and discipline corporate managers. The proposed solutions consist in increasing the accountability of managers to the boards and that of boards to shareholders: to achieve this, it has been suggested, following the continental tradition, to

introduce a two-tiers internal system of corporate governance and/or to create a special class of professional outside directors independent from managers and maintaining close links with institutional shareholders. In the same spirit, a remedy to short termism was suggested by replacing external discipline exercised through takeovers by internal discipline by investors committed to hold significant blocks of a corporation's stocks. To encompass such situations the term relational investing has been created. The rationale for relational investing is based on a number of theoretical works (some of them will be referred to in the next section) which insist on the costs of takeovers and on the advantage of introducing closer links between owners and corporate governors. After the period when the mere threat of takeover was considered as enforcing efficiency in the management of corporation (Fama, 1980) and the spectacular increase in the number of takeovers in the 1980s, we can observe a swing of the pendulum: the legal environment has changed in favour of incumbent boards (poison pills, state antitakeover statutes) and at the beginning of the 1990s hostile bids are less common than in the 1980s.¹⁵

On the other hand, in Germany the relationship between finance and industry is becoming less close, several companies deciding to open up their until recently strongly interlocked capital structures and control systems. The German firms seem to be discovering the virtues of public quoting. The long-term relationships established between firms and banks (and also between firms) are considered as beneficial in terms of providing commitment and trust but less so in imposing pressure on managers. Edwards and Fischer (1991) show that German supervisory boards exercise limited control over management boards. Symbolically it is important that a firm such as Daimler Benz has become the first German company to list its shares on the US stock exchange and follow American accounting standards.

The tendency towards convergence of the previously quite different financial systems will probably be further reinforced by demographic trends. It seems that the way social security is financed has an important impact on the form of financial system. In Germany, the growing pension burden (and elsewhere) can contribute to an important change in the financial system. In order to avoid the possibility of a collapse of the pension system it may become necessary to shift the burden from the public to the private sector. The emergence of large private retirement funds may modify the functioning of the capital market: insisting on financial returns they may bring about the breaking down of the links between the corporate and the financial sectors. The Anglo-Saxon big pension funds, because of their growing size are increasingly bound to become more actively involved in corporate governance: instead of constantly changing their investment portfolio, they will have to take a more active position and exercise some pressure on underperforming big companies.

Theoretical argument

Looking at recent economic theory we can find three arguments explaining the advantage of financial intermediaries (such as banks) over the non-intermediated markets referring in various degrees to their control and informational strengths.

Long-term commitment. Shleifer and Summers (1988) and Mayer (1988) argue that in the situation of incomplete contracts (i.e. when it is impossible to specify all future actions and payments because these are too complex to be described or because managerial decisions are not verifiable) banks help reduce moral hazard between financiers, managers and employees through the creation of the mechanism for long term commitment. Without such commitment implicit contracts between investor, manager and employees may be unsustainable (Franks and Mayer, 1990). Employees, for instance, may be unwilling to invest in firm-specific training and managers may be unwilling to invest in long term R & D projects : if firms are listed on the stock exchange takeovers and the resulting change in ownership may breach an implicit contract. A relational investor as a long term stakeholder in the firm introduces an element of trust and long term commitment. In this view the main threat to long-term commitment comes from competition from other financiers. Hence the case for a main bank relationship.¹⁶

Debt as governance structure. Another theoretical case for the banking intermediation comes from literature on the optimal capital structure. In particular, several authors have argued that it is desirable to have several principals outside the firm : securities being always characterized by both income rights and control rights, debt is desirable in order to transfer the right to control from shareholders to creditors during periods of poor financial performance (Aghion and Bolton, 1992 ; Dewatripont and Tirole, 1991).¹⁷ Although we are concerned here with institutional arrangements and not with the types of securities issued,¹⁸ in literature on the optimal capital structure the arguments in favour of debt are sometimes identified with arguments in favour of strong links between banks and industry. These are obviously separate, though connected, issues. Let us, however, stress the fact that banks' objective as creditors is not to maximize expected returns to shareholders but to assure low probability of bankruptcy : creditors' behaviour may be too cautious for shareholders. The debt imposes a rigour on the firm - emphasizing the probability of repayment - but it does not allow for sharing in profits of exceptionally favourable incomes and it does not give appropriate incentives to exploit the upside potential. Consequently banks will be interested in gathering a very specific type of information and the objective of their monitoring will obviously be very different from that of shareholders' : to maximize the overall return to

capital in one case, to minimize losses in the other. The creditors' intervention in the case of default may occur too late.

Moral hazard may be reduced if the bank also has an ownership stake in the firm, allowing it to reap some benefits of riskier strategy. In such case, however, the situation of managers may become too comfortable: the risk of stopping a particular investment project will be smaller than if creditors do not own shares.

Also according to Williamson (1988) the choice of debt versus equity may be understood in terms of choosing an appropriate governance structure. He introduces a notion of assets specificity: if assets of a company are easily redeployable, debt may be favoured ; if assets are highly specific and contractual hazard amplifies, more complex governance structure is needed and equity (i.e. purchasing residual rights of control) is preferred. The underlying idea is that suppliers of finance wouldn't have confidence in debt if assets are poorly redeployable.

Delegated monitoring. Getting additional information about an agent is obviously considered as useful in situations involving informational asymmetry between financiers and managers. The delegated monitoring models (Diamond, 1984) see the advantage of banking intermediation (relative to direct lending and borrowing) in terms of alleviating information and incentive problems in situations involving asymmetric information (i.e. hidden actions and/or hidden characteristics). It is argued that there are net benefits from delegating informational task to intermediaries. In the case of direct finance security holders contracting directly with borrowers would either free ride on monitoring (because their share of the benefit is small) or would have to repeat monitoring individually, which is costly and useless. Both solutions are inefficient. Banks, due to the economies of scale in monitoring and control perform better (i.e. less costly) than stock markets.

In delegated monitoring models the crucial issue is the moral hazard problem due to ex post informational asymmetry : what an intermediary monitors is information that the entrepreneur observes (managerial effort, actual output). An intermediary does not make public the information monitored from each borrower which helps him to enforce the contract and not to sell assets.

The argument about the uselessness of duplicated monitoring has been recently challenged in a very interesting way by Allen (1993). He admits that in some cases repeating monitoring may not be useful: this is notably the case of competitive industries with well established technologies where the opinions of a great number of producers about the

production technology are confronted and give rise to a common view of how the firm should be run. In such case the issue is to check whether standard production technologies are effectively implemented. Then banks can screen and monitor at lower costs than individual investors. But in monopolistic and oligopolistic industries or in sectors characterized by rapid technological change, it is extremely valuable to get diverse views about the likely future performance of an investment. So, Allen argues that in cases where there is no widely shared consensus about the optimal policies a firm should pursue, stock markets may perform better than banks in checking the managers' views of their firms' production functions : a quotation on the stock market means that investors and analysts have constant incentive to check how the firm is managed. They express their opinions on the stock market which, due to the spillover and aggregation of this information, improve the allocation of capital.

Holmström and Tirole (1993) also view the stock market as an important source of socially valuable information. Their approach is, however, different from Allen's. They focus on a controlling function of the stock market and the information needed to create an adequate mechanism of monitoring : control can be exercised from the outside, through takeovers but also from the inside, using remuneration schemes for managers based on stock prices. Holmström and Tirole show that increasing market liquidity, i.e. decreasing the fraction of shares held for long term investment, create incentives for investors and analysts (or speculators) to spend time and effort on collecting information about the performance of managers. This allows to improve the value (quality) of information provided by stock prices which in turn help design a more efficient managerial contract.¹⁹

What emerges from this sophisticated literature which might be (and sometimes is) referred to in discussing CEEC policy options, is far from any clear cut conclusions about the superiority of one financial system over another. Various papers usually deal with one specific aspect of agency relation and look at the impact of a particular mechanism on that dimension. Our understanding of this literature is that we can only speak about *relative* advantages of various institutional arrangements : as long as we do not distinguish between different functions of financial systems, and notably between, on the one hand, their capacity to *generate* information about the value of firms and information allowing to reduce adverse selection and, on the other hand, their capacity to *collect* information about managers' behaviour allowing to alleviate moral hazard, the costs and benefits of different institutional arrangements cannot be properly examined. In particular, in some circumstances mitigating adverse selection phenomena may be more important than alleviating moral hazard.²⁰ If bank monitoring and relational investing may be more appropriate to deal with the latter, for the former an open contest, a great number of evaluation by third party bidders and listing on the stock exchange may have an advantage. This may be the case of innovative industries where

there is no consensus on what the investment strategy should be (Allen, 1992) or of a firm which has to change its basic production profile (activities). More generally, multiple external assessment of a firm's value and of its expected future performance may be desirable in special moments in the development of some countries. We will discuss the implications of this issue for the CEE countries in the next section.

4. Specificity of the countries in transition.

Part of the literature advocating the adoption of a bank based financial system in CEEC does not refer to any theoretical or empirical arguments. A number of authors implicitly accept an agnostic view about the relative advantages of various systems but claim that in fact reformers do not face any real choice: the stock exchange for a long time will play but a marginal role and the only feasible solution consists in relying on the development of the banking sector. In other words, banks cannot afford to remain passive, they have to actively participate in privatisation, preparing it, underwriting new public issues, providing financial advice, swapping debt into equity, etc.²¹ Additionally, it has been argued that in the case of mass privatization implying dispersed ownership, financial intermediaries, and notably banks, may provide control on managers and alleviate agency costs.

Clearly, the banking sector has a very important role to play in the process of transition and its strengthening should be high on the agenda of reform measures. This is well understood in all countries and in most of them the process is under way.²² Our concern here is, however, that choosing early in the transformation process the model of financial system characterized by a close relationship between banks and enterprises, with little information on the value of firms being publicly available, may hinder the quality of restructuring. The problem is not simply that the existing state banks do not have adequate skills to play an important role in the governance structure of enterprises.²³ More generally, close relationship between lenders and borrowers and interlocking ownership structure might have a harmful effect on the generation of information by many independent agents.

Why should the need for external assessments of the prospects for a firm be stronger in CEE countries than in developed countries ?

To answer the question we have to carefully look at the legacy central planning has left in the industrial sector, in the financial sector and in the sphere of the relationship between the two.

In the industrial sector any restructuring strategy must deal with three phenomena : an overconcentrated industrial structure with a low number of small- and medium-sized industrial enterprises, an excessively developed industrial sector as compared with services and, last but not least, irrationally bundled assets. The latter are the result of the investment process in centrally planned economies. Property rights were untradeable and the state was actually the owner of the firms: it exercised political control over the economy by imposing its preferences but also by rescuing firms from financial difficulties. Central planners disposed themselves of capital: they used to decide what part of the GDP should be devoted to investment, how the investment funds should be allocated between sectors and individual enterprises, which enterprises should be created, enlarged or contracted. As has been fully shown in the literature these decisions were taken in the process of permanent negotiations and bargaining with enterprises, industrial associations, and ministries, who manipulated information and used overbidding as their main investment strategy. Central planners provided themselves some checks on firms' decisions through a baroque and contradictory system of permanently changing success indicators and incentive schemes for managers.²⁴ State intervention in the everyday functioning of firms created an institutional environment that was basically unstable and discouraged the firms' effort, while the lack of the risk of bankruptcy created a feeling of security. Both gave the firms an incentive to formulate very ambitious investment demands. The final allocation of investment funds, resulting from a complicated bargaining process between enterprises and various layers of economic bureaucracy, was highly inefficient.

Under the new regime enterprises need to be very profoundly restructured. What this really implies is not simply reorganizing firms in order to improve their productive efficiency or restating balance sheets and writing off debts but also, more importantly, withdrawing assets from particular lines of production, from particular enterprises and sectors, and redeploying them elsewhere. In the discussion of enterprise restructuring in CEEC the misallocation of resources and consequently the degree of the necessary redeployment of assets usually are not properly appreciated.

This process will inevitably take place in the situation where it is extremely difficult to assess the prospects of a firm. Several factors explain this unusually high uncertainty:

- the fundamental change of the domestic and international environment: trade liberalization, break up of CMEA trade, import tariffs, uncertainties of macroeconomic policy (inflation ? taxes?), contribute to rapid changes in relative prices and demand for the firm's products ;

- the lack of a modern accounting system (it is slowly being put in place): there is no reliable historical track record of firms, because accounting under central planning was not supposed to be an information system - it was a kind of arithmetical exercise ;

- high indebtedness of enterprises makes the sorting out of the hopeless cases from the potentially promising ones difficult: firms making persistent losses and heavily indebted (to the banks, to the budget, to suppliers) may have good prospects for survival ;

- investors have difficulty in identifying the most suitable managers and in telling whether poor performance of a firm should be attributed to managerial inefficiency or to unfavourable conditions external to the firm: managerial labour market is emerging very slowly ;

- young and unexperienced democratic institutions and high costs of market oriented transformation put a permanent stress on the reform process and amplify political uncertainty.

The difficulty of assessing the value of and the prospects for a firm in the situation of such an exceptionally high aggregate uncertainty is obviously reinforced by the weakness of financial markets and of the banking sector. The commercial banks which have been separated from the central bank (monobank) at the initial stage of transition, have inherited non-performing loans to enterprises. Banks know well enterprises with which they have been linked for a long time. This knowledge, however, which is often considered as the main argument for making banks play an active role in the restructuring of the enterprise sector, does not seem to be adequate for enhancing the efficiency of resource allocation. To some extent banks can be considered as insiders having privileged access to a specific type of information, notably that helping to alleviate moral hazard: they may facilitate *gathering* information on managerial slack and actual return. But they are unable to provide a fresh view of the company's potential or to make various ideas about the production function enter in competition one with another.

The crucial issue in the restructuring of post-centrally planned economies is to *generate* information about various investment opportunities: working out imaginative business plans, introducing new product lines, proposing new ideas, processes, products. After years of the lack of contestability, there is a great need of external evaluation of the potential of the companies. The insiders have some "historical" knowledge of their firms which in a routine situation might be valuable. The argument about information advantage of insiders has been used by several authors (van Wijnbergen, 1994, Joskow, 1994) who opposed the attempts to transfer control over enterprises to a government agency responsible

for restructuring. To be sure, a fine-tuning approach to restructuring comes up against the lack of information about what an efficient firm should look like. However, it would be a mistake to build a strategy of transformation (including privatization and debt restructuring) on the presumption that insiders know best. Different managers and investors may have different ideas about the possible future performance of the firms, they may differ in assessing the firms' production functions. They should be induced to spend time and resources on searching improvements relative to the plans of incumbent management. The latter have been mostly selected on the basis of non-market considerations: some of them prove to be successful in the new environment, but others are clearly unable to offer their firms any prospects of survival. Allen (1993) suggested that diverse views about how the firm should be run are important when industries are uncompetitive or when technology is evolving quickly. Such dispersed and idiosyncratic information is particularly valuable when an economy is in the process of profound restructuring.

Some would argue that banks can acquire such information through monitoring or by hiring skilful consultants. It may happen indeed that brilliant ideas will be found in such a way. But the probability of finding value increasing investment opportunities will be higher if a great number of various assessments (guesses) are encouraged to compete.

According to Mayer (see section 3), increased competition in financial markets may be achieved at the expense of more fundamental objectives of promoting investment and risk taking, because without commitment the long term capital will be lacking. This argument points out the trade off between the development of capital markets and restructuring that would seem to be particularly important in CEE countries. A long-term investment is clearly needed for restructuring and given the very incomplete contracts an alternative mechanism of commitment could be envisaged through establishing close relationship between the bank and the firm (Mayer, 1988). However, successful restructuring in CEEC also requires well informed short-term assessments of expected returns.

In a mature economy the information provided by capital market on managerial performance may not be an adequate measure of what managers are doing : short term profits may not adequately reflect the long term strategy. In CEEC, however, it is important to impose a check on managers and short term indicators may reflect their capacity of adjustment. Alternative assessment of management, of investment projects, of the value of the firm, of the firm's future profitability contingent on various business plans, technological changes, reorientation of production and change in the basic activities etc., are vitally important. Imposing stable ownership patterns: crossshareholdings, holdings, interlocking ownership structure, etc. and creating some kind of relational investing early in the process of

transforming the CEE countries will hinder the emergence of value enhancing ideas. It will provide too much security to managers: what they really should get is contestability, not protection.

Clearly, it is important that good projects with gains in the distant future are not ignored because current profits are valued more than future profits. In the case of new companies or the expansion of existing operations which have low probability of high pay off and high probability of low pay off (or which normally will take several years before significant expected returns can materialize), the development of venture capital firms seems to be a desirable solution. In venture capital firms the provision of capital (through the purchase of stocks, options or convertible securities) is correlated with managerial expertise, monitoring and selection functions. The managers of venture funds usually have skills that go beyond purely financial analysis: they provide business expertise and experience in industrial management, marketing, etc.²⁵ The need for such competences is confirmed by the experience of a few venture capital funds in Poland: the bottleneck of financing investment projects is not the lack of capital but the scarcity of good ideas with reasonable prospects for success.²⁶

It is also important to fully appreciate other risks of creating a bank based financial system and an interlocking ownership structure in the countries trying to separate the until recently closely interlinked political and economic spheres. Inevitable pressures for financing based on political connections may hurt fragile democratic institutions. In order to avoid cartelization, collusion, and monopoly abuses strong government regulation would be necessary. But if regulation fails - because of the lack of experience, or because the government proves to be unable to resist a great number of conflicting claims and pressures, then the whole system will be in jeopardy. Moreover, maintaining strong links between the banking and the industrial sector may slow down exit processes and make more difficult entry of new firms. There is the risk that existing borrowers would be favoured to the detriment of new clients, the latter having difficulty in raising funds from banks: instead of demanding the liquidation of hopeless cases banks have a tendency of rolling over bad debt.

4. Recent developments.

There is a growing concern in several CEE countries that through various mechanisms large banks are starting to strongly dominate the enterprise sector. Below we give just a glimpse of recent evolution in the Czech Republic and in Poland.

In the Czech and Slovak Republics major commercial banks have acquired a great power in the process of voucher privatization: through the establishment of their investment privatization funds banks have become co-owners of an important part of the economy. The six biggest investment companies established by banks gathered 3,200 million voucher points, i.e. 53 % of voucher points given to Investment Privatization Funds and almost 40 % of the total number of points distributed in the first wave of voucher privatization (8,500 million). Regulation intended to limit banks' involvement was introduced after the funds started operating, and is not respected. A fund should not own more than 20 percent of the capital of any company but, according to some estimations, there are about 100 companies in which fund ownership is more important. Another rule according to which any shareholding in any company cannot represent more than 10 percent of the overall assets of a fund is also flouted: the government has been apparently captured by funds claiming that if they had to sell shares they own in excess of the limit, the stock prices would abruptly go down.²⁷

Banks became owners not only of a large part of non-financial companies but also, regulatory restrictions notwithstanding, they came to own each other. In order to circumvent the provision forbidding bank funds to own shares in other banks, major commercial banks acquired shares in each other through the intermediary of their daughter investment companies. In some cases banks indirectly became even owners of their own shares.²⁸

In Poland several mechanisms have been designed to make banks actively participate in privatization and the restructuring of the enterprise sector. Banks often acquire shares of enterprises listed on the stock exchange either participating in initial public offerings or investing on the secondary market²⁹, they provide equity capital to companies bought out by the employees³⁰, or sold to domestic investors³¹; banks participate in the mass privatization programme through establishing management funds that will take control of 20 - 30 enterprises each; a new programme called "Stabilization - Restructuring - Privatization", which has been discussed for the last two years but which is going to be eventually implemented in the cooperation with the EBRD, offers also a very important role to banks as active agents of enterprise restructuring; finally, banks convert debt into equity in the framework of the Conciliation Proceedings Act of 1934.³²

In order to deal with the non-performing debt problem an interesting alternative to the very slow and inefficient Conciliation Proceedings was introduced in March 1993 as the Law on Financial Restructuring of Enterprises and Banks. The law enables all banks to initiate bankruptcy proceedings without court participation.³³ A rationale for the law was that the consolidation of the financial system would not succeed if the enterprise sector were not restructured at the same time. Also it was assumed that the government would be unable to do

the job.³⁴ During the working out of the law the debt/equity swaps were considered as the key mechanism of solving the problem of debt. An effort has been made to provide banks with correct incentives to collect relevant information about the performance and the prospects of firms. However, banks proved to be reluctant to swap debt into equity and to take control of enterprises: they do not feel competent enough to play the role of strategic investors, controlling the every day management of enterprises.³⁵

Preliminary results of the financial restructuring undertaken in the framework of the law seem to be more limited than expected: 130 conciliatory procedures have been started (instead of 700 expected) and half of the total (16 trillion zlotys) value of bad debts have been dealt with.³⁶ In general, the law probably turned to be more beneficial to banks than to enterprises: banks have been capitalized, the share of bad credits in banks' portfolio decreased³⁷, banks have acquired some expertise in dealing with bad debts and in most of them are in the process of putting in place more or less independent departments or funds specialized in investment banking. On the enterprise side it is too early to assess the impact of the Law. According to the authors of the law the bank conciliation procedure has been designed for dealing with large enterprises and the latter have indeed been involved in most settlements. However, the important perverse effect of the law seems to be its impact on small and medium enterprises in relatively good condition. There is some evidence that they had to bear the cost of the restructuring operation: as minority creditors they had to accept the reduction of their debts and could be forced into a restructuring agreement if it has been approved by creditors holding more than 50 per cent of debt.³⁸

5. Conclusions

The form of financial institutions that will prevail in Central and East European countries may prove to be crucial for the quality of restructuring and adjustment of the industrial sector. It is difficult, however, to find clear guidelines for building the institutions of financial system. Empirical evidence is, not surprisingly, rather ambiguous as far as the performance of different financial systems is concerned. Economic theory provides, at best, some clues about trade offs that might exist between various functions - financing, information and control - a financial system is supposed to perform. So, there may be no ready-to-wear blueprints and we should rather carefully consider *relative* advantages of various financial institutions.

This might suggest that in the particular situation of CEEC the priority should be given to eliminating impediments and stimulating information generation about various investment opportunities.

Even if financial markets are initially weak in transition economies and should probably play a limited role for some time to come they should not be considered as a funny byproduct of the childish fascination of East European reformers with "capitalism". If in developed countries equity markets play a marginal role in raising funds, in developing countries their contribution is important. More importantly, however, stock exchanges provide incentives to competitive assessments of firms which may have an unusually high value in the first years of restructuring.³⁹

The establishment of universal banking in CEE countries has occurred, is probably desirable and anyway conforms to the spirit of European financial institutions. However, within the universal banking regulation there are important differences between, for instance, Germany, France and the UK. Commercial and investment banks can certainly play an important role as intermediaries both in the venture capital-type role and in underwriting and placing securities for moderate size firms. It would be important for Central and East European countries to retain some of the benefits of bank involvement (mitigating moral hazard) without the concentration of ownership and interlocking relationship that characterize the German system. Given the starting point of the reforms - high concentration, lack of information about the value of capital stock, lack of competition and of managerial competence - a pure insider model, in which a bank is not only privileged creditor but also a shareholder of a firm, may not contribute to a dynamic adjustment of enterprises: the information needed for an efficient restructuring may become the victim of an excessive commitment. Moreover, if banks are going to become owners of a great number of enterprises, privatization of both, banks and enterprises, may be slowed down and state intervention facilitated.

The development of financial systems in CEEC is obviously largely influenced by particular privatization strategies. If we look at financial systems as devices for generating and transmitting information necessary for the improvement of resource allocation mass privatization programmes are certainly desirable as they bring an important number of firms to the stock exchange. But as far as these programmes lead to the emergence of strong financial intermediaries, from the information generation point of view, it is not indifferent whether those intermediaries will be German-type banks maintaining close links with enterprises or investment funds listed themselves on the stock exchange and having in their portfolio listed firms.

Let us end by quoting Mancur Olson : "*Because uncertainties are so pervasive and unfathomable, the most dynamic and prosperous societies are those that try many, many different things. They are societies with countless thousands of entrepreneurs who have relatively good access to credit and venture capital, trying this and that and almost everything else. There is no way that a society can predict the future, but if it has a wide enough span of entrepreneurs able to make a broad enough array of mutually advantageous transactions, including those for credit and venture capital, it can cover a lot of the options - more than any single person or agency could ever think of.*"⁴⁰

Notes

1. See, for instance, World Bank (1989), King and Levine (1993 a, b).
2. Control exercised on corporate managers by financial institutions is obviously part of a complex web of other constraints among which are the product and labour markets, a bankruptcy law, some cultural norms, etc.
3. The number of firms covered by financial analysts is 1200 in the UK and 200 in Germany. Cf. Nelson Directory of Investment Research, 1992.
4. A buy-out is a purchase of a company by the incumbent management : buy-in is a purchase of a company by new incoming management.
5. The only legal limit on a bank's shareholding is that it cannot exceed 15 per cent of a bank's equity.
6. Banks' voting power comes mainly from proxy votes, less so from direct equity holdings. In 100 biggest companies banks had 5 per cent of control rights due to direct holdings, but 36 per cent due to proxies. Cf. Cable (1985).
7. The employees sit on supervisory boards : they appoint one third of the board members in corporations employing less than 2000 employees, half in corporations employing more than 2000 employees. Cf. Edwards and Fischer (1991).
8. This argument could have but has not been used in the discussion about CEEC : Gerschenkron's (1962) case for universal banking has been extensively discussed by economic historians (Cameron, 1972) ; Hellwig (1990) carefully analyzes Gerschenkron's idea in terms of recent developments in economic theory.
9. But laws and regulations do not predetermine unambiguously the form of financial system : in the UK where there was no law against universal banking, commercial banks spontaneously specialized in deposit banking ; in Japan where after the second world war a law imposed a separation of deposit activities and of investment banking, in practice creditors have been playing the role similar to that of shareholders.

10. Weinstein and Yafeh (1994) interpret the low growth rate of main bank firms as the consequence of bank pressure to avoid some risky investment projects with positive net present value to shareholders. They argue that when capital markets are underdeveloped, a system of close ties between firms and financial institutions is likely to lead to a redistribution of rents away from the manufacturing sector to the financial sector.
11. The example of industrial conglomerates in Latin America is clearly a negative one. In Japan, since 1993 industrial cartels have been severely criticized for having acquired too much power : "The collusive iron triangle of politicians, bureaucrats and industrialists that for decades sacrificed consumer interests for industrial competitiveness should get 'a coup'" (The minister responsible for industrial policy quoted in *International Herald Tribune*, 14.09.1993). A historical perspective relativizes the merits of the German system : "The criticism of the British banking system in the twenties and the praise of its German equivalent ceased in the thirties when the economic crisis of 1929-31 exposed the vulnerability of the universal banks leading to the collapse of a number of them. But since 1945 with the rapid growth of the German economy, attention has turned to the merits of the Universal banks". (Michie, 1992)
12. Mayer (1989) shows that in the period 1970-1985 securities markets in advanced countries did not contribute in a significant way to corporate finance. Mayer and Alexander (1990) show that in 1982-1988 large corporations in Germany and the UK were net *purchasers* of equity.
13. Singh and Hamid (1992) show that the top corporations in Jordania financed more than 50 % of their growth from equity issues, the biggest Turkish firms over 60 % , and the Korean firms 40 %.
14. This alleged passivity should, however, be qualified given that boards of directors of several large American floundering corporations have recently fired chief executives of IBM, General Motors, Westinghouse and American Express (Cf. *The Economist*, 6.2.1993).
15. Let us note, however, that the dangers of short-termism, hotly discussed in the second half of the eighties, are less so since 1993 when takeover activity nearly returned to the level of the boom years of 1988 and 1989. In the 1990s takeovers are justified rather by strategic arguments than purely financial ones (Cf. *Financial Times*, 17.02.1994).
16. Hellwig (1990) stresses the fact that we do not observe everywhere main bank relationship which contradicts the prediction of Diamond's theory.
17. Also it is sometimes argued that issuing debt by a firm may be considered as a signal of good prospects, because issuing debt by a firm with poor prospects would increase the probability of bankruptcy which is normally costly to management.
18. This distinction is important because, as says Hellwig (1990), "in countries where stock markets are organized and dominated by banks, a stock issue will be just as dependent on the firm's bank as a bank loan". Also with such financial innovations as introducing some form of contingent contract between a firm and its bank (allowing the latter to participate in the future profits of the firm) the distinction between debt and equity is becoming less clear cut. In the case of a normal loan the interest rate is independent from the profits earned by the firm.
19. According to Holmström and Tirole the crucial advantage of the information generated by stock prices as compared with direct assessment of managerial performance by board of directors is the objectivity and integrity of the stock markets. However, Mayhew and Seabright (1992) argue that in reality we observe much less remuneration schemes based on stock prices that the theory would suggest.
20. Let us note, however, that the long-term commitment argument (which provides the rationale for the relational investing approach) shows that some mechanisms, such as takeovers, allowing to alleviate the adverse selection may exacerbate the moral hazard problem.
21. See for instance Bokros (1993).
22. For an accurate account of banking reform see Dittus (1993).
23. Frydman et al. (1993) argue that the symbiotic and perverse links between the existing enterprises and state banking sector should be broken up : they suggest that instead of recapitalizing the existing banks the government should capitalize the new banking institutions (in the process of solving the problem of non-performing debt). But they make a strong case for the bank based system in Eastern Europe.

24. At the macro level planners reacted to various disequilibrium signals but only after the imbalances went beyond some threshold. Cf. Grosfeld (1987).
25. An important condition for the development of venture capital firms seems to be the existence of divestment options. It is interesting to note that such firms have been established in those developing countries which had an active stock market, i.e. in Taiwan, Korea, Malaysia, India. See Sagari and Guidotti (1992).
26. See, for instance, Lipinski and Dunin-Wasowicz (1993).
27. Another argument used by funds is that after the second wave of voucher privatization their assets will increase and the 10 percent limit may not be attained.
28. This is the case of the Czech Investiční banka which owns 17 % of its own shares and of Slovak Investiční banka which owns 19% of its own shares. Cf. Mladek (1994).
29. For instance, BIG SA owns 11 % of Uniwersal, Bank Slaski 16 % of Polifarb, Polski Bank Rozwoju 18 % of Tonsil and 11 % of Krosno, Bank Handlowo-Kredytowy 18 % of Wolczanka and 10 % of Zywiec.
30. For example, Polski Bank Rozwoju invested in Budokor.
31. According to the banking law, investment in shares and bonds of companies cannot exceed 25 % of own capital (unless the president of the National Bank of Poland raises this limit to 50%).
32. See, for instance, the role of Polski Bank Rozwoju in the case of Stocznia Szczecinska.
33. The minister of justice, aware of the very limited processing capacities of courts , strongly supported the idea of introducing the possibility of non-court conciliation proceedings. (Cf. comments by Stefan Kawalec at the seminar organized by the CASE Foundation and the Polski Bank Rozwoju, 21.04.1994).
- *34. Giving a rather critical assessment of the preliminary results of the implementation of the law, Henryka Bochniarz, ex-minister of industry and now consultant to Bank Zachodni (one of the seven banks concerned) admitted, however, that she had much more opportunities to influence restructuring of enterprises as consultant than as minister (at the seminar organized by the CASE Foundation and Polski Bank Rozwoju).
35. As was expressed by one banker : "Banks are looking for secure investments. It easier to deal with bad credits than with bad shares. The best situation for banks is when large foreign investor comes in and banks take minority shares. Banks do not want to become dominant shareholder and creditor at the same time". Quoted in : Boguszewski et al. (1993).
36. See *Rzeczpospolita*, 20.04.94. The law imposed on banks that have been capitalized ex ante with 11 trillion zlotys in Treasury bonds of 15 years maturity, the obligation to take, before the end of March 1994, a decision about the debt qualified at the end of 1991 as bad. According to the law, several options were available to creditors : 1. they could sign a conciliation agreement (involving conversion of debt into equity, debt reduction and/or debt rescheduling) ; 2. if a debtor was considered non viable or did not agree to a restructuring plan banks had to sell the debt (securitization), to file for bankruptcy in the court or initiate liquidation.
37. For instance, the share of bad credits in Bank Gdanski fell from 32 % in 1991 to about 15% *Rzeczpospolita*, 20.05.1994.
38. At the beginning of May 1994 the Ombudsman asked the Constitutional Court to abrogate the Law on Financial Restructuring of Enterprises and Banks as being incompatible with Constitution : he argued that the Law has introduced an unequal treatment for creditors, and in particular that it has created a privilege for banks and for creditors benefitting from conciliatory proceedings. Banks usually dominate creditors' meeting and can impose their solution on other creditors.
39. At the beginning stock markets may not properly reflect the value of firms. In the Czech Republic a sudden jump in the supply of shares has initially depressed prices. The prices on the Warsaw Stock Exchange, after the spectacular increase in 1993 when the performance of listed companies was mediocre, have dropped to a more reasonable level in the first half of 1994, while the performance of most of companies significantly improved.
- Information disclosure can also be stimulated in other ways. In Chile, for instance, all companies with limited liability are obliged to publish the same information as companies listed on the stock exchange.
40. Olson (1992), p. 69.

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