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Lessons from the Japanese Main Bank System for Financial System Reform in Poland

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Abstract

This paper compares the problems facing the Japanese financial system following World War II with those currently facing Poland. In particular, we consider whether the Japanese experience offers important lessons for Polish decision-makers responsible for structuring a new financial system to support the transition to a market economy. We argue that there are several reasons to suspect that Poland would benefit from arranging its banking system along the lines of the Japanese system.

The paper begins by pointing out the principal similarities between the two situations: 1) that both economies were emerging from a period of considerable centralization, 2) that in each case banks had been instructed by the government to lend to certain designated firms (often without regard to the profitability of loans), 3) that both economies experienced very high inflation along with acute capital shortages at the beginning of the transition to capitalism, and 4) that in both cases as the transition began the balance sheets of firms and banks throughout the economy were filled with massive amount of bad debts. We then review the Japanese experience and outline the theoretical and practical advantages of their approach. We argue that the institutional arrangements that permitted banks to play an active role in corporate governance were especially beneficial. We close with an assessment of the current Polish situation and a discussion of the potential for application of the Japanese Main Bank System in Poland.

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0. Introduction

Poland has, for more than three years, been engaged in a process of economic reform from a planned to a market economy, and as the first of the formerly communist eastern and central European countries to engage in the reform process, it has had to grapple with enormously complex problems without many meaningful precedents. The reform process in Poland can be characterized as having four central components: macroeconomic reform and stabilization; institutional reform to establish the basic legislative and structural mechanisms to support a market economy; financial system reform to separate the central bank from commercial banking, and to introduce intermediation into the economy; and, privatization of state assets. When comparing the command planning system of Poland and its Warsaw Pact allies with the capitalist systems of the industrialized western countries, the differences are obvious and substantial. But when presented with the task of actually establishing some kind of market economy where there has been none for decades, it quickly becomes clear that there exists a multitude of alternative arrangements within the general rubric of a "market economy," each of which have compelling attributes that vary as a function of political and economic circumstances, transitional properties, and the need for complementarity amongst the four components of reform.

In this paper we focus on the choice facing Polish policymakers regarding how to structure the financial system, and its relation to the privatization and restructuring of Polish industry. Financial sector reform has progressed painfully slowly in Poland despite its crucial role in enabling the revitalization of Polish industry. Indeed, more than three years after the introduction of the "shock therapy" macroeconomic reforms

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on January 1, 1990 the banking system remains almost entirely state-owned and operated, and, more importantly, remains largely dysfunctional in collecting funds from depositors and allocating them to the most worthy borrowers.

As the Polish economy begins to emerge from a severe downturn, the failure of the financial system is widely viewed as a crippling impediment to recovery.[1] Taking a longer term perspective, privatization and restructuring of Polish state enterprises will require careful valuations of companies and planned investment projects, large infusions of capital where warranted, and substantial financial expertise in the management of the privatized enterprises. In addition, the rapidly growing small private business sector in Poland also badly needs efficient and accessible intermediation to support further development. New legislation allows for the creation of private banks, and some have been established, but their share of banking activity remains quite low. Only a few foreign-owned banks have been established, and there has also been little foreign investment in Polish banks. Bankruptcy procedures exist, but they are cumbersome and often disadvantageous for creditors and, hence, are rarely used.

Meanwhile, the nine regional commercial banks that were spun-off from the National Bank of Poland continue to have the vast majority of the deposit and loan business. First steps toward the privatization of these nine banks have taken place, including the commercialization of the banks, the creation of a Supervisory Board overseeing the management of each bank, the classification of all outstanding loans into five categories on the

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[1]See Berg and Blanchard (1992).

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basis of likelihood and timeliness of repayment, and the imposition of Ministry of Finance restrictions on further lending to state enterprises with existing non-performing loans.[2] As an incentive for improved management, the Ministry of Finance plans to privatize the banks in an order determined by their relative financial performance.

Although there is no precedent among eastern and central European countries for the problems of financial system reform, there are important lessons to be learned from the post-World War II experience of Japan. The post-war Japanese economy was faced with transitioning from extensive centralization and government intervention in the economy to support the war effort, including measures that directed funds and tangible resources to enterprises supplying the military, to a de-militarized, market economy. Post-war Japan, too, had severely limited productive capacity, a very high rate of inflation, and extremely close ties between large banks, large firms and government administrators. Japanese banks were left after the war with balance sheets full of munitions company loans that were initially guaranteed by the government, but following pressure from the Allies the guarantees were dropped and the loans were uncollectible. The large Japanese banks thus faced a balance sheet clean-up problem similar to that currently faced by the Polish banks, whose assets are almost entirely loans to state enterprises, the majority of which are likely to be uncollectible.

Rather than adopting a financial system based largely on financing through equity, bond markets and arms-length bank lending, like the US system and the system currently contemplated for Poland, Japan developed a

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[2]Commercialization involves the conversion of a state-owned enterprise into a joint-stock company, in which the state initially owns all of the shares. Commercialization is a pre-condition for privatization.

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system dominated by financial intermediation through banks, in which banks also own some equity of the companies to whom they lend money. In the former system corporate control is exercised through the stock market by shareholders and their elected representatives, and in the latter banks are more important, particularly in periods of financial distress when they often exercise control. In many cases, large Japanese firms pair off with a single bank that becomes the dominant lender to the firm. These "main banks" play a particularly active role in the governance and long-term financial needs of their large corporate customers.

Recent theoretical and empirical analysis suggests that the "main bank" system has several advantages over the arms-length banking relationships and reliance on securities market financing common in Anglo-Saxon countries; and, these advantages are especially important for firms in financial distress. Concisely stated, the principle advantages are reductions in monitoring costs associated with long-term, closely integrated relationships, reductions in agency costs from significant bank ownership of debt and equity, coordination efficiencies from having one bank with a large stake as lead lender and reductions in rescue or liquidation costs for firms in financial distress.

There are clearly a number of important differences between post-war Japan and Poland in the early 1990s, but the parallels are sufficient to support further analysis of the virtues of the Japanese system for Poland. In particular, the circumstances facing Polish industry and the current condition of the Polish banking system raise additional challenges that seem well suited to the main bank structure: a complete lack of "modern" organizational and technological banking competence; the need for a long-

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term financial commitment to support restructuring of Polish enterprises; and the enormous information and credibility problems posed by an unstable economy with inexperienced and poorly trained managers.

Furthermore, Poland has embarked on a novel and highly complicated Mass Privatization Program that is aimed at rapidly privatizing hundreds of companies. Under the terms of this program, the shares of the privatized companies would be held by roughly 20 management funds, and each fund would hold a substantial ownership share in a few companies (as much as 50-60%). The management funds will have foreign investment banks and venture capitalists as advisors and are expected to behave as active investors, choosing and monitoring management, selling assets and facilitating restructuring through advice to management and the provision of capital. The management funds, in turn, are to be owned by the Polish citizenry, each of whom will receive one share in each fund. The management funds are intended to concentrate ownership and introduce scarce management expertise, thereby facilitating restructuring. The source of financing for these funds has been assumed to follow from the foreign advisors' access to capital markets. Since foreign direct investment in Poland has, to date, been far less than what is necessary to finance restructuring and investment on a large scale, substantial domestic funds will be required to support the privatization effort.

The main bank system presents a model for financial system reform that offers many benefits for the cluster of problems facing Poland's economy. The privatization and restructuring of Polish enterprises seems especially well-suited to take advantage of the distinctive attributes of a main bank system. However, it is crucial to distinguish between the benefits of a

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main bank system for private Polish banks and the adoption of a main bank system under the current largely state-owned banking structure. The main bank system will work effectively if, and only if, the large commercial banks are privatized and well capitalized, and bank managers operate under profit-based incentives that prevent the lending of funds to unworthy borrowers. "Soft budget constraints," a fundamental characteristic of banking under the communists, will not arise with a main bank system in which managers of banks are rewarded for the profitable use of private capital.

In the remainder of this paper we examine the relative merits of the main bank system for Poland. The next section describes the problems facing Japan during the period when the main bank system emerged. Section 2 discusses how the system resolved these problems and the more general features of the modern main bank system. Section 3 describes the Polish situation in greater detail, and draws on the preceding sections to analyze the virtues of the main bank system for Poland. Our conclusions are in the final section.

1. The Background Leading to the Development of the Main Bank System in Japan

The purpose of this section is to review the pre-conditions that led to the development of the main bank system in Japan. Although the version of the Japanese Main Bank System that was operative during the high growth era (1955-1973) has been widely studied and is nicely summarized in Chapter 1, it did not emerge instantly following World War II. Rather the system

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evolved from the financial system that was in place at the conclusion of the war through the process of dealing with the challenges associated with rebuilding the economy.

The analysis here will focus on four key economic conditions that contributed to the emergence of the main bank system. First, the manufacturing and financial sectors of the economy underwent an extreme concentration during the militarization of the economy. Second, the government arranged centralized financing by pairing banks and firms, and the bank was charged with taking care of the firm's financial needs. The end of war brought with it two significant challenges. One problem was a near-hyperinflation that destroyed much of the country's wealth just as the economy needed to be rebuilt. A second difficulty was that Japanese banks and industrial firms were left with balance sheets full of wartime commitments that were ultimately repudiated. It will be argued that these four factors had a lasting effect on the banking system.[3]

Of course, there were other important factors that shaped the system, and it is important to recognize both the continuity and the shifts that occurred in the transition between the wartime and postwar financial system. For example, monitoring patterns in the wartime banking system differed significantly from those in the post war system. Nevertheless, there are some similarities between the two systems and the purpose of this section and the next one is to explain how the transition occurred and why the process of working the problems the economy faced after the war

[3] In Chapter 2, Teranishi emphasizes another factor: the loan syndication arrangements that became prevalent during the war. He argues that these arrangements were instrumental in the development of the lending consortia that are an important characteristic of the main bank system.

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ultimately led to a system that was so successful during the high growth era.

One of the main effects of war was an increase in the concentration of the Japanese banking sector. From the onset of hostilities with China in 1937 through the end of WWII, the number of banks in Japan shrunk from 377 to 61. It appears that several laws passed by the government to assist in the war effort were largely responsible for this shift and for an increase in the concentration of the banking and industrial sectors of the economy.[4]

The first of these acts occurred in 1937 when a set of financial controls were designed to allocate funds preferentially to war-related industries. These industries tended to be located in the regional centers, (Teranishi 1982, pp 341-342), so that by discriminating against firms in non-war-related industries, the policies generally hurt firms that were located outside of the metropolitan areas. As these companies declined, so did the regional banks with whom they did business. Thus many regional banks eventually found that their best option was to merge with larger banks.

The war-time controls also were particularly advantageous to the largest banks because they had the most funds available to direct to the war effort. By acquiring small banks the larger banks grew further during this period. Table 1-1 confirms this observation by showing time series information on the share of the five largest banks in various activities. Notice that even between 1940 and 1945, there was a considerable increase

[4] As Hoshi (1993a) describes, the government had previously passed other laws that led to considerable concentration in the bank sector - overall between 1901 and 1945, 98% of the banks in Japan disappeared.

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in concentration. By all conventional measures the militarization of the economy left Japan with an incredibly concentrated banking sector.

Another way to measure the importance of the war effort is to note the compositional shift in output towards heavy capital-intensive industries at the expense of light industries. For instance, Hoshi (1993a) reports that between 1934 and 1942 the share of output coming from steel and metal and machinery industries increased from 27% to 49%, while the fraction of output produced in the food and textile industries declined from 42% to 19%. Along with this general shift towards heavy industry, the government also sought to shift production to certain favored firms.

The result was that the zaibatsu firms significantly increased their importance in the economy over this period. For instance, Hadley (1970, pp 48-55) reports that the "Big Four" zaibatsu (Mitsui, Mitsubishi, Sumitomo and Yasuda) accounted for roughly 15% of production in heavy industries (defined as mining, metal manufacturing, machine tools, shipbuilding and chemicals) in 1937 and 32% of production by the end of the war. Apparently, many of the gains came because the Japanese army and navy routinely "turned industrial and mining areas coming under Japanese jurisdiction over to Mitsui, Mitsubishi or Sumitomo to operate." (Hadley 1970, p 41) In fact, Hadley's data indicate that in the non-Japanese territory controlled by Japan, the Big Four zaibatsu accounted for over 60% of production in heavy industries at the end of the war. Overall, the drive to convert the economy to prepare for war left both the manufacturing sector and financial sectors highly concentrated.

This reorientation of the manufacturing sector led to further changes in the credit flows. An examination of the sources of industrial funding

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during this period shows that with the increasing importance of capital intensive sectors in the economy, firms were no longer able to rely on internally generated funds to finance their investment. These changes led to a pronounced aggregate increase in the demand for bank financing. For instance, the share of firm financing coming from banks more than tripled between 1936 and 1944 - increasing from 18% to 58% - while the share financing coming from internal funds fell by nearly half - from 47% to 24%. (See Ministry of Finance 1978, pp 462-463.)

To assist with this adjustment, another set of legal changes regarding the way that individual companies arranged their financing was implemented. Initially these changes were made at the industry level. For instance, soon after Japan initiated the war with China, the Temporary Funds Adjustment Law was promulgated in order to guide the overall allocation of long term funds and provide preferential allocations for war-related industries.[5] Over the next six years the government passed a series of laws that gave increasing authority over the way funds would be allocated throughout the economy - see Hoshi (1993a) for more details.[6]

The financial controls reached the final phase when the government passed the Munitions Companies Act (October 1943) and the Munitions Companies Designated Financial Institutions System (January 1944). The Munitions Companies Act put major companies that were considered

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[5] Operationally this meant that each industry was classified into one of three categories: those which were to get approval for most long-term funding requests, those which would sometimes get approval, and those which could generally not expect to get approval.

[6] During this period the demand for loans by war-related industries increased dramatically. The commercial banks responded to demand by forming lending consortia. See Chapter 2 for more details on this process and an argument for why these lending consortia may have had a lasting effect on lending arrangements in the post-war main bank system.

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strategically important under the direct control of the government, while the Munitions Companies Designated Financial Institutions System assigned a major bank to each munitions company to take care of the firm's financial needs. Large firms sometimes had more than one bank assigned to help them.[7] In many cases, a lending consortium was formed around the designated bank to serve the munitions company.

Judging from the "Selection Policy for Munitions Companies Designated Financial Institutions" many of the designations are likely to have been based on the past relations through loans, shareholdings, and directorship (Bank of Japan Research Bureau 1973, p 397 and Mitsubishi Bank 1954, pp 348-350.) Thus some assignments under the Munitions Companies Designated Financial Institutions System served only to reinforce pre-existing ties between banks and firms - especially in cases evolving zaibatsu firms and banks.

But historical accounts of the matching process also suggest that there was competition among banks to receive designations for munitions companies. For example, in the corporate history of Mitsubishi bank, it is reported that the bank lobbied to obtain as many designations as possible because loans made to munitions companies were perceived to be riskless (see Mitsubishi Bank 1954, pp 349-350. Also Miyazaki and Itoh 1989, p 202, in their review of the history of Fuji Bank, reach the same conclusion.)

As a result of this process some non-zaibatsu firms started to have close ties to zaibatsu banks. An interesting example is Ajinomoto, which

[7] The Munitions Company Act also allowed managers to increase their power relative to shareholders by giving the managers much more autonomy provided that they were acting in the interests of the nation by trying to "increase productivity". (See Okazaki 1991, pp 392-393.) Hoshi (1993a) explains how this shift in power further contributed to the rise of a bank-led financing system.

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changed its name to Dai Nippon Kagaku Kogyo during the latter stages of the war and then was designated as a munitions company and assigned to Mitsubishi Bank. Judging from the low levels of debt prior to the war, Ajinomoto does not appear to previously have had extensive relations with Mitsubishi (or any other bank) before the war. (Ajinomoto 1971, Vol. 1, Appendix, pp 10-11).[8] After the war, Ajinomoto gradually moved closer to the Mitsubishi group. For example, during the reconstruction period, Mitsuo Ogasawara of Mitsubishi Bank served as one of its five special managers charged with supervising the rebuilding of the firm. By 1962, Mitsubishi Bank was the largest lender to Ajinomoto and by 1972 had become both the largest lender and largest shareholder of Ajinomoto (Keizai Chosa Kyokai 1963, 1973). In addition to the financial ties, Ajinomoto and the Mitsubishi group developed close relations in intermediate product markets. For example, Ajinomoto's Tokai factory purchases raw materials from Mitsubishi Chemical, Mitsubishi Petro-Chemical, and Mitsubishi Monsanto (Ajinomoto 1989, p 281). Thus, even for the former <u>zaibatsu</u> banks there appear to have been new long-lasting relationships that formed because of the designation system.

For the non-<u>zaibatsu</u> banks that were far less likely to have had many long-standing ties to draw upon, the designation system may have been the key to establishing a number of new relationships. Hoshi (1993a) attempts

[8] A further hint that suggests the lack of any prior ties between Ajinomoto and Mitsubishi is that another munitions company, Showa Nosan Kako, which was established by Ajinomoto to deal with alcoholic liquor business in 1934, was assigned Teikoku and Yasuda Banks as its designated institutions. Interestingly, Showa Nosan Kako, which changed its name to Sanraku Ocean after the war had Mitsubishi Trust as its largest lender and the third largest shareholder in 1962. This suggests the ties established through government assignments were not as strong as the ties between a company and its former subsidiaries.

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to calibrate the importance of these designated arrangements by comparing the identity of a firm's main bank in 1962 with its designated lender during the war. Among 158 munitions companies that were assigned designated financial institutions during the first round of designation in 1944, he is able to track 112 of these companies and their successors. Of these 112 cases, the designated financial institution was both the largest lender and one of the ten largest shareholders in 1962 in 71 cases (63%). In another 13 cases the trust bank or the life insurance company in the same enterprise group as the designated financial institution is the main bank, so that the proportion rises to 75%. Finally there were 16 other cases where the designated financial institutions were the largest lenders but not one of the top ten shareholders, so, by this "looser" standard, the designations had a persistent effect on the financing patterns for 89% of the former munitions companies.

To the extent these figures merely confirm the fact that many former-*zaibatsu* firms and banks stayed together after the war, they are not particularly noteworthy; among the 112 companies Hoshi studied, 42 are considered to have had close links to one of the *zaibatsu* even before the designation of financial institutions and therefore may be of less interest. A more important finding, however, is that the ties through the designated financial institutions system were long lasting even for the other 70 firms which did not have close ties to *zaibatsu*. Out of 70, 61 companies (or 87%) had their designated institution or a financial institution in the same group as their largest lender in 1962.

The same war-time controls that laid the groundwork for a strong bank-led financing system also caused some problems. The most important problem

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for the financial system was the paralysis of its monitoring function. Financial institutions were turned into organizations which merely followed the government's lending orders. The evaluation and monitoring of borrowers, which are central to a healthy banking system, were no longer the banks' business in the war-time economy. The following quote taken from a banker's memoirs shows what the banking business was like during the war:

> I was in charge of the loan business for the companies connected with production of top secret bombs: balloon bombs. My name was registered with the Army Headquarters for Weapon Administration, and my activities were a closely guarded secret. I dealt with all the loan documents related to balloon bombs, which was flagged by a letter "fu." ("fu" for "fusen," the Japanese word for balloon) Incidentally, the documents with a letter "ro" was for rocket bombs for Navy, and another person was in charge of these loans.
>
> My job was to make the loan immediately whenever a slip with a letter "fu" came to my desk. Lots of companies, such as paper manufacturers, producers of percussion caps, and konnyaku paste-makers (paste made from arum root), took part in the production of balloon bombs. (Matsuzawa 1985, p 14)

This absence of any monitoring was also reported in the corporate history of the Mitsubishi bank. For instance, Mitsubishi Bank (1954, pp 351-353) notes the managers of the munitions companies "never had to worry about financing" and the banks "could rarely use their own judgements regarding loan requests." Ironically, the result of the massive intervention by the Japanese government to support the war effort seems to have left the financial system operating with a set of "soft budget constraints."[9]

With the conclusion of World War II Japan found itself facing two additional problems (that more recently Poland has also had to confront).

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[9] "Soft budget constraints" is a term coined by Janos Kornai to describe the communist systems' willingness to subsidize poor performing companies and reluctance to press insolvent firms into bankruptcy and liquidation.

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One problem arose because the war destroyed much of the capital stock. As Table 1-2 shows, during the war, Japan lost about 25% of the total productive assets and 30% of transportation related durables and infrastructure. Until 1949, a major portion of the funds used to support the rebuilding effort came from the Reconstruction Bank, which raised the money by issuing Reconstruction Bonds. Unfortunately, in many instances, more than 60% (and sometimes more than 90%) of the bonds were bought by Bank of Japan (Kosai 1981), and the Reconstruction Bank financing fueled inflation.

This inflation, in turn, destroyed much of the financial wealth in the economy. Table 1-3 shows the level of gross financial assets for the personal sector and corporations. Although the nominal value of financial assets increased during the period of 1946-1954, relative to GNP the stock of financial assets fell substantially during the 1946-47 hyperinflation and still had not recovered by 1954.[10] Thus, like Poland 40 years later, Japan found itself trying to rebuild its economy with an acute shortage of domestic funds.

A second dilemma brought about by the end of the war was the extraordinary amount of wartime compensation that the government owed the munitions companies. The Japanese government initially planned to pay the compensation by collecting property taxes, but following pressure from Allies, the government eventually decided to completely suspend

[10] Even afterwards, relative to the US, where comparable ratios at that time were around 1.5 for household financial assets and around 2 for private nonfinancial sector assets, the Japanese ratios seemed low. In fact, Hamada and Horiuchi (1987 p 229) report that it took Japan another 30 years to catch up with the US in this respect.

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compensation payments.[11] Since financial institutions obviously had high exposure to munitions companies, the suspension of wartime compensation also seriously damaged their balance sheets. To make the matter worse, the government also decided to drop its commitment to honor government guaranteed corporate bonds, most of which were held by financial institutions, and to suspend compensation for the losses due to uncollectible government-ordered loans to munitions companies.

The total losses stemming from the default were enormous. The government estimated the amount to be 66.9 billion yen.[12] If one adds the losses due to the repudiation of government guaranteed bonds (19.8 billion yen) and the losses due to the suspension of compensation for losses arising from government-ordered loans (5.0 billion yen), the total losses rise to an estimated 91.8 billion yen. This is almost one fifth of Gross National Expenditure in the fiscal year 1946 (474.0 billion yen).[13]

To sum up, Japan was forced to rebuild its economy starting with a highly concentrated manufacturing sector that was receiving unmonitored credit from a highly concentrated but nearly insolvent banking sector. Moreover, losing the war had wiped out much of the capital stock and the inflation after the war had wiped out much of the nation's wealth. Thus, credit during the early phase of the reconstruction was likely to be scarce. Against this backdrop the main bank system emerged. The next

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[11] For a detailed description of negotiations between the Japanese government and Allies, see Ministry of Finance (1983a), pp 183-347.

[12] This estimate was published on October 2, 1946. See Ministry of Finance (1983b), p 699.

[13] Ministry of Finance (1978), pp 26-27.

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section investigates both the institutional and theoretical considerations that suggest that the main bank system was well-suited to the challenge.

2. The Rationale for the Main Bank System in Japan

In this section it will be argued that each of the major problems discussed in the last section - particularly, the pairing of specific banks and firms and the associated soft-budget constraint problem, the massive amount of required rebuilding starting from a position of low wealth, and the significant balance sheet problems - played an important role in the selection of a bank-led financing system that eventually became the main bank system. Of course, the Japanese banking system was going through a major transition following the war and these considerations were only some of the factors that ultimately led to the main bank system. Some of the other factors will be discussed at the end this section.

In examining the Japanese system, two points deserve particular emphasis. On the one hand, it will be argued that a bank-led financing system was well-suited to addressing the critical problems facing the economy. However, a second point is equally important: no other alternative to a bank-led financing system would have been likely to succeed. As discussed by Aoki, Patrick and Sheard in Chapter 1, the main alternative to a main bank style financing system would be a securities market based system. In the latter, significant funding is obtained through equity and bond markets and the equity market plays a central role in the corporate governance structure. Throughout this discussion, it is important to recognize that while the main bank system may be imperfect it must be contrasted to a realistic alternative.

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Perhaps the contrast between the relative strengths of a bank-led system and a securities market based system is sharpest in terms of the difficulties posed by the balance sheet problems that existed in Japan at the end of the war. The Japanese tackled these problems by initially freezing the balance sheets of both banks and industrial firms in August 1946.[14] The rules were finalized in October of that year.[15] The authorities hoped by taking these measures they could stop the accumulated war related debts from choking the ongoing operations of the firms. Thus the policymakers explicitly recognized that for any progress towards reconstruction to occur, the adverse incentive effects of the insolvency of lenders and borrowers had to be addressed.

Because the Polish banks now face a similar solvency problem it seems appropriate to review how the Japanese addressed the problems.[16] For the financial institutions their balance sheets were separated into a new account and an old account. Those assets that were expected to be uncollectible because of suspension of wartime compensation were assigned

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[14] The restructuring of financial institutions and industrial companies was only one of many changes that the Japanese financial system went through. The Japanese government, under the supervision of the Allies, implemented several other important financial reforms. Financial institutions in the former Japanese colonies (such as Taiwan Bank and Chosen Bank) and those for wartime controls (such as Wartime Finance Corporation) were completely shut down. The Munitions Companies Designated Financial Institutions System was formerly abolished. New financial institutions which exclusively handled the distribution of long-term funds were created to replace the pre-war special banks. Financial institutions specializing in the financing of small and medium-sized firms and those for farmers were also established and the Bank of Japan Act was partially reformed to increase independence of the central bank from the government (see Kato 1974).

[15] The initial laws were the Financial Institutions Accounting Temporary Measures Act (FIATMA henceforth) and Corporations Accounting Temporary Measures Act (COATMA) and the permanent laws were called the Financial Institutions Reconstruction and Reorganization Act (FIRRA) and Corporations Reconstruction and Recrganization Act (CORRA) - see Teranishi (1991b, pp 23-24) for a brief description of FIATMA and FIRRA.

[16] The discussion below relies on Ministry of Finance (1983b), pp 213-327 and pp 699-913.

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to the old account and this account was expected to go through a reorganization. In the meantime, the banks were encouraged to continue operations using the new account. This new account included cash, government and municipal bonds, credits against the government other than bonds, credits against other financial institutions, and other assets specified by the Finance Minister. This meant that because most of the munitions company loans and government guaranteed bonds were expected to be uncollectible, they were placed in the old accounts. The liabilities of the new account included a limited amount of deposits,[17] tax obligations to central and local governments, loans from other financial institutions, and other liabilities specified by the Finance Minister. Depositors were left with access to only a fraction of the money that they had put into the bank. In aggregate about half of the deposits were transferred to the old accounts where they were frozen and were at risk of being canceled to cover the bad munitions company loans and government guaranteed bonds.[18] The banks' capital and retained earnings were also put in the old account and were, therefore, at risk. Differences between assets and liabilities in one account were recorded as an unsettled account against the other. For instance, if the liabilities of the new account happened to exceed its assets, the difference was entered as a credit against the old account.

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[17] In February 1946, in order to combat run-away inflation, the government prohibited withdrawals of deposits that exceed the minimum amount assumed to be necessary for living. Financial Institutions Accounting Temporary Act classified a limited amount of frozen deposits (per household) into the new account (these were termed first line frozen deposits), and classified the rest into the old account (second line frozen deposits). Much of the second line frozen deposits were later repudiated during the process of reorganization. See Teranishi (1991a) for more on frozen deposits.

[18] Ministry of Finance (1983b), p 228.

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If, in the course of doing business, a bank used assets (such as offices) in the old account, then compensation had to be paid from the new account to the old account. These sorts of payments generated some transfers to the old accounts. Finally, in March 1948, the assets were marked up to current prices and the losses due to suspension of wartime compensation were canceled out.[19] This process was finished in May 1948 when new and old accounts were merged. Most banks were forced to significantly reduce capital and to cut into the frozen deposits to cover the losses. For example, 55 out of 61 ordinary banks reduced their capital by more than 90% and had to default on some of the deposits. The capital was subsequently replenished by issuing new shares.

The restructuring of the non-financial corporations was done in a parallel fashion but proved more difficult. The process began with the government letting the companies which were expected to be damaged by suspension of wartime compensation declare themselves "special account companies" (tokubetsu keiri gaisha). These companies then had their balance sheets separated into new and old accounts on August 11, 1946, and were allowed to operate using the new account. In this case, the assets of the new account included only those assets that were deemed necessary to "continue the current business and promote the post-war development."[20] Meanwhile the firm's liabilities and other assets were moved into the old

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[19] The following prioritization was used in the process: first, capital gains on assets; second, retained earnings; third, then up to 90% of the bank's capital; fourth, 70% of the deposits that were at risk would be written down, followed by the remaining 10% of the capital; and, finally, the remaining 30% of the deposits would be written down.

[20] Ministry of Finance (1983b), p 734.

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account and the total value of assets classified into the new account was recorded as the liabilities of the new account against the old account.[21]

More importantly, this process included an important role for banks. Specifically, in the process of restructuring non-financial firms, each firm had to select a set of "special managers" (tokubetsu kanrinin). As a rule, the special managers consisted of two of a company's own executives and two representatives of the firm's creditors. So, in almost all the cases, former munitions companies had representatives from their designated financial institutions as their special managers. For example, as pointed out earlier, Mitsuo Ogasawara of Mitsubishi Bank became a special manager of Ajinomoto.

Special managers played a central role in the restructuring process. For instance, it was their responsibility to determine which assets should be included in the new account. They were also required to draw up a restructuring plan and submit it to the Finance Minister for approval. Miyajima (1992, pp 229-30) reports that drafting a restructuring plan required the special managers to assess the value of remaining assets, make plans for future production and finance, and create forecasts of balance sheets and income statements. Accordingly, the restructuring of special account companies gave the special managers (and, therefore, the banks) an excellent opportunity to acquire information about the companies. Indeed Miyajima (1992) argues that the "banks accumulated information about borrowers during this period rather more intensively than during the period of Designated Financial Institutions System, when the government legally

[21] The special account companies were prohibited from settling liabilities incurred before August 11, 1946, and were protected from seizure of their assets (in the old account). The companies were also forbidden to declare bankruptcy.

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forced loan contracts and basically guaranteed against the risk." Ultimately, the accumulation of information and the responsibility associated with the restructuring process must have significantly enhanced the capabilities of banks. In effect, this process served to reverse the deterioration of bank monitoring skills that had been brought on by the wartime forced lending arrangements.

The restructuring of non-financial companies took much longer than the restructuring of financial institutions, and not until four years after the process began (in late 1950) had all the special account companies submitted their restructuring plans. The process was delayed because coordination with anti-trust measures was required. The implementation of the plans took even longer, and more than 20% of the special account companies were still undergoing restructuring as of the end of 1952. About 12% of the companies seem to have disappeared without completing the restructuring.[22] The losses incurred by shareholders and creditors were not as large as expected. The profits of the old account, which included the proceeds from sales of assets, reached 45.9% of the total losses, and the capital gains of assets covered another 21.3%. Thus the losses of shareholders and creditors were "limited" to 32.8% of the total losses (or 30 billion yen).[23]

In evaluating the entire restructuring process it is essential to recognize that the pivotal role played by banks was almost unavoidable. For instance, suppose authorities had opted for a securities market approach to restructuring where companies were instructed to issue equity

[22] See Ministry of Finance (1983b), pp 899-900.

[23] See Ministry of Finance (1983b), p 902.

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to reliquify themselves. Given the complex web of debts between banks, the government, and firms and the considerable uncertainty over how the various obligations would be resolved, it would have been hard to establish the value of a typical firm. But without accurate valuations, equity financing would have been very difficult to attract, since equity financiers have only a junior claim against the firm.

Attempts to rely in any significant way on equity financing would have been further complicated because most Japanese investors had only limited experience with the stock market. The pre-war market had been small. One of the goals of the Occupational Forces in Japan was to breakup the zaibatsu companies that were thought to have been responsible for encouraging military aggression (see Hadley 1970). In the course of engineering this dissolution, the government decided to sell shares in the companies. However, the government and securities industries found that they had to educate potential investors about the opportunities associated with stock ownership.

Responding to this "securities democratization" movement, many households put their savings into stocks. Other measures such as low interest loans for employees purchasing their own company's shares and permission to use frozen deposits to buy shares also helped to create the demand for shares. Although the stock exchange was closed, people actively traded shares at Shudan Torihiki (collective trading), where many securities companies gathered to offer over-the-counter trades. When the stock exchange was reopened in 1949, it started with a boom but soon began to sag, as the Dodge stabilization plan took hold and the economy slid into a recession. The Tokyo Stock Exchange composite stock index lost more than 50% from the reopening of the exchange (May 1949) to the end of the year -

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Ministry of Finance (1979), p. 399. Thus, many investors were left with initial skepticism regarding the virtues of equity ownership. In our view, these sorts of difficulties with establishing an active securities market are probably unavoidable when an economy is beginning such a transition.[24]

The disinflation program also had other important effects. For instance, by cutting off credit extensions from the Reconstruction Bank, the Dodge Stabilization Plan also led to a serious credit contraction. While documenting a credit crunch is always difficult, there is abundant anecdotal evidence suggesting that credit became quite tight. For example, Toshio Nakamura of Mitsubishi Bank recalled "shortage of funds made it difficult to lend to even keiretsu firms" during this period (Ohtsuki 1987, p 77). Research reports from the Bank of Japan also frequently discussed the shortage of funds.[25]

In response to these financing problems many companies turned to banks, and the banks seem to have increased their power over industrial firms. Banks rescued many companies from the ensuing liquidity crisis, and sometimes directly intervened in their management. In his memoirs, Eiji Toyoda, who was president of Toyota Auto from 1967 to 1982, looks back on this time as the period when Toyota Auto reluctantly started to depend on banks, especially Mitsui Bank, and was forced to accept bank intervention in management.[26] Mitsui Bank and other banks helped Toyota through its liquidity crisis in 1950, but required substantial layoffs and that Toyota

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[24] Of course, this does not mean that a stock market cannot be useful in helping to redistribute ownership. Rather, given the fragile nature of the economy, it seems very unlikely that much new money can be raised to finance businesses.

[25] These reports can be found in Bank of Japan Research Bureau (1980), pp. 451-592, and occur between December 1947 to December 1951.

[26] Nihon Keizai Shimbun-sha (1987).

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split up the sales department as conditions for the rescue. Mitsui Bank also sent in a director, Fukio Nakagawa, who later served as president of Toyota.

This type of rescue operation seems to have been quite common during this period. Indeed, Miyajima (1992, pp 233-235) argues that between 1949 and 1952 many banks regularly began sending their employees in as directors to the companies to which they were lending. He also finds that main bank dependence was negatively correlated with profitability during this period, but not during other periods. He interprets this correlation as evidence that the main banks were systematically taking on a higher fraction of distressed clients in the aftermath of the stabilization. Thus, the taming of inflation not only left the banks in a better position to monitor their clients, but also seems to have accelerated the practice of the banks intervening in cases of financial distress.

With the disinflation program, however, the banks also suffered from a shortage of funds. For instance, Makoto Usami of Mitsubishi Bank recalled that "the demand for funds came in continuously, but not the deposits."[27] The recent memory of high inflation and the deposit freeze undermined the public's trust and reduced their willingness to let the banks manage their money. The situation was especially serious for large _zaibatsu_ banks, which depended heavily on deposits by large _zaibatsu_ companies. Because those companies were in the process of restructuring, they did not have much money available to deposit.[28] Thus, the large banks had to compete

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[27] Nihon Keizai Shimbun-sha (1980).

[28] Sumitomo Ginko (1979), pp 400-401. Also see Miyajima (1992), Tables 5-6 (p 229).

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for inter-bank loans and Bank of Japan lending to make up for the shortage of deposits.

This competition among large banks also seems to have further helped the soft-budget constraint problem that had characterized the wartime lending arrangements. Since the banks had their balance sheets cleaned up and were now solvent, they did not seem inclined to waste money on loans to friendly, but unworthy companies. The case of Mitsui Seiki described by Goro Koyama of Mitsui Bank is suggestive (see Edo 1986, p 129). Although Mitsui Seiki was chokkei (of direct lineage) of Mitsui, and, therefore, considered to be a central Mitsui company, it got into trouble after the war because of loose management. Koyama argued that Mitsui Bank should help other firms that were trying hard rather than instinctively helping Mitsui Seiki because it had the "Mitsui" name. This argument persuaded President Sato of Mitsui Bank to let Mitsui Seiki go through restructuring under Kaisha Kosei Ho (Restructuring Law). Consequently, Mitsui Seiki became the first company to be restructured under that Restructuring Law.

As the economy emerged from the restructuring in the early 1950s, funding continued to be difficult to obtain and the possibility of facing financial distress was a concern for most companies. Against this backdrop banking relations continued to evolve. By the middle of the decade many of the features of the main bank system were in place. In particular, three important patterns had emerged. First, banks were firmly established as the primary providers of external financing for firms. Second, banks had been permitted to hold equity (as well as debt) claims of their clients and were regularly taking an active role in corporate governance (for instance by serving on boards of directors). Finally, firms and banks were

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continuing to pair off, so that everyone could clearly identify the main bank of a particular firm.

As discussed in Chapter 1, these attributes are only a subset of the sorts of ties that characterize the main bank system. But in suggesting that Poland borrow from the Japanese experience, we think these attributes are essential and would have to be adopted for the system to be successfully implemented in Poland. We close this section with a discussion of how these three characteristics of banking relationships assist in the delivery of financing to firms in an economy with scarce capital and assist in minimizing the costs of financial distress.

Starting with firms experiencing cash flow problems, the main bank system provides four distinct theoretical advantages over a US style system where banks' actions are more tightly controlled. First, concentrating the firm's financial obligations eases the type of coordination problems that typically accompany any reorganization effort and thus helps improve the delivery of financing. In most cases, different creditors will have very different incentives for providing relief or additional funding. In a system where there are few debtholders with large stakes, the number of parties that must come to an agreement about the fate of the company can be (and often seems to be greatly) reduced. Indeed, in many unsuccessful workouts one of the major hurdles is securing agreements from small or marginal investors.

A second and related benefit is that by allowing debtholders to take equity positions, one helps align the interests of the two parties. Thus if some bargaining is required in the course of negotiating an agreement, the disparate interests of debt and equity holders are less likely to be a stumbling block. This effect can be relatively small unless the debt

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holders have significant equity positions, so as an empirical matter it is unclear whether this feature is particularly important.

On the other hand, in the US there are a number of legal impediments that limit a bank's incentive to intervene and try to bailout one of its clients prior to the start of formal bankruptcy proceedings. For instance, the laws regarding the treatment of concessions offered by creditors differ depending on whether a firm has been declared bankrupt. Similarly, the nature of public debt contracts (where unanimity is effectively required to defer the payment of principal or interest) also makes it difficult for bargaining to take place outside of bankruptcy proceedings. Overall, the considerable consolidation of claims and alignment of the interest of the creditors in Japan may lead to important differences in the efficiency with which these type of cases are resolved in the two countries.

A third benefit of the main bank system in cases of financial distress is that the main bank is well positioned to make informed judgements about whether additional assistance is prudent. In many cases, the inability to reach an agreement on the likely impact of an assistance package comes into play. Even if creditors can agree on what steps to take, assuming the benefits of these steps were certain, no single creditor is well enough informed to help the group come to a decision. The main bank by virtue of its close ties to the firm should be able to make such a decision and is likely to be looked to for leadership.

A fourth consideration that is closely related to the last point, and is emphasized by Hoshi (1993b) is the repeated participation of the same principal lenders across a number of deals helps facilitate workouts. If the largest creditors have previously been through other workouts and know that they will likely gain by cooperating in subsequent situations, these

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parties may be better able to reach a compromise than would be true in a one-shot bargaining session. In essence, the environment permits reputational factors to be deployed to help smooth over disagreements and may help to reduce the costs of financial distress.

In analyzing the actual Japanese experience, one might debate whether this assistance is always efficient since from an economy-wide perspective the bailouts may lead to too few failures. The main bank system has one feature that does help on this front. Specifically, these bank-led assistance programs often include significant managerial reorganizations.[29] The well-known Sumitomo group bailout of Mazda provides an excellent example of this practice. The combination of the first OPEC oil shock and the low fuel efficiency of their new rotary engine vehicles left Mazda with serious financial problems. Worse yet, Mazda's management was already widely viewed as being ineffective. For instance, the company had the highest production costs of all Japanese automakers. As Pascale and Rohlen (1983, p 223) put it, "the oil crisis of 1973 did not cause Toyo Kogyo's (Mazda's Japanese name) problems, it simply exposed them." Mazda's main bank, Sumitomo, stepped in and provided new cheap loans, wrote down some existing loans and convinced other lenders and suppliers to stick with the firm. Perhaps even more importantly, Sumitomo bank sent Tsutomu Murai and four other employees as "delegates" to Mazda, who were responsible for overhauling Mazda's management structure (see Pascale and Rohlen 1983). This direct intervention by the bank was instrumental in transforming an inefficient company into an efficient company. As Sheard (1989, p 399)

[29] Kaplan and Minton (1993) found that in a sample of 121 large Japanese firms, during the 1980s, the appointments of outside directors with bank experience tended to rise when the firm's cash flow deteriorated.

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puts it, "The main bank system substitutes for the 'missing' takeover market in Japan."

A second set of features become relevant when assessing the ability of the main bank system to deliver funds to firms that are financially healthy. Here there are four distinct effects of the main bank system. The first effect is that the system helps prevent duplication of monitoring efforts. In other words, because the main bank has such a large stake at risk with the firm, it will have definite incentives to keep tabs on the firm. Since all other lenders recognize that this is the case, less monitoring is required and the system will be more efficient than one in which multiple monitors might be required.

A second reinforcing effect arises due to the different channels of significant information flowing back and forth from the bank and its customer. The example cited earlier where Mitsui sent an employee to Toyota who later became a senior manager at Toyota appears to be quite common. For instance, Hoshi, Kashyap and Scharfstein (1990) report that as of 1982, roughly 34% of the firms listed on the Tokyo Stock Exchange had one internally appointed board member whose last employer prior to joining the current firm was a bank that did business with the current firm.[30] They also report that an additional 8% of the firms had a board member that was currently employed by a bank. Through these sorts of informal ties the main bank can conduct its policing activities quite effectively, so that

[30] Kaplan (1992) reports, however, that in most cases, by the time a person is appointed to be a board member at the very largest Japanese firms, that person has typically been employed by the company for at least 7 years. It is not clear how to interpret this evidence. The data we reviewed supports the following arrangement: a person works for a bank for 25 to 30 years, then moves to the client company as a senior manager; and after another 7-10 years, this person becomes a board member.

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the monitoring that does take place uses fewer resources than would otherwise be necessary.[31] (See Chapter 1, as well as Schoenholtz and Takeda (1985) and Sheard (1989) for more discussion on these points.)

Hoshi, Kashyap and Scharfstein (1991) identify another channel by which a main banking system can be beneficial. This channel emerges because of standard asymmetric information problems that lead to a cost differential between internally generated funds and externally generated money. To the extent that investment opportunities are less cyclical than firms' cash flows this cost differential may lead to underinvestment. Hoshi, Kashyap and Scharfstein (1991) point out that a firm with an informed main bank may partially circumvent these difficulties. Indeed, they find the investment of firms with tight banking relationships is less sensitive to fluctuations in internal funds than is the investment of firms without tight bank relationships. These findings suggest the presence of a main bank may help insulate some Japanese firms from business cycles and other disturbances.

An additional effect comes from the interaction of the main bank system with the tax code. In Japan, like many other countries, interest

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[31] Another chance for informal information sharing occurs at the regular monthly meetings which are attended by the chief executive officers of the core companies in the kigyo shudan. These gatherings, commonly referred to as shacho-kai (Presidents Club) meetings, are generally described as being somewhat ceremonial and more oriented towards being an outlet for informal information sharing rather than for explicit strategic planning. (For details see Gerlach (1992), chapter 4.) Nevertheless, the banks seem to play a central role when a joint decision among the members is made. For example, Toshio Nakamura, a former president of Mitsubishi Bank, reports that the bank was instrumental in the joint projects started by the Mitsubishi group, including Mitsubishi Cement (1954), Mitsubishi Petro-Chemical (1956), and Mitsubishi Atomic Power (1958). He also notes that the bank coordinated the group's effort to buy Mitsubishi Oil shares from Texaco after Texaco had acquired the shares by taking over Getty Oil (Ohtsuki 1987, pp 80-81). Similarly, Tsuda (1988, pp 100-101) describes how Sumitomo Bank mobilized the Hakusui-kai (the Sumitomo Presidents Club) in its rescue plan for Sumitomo Machinery in 1954 when the manufacturer was financially distressed.

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payments on debt are tax deductible. Because of the previously mentioned lowered costs of financial distress, Japanese firms are able to load up on more debt than they otherwise would. From a purely corporate perspective, this is another advantage of the main bank system, although from society's point of view it is not clear whether this is desirable. Overall there appear to be a number of reasons why the main bank system has been advantageous for Japan.

Lastly, it is worth noting that while the banking system was very important in Japan, until very recently securities markets remained fairly primitive. As mentioned earlier, in the immediate aftermath of the war the stock market was shut down, but even after it reopened in the 1950s it was not a terribly important source of funding for even the large corporations. Given the low level of wealth of most investors, it is perhaps not surprising that concerns about diversification might have led them to shy away from investing in particular companies. The alternative of pooling money with other investors by lending to a bank that can invest in many firms might have been much more attractive.

Regarding bond markets, one would also suspect that, in the initial period following the war with turbulence in the economy, unmonitored lending that was secured by a borrower's reputation would have been unlikely to succeed. Rather investors would probably insist that firms either post collateral (which would mitigate the attractiveness of this borrowing strategy) or receive some sort of credit rating to guarantee their credit worthiness. While this would have been difficult at the outset of the high growth era, one might have thought that as the economy matured, a deeper bond market would develop. However, regulation seems to have prevented the growth of the bond market. In fact, until the early

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1980s, bond issuance was tightly controlled, so that firms had little choice as to where they would get their external funding.[32]

Since the restrictions have been eased, there has been a flurry of bond issuance among the largest, most successful Japanese companies - see Hoshi, Kashyap, and Scharfstein (1993). In advocating that Poland and other countries consider mimicking the main bank system, we want to be clear that we do not favor following the Japanese example with regard to the regulations pertaining to bond and equity markets. Rather our view is that until the economy reached a fairly mature state, the economic advantages of the main bank system described above would have made bank financing relatively attractive even if the bond and stock markets were not so tightly controlled.

3. Financial Reform in Poland

The preceding sections have described the emergence of the main bank system in post World War II Japan, and discussed research findings concerning the distinctive differences between the Japanese main bank system and the "arms length" separation of lending from ownership and control that characterize the US and British banking systems. This section considers whether the features of the main bank system are attractive for the ongoing reform process in Poland. The applicability of the main bank system depends on the existing institutional structure and economic conditions in Poland, as well as the specific demands that the privatization and reform process places on the financial sector. These issues are considered in turn.

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[32] It is often asserted that the costs of raising funds in the equity market were unnecessarily high because of regulation (see Miller 1992).

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3.1 The Economy and the Financial Sector in Poland

The first Solidarity-led government was installed in September 1989 under Prime Minister Mazowiecki, and it moved quickly and with remarkable resolve to implement a package of sweeping reforms, most of which began on January 1, 1990:

> essentially all price controls were removed (food prices had been liberalized in August 1989), and energy prices were increased by as much as 500%;
>
> the government budget was brought into balance through the reduction of subsidies to state enterprises and the elimination of tax credits;
>
> current account convertibility was introduced and the zloty was pegged to the US dollar;
>
> foreign trade was liberalized and government allocation of materials was eliminated;
>
> the "excess wage" tax was increased and virtually all exemptions were eliminated in an effort to slow the growth of wages in response to rising prices;
>
> the National Bank of Poland (NBP) moved to establish positive real rates of interest after years of negative real rates and very high inflation.

The discontinuous nature of these reforms contrasted sharply with calls for a gradual reform process, and earned the name of "shock therapy." The effect of these reforms on the key macroeconomic variables is evident in Table 3-1: the hyperinflation was stopped, the real interest rate increased substantially, the government achieved a surplus, and output fell precipitously. The substantial fall in industrial output was all accounted for by state enterprises and output in the state enterprise sector fell further in 1991, in part, because of the loss of the CMEA export market.

Although the "shock therapy" macroeconomic reforms were the most dramatic and widely discussed of the economic reforms, a distinguishing feature of the Polish economy is a history of important reforms implemented by the communists as early as 1982 in an effort to resuscitate the

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floundering Polish economy.[33] The National Bank of Poland (NBP) was separated from the Ministry of Finance in 1982 and given independent authority to lend on commercial criteria. Although this authority was rarely exercised, the independence of the NBP was an important first step in the separation of banking from the planning system. Five years later, in 1987, the State Savings Bank (PKO BP) was spun-off from the NBP, and given primary responsibility for personal savings deposits and housing loans.

The most important financial reform took place in January 1989 with the passage of the New Banking Law and Act on the National Bank of Poland. Under the terms of this legislation, the nine regional offices of the NBP became autonomous commercial banks and the NBP remained as a central bank with few commercial activities.[34] The 1989 Banking Law also authorized universal banking, although the concept has not yet been clearly defined in law or in practice. The new commercial banks inherited the assets and liabilities associated with the depositors and borrowers in their region and were expected to serve as generalists; ie, there was no specialization amongst the commercial banks. It is important to emphasize that although the banks were subsequently commercialized (ie, turned into joint stock companies) in preparation for privatization, commercialization left ownership in the hands of the government, and the senior executives for each bank were appointed by NBP officials. Not surprisingly, there was little increase in competition amongst the banks for deposit or lending

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[33] The discussion of banking and macroeconomic reforms draws heavily on Corbett and Mayer (1991) and Berg and Blanchard (1992).

[34] The NBP continued to issue hard currency accounts and was involved in channelling credit from the PKO BP (savings bank) to the other commercial banks.

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opportunities. The NBP, meanwhile, was left with conventional central banking responsibilities, and the imposition in 1989 of limits on credits to the government increased the NBP's capacity to operate as an independent institution. A Department of Bank Supervision was created within the NBP in May 1989 in an effort to begin building the capacity to monitor banks and ensure stability in the financial sector.

The 1989 legislation also amended the charters of three other special function banks that the communists had operated, to allow these banks to engage in commercial banking. The Bank Handlowy serviced the needs of Polish state enterprises engaged in foreign trade, and the Bank PKO SA handled all foreign currency transactions for private persons. The Bank Gospodarki Zywnosciowej (Bank of Food Economy), a collection of 1,500 small cooperative (but state-controlled) banks, served the many small Polish family farms.[35] These specialized banks had been established by the government with non-overlapping scopes of activity to ensure that there was no competition; each had a monopoly over a sector of the economy. Consequently, the specialized banks, together with the NBP, held the vast majority of deposits in the banking sector.

The reform process begun in 1989 did little to change the level of concentration. New rules were implemented in July 1989 allowing enterprises to have deposit accounts at more than one bank, which were intended to increase competition amongst the banks. Nonetheless, nearly two years after the separation of the nine commercial banks from the NBP, the four specialized banks and the NBP still held more than 75% of total

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[35] Polish agriculture remained in private hands under the communists, and its small scale made centralized banking very difficult for the agricultural sector.

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Polish banking deposits (see Table 3-2), despite the fact that the nine commercial banks inherited the assets in their region.[36]

The Banking Law of 1982 permitted, in theory, the establishment of new banks with non-state capital. However, any new bank had to be approved by the Council of Ministers, who were free to decide on the scope of operations, location, and name of the bank. During the period 1982 to 1989 no new banks were established as a result of this "reform."

The restrictions on the establishment of new banks were liberalized substantially in 1989, and have been amended subsequently. Permission from the president of the NBP to open a new bank requires that three conditions be met:

i) own capital (in 1990) of 20 billion zloty or $2 million for Polish owned banks; and, $6 million for foreign-owned banks.

ii) suitable premises for banking operations.

iii) senior bank officials with suitable experience and training.

By early 1991 there were more than 100 new commercial and cooperative banks, and four foreign-owned banks. However, these new private banks were very small and accounted for less than 3% of total banking assets. Capital requirements for new private banks had been lower in previous years - roughly $100,000 in 1989 - and most private banks were created under those less stringent conditions.

At this point, with the banks commercialized, the next step in banking reform in Poland is widely considered to be the privatization of the nine commercial banks. Several have already been "twinned" with western banks to develop greater banking skills and improved infrastructure. The

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[36] The low level of deposits in the nine commercial banks spun-off from the NBP was clearly also a function of the financial circumstances facing state enterprises - their main customers.

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critical actions that must be taken prior to privatization are rationalization of their loan portfolios to eliminate bad debts and recapitalization to assure solvency after cleaning up the balance sheets. Since under the communist system the banks did not face credit risk, they had no reserves against loan losses. Therefore, in the absence of infusion of new funds the writing-off of bad loans would directly reduce the banks' capital.[37]

The severe recession within the state sector in 1990 and 1991 (see Table 3-1) greatly worsened the quality of the banks' loan portfolios. The Ministry of Finance has recently overseen the review and categorization of all significant loans currently on the books of the nine commercial banks. Using a five-category hierarchy from very high to very low likelihood of collection, more than half the zloty value of the total loans were rated in the lower two categories. Although precise figures are hard to find, it is clear that cleaning-up balance sheets prior to privatization will be a time-consuming and costly process. As an incentive for improvement in bank balance sheets, the Ministry of Finance has committed to privatizing the nine banks in an order determined by the quality of their balance sheets.

The first bank privatization, the Wielkopolski Bank Kredytowy (WBK) in Poznon, finally took place in April 1993 when shares were issued on the Warsaw Stock Exchange. The Ministry of Finance judged WBK to have done the best job of the nine commercial banks in improving the quality of its balance sheet, mainly by curtailing lending to state enterprises and

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[37] A June 30, 1990 study of three banks by international auditing firms suggested that roughly 15% of their portfolios were non-performing. Applying the estimates of bad loans from the three banks to all nine banks, their capital after provision for loan losses in June 1990 would have been about 9%, which compares favorably with international standards.

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carefully increasing lending to private entrepreneurial companies. The WBK also distinguished itself by attracting a large deposit base of more than 250,000 people served by 44 branches around Poznon. The European Bank for Reconstruction and Development invested $10.6 million to purchase 28.5% of the newly issued shares.

Progress in privatizing state enterprises has also been agonizingly slow. There have been at least three mechanisms used to privatize industrial assets. First, in the few cases where large Polish enterprises were considered to have positive net worth and be viable in the near term, western consultants performed valuations and the firms were sold using initial public offerings (ie, the "British model"). This process turned out to be very slow and extremely costly, with consultant fees occasionally exceeding the proceeds of the sale, and it has been used for fewer than 20 enterprises. Second, small companies have been sold on an ad hoc basis to incumbent managers or local business people. The vast majority of retail shops, restaurants, etc., have been sold by local governments to private owners. Indeed, more than 60% of wholesale and retail trade is now in private hands.[38] Third, a Mass Privatization Program (MPP) was developed and approved by the Parliament to quickly privatize hundreds of industrial enterprises.

The MPP was formulated as a means to simultaneously achieve four goals: speed, low administrative cost, concentration of control to facilitate restructuring, and, broad-based ownership amongst the Polish citizenry. Clearly the latter two goals require a novel solution, since concentration of control and broad-based ownership are difficult to

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[38] Note that Polish agriculture remained largely in private hands under the communists.

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reconcile using traditional mechanisms. The MPP was originally conceived as a means to privatize a substantial percentage of Poland's 8,000 industrial state enterprises. The scope of the MPP's initial activity, however, was restricted to the healthiest enterprises in an effort to learn from the most promising cases before tackling the more difficult cases. Thus far, only those firms with both positive net cash flow and positive operating profits have been allowed into the MPP. As of early 1993, only roughly 600 enterprises met these criteria and were slated for inclusion in the MPP.

Under the complicated terms of the MPP, the 600 enterprises are first commercialized into joint-stock companies.[39] The shares are then allocated 30% to the state, 10% to the current work force, and 60% to twenty "management funds" established under the MPP. Initially, roughly 30% of each enterprise will go to one "lead" fund and the remaining 30% will be evenly distributed amongst the remaining 19 funds. Funds will then be allowed to trade shares amongst themselves which, of course, will likely lead to further concentration of ownership of the individual companies by a "lead" fund whose controlling interest can be used to facilitate the restructuring or the sale of assets. The management funds will engage western firms as advisors, or managers, under contract with the Ministry of Privatisation.[40] The fund managers will be empowered to borrow money and issue new shares in the funds.

Every Polish citizen 18 years of age and older will receive a share in each of the 20 management funds. In an effort to forestall speculation and

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[39] For details see Polish Ministry of Privatisation (1992).

[40] The fund managers will have performance-based incentives.

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quick concentration of ownership among a few people, the shares will not be tradable for a period of at least several months. Since the shares in the enterprises themselves are not initially traded in a well-defined market, it will be difficult to value the citizens' ownership shares in the management funds. The plan foresees the management funds moving to public offerings for the enterprises in their portfolios when restructuring has proceeded to an appropriate extent, and gradually the enterprises would leave the management funds, the management funds would hold cash or tradable securities, and the citizens would have ownership shares with clearly defined market values. The MPP was to be implemented in the fall of 1992, but after several setbacks in the Polish Parliament, it was finally approved in the spring of 1993 and is expected to be implemented in the very near future.

There has been little recognition of the connection between the privatization of the state industrial enterprises and financial sector reform. One important manifestation of this lack of connection is that responsibility for privatizing the banks rests with the Ministry of Finance, and the process has been kept almost entirely independent of the enterprise privatization process managed by the Ministry of Privatisation and the Ministry of Industry. In addition, a number of schemes have been proposed for cleaning-up bank balance sheets that involve debt-for-equity swaps in which the old debts of state enterprises are forgiven in exchange for equity in the new privatized company. Clearly such an arrangement would have to be integrated into the other privatization processes - especially the MPP - but there has been little discussion of integrated solutions to these problems.

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The much more rapid and dynamic road to private ownership in Poland has been the establishment and growth of private small businesses. Under the communists legitimate private business was virtually non-existent outside the agricultural sector. Liberalization of the rules governing the formation of private cooperatives in 1982 marked the beginning of the explosion of private employment in Poland. Legal changes in 1985 for the first time in the communist era permitted the registration of private limited liability companies under the terms of the 1934 Code of Commerce. Finally, the 1989 New Law on Economic Activity removed most licensing and registration restrictions on self-employment and the establishment of unincorporated firms. The process for setting-up joint ventures was also liberalized significantly in 1989.

The response to these reforms has been swift and dramatic. The first joint-venture company was registered in July 1986, and 52 more were registered in the next two years. Table 3-3 shows that since 1989, however, the number of private limited liability companies, including joint-ventures has grown several fold. Likewise, Table 3-4 shows that the number of persons self-employed or with unincorporated businesses had grown to nearly 2.5 million by September 30, 1991. Total non-agricultural private employment was in excess of 3 million persons by the end of 1991.

The near absence of private businesses until recently in Poland meant that the state banking system had no experience with the needs of growing small businesses. Indeed, the banking system was structured to allocate funds amongst large state enterprises according to the terms of the plan, and there were no incentives for bankers to consider even opening deposit accounts for small or private businesses. Data from small businesses that have been successful during the economic reform show that their growth has

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been **in spite** of the banks' unwillingness to provide loans or, in most cases, even to provide simple transactions processing on a timely basis.[41]

Irrespective of the details of future economic reforms in Poland, it is abundantly clear that the sustained growth of the private small business sector is vital for economic revitalization and job generation. Given the crucial role of external financing in small firm development, it is equally clear that the Polish financial sector must reform itself in a fashion that supports the needs of the small business sector as well as the restructuring of the large state enterprises.

4.2 Financial Restructuring and the Future of Reform in Poland

The preceding discussion has described the context in which competing financial reform proposals must be the considered. The objectives for any financial system in Poland can now be stated concisely:

1) the provision of a credible and stable depository system that attracts domestic savings for investment;

2) given the dysfunctional state of Polish accounting systems and budgeting procedures, and the lack of valuation mechanisms that follow from these systems and procedures, lenders must have the capacity to distinguish amongst prospective borrowers under conditions of poor information, scarce experience or credit history and unreliable projections of future earnings;

3) a long time horizon to support lending to enterprises in need of massive restructuring and small businesses whose profitability and growth may occur only several years after the first provision of financing;

4) the capacity to play an active role in helping borrowers to acquire badly needed general management expertise, especially with respect to management under conditions of financial distress and an inadequate supply of capital;

5) an absence of "soft budget constraints": the lenders must be willing to curtail lending to firms with inadequate prospects for future earnings and lend only to those that can deliver at least the market rate of return on borrowed funds;

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[41]See Johnson (1992) and Johnson and Loveman (1992) for evidence from the small business sector.

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6) an avoidance of inefficient liquidations; that is, the capacity to prevent the liquidation of any enterprises with positive net present values.

The first of these six criteria has relatively little to do with Poland's choices for banking reform, although in a country with low levels of financial assets, because of consumers' desire for diversification, bank-led financing systems may be superior to a securities-market led systems. The other five criteria, however, can be used to distinguish powerfully between two distinct alternatives: the Japanese main bank system and the combination of equity, bond and "arms-length" banking found in the US and the UK.[42]

In assessing the merits of the main bank system for Poland, it is important to consider both the transition issues and the long-term, or steady-state, characteristics of the main bank system. There are two necessary transition conditions for the main bank system to succeed in Poland. First, the main banks must not offer "soft budget constraints" to enterprises. This concern is often voiced in Poland, where decades of lending without reference to ability to repay has led to a gross misallocation of funds. The best insurance against a soft budget constraint is competition amongst adequately capitalized private banks. Solvent private banks will not find it in their interest, as equity holders or otherwise, to lend to firms that lack the capacity to repay.[43]

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[42] The German system provides an intermediate case. See Corbett and Mayer (1991) and Chapter 1.

[43] Of course, as has been demonstrated by the US Savings and Loan crises, private ownership per se does not necessarily stop excessive risk-taking. In the Polish case, once the bank recapitalization is completed, it will be important for the regulators to promptly close any institutions that subsequently become insolvent. Similarly, the central bank should not supply so much credit as to encourage expansive lending by banks.

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therefore, the reform process must include privatization of the banks that will serve as main banks. Moreover, some large banks may need to be divided into multiple entities to enhance competitiveness.

Second, existing Polish banks lack many of the most fundamental banking and managerial skills. Consequently, there is understandable reluctance on the part of many people to give the banks any more power than is absolutely necessary in the reform process. One manifestation of this unwillingness to rely on the banks has been the separation of the banks from the MPP. Although the current lack of confidence in the banks is completely warranted, any reform process must include a massive effort to quickly build basic banking competence. If nothing else, one can confidently predict that it will be easier to regulate a concentrated main bank system.

The post-war Japanese financial sector, too, faced the problem of eliminating soft-budget constraints between enterprises and their designated banks. The Dodge plan helped to stop the flow of easy credit to the banking system. The curtailment of inefficient lending in Japan was further reinforced by two key actions: the cleaning-up of bank balance sheets to remove uncollectible loans, thereby removing any perverse incentives for further lending to uncreditworthy borrowers; and, the use of "special managers" from the banks to work-out existing loans to enterprises. Recall that in Japan the munitions companies were paired during the war with "designated financial institutions." The restructuring of the former munitions companies was accomplished by "special managers" drawn from the debtor companies and the banks. The bankers involved in the restructuring gained invaluable familiarity with the debtor companies, and

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undoubtedly developed important monitoring skills that served them well as lenders in subsequent years.

Current Polish circumstances are, likewise, suited to having commercial bank managers involved in the resolution of enterprise debts, both to banks and to other enterprises. The use of "special managers" could develop badly needed monitoring expertise amongst Polish bankers while also generating enterprise-specific knowledge useful for future lending decisions. As was the case in Japan, the restructuring process that featured "special managers" was premised on existing close relationships between an enterprise and a bank, and the process clearly facilitated the emergence of a main bank system in Japan. Given similar conditions, the same debt restructuring process could be used as a mechanism for establishing a main bank system in Poland.

An examination of the substantive parallels between the post-war Japanese experience and the current Polish circumstances suggests that many of the conditions that led to the success of the main bank system are extant in Poland. First, both economies had histories of centralized control of financial and non-financial assets. In Japan the wartime controls on the allocation of credit meant that the market mechanism for allocating funds to the most worthy borrowers failed to function. In Poland the problem is more severe because the precedent and expertise necessary for market allocation of credit must be traced back more than forty years.

Second, the Polish banks are themselves concentrated and have very close financial relationships the highly concentrated industrial sector of the economy. If the soft-budget constraint problem can be solved, then the evidence regarding the Japanese main bank system suggests that these

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relationships may actually be valuable. Given the existing web of financial ties between the banks and the state enterprises, a banking system that builds on these connections, i.e., the Japanese main bank system, would seem desirable.

Third, hyperinflations in Japan and Poland, along with other factors, left both economies with low levels of financial assets, while a largely destroyed (Japan) or woefully inefficient (Poland) industrial sector required large amounts of financing for reconstruction. Together, this combination of factors on the supply and demand sides of the credit markets suggests that careful allocation of credit will be crucial.

Finally, the problems associated with accurate valuation of companies and severe information and reputational inadequacies make the extensive use of equity financing quite difficult.[44] The Japanese stock market did not reopen until 1949, and in Poland as of early 1993, the fledgling Warsaw Stock Exchange has 17 listed securities and the total value of the outstanding shares is about $400 million.[45] With privatization and equity markets in Poland in their infancy, there is likewise little capacity for shareholders to exercise meaningful control over the management of industrial companies.

Lacking widespread access to equity markets, the issue for financial reform becomes focused on the best structure for banking, wherein banks will be the primary source of financing. Furthermore, since corporate control will not be exercised by shareholders there is a vital need for another form of effective control. The main bank system, unlike "arms-

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[44]See Lipton and Sachs (1990).

[45] Similarly, bond markets offer little hope for raising substantial sums of money for restructuring.

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length" systems, provides a mechanism that can both deliver financing and exert substantial control over the managerial actions of its borrowe-s. As a substantial shareholder in the company, the main bank can act dir tly to influence the composition of the board of directors and, hence, the activities of senior management.[46] Through its position as a la.ge holder of debt and equity, the bank has an incentive to work diligently to increase the borrower's long-term performance. In Poland, where managerial expertise is currently very scarce, the provision of such skills from a bank would be an important resource, and such a conveyance of skills is much more likely under a main bank system. Moreover, so long as bankers are lending private money under profit-driven incentives, there is no reason to fear that "soft-budget constraints" will lead to the ill-conceived lending practices of the communist system.

In sum, the main bank system has several virtues with respect to its control properties that recommend it for the current Polish circumstances. But it is the economic efficiency properties, documented from Japan in Section 2, that make the strongest case for adoption of the main bank system in Poland. The results from research on Japan suggest that the main bank system is particularly well suited to meet the challenges associated with financial sector reform in Poland.

First, the main bank system has been shown to have a number of advantages in achieving the most efficient monitoring of borrowers. The close ties between the bank and the debtor firm, sustained over a long period of time, reduce information asymmetries and permit the bank to make more informed lending decisions. Thus the system saves on two margins, by

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[46]Evidence on bank personnel serving on the boards of directors of Japanese companies is given in Section 2.

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both reducing duplication in monitoring and by increasing the efficiency of the monitoring that takes place. These savings are especially important in the Polish context, where information is poor, credit histories are non-existent, projections are inaccurate and few managers have significant reputations.

Evidence was presented in Section 2 which showed that main banks are especially preferable to "arms-length" banking when the borrower is experiencing periods of financial distress. The main bank is better positioned, as a consequence of its monitoring efficiencies, to make decisions on additional lending. Inefficient liquidations are, therefore, less likely, and companies in financial distress are better able to undertake investment projects with positive net present values. Furthermore, the evidence from Japan suggests that even healthy firms were less reliant on internal funds for capital investments when they had a main bank relationship.

Since main banks accumulate substantial experience with their customers over time, they are better able to manage the working-out of bad loans. In systems with "arms-length" banking relationships, work-outs for large debtors typically involve many lenders who may have widely varying incentives with respect to the disposition of the debts. A main bank relationship, conversely, reduces coordination costs by reducing the number of lenders and by providing very high quality information about the debtor and other creditors. In Japan main banks have, on occasion, gone to the debtor's suppliers to effectively guarantee outstanding trade credits so that actions by suppliers will not bring the debtor into bankruptcy. Polish enterprises currently have a tremendous amount of trade credit that accumulated during the recession. Management of the outstanding trade

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credit by main banks would facilitate efficient decisions as to the choice of enterprises that should be liquidated.

It is difficult to overemphasize how important the monitoring efficiencies may be in Poland where state enterprises face such massive restructuring problems and where such a large portion of the existing capital stock will require modernization and rationalization. It is difficult to imagine how a system based on diffused financing can succeed given the problems that will arise in trying to finance massive restructuring in Poland. Of course, it is also hard to imagine how a solvent and efficient decentralized banking system could be feasibly developed from the existing Polish banking system.[47]

A final important consideration favoring the selection of the main bank system for Poland stems from the long time horizons associated with equity ownership. There is no doubt that privatization and restructuring will require a period of several years before enterprises can reasonably expect to generate consistent profits. A key factor underlying the patience demonstrated by the main banks is that as their clients mature, the banks long-term commitments are rewarded with significant equity returns. The alignment of interests between debt and equity holders would greatly facilitate the flexibility needed by Polish managers to undertake comprehensive change and restructuring.

While the advantages of the main bank system for large Polish enterprises follow clearly from the Japanese precedent, there is little

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[47] In general, bank-led financing system seems better suited to handling coordination problems in investment decisions than a securities-market based financial system. Because of coordination problems some analysts argue that it is important to develop specialized institutions to provide long-term financing. See Chapter 4 for a discussion of the impact of funding by long-term financial institutions on growth in Japan.

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evidence regarding main bank involvement with small businesses.[48] Given the central role currently played by small businesses in Poland it is important to consider how the banking system can best serve their credit needs. Small businesses in Poland currently receive virtually no external financing from any source,[49] and finance themselves largely from personal savings and retained earnings. Interestingly, many Polish small businesses began by providing services or other non-capital intensive activities to generate sufficient cash flow to finance capital acquisitions, and then they gradually moved into manufacturing and construction.[50] The unavailability of credit to small businesses is a very large impediment to the growth and job generation process in Poland.

Financing for small businesses is often considered to be inadequate and poorly allocated even in western industrialized countries. Governmental entities, such as the US Small Business Administration, and venture capitalists play an important role in funding new businesses, while banks typically find new businesses to be too small or too risky to service profitably.

There is little evidence upon which to base an argument about the efficacy of a main bank system for Polish small businesses. On the one hand, small businesses share the need for careful monitoring, effective control and long-term financing experienced by large state enterprises. The proven ability of main banks to reduce the reliance of Japanese firms

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[48]There has been little research on the Japanese main banks' relationships with medium and small firms. An exception is Horiuchi (1988).

[49]See Johnson (1992) for evidence from a sample of 300 small firms in the Warsaw region.

[50]See Johnson and Loveman (1992) for evidence on this point.

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on internally generated funds bodes well for their application to small business, who often experience periods of severe cash shortages despite having many positive net present value projects. In this respect the main bank system seems sensible. On the other hand, the sheer volume of small businesses could easily overwhelm the capacity of a concentrated banking sector to provide effective and profitable service. Whether or not a main bank system is chosen in Poland, it is clear that government policy must address the specific needs of small businesses so that their access to credit markets is given the proper priority. The growth of small private banks in Poland seems most promising in this respect, and policies should be considered to enhance the attractiveness of small bank lending to entrepreneurs.

Finally, the development of the MPP has proceeded with little direct involvement or consideration of the Polish banks. There is an important role for main banks to play in such a process, however, because the management funds could draw on the main banks for financing and assistance in control of the constituent firms. The main banks need not be part of the MPP's formal structure, but at a minimum the financial reform process must proceed at a pace that would permit main banks to be available to support the management funds in their restructuring efforts. Without direct bank support, the management funds will be dependent on raising funds through the sale of companies or their assets, internally generated funds from the companies, or solicitation from a number of banks in and outside of Poland. None of these alternatives seem very likely to generate an adequate or consistent source of financing. Moreover, there has been little, if any, discussion of the Polish commercial banks being given access to shares in the management funds. This is due largely to the

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government's aim to distribute shares to individuals and workers as a right of citizenship, rather than to institutions. The exclusion of the banks is also likely a consequence of a desire to separate the planned restructuring of enterprises under the MPP from the unimpressive management and poor financial condition of the banks.

5. Conclusion

This paper has examined the main bank system developed in Japan after World War II as a model for the financial system reform in Poland. Pointing out some important similarities between the economic conditions for Poland today and Japan immediately after the war, we have argued that the main bank system is a preferred model for Poland due to both (i) the performance of the system and (ii) the low implementation costs given the current situation in Poland.

We do not claim that we now have a concrete policy proposal for financial reform and privatization in Poland, although we believe that the main bank system should be an important component in such a proposal. In order to develop a specific policy toward financial reform, our analysis must be supplemented by additional considerations. For example, the main bank system does not have any clear implications for the deposits collection mechanism, which as was pointed out in the last section, is an important aspect of any financial system. Safety of the deposits is especially important for an economy like Poland, because each household holds a small amount of financial wealth. Analysis of regulatory mechanisms and deposit insurance that increase the safety (and hence supply) of the deposits must complement the analysis in this paper.

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Another consideration is the participation of international organizations and foreign banks in the financial reform in Poland. The supply of expertise from foreign countries will be important in developing the human resources necessary to establish a well functioning banking system. As the last section has pointed out, the lack of fundamental banking skills is a serious problem in Poland and may be considered especially damaging to a main bank approach to reform.

Similarly, we have ignored the political economy aspects of economic reform. In immediate aftermath of World War II, the Allies were able to impose many reforms on the Japanese government. It is unclear how many of these changes would have been possible without this guidance or whether these reforms could have taken place without the help of the Japanese bureaucracy. Relative to Poland, there was considerable amount of stability in the Japanese government during the period when the reform was taking place. While the political instability must make reform of any sort more difficult in Poland than it was in Japan, it is not obvious to us that this necessarily makes it much more difficult to move to a main bank style system rather than to an arms length banking system.

Nonetheless, we do not claim that the main bank system is an ideal financial system. While this paper has focused almost exclusively on the benefits of the main bank system, in closing we want to emphasize that the system does have some limitations and is not necessarily appropriate for all types of economies. In particular, a major consideration in the design of the banking system was the list of possible alternative financing arrangements. For reasons that we have discussed above, both in Japan in the early 1950s and in modern-day Poland, the feasibility of a system that did not rely on bank financing seemed dubious. Thus the debate over the

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of the financial system is effectively limited to a discussion over which set of banking rules to adopt.

Obviously in many other cases, a system based on security market financing is a completely viable alternative to a bank led financing system. In comparing these two types of systems one would likely be led to study a different set of contrasts than we have focused on in this paper. For instance, to the extent that unmonitored lending can succeed, the associated savings in monitoring costs make it probable that bank lending will be a dominated form of financing. Of course, a firm's reputation is likely to be the central determinant of whether it can rely on public bond and equity markets to secure funding. Therefore, if an economy includes a significant number of firms that can circumvent bank dependence, then the financial system is likely to evolve to de-emphasize the role of banks. Indeed, one way to view the US economy is that by relying on public markets and exploiting firms reputations the US is able to run a financial system that is much less dependent on bank financing than many other capitalist economies. An implication of this setup is that banks no longer seem like the natural party to be involved with corporate governance. From this perspective it is not surprising that the US system of corporate governance has been different than that of Japan in the 1950s and 1960s.

An interesting recent development in Japanese corporate financing is that many large Japanese companies have begun to shift away from bank financing in favor of bond and equity financing. As Hoshi, Kashyap and Scharfstein (1993) discuss this shift appears to be driven both by deregulation that has made the use of these instruments legal and by the continued success and improved visibility of the companies that have made the securities attractive to investors. Ironically, although the major

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Japanese corporations may previously have been very well served by the type of main bank system that we have described, they may have outgrown it. In thinking about Poland, we think it also prudent to recognize that this type of evolution is possible, but it remains a long way down the road of economic reform.

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Table 1-1 Shares of the Five Largest Banks in All Ordinary and Savings Banks

End of Year	Paid-In Capital %	Deposits (%)	Lending (%)
1900	5.4	15.1	10.6
1910	10.2	17.4	15.1
1920	13.9	20.5	16.5
1930	24.1	31.0	27.6
1940	31.6	35.4	44.7
1945	40.4	45.7	58.6

Source: Teranishi (1982), p 295.

Note:

1. The five largest banks include Mitsui, Mitsubishi, Sumitomo, Daiichi, and Yasuda until 1942, and Mitsubishi, Sumitomo, Yasuda, and Teikoku after 1943. Teikoku was created through a merger of Mitsui Bank and Daiichi Bank in 1943, it then acquired Juu-Go Gank in 1944. In 1948, Teikoku split back into Mitsui and Daiichi (with the former Juu-Go branches belonging to Mitsui).

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Table 1-2 Damage of National Wealth by the War

	Total Damage	Wealth at 1945	Damage Ratio
Producer durables	19,838	59,689	24.9
Consumer durables	34,823	105,894	24.7
Transportation durables	9,617	23,269	29.2

Source: Ministry of Finance 1978, pp 14-15.

Notes to Table 1-2:

1. The damage ratio is defined to be (Total Damage)/(Total Damage + Wealth at 1945).

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Table 1-3 Gross Financial Assets Held by Nonfinancial Private Sectors

Year	Households (¥ million)	All Private (¥ million)	Households (per GNP)	All Private (per GNP)
1946	259,511	380,574	0.547	0.803
1947	259,811	655,097	0.351	0.501
1948	827,241	1,216,852	0.310	0.456
1949	929,101	1,384,109	0.275	0.410
1950	1,376,204	2,017,051	0.349	0.511
1951	1,887,053	2,796,976	3.443	5.103
1952	2,726,759	3,994,592	0.428	0.627
1953	3,547,437	5,195,570	0.475	0.690
1954	4,223,028	6,104,910	0.540	0.780

Source: Ministry of Finance 1978, pp 424-441.

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Table 3-1 Basic Macroeconomic Statistics: 1990-91

	89:4	90:1	90:2	90:3	90:4	91:1	91:2	91:3	91:4
Industrial Sales	1.00	0.77	0.72	0.74	0.75	0.65	0.57	0.57	0.57
Employment	17.6				16.5				15.9
(State)	11.7				10.0				8.8
(Private)	1.8				2.3				3.0
Unemployment Rate	0%	2%	3%	5%	6%	7.1%	8.4%	10.4%	11.4%
CPI Inflation	31%	32%	5%	3%	5%	8%	3%	2%	3%
Exports									
Dollars	2,412	2,182	2,705	3,133	4,000	2,751	4,459	3,196	4,182
TR	3,910	2,688	3,110	2,305	3,011	561	560	84	175
Imports									
Dollars	2,182	1,573	1,465	1,825	3,391	3,050	3,457	3,047	4,692
TR	2,725	1,706	1,505	1,443	1,985	558	163	68	47
Markups	40%	31%	29%	28%	24%	16%	14%	19%	13%
Gvt surplus (% of GDP)	-3.6	1.6	3.4	1.7	-3.9	-2.4	-3.6	-3.8	-3.1
Refinance Rate	12%	22%	5.8%	2.8%	4.3%	5.5%	5.3%	3.8%	3.3%

Source: Berg and Blanchard (1992)

Notes: The index of real sales is measured in the last month of each quarter. Employment is measured in thousands at the end of the year. Private employment does not include agriculture. Umemployment is in the last month of each quarter, expressed as the share of the labor force. CPI inflation is the average monthly inflation for the quarter. Exports and imports are for the quarter, in millions of transferable rubles (TR) and dollars. The markup is defined as (Sales - Costs)/Costs for the quarter, for the socialized sector. Government surplus is for the quarter, as a percent of GDP. It is computed as the surplus as a share of expenditures, multiplied by the ration of expenditures of GDP for the year. The refinance rate of the NBP is the averge for the quarter in monthly rates. Some data is not (yet) available on a comparable basis for 1992. Real sales in industry are seasonally adjusted in 1992.

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Table 3-2 Polish Banks by Balance Sum and Own Funds - Capital (at the end of 1990, in billion zloty)

	Balance Sum	Own Funds
Total of all banks	481,782	29,379
Narodowy Bank Polski	145,147	2,079
Bank Handlowy w Warszawie SA	103,479	6,313
Bank Polska kasa Opieki SA	54,456	2,855
Powszechna kasa Oszczednosci BP	38,700	686
Bank Gospodarki Zywnosciowej	29,376	2,927
Panstwowy Bank Kredytowy (W-wa)	14,522	1,845
Bank Slaski (Katowice)	12,673	2,122
Banki Spoldzieicze	11,583	884
Bank Przemyslowo-Handlowy (Krakow)	11,390	1,336
Powszechny Bank Gospodarczy (Lodz)	9,305	845

Source: The statistical data contained in this paper are taken from materials of Narodowy Bank Polski.

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Table 3-3 The Number of Private Spolki[1] in Poland: Domestic and Joint Venture (j.v.)

	31.12.1989	1.12.1990	30.06.1991
Industry			
Domestic	2,769	7,014	7,698
j.v.	240	853	1,431
Construction			
Domestic	2,640	5,646	7,164
j.v.	12	71	167
Agriculture			
Domestic	83	342	285
j.v.	14	48	62
Forestry			
Domestic	10	36	39
j.v.	3	4	5
Transportation			
Domestic	86	356	507
j.v.	14	67	124
Telecommunication			
Domestic	18	56	80
j.v.	-	5	7
Trade			
Domestic	1,759	8,661	12,598
j.v.	32	198	475
Other branches of material production			
Domestic	2,979	7,098	5,837
j.v.	80	258	296
Municipal economy			
Domestic	76	160	163
j.v.	1	6	9
Nonmaterial production			
Domestic	1,273	3,870	4,145
j.v.	33	135	264
Total	11,693	33,239	38,516
of which, j.v.	429	1,645	2,840

Source: Johnson (1992)

[1]Spolki are firms in which private individuals have at least 51% ownership.

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Table 3-4 Employment in Unincorporated Firms in Poland

	31/12/90	30/06/91	30/9/91
Industry	334,613	339,291	348,803
Construction	165,541	165,428	170,618
Transportation	61,368	56,913	60,203
Trade	346,294	456,844	514,778
Catering & restaurant	22,511	30,443	34,845
Other material services	122,099	122,555	124,768
Nonmaterial services	83,066	100,923	111,629
Total	1,135,492	1,272,397	1,365,644

Source: Official Polish government statistics, see Johnson 1992.

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