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# Politics, power, and institution building: Bank crises and supervision in East Central Europe

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## ABSTRACT

Over the past 10–15 years the debate about the creation of economic governance institutions has shifted from an emphasis on the state rapidly implanting optimal incentives to a state capable of acting strategically and regulating. But how a government with little prior relevant skills or resources actually achieves the latter is still unclear. This article examines how different political approaches to transformation shape the creation of new institutional capabilities by analyzing bank sector reforms in the 1990s in three leading postcommunist democracies—Hungary, Poland, and the Czech Republic. Politicians create different political strategies that shape the organization of policymaking power, which, in turn, can facilitate or hinder the ability of relevant public and private actors to experiment and learn their new roles. With its emphasis on insulating power and rapidly implementing self-enforcing economic incentives, the 'depoliticization' approach creates few changes in bank behavior and, indeed impedes investment in new capabilities at the bank and supervisory levels. With its emphasis on distributed authority and rules of information sharing, the 'participatory restructuring' approach appears to have fostered innovative, cost-effective monitoring structures for recapitalization, a strong supervisory system, and a stable, expanding banking sector.

## KEYWORDS

Institutions; transitions; banks; regulation; development; policymaking.

## INTRODUCTION

This article examines the way different political approaches to economic transformation shape the creation of new institutional capabilities. It does so by analyzing the resolution of bank crises and creation of

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supervisory institutions in the 1990s in three leading postcommunist market democracies—Hungary, Poland, and the Czech Republic. In the wake of the recent financial crises in Russia, East Asia, and South America, we have witnessed an important shift in the debate about the creation of economic governance institutions in emerging market democracies. At the beginning of the 1990s, much of the debate centered on the ability of the state to impose rapidly on society a new set of rules based on high powered economic incentives via such policies as price liberalization and mass privatization. By the end of the 1990s, the emphasis was on the ability of the government to act strategically toward certain sectors and build what could be called the 'modern regulatory state' (Bruszt, 2002). Indeed, that should surprise few, as scholars increasingly note how even the 'unregulated' market in places like the USA was built through assertions of policy and regulatory power (Dobbin and Dowd, 2000). In East European banking, the multilaterals now emphasize the ability of the state to make assistance to banks conditional on certain organizational changes and to provide adequate prudential supervision.[1]

This shift, however, still begs questions about how the policymaking process (and politics in general) can shape the construction of new institutional capabilities at both the bank and government levels. For instance, although state intervention began to stabilize the Russian banking system (Johnson, 2001; Spicer, 2002), any reference to a strong or embedded state opens further questions about limiting state capture by entrenched interests and about the creation of the requisite skills and knowledge by the relevant public and private actors that would not necessarily exist *a priori*. Similarly, although research shows a constrained executive, party competition, and the relatively dispersed political power can facilitate consistent economic policies and reductions in patronage (Hellman, 1996; O'Dwyer, 2004; Montinola, 2003), it is less clear how multiple centers of power translate into institutional coherence, adjustment, and learning instead of paralysis (Bruszt, 2000; Ekiert and Hanson, 2003).

To overcome these dilemmas, this article begins by emphasizing that policymaking and institution building are processes, in which relevant public and private actors experiment with new roles and rules to solve common problems and recombine existing resources at different levels of society (Hay, 2004; Johnson, 2001; Kerr, 2002; Thelen, 2003). In this view, then, social and institutional legacies can shape strategies, but are not wholly determinate (Bunce, 2003). Politicians, especially during periods of crisis, have choices not simply about policies but namely about the control over policymaking that defines a logic of change. For instance, Hall and Soskice (2001), Jacoby (2000), and Bruszt (2002) note that policy across countries can vary with the ways governments incorporate different public and private actors into the policymaking process.

In turn, the creation of new institutional capabilities is less about optimal designs or strong states and more about how different *political approaches* to reform can induce or impede collective problem solving among relevant public and private actors as they learn to monitor one another. A government's political approach to transformation, my independent variable, is defined as the organization of policymaking – the distribution of authority to participate in policymaking and the mechanisms for information feedback and accountability (Hellman, 1996). At one end of the spectrum, the 'depoliticization' approach rests on insulating centralized policymaking power and rapidly implementing new, self-enforcing economic incentives. At the other end, the 'participatory restructuring' approach rests on authorizing multiple public and private actors to undertake restructuring experiments and binding them to basic rules of information sharing. The former approach understands institutional change as epochal. But it can retard the development of institutional capabilities and, ironically, be highly susceptible to self-dealing and patronage, since the reliance on insulation and incentives creates barriers for public and private actors to invest in the new skills and routines for effective monitoring and supervision. In contrast, the participatory restructuring approach understands institutional change as evolutionary and appears to induce collective problem solving and mutual monitoring, in turn improving institutional capabilities.

For the purpose of this paper, these capabilities are the ability of banks to restructure loans while inducing firms to reorganize their operations and the ability of regulators to monitor banks and induce them to restructure loans in accordance with risk based provisioning. I measure these capabilities, and thus my multidimensional dependent variable, as the public cost of bank restructuring, bank stability and performance, and the procedures and capacity of the relevant bank supervisory agency.[2] I argue that the different political approaches to transformation in general, and systemic bank insolvency in particular, in the Hungary, Poland, and the Czech Republic strongly shaped the cross-national variation in each of these components, and thus the variation in bank crisis resolutions and the creation of supervisory institutions.

Section I links existing research on bank reform and institutional change with recent insights from evolutionary theories of organizations. Section II discusses the different approaches Hungary, Poland, and the Czech Republic took toward economic reform in general and the bank solvency crisis in particular. The comparative method employed here follows Montinola's (2003) call for more detailed comparative research on resolutions of bank crises, as it can control for typical structural explanatory factors while focusing on the variations in the political approaches to reform (Ragin, 1987).[3] All three countries confronted the common postcommunist challenge of simultaneously building new economic governance institutions and resolving solvency crises in their dominant state banks (Bonin and Wachtel,

1999). All three in general aimed to restore bank solvency and privatize the banks, were arguably the most advanced democracies and economies of East Central Europe, had little significant experience in market based banking systems, followed standard macroeconomic stabilization policies, and had similar banking structures. Moreover, analysis of bank reforms is ideal since approaches toward institutional change based on optimal economic incentives would be expected to have their best impact in finance (Boycko *et al*., 1995; World Bank, 1996).

Section III discusses the outcomes of these approaches by the mid- to late-1990s. The Hungarian and Czech approaches led to costly, multiple bailouts, unstable banks, and delayed supervisory capabilities. The Polish approach led to delayed privatization but also to one of the most cost-effective bad debt resolutions, a stable banking sector with increased lending, and a strong supervisory authority.

Section IV argues that these differences can be explained largely by the different political approaches to transformation. To differing degrees, the depoliticization approaches of Hungary and the Czech Republic led to an insulation of centralized policymaking to promote rapid bank reform via a bailout coupled with new incentives (i.e. new banking laws and rapid privatization). The reliance on self-enforcing incentives did little to change bank behavior, retarded the building of new oversight capabilities, and actually allowed the executive to intervene in bank reform for its own short-term political ambitions. In contrast, in the Polish form of 'participatory restructuring' the government chose to empower various state agencies and bank actors to restructure banks and large firms. In turn, the government focused on having its new public agents develop monitoring capabilities and experiment with rules that could change private behavior.

Section V concludes the article. By viewing institution building as an experimental process in developing public and private capabilities, one can begin to focus more on how the trade offs between transparency and accountability, on the one hand, and authority and discretion, on the other, can improve the governance of change (Ostrom, 1999). In this sense, the argument here can help show how the political organization of policymaking can mediate the impacts of international factors and of the dispersion of power across parties and interest groups on changes in economic institutions (Epstein, 2001; Hellman, 1996; Johnson, 2006).

## DEPOLITICIZATION, DELIBERATION, AND INSTITUTION BUILDING

The stable resolution of banking crises in transforming countries centers on resolving the stock of existing bad debt and the flow of future credit, namely to firms (Glick *et al*., 2001). The stock problem is resolved by a one-time form of public assistance (debt restructuring, write-offs, and

recapitalizations) that also limits expectations of further bailouts. The flow problem is a longer term issue and a function of institutional change – ownership and governance of the bank, creditor rights, prudential regulation, etc.

The policy consensus of the early 1990s conceptually and operationally separated the stock and flow problems, and in turn bank and debtor firm restructuring. The state would strengthen bank solvency one time by a combination of recapitalization and carving out bad loans. The rapid installation of new incentive systems via mass privatization, strict banking regulations, strengthened creditor rights, and tough bankruptcy laws focusing on debtor punishment would bring behavioral changes in banks, thus resolving the flow problem.

By the end of the 1990s, students of finance argued for linking together bank and firm restructuring with the development of regulatory institutions (Barth *et al.*, 2001; Caprio and Klingebiel, 1996; Hoelscher and Quintyn, 2003; Meyendorff and Thakor, 2002). Bank crisis resolution improved with the state making recapitalization and debt removal conditional upon banks reorganizing operations and management as well as initiating the restructuring of the largest debtor firms. Governments and central banks needed to establish sound prudential regulatory regimes that made bad debts more readily transparent, insisted on risked-based provisioning, and helped supervisory agencies invest in the capabilities to monitor and inspect banks effectively.

A key problem with these different policy views is that they are premised on different conceptions of policymaking control and change. The policy views of the early 1990s emerged out of an understanding that institutional change is epochal, and prioritized the need to insulate powerful 'change teams' from particularistic interests (Boycko *et al.*, 1995; Haggard and Kaufman, 1995). The rapid imposition of new rules based on high powered economic incentives could maintain the aims of speed and insulation, since the incentives would foster immediate restructuring and not require deliberations with interest groups or politicians about their design or alterations (McDermott, 2002). But a policy view that understands behavioral changes resulting from a state using conditionality and regulation strategically clearly goes beyond reliance on incentives and also opens up dilemmas typical of any model of institutional change based on state activism (Amsden, 1989; Evans, 1995; Moon and Prasad, 1994). Any attempts at strategic privatization, conditionality enforcement, or regulatory supervision would demand the creation of new state capabilities and thus a level of sustained interaction between public and private actors that breaches an insulated state.

But then how might we frame the political conditions that could allow these different forms of institutional development and policymaking to emerge? An answer begins by combining research from the political

economy of financial restructuring and evolutionary theories of organizations. The former has shown that crises and regime change are moments of extraordinary politics where governments can disrupt entrenched elites and create new coalitions and policies that profoundly shape the future consolidation and stability of new institutions (Haggard and Maxfield, 1996; Johnson, 2001; Thelen, 2003). The latter has shown that often new knowledge and capabilities come from empowering groups (within and across organizations) to interact in new, disciplined ways, drawing on one another's experience and engaging in collective problem solving (Helper *et al.*, 2000; Kogut and Zander, 1992; Winter, 2003).

Scholars of comparative politics and sociology coincide with these views by noting that these are choices are fundamentally about different political approaches to transformation that define the *organization of policymaking power* – the distribution of authority to participate in policymaking and the mechanisms for feedback and accountability (Ansell, 2000; Dobbin and Dowd, 2000; Hellman, 1996; Kerr, 2002). Policy innovations and institutional adaptation begins by embedding the state in professional and inter-organizational networks that provide alternative channels of information, resources, and experience (Evans, 1995; Jacoby, 2001; Stark and Bruszt, 1998). Policymaking concerns concerted action between the state and socio-economic actors, but the latter is not limited solely to peak-level groups of capital and labor (Ansell, 2000: 308). To limit problems of self-dealing while accelerating the learning process, scholars have further argued that deliberative or participatory forms of governance may be helpful (Evans, 2004; McDermott, 2002; Sabel, 1994). For instance, Sabel (1994) and Stark and Bruszt (1998: Chapter 6) suggest that one should focus on whether governments can initiate political approaches that merge mutual monitoring and learning by the relevant actors involved in the collective experiment. In discussing economic and institutional changes in developing countries, Evans (2004), Montero (2002), and Ostrom (1999) argue that policymaking forums that include a variety of stakeholders and require collective problem solving improves mutual monitoring and knowledge diffusion for both public and private actors.

This article, in turn, argues that efficient and stable resolution of bank crises and sound development of supervisory capabilities are linked together and depend largely on the degree to which a government's political approach to transformation combines delegation and deliberation: it gives relevant public and private actors direct restructuring and oversight authority and provides a legal framework that forces them to continually share information about their related restructuring experiments. Rather than viewing institutional development as determined by the state versus the market, one should view the process as shaped largely by whether

governments advance political approaches based on 'depoliticization' versus 'participatory restructuring'. This distinction can help clarify the organization of policymaking power, levels of interaction, and feedback mechanisms that enable sustainable, incremental change (Hay, 2004; Thelen, 2003).

With its dual aims of insulated power and rapid change, depoliticization eschews deliberations between the state and socio-economic actors about the initial policies and their subsequent revisions.[4] The central state aims to construct a powerful, insulated 'change team' to impose rapidly a new set of rules with self-enforcing economic incentives. Depoliticization would lead governments to avoid legislation on specific reforms and rely heavily on a few rules with self-enforcing incentives so as to maintain insulated and rapid policymaking. For instance, although the government might attempt a one-time bank recapitalization to solve the stock problem, its fear of getting bogged down in protracted negotiations with managers would override making recapitalization conditional upon specific changes in the organization of banks and their relationships with troubled firms. Instead, the government would rely on the immediate imposition of new market incentives (e.g. mass privatization, capital adequacy rules, bankruptcy as liquidation, etc.) to solve the flow problem. However, from an evolutionary point of view, the lack of conditionality and feedback mechanisms would lead to limited behavioral change in banks, costly repeated bailouts, and weak development in the capabilities of both banks and supervisory institutions.

Participatory restructuring begins with the aforementioned principles of delegation and deliberation. One would expect an approach to bank crisis resolution based on focused legislation that emphasizes the transparency and oversight independence to impose effective conditionality. Subsequently, actors at the bank and government levels would have to develop rules to monitor one another and dedicate resources for the development of the new requisite capabilities. Forums for multi-party monitoring backed by clear legislation allow for a more embedded state to adjust policies, invest in new skills, as well as to avoid capture and wasteful bailouts. In turn, a participatory restructuring approach would lead to cost efficient bank crisis resolutions, a stable banking sector, and new monitoring capabilities in the relevant banks and supervisory institutions.

Section II will now show how the Czech, Hungarian, and Polish approaches to transformation and especially the common bank crisis, varied. To different degrees, the Czechs and Hungarians chose to insulate centralize policymaking power, avoid focused legislation and conditionality, and prioritize self-enforcing incentives. The Poles chose to use focused legislation and conditionality that empowered a variety of public and private actors to restructure banks and build new forms of monitoring.

**Table 1** Number of banks (excluding cooperative banks) and bank intermediation

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

*Sources:* BIS, Tang *et al.* (2000), IMF.

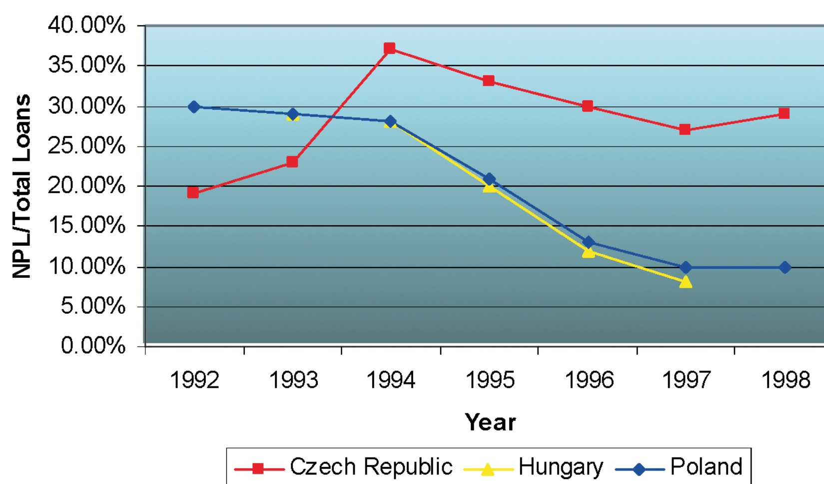
## PRIVATIZATION AND BANK REFORM IN THE CZECH REPUBLIC, HUNGARY, AND POLAND

The creation of a two-tier bank system began in 1987 for Hungary, 1989 for Poland, and 1990 for the Czech Republic.[5] The three banking sectors had had weak capital structures, but varying levels of intermediation.[6] Between 1990 and 1992, all three countries initiated stabilized and liberalized their economies, and initiated the bank reforms promulgated by the multilaterals (EBRD, 1994; World Bank, 1996), including the liberalization of entry, interest rates and product markets; implementation of Basel prudential banking regulations, especially a requirement for banks to have capital adequacy ratios (CARs) of 8% (immediate for new banks, a few years for state banks); and creation of an independent central bank focused on currency stability.

While the number of banks increased rapidly, the top five state commercial and savings banks typically accounted for 60–66% of total bank assets, loans, and deposits during 1991–1996. From the outset, the three governments aimed to restructure and privatize the state owned banks quickly, but their solvency came under attack by 1991. The collapse of the Soviet market, the general recessions, and the restrictive monetary and fiscal policies had led to large, rapid increases in inter-firm debt and non-performing loans, reaching 25–35% of total outstanding loans (Anderson and Kegels, 1998; Borish et al., 1995). At this point, the three countries began to vary their policies toward bank crisis resolution and sectoral reform, reflecting differences in their broader political approaches to the transformation of economic institutions.[7]

### The Czech Republic

By the mid-1990s, the Czech Republic stood out in the region as the leader in rapid, mass privatization and monetary stability (Bruszt, 2000). Orthodox




*Sources:* Tang et al. (2000).

**Figure 1** Non performing loans in banks.

communist policies had left the country with a stable macro-economy, low foreign debt, poorly organized social and political groups, and a central government with virtually complete legal control of assets. Vaclav Klaus, first the Minister of Finance and then Prime Minister, ascended to power by building a coalition that used these conditions to construct a strong policy apparatus that cut itself off from potential 'rent-seekers', such as parliament and special interest groups. It weakened workers councils and subnational governments. Armed with broad laws on economic transformation and privatization,[8] Klaus and his allies increasingly put policy control into the hands of a team based in the Ministries of Finance and Privatization and prioritized mass privatization via the now famous voucher method. This approach enabled the Czechs to privatize over 1,800 firms and four of the five main (beginning with about 50% of equity) in less than four years.

Bank sector reform followed this approach with an independent central bank and high powered economic incentives. The governor of the central bank (CNB) was appointed by the president, subject to parliamentary approval (Czech National Bank, 1999). The CNB housed the Bank Supervision Department (BSD), which had extensive formal powers of enforcement over banks, including management changes, capital and reserve changes, imposition of fines and forced administration, and approval and revocation of licenses.

In order to minimize protracted state intervention, the Czechs aimed to resolve the bad debt stock and flow problems by separating limited

restructuring from privatization via decree powers and existing privatization legislation. The government carved out communist era trade loans, placed them with lower interest rates and longer terms in a new state owned 'hospital', and provided a one-time recapitalization of banks in 1991–1992.[9] It then emphasized an abrupt change in incentives, via voucher privatization, a strict CAR schedule, and a bankruptcy law that focused on liquidation of problem debtors. The combination of a stronger capital base and the new incentives was to propel banks to reorganize themselves, lead the restructuring of transforming firms, and lend prudently.

### Hungary

Although the Hungarians used vouchers minimally, their approach to transformation and bank reform began conceptually similar with the priorities of speed, centralized policy control, and incentives. Elected in 1990, the Antall government aimed to use privatization of firms and banks to gain revenues quickly and take '*de facto*' control of firms back from managers.[10] The two subsequent privatization agencies became accountable directly to the prime minister and the Minister of Finance with only limited parliamentary oversight. After initial bureaucratic delays, Antall was able to use this control structure to change privatization procedures to simplify and accelerate asset sales to both Hungarians and foreigners (Antal-Mokos, 1998; Mihalyi, 1998; Stark and Bruszt, 1998).

The National Bank of Hungary (NBH) and bank supervision were less unified and independent than their counterparts in the Czech Republic, as the executive branch exerted power over both. For instance, the State Banking Supervision (SBS) was housed in the Ministry of Finance and needed approval of the Banking Supervisory Committee (BSC) to issue any decree or standard and take any strong enforcement actions. The BSC's nine members included high-ranking officials of the government, NBH, the SBS itself, and relevant experts from the banking community. At the same time, the NBH, which depended on the prime minister's appointments, set up a supervision division in 1993 to monitor short-term monetary issues.

Like the Czechs, the Antall government avoided making bailouts conditional upon specific restructuring steps in the banks and their large debtor firms. It guaranteed a certain class of communist era loans and recapitalized the banks in 1991–1992. In late 1991, the government also enacted a strict bankruptcy law that forced managers with past-due debts to enter into bankruptcy negotiations with creditors or the liquidation process. The government believed that while rapid recapitalization would strengthen the banks and the bankruptcy law would lead to debt restructuring, the banks would quickly be ready for sale to foreigners.

**Poland**

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

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

Despite the government's priority of privatizing banks and firms, its approach to bank crisis resolution became markedly different than those of Hungary and the Czech Republic as it aimed to solve the stock and flow problems together. In 1992, the Ministry of Finance began restricting the entry of foreign banks and ordered international audits of audits of the state banks identify the worst and largest debtors to state banks. The government sought to restructure the nine regional commercial banks and two national savings banks prior to privatization while forcing changes in bank operations and bank–firm relations (Montes-Negret and Papi, 1997).[11] First, in the 1992 legislation for the Enterprise Bank Restructuring Program (EBRP) that became effective in March 1993, the government offered seven of the nine regional banks a one-time recapitalization sufficient to deal with classified debts that originated prior to 1992. In return, the banks had to establish workout departments and had to reach a debt resolution agreement with their main debtors by March 1994, to be fully implemented by March 1996. Such an agreement allowed for five paths of debt resolution, including demonstration of full debt servicing (about 40% of the 787 total firms), debt/equity swaps, bankruptcy, liquidation, debt sale, and a new regime called 'bank conciliation', which ended up restructuring 23% of firms and 50% of debt in EBRP. Conciliation was essentially a legal framework facilitating accelerated restructuring negotiations between the firm and the main creditors. EBRP forced each of the regional banks (which held about 60% of outstanding firm debt) to become responsible for 200–300 SOE workouts.

**Table 2** Major differences between approaches to bank crisis resolution

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

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

Second, the Ministry of Finance initiated changes in the organization and capabilities of the banks. It hired Polish restructuring specialists, each of whom would direct a new workout unit (of about 15 people) in each of the banks and would receive a seat on the management board of the bank. Each bank also received technical assistance from foreign restructuring specialists.

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

Table 2 summarizes key distinctions between the three countries with respect to their approaches to resolving the bank crises. Although their details differ, the Czech and Hungarian approaches were quite similar as they relied largely on self-enforcing economic incentives to resolve flow problems but avoided the conditionality of tying state assistance directly to bank and large debtor firm restructuring. In contrast, Poland tied reorganization conditions to recapitalizations, and thus linked bank and large debtor firm restructuring.

## OUTCOMES OF THE DIFFERENT APPROACHES

The outcomes of these different approaches are summarized in Tables 3 and 4. The Czechs became the early leaders in transferring ownership of

**Table 3** Divergence in privatization (1995) and bank restructuring costs (2000)

| | % of GDP in private hands | % of industrial output in private hands | % of bank assets w/in state banks | Bank restructuring costs to govt and central bank (% of GDP) |
|---|---|---|---|---|
| Czech Republic | 70 | 93 | 19.5 | 30.2 |
| Hungary | 60 | 65 | 62.8 | 12.9 |
| Poland | 60 | 60 | 71.1 | 7.4 |

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

assets to private hands, while the Hungarians and the Poles sold state banks to mainly foreigners after 1995 and 1997, respectively. But dramatic differences emerged in terms of costs to the taxpayer, bank stability and performance, and supervision development.

By the end of the 1990s, the fiscal and quasi-fiscal costs of bank restructuring for the Czech Republic were about 30% of GDP, for Hungary about 12.9%, and for Poland only 7.4% (Tang *et al.*, 2000). Bank sector performance indicators for the 1990s show a similar pattern. For instance, by 1998 nonperforming loans remained at about 30% of total loans in the Czech Republic, but dropped to 8% in Hungary and 10% in Poland (Tang *et al.*, 2000).

**Table 4** Differences in employment and inspections at supervisory authorities

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

*Sources:* All data from the supervisory authorities of respective countries.
*Notes*: *Employees at regional branches also monitor small cooperative banks. No. of banks does not include the many, small agricultural cooperative banks.

Zoli's (2001) index on improvements of the banking sector stability and lending for 1991–1998 showed that the Polish banking sector significantly out performed all others in the region, followed by the Hungarian and Czech banking sectors.[12] The Czech approach did little to restructure firm-bank relations but fostered an increase in lending in the mid- to late-1990s that ultimately proved unstable. The Hungarian approach led to multiple bailouts. A persistent decline in bank lending to firms and subsequent stability came first from the severe, automatic trigger in the bankruptcy law (repealed in 1993) and then the restrictive lending policies of new foreign owners after 1995. Only in Poland does one see a combination of continued bank sector stability, consistent growth of bank loans to firms (largely mid- and long-term loans), and increased confidence in banks (indicated by a consistent decrease in currency to deposit ratios).[13]

Despite the lack of systematic, comparable data for the 1990s, the pattern for the development of regulatory and supervisory institutions is similar. Indeed, this may not be so surprising, as Pistor (2001) has shown in her comparative analysis of capital market soundness, the Czechs had significantly weaker investor protection regulations and supervisory institutions than the Hungarians and Poles.[14] In banking, key differences emerged in the development of monitoring activities and enforcement of risked-based provisioning. As can be seen in Table 4, Poland began to invest more rapidly and more extensively than Hungary, and especially the Czech Republic, in supervisory personnel and on-site inspections of commercial banks in the early to mid-1990s. By the late 1990s, World Bank estimates showed that Poland had the highest number of professional supervisors per bank of the three (Barth *et al*., 2002a: Figure 7).

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

Hungarian supervision lacked focus, capacity, and authority for much of the 1990s. The divided structure of bank supervision was prone to political intervention, with the SBS having weak on-site capabilities and inadequate information systems for consistent off-site supervision (Borish *et al*., 1996:

88–9). Despite reforms triggered by the new banking acts of 1996 and 1998 and the dominance of foreign banks after 1995, weaknesses remained. The SBS had a relatively low number of professional supervisors per bank, had problems retaining trained and experienced supervisors (especially compared to Poland),[15] and could not prevent the collapse in 1998 of Postabank, the second largest retail bank that had substantial private (Hungarian) ownership (Abel, 2002; Petrick, 2002). While the IMF praised the Hungarian bank sector for its gains in systemic stability in 2001, it noted continued shortcomings in risk assessment and supervisory autonomy (IMF, 2001b).

Despite their concerns about delayed bank privatization and restricted foreign entry, outside experts have given Poland high marks in its organization of inspections and risk assessment (IMF, 2001a; Tang *et al*., 2000), early focus on building the GINB's capacity, and empowerment of the GINB to issue legally binding resolutions to banks. In declaring that the GINB 'represents one of the strengths of Poland's overall financial infrastructure and institutional capacity', Michael Borish, a former World Bank analyst, explained that these efforts

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

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

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

## EXPLAINING THE DIFFERENT PATHS

How can one explain these contrasting outcomes in bank crisis resolutions and prudential bank supervisory capabilities? Typical reference to market

based incentives, a strong central bank, or prior social conditions may not prove so helpful here. For instance, the Czech use of rapid privatization and liberalization potentially undermined bank governance, while the Polish bank sector developed stably despite significant state ownership of bank assets. Although the Czech's had an internationally praised central bank, its monetary authority did not translate into investment into regulatory institutions.[16] Despite having by far the most experienced bank professionals of the region prior to 1990, Hungary appeared to mis-manage bank restructuring (Anderson and Kegels, 1998).

More useful explanatory categories may be the different political approaches to transformation: depoliticization versus participatory restructuring. The paths of crisis resolution and institutional development depend largely on the degree to which political approaches to transformation facilitate or impede the ability of relevant public and private actors to learn from and monitor one another. Depoliticization impedes the development of bank and supervisory capabilities, since the emphasis on speed and insulated policy making power prioritizes the use of rules based on self-enforcing incentives but overrides any interest in imposing conditionality and developing the ability to monitor bank activities. Participatory restructuring begins with a suspicion of methods based on bureaucratic directives or arms-length incentives. Conditionality combines incentives with means of acquiring new knowledge and changes in the organization of the bank. The priority is placed on creating adequate monitoring capabilities, which in turn opens up a process of disciplined interaction between public and private actors that enhances learning and investment of resources into the relevant institutions. Indeed, these different political approaches suggest broader implications for the potential abuse of reforms by 'reformers' for short-term political gains. Despite its overt aim of removing the 'grabbing hands' from policymaking, depolitization's emphasis on the insulating power in a few hands and avoidance of focused legislation, undermines the development of multiple sources of mutual monitoring. In turn, the policymaking process not only lacks the capabilities and room for adjustment, but also becomes ripe for abuse of patronage and self-dealing. In contrast, participatory restructuring's emphasis on focused legislation, empowerment of multiple public and private institutional actors, and investment into monitoring capabilities has the potential to increase accountability and limit abuse.

### The Czech Republic: Extreme depoliticization

The Czech Republic is the clearest example of the depoliticization approach to transformation. As noted above and elsewhere (McDermott, 2002, 2004), the political rise of Vaclav Klaus and his coalition solidified the model of insulating a powerful group of technocrats focused on the

rapid implementation of market incentives. A combination of rapid, mass privatization, a one-time recapitalization, liberal market entry rules, and a strict bankruptcy law that focused on liquidation were to lead the main banks to restructure or cut off problem firms.

Yet this approach undermined the development of the banks and supervision. First, the new incentives and creditor rights could do little to alter the strong inter-dependence between the main banks and especially troubled manufacturing firms, since bankruptcy was a fast track to a wave of liquidations and systemic financial instability (Mitchell, 1998). The main banks chose rather to roll over existing loans. In the wake of the 1998 Russian crisis, the solvency of the largest manufacturing firms and the banks became increasingly tenuous, leading to their virtual re-nationalization and re-privatization by the newly Social Democrat government in 1999.

Second, although the central bank was given strong independence in monetary policy and established legal norms in line with Basel recommendations, the policies of recapitalization, partial debt removal, and rapid privatization hardly involved the nascent supervisory department (BSD) and did not compel the government or the central bank to invest in personnel and monitoring resources. The big banks met their 8% CAR by late 1994 and that was sufficient. Until 1994, the main banks even had ample discretion in classifying non-performing loans. After 1994, the CNB expanded supervisory activities demanded uniform classification of non-performing loans. But the BSD focused mainly on smaller banks, since resources were limited and the weaknesses of the smaller banks were the most visible. At the same time, the main banks continued to battle the over-stretched BSD over the proper valuation of collateral and proper provisioning (CNB, 1999; Pazderník, 2003).

Depoliticization had become a double-edged sword, as it increasingly constrained the Klaus government's ability to develop new institutional capacities and defined its mode of holding onto political power (Orenstein, 2001). The Czech approach tied the Klausian's political future to the speed of privatization and the outward stability of the dominant banks, with their weak assets and mismanaged investment funds. Any new policies would have damaged his government's *raison d'etre*, empowered institutions not under Klaus's direct control, slowed mass privatization, and brought parliament back into policymaking and oversight.[17] For instance, as early as 1991–1992, Klaus maneuvered to block an alternative proposal for tying bank recapitalization to large firm restructuring since much of policymaking power would have transferred to the Ministry of Industry and Trade, the minister of which was not trusted by Klaus. In the name of avoiding further interference and delays in bank privatization, Klaus did have the loyal Ministry of Finance block the BSD's early efforts to impose a more stringent classification of non-performing loans on the big banks (Pazdernik, 2003). A similar story can be told for policy initiatives in firm restructuring

and diluted reforms of capital markets and bankruptcy in the mid-1990s.[18] Only after the Klaus government fell in 1997 did the BSD enforce stricter provisioning rules, bringing to light the true fragility of the sector. But even further privatization could not make up for the weak institutions. For instance, although the caretaker government sold its remaining 30% of equity in Investicni Postovni Banka, the second largest bank, to Nomura Securities in early 1998, the bank collapsed as a looted shell in 2000.

### Hungary: Moderate depoliticization

While the Hungarians did not pursue voucher privatization like the Czechs, they did adhere to depoliticization tenets of insulated power and speed (Stark and Bruszt, 1998: Chapters 5–6). The Antall government diminished the importance of maximizing revenue and transparency in favor of rapidly recapitalizing banks and accelerating privatization. Privatization agencies, the Banking Supervisory Commission, and even the Governor of the NBH came under increased control of Antall's office and his Minister of Finance, while policy toward the banks was a matter of decree rather than legislation.

First, the various bank recapitalizations lacked any effective conditions on banks. The first bailouts were noted for their lack of consistent definitions of loans to be guaranteed or swapped and lack of any demands on banks to change operations, management, or relations with firms (Anderson and Kegels, 1998; Borish *et al.*, 1996). The attempts in 1992–1994 to demand that banks generate restructuring plans for problem debtor firms in return for bond swaps resulted in a small number of firms and a limited amount of outstanding debt being restructured. The plans suffered from incoherent guidelines on debt and firm selection as well as consistent efforts by the Antall team to accelerate privatization of non-financial firms. The latter in particular led to repeated interventions in firm selection and restructuring negotiations that undermined bank interest and the authority of a newly proposed monitoring unit in the Ministry of Finance (Baer and Gray, 1996; Balassa, 1996; Borish *et al.*, 1996: 56–7; Tang *et al.*, 2000).

Second, the government's draconian bankruptcy law in 1992 failed to induce the banks to engage in restructuring. Hardly any banks initiated or participated actively in bankruptcy procedures, rather only firms did – as debtors and creditors. The most important impact of the law before the automatic trigger was repealed in 1993 was that it had forced a large number of firms into bankruptcy, exacerbated the insolvency of firms and the main commercial banks, and reinforced an existing decline in lending and economic growth (Bonin and Shaffer, 2002; Mitchell, 1998). In turn, the Hungarian approach to bank restructuring only exacerbated moral hazard dilemmas and undermined the change in bank behavior and investment in new capabilities.[19]

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

Similar to the Klausians, the Antall government was increasingly constrained by its wedlock to the tenets of speed and insulated policy-making power. Tying bank and firm restructuring as well as investing into supervision would have forced the government to include parliament in new laws and oversight activities, clarify its relationship to the NBH, and alter its privatization goals and timeline. The turning point for Hungarian bank sector development came in 1994–1995, namely with the election of a new government led by Gyula Horn. Lacking funds for further bank restructuring and looking to score points at home and abroad, Horn privatized the banks, which were now recapitalized enough to make them attractive to international investors. The foreign owners effectively stabilized the banks and brought in new risk management and organizational systems. Moreover, once relieved from bank restructuring and under renewed pressure from the new owners, the multi-laterals, and the EU, the government focused on putting its supervisory and regulatory system in order. The new banking law in 1996 brought important regulatory changes and began a process of consolidating supervisory activities and improving the authority and resources of the SBS.

### Poland: Participatory restructuring

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

Bank sector policies should be seen as part of a larger approach to transformation and ownership change. The political set-backs to rapid mass privatization in 1990 perhaps inadvertently led the government to pursue

various methods of linking ownership change with restructuring. As analyzed elsewhere (McDermott, 2004), these methods had the common principles of empowering relevant public and private actors to restructure assets while providing a framework that facilitated risk sharing and mutual monitoring. For instance, the 1990–1991 government began experimenting with restructuring large, distressed firms like in shipbuilding by offering partial financial assistance and property rights to relevant suppliers, creditors, work councils, and local governments in exchange for the creation and execution of coherent reorganization plans. The 1990 law also spurred one of the most popular and successful methods of ownership change by allowing a majority of employees and managers buy-out their own firms with the help of a low-interest loan. Approval and monitoring of such projects became the responsibilities of the Ministry of Ownership Transformation and the 49 regional administrations (voivodships). These are just two examples whereby the Polish government provided a framework for firms and banks to reorganize their commercial relations and for public actors at the national and regional levels to experiment with new roles in the economy.

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

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

different restructuring methods and the government actors to learn how to improve their own auditing and monitoring techniques.

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

The regulatory institutions also benefited. First, by including the banking supervisors and the state auditors in the program and the deliberations, both groups began to learn directly how to collect off-site inspection information and conduct on-site inspections. For instance, as can be seen in Table 4, the supervision authority began to shift from comprehensive inspections to many narrower inspections. This may have improved the efficient use of resources, and it appears consistent with the notion that innovation and capabilities development under uncertainty can often be best achieved incrementally through frequent smaller experiments than large, time-consuming, incoherent projects (Argote and Darr, 2000; Helper *et al.*, 2000; MacDuffie, 1997). Moreover, auditors and supervisors deployed resources both centrally and regionally, which improved the use of decentralized knowledge while testing the effectiveness of broader evaluation and feedback methods (McDermott, 2004). Second, by committing itself publicly and legally to bank restructuring with delayed privatizations, the government was forced to invest in relevant personnel and systems early

on. The Polish supervisory authority became a leader in the region from the early 1990s by expanding rapidly its staff, implementing extensive training programs, retaining experienced supervisors, publishing guidelines, and having the de jure and de facto authority to enforce new prudential rules (Borish, 1998; Borish *et al.*, 1996).

In sum, I classify the Polish approach as participatory restructuring in both the narrow and broad meanings of the term. By imposing conditionality on the banks and their major debtors, the Polish government sought to ensure compliance without interfering in the details. In turn, monitoring via deliberations occurred at two levels – between the government actors and the banks and between the banks and their debtor firms. The monitoring rules forced the frequent exchange of information to promote mutual evaluation, transparency, and learning. At a broader level, Poland did not seek to insulate concentrated government power for rapid changes based on incentives alone, as did the Czech Republic and Hungary. Rather, Poland appears to have been able to achieve some balance of transparency and accountability with operational coherence and discretion. Privatization and bank restructuring programs were authorized by law, making them accountable to Parliament and not simply the Prime Minister's office. The NBP and supervisory office have relatively strong clear authority in regulating banking activities, but they respond to the Parliament and President. The rules of EBRP allowed outsiders to track in fairly fine detail the uses of public funds and the measures taken by the banks.[20] These legal foundations indeed may have well been vital in allowing EBRP and the SBS to continue to develop even as governments and coalitions rose and fell.[21]

## CONCLUDING REMARKS

This article has argued that institutional development depends largely on whether political approaches to transformation facilitate or impede the ability of public and private actors to experiment with new roles and learn to monitor one another. In doing so, it also has argued for categorizing these approaches as ones of depoliticization versus participatory restructuring instead of analyzing institution building solely in terms of state versus the market or autonomy versus embeddedness.

The article has illustrated the relative strengths of this framework in an examination of the policies impacting the resolution of bank crises and the development of banking supervision in Hungary, Poland and the Czech Republic. To different degrees, Hungary and the Czech Republic typified a depoliticization approach by emphasizing speed and insulated policy-making power, and, in turn, relied largely on rapidly implanting new self-enforcing economic incentives to affect changes in bank behavior. The new incentives alone did not offer the banks a coherent framework

of conditionality to facilitate the risk-sharing and information exchange needed to change relations with large firms and build new organizational capabilities. At the same time, relevant public actors were given scant opportunities and resources to gain oversight experience and invest in needed skills.

Poland appears to have followed a path of participatory restructuring because of the way it distributed restructuring and policymaking power among relevant public and private actors via the use of the principles of delegation and deliberation. In using these principles, the government effectively combined monitoring and learning and was able to place significant reorganization conditions on banks in return for recapitalization, thus linking bank and large firm restructuring. The government gave relevant bank and public actors the incentives and authority for restructuring and oversight. It also provided a forum with rules of information exchange for these actors to engage in frequent disciplined deliberations that helped them learn how to develop new capabilities of monitoring and financing. Subsequently, the supervisory body gained valuable experience and invested rapidly in new skills and systems.

By casting institutional development as an experimental process, this article has argued that institutional analysis focus less on ideal policy incentives or on social preconditions and more on the political conditions that would more or less likely advance the governance of institutional learning. A basic conundrum in development is how the process of political governance can allow public and private actors to develop new capabilities and roles without cycling into bureaucratic suffocation or self-dealing. Depoliticization approaches can retard this development because the emphasis on speed and the insulation of centralized policymaking leaves little room for government agencies to gain new knowledge, adjust policies, and learn which methods and resources are vital to monitor market actors. Participatory restructuring approaches may have the advantage of micro-level governance structures that combine mutual monitoring and learning. But identification of the background political architecture fostering and stabilizing that approach is less clear.

The evidence in this article suggests that grounding areas of institutional change in specific legislation may aid the balance of accountability and authoritative discretion. For instance, the reformist governments of Hungary and the Czech Republic avoided specific legislation on bank crises and increasingly sought to insulate their control over relevant policies. This approach may be good for the speed of initial changes, but not in making transparent and informed adjustments. In contrast, Poland had legislation that empowered specific actors and provided a means for oversight of the attendant activities. Such a conclusion would be consistent with recent research on regulation and the political economy of development (Henisz and Zelner, 2004; Levy and Spiller, 1996; Montinola, 2003). While legislation

often enables parliamentary oversight and institutional independence, increased political constraints may indeed facilitate change, even in the face of failures, by improving the likelihood of compromises, transparency, and broad based alliances (Stark and Bruszt, 1998; Montinola, 2003). The rub may not be, however, the number of veto points, but rather the *process* that guides interaction among policymakers and stakeholders, thus their ability to develop credible means of mutual monitoring (Sabel, 1994; Stark and Bruszt, 1998). Greater emphasis on process indeed coincides with recent research in comparative finance that finds limited significance of typical institutional structural variables in explaining cross-country variation of bank sector performance (Barth *et al.*, 2001, 2002b, 2003).

Analyzing both political structural and process variables shaping institutional development can also help evaluate the trade-offs and their relative importance on the path initiated (Kitschelt, 2003). That is, any political approach translates into constraints for a government and commitment to a set of goals. Depoliticization in general can greatly constrain policy adaptation. The more the government becomes identified with rapid, narrow solutions, the more its political identity is damaged with publicly observed adjustments and delays. Moreover, more pragmatic approaches, such as conditionality, would demand investing in new institutional resources and open up a government's hold on power. Adjustment might only come after another crisis and change in administrations, such as in the Czech Republic, and somewhat in Hungary. On the other hand, participatory restructuring still has its costs, as certain areas of policy may be delayed. Indeed, as the first set of institutional experiments take root in a fruitful fashion, governments may mistakenly believe that the delayed policy areas may be less important. After taking power in 1993, the socialist government in Poland further delayed bank privatization and removal of previously temporary restrictions on foreign bank entry. Change in these policies came only after strong pressure from the multilaterals and the EU (Epstein, 2001).

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

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## NOTES

1 For discussions of this shift, see Bruszt (2002), Ekiert and Hanson (2003), Johnson (2001), Kapstein (1996), Montinola (2003), Quinn and Inclan (1997), and, especially, EBRD (1994, 2000) and World Bank (1996, 1999, 2000).

2 See Barth *et al*. (2002) and Tang *et al*. (2000) for overviews and applications of these measures.

3 In addition to secondary and government data sources, this article draws on a series of 32 semi-structured interviews I conducted in each country during 2001–2003 with relevant bank manager, supervisory directors, and policymakers.

4 See McDermott (2002) for a discussion of depoliticization views as they appear in economics, rational choice, and developmental statism. The critique draws on Moon and Prasad (1994) and Grindle (1991).

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

6 For instance, by 1989 domestic bank debt to GDP was 70% in Czechoslovakia, 44% in Hungary, and 30% in Poland. This variation was due to different methods of financing state firms and the macroeconomic imbalances in Hungary and Poland. These differences in the 1990s did not necessarily reflect relative strengths in capital market development. For instance, the region's most vibrant and liquid stock market, Poland's, did not effectively begin until after 1996.

7 Unless cited otherwise, the following description of the reforms of the central banks, bank supervision, and bank crisis policies are from Anderson and Kegels (1998), Borish *et al*. (1996), and EBRD (1994).

8 I speak mainly about the 1990 law on Economic Transformation and the 1991 law on Large Privatization. See McDermott (2002: Chapter 3) and Orenstein (2001: Chapter 3).

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

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

11 Although EBRP focused on the seven regional commercial banks, the framework extended with time to the three largest national specialized banks (Borish *et al.*, 1996; Pawlowicz, 1995). The following also draws on Gray and Holle (1998).
12 Zoli's index is the average of the increase in credit to the private sector, increase in M2-to-GDP ratio, decline in the central bank credit to banks, decline in the currency-to-deposit ratio, decline in M1-to-M2 ratio, decline in the share of non-performing loans following the resolution of banking sector problems (Zoli, 2001: 23–4). Poland scored 35, Hungary 27, and the Czech Republic 10.
13 See, for instance, Anderson and Kegels (1998), Borish *et al.* (1996), Tang *et al.* (2000), and Bonin and Shaffer (2002).
14 Rogowski (2004) notes that officers of the GINB also worked closely with the stock market regulator and that the GINB prohibited bank supervisors from taking jobs in the regulated banks.
15 For a critical analysis of the authority and capacity of the Hungarian supervisory structure, see Borish *et al.* (1996). Data on the professional supervisors per bank, supervisor tenure, and the likelihood of a supervisor moving into banking can be found in Barth *et al.* (2001: Figures 7, 18–9). According the Barth *et al.* (2001) and the CNB, by 2000, average tenure of bank supervisors was: Czech Republic, 6.4 years; Hungary, 5 years; and Poland, 9.5 years.
16 Indeed, recent research shows little significant impact of central bank independence on banking and regulatory development (Barth *et al.*, 2001, 2003).
17 The general laws on privatization and bank regulation were passed in parliament. Changes to previously approved regulations and privatization projects would demand parliamentary action and oversight. The Minister of Industry for 1990–1992 was Jan Vrba, who was developing a more interventionist approach to restructuring. He was ousted in June 1992. For details on both matters, see McDermott (2002: Chapter 3).
18 For fuller discussions of these issues, see McDermott (2002: Chapters 4–5).
19 For a similar line of reasoning see Stark and Bruszt (1998: 149–53). They argue that the assertions of control over assets and policy by the Antall government did little to change bank behaviour or develop institutional capacity.
20 See for instance the fairly detailed studies on EBRP by the World Bank and Polish institutes (Gray and Holle, 1998; Montes-Negret and Papi, 1997; Pawlowicz, 1995).
21 The Socialist (SLD) government came into power in the late 1993 for four years.

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