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"The Role of Financial Institutions in the Transition to a Market Economy"
by Hans J. Blommestein and Michael G. Spencer

The economic transformation under way in the former centrally planned economies (FCPEs) was motivated in part by the recognition that central planning has failed to allocate financial and real resources efficiently. This paper addresses the question of what kind of financial system should replace central planning in allocating capital and maintaining effective corporate governance during the transformation period.

Financial sector reform has, at times, been portrayed as a question of adopting either a bank-based or a (securities) market-based model. In the bank-based model, commercial banks, often licensed as "universal" banks, take the lead in financing enterprise restructuring and investment. Proponents of the market-based model argue that the structural problems in the banking sector cannot be overcome easily; so firms will have to look to equity and bond markets for sources of new capital.

Equity and bond markets in the FCPEs are not sufficiently well developed to support significant issues of new securities or to provide a mechanism for corporate control. They lack adequate liquidity, regulatory oversight, information disclosure, and clearing and payment systems. The important role of banks in maintaining the payment system and in providing credit to market participants to support trading and settlement means that until banks are restructured and recapitalized, securities market development will be constrained.

Investment funds emerging from mass privatization schemes may create concentrations of equity ownership that would allow them to play an important role in corporate control and perhaps, too, in finding sources of investment capital. They are a relatively recent innovation, however, and it remains to be seen how active they will be in financing and managing privatized enterprises.

The authorities should first establish a healthy banking sector, because it is the banks that are the most promising source of working capital and corporate control. This does not mean that securities market development should be ignored, only that it should not be a priority use of scarce government resources at the present time.

Many observers recommend that banks be given the power to act as universal banks, combining lending with securities market operations and equity investment. The potential problems associated with such a model in the FCPEs during the transformation period outweigh any potential benefits. It is recommended, therefore, that commercial banking and investment banking activities be separated, at least until banks have demonstrated competence in their commercial lending operations.