

# CZECH BANKING IN COMPARATIVE PERSPECTIVE

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## **Abstract:**

Banks played a central and, at times, controversial, role in the post-1989 transformation of the Czech economy. This article is trying to assess that role by setting it in a historical and comparative context. Economic historians have specified two broad models of banking behaviour, although the differences can be exaggerated. Transition economies show some common characteristics, but past history gave Czech banks a particularly important role and policy makers pursued a conception under which they would finance rapid economic transformation, partly following a model from the past. With varying degrees of willingness, established banks took on this role, undermining their own financial solidity. As the Czech road ran into difficulties, so a different conception of banks' development was adopted, closer to policies more familiar across Central and Eastern Europe.

**Keywords:** transition, Czech economy, banks, banking history

**JEL Classification:** G21, G28, N20, P30

## **1. A Historical Perspective**

Banks in a market economy are generally defined by their core activities of taking in deposits and granting credits. Their place reflects individuals' lack of confidence, resources or ability to invest their savings into specific projects. A bank can bring together substantial sums, build up expertise and identify good targets for investment. This general framework leaves scope for substantial variety. The behaviour of banks themselves, and their place alongside other financial institutions, varies between countries and time periods.

This links to substantial variations in the "role", or "function", of banks in economic development, a concept that requires careful interpretation. Banks are typically formed as profit-seeking businesses with a primary responsibility to owners and depositors. Their impact on the pace and nature of economic development is a result of how they seek to make their profits rather than to focus on the primary purpose of their founders. Differences in behaviour reflect different perceptions on the part of banks as to how best to pursue the objective. This point is worth considering as, both in history and in more recent Czech experience, arguments have appeared

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suggesting that banks have accepted, or “should” accept, some sort of wider responsibility to the economy as a whole. The implication, although rarely stated, is that they could be asked to set a wider interest above those of their depositors and shareholders.

Combining the two elements of banks’ role in economic development and banks’ means of making a profit, differences across time and space can roughly be summarized around different weightings for four broad “functions” in economic development.

The first is in ensuring smooth operation of the payment system. Historical accounts (e.g. Collins, 1995), show how banks started by taking in deposits and, at a relatively early stage, developed methods of payment by cheque, allowed credits for working capital to smooth out short-term difficulties and sought means to settle the resulting inter-bank debt. Despite the importance of these activities to the economy as a whole, they are not a major direct source of banks’ profits. However, speed and reliability of payments and easy access to accounts are important for attracting deposits without which banks would lack the means to undertake other, more profitable, activities.

The second “function” is in mobilizing and allocating savings, giving banks an important place in driving investment and hence economic growth. Profits come from the higher interest rate on credits than on deposits, but risks can be substantial. Banks typically suffer from an imbalance between the need to honour deposits rapidly and the longer time span for repayment of loans. Granting of long-term credits therefore assumes expertise and experience in judging the reliability of clients.

The third “function” is as a “substitute” for entrepreneurship, in developing new businesses, reorganizing and merging existing businesses and exercising corporate governance. This requires still greater expertise. Moreover, close involvement with industrial enterprises – particularly if both by credits and share ownership – can expose a bank to very substantial risks, possibly putting the first “function” in jeopardy.

The fourth is a “parasitic” role whereby banks transfer resources away from productive activities, for example into speculation or capital flight. The aim may still be profit maximization for the bank, but that need not be the case. There may be a divergence between the interests of depositors and those who control the bank’s behaviour – be they original founders, owners or managers – with the latter seeking personal enrichment at the expense of the former. Where regulation is under-developed and where the legal framework is weak, the scope for fraud may be enormous and the banking system may play a very destructive role.

Most debate among historians has centred on the second and third functions. Gerschenkron (1962), referring to nineteenth century European industrialization, made a distinction between “early” and “late” developers, with banks playing a larger role in financing long-term investment and enterprise development in the latter. The archetypal “early” developer was Great Britain where industrial investment was largely financed from internal sources and, later in the nineteenth century, also by new share issues. Subsequent decades saw the emergence of a plethora of funds, insurance companies and other institutional forms that could bridge the gap between distrustful individual savers and potential investors. Commercial banks throughout all these periods concentrated primarily on granting short-term credits. This has been referred to as the “Anglo-Saxon” model, as opposed to a deeper involvement of banks in enterprise development in the “German” or “Central European” model.

In nineteenth century Germany banks often initiated the founding of joint-stock companies, thereby channelling savings towards industrial development (see Feldenkirchen, 1991; Tilly, 1966). Czech banks played a similar role before 1914. In the

words of the leading banker of the time, they alone “enjoyed a degree of trust, with which they could gain the necessary conditions for founding an enterprise” (Preiss, 1912, p. 6). They alone could put together large sums of capital. They went further, becoming involved in organizing trading and sales and in ensuring other forms of close cooperation between companies. In the interwar period too, banks in Czechoslovakia and Austria arranged share issues, often retaining some within their own portfolios. They held directorships, changed managements and arranged mergers and takeovers. In turn, industrialists sat on bank boards so that it was not always clear who was driving decisions (see Lacina, 1994; Mosser and Teichova, 1991).

Nevertheless, the extent of differences between the two models may not be that great. British banks often have become closely involved with companies, establishing long-term relationships by continually rolling over short-term credits. There have been many cases of banks intervening in firms’ affairs when they see it as necessary to protect their own interests, in other words, when it is a logical part of their profit-seeking activities. Substituting for entrepreneurship elsewhere appeared attractive only in the early stages of development. Active roles in reorganising existing enterprises, or in corporate governance, were generally seen as a last resort. German bankers showed their preference for safe, short-term credits, retaining a wider role only when shares could not be sold (see Feldenkirchen, 1991). Like their United Kingdom counterparts, they openly resisted pressure to be more generous in giving credits to industry, which they felt lacked commercial logic, when the government was hoping for rapid recovery after the First World War (see Feldman, 1991).

Czech bank leaders also made clear that permanent participation in running other businesses was a very infrequent aim. Their primary concern was with the fate of credits and it was this that led them to play a wider role in economic development, substituting for the lack of expertise on the part of newly-emerging Czech managers, as well as the lack of capital (see Preiss, 1912). Their motivation – to make a profit – and the preferred means to achieve it – by granting safe credits – were the same as those of British commercial banks. This required closer involvement with enterprises because of the low level of managerial expertise outside the banks.

Banks still preferred safe, short-term credits and became involved with enterprises largely as a supplement to that, either to help enterprises develop or to intervene when things have gone wrong to such an extent as to threaten with non repayment of credits. Both in Great Britain and in countries where banks are said to play a larger role, such as Japan and Germany, the form of intervention has typically amounted to little more than changing management and imposing sales of assets (see Ross, 1996; Edwards and Fischer, 1994; Aoki, 1994). Banks lack the expertise for a more active role in corporate governance.

Doubts over the extent of the difference between the two models lead to doubts over its significance. British financial institutions have been blamed for failing to provide the financial resources for industrial modernization in both the late nineteenth and twentieth centuries thereby contributing to slower growth relative to other European countries, particularly Germany. A strong case can be made for institutional weaknesses and rigidities affecting economic performance (see Elbaum and Lazownik, 1986), but it is less clear that banks were the key culprit or that they “should” have behaved radically differently. As an “early” developer, Great Britain benefited from a more sophisticated capital market with other actors that financed long-term investment and became involved in share ownership (see Ross, 1996; Capie and Collins, 1992; Collins, 1995, 1998).

Closer involvement of banks with enterprises carried high risks. British banks in the inter-war period may have created some antipathy by eschewing active involve-

ment in enterprise affairs, but they also benefited from the absence of a major banking crisis. History in a number of other European countries saw fluctuations between governments encouraging banks to take on a wider role and then, following a crisis, imposing rules that restricted them from long-term ownership in non-financial enterprises (see James, Lindgren and Teichova, 1991; Collins, 1998).

The particular circumstances of economic transition have presented both a distinct set of constraints and a different set of opportunities. A historical analogy might suggest that, in view of the absence or weak development of other institutional forms, banking would play the role more familiar from late developers. It would accumulate savings, channel finance into restructuring and new enterprise development and perhaps even take a role in corporate governance.

Banks, however, were ill-equipped by their past experience for playing even the most basic role of granting credits. They brought little experience from central planning of evaluating risks, assessing managements or directing investment towards new activities. This would point rather towards an ultra-cautious approach, emphasising credits to activities undergoing minimal change, such as electricity generation or raw material production, thereby effectively avoiding any central role in economic transformation. An attractive alternative might even be a parasitic role. Transition economies, unlike countries in early stages of industrialization, are blessed with substantial stocks of wealth that could be appropriated for private gain.

Practice revealed a diversity of experience both between countries and between banks in individual countries. Indeed, differences between Central and East European countries (CEECs) and Russia are so great as to cast doubt on the validity of referring to transition economies as a general group. There were also differences between CEECs, which reflected both the heritage of the past and different reform strategies.

## **2. The Czechoslovak Past**

Czechoslovakia's past could give banking an unusually prominent place, based on relatively high levels of personal savings and of credits. Savings deposits increased steadily from 3.3 per cent of net material product (NMP) in 1954 to 44.8 per cent in 1989. A relatively small proportion of this was matched by personal loans so that, in macroeconomic terms, these savings were balanced by investment from the enterprise sector. In Poland savings deposits relative to NMP grew more slowly, reaching 24.7 per cent in 1980 and then peaking at 30.8 per cent in 1981 (PSO, 1990, p. xivi), the year when NMP fell by 12.0 per cent. The Czechoslovak history of low inflation and relatively high living standards helped establish the habit of putting deposits in a trusted domestic bank.

Macroeconomic stability also meant that credits could play an unusually prominent role in the Czechoslovak version of central planning (see Myant, 2002). External funding of enterprises was often favoured by central planners, enabling the state bank to play a role in checking and controlling enterprise performance. Credits grew from 32 per cent of NMP in 1960 to 69 per cent in 1969 and 87 per cent in 1983 (FSÚ, 1985, p. 142). This had fallen slightly to 83 per cent in 1989 (FSÚ, 1990, p. 182), following efforts to impose austerity. Table 1 provides a comparison with other transition economies, showing the variations in deposits and credits before 1989 and the extent of continuity into later years. These use available figures from the International Monetary Fund (IMF) which generally differ slightly from domestic statistical sources, albeit with significant problems over the interpretation of a deposit in a planned economy.

Table 1  
**Deposits and Credits as a Percentage of Gross Domestic Product**

		Deposits	Credits
Russia	1993	17.3	25.9
	1999	15.5	32.7
Poland	1982	3.6	75.1
	1988	3.1	41.7
	1992	28.0	38.2
	1999	36.6	39.3
Hungary	1982	22.1	101.5
	1989	30.0	88.9
	1992	39.8	96.2
	1999	39.0	52.5
Slovenia	1993	27.8	33.6
	1999	43.1	52.1
Czechoslovakia	1982		82.6
	1989		77.2
	1992		79.6
Czech Republic	1993	62.0	72.0
	1999	77.2	81.8
Slovakia	1993	58.4	75.3
	1999	57.0	60.2

Source: Calculated from IMF International Financial Statistics Yearbook, 1993 and 2001.

There was also considerable continuity in the kinds of credits. In the Czech Republic credits to businesses accounted for almost 93 per cent of the total in 1991 and still for 90 per cent in 1999: an approximate 50:50 split between businesses and households is usual in the United Kingdom and other mature market economies. Deposits were predominantly from households, 60 per cent in 1991 and 67 per cent in 1999, implying that their savings were financing the needs of the business sector. Comparisons with other CEECs show some with similar, and relatively stable structures: 70 per cent of Polish bank deposits were from households in 1993, rising to 74 per cent in 2001 while over 80 per cent of credits were to enterprises. There are also differences. About half of credits in Hungary, both in the 1980s and in 1999, were to the government, reflecting an established method of handling the state budget. There was growth in credits to households in Slovenia, albeit still only reaching 31 per cent of the total in 2000 (Bank of Slovenia, 2000, p. 57). Credits in Russia remained relatively low in relation to gross domestic product (GDP), but with a growing bias towards loans to the government, reaching 19.9 per cent of GDP in 1999.

In the Czech Republic banks were the most heavily tied to enterprises and enterprises were in turn exceptionally dependent on bank credits (see Chvojka, 1999). The heritage from the past was reinforced by the nature of the transformation, for example with voucher privatization limiting scope for raising finance by new share issues and leaving a potential vacuum in corporate governance. The scene was set for policy makers to see solutions to a number of problems if banks could be persuaded to play a role analogous to that in "late developers".

### 3. Banks in the Czech Transformation

The initial discussions of economic reform in the Czech Republic included few public references to the role of banks. There was, however, a general conception, occasionally made explicit, that liberalization, privatization and competition would solve the problems for this sector, as for others.

Liberalization could be interpreted in different ways, ranging from free licence for new economic actors to a process ordered and controlled by a central authority. The subsequent chaos in the Russian banking system can be attributed in part to the way how the old system broke up, leaving an institutional and political vacuum in which warring business interests could gain dominance over political power. Liberalization in CEECs meant a more ordered process with considerable organizational continuity as new central banks, and a small number of commercial banks, evolved out of existing state banks.

In Czechoslovakia, and subsequently the Czech Republic, this was associated with an "unspoken" strategy towards banking. Despite silence in major programmatic documents, there was a conception among those guiding policy, albeit a changeable and evolving one, of how banking should develop. This can be followed around the development of broad categories of Czech bank and of individual big banks. Key elements of the relationships that emerged are indicated in Table 2. The first four, the big banks, were inherited from 1989. The Agrobanka belonged in an intermediate category, formed in 1990 and alone of new banks reached a significant size, for a time. The others were new, small banks.

Table 2  
**Volume of Deposits and Credits of Czech Banks** (December 1995)

	Deposits		Credits	
	CZK bn	per cent	CZK bn	per cent
KB	222.4	25.7	227.2	26.0
ČS	294.7	34.8	118.7	13.6
ČSOB	83.4	9.6	80.9	9.3
IPB	139.4	16.1	128.9	14.7
Agrobanka	49.7	5.8	38.7	4.4
Others	75.0	8.8	279.7	32.0
Total	865.7	100.0	874.1	100.0

Source: Mervart, 1997, p. 35.

These new banks were seen as a source of possible diversity and competition for the established banks. They never played this role. The group peaked at 22 banks in 1993 and their highest share in bank assets was 8.8 per cent in 1994. Lacking a branch network to accumulate deposits, they typically raised finance on the inter-bank market, leading to the imbalance between their shares in deposits and credits as shown in Table 2. Credits often went to owners and friends, to help with personal enrichment or with unsound business projects, leading to escalating problems in the

small bank sector (see Mervart, 1997). They were the closest in Czech experience to the "parasitic" model.

Czechoslovak rules for new bank formation were extremely lax. At first the only requirement was the equivalent of a manual worker's annual pay plus the names of board members. The remarkable point is therefore the small number that emerged. Comparisons across CEECs show similar numbers and trends, with a rise and then fall, albeit generally less pronounced than in the Czech Republic. In Russia, the number of banks reached 2,500 at one time, with little control over their activities (see Johnson, 2000).

The difference can be related partly to the more chaotic process of disintegration of the old system in Russia and partly to the subsequent behaviour of Central European central banks. In CEECs there was generally little incentive for large established enterprises to set up their own banks, a key factor in proliferation in Russia. They were tied in to the existing big banks by past credits, by the need for more credits and by the need for security for their own deposits. In short, the established banks offered a functioning system that adequately served their needs. Moreover, in contrast to a certain period in Russia, there was no disintegration of the established big banks with local branches setting up on their own. This too would have made little sense when customers, and deposits, came to the large and established banks.

By mid decade, when the Czech small business sector had taken off and voucher privatization had created scope for enrichment from share dealing and speculation, a base might have existed for a genuine explosion in bank numbers. The central bank prevented this with a tightening of rules and no new licences were granted to small banks after 1993. The central bank then intervened in various ways, ultimately eliminating several small banks. The number fell to two by 1999, as their financial difficulties grew following incompetence, naivety and very often corruption.

The central bank even sought to encourage foreign banks to enter the market by buying existing Czech small banks, a solution that was actively blocked in Russia from 1992 onwards by then powerful banking lobby (see Johnson, 2000). Progress was at first slow, but foreign banks' share in total bank assets grew to 11.3 per cent in 1994 and 27.2 per cent in 1999, slightly higher than the Polish figure at the time.

The four big banks heading the list in Table 2 were given the freedom at the start of 1990 to undertake normal commercial banking activities. There was some discussion, albeit with limited public participation, of whether to pursue a model of universal or specialized banking. A combination of wanting to build on past history, an atmosphere favouring liberalization and practical difficulties that would be imposed on any bank restricted to certain parts of the economy, all led to an acceptance that the four state-owned banks should become universal, commercial banks (see Revenda, 1991).

Taken over the whole period from 1989 to 2002, banks inherited from the past met a fairly similar fate across CEECs. They remained under full, or predominant, state ownership throughout most of the 1990s and were gradually sold off to solid foreign banks. However, there were specific features to Czech development that stemmed from the position of banks within the country's transformation process.

They were given the opportunity of a fresh start, freed by 1992 from much of the burden of past credits that were unlikely to be repaid. This process was generally slower in other CEECs, in some cases linked to resolving problems of debtor enterprises. The nature of the fresh start was confirmed by partial privatization in the first voucher wave for three big banks. Thus, rather than sale to a foreign owner, they were primed for a central role in the development of Czech capitalism. They took part in the voucher waves by setting up funds that acquired shares and there were soon voices welcoming banks taking an active role in ownership. Some even spoke



of banks becoming the key force in directing and controlling enterprises (see Jonáš, 1997), foreseeing an analogy to what they believed to be the Japanese model, or even the Czech past. This was not pressed as a coherent and open government policy, but there was a clear general conception underlying many individual policy choices.

By way of contrast, to some extent aware of their own shortcomings (see Salzmann, 1990), Czech banks started by favouring a cautious approach. Soon, however, they came under strong pressure from the government to help finance the growth in new small businesses, the revival of large firms in financial difficulty and the individuals seeking credits for privatization. State ownership helped managements to comply with the government's conception, "not least because of a fear that they would be removed from their positions" (Kunert, 1997, p. 12). The pressure, stemming from clear frustration on the part of government ministers, was also quite open.

Banks were accused of "putting their own interests before the interests of the state budget or other entrepreneurs" (Valášek, 1993, p. 3) and chastised by Minister of Finance Ivan Kočárník for choosing "the route of excessive security of credits with property and the like" (1993, p. 4). He blamed this on their "inexperience with assessing business risk", seeming to imply that they should recklessly ignore their own weaknesses. In the words of one leading banker, the assumption was that "in our thoroughly under-capitalized land, everything was to be replaced by credit" (Kunert, 1999, p. 307).

Banks were often willing accomplices, buoyed up by the widespread optimism that the transition to a market economy would lead to rapid growth and increased prosperity. However, there were differences between them and they did not always comply with all the government pressures. The result was often a compromise that reflected an array of differing opinions and perceived interests. However, the more immediate point is the contrast with other CEECs. In the Czech Republic the focus had shifted the furthest from one of how a solid banking system could be created to one of how banking could help a particular conception of economic transformation. The reasons were partly objective, in the sense that banks had the resources and the demand for credits was very high both from established and from new enterprises, but the key reason lies in the choices made by the political leaders.

The result was an escalation of bad debt. Much of the credit granted by Czech banks was unsound. The proportion of "classified" loans (including risky and loss-making loans) in the Czech Republic reached 37 per cent of the total in 1994 (see Matoušek, 1998). A figure around 2 per cent is normal in advanced market economies, with figures around 10 per cent often associated with a banking crisis. Poland saw a fall from 30.1 per cent in 1993 to 10.2 per cent in 1997, followed by a renewed rise (NBP, 2002, p. 36). Generally, much of the bad debt in CEECs reflected credits inherited from the past and the gradual improvement was partly due to their slow resolution. Banks did come under various pressures, but this background tied them more to developing as orthodox banks, with a primary responsibility to clients and shareholders. Czech banks, after the hopes of a fresh start by 1992, built up more bad assets from their role during the transition process.

#### **4. Diversity Among the Big Banks**

Differences among the Czech big banks reflected their past, hints from the government on how they should behave and choices made by their managements which sometimes ignored, sometimes resisted and often complied with government



pressures. Basic information is provided elsewhere (see Janáček and Tomšík, 2000; Myant, 2003).

**Česká spořitelna (ČS)**, the Czech savings bank, emerged from voucher privatization with the state holding 53 per cent of the voting shares and no other owner able to have significant influence. It inherited a network of branches and a substantial body of personal savings. In December 1995, as Table 2 shows, it still had 35 per cent of total deposits. The rate of personal savings increased after 1989, stabilising at about 10 per cent, giving the ČS a surplus of resources for investment, with credits less than half the level of deposits in 1995. Before 1989 it had lent to households. Developing that role, with mortgages and consumer credits, might have been a safer option, but the management preferred the simplicity of larger loans. Any government pressures were also in that direction.

It started lending to some big and small enterprises and, above all, it funded the rapid expansion of the small banks that lacked the public trust and branch networks required to build a deposit base of their own. This was presented as a positive step towards "the diversification of the banking industry" and "enabling the newly emerging banks to start up their activities" (Klapal, 1994, p. 3). A historical comparisons rather suggests that it amounted to a dangerous inversion of the usual relationship between big and small banks. In the inter-war period there had been 7,000 cooperative and small savings banks in Czechoslovakia with deposits five times the level of the 23 joint-stock banks, but their funds were used for credits by the few large banks that had the expertise to take such decisions (see Mervart, 1996; Lacina, 1994). The inevitable result was the mounting problems in the small bank sector damaging the ČS's balance sheet. It came under pressure to help by taking over ailing banks, but generally preferred to make use of its deposit base by lending abroad.

**Komerční banka (KB)**, the Commercial Bank, inheriting close links with established enterprises, emerged after the voucher waves with 52 per cent of shares in state hands. Its status meant that it came under the strongest pressure to accept its "responsibility" to the economy as a whole. Thus, despite frequent assurances that it was developing sophisticated methods of checking before granting credits, it lent heavily to new small businesses and to established enterprises, both of which activities pleased key policy makers. Much, probably about one third, of the credit was unsound and subsequent investigations suggest that bribes to branch managers may have been routine.

The government also tried to involve the KB in helping specific major enterprises and was keen that it should take a share in ownership, for example in the Škoda Plzeň heavy engineering combine in 1992 and the Poldi steel producer in 1996 (see Myant, 2003). Here the bank proved to be more cautious, even gradually cutting off credit to enterprises that proved reluctant to pay their bills. It became more concerned when its interests were clearly threatened by the imminent insolvency of major enterprises at the end of the 1990s, but there is little that a bank can do in such situations. It rarely had enough power even to impose the changes it wanted to see in top management. Involvement therefore amounted to cooperation with the government, particularly around the Revitalization Programme introduced in 1999 and affecting a few key enterprises. This failure to become a full substitute for other forms of corporate governance is, as already indicated, in line with banking experience elsewhere in the world.

**Československá obchodní banka (ČSOB)**, the foreign-trade bank, remained under a form of full state ownership until 1999. It was the most cautious, with a management experienced in international banking practice, and accounted for less than 10 per cent of both credits and deposits in December 1995. It avoided identifi-

cation with politicians and proved capable of resisting pressures from government. It may have been helped by an ownership structure that gave 50 per cent of the shares to the Czech and Slovak central banks rather than to the Czech government. It may also have benefited from the international experience of leading personnel, possibly encouraging the belief that business and politics should be kept well apart. It was the most successful at raising loans from foreign banks and stands as the example for what could have been had all banks stuck closer to a traditional caution. It made only a few attempts to become involved in the affairs of enterprises and was generally more willing than other big banks to seek solutions by pressing for bankruptcy.

**Investiční a Poštovní banka (IPB)**, the Investment and Postal Bank, developed out of the Investment Bank, set up under the reform proposals of 1989. Privatization initially left the state with a 48 per cent share. The management set itself the aim, which was in harmony with government thinking at the time, of creating a universal bank in which the role of the state would be relatively small (see Tesař, 1993). Within this it saw investment banking as a key activity. It had to fight from a position of initial weakness and proved itself innovative, aggressive and unorthodox. It broke its dependence on the inter-bank market by establishing a deposit base after merging at the start of 1994 with the newly-established Post Office Bank.

The management brought two great innovations. The first, taking advantage of possibilities opened up by voucher privatization, was a close coordination between the bank and its investment funds to acquire shares across much of the economy. The second was to mastermind its own "privatization by stealth", using control over investment funds to acquire shares in the bank itself. The state, probably reflecting general happiness with the management's aims, failed to take part in new share issues, allowing its total share to fall to 36 per cent in 1994. The additional shares found their way to owners allied to the management.

Privatization thereby gave the management some security, but it was implicitly conditional on help, with generous credits and purchases of new share issues, to emerging business empires that in turn took shares in the IPB. There were also links to government politicians, and individuals close to Klaus sat on the Supervisory Board. The exact significance of this remains unclear, but the IPB certainly earned the reputation among state officials as "the most flexible" of the banks (Češka, 1996, p. 2). It helped with finance for the privatization of enterprises that could otherwise not be sold and gave loans to a number of aspiring conglomerates, the collateral for which were the shares they purchased. Thus, although its share in total credits was small, it became a key element encouraging hopes within the government of creating a specifically Czech capitalism based on domestic ownership.

The distinctiveness of this role emerges from international comparisons. Unlike banks in Russia, it was not controlled by enterprises – its management used their support to cement its own position – and nor did it control politicians. Its core activities were the normal banking practices of taking in deposits and granting credits, supplemented by share ownership and dealing as a further method intended to yield a future profit. As would be expected in view of its inevitable lack of experience and the perceived need on the part of management to bend financial criteria in the interests of friendship with politicians and business interests, it did not perform these roles very well.

It also differed from the central European model of banking. It actively threw caution to the wind in acquiring shares across a diverse range of enterprises, preferring this to safer banking activities. Unlike some successful investment banks elsewhere, it did not back this with aggressive rationalization of enterprises it controlled. Ownership was usually passive, amounting to support for existing manage-

ments. The IPB tried to become more actively involved when enterprises were threatened with insolvency in the later 1990s. As with the KB, it could do little to recoup losses from unsound credits and share purchases, except when helped by the government.

This, then, was the story of an investment bank that lacked the necessary pre-conditions to fulfil its chosen role. Indeed, the central bank began expressing concern from early 1994 that the IPB was pursuing a dangerous strategy of widespread, and apparently random, share acquisitions at excessively generous prices. The management was able to find a means to survive growing external pressure by persuading both the government and the central bank to accept a form of full privatization in March 1998 that gave a controlling minority share to the Japanese investment bank Nomura. This covered up the problems for a time, but brought no lasting solution.

## **5. Privatization, at Last**

In the mid 1990s there seemed to be no need to rush to complete bank privatization. State ownership seemed to be an advantage. Big banks' managements were complacently satisfied that they had done an excellent job and saw no need for new owners. International agencies gave high ratings to Czech banks, partly because state ownership carried an implicit guarantee of help should things go wrong. Klaus was also reassured that partial state ownership ensured a clear link to the interests of the domestic economy. In other words, it meant that they could undertake activities that a private bank should have considered too risky. He was generally happy to procrastinate in the hope that powerful Czech business groups would in time emerge to take over the remaining banks. Privatization would then mean a further strengthening of a specifically Czech capitalism. Nobody seemed to want to hand control to foreigners.

Such conceptions were shattered by growing difficulties across the whole banking sector. Crisis in small banks, threatening the reputation of the sector as a whole, was one of the factors persuading the government to allow Nomura into the IPB. Meanwhile, the big banks in general gradually stopped lending to small banks, to much of the new small business sector and to a number of established enterprises (see Buchtíková, 1999). Despite the earlier government pressure, they were not prepared to continue with lending to firms that clearly could not repay loans from the past. There was also a squeeze on credit opportunities as foreign banks became more willing to lend to the safest Czech companies, such as utilities, on terms that the Czech banks could not match.

Still buoyed up with a healthy domestic deposit base, the ČS and KB searched out new opportunities abroad, with the former choosing to speculate on the Russian capital market. The resulting losses were catastrophic. By the end of 1998 the ČS faced a situation so serious that it was threatened with the withdrawal of its licence. The KB was in a similar situation a year later.

This suddenly gave a new impetus to ideas of bank privatization. From late 1998 the government, by then a minority Social Democrat administration, saw no alternative to reestablishing full state control followed by speedy sales to established foreign banks. The majority of ČSOB shares were sold to the Belgian bank KBC. The ČS required a rescue package to cover for past losses that were greater than the price ultimately received for a majority share from the Austrian Erste Bank Sparkassen. The state's shares in KB, by then 60 per cent of the total, were sold to the French bank Société Générale in 2001. The IPB, threatened with insolvency after its past irresponsibility, exacerbated by the sale of some valuable assets to the be-

nefit of Nomura, was effectively renationalized when the central bank imposed direct control in June 2000. It was then handed to the ČSOB under conditions that would oblige the state to cover for losses. This, it was argued, was the only means to ensure stability of the payments' system.

Thus, a completely new banking structure is being created. The small banks have gone, foreign-owned banks have gained an increasing share of the market, and the big banks themselves have been sold into foreign ownership. Similar end results are emerging across Central and Eastern Europe, albeit by different routes. There will be no return in the Czech Republic to the easy lending practices or widespread share acquisitions of the early 1990s.

## **6. Conclusion**

The Czech banking sector remained under state domination throughout the period when enterprises in other sectors were undergoing rapid privatization. This has invited speculation that privatization could have been purely formal, leaving power with a state authority via control over banks which in turn, through their investment funds, could control much of the economy. The term bank socialism gained some popularity in the mid 1990s, with the implication that there might have been little change in the essential functioning of the economy, or at least no strong pressure on enterprises for greater efficiency.

There are several different versions of this argument, but they generally reflect too simple a view of the role of state ownership. There was no state authority giving detailed orders, and certainly not instructions that could be transferred down the hierarchy postulated above. The pressure on banks was in one sense in an exactly opposite direction, to aid the speediest possible transfer away from direct state control. Perhaps somewhat paradoxically, this conception appeared to be embraced most enthusiastically by the IPB, the big bank most able to distance itself from direct government control.

Although policy makers may have believed banks were adopting a role familiar from history and from experience elsewhere, there actually were important differences. The crucial one was the lack of experience and expertise within the banking sector that made them unsuited to so ambitious a role. In this sense, then, state domination over banks did serve to protect inefficiency. It meant that credits went to enterprises, both new and established, that could survive without modernization. This was central to the relative economic success of the mid 1990s, when credits helped recovery from the transformation depression, and to the depression of the later 1990s, when banks, themselves experiencing growing difficulties, stopped lending to domestic enterprises.

Any alternative for banking would therefore have implied a different strategy for transformation of the economy as a whole. The government could have used its influence to persuade banks to develop with traditional caution, concentrating on safe loans and gradually building up the experience to assess risks. Rapid privatization and the scale of the growth of the new private sector would then have been practically impossible. Privatization would probably have been both slower and more dependent on sales to foreign owners, with less scope for concern over the terms they were prepared to accept.

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