Deloitte Touche Tohmatsu

Slovakia: Structural Reform, Debt Resolution, and Growth

With Hjoerdis Bierman

Delivery Order #15
Contract # EUR-0014-I-00-1056-00

Prepared for:

USAID

January 1995

Deloitte Touche Tohmatsu International

CONTENTS

c

PREFACE

This report was carried out in the period November 1994 to January 1995. The work included meetings in Bratislava in the period November 30- December 17, 1994. The cooperation of the Slovak authorities is greatly appreciated.

CHAPTER 1.

LAYING THE FOUNDATIONS FOR GROWTH.

I. MACROECONOMIC PERFORMANCE AND THE CAUSES OF BAD DEBT 1989-93.

Between the "velvet revolution" in 1989 and 1993, Slovakia's real GDP is estimated to have declined by approximately 25 percent. This includes a decline of 4 percent in 1993, following the dissolution of the former Czechoslovakian Federation (CSFR) into two independent states at the end of 1992. At the aggregate level, the decline in real output reflects the collapse of both foreign and domestic demand for Slovak goods.

The decline in foreign demand for Slovak goods came with the collapse of the CMEA, embargoes on trade with a number of Slovakia's major trade partners, and temporary disruptions in trade with the Czech Republic. The gains made in exports to Western markets were far too small to compensate for the loss of traditional markets. At the same time, both private and public sector domestic demand contracted during the transition, as real income declined and the public sector sought to reduce both its scope and its use of resources.

The contraction in output was aggravated by and contributed to an increase in the indebtedness of enterprises, both in the form of inter-enterprise (trade) debt and in the form of loans from financial institutions. As enterprises saw their markets collapse, they became increasingly unable to service their debts. At the same time, liberalization measures meant an increase in interest rates on their debt and in their overall debt service obligations. In order to avoid interruption of production and/or to invest in machinery and equipment in anticipation of new market opportunities, enterprises in fact often incurred additional debt, which they also were unable to service.

For their part, the banks had inherited portfolios which held significant problem debt shares at the time of the break-up of the previous monobank system, without the necessary reserves and capital to cover these. As the debt problem was aggravated, they were unwilling to accept large losses which would have resulted from recognizing their bad debts, and/or from liquidation of many of the companies. Instead, the banks retained these loans, capitalizing interest and providing automatic loan renewal, and in many cases provided further loans with the expectation that the companies in question would eventually become profitable and creditworthy.

Thus the inherited bad debt problem was aggravated by the expansion of bad debt. Attempts to resolve the problem by removing

a portion of the bad debts from the portfolio of the commercial banks in the former CSFR only reduced the stock of bad debt, but did not prevent further significant bad debt accumulation, and thus can not be said to have been successful.[1]

As the enterprises were not forced (by the imposition of a hard budget constraint by the banks or the government) to consider serious operational and financial restructuring or liquidation, they became increasingly hampered by lack of funds. Simultaneously, the commercial banks' balance sheet became dominated by the rising level of nonperforming debt, which has had a damaging effect on both the financial system and the economy at large.[2]

The bad debt accumulation has now resulted in a situation in which the banks' ability and willingness to extend credit to other customers appear severely limited, while inefficient and/or loss-making enterprises continue to operate and receive credit. As noted above, the bad debt problem has been aggravated by the introduction of market rates of interest which has made it even more difficult for the enterprises to repay loans and has led to faster rates of capitalization of interest.

As in other economies in transition, the bad debt/enterprise overindebtedness problem in Slovakia appears to be hampering economic growth and the transformation process itself. Banks saddled with portfolios which contain a large share of bad debt capitalize the overdue interest; have not provisioned for the bad loans; and in many cases continue to support the overindebted enterprises, rather than recognizing the debt problem. At the same time, few resources are available, at high interest, for new customers.

On the enterprise side, the overindebted enterprises have few incentives to restructure, downsize or liquidate, to the extent that the banks continue to provide financing without assurances that measures are being taken which will make the enterprises creditworthy. The efficiency of monetary policy is being hampered by the lack of interest sensitivity of the bad debt share of banks' portfolio, as significant resources continue to be directed to the inefficient enterprises, regardless of their performance. At the same time economic performance suffers from the inefficiencies of

---

[1] The initial attempt of eliminating much of the inherited bad debt from the portfolio of the commercial banks is described below in Chapter II.

[2] Even though there is some evidence that the original debt relief measures led to a reduction of bad debt in 1991-92. See Chapter II below.

these enterprises and the lack of credit to an emerging credit worthy private sector.

II. RESOLUTION OF THE BAD DEBT PROBLEM AND ITS POTENTIAL CONTRIBUTION TO MACROECONOMIC PERFORMANCE.

There is general agreement that the bad debt problem between the enterprises and the banks as well as the accumulating inter-enterprise debt need to be resolved to improve the economy's capacity for sustained strong economic growth. However, it is not a sufficient condition to ensure improved macroeconomic performance.

A well functioning market economy needs both a banking system which provides effective and efficient resource allocation and a competitive enterprise sector. Depending on the modalities of the debt resolution process, this process by itself can provide some of the necessary ingredients to achieve the objective in both the banking and the enterprise sectors. However, the mere injection of liquidity into the banking system, with or without a debt resolution process, to ensure additional credit availability may not ensure improved macroeconomic performance.

Credit availability does not create or identify growth opportunities. And debt resolution may not encompass the correction of many distortions, which now hamper the development of a market economy. However, such a market system is needed to ensure that the most profitable opportunities are seized and that the banking system channels financial resources efficiently from depositors to support the most efficient activities.

Thus, as a byproduct of debt resolution, improved credit availability is important for macroeconomic performance. However, it can not be overemphasized that credit availability/debt resolution is only one of a number of issues which need to be addressed to improve the conditions for sustained growth. Growth prospects may therefore not improve significantly, even with improved credit availability or a comprehensive debt resolution process, unless the underlying conditions for the transition to a more market oriented economy are established.

The main focus of this paper, as an input to the decision making process, is on an analysis of the possible macroeconomic impact of a relatively fast and comprehensive resolution of the bad debt issue versus a slower, piecemeal reform. In Chapter 2, international experience in dealing with bad debt is summarized, including the experience regarding government intervention, decentralized and centralized debt resolution processes, the pace of bad loan resolution and the need for restructuring. Drawing on this experience, the medium term macroeconomic implications of

alternative solutions for Slovakia are analyzed in a financial programming framework in Chapter 3.

The analysis in Chapters 2 and 3 concludes that a relatively fast and structured debt resolution process has a clear advantage over a slower, piecemeal one: the former provides an early, firm foundation for sustaining the emerging strong economic growth in an environment of relative price and exchange rate stability. Thereby, it makes it possible for the economy to move to a higher growth path than would be possible without the reform.

However, whether this growth path will in fact be realized depends not only on the debt resolution process chosen, but also on the successful resolution of other issues, by specific policy action, discussed in the remainder of Chapter 1. These are the important actions needed - discussed below in Section VI - to remove major obstacles to the transition to a less distorted and more transparent market economy.[3]

In essence, the supporting actions ensure the creation of an enabling environment for private sector operations in a market economy. These actions are important not only because 1) they contribute to the creation of a relatively market oriented economy, in which scarce resources are allocated more efficiently, i.e. according to (undistorted) price signals; and 2) they create a system in which rules and regulations, operations and accounts are clear and transparent, thus facilitating private entrepreneurs at home and abroad, and promoting confidence in the economic, political and social system.

III. STATE INTERVENTION AND THE ISSUE OF MORAL HAZARD.

It should be remembered in dealing with the bad debt problem in the Central and Eastern European countries (CEEC) that essentially this reflects, at least originally, the political decision to support state enterprises outside of the budget, i.e. using the old (state) monobank system. Furthermore, to the extent that this bank support has been permitted to mushroom in the transition period, this implies tacit political acceptance of continuation of this support. As is normally the case, enforcement

---

[3] To ensure that rational entrepreneurs identify the opportunities correctly, take the right decisions and implement their activities efficiently conditions need to be changed to generate improved information about, transparency of and confidence in the system. In this ideal environment an efficiently functioning banking system is needed to ensure that identified opportunities are not lost because of imperfections in financial resource allocation.

of the hard budget constraint is a difficult political decision which in many instances has yet to be taken. Furthermore, it has been convenient to use the banks for financing of the enterprises, rather than the government budget. Accordingly, there has been few incentives for enterprises to reduce their losses and for banks to reduce lending to these enterprises. In essence the enterprises have been incurring fiscal deficits, financed by the banks rather than by the government budget.

Appropriate and transparent fiscal accounting would require that these deficits, properly adjusted, to include interest subsidies on credit, should be accounted for as part of the nonfinancial public sector's overall deficit. To some extent, the continued granting of bank credit to bad debtors reflects the lack of decisiveness in dealing effectively with the bad debt problem, either directly or indirectly, the latter by changing regulations to encourage, support and force banks to reduce their bad debt portfolio.

The tacit acceptance by government of the continuing relationship between the banks and their bad debtors is fraught with moral hazard. Both banks and enterprises may be justified in continuing business as usual in the expectation of a "bailout" from a situation which at least originally was beyond their control and which they have not been encouraged to resolve.

When viewed in this light, the bad debt problem is essentially a hidden fiscal problem. It is therefore not surprising that government intervention and fiscal measures have been employed to deal with the problem, and are again under consideration. However, in the case of Slovakia at present, great care must be taken to avoid the impression that the government stands ready to provide even further bailouts in the future. There is a particular danger of this in the case of Slovakia, partly because a bailout at this time would already represent a repetition, and partly because the banks and enterprises come from a tradition in which they are not used to having a hard budget constraint.

IV. THE NEED FOR SUPPORTING ACTION.

As noted below in Chapter 2, it is generally recognized that early resolution of the bad debt/enterprise overindebtedness problem in Central and Eastern Europe is desirable because of its potential impact on the speed and efficiency of the transformation of the system from a centrally planned to a market economy. In particular, given the significant role of the banking system in a market economy, it is argued that the lack of a healthy banking system in Central and Eastern European countries is hindering restructuring and transformation and the emergence of a full-fledged market economy. The longer the delay in cleaning up the

banking system, the higher will be the costs -- both budgetary and economic.[4]

However, the macroeconomic impact of resolving the bad debt problem will depend significantly on its modalities as well as the extent to which it is accompanied by other measures which create an enabling environment for the private sector. For example, debt resolution may or may not result in a sound banking system as discussed below in Chapter 2. This will depend on both the modalities of the debt resolution process and the extent to which action is taken to reduce the risk of recurrence, such as measures to strengthen bank supervision and prudential regulations and emphasis on risk analysis in the individual banks.

Furthermore, even if measures are taken to ensure a strengthened banking system in the context of or supporting the debt resolution, this provides no guarantee that debt resolution will result in increased growth and improved resource allocation for the economy. If other prices and incentives in the economy are distorted, or if general policies do not produce confidence at home and abroad, growth may not materialize or may be shortlived, and stability could be threatened.

Thus, while debt resolution in one form or another is needed in Slovakia, the impact of debt resolution will vary, both depending on its form, and on the degree to which it is accompanied by supporting measures. Some of these may be narrowly focused on facilitating the debt resolution process; sometimes these have been included as an integral part of the debt resolution process. Others are focused on bolstering the banking sector operations and the management of the enterprises. Finally, a set of measures are aimed much broader, to signal and implement the intent of the public sector to reduce its role in the economy and to create an enabling environment for private sector activities in the context of a market economy.

When emphasizing the need for cleaning up of bad credits, and preferably an early cleanup, justified by its expected impact on improved growth performance, there is an implicit assumption, that credit availability and a sound banking system is in fact the most important constraint to growth. Experience in the CEEC and in other countries has shown that in fact clean up of bad loans may not result in improved growth, and that credit availability in itself is not an important determinant of growth.

The conclusion is that a sound banking system and credit availability to the private sector on market terms facilitates and supports growth. However, it does not produce sustainable growth in an economic system which suffers from other serious weaknesses,

---

[4] Blommestein and Lange, 1993, p.15.

such as those still present in Slovakia. Correction of these weaknesses are therefore as important as the resolution of the debt problem itself to ensure a strong impact on growth. Some of the major areas in which action is needed in Slovakia in this respect are addressed below.

V. CREATION OF AN ENABLING ENVIRONMENT.

A. THE ROLE OF GOVERNMENT.

It is important for all economic agents that the government identify at an early point its exact role in the economy, including the areas in which it will remain fully involved, and the areas which will be left to the private sector. This should include specification of the support which will be given the private sector. For example, the basic functions of government could be specified as 1) provision of national security, law and order; 2) provision of an enabling environment for private sector operations, including macroeconomic, social and political stability, minimization of distortions and restrictions, and establishment of transparent rules, regulations and accounts; 3) provision of certain services such as basic health and education and physical and economic infrastructure, for example certain utilities or roads. In the case of Slovakia, which has already had several governments in its two years since independence, it may be particularly important to make clear the government's perception of its role, followed up by action, at an early stage so that economic agents can have a degree of confidence in the expected direction of political and economic developments.

B. REDUCTION OF DISTORTIONS AND IMPROVED TRANSPARENCY.

In order to facilitate decision making to improve the soundness of the economic system, the economic and accounting systems should be transparent and relatively free of distortions, and where needed provide incentives which encourage the transformation. To the extent that subsidies or taxes distort prices, resource allocation is also distorted and attempts should be made to minimize such distortions. Price controls which keep prices below market levels will result in below optimal production by private entrepreneurs (or in subsidized production, if the political decision is to maintain a certain output regardless of the profitability of production). In either case, resources are being allocated suboptimally.

Examples which are pertinent to Slovakia and the debt resolution process are 1) the overemployment in consequently inefficient enterprises; this may be the result of political decisions, but in any case has been facilitated by the reluctance of the creditor banks to enforce restructuring or liquidation of

indebted enterprises; 2) the bankruptcy law, provisions of which has not been changed to facilitate enterprise/ bank restructuring or liquidation and which therefore has not been an effective instrument to promote the transformation to a more efficient economy; 3) the tax code, which continues to encourage banks' underprovisioning for bad loans, as provi
sioning is not tax deductible.

Suboptimal allocation of resources of resources also continues to result from the inefficiencies still embedded in the banking system, reflecting lack of experience in commercial banking practices as well as still weak bank supervision, even though progress has been made in strengthening the system.

Finally, perhaps the most evident remnant of the central command system is the continued state ownership (majority or minority) of many productive enterprises and banks. These areas are discussed separately below, with an indication of the action needed to be taken together with any debt resolution process, in order to maximize the impact of this process on stability, growth and investor confidence.

Foreign capital, technology and management experience could greatly relax some of the present constraints to growth in the Slovak economy. However, the flow so far has been disappointing. Private investment and capital inflows occur in response to the expectation that profits can be made. Foreign, as well as domestic, investors must be convinced that the economy is basically sound, stable and moving in the right direction. The resolution of the bad debt problem would appear to be central to the objective of achieving strong foreign investment. However, progress in all of the supporting areas would also contribute to the creation of confidence, at home and abroad, which would facilitate investment in Slovakia.

1. Overemployment in Enterprises.

There is ample evidence that many enterprises retain a much higher workforce than needed. Furthermore, the cost of this overemployment is not now reflected in a way which facilitates rational policy decisions. Transparent fiscal accounting, registering the subsidy provided by the banking system as a fiscal subsidy, at least in cases where this has been provided because of political decisions to maintain employment, would provide a better basis for decision making regarding the restructuring of the enterprises. In particular, the enterprises' employment decision should be taken from the point of view of maximizing profits, not employment. This would eliminate the now implicit fiscal subsidy for most enterprises. In cases where a political decision is explicitly taken to maintain the subsidy in view of the employment generating or strategic impact of an enterprise, this would become an explicit budget subsidy.

Assuming that the present bad debt stock problem is resolved, the result of the above actions would be that banks would be able to make their future credit decisions based on commercial banking criteria; the government would make its decisions with a much clearer picture of the resources required to support excess employment, i.e. it would have the information required for its rational decision making in allocating budget resources among competing demands; and the enterprises would be free to act to maximize profits, except where government decides to support the enterprises.

There is no doubt that this would initially result in increased unemployment. However, the savings from the previous (implicit) support to the enterprises could be used to support the unemployed workers without a deterioration in the financial condition of the government. The increase in the real growth rate, which would be expected to accompany these fundamental measures to create a more market oriented and enabling environment, should ensure relatively fast reabsorption of the unemployed workers, as well as increased tax revenues to finance at least some of the increased social expenditure. Additional scope for financing this would come from reform of the present social safety net to ensure better targeting.

Because of lack of quantification of the present (implicit) subsidies to enterprises and the amount of unemployment which might occur from a thorough restructuring of the enterprise sector, it is, however, not possible to indicate in the present study the extent to which the savings in subsidy payments and additional resources generated by better targeting of social expenditure would cover the social safety net expenses generated by the enterprise restructuring.

2. The Tax Code and Provisioning.

So far, the banks have had little incentive, other than that of establishing a viable bank, to provision against bad loans. Under the tax law, provisioning for bad debt is an expense, which is not deductible. Thus it reduces the profitability of the bank by its full amount. Furthermore, the banking regulations did not require provisioning against bad loans until recently, when the National Bank of Slovakia established rules for capital adequacy management in order to determine a minimal capital-to-risk weighted assets ratio of the banks. The lack of adequate loss provisioning and uncertainties regarding the implementation of the bankruptcy law have worked against them initiating bankruptcy procedures against enterprises with nonperforming debt (see below). The banks have also been locked further into their relationship with the enterprises by the privatization wave of 1992, since the major investment companies were owned by the banks.

As the bad debts have evolved, the low level of reserves and lack of provisioning have contributed to a vicious cycle where the banks have had a strong incentive to roll over maturing debts and capitalize interest, in order to hide the level of nonperforming loans, and still declare a profit. This has resulted in low capital, reserves and loss provisions. Because of the absence of a proper loan classification system, the capital adequacy ratios (CAR) indicated by the banks may have been significantly overstated, as they are not always measured against risk weighted assets.[5]

A recent preliminary analysis indicates that if loan loss reserves for the 8 largest banks in Slovakia of 11.4 percent were required, the banks will maintain "minimal, but probably acceptable levels of capital" if the loan loss provisions are deductible from income taxes. If loan losses are significantly above 11.4 percent, or if the provision is not tax deductible, the CAR will be reduced.[6] To avoid the accumulation of the bad debts for the future, banks should be required to classify loans based on objective criteria, and to provision for these loans. An incentive to do so may be provided by the tax code, which could make provisioning tax deductible. In any case, loan classification and provisioning should be strictly enforced by a strong system of banking supervision.

3. The Bankruptcy Law.

As in the Czech republic, although Slovakia has a bankruptcy law, it is rarely applied. In part, this is because it is both difficult and time consuming under the Law to get through the legal procedures. Partly it is because the major creditors (banks and other enterprises) are too locked into the enterprises to institute bankruptcy procedures. While the bad debt resolution process should take care of these interlocking relationships by resolving the stock of bad debt claims, the bankruptcy law should be amended to facilitate its use both as needed for the bad debt resolution process and as a readily available instrument in the future to ensure that bankruptcy proceedings are initiated when warranted. In this respect, an adequate bankruptcy law becomes part of the safety net which will act by example to prevent future abuse of the banking system and ensure that unhealthy enterprises do not continue operation.

---

[5] This situation is expected to have been corrected in the course of 1994. Banks have been in the process of classifying their loans into four main categories, as a first step in moving towards an acceptable CAR.

[6] Haswell, p.33-34

4. Regulation, Supervision and Commercial Banking.

Although Slovakia has made progress in instituting rules and regulations appropriate for a market economy, residues of the old mono-banking system remain deeply imbedded in the banking system. This includes the continued lack of commercial lending decisions, related to the close relationships between the banks and enterprises; the automatic loan renewal and capitalization of interest; and the hesitancy to initiate bankruptcy procedures and/or deny noncreditworthy, old customers further credit extension.

To ensure that banks perform their essential role of collecting and allocating savings to their most productive investment in the future, there is a need not only for regulation of commercial banks, but also for better supervision to enforce the regulations, and for a radical change in bank management to a commercial bank orientation, including in particular emphasis on risk analysis.

5. Privatization.

Several hundred Slovak enterprises have been either fully or partially privatized in "the first wave" of privatization under the CSFR, which was intended to lock in reform momentum and speed economic revitalization at an early stage in the transition process.[7]

Further privatization of banks is needed to make them more efficient in resource mobilization and allocation, and delinking their operations from political decisions. This will also require that monetary policy be conducted mainly through the use of indirect policy instruments. As noted above, an efficient banking sector will result in an overall more efficient and productive economy, provided that other distortions in the economy are corrected, and provided that banks do not retain monopoly powers. At present, the major banks are partly privatized. However, the National Property Fund holds a significant stake in some of them. Resolution of the bad debt problem will clear the way for further privatization of the sector. At the same time, although some of the banks, in particular the savings bank, has a monopolistic position, competition is increasing in the sector, as many new banks have begun operation in recent years.

Further privatization of productive enterprises remaining on state hands is also needed in order to reduce the role of the state in the productive sector, and to make further progress in the

---

[7] For a detailed description of the "first wave" see World Bank (1994), pp.43-51

transition to a market oriented economy. So far, the "second wave" of privatization which was originally scheduled to take place in September 1994 has been postponed, as changing governments have changed the modalities of the privatization in view of what was learned during the first wave.

CHAPTER 2.

INTERNATIONAL EXPERIENCE WITH BAD DEBT RESOLUTION.

I. INTRODUCTION.

This chapter examines the origin, the modalities and the degree of success of debt resolution processes used in a number of countries where the bad debt problem has reached such magnitudes that government intervention in one form or another was warranted. Some lessons of these experiences are summarized at the end of the chapter, to the extent that they may provide guidance on the design of a successful debt resolution process in Slovakia.

The chapter discusses both the origin and handling of bad debt problems and its impact, to the extent this is discussed in the literature, in the CEEC countries and other countries in Europe (Austria and Spain), Asia (Malaysia) and Latin America (Chile). However, it should be noted that the literature contains little information regarding the specific macroeconomic impact of the debt resolution processes adopted.

In general, the specific debt resolution process may have been chosen for a number of reasons, of which (income) distributional and social impact may have had as much or more weight than macroeconomic considerations. The experience of each of the countries is discussed in this section, and the lessons learned are the background to the recommendations for the resolution of the bad debt problem in Slovakia.

The discussion in this chapter covers 1) causes of the bad debt problem; 2) the modalities of the debt resolution process adopted to deal with the problem in various countries; 3) the distributional, social and macroeconomic consequences of the debt resolution process (to the extent this is known); 4) an assessment of the degree of success of the debt resolution processes adopted; and 5) a summary of the lessons learned from these debt crises and their resolution, which should be applied to Slovakia.

II. THE CAUSES OF THE BAD DEBT PROBLEM.

Banks have had to deal with bad debts and consequent losses as long as banking has existed. Normally, in a well functioning banking system in a market economy, banks will absorb these losses. To deal with losses arising from such debts, they are supposed to provision for bad loans, and to have a certain level of reserves and capital. When they fail to provision sufficiently, and lack sufficient reserves and capital to absorb the losses, they can

still go on operating until the resulting insolvency is transformed into illiquidity.[8]

Analysis of the bad debt problem in a number of countries at different times and under different economic systems and conditions point to a few factors which are generally associated with the appearance of large scale bad debt problems and need for state intervention. Dramatic changes in the macroeconomic environment, through external shocks, sometimes aggravated by domestic policy decisions, have played important roles in the accumulation of bad debt. Another common factor which has contributed to bad debt accumulation has been a change in the degree of restrictiveness of the economic and/or banking system which has led to a change in the functions or practices of the banking system.

Unsound banking practices have been made possible, because of banking regulations and supervision which were inadequate to deal with the new situation and because of accounting standards which made it possible to hide problems. At the same time, they often reflect inexperience of the commercial bank management and staff. A third important common feature of the case studies is the tendency for the banks with an already significant bad loan portfolio to support in particular large troubled customers by rolling over debt and extend new credits in the hope that these will enable the customers to recover and repay the accumulated debts.

Finally, in the cases examined, banks have generally not been forced to provision adequately, and have continued to declare profits and pay dividends, even when de facto losses were made. This may have been permitted by the economic and regulatory systems and facilitated by the accounting system used. However, sometimes it also involved fraudulent behavior and misinformation. As a result, bad debts have accumulated to the point that state intervention has been necessary to resolve the bad debt problem.

A. AUSTRIA

The collapse of the Austrian Credit Anstalt (CA) was caused by a combination of hyperinflation in the early 1920s (which eroded the capital base of the bank), and the deep depression of the late 1920s, which caused both an unhealthy strengthening of ties to industry (with the conversion of nonperforming loans to equity) and a compounding of the bad debt problem, as collapsing banks during the 1920s were merged (under political pressure) with perceived sound, larger banks.

---

[8] Where regulations do not direct otherwise.

The fact that the CA could carry on for several years with severe losses, which eventually resulted in a magnification of the crisis, reflected the rudimentary bank accounting and auditing and lack of banking supervision, which at the time may have been considered consistent with the "laissez faire" approach adopted. Because of this, the CA declared profits and paid dividends every year until its failure, and the extent of the losses was neither known to the government or the Central Bank, nor to the external auditors until months after the initial announcement. In fact, they turned out to be about 7 times larger than stated in the initial announcement.[9]

B. CHILE

Much more recently, the origin of the Chilean debt crisis 1981-83 reflects some of the same features as the much earlier Austrian one. In summary, the crisis reflected a dramatic change in the macroeconomic environment and economic liberalization without adequate bank regulation and supervision, with the result that the banks (inexperienced in operating in a liberalized environment) adopted loose lending practices, including large loan concentration in affiliated companies.

The crisis was preceded by a period of deregulation and liberalization of both monetary policy instruments and the economic system in general, real GDP grew strongly, and the banking system experienced a period of rapid growth and improved efficiency. This expansionary period came to an end when Chile faced acute macroeconomic problems in 1981 and a depression began, due to the loss of competitiveness. The resulting bank crisis, with intervened and/or liquidated banks covering 60 percent of the total loan portfolio of the banking system, reflected the lack of financial sector regulation; the inexperience of the bankers in operating in a deregulated environment; and the strong ties between industrial enterprises and banks (including from bank privatization in 1974, in which businessmen bought banks and then had to get credit from the banks for the purchase), which resulted in too large loan concentration to affiliated businesses.[10]

C. SPAIN

The banking crisis in **Spain** (1978-84) also occurred after a long period of economic prosperity, during which the former

---

[9] Schubert, p.97-98

[10] Larrain p.1-10

strict regulation of the financial system was relaxed without the establishment of an adequate bank supervision system or prudential regulatory guidelines. When the economic conditions deteriorated, the generally well managed banks weathered the recession. The crisis affected those banks who 1) were closely tied to business groups to which they had made unwise loans, ignoring sound basic banking practices; 2) had concentrated their risks in other banks; and 3) took highly speculative risks, notably in real estate development. The three factors were present in all banks that experienced difficulties.[11]

D. MALAYSIA

The **Malaysian** banking system and (legal and illegal) nonbank deposittaking financial institutions expanded strongly along with real GDP during the 1970s, supported by prudent fiscal policies. When world recession in 1980 threatened to interrupt this performance, the government took countercyclical measures, which however, proved to be unsustainable and forced a structural adjustment program from 1983. The position was aggravated by the fall in commodity prices world-wide in 1985.

As many entrepreneurs were caught in a triple squeeze of declining income flows, collapse in asset values and a rise in debt servicing (due to exchange rate depreciation), they became unable to service their loans. The first deposit taking institution failed already in September of 1985, as the slowdown of the economy took hold and as depositors became increasingly nervous. A series of runs and failures of financial institutions followed, making further failures increasingly probable.

In general, it appears that the crisis was caused by the economic recession, but was precipitated and magnified by the collapse of the (illegal) nonbank deposit taking institutions (DTIs) and the near collapse of the deposit taking cooperatives (DTCs), which were subject to weak regulations and supervision. However, the crisis spread to the banks, with 4 of the banks identified as having been mismanaged. Nonbank financial intermediaries had much higher incidence of fraud and mismanagement, including breaches of existing rules and regulations. In his analysis of this crisis, Sheng identifies the "lack of trust-worthy and prudent management, together with undercapitalization and weak supervision (as) a formula for disaster."[12]

---

[11] de Juan, p. 113-117

[12] Sheng, 1989, p.1-14

Among the nonbank financial intermediaries, the DTCs and the illegal DTIs constituted the weakest link. The DTCs were subject to very weak supervision (not from the Central Bank) while DTIs had none, and the financial distress in fact became evident first in one of the illegal institutions. Between 1985 and 1987, 33 illegal DTIs failed, and nervousness spread to depositors in other institutions, eventually resulting in a crisis in the DTCs leading to the government intervention.

E. CENTRAL AND EASTERN EUROPEAN COUNTRIES (CEEC)

By contrast, in the CEEC countries, the original bad loan portfolio of commercial banks were inherited from the previous command economy in which the monobank allocated resources as decided in the centrally planned system. These initial debts were taken over at the transformation to the two-tier system (except in Germany) without corresponding capital and reserves. Thus, from the beginning, the commercial banks in the CEEC had a weak financial position, characterized by a loan portfolio which had not been decided on commercial banking criteria, including interest and repayment terms; and a weak reserve and capital position.

However, most of the bad loans accumulated after the establishment of the two tier banking systems. This reflected a combination of many factors, including

1) the economic downturn (and the collapse of the traditional COMECON markets);

2) weak bank supervision capabilities and regulations;

3) the inexperience of commercial bank management, particularly in risk assessment;

4) the banks' interlocked position with bad debtors;

5) the change to commercial lending terms, which the original debtors could not meet; and

6) a political decision to avoid large scale bankruptcies and unemployment.

It appears that despite the difference in economic situation, the origins of the bad debt crisis in the CEEC countries, including Slovakia, are in many respects similar to those in the non CEEC countries, as analyzed above. At least the first 4 factors above have been identified in the preceding analysis as common in the origin of bad debt and bank crises.

However, a number of factors special to or more pronounced in the CEEC countries may account for the depth and intractability of the bad debt problem in these countries and should be taken into account in the design of the debt resolution process to ensure a successful outcome. These are summarized below.

First, most of the bad debt problem was/is concentrated in the large banks, which were originally state owned, and of which many still have significant government ownership. This may have contributed to (and still may contribute to) less than commercially sound credit and roll-over decisions, to accommodate the social objectives of avoiding large scale bankruptcies.

Second, the original bank debtors (the state enterprises) were, and to a large extent still are, unfamiliar with business management in a competitive economy. They had not contracted bank credit on commercial principles, and the bank credit terms (including short maturity) after the liberalization did in fact most often not take into account the enterprise's ability to repay.

Third, the collapse of traditional markets in the CEEC was much more sudden than the deterioration which contributed to the bad debt crisis in Spain, Chile and Malaysia. This of course further intensified the debt service problems of the enterprises.

Fourth, commercial banking was a concept unfamiliar to the CEEC new commercial state banks, and the introduction of Western style legislation and regulations did not have an immediate impact on practices. Blommestein and Lange in their analysis of the experience of the CEEC with portfolio restructuring and privatization note that "Residues of the old mono-banking system remain deeply embedded in the banking system."[13] Not only was staff and management not prepared for commercial banking, but the management in place was often incompetent and the staff lacked motivation. This reflected the neglect of the banking system (and the service sector in general) under the socialist system, because it was considered unproductive.

Fifth, in virtually all the cases examined, the close relationship between the banks and their traditional customers has played a major role in the aggravation of the debt problem. This appears to be a much more widespread phenomenon than in the individual country cases studied above. Banks have

---

[13] Blommestein and Lange, p.17

become increasingly locked into the industries as bad debts have accumulated. In the case of the former CSFR and Slovakia this relationship has intensified as banks have also become major owners of enterprises, through their ownership of privatization investment companies.

Sixth, in the CEEC countries, following 1989 the perceived need to reorient, upgrade and modernize outdated enterprises intensified the bad debt problem to a degree not seen in the other country cases. Many of the investments and bank loans granted for this purpose were ill conceived, both because of the lack of experienced commercial enterprise management, and because the banks were ill equipped, and possibly did not understand the need, to grant credit based on an assessment of the proposed investments and the expected capacity of the borrowers to service the debt.

In Slovakia it was recognized early that the inherited loan portfolio of "special credits" of the commercial banks - which constituted a large share of their portfolio, had no fixed maturity and low interest rate - could lead to potential problems for the banks.[14] An initial attempt to establish maturities (relatively short term) and higher interest rates for these loans, rather than resolving the problem led to an increase in the debt service obligation of the enterprises and a further aggravation of the bad debt problem, instead of resolving it.

III. MODALITIES OF THE DEBT RESOLUTION PROCESS.

Discussion of the appropriate debt resolution process focuses on its time path and exact nature, including the extent of government intervention, as well as specific financial and other incentives. Should the rehabilitation be a gradual and piecemeal one, in which the concerned banks and enterprises negotiate a solution independently? Or should it be a relatively faster and structured, centralized or decentralized program?[15] And to what extent should it encompass or be supported by operational restructuring of the banks and enterprises concerned?

---

[14] These were the loans to enterprises inherited from the monobank system.

[15] A proposed debt resolution process is detailed in Haswell, 1994. This proposal involves both some government involvement and financial incentives to restructuring and/or liquidation of enterprises, and rescheduling and partial write-off of debt.

In developing concrete modalities, an important consideration has been the need to guard against overinflated claims of bad debt to be bailed out, as well as against a continuation of the practices and expectations, which in the first place led to the bad debt problem. Additionally, as noted above, the specific debt resolution process adopted may have been chosen to accomplish a number of objectives, of which the income distributional and social impact may be as important as macroeconomic objectives. Therefore, the basic bad debt stock resolution measures (incentives for banks to provision and write off losses, bailouts and privatization) have often been supplemented by other measures as indicated below. Furthermore, the mechanisms to deal with the bad debt have often changed during the resolution process, reflecting changing perceptions of the extent of the problem and experience gained in the early stages.

A. AUSTRIA

The case of CA is a case where the government attempted to pursue a comprehensive plan without knowledge of even the approximate magnitude of the losses involved. As a result, the strategy had to change during the reconstruction phase, and became very costly.

The initial reconstruction plan for the CA was based on new capital infusion and covering of losses, with the major share of financial support provided from the Austrian Government. The plan was that shareholders would loose much less money than indicated by the initial loss report. However, there were persistent rumors that the losses were much larger than initially estimated, so that deposit withdrawals continued and led to a liquidity crisis. The replacement of the management of the CA took months, which led to further lack of confidence. To support the CA, the Austrian National Bank supplied the necessary liquidity, and the Government guaranteed the liabilities of the CA. In turn, this provoked a capital outflow from Austria, given the expectation that the true size of the losses (yet to be disclosed) basically underwritten by the government, would have a serious impact on the government's financial position and weaken the overall economy.

Eventually, the Government settled the domestic claims on CA with a transfer to the ANB, the size of which caused the debt of the government to rise by one third. This was a major step in cleaning the balance sheet of the CA. Settlement with the foreign creditors was reached later, with the foreign creditors giving up some claims, receiving shares in the reconstructed CA, and the government promising to pay annuities for some claims. In sum, the government took responsibility for 70 percent of the losses, in return for 51

percent of the shares in the reconstructed bank. The initial shareholders lost their investment.

B. CHILE

The case of Chile is a relatively early example of a debt resolution process which grew in complexity as the banking crisis wore on and its magnitude was increasingly understood.[16] After initially adopting some measures which only postponed the crisis, the Central Bank intervened much more aggressively than in a number of other countries.

Handling of the crisis involved 1) initially (in 1981-82) intervention and liquidation of 11 financial institutions; 2) in January 1983, intervention and liquidation of three more large banks and rehabilitation of 5 banks (two of which the largest private banks) based on the assumption that the cost of rehabilitation would be outweighed by the macroeconomic benefits. These five banks were not only affected by the macroeconomic situation, but had also heavily concentrated their loan portfolios in affiliated companies.

At the initial liquidations depositors were compensated. Government and shareholders took the losses. Shareholders lost their equity, the government the rest. In the case of the three financial institutions that were liquidated, the Government offered to purchase the credits of both domestic and foreign creditors at 75 percent of their face value. Foreign creditors exerted pressure to get full compensation. In the end, these foreign liabilities were guaranteed by the Government within the overall restructuring of the external debt. Domestic depositors accepted the 75 percent offer, and thus shared the loss with shareholders and government.

---

[16] Based on the 1986 numbers, the magnitude of the risky loan portfolio in Chile (35.6 percent of total loans) appears to be close to that of the Slovakian banking system. However, it should be noted that the Chilean data were derived during the process of debt resolution, while the Slovakian estimates have been made prior to the resolution efforts. As noted, there is a tendency to understate the magnitude of problem loans prior to the debt resolution process.

Four main mechanisms were used to rehabilitate the banks:[17]

1) debt relief schemes for borrowers, including preferential exchange rates for repaying their dollar-denominated debts, across-the board reschedulings and de-dollarization of certain debts; the Central Bank paid the difference between the original debt service and that obtained under the debt relief schemes;

2) purchase of risky loans by the Central Bank with a repurchase obligation on the part of banks' shareholders;

3) recapitalization and subsequent sale of intervened banks to small investors; and

4) streamlined supervision and prudential regulation and explicit deposit guarantee for confidence reasons.

Thus, the government absorbed an important part of the losses through cost sharing by shareholders, and to a very limited extent by depositors. The resolution of the crisis was handled by a combination of direct purchase of risky loans from the banks, debt relief schemes for borrowers and recapitalization. A major share of the cost was paid by the Government (Central Bank), but shareholders and depositors also took losses. Finally, the resolution of the crisis involved aggressive intervention in bank management, liquidation, privatization and reforms in supervision and prudential regulations to preclude repetitions.

The alternative of allowing two thirds of the system to go bankrupt was discarded because of the time it would have taken to restore confidence and rebuild the system so it would support the adjustment that was taking place in the real sector of the economy. A complete bailout was also discarded because the cost of the crisis would have been totally absorbed by the government, and market discipline would have been abandoned.[18]

C. SPAIN

When the banking crisis erupted in late 1977, Spain did not have the legal mechanisms to rehabilitate banks. Neither did it have good supervision or adequate prudential regulations. When the first banks began to experience difficulties, there was really very little that could be done, short of

---

[17] More detail of these mechanisms is provided in Annex 1.

[18] See Larrain, 1989

improvising ad hoc solutions, while at the same time introducing new and more permanent measures.

To avoid a collapse of the banking system, some measures were adopted at the beginning of the crisis in 1977 to deal with the initial banks experiencing difficulties. Specifically, it was decided to establish a protection scheme for small depositors. However, the Guarantee Fund for Bank Deposits (the Fund), which became the basic instrument for coping with the banking crisis, was not established in its present form until 1980.

The early stage: In 1978 the Bank of Spain decided that it should not continue to discount portfolios of Banks who appeared to have insolvency problems. To administer the problem banks (i.e. those with chronic liquidity problems), it established a private management company "Corporacion Bancaria" owned 50:50 with the private banks and required that its liquidity facility be made available only to those banks who had sold a controlling interest to the "Corporacion" so that the latter could take over its management. This became known as the "bank hospital." This approach solved the liquidity problems, but did not resolve the fundamental underlying problem of restoring the capital base of the banks.

Establishment of the Guarantee Fund: In 1980, almost three years after the crisis began, the Deposit Guarantee Fund for banking institutions was established. It is legally able to assume bank ownership, has the financial resources to reconstruct the capital of problem banks and combines the management function of the Corporacion with the deposit guarantee function. Similar funds were set up for savings banks and credit unions by 1982. Since 1980, the rehabilitation of the Spanish banking system was accomplished through the mechanisms set up by these funds.

The typical rehabilitation process involves

1) identification of significant shortage of capital in a bank;

2) acquisition of legal ownership by the Deposit Guarantee Fund;[19]

---

[19] The Fund acquires legal ownership, either by purchasing a controlling interest at a symbolic price, or subscription to a capital increase. To ensure that either will take place, the Fund informs the bank that if its shareholders cannot reconstitute its capital, the bank's membership in the Fund will be canceled with due publicity. Furthermore, the Bank of Spain can condition its role as lender of last resort on the outcome of

3) the "accordion operation" involving a simultaneous reduction and increase in capital to write off potential bank losses and to penalize previous shareholders by diluting or virtually writing off their participation in the ownership. This becomes a cost sharing triangle between the central government, the banking system and the shareholders. .

4) Appointment of new management to keep the bank running, verify its accounts, restructure and sell the majority interest owned by the Fund. In particular it must determine the bank's true financial situation, which almost always proves to be more serious than had first been perceived. Next, it must help design the financial assistance package to be provided by the Fund, which mainly consists of the purchase of assets and long-term loans to restore the bank's solvency and profitability. This package is the basis on which the bank is ultimately offered for sale. After 1 year, the Fund must put its shares up for sale. After the sale, the Fund provides the financial assistance, usually the purchase of non-productive and/or doubtful assets at book value.

5. Liquidation of assets and temporary management of these until liquidation.

D. MALAYSIA

The response of the Government of Malaysia, through the Central Bank, to the crisis in Malaysia can be divided into two major areas: regulatory measures and rescue packages.

a. Regulatory measures.

In 1985/86 the Central Bank put into place a number of regulatory measures, designed to assess the impact on the banking system of the recession, and to strengthen the structure of the banking system and its own regulatory powers to prevent and control damage arising from the recession. These included

1) a minimum capital adequacy requirement;

2) dispersion of ownership in financial institutions;

---

either of the decisions.

3) introduction of penalties to prevent abuse of authority in the lending process;

4) restrictions on lending, to avoid loan concentration and to prevent conflict of interest and abuses;

5) Improved accounting, reporting, examination and auditing procedures.

b. Rescue Packages.

In the light of the budgetary constraints, it was decided that the Central Bank should shoulder the brunt of the burden of the investigation, diagnosis of the problems, evaluation and execution of the rescue plans, as well as their funding.

The Central Bank rescue packages were based on the premise that while liquidity needs of ailing financial institutions could always be met, two elements were vital to rehabilitate the banks, i.e. capital and management. On the one hand, capital without good management would not prevent losses and on the other, without adequate capital, a turnaround of the institutions was not considered possible, even with the best management. With regard to capital, it was considered that financial institutions should have enough funds to generate income to service their overheads and deposit liabilities.

In the rescue packages for banks, the Central Bank

1) required the immediate recognition by the institutions of all losses and interest in suspense, rather than attempting to defer the problems;

2) changed the management and appointed tested professionals;

3) required existing shareholders to inject as much capital as possible and supplement capital as required to meet the minimum CAR through the Central Bank; and

4) tightened reporting requirements of the affected institutions in "intensive care."

Change of management was considered vital in any rescue plan. The Central Bank intervened the 4 hardest hit banks, changed the management and made arrangements to inject fresh capital into the banks including direct Central Bank capital into 3 of them. The finance companies were also hard hit, but many had a strong capital base, so that they were able to inject new capital to cover their losses. However, the Central Bank

assumed control of 4 finance companies, which could not cover their losses.

The DTCs represented a more complicated problem, given the lack of Central Bank authority over these intermediaries. As the crisis intensified, the Government directed the Central Bank to suspend and investigate 23 of the 35 DTCs. The Central Bank powers were also strengthened by legislative action which enabled it to combat illegal deposit taking activities and gave it wide authority over any deposit taker.[20]

In the rescue packages for the 24 DTCs, the government decided as a matter of principle that the public should not be responsible for the large losses arising from the bad management of the cooperatives. Thus, depositors would be able to receive the amount of their deposits in proportion to the net asset backing of their respective DTC.

The final rescue package was carried out in three stages. First, 11 of the least hit DTCs received soft loans from the central bank; agreement was reached for these DTCs with banks and finance companies to take over their assets and liabilities with full payment in cash to be made to all depositors over periods of up to five years without interest.

Second, all assets and liabilities of the 12 DTCs with moderate to heavy losses were absorbed in a financial institution, which the Central Bank was permitted to acquire and utilize as a rescue vehicle for the depositors. These in turn were assured a dollar for dollar return by 1989, but with 50 percent only in cash, the rest converted into equity.

Third, the assets and liabilities of the largest of the DTCs was taken over by a public listed company. Again, depositors would be repaid in full on a 50:50 basis, but with the 50 percent repaid initially in the form of irredeemable convertible unsecured loans stocks, noninterestbearing for the first two years.

With the subsequent recovery, the Central Bank made a radical switch in approach to the problem of non-performing loans in 1988. when the focus was switched to the enterprise level. The Central Bank established a M$ 500 million Enterprise Rehabilitation Fund in 1988. The fund would provide seed capital for recession-hit indigenous enterprises which have been found fundamentally viable. The projects would be co-financed with existing lenders. Specialist Turnaround Groups, comprising leading professionals in the fields of manufacturing, trading, agriculture and property, would

---

[20] Subject to the advice of an Advisory Panel.

evaluate the viability of eligible enterprises for recommendation for assistance under the Fund.

E. CEEC COUNTRIES

1. CFSR. The debt resolution process carried out by the CSFR in 1991-92 involved takeover of a large part of the bad debt (and corresponding liabilities); provision of resources from the government to the involved banks to permit them to write off bad loans and improve their capital asset ratio; and privatization of 5 major banks in the voucher privatization in 1992. The modalities of the Czechoslovakian debt resolution process are summarized below.

In June 1991, the Consolidation Bank, established by the government for this purpose, took over 2/3 of the "special credits" originally inherited from the monobank (CSK 110 million) along with the liabilities to cover the credits. The Consolidation Bank provided better loan conditions to the enterprises. At the same time, the transfer of problem assets reduced bank assets, improved their composition and the capital asset ratio, and reduced their dependency on deposits from the savings bank.

Simultaneously with the creation of the Consolidation Bank, CSK 50 billion of state bonds were distributed to the banks free of charge from the privatization fund. Of this CSK 12 billion was earmarked for strengthening capital, and the remainder to write off bad debts.

Despite indications that there would be no further "bailout" in January 1994, the Czech and Slovak governments recapitalized the jointly owned foreign owned trade bank (CSOB) and transferred CSK 40 billion of bad and doubtful loans to two new recovery units to be funded and managed by CSOB. At the same time CSOB wrote down some of its loans.

2. Poland. In Poland it became clear by mid-1991 that seven of the nine state owned banks were in trouble. It was decided to adopt a decentralized and market oriented approach to strengthen the banks prior to privatization. This involved 1) recapitalization of banks to such a level that they would be able to create adequate provision for the bad loans and 2) mechanisms to encourage and ultimately force the banks to undertake specific actions.

In particular, in return for the restructuring bonds, each recapitalized bank agreed that within a short time period it would either restructure or liquidate all its borrowers with bad debts, or face a possible take over by the central bank. Each bank was instructed to create its own "work-out"

department (responsible for management of the bad debt), and a new legal framework provided for streamlined out-of court creditors' agreement on the financial restructuring of enterprises.

A subsidiary government intervention mechanism was designed to permit the government to support the restructuring or cushion the liquidation of enterprises which were regarded by the government as important from the socio-political perspective, and which were unable to reach conciliation agreements with their creditors. The financing for this was provided by the World Bank's EFSAL loan.

According to the Law on financial Restructuring of Enterprises and Banks (approved March 1993), restructuring requires the bank's acceptance of an enterprise-devised coherent business plan. A bank's restructuring proposal must be accepted by all creditors whenever it is approved by creditors holding at least 50 percent of the firm's debts.

Furthermore, claimants holding at least 30 percent of a state enterprise's debt would have the right to exchange their debt for equity, with a bank's maximum equity position set at 25 percent.

3. Hungary. The Hungarian approach to debt resolution is characterized by its evolving nature. The solution adopted at each of the stages listed below proved in retrospect to be insufficient and led to further and costlier involvement. This may in part be due to underestimation of the magnitude of the problem, but may also reflect the fact that the scheme did not include any replacement of bank management or an improved business plan.

The first stage, January 1987-December 1991. The original approach was to not allocate funds from either the state budget or privatization receipts to solve the bad debt problem. Instead, the most affected three largest commercial banks were allowed to retain a large percentage of their high profits to build reserves. However, this was not sufficient to cover the bad debts, which in fact rose relative to assets.

Second stage, mid 1991. The government established a guarantee to cover about half of the bad debt that the three largest commercial banks inherited before 1987. In addition, the high profit retention policy was continued and banks were told to pursue a restrained investment policy.

Third stage, December 1992. A government recovery agency was established in December 1992, which exchanged government consolidation bonds for bad assets from banks in 1992 and 1993. The assets were transferred to the Hungarian Investment

and Development Bank which was to work them out. However, the bank lacked the capabilities and asked the individual banks to continue managing this portfolio under contract. As a result, the net effect was the removal of the assets from the banks books, but no relief to the companies.

Fourth stage, December 1993-June 1994. As the bad debt problem intensified and spread to many other banks, eight Hungarian banks traded bad debt and equity in a government recapitalization scheme, about the size of the one carried out in the third stage.[21]

IV DISTRIBUTIONAL, SOCIAL AND MACROECONOMIC CONSEQUENCES OF THE DEBT RESOLUTION PROCESS.

In summary, all of the debt resolution schemes considered have involved heavy financial resource injection by the government (or central bank), even in countries where in the beginning this was not an option under consideration. Intervention has been generally considered when it was feared that the banking system or a considerable part might collapse, resulting in instability and lack of confidence (both external and domestic); when the weakness of the banking system has been such that it has been considered a severe, binding constraint to the development of the economy; and when it appeared that the banks might not be able to resolve the problem on their own, or could only resolve the problem at a slow pace, which imposes severe costs on the economy.

In some countries, the specific form of the debt resolution mechanism was clearly designed to protect depositors (notably Chile and Spain), and/or to punish shareholders (Austria, Malaysia and to some extent Chile). Furthermore, there are clear distributional implications from the forms and magnitude of debt relief schemes for the debtors (Chile represents an outstanding example).

These distributional consequences, including the impact on taxpayers of funding any additional government expenditure for debt relief or bad debt resolution, should however be weighed against the consequences for both the level and the distribution of income of a collapse of the banking system, or a system hampered by the bad debt overhang.

---

[21] In part the increase may be due to the new Bankruptcy Law and the new Banking Law. The former made initiation of Bankruptcy procedures obligatory when debt became more than 90 days overdue. The latter established strict loan classification and risk reserve policies and a minimum risk weighted capital adequacy ratio.

Other significant social consequences relate to the impact of debt resolution on unemployment. Because bad debt problems often appear in an economic downturn, it is particularly difficult to make decisions which further impact adversely on unemployment. In most of the cases examined outside of the CEEC, the objective has been overwhelmingly on restoring confidence and stability to the system, and it appears that much less attention has been paid to the specific employment effects of bad debt resolution. Possibly because the employment effect of doing nothing would also be considerable. In these countries the bad debt problem was also not caused by an economic system which relied on major noneconomic enterprise activity, to be indirectly subsidized by the banks.

By contrast, in the CEEC, the employment considerations have been much more important, both in contributing to generate the bad debt problem, and in the consideration of specific debt resolution mechanisms. This is in part because of the tradition in the CEEC of enterprises producing on noncommercial terms, and the continued overemployment in enterprises, which are not producing in a cost effective manner. Any successful bad debt resolution in Slovakia will need to break the practice of providing indirect subsidies to these enterprises through the banking system. Given the present economic structure, the employment impact of a decision to enforce the hard budget constraint on the enterprises will be major, at least in the short term (such as has been seen in Hungary). However, this should be weighed against the long run cost of uneconomic production, a failing banking system and a dwindling of domestic and external confidence.

To the extent that debt resolution involves a softening of terms for debtors which permits continuation of enterprise activities, the unemployment impact of bad debt resolution is softened. This may permit the continuation of activities which are viable, once the debt has been restructured. However, it may also permit the continuation of activities which are nonviable. In the latter case, the probability is that bad debts will continue to accumulate and the bad debt situation can recur.[22] The reluctance (of the government and the banks) to impose the hard budget constraint on the enterprises in Slovakia appears to be the reason for the reemergence of the bad debt problem.

In the end, all of the interventions to resolve bad debt portfolios have taken place in order to ensure continuity, stability and external confidence in the economic system, and with the intention of creating banking systems supportive of market oriented activities and strong growth.

---

[22] Unless such activities are explicitly continued for their social consequences, and are supported by a straight budget subsidy, rather than implicitly through bank credit.

It is difficult, and in many cases (as for the CEEC countries) still early to evaluate the macroeconomic result of the debt resolution processes. However, in the cases of Chile, Malaysia and Spain, it appears that a much stronger banking system has emerged, supporting high growth for a number of years after the crises in a relatively stable environment. With regard to the early CSFR attempt at debt resolution, it appears, however, from the present problems of the banking sector in the Slovak Republic, that this fell short of resolving the bad debt problems, and thus did not lay the foundations for a banking system capable of supporting strong economic growth.

V. THE SUCCESS OF THE DEBT RESOLUTION PROCESS.

So far, the assessment of the debt resolution in Chile, Malaysia and Spain are that they have all been successful. This assessment is based on the rehabilitation of the banking system which occurred in connection with the debt resolution process, the apparent continued soundness of the system, and the return to stability and rapid economic growth which followed the process. Although the bad debt resolution was costly for the governments (central banks) involved, it appears that the results were worth the cost measured in terms of the impact on GDP growth, price stability and efficiency of the financial system.

With regard to the Austrian case, although in the end it was successful in rehabilitating the CA, it was very costly to the Austrian economy and in retrospect one wonders whether alternative debt resolution mechanisms would have been chosen, had the magnitude of CA losses been clear from the beginning.

While the Austrian case appears to have been exceptional, solely because of its magnitude and its macroeconomic impact, the Chilean, Malaysian and Spanish bad debt resolution processes suffered from a similar initial lack of information regarding the extent of the problem, and from consequent shifts in strategy during the debt resolution period. In addition, the Spanish debt resolution process initially was hampered by the lack of legal powers and institutions to deal with the debt problem.

With respect to the bad debt resolution in the CEEC, while the balance sheets of the banks were partly cleaned up in the cases analyzed, the debt resolution process did not provide any guarantee that the scheme will not have to be repeated. At least in Slovakia, the practices which led to the bad debt problem in the first place have not been changed. Therefore, the debt resolution process can be said to have been less than successful even though the debt resolution process did address the stock problem of bad loans.

VI. LESSONS LEARNED.

The case studies above provide a number of general conclusions regarding the timing and modalities of successful/unsuccessful bad debt resolution processes, which could usefully be kept in mind in the design of other debt resolution schemes.

1. The first priority is to get an accurate picture of the extent of the problem, as the basis for determining the action to be taken.

   In this regard there is general agreement that problems in ailing financial institutions generally have been much worse than they appear at first sight. To get a correct picture of the state of affairs as a basis for deciding on a strategy, very stringent and comprehensive accounting and auditing rules are essential.

2. Prompt and decisive action to address all problem areas with a comprehensive and consistent strategy is essential to stabilize confidence and to reduce the cost of debt resolution schemes.

   Failure to admit the size of the problems or delays in the resolution of these issues almost always compound the problems and the costs involved.

   Both in Chile and Malaysia the authorities were credited for moving fast and decisively, although the action was based on less than full information regarding the magnitude of the problem, and consequently was changed as the crises evolved. On the other hand, in Austria, the Government also moved fast, but because it was ill-informed, its actions only led to a further confidence crisis. Postponing the final solution of the underlying weakness and concentrating the risks in fewer and fewer institutions was a bad and costly approach.

3. There are three basic ingredients in successful debt resolution:

   1. provision of adequate capital;
   2. change in management responsible for the problems and replacement with competent and tested professionals;
   3. adoption of adequate accounting standards, including loan classification and loss provisioning rules, and strengthening of bank supervision.

   These three basic ingredients were all explicit parts of the three most successful restructuring processes. Once

adequate capital had been provided, management would need to change to ensure a discontinuation of past practices. In the absence of adequate capital, it was considered extremely difficult in all three cases for a bank to rehabilitate itself, and in Hungary, where it was tried, it was not successful.

There are also strong arguments against letting the banks rehabilitate themselves. First this would require letting good debtors pay for bad debtors, which would result in an undesirable distortion in resource allocation and reduction in investment and growth. Second, the need to restore capital might encourage banks to undertake further risky (i.e. high interest) ventures which could further weaken the affected banks. Third, under the best of circumstances, to let the banks work up to an adequate capital basis and a clean balance sheet would take years, during which the confidence of the public and the efficiency of the banking system would both be less than desirable. As a consequence, a rapid cleaning of the books of the banking sector is crucial.

The importance of additional equity capital has proved to be vital in any rescue package. Nonperforming loans can only be supported by non-interest bearing capital. Lending high interest loans to tide over liquidity problems for an insolvent institution is pouring good money after bad. Without adequate capital and setting the gearing into the right levels, the strongest of management would have difficulty in turning around ailing institutions. This was clear in Malaysia from the beginning and a central focus of the debt resolution process, whereas in Hungary the authorities originally thought that permitting higher profit retention for weak banks would eventually resolve the problem. The Hungarian approach proved unsuccessful.

4. In identifying problem banks in Spain it was noted that persistent liquidity problems are signs of insolvency, which should be dealt with as soon as possible.

5. When taking over bank management for rehabilitation, the shorter the period for emergency rehabilitation management, the better, and in any case less than one year. Otherwise the bank gets a "problem image" and it becomes difficult to restore public confidence.

6. If the goal is to have a system which gives early warning signals and recognizes insolvency problems promptly, bank supervision must give absolute priority to analyzing asset quality rather than focus on formal regulation compliance.

7. An implicit or explicit insurance for the banks and their depositors has to be avoided as long as there is not adequate supervision. This is in particular true in the CEEC countries, which have a tradition of state support, and where therefore deposit insurance schemes may create significant moral hazard.

8. It is extremely important to avoid a vicious circle of mutual dependence between industry and banking.

   Such a cycle appears to have been part of the bad debt problem in all the case studies. It developed in Austria as non-performing loans were converted into equity holdings, and industrial shares were being bought up by the banks in order to support their market values.

   In Chile, such a relationship also developed as the banks lent to industrial enterprises, which held equity in the banks, financed by the banks themselves. Furthermore, the loan concentration to associated enterprises was very high. In Spain and Malaysia the hardest hit institutions were also those with a close relationship to industry and concentration of loans to associated enterprises.

9. The banks' balance sheet should be cleared as soon as possible. Thereafter, it is important to ensure the technical competence for the work out departments or a centralized organization.

   In the case of Chile the balance sheets of the banks were cleared, and then the bad loans were administered by the individual banks, which were provided with an incentive to accomplish a work-out. In Poland, the individual banks were forced to undertake active restructuring and adjust their organization to deal with the bad debt problem in return for restructuring bonds. Through this process they were expected to acquire valuable experience and new skill in credit risk assessment as well as register a painful experience of losses for the future. In the CSFR a central work out unit was established.

9. Because of the special problems of the CEEC countries it is of paramount importance that the debt resolution process encompasses changes not only in bank management but also in industry management.

   This is a major change in policy, which the banks can not be expected to implement, unless there is explicit political backing. By envisaging the active role of the banks, the Polish program contributed also to positive changes at the individual enterprise level i.e. the possibility of debt reduction and fear of the sale of

debt or bankruptcy forced some enterprises to undertake far reaching restructuring efforts.

The rehabilitation of banks in Slovakia requires that the bad assets are written off, that the banks are adequately recapitalized and that practices are instituted in both the management of industry and enterprises which will ensure a nonrecurrence of the bad debt problem. In view of the importance of an efficient financial system for the successful transformation and operation of a market economy, this process should be accomplished as soon as possible. Government involvement is inevitable and seems to be justified both because of the macroeconomic consequences of not resolving the debt problems at an early stage and because most of the bad debtors are, or were, state-owned enterprises. As indicated by the analysis above, the real cost of the reform effort will be increased and perpetuated by failure to mobilize fiscal resources to finance the cost of restructuring the banking sector in a timely manner

CHAPTER 3.

THE MACROECONOMIC IMPACT OF BAD DEBT RESOLUTION IN A FINANCIAL PROGRAMMING FRAMEWORK. [23]

I. INTRODUCTION.

The lessons of international experience support the argument for an early and comprehensive solution to the bad debt problem in Slovakia, including in particular a cleaning up of the balance sheets of the affected commercial banks and provision of adequate capital to deal with the bad debt and still retain a strong capital position. It also points to the importance of measures to avoid a recurrence of the problem. This includes strengthening of the management and supervision of commercial banks as well as of the management of enterprises. In particular, international experience strongly suggests the need for a change in management.

Given the fact that there have been previous attempts at resolving the bad debt problem in Slovakia (in the CSFR), and given the socialist tradition of reliance on the state, it is even more important, and more difficult, than in other countries to establish a debt resolution mechanism which will clearly be seen as non-repeatable. At the same time, there is ample reason for state support to the debt resolution process, if one considers that the bad debts have been incurred for social reasons, and with tacit political approval, i.e. they are fiscal in nature.

The macroeconomic impact of a bad debt resolution scheme, in which the government cleans the balance sheets of commercial banks by buying the bad debt at a discount is illustrated in this chapter which uses a financial programming framework. As noted previously, the impact of the debt resolution scheme will vary, depending on the extent of supporting actions, i.e. improvements in the management of banks and enterprises and in the economy at large. A high and a low impact scenario is presented and compared to the status quo "basic scenario." The impact of the alternatives is obtained by comparison of the relevant medium term financial programming projections. All the projections are based on the most recent data on economic performance in 1994.

The illustrative nature of the projections should be emphasized, given the difficulties in quantifying the macroeconomic impact of many of the variables considered, including both economic and noneconomic. Additionally, as indicated in chapter 2 above,

---

[23] References in this Chapter to "program" and "programmed performance" are to the financial program for 1994 supported by the IMF.

experience shows that the true magnitude of the debt problem generally is not revealed until well into the debt resolution process. Thus, although considerable work has gone into the estimates of the magnitude of the bad debt problem in Slovakia, the estimates indicated below may well turn out to be quite conservative.

II. PERFORMANCE IN 1994 AND THE MAGNITUDE OF BAD DEBT IN SLOVAKIA.

A. ECONOMIC PERFORMANCE IN 1994.

After the sharp decline in real GDP through 1993, the economy appears to have performed much better than expected in 1994. It is estimated that GDP grew by about 4 percent in real terms, while inflation declined to 14 percent in 1994,[24] and the external current account turned from a deficit of Sk 12.6 billion (3.7 percent of GDP) in 1993 to a surplus of Sk. 2 billion (0.5 percent of GDP). In all of these areas the Slovak economy performed significantly better than programmed, except that the inflation target appears to have been just met. The somewhat slower than programmed net inflow of capital was more than offset by the better external current account, so that the net international reserves improved much faster than anticipated. The improvement on the external current account relative to target reflected continued containment of domestic demand, both from the government and the private sector, while there was a surge in exports. The government deficit, and its use of domestic credit, are estimated to have been well within the program targets.

Reflecting these developments, money and quasimoney is estimated to have grown faster than program projections. The higher growth of liabilities and a slow growth of domestic credit was reflected in the sharp improvement in the net international reserves.

It thus appears that Slovakia has registered an economic turnaround in 1994, notwithstanding the continued bad debt/enterprise overindebtedness problem. Analysis of the performance indicates that the sharp improvement on the external trade and current account in part reflected a recovery of exports, and in part a significant reduction in imports from the Czech Republic. These developments were explained as the combined result of three significant actions taken in early 1994: 1) the imposition of a 10 percent import surcharge on consumer goods for protective purposes; 2) the depreciation of the Slovak Koruna, and 3) the certification requirement for all importers (i.e. exporters

---

[24] As measured by the annual average increase in the consumer price index.

from other countries selling to Slovakia). The latter requirement hit in particular the Czech Republic.

Table I.

Macroeconomic indicators of Performance in 1994

	Programmed performance	Estimated outturn
	(In percent)	
GDP, real growth	0	4
Inflation, CPI, ann.aver.	14	14
	(In percent of GDP)	
Government deficit (-)	4	-2.4
External current account deficit(-)	- 2.6	3.7
Capital account surplus	6.9	6.2

Source: IMF Staff Report (July 1, 1994) and Table 1, attachment.

At the same time, there is no indication that the recovery has been supported by significant efforts at restructuring the enterprises who suffer from overindebtedness and continue to produce at a loss. Neither does the recovery appear to have been supported by credit expansion. In this regard it appears that the banks themselves, rather than the IMF program limits, provided the effective constraint to credit expansion, with credit expansion to the economy (i.e. excluding that to government) amounting to only about 1 percent (compared to the programmed 4.4 percent). With the significant amount of nonperforming debt being turned over, this supports the contention that bank credit is very difficult to obtain for new entrepreneurs, and suggests that the bad debt problems are an effective constraint on the economic recovery.

B. THE MAGNITUDE OF THE BAD DEBT PROBLEM.

The magnitude of the bad debt problem in Slovakia has been estimated in some detail recently in the context of the U.S. AID's proposal for establishment of a debt resolution process.[25] Although the quantitative estimates of problem loans are admittedly

[25] Haswell p.2-5 and Chapter 3.

tentative, they have been used as the basis for the financial programming exercise to illustrate the impact of the resolution of the bad debt crisis.

As of October 1994, problem loans of banks were estimated to be between SK 60 and Sk 65 billion (U.S.$ 1.9-2.1 billion) or about 1/3 of the loan portfolios of the banks. Losses to the banks were estimated to be between Sk 11 and Sk 26 billion. In addition, trade debts amount to about Sk 288 billion of which Sk 102 billion was past due.

III. BASIC MEDIUM TERM SCENARIO.

The basic medium term projections are summarized in Table 1, attached. Consistent with the financial programming approach, the table consists of 4 interrelated sectors, i.e.

1. the fiscal accounts, consisting of the accounts of the consolidated general government. For purposes of the medium term projections, only the targeted deficit and its financing are shown in table 1. Through its financing, the fiscal accounts are linked to the monetary as well as the external accounts (through bank credit to government in the monetary accounts and through government debt service and capital inflows to government in the external accounts;

2. the monetary accounts, showing the annual change in the consolidated summary balance sheet of the banking system at year end. These accounts are linked to the balance of payments through the change in net international reserves (which is defined to be identical to the overall balance in the external accounts); they are linked to inflation and real GDP through the change in money and quasimoney as well as through the change in credit to the rest of the economy;

3. the external accounts, which in the projections are aggregated to indicate the external current account balance, the net inflow on capital account and the overall balance. The linkages to the fiscal and monetary sectors are specified above. The external accounts are also linked to real growth, inflation and the exchange rate.

4. The real sector, which includes both real growth of GDP and inflation and the exchange rate. Its linkages have been specified above.

   The last part of each of the tables shows additional data developed as needed for the analysis.

The five key assumptions for the basic medium term projections are

1. that the government will gradually reduce its deficit (in line with the IMF's original medium term projections);

2. that the exchange rate will remain stable, implying that domestic inflation should not deviate significantly from inflation in Slovakia's main trading partners;

3. that the international reserve position of the National Bank of Slovakia as well as of the rest of the banking system will be substantially strengthened.

4. that the real growth momentum can not be maintained, given the overindebtedness of the enterprises and the bad loan problem of the banking system; and

5. that there is no concerted effort at resolving the bad debt/enterprise overindebtedness problem or restructuring effort, or implementation of other reforms to create an enabling environment for the private sector.

The basic scenario in Table 1 thus assumes a tapering off of real GDP growth from 1994 coupled with maintenance of single digit declining inflation (on a year end basis) as needed for maintenance of the nominal exchange rate (relative to the U.S. dollar). GDP growth is declining from 4 percent in 1994 to 3 percent in 1995 and 1996 and to 2 percent in the remainder of the projection period as profit opportunities are either dwindling; not found because of lack of transparency or distorted signals; or can not be pursued due to lack of funding. Inflation is targeted to decline from 12 percent in 1994 to single digit in 1995, tapering off to 3 percent by the end of the period. (Section IV in table 1).

The contribution of the government sector to this scenario is shown in the fiscal accounts (Section I) with the government deficit targeted to decline from 3 percent of GDP in 1995 to 1.8 percent of GDP in 1999, i.e. identical to the IMF's medium term projections.[26] As indicated below, in the discussion of the monetary accounts, the full bank financing of this deficit will create a problem of crowding out for the rest of the economy, as very little credit will be left, once the government deficit has been financed. This may be a reason to tighten the fiscal targets. However, for this exercise, it has been assumed that while most of

[26] IMF, July 1994, table 2.

the deficit will have to be domestically financed,[27] about 20-25 percent of it will be financed outside the banking sector.[28]

In the external accounts, assuming that annual net capital inflows are equal to approximately the 1993 inflow in the period 1995- 1999 (i.e. much lower than with structural reform and comprehensive debt resolution), achievement of the targets for international reserve accumulation, points to the need for maintenance of a significant current surplus in 1995, and a position of current account balance by 1996, with this position maintained for the remainder of the projection period. The reduction in the external current account surplus between 1994 and 1997 is consistent with the tapering off of real growth, a reduction in the impact of the certification requirement on imports originating in the Czech republic (as the certification is a one time requirement which is in progress), and an increase in import demand as domestic income recovers gradually. [29]

The monetary accounts supporting this scenario are shown in Section II of table 1. The banking system's cash holdings and deposits, money and quasimoney, are projected to rise at the rate of growth of nominal GDP; the change in the international reserves of the banking system is targeted as indicated in the external

---

[27] External financing to government, for example for onlending in the context of financial sector restructuring, is not included in the IMF's concept of government financing. Accordingly, it is not part of the targeted deficit in Section I of Table 1.

[28] The projection assumes that the NPF will not service the government's debt, in line with undertakings in the program for 1994. However at the end of 1994, the possibility of NPF servicing Sk 23 billion was under discussion in the context of the budget preparations for 1995. If NPF is to service significant debt for the government the basic projections will need to be modified accordingly, reflecting also the extent to which NPF will obtain financing from the banking system, draw down its own cash position, or finance the debt servicing from privatization proceeds.

[29] Lack of data regarding the relationship between imports and exports on the one hand and domestic production on the other hand precludes a more detailed programming of the external current account, which would have been desirable. The data problem relates partly to the lack of national accounts data for any significant period, and partly to the fact that the relationships can be expected to be rapidly changing, given the transformation of the economy. It is partly for this reason that the financial programming exercise is only illustrative.

accounts; and credit extension to the government is consistent with the fiscal projections.

Under the assumption that the commercial banks will gradually write off some of their losses, and will begin to report proper profits, the decline in their other assets (net) is projected to taper off over the projection period. With this assumption, given the international reserve targets and the growth of money and quasimoney, credit to the rest of the economy can only expand by 3.5 to 5.3 percent per year. This may be considered low to support the growth and inflation targets, but is above the estimated increase in 1994, in which higher growth and inflation rates were recorded. Furthermore, the rate of gross credit extension is really higher than indicated by these numbers. This is because to the extent that loan write off occurs, it reduces the level of outstanding credit. Thus, the value of such write offs should be added on to the net credit expansion numbers calculated from the change in credit stock outstanding at the end of each year.

If one concludes that the projected rate of credit expansion is insufficient to support the targeted growth and inflation rates, this indicates that the basic projection is inconsistent. Relaxation of the net international reserve target, for example, would give room for more credit expansion to the rest of the economy to support growth and inflation targets. This would not affect the fiscal accounts or other variables in the monetary and real sectors. However, it would affect the balance of payments projections. It would call for an adjustment in either the net capital inflows (downward) or in the current account (to record a reduced surplus or larger deficit), or perhaps a combination of both.

In the absence of a more definite data on the relationship between the national accounts and the external current account (particularly exports and imports), and given the uncertainties on capital inflows, it is indeed difficult to specify an exact relationship. However, given the assumption that there is no comprehensive debt resolution process or supporting action, it would be most appropriate to assume that the external current account would adjust, i.e. capital inflows would be projected conservatively.

An increase in projected or targeted inflation or real GDP would result in an increase in resources available for credit extension.[30] However, it is unlikely that banks would in fact

---

[30] Similarly, higher real growth and lower inflation would also be consistent with this credit extension. However, a higher real growth rate would be considered difficult to sustain unless significant progress is made on the debt and restructuring problems.

convert available resources into credit, as was the case in 1994. With no change in the economic environment or a comprehensive solution to their bad debt problems, banks can be expected to continue to be cautious. The requirement on banks to improve their capital adequacy ratio also appears to be working against rapid credit extension. Therefore, higher growth and inflation is ruled out in the assumptions of the basic scenario. On the one hand, this scenario assumes continuously very cautious banks, and on the other, it assumes an enterprise sector still overburdened with debt, and therefore on the whole not very credit worthy. Finally, it assumes an economy which gives no reason for confidence, to external or domestic entrepreneurs.

IV. ALTERNATIVE DEBT RESOLUTION METHOD AND ITS REFLECTION IN THE FINANCIAL PROGRAMMING FRAMEWORK.

The basic medium term scenario assumes that granting of incentives for a gradual write off of bad debt by the commercial banks is being pursued. However, it does not contain any comprehensive cleaning of commercial banks' balance sheets, nor a central mechanism to ensure that the bad loan situation will not recur, i.e. there is no dramatic change in the banks' and the enterprises' management, so that the budget constraint on the enterprises may not be enforced on the enterprises. This is why the enterprises still are not creditworthy and the banks hesitate to lend. Similarly, the broader changes in the system to promote private sector activity are either not being introduced, or only at a slow pace. As a result foreign investment drops after 1994, the current account balance deteriorates, and GDP growth tapers off.

The analysis in this chapter focuses on the likely macroeconomic scenarios associated with debt resolution, and ignores distributional consequences. Given this focus, the analysis of alternative debt resolution processes has been simplified. Essentially, it is assumed that the Government cleans the balance sheets of the banks by issuing interest bearing debt replacement bonds equivalent to 70 percent of the estimated bad debt. Fast cleanup of banks' balance sheets and recapitalization is essential for successful debt resolution. This would replace bad debt of about Sk 60 billion with interest paying assets of Sk 42 billion. The banks would thus loose somewhat in the swap, assuming that the higher range loss estimates (Sk 26 million) on bad debt are correct.

Depending on the scope of the accompanying measures, such a debt swap may or may not have beneficial consequences. This is examined in sections VI and VII below, together with the fiscal cost of the bailout. Section V first analyzes the pure accounting effect of the debt-bond swap, since this accounting effect should be adjusted for in comparing the basic medium term scenario directly with the alternative scenarios.

V. A DOMESTICALLY FINANCED GOVERNMENT DEBT SWAP AND ITS ACCOUNTING.

Table 2 attached incorporates the effect of the assumed debt replacement in the basic scenario. The assumptions for the basic scenario remain unchanged. The bailout is reflected in the accounts of the government and the banking system as follows:

The government purchases an assumed stock of bad debt held by banks of SK 60 billion at 70 percent of face value. The purchase is assumed to be spread over three years.[31] The government pays for the debt by issuing interest paying bonds. This is reflected in the government's accounts by including the bailout expenditure in the government's deficit as well as in its financing in table 2. There is also an annual increase in government expenditure to pay for interest on the bonds. However, given the assumption that the government's targeted deficit (excluding the bond issues) does not change, the government will have to raise revenue to pay the interest expenditure. Thus, the additional interest expenditure is not reflected in the deficit. In the banks' accounts, there is a corresponding increase in their credit to government (SK 14 billion annually) and a larger reduction (SK 20 billion) in credit to the rest of the economy, reflecting loans sold to the government.[32]

This latter sale is responsible for the negative growth rate in credit to the economy shown in table 2 for the years 1995-97. The rate of credit expansion to the rest of the economy, adjusted for the reduced base every year from 1995-97, is showing a higher, albeit still relatively small growth rate relative to that in the basic projection and also relative to the growth of real and nominal GDP.[33]

The loss of Sk 6 million (annually) taken by the banks is indicated in table 2 in the increase in "other assets net," relative to its value in table 1. However, this loss has to be measured against the benefit of having swapped a bad portfolio for an income generating and safe one, and in any case their loss of SK 18 million over the three years is less than the estimated loss on

---

[31] This assumption has been made to facilitate comparison with the high growth scenario, where a longer time period is required for the debt replacement bond issue, in order to insure that this issue is accompanied by other structural improvements.

[32] Comparisons, increases and decreases in this section are relative to the basic scenario in table 1.

[33] This adjusted rate of credit expansion is shown in table 3, page 3, which contains some supporting statistics for the table.

the portfolio (assuming that the upper estimate of SK 26 billion for loan losses holds). It is this improvement which should provide the foundation for the increased capacity of the banks in future lending operations.

VI. DEBT RESOLUTION WITH LOW GROWTH SCENARIO.

Table 3 attached illustrates a bailout which is only partially successful. Although the banks improve their portfolio, the financial restructuring is not accompanied by comprehensive management changes or operational restructuring. Accordingly, the change in bank and enterprise management is not complete. Furthermore, there are no significant changes in the overall macroeconomic environment. Given these assumptions, the annual real growth rate of 4 percent assumed in this alternative may be considered on the high side.

As a result of the lack of reform, enterprises may not be creditworthy, even after the bailout; seeing this may also discourage foreign investors, who as a result may expect another debt crisis in the medium term, and certainly do not see the economy as in a strong position, because of the lack of restructuring. The projections accordingly incorporate only a small increase in foreign capital inflows relative to the basic scenario.

Financial resource availability for growth is limited as banks hesitate to extend credits, and only relatively little foreign capital is being injected. However, as the economy recovers somewhat, domestic demand also recovers from its depressed levels. While both exports and imports rise, imports rise faster than exports, both for consumption and investment purposes. The resulting small external current account deficit can be financed without endangering the net international reserve targets, because of a (small) increase in capital inflows.

With regard to the government accounts and the bailout, it is assumed that the government's deficit target stays unchanged in terms of GDP (and adjusted by the bond issue). Therefore, as GDP increases in the low growth scenario relative to the basic projections, so does the government's nominal deficit target.

Interest payments are shown in a separate line under the government accounts for the period 1995-99. As noted in section V above, the payments must be included in the government deficit target, and to the extent necessary to meet the deficit target, this will mean that there is a need to raise additional revenue. However, it is worthwhile noting that the increase in projected real growth, even in the low growth scenario, will generate additional government revenue which exceeds the projected interest

outlays on the government bonds from 1997, and rising rapidly towards the end of the projection period.[34]

Not included in this table is the payment by government of the bonds at due dates (as this is outside of the projection period), which should be partly offset by any recovery of loans in the portfolio of Sk 60 million which has been purchased.

VII. DEBT RESOLUTION WITH HIGH GROWTH SCENARIO

The high growth scenario is basically different from the low growth scenario because it assumes that the financial restructuring has been accompanied by organizational restructuring, including changes to bank and enterprise management, adoption of adequate accounting standards, strengthened bank supervision, and that major policy action has been implemented to facilitate private sector activity.

Specifically, with regard to the enterprises it assumes that appropriate downsizing or liquidation is accompanying the debt resolution; that management of the enterprises has been improved so that the enterprises are run on commercial principles[35]; and that the enterprises are able to base their plans and decision making on a relatively undistorted and transparent economy.

With regard to the banks it assumes that the management of the individual banks has improved, so that lending is based on commercial banking principles; that banking supervision has been significantly strengthened in the process of the debt resolution; that the bond issue has been sufficient to restore banks' capital to at least a minimum level; and that monetary policy as carried out by the National Bank of the Slovak Republic will use market oriented policy instruments to further improve the effectiveness and efficiency of the banking system.

Planning and decision making is also assumed to take place in the enabling environment created by the specific measures discussed in Chapter 1. As a result, banks are confident about lending, although they are not very liquid, the enterprises are creditworthy and competitive, and foreign investors see promising prospects in Slovakia.

---

[34] For this calculation, see Table 3, Memorandum items to the fiscal accounts, and Table 3, page 3.

[35] Except to the extent that the government decides that this should not be done, and provides the needed subsidy through the budget.

This scenario is illustrated in table 4. Section 4 of the table shows the recovery gathering momentum to the end of the period, where GDP is projected to grow at 6 percent in 1999, compared to the 2 percent growth projected in the basic scenario.

Reflecting the increased nominal GDP (inflation remains unchanged relative to the basic scenario) throughout the period, the resources of the banking system rise faster than under the low growth scenario and domestic credit expands relatively rapidly to support credit for both production and consumption. In the external accounts, the sharp rise in GDP is reflected in a return to a current account deficit, as the strong growth is reflected in increasing imports, again both for consumption and production purposes.

However, the improved economic outlook, and the increasing external confidence in the economy is reflected in a sharp increase in capital inflows, so that the net international reserve position at the end of the period is only marginally below that under the slow growth outlook.

Under the high growth scenario, part of the reason for the increased credit extension is to be found in the sharp improvement in the external capital account and in the assumed foreign and domestic placement of equity funds in the banks. As confidence in the economy is gained abroad and the reforms in the banking system make these acceptable, part of the foreign capital inflow may well be directed to obtain more equity in the banking system. At the same time, as liquidity improves domestic privatization efforts may also proceed. This is reflected in the improved equity position of the banks (included in line 10 of table 4) for the period 1995-97.

With regard to the fiscal impact of the debt replacement bonds in the high growth scenario, this is summarized in the memorandum items to table 4, Section I. The interest cost of the bond issue under this scenario is offset or more than offset for every year of the projection period, by the increased revenue generated by the high additional growth.[36]

---

[36] The note at the bottom of p.1 of table 4 suggests the treatment of the redemption of the principal and the recovery of purchased loans.

CONCLUSION.

The preceding analysis suggests that the bad debt problem is one of a number of issues which need to be addressed urgently and comprehensively in order to raise Slovakia's growth rate in a sustainable manner. Lack of financial resources is one factor which hampers development at present. However, there are many other constraints which may be less obvious, but as important to achieve a strong economic performance. Without improvements in these constraints to create an enabling environment for the private sector, debt resolution schemes may have little impact on growth and may in fact be unsuccessful.

To the extent that resolution of the bad debt results in increased financial resource availability, one constraint to growth would be removed. However, to some extent the lack of financial resources is a symptom of much deeper problems which need to be addressed in order to raise Slovakia's potential for growth. This includes the overemployment in the enterprise sector which results in lack of cash generation and production at a loss, and the lack of risk assessment and continued support of bad debtors by the banks. Unless the debt resolution encompasses the correction of these problems, the bad debt problem can be expected to recur.

Furthermore, credit and availability of financing does not create, but only supports productive activities. Even when debt resolution is accompanied by measures to improve management of both enterprises and banks, if the overall economic system is distorted or nontransparent, the participants in the economy do not have the information needed for planning and decision making. To the extent this is the case, they fail to optimize resource use. This results in lower than otherwise possible growth over the long run.

Resolution of the bad debt problem will therefore have the optimum long run impact on macroeconomic performance when it is accompanied by other measures which correct underlying distortions in the economy. This is illustrated by the scenarios in tables 1,3, and 4.

The fact that the government's interest payments on the bonds are more than covered by the increase in revenue in both the low and the high scenarios is not as paradoxical as it may seem, i.e. it does seem that the government is spending its way to recovery.[37] In fact, it is not the spending per se, but the change in behavior of all market participants, encouraged by the reforms, which produce the increase in growth and the derived increase in

---

[37] As noted, to the extent that debt recovery is accomplished on the bad debt, this may pay in part for the redemption of the debt replacement bonds.

government revenue. Finally, it should also be noted that part, if not all, of the gain which the government reaps from the combined debt resolution/reform effort will probably be needed, at least in the short run, for social expenditure as unemployment will rise as a result of the reforms. The extent of the unemployment or the need for additional expenditure for this purpose are not addressed in this analysis.

ANNEX I

CHILE.

Mechanisms Employed in the Bank Rehabilitation.[38]

1. Debt relief measures for borrowers.

Debt relief measures included a preferential rate for foreign currency denominated debts, to be adjusted for inflation so the debt would remain constant in real terms. The central bank paid the difference. Originally it was paid in cash, but it was gradually restricted, and paid with negotiable interest-bearing bonds, until it was eliminated (duration June 1982 -February 1987.) The bonds could be repurchased by the central bank at a discount in the secondary market. In June 1985 it was decided to gradually phase out the exchange rate differential, and this was done by February 1887, when the two rates were unified. This was the program that had the largest cost for the Central Bank.

1983 Across-the Board debt rescheduling. In april 1983 the central bank instructed banking institutions to provide across-the-board debt relief for at least 30 percent of the debt of their "productive" borrowers and loans granted to borrowers considered financially unviable. The conditions on the debt rescheduling were maturities extended up to ten years and reduced interest rates. The repayment of principal had a grace period, and so did interest rates. The central bank made the difference up to the banks, so there was no loss for banks.

1984 Across the Board debt rescheduling. The proportion of debt to be rescheduled was increased and terms further eased.

1983 mortgage and consumer loans were also refinanced at the instruction of the central bank. central bank provided matching funds. Borrowers were required to repay the rescheduled amounts after the end of their original mortgages. In 1984 this program was also expanded under eased terms.

Dedollarization of debts. In September 1984, small and medium sized borrowers in foreign currency were offered the opportunity to prepay their debt with new credit in domestic currency. The cost was absorbed by the central bank.

According to the superintendency of Banks' estimates, the amount of loans that were rescheduled and their previously described

---

[38] Summarized from Larrain, 1989

mechanisms represented about 25 percent of the banking systems total loan portfolio.

2. Purchase of Risky loans by the Central Bank.

In February 1984, the central bank offered to purchase risky loans from financial institutions up to 150 percent of their equity capital as of November 1983. This percentage later was increased to 250. Banks had to use the cash resulting from these sales to the Central Bank to either repay emergency loans previously granted by the central Bank or to buy Central Bank promissory notes. This restored their solvency and profitability at once. Moreover, the fact that the cash had to be used to repay emergency loans or to buy CB promissory notes neutralized the monetary expansion effect.

Shareholders were bound to repurchase the risky loans from the Central Bank out of their profits. The amount of risky loans to be repurchased was adjusted according to inflation plus a 5 percent surcharge.

The administration of the purchased loan portfolio remained in each bank, which received a mandate from the central bank to administer and collect it. All collection had to be allocated to repurchase risky loans.

3. Recapitalization and subsequent sale of Intervened Banks.

Because sale of risky loans alone would not be sufficient to return the intervened banks to solvency, the central bank did not agree to purchase risky loans from them until their financial condition was improved. Therefore, a further capital injection was necessary. In early 1985 a law was enacted authorizing the Superintendency of Banks to require from banking institutions under intervention the necessary capital increases to make them financially viable. This was first to be offered to existing shareholders, then to the public in general, then the central bank would take over the rest, by converting central bank emergency loans into equity. Once the capital increase required by the Superintendency of Banks had been paid in, each intervened banking institution was entitled to sell risky loans to the central bank.

Subsidies and credit facilities were offered to small investors to encourage them to purchase the stock of intervened banks.

This procedure used in the case of the two largest intervened banks. Tow other banks were sold to other domestic investors and the smallest one was absorbed by another domestic bank.

4. Streamlined supervision and prudential regulations.

There was a shift in the focus of supervision towards credit risk analysis and assessment of the overall financial condition of each bank.

REFERENCES

Bank Austria, The Slovak Republic After One Year of Independence, (July 1994).

Blommestein, Hans and Jean R. Lange, "Balance Sheet Restructuring and Privatization of the Banks," in OECD (1993) 13-33.

European Commission, "The Slovak Republic, Recent Economic Performance and Priorities for Reform," presented at the G-24 High Level Meeting on the Slovak Republic (September 6-7, 1994).

Haswell, Carleton R. "Slovak Debt Resolution Process," October 1994.

International Monetary Fund, "Slovak Republic: Staff Report for the 1994 Article IV Consultation and Use of Fund Resources-Request for a Stand-By Arrangement and a Purchase Under the Systemic Transformation Facility" (July 1, 1994).

Juan, Aristobulo de, "Dealing with Problem Banks: The Case of Spain (1978-84)" in OECD (1993): 113-127.

Kawalech, S., S. Sikora and Piotr Rymaszewqski, "Polish Program of Bank and Enterprise Restructuring: Design and Implementation, 1991-1994," draft paper presented to the Central and Eastern European Privatization Network's workshop on linking bank rehabilitation with enterprise restructuring and privatization, (June 24-25, 1994).

Larrain, Mauricio, "How the 1981-83 Chilean Banking Crisis was Handled." Background paper for the World Bank's 1989 World Development Report.

Marrese, Michael, "Banking Sector Reform in Central and Eastern Europe," forthcoming in East Central Europe, Joint Economic Committee, Congress of United States.

Nyers, Rezso and Gabriella Rosta Lutz, "Restructuring of the Banking System in Hungary," in OECD (1993): 59-68.

OECD, Transformation of the Banking System: Portfolio Restructuring, Privatization and the Payment System, Paris (1993).

Schubert, Aurel, "Restructuring the Banking Sector in Central and Eastern Europe: Some Lessons from the Credit-Anstalt Crisis in 1931," paper presented at the OECD Seminar on Bank

Restructuring in Central and Eastern European Countries, Paris, (February 5-7, 1992).

Sheng, Andrew, "Bank Restructuring in Malaysia 1985-88." Background paper for the World Bank's 1989 World Development Report.

Sheng, Andrew, "Bank Restructuring in Transitional Socialist Economies (TSE): From Enterprise Restructuring to Bank Restructuring." Paper presented at the World Bank EDI Senior Policy Seminar on Financial Reform in Transitional Socialist Economies (September 10-12, 1990).

Slovak Republic, "Slovakia, Financial Sector," country presentation to the Meeting of the Group of Financial Experts on Central and Eastern European Countries, (June 13, 1994).

Vojtisek, Petr, "Restructuring of the Banks in the Former Czech and Slovak Federal Republic, " in OECD (1993): 69-75.

World Bank, "Slovakia, Restructuring for Recovery," (July 11, 1994).

Wyezanski, Pawel and Zebrowski, Janusz, "Restructuring of the Banking System in Poland," in OECD (1993): 77-85.

Table 1 Slovakia: Basic Projection 1995-99

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
I. Fiscal							
1. Government deficit	-25.5	-9.6	-13.7	-13.2	-13.9	-12.0	-11.6
2. Financing (-1=2=3+4)	25.5	9.6	13.7	13.2	13.9	12.0	11.6
3. External	0.0	1.6	2.0	2.0	1.5	1.5	1.5
4. Domestic (4=5+6)	25.5	8.0	11.7	11.2	12.4	10.5	10.1
5. Bank	26.0	8.0	11.7	9.2	9.9	8.0	7.6
6. Nonbank	-0.5	0.0	0.0	2.0	2.5	2.5	2.5
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	2.7	40.0	23.0	18.0	15.0	15.0	15.0
8. Change in net domestic assets. (8=5+9+10)	32.2	-1.2	15.8	19.2	18.6	17.6	15.8
5. Change in credit to government	26.0	8.0	11.7	9.2	9.9	8.0	7.6
9. Change in credit to rest of economy	26.4	2.8	12.1	14.9	11.7	12.6	11.2
10. other assets, net	-20.2	-12.0	-8.0	-5.0	-3.0	-3.0	-3.0
11 Change in money and quasimoney	34.9	38.8	38.8	37.2	33.6	32.6	30.8
III External accounts							
12. External current account deficit (-)	-12.6	15.0	8.0	3.0	0.0	0.0	0.0
13. Capital, net	15.3	25.0	15.0	15.0	15.0	15.0	15.0
Overall balance = 7. Increase in net for. assets (7=12+13)	2.7	40.0	23.0	18.0	15.0	15.0	15.0

Table 1 Slovakia: Basic Projection 1995-99

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
I. Fiscal							
1. Government deficit	-7.5	-2.4	-3.0	-2.6	-2.5	-2.0	-1.8
2. Financing (-1=2=3+4)	7.5	2.4	3.0	2.6	2.5	2.0	1.8
3. External	0.0	0.4	0.4	0.4	0.3	0.2	0.2
4. Domestic (4=5+6)	7.5	2.0	2.6	2.2	2.2	1.8	1.6
5. Bank	7.6	2.0	2.6	1.8	1.8	1.3	1.2
6. Nonbank	-0.1	0.0	0.0	0.4	0.4	0.4	0.4
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	0.8	9.9	5.0	3.5	2.7	2.5	2.3
8. Change in net domestic assets. (8=5+9+10)	9.4	-0.3	3.5	3.8	3.4	2.9	2.5
5. Change in credit to government	7.6	2.0	2.6	1.8	1.8	1.3	1.2
9. Change in credit to rest of economy	7.7	0.7	2.6	2.9	2.1	2.1	1.7
10. other assets, net	-5.9	-3.0	-1.7	-1.0	-0.5	-0.5	-0.5
11 Change in money and quasimoney	10.2	9.6	8.5	7.3	6.1	5.4	4.8
III External accounts							
12. External current account deficit (-)	-3.7	3.7	1.7	0.6	0.0	0.0	0.0
13. Capital, net	4.5	6.2	3.3	2.9	2.7	2.5	2.3
Overall balance = 7. Increase in net for. assets (7=12+13)	0.8	9.9	5.0	3.5	2.7	2.5	2.3

Table 1 Slovakia: Basic Projection 1995-99

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
			(In billions of Slovak Koruny)				
IV Real Sector							
Nominal GDP	340.8	404.1	457.8	509.2	555.8	600.9	643.6
Real growth, in percent	-4.1	4.0	3.0	3.0	2.0	2.0	2.0
Inflation, in percent (Av.)	23.1	14.0	10.0	8.0	7.0	6.0	5.0
Inflation, end of year, %		12.0	8.0	6.0	5.0	4.0	3.0
Exchange rate, SK/US Dollar							
Average	29.0	32.3	31.5	31.5	31.5	31.5	31.5
End of period	33.2	31.5	31.5	31.5	31.5	31.5	31.5
Money stock, basic scen end of period	253.2	292.0	330.8	368.0	401.7	434.3	465.1
Outstanding credit to govt.	92.0	100.0	111.7	121.0	130.9	138.9	146.5
Outstand.cred.to rest.econ	268.7	271.5	283.6	298.5	310.3	322.9	334.1
Credit expansion, relative to MQM, to rest of econ, in percent		1.1	4.1	4.5	3.2	3.1	2.6
Credit expansion to rest of econ,%		1.0	4.5	5.3	3.9	4.1	3.5

Table 1 Slovakia: Basic Projection 1995-99

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
			(In percent of GDP)				
Money stock, basic scen end of period	74.3	72.3	72.3	72.3	72.3	72.3	72.3
Outstanding credit to govt.	27.0	24.7	24.4	23.8	23.5	23.1	22.8
Outstand.cred.to rest.econ	78.8	67.2	62.0	58.6	55.8	53.7	51.9

Table 2. Slovakia: Projection 1995-99
Accounting treatment of debt replacement bonds

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
I. Fiscal							
1. Government deficit including bailout	-25.5	-9.6	-27.7	-27.2	-27.9	-12.0	-11.6
2. Financing (-1=2=3+4)	25.5	9.6	27.7	27.2	27.9	12.0	11.6
3. External	0.0	1.6	2.0	2.0	1.5	1.5	1.5
4. Domestic (4=5+6)	25.5	8.0	25.7	25.2	26.4	10.5	10.1
5. Bank	26.0	8.0	25.7	23.2	23.9	8.0	7.6
6. Nonbank	-0.5	0.0	0.0	2.0	2.5	2.5	2.5
Bailout expenditure			14	14	14		
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	2.7	40.0	23.0	18.0	15.0	15.0	15.0
8. Change in net domestic assets. (8=5+9+10)	32.2	-1.2	15.8	19.2	18.6	17.6	15.8
5. Change in credit to government	26.0	8.0	25.7	23.2	23.9	8.0	7.6
9. Change in credit to rest of economy	26.4	2.8	-7.9	-5.1	-8.3	12.6	11.2
10. Other assets, net	-20.2	-12.0	-2.0	1.0	3.0	-3.0	-3.0
11 Change in money and quasimoney	34.9	38.8	38.8	37.2	33.6	32.6	30.8

Table 2. Slovakia: Projection 1995-99
Accounting treatment of debt replacement bonds

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
I. Fiscal							
1. Government deficit including bailout	-7.5	-2.4	-6.1	-5.3	-5.0	-2.0	-1.8
2. Financing (-1=2=3+4)	7.5	2.4	6.1	5.3	5.0	2.0	1.8
3. External	0.0	0.4	0.4	0.4	0.3	0.2	0.2
4. Domestic (4=5+6)	7.5	2.0	5.6	5.0	4.7	1.8	1.6
5. Bank	7.6	2.0	5.6	4.6	4.3	1.3	1.2
6. Nonbank	-0.1	0.0	0.0	0.4	0.4	0.4	0.4
Bailout expenditure							
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	0.8	9.9	5.0	3.5	2.7	2.5	2.3
8. Change in net domestic assets. (8=5+9+10)	9.4	-0.3	3.5	3.8	3.4	2.9	2.5
5. Change in credit to government	7.6	2.0	5.6	4.6	4.3	1.3	1.2
9. Change in credit to rest of economy	7.7	0.7	-1.7	-1.0	-1.5	2.1	1.7
10. Other assets, net	-5.9	-3.0	-0.4	0.2	0.5	-0.5	-0.5
11 Change in money and quasimoney	10.2	9.6	8.5	7.3	6.1	5.4	4.8

Table 2. Slovakia: Projection 1995-99
Accounting treatment of debt replacement bonds

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
III External accounts							
12. External current account deficit	-12.6	15.0	8.0	3.0	0.0	0.0	0.0
13. Capital, net	15.3	25.0	15.0	15.0	15.0	15.0	15.0
Overall balance = 9. Increase in net for. assets (12+13)	2.7	40.0	23.0	18.0	15.0	15.0	15.0
IV Real Sector							
Nominal GDP	340.8	404.1	457.8	509.2	555.8	600.9	643.6
Real growth, in percent	-4.0	4.0	3.0	3.0	2.0	2.0	2.0
Inflation, in percent (Av.)	23.1	14.0	10.0	8.0	7.0	6.0	5.0
Inflation, end of year, %		12.0	8.0	6.0	5.0	4.0	3.0
Exchange rate, (SK/US dollar)							
Average		32.3	31.5	31.5	31.5	31.5	31.5
End of period	33.2	31.5	31.5	31.5	31.5	31.5	31.5
Money stock, basic scen end of period	253.2	292.0	330.8	368.0	401.7	434.3	465.1
Outstanding credit to govt.	92.0	100.0	125.7	149.0	172.9	180.9	188.5
Outstand.cred.to rest.econ	268.7	271.5	263.6	258.5	250.3	262.9	274.1
Credit expansion, relative to MQM to rest of econ, in percent		1.1	-2.7	-1.5	-2.2	3.1	2.6
Credit expansion to rest of econ,%		1.0	-2.9	-1.9	-3.2	5.0	4.3
Credit exp. to rest of econ including loans sold to govt., %		1.0	4.5	5.3	3.9	5.0	4.3

Table 2. Slovakia: Projection 1995-99
Accounting treatment of debt replacement bonds

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
III External accounts							
12. External current account deficit	-3.7	3.7	1.7	0.6	0.0	0.0	0.0
13. Capital, net	4.5	6.2	3.3	2.9	2.7	2.5	2.3
Overall balance = 9. Increase in net for. assets (12+13)	0.8	9.9	5.0	3.5	2.7	2.5	2.3
IV Real Sector							
Money stock, basic scen end of period	74.3	72.3	72.3	72.3	72.3	72.3	72.3
Outstanding credit to govt.	27.0	24.7	27.5	29.3	31.1	30.1	29.3
Outstand.cred.to rest.econ	78.8	67.2	57.6	50.8	45.0	43.7	42.6

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increase in growth: low growth scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
			(In billions of Slovak Koruny)				
I. Fiscal							
1. Government deficit	-25.5	-9.6	-27.8	-27.4	-28.3	-12.6	-12.4
2. Financing (1=2=3+4)	25.5	9.6	27.8	27.4	28.3	12.6	12.4
3. External	0.0	1.6	2.0	2.0	2.0	2.0	2.0
4. Domestic (4=5+6)	25.5	8.0	25.8	25.4	26.3	10.6	10.4
5. Bank	26.0	8.0	25.8	23.4	23.8	8.1	7.9
6. Nonbank	-0.5	0.0	0.0	2.0	2.5	2.5	2.5
Additional expenditure for debt replacement bonds			14	14	14		
Memorandum items:							
A. Expenditure which must be accomodated in above deficit target:							
Interest to banks from govt. from debt replacement bonds			2.1	3.9	5.6	5.6	5.6
Interest, 5 percent in real terms			2.1	2.1	2.1	2.1	2.1
at issue				1.8	1.8	1.8	1.8
Principal=SK .4 billion*3					1.7	1.7	1.7
Maturity 10 years							
B. Increased revenue, from add.growth (at 40 percent revenue/GDP)			0.9	3.0	6.6	12.0	18.1
Net contribution to reduction (+) of deficit From restructuring scenario			-1.2	-0.9	1.0	6.4	12.5

NB. In years 2005,2006 and 2007 the government will need to redeem the bond issues at Sk 14 billion per year.
Assuming that the extimates (that the loss on the portfolio would be about SK 20-26 billion, the government should recover SK 30-40 billion which should be earmarked for early bond redemption
To the extent such recovery is made, this would reduce the budget impact of interest payments over the projection period, and of course also the impact of the redemption at maturity.
Furthermore, such early recovery and reduction in bank holdings of bonds would increase the liquidity of the system.

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth low scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
			(In percent of GDP)				
I. Fiscal							
1. Government deficit	-7.5	-2.4	-6.0	-5.3	-4.9	-2.0	-1.8
2. Financing (1=2=3+4)	7.5	2.4	6.0	5.3	4.9	2.0	1.8
3. External	0.0	0.4	0.4	0.4	0.3	0.3	0.3
4. Domestic (4=5+6)	7.5	2.0	5.6	4.9	4.6	1.7	1.5
5. Bank	7.6	2.0	5.6	4.5	4.2	1.3	1.1
6. Nonbank	-0.1	0.0	0.0	0.4	0.4	0.4	0.4

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increase in growth: low growth scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	2.7	40.0	23.0	18.0	18.0	16.0	16.0
8. Change in net domestic assets. (8=5+9+10)	32.2	-1.2	17.4	23.0	24.1	26.3	25.9
5. Change in credit to government	26.0	8.0	25.8	23.4	23.8	8.1	7.9
9. Change in credit to rest of economy	26.4	2.8	-6.4	-1.5	-2.7	21.2	21.0
10. Other assets, net	-20.2	-12.0	-2.0	1.0	3.0	-3.0	-3.0
11 Change in money and quasimoney	34.9	38.8	40.4	41.0	40.1	42.3	41.9
III External accounts							
12. External current account deficit (-)	-12.6	15.0	8.0	0.0	-2.0	-3.0	-3.0
13. Basic capital acct.	15.3	25.0	15.0	15.0	15.0	15.0	15.0
Addl. inflow				3.0	3.0	4.0	4.0
Overall balance = 9. Increase in net for. assets (12+13)	2.7	40.0	23.0	18.0	18.0	16.0	16.0
IV Real Sector							
Nominal GDP	340.8	404.1	460.0	516.7	572.2	630.8	688.8
Real growth, in percent		4.0	3.5	4.0	3.5	4.0	4.0
(Of which, generated by restructuring)			0.5	1.0	1.5	2.0	2.0
Inflation in %, Average		14.0	10.0	8.0	7.0	6.0	5.0
Inflation in percent, end of year		12.0	8.0	6.0	5.0	4.0	3.0
Exchange rate, SK/US Dollar							
Average		32.3	31.5	31.5	31.5	31.5	31.5
End of period	33.2	31.5	31.5	31.5	31.5	31.5	31.5

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: low scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	0.8	9.9	5.0	3.5	2.8	2.5	2.3
8. Change in net domestic assets. (8=5+9+10)	9.4	-0.3	3.8	4.4	4.2	4.2	3.8
5. Change in credit to government	7.6	2.0	5.6	4.5	4.2	1.3	1.1
9. Change in credit to rest of economy	7.7	0.7	-1.4	-0.3	-0.5	3.4	3.1
10. Other assets, net	-5.9	-3.0	-0.4	0.2	0.5	-0.5	-0.4
11 Change in money and quasimoney	10.2	9.6	8.8	7.9	7.0	6.7	6.1
III External accounts							
12. External current account deficit (-)	-3.7	3.7	1.7	0.0	-0.3	-0.5	-0.4
13. Basic capital acct.	4.5	6.2	3.3	2.9	2.6	2.4	2.2
Addl. inflow							
Overall balance = 9. Increase in net for. assets (12+13)	0.8	9.9	5.0	3.5	2.8	2.5	2.3
IV Real Sector							
Nominal GDP							
Real growth, in percent							
(Of which, generated by restructuring)							
Inflation in %, Average							
Inflation in percent, end of year							
Exchange rate, SK/US Dollar							
Average							
End of period							

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increase in growth: low growth scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
Money stock, end of period	253.2	292.0	332.4	373.4	413.5	455.9	497.8
Outstanding credit to govt.	92.0	100.0	125.8	149.2	173.0	181.2	189.1
Outstand.cred.to rest.econ	268.7	271.5	265.1	263.7	261.0	282.2	303.3
Credit expansion relative to MQM to rest of economy, in %.		1.1	-2.2	-0.4	-0 7	5.1	4.6
Credit expansion to rest of econ.%		1.0	-2.3	-0.6	-1.0	8.1	7.5
Credit expansion, taking into account the reduction in credit from govt.debt buyout			5.0	6.5	5.7	8.1	7.5
Baseline GDP	340.8	404.1	457.8	509.2	555.8	600.9	643.6
Revised GDP	340.8	404.1	460.0	516.7	572.2	630.8	688.8
Increased GDP from restructuring	0.0	0.0	2.2	7.4	16.4	29.9	45.2
Derived increase in Govt. taxation (at 40 %)	0.0	0.0	0.9	3.0	6.6	12.0	18.1

Table 3: Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: low scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
Money stock, end of period	74.3	72.3	72.3	72.3	72.3	72.3	72.3

Table 4. Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
I. Fiscal							
1. Government deficit incl.debt replac. bonds	-25.5	-9.6	-27.9	-27.6	-28.9	-13.4	-13.4
2. Financing (-1=2=3+4)	25.5	9.6	27.9	27.6	28.9	13.4	13.4
3. External	0.0	1.6	2.0	3.0	3.5	3.5	4.0
4. Domestic (4=5+6)	25.5	8.0	25.9	24.6	25.4	9.9	9.4
5. Bank	26.0	8.0	24.9	23.1	23.4	7.4	6.9
6. Nonbank	-0.5	0.0	1.0	1.5	2.0	2.5	2.5
Additional expenditure for debt replacement bonds			14	14	14		
Memorandum items:							
A. Expenditure which must be accomodated in above deficit target:							
Interest to banks from govt. from debt replacement bonds			2.1	3.9	5.6	5.6	5.6
Interest, 5 percent in real terms			2.1	2.1	2.1	2.1	2.1
at issue				1.8	1.8	1.8	1.8
Principal=SK 14 billion*3					1.7	1.7	1.7
Maturity 10 years							
B. Increased revenue, from add.growth (at 40 percent revenue/GDP)			1.8	6.0	15.5	26.8	40.0
Net contribution to reduction (+) of deficit From restructuring scenario			-0.3	2.1	9.9	21.2	34.4

NB. In years 2005,2006 and 2007 the government will need to redeem the bond issues at Sk 14 billion per year.
Assuming that the extimates (that the loss on the portfolio would be about SK 20-26 billion, the government should recover SK 34-40 billion which should be earmarked for early bond redemption
To the extent such recovery is made, this would reduce the budget impact of interest payments over the projection period, and of course also the impact of the redemption at maturity.
Furthermore, such early recovery and reduction in bank holdings of bonds would increase the liquidity of the system.

Table 4. Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
I. Fiscal							
1. Government deficit incl.debt replac. bonds	-7.5	-2.4	-6.0	-5.3	-4.9	-2.0	-1.8
2. Financing (-1=2=3+4)	7.5	2.4	6.0	5.3	4.9	2.0	1.8
3. External	0.0	0.4	0.4	0.6	0.6	0.5	0.5
4. Domestic (4=5+6)	7.5	2.0	5.6	4.7	4.3	1.5	1.3
5. Bank	7.6	2.0	5.4	4.4	3.9	1.1	0.9
6. Nonbank	-0.1	0.0	0.2	0.3	0.3	0.4	0.3

Table 4. Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth, high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	2.7	40.0	23.0	15.0	15.0	12.0	12.0
8. Change in net domestic assets. (8=5+9+10)	32.2	-1.2	19.0	29.8	35.8	41.1	42.6
5. change in credit to government	26.0	8.0	24.9	23.1	23.4	7.4	6.9
9. change in credit to rest of economy	26.4	2.8	0.2	9.6	11.5	33.7	35.7
10. other assets, net	-20.2	-12.0	-6.0	-3.0	1.0	-3.0	-3.0
11 Change in money and quasimoney	34.9	38.8	42.0	44.8	50.8	53.1	54.6
III External accounts							
12. External current account deficit	-12.6	15.0	3.0	-5.0	-8.0	-13.0	-13.0
13. Base case capital, net	15.3	25.0	15.0	15.0	15.0	15.0	15.0
Additional capital			5.0	5.0	8.0	10.0	10.0
Overall balance = 9. Increase in net for. assets (12+13)	2.7	40.0	23.0	15.0	15.0	12.0	12.0
IV Real Sector							
Nominal GDP	340.8	404.1	462.2	524.2	594.5	668.0	743.5
Real growth, in percent	-4.1	4.0	4.0	5.0	6.0	6.0	6.0
of which: add. growth from restruct.			1.0	2.0	4.0	4.0	4.0
Inflation, in percent (Av.)	23.1	14.0	10.0	8.0	7.0	6.0	5.0
Inflation, end of year, %		12.0	8.0	6.0	5.0	4.0	3.0
Exchange rate, SK/US Dollar							
Average		32.3	31.5	31.5	31.5	31.5	31.5
End of period	33.2	31.5	31.5	31.5	31.5	31.5	31.5

Table 4. Slovakia. Projection 1995-99
Debt replacement bonds, with increased growth high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
II. Monetary Accounts							
7. Change in Net foreign Assets. (7+8=11)	0.8	9.9	5.0	2.9	2.5	1.8	1.6
8. Change in net domestic assets. (8=5+9+10)	9.4	-0.3	4.1	5.7	6.0	6.2	5.7
5. change in credit to government	7.6	2.0	5.4	4.4	3.9	1.1	0.9
9. change in credit to rest of economy	7.7	0.7	0.0	1.8	1.9	5.1	4.8
10. other assets, net	-5.9	-3.0	-1.3	-0.6	0.2	-0.4	-0.4
11 Change in money and quasimoney	10.2	9.6	9.1	8.5	8.6	7.9	7.3
III External accounts							
12. External current account deficit	-3.7	3.7	0.6	-1.0	-1.3	-1.9	-1.7
13. Base case capital, net	4.5	6.2	3.2	2.9	2.5	2.2	2.0
Additional capital							
Overall balance = 9. Increase in net for. assets (12+13)	0.8	9.9	5.0	2.9	2.5	1.8	1.6
IV Real Sector							
Nominal GDP							
Real growth, in percent							
of which: add. growth from restruct.							
Inflation, in percent (Av.)							
Inflation, end of year, %							
Exchange rate, SK/US Dollar							
Average							
End of period							

Table 4. Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In billions of Slovak Koruny)						
Money stock, end of period	253.2	292.0	334.0	378.8	429.6	482.8	537.3
Outstanding credit to govt.	92.0	100.0	124.9	148.0	171.4	178.7	185.6
Outstand.cred.to rest.econ	268.7	271.5	271.7	281.3	292.8	326.5	362.2
Credit expansion relative to MQM to rest of economy, in percent		1.1	0.1	2.9	3.0	7.9	7.4
Credit expansion to rest of economy, in percent		1.0	0.1	3.5	4.1	11.5	10.9
Credit expans. to rest of economy, adjusted for loans sold to govt. in percent.		1.0	7.4	11.8	13.0	11.5	10.9
Baseline GDP	340.8	404.1	457.8	509.2	555.8	600.9	643.6
Revised GDP	340.8	404.1	462.2	524.2	594.5	668.0	743.5
Increased GDP from restructuring	0.0	0.0	4.4	14.9	38.7	67.1	99.9
Derived increase in Govt. taxation (at 40 %)	0.0	0.0	1.8	6.0	15.5	26.8	40.0

Table 4. Slovakia: Projection 1995-99
Debt replacement bonds, with increased growth: high scenario

	Prel 1993	Est 1994	Proj 1995	Proj 1996	Proj 1997	Proj 1998	Proj 1999
	(In percent of GDP)						
Money stock, end of period	74.3	72.3	72.3	72.3	72.3	72.3	72.3
Outstanding credit to govt.	27.0	24.7	27.0	28.2	28.8	26.8	25.0
Outstand.cred.to rest.econ	78.8	67.2	58.8	53.7	49.2	48.9	48.7