Deloitte Touche Tohmatsu

Slovakia Enterprise Restructuring and Debt Conciliation Project

The Long-Term Impact of Bad-Debt and Alternatives to Resolve the Bad-Debt Problem

U.S. Agency for International Development
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Delivery Order No. 33

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February 26, 1996

Mr. Lawrence Camp
USAID ENI/PER/EP
1800 North Kent Street
Rosslyn, VA 22209

Re: Contract No. EUR-0014-I-00-1056-00, Delivery Order No. 33, Slovak Enterprise Restructuring -- Slovakia Policy Analysis

Dear Lawrence:

We are pleased to submit the enclosed report, *The Long-Term Impact of Bad-Debt and Alternatives to Resolve the Bad-Debt Problem*. This report elaborates on the impact of bad-debt on Slovakia's ability to undergo a successful transition to a market economy and presents three policy scenarios and analyzes the ability of each to resolve the bad-debt burden. A condensed version of this report is being submitted under separate cover entitled, *The Long-Term Impact of Bad-Debt and Alternatives to Resolve the Bad-Debt Problem -- Summary and Conclusions.*

This report was prepared by Miles Wortman at your request to expand on Function C of this Delivery Order as it was originally written. Mr. Wortman has taken great efforts to incorporate the comments of Roy Grosh, USAID/Bratislava into this revised version of this report. At your direction, we did not undertake translation of this report into Slovak as originally planned.

If you have any questions or comments regarding this report, please contact me at (202) 879-5650.

Sincerely,

Adrienne Brombaugh

THE LONG-TERM IMPACT OF BAD-DEBT AND ALTERNATIVES TO RESOLVE THE BAD-DEBT PROBLEM

SLOVAKIA, 1995 - 2004

PREPARED FOR:	**USAID**
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DELOITTE TOUCHE TOHMATSU INTERNATIONAL

The opinions expressed herein represent the views of the author and do not necessarily represent that of the United States government or that of its agencies.

PREFACE

This report was prepared between May 1995 to November 1995. The work included meetings and interviews in Bratislava and Washington in July and September 1995. The cooperation of the Slovak authorities is greatly appreciated.

An Executive Summary and Conclusions is published under separate cover as an addendum to this report.

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INTRODUCTION

This paper examines the structure of the Slovak economy, the impact of the bad-debt problem on future growth, and develops macroeconomic alternatives for Slovakia's future given its competitive strengths. It describes the current drag of bad-debt on the Slovak economy and weighs the relative impact of current debt reform proposals on future growth.

The paper is organized in four parts:

> **Part One** discusses the issue of bad-debt in Slovakia in broad macroeconomic terms.
>
> **Part Two** explores current trends, the bases for Slovakia's current growth, the risks of continuing current policies for future competitiveness, and the role of bad-debt in limiting future growth.
>
> **Part Three** describes macroeconomic alternatives.
>
> **Part Four** offers quantitative and qualitative analyses of the impact of debt reform proposals on economic growth and government finances.

Statistics

Statistical sources for data in Slovakia are imperfect and should be used with great care. Most statistics are used in this report to paint a broad picture, i.e., to understand current structures and future models, the relative size of various sectors and population, potential growth, and the impact of bad-debt on production. Microeconomic information requires future study.

The Statistical Office of the Slovak Republic is the repository of most data that derive from various administrative agencies and private sources. These sources use a wide variety of methodologies and achieve varying degrees of accuracy. Basic data on population growth, trade, and government budgetary items are deemed to be reasonably accurate. Company production and profitability is not reliable. Banking information on savings and investments is reasonably good. Loan classifications and performance are vaguely defined and open to broad interpretation. **Unless otherwise stated, statistical sources for data in this report derive from the Statistical Office**.

Other sources employed include the Slovak Central Bank and Ministries of Finance, Agriculture, and Economics; The World Bank; U.S. Agency for International Development, U.S. State Department, and U.S. Treasury; International Monetary Fund; United Nations Economic Commission for Europe; Deutsche Bank; Bank Nomura; Deloitte Touche Tohmatsu International; Symsite; and annual reports from Slovak banks and insurance companies.

I. THE ISSUE: ADDRESSING BAD-DEBT AND PAYING THE COST OF TRANSITION

In late 1995, Slovakia faces a broad range of options and decisions that will determine the future wealth of the nation. It is forming a new country and undergoing a basic transition from what was a Czechoslovak socialist regime to a Slovak free market nation.

Of all the changes, the economic and financial transformations are some of the most complex. Slovakia faces the challenges of overcoming vanished trade markets, outmoded technology, vestigial managerial structures, and antiquated laws and regulations. The manner in which Slovakia liberalizes its economy and financial markets will determine its ability to develop a balanced, innovative, and efficient productive apparatus and a strong position in the modern world economy. It remains to be seen if free, domestic capital markets be allowed to emerge to take full advantage of Slovakia's wealth, and nurture its managerial, technological, and productive apparatus or whether the government will serve as arbitrator of investment and capital flows.

At issue is how to gain support for those areas of the economy that show dynamic growth and have the potential to improve their competitive position by reducing drags such as high interest rates, weak financial institutions, a dearth of investment capital, and overregulation by government. Slovkia must develop its macroeconomy to reduce reliance on a few heavy industrial sectors and become innovative, competitive, diversified and able to withstand global market shocks.

Unlike other nations with less natural resources and human talents, Slovakia has shown that it can compete in international metallurgical and chemical sectors. Ship construction, autoparts, appliance, and optic industries have all attracted foreign partners. But, in the current international climate, nations must respond quickly to rapidly changing markets. Slovakia lacks that ability at this time.

Experience throughout the world, especially in Asia and Latin America, has shown that free markets reinforce national sovereignty by developing strong economies. Alternatively, statist regimes reinforce continued reliance upon multilateral and bilateral donors for subsistence, compelling ongoing negotiations with foreign groups over conditionality and revisions of national laws.

SLOVAKIA'S FUTURE: THE PRICE OF TRANSITION

Current, short-term economic growth masks structural weakness. As long as inefficiencies and uneconomic enterprises are rewarded, the Slovak economy will be highly vulnerable to external pressures. Once economic performance in Western Europe lags and global chemical prices decline in the next recessionary cycle, Slovakia will suffer dramatically.

The bad-debt situation is one of the key drags on future growth. Estimated at anywhere from Sk 45 billion to Sk 120 billion, it constrains the development of Slovak financial markets, corrupts attempts at bank reform, and distorts efforts to modernize industry. Financial resources to sustain bad-debts crowds out private sector development, thus harming job creation and modernization.

In the current growth cycle, Slovakia has a window of opportunity to recognize the bad-debt problem as the price of transition, and to restructure old firms and their workers into the new, modern world economy. However, either today or in the future, this Sk 45-120 billion must be paid, through financial and regulatory restructuring, the writing off bad-debts, and, eventually, the encouragement of new investments.

The source of the bad-debt problem is now well-understood. With the loss of Comecon markets during the transition from socialism, many public sector firms fell into deficit and relied upon banks to support ongoing costs. Unpaid receivables from Comecon countries and inter-company debts created financial havoc. A temporary shortage of raw materials and the whipsaw effect of price liberalization (which caught firms between high import inputs and low domestic retail prices) produced massive losses. A lack of credit and supplies in the agriculture sector compelled the government to issue massive, unpayable loans to state farms, cooperatives, and grain elevators. Intercorporate indebtedness rose significantly. Finally, the breakup of the Czechoslovak Republic aggravated losses. Czech banks withdrew deposits from Slovakia, causing bank decapitalization and therefore depleting reserves.

The price of resolving these past problems must be paid if Slovakia is to progress in the future. The purpose of this report is to examine macroeconomic scenarios and alternate strategies for resolving the bad-debt situation and to measure the impact of each of these strategies on long-term growth prospects.

SLOVAKIA'S FUTURE: EXOGENOUS FACTORS

It is evident that exogenous factors will have a major influence on the future of Slovakia's economic structure and performance. All macroeconomic models must reflect these inputs:

- First, old trade channels and production are withering and will not contribute to future growth. For instance, the Slovak military industry is technologically outmoded and lacks the trade linkages that it once enjoyed. While it may export spare parts or make an occasional sale, this sector will not be a basis for future growth.

- Second, it is also evident that Slovakia's future prosperity is heavily dependent upon linkages to Western Europe for trade, capital, and technological improvement. While some markets for Slovak production may develop in Russia, Central Europe, and the Eastern Mediterranean, their relative purchasing power vis-à-vis Western Europe is small. In other words, the most profitable markets are to the west and will likely remain so for the foreseeable future. This, in turn, raises two major questions: how much protectionist sentiment in the European Community will limit Slovak markets; and how well can

Slovakia liberalize its economy in the event of an expansion of the European Community?

- Third, competition from Russia, Central Europe, and the Eastern Mediterranean will increase. For instance, Slovakia enjoys relatively few competitive advantages in wages, raw material costs and transport costs against modernizing Russian and Turkish iron ore, steel, and petrochemical industries. The Czech steel and chemical sectors are undergoing rapid and extensive retooling and will compete strongly both in the local market and in Western Europe.

- Fourth, Slovakia will continue to rely upon imports for basic raw materials and, for the foreseeable future, food. Consequently, Slovakia is vulnerable to international price fluctuations. The only means to minimize this vulnerability is to develop competitiveness in productivity, technology, and management. If Slovakia does not, it will face future crises and challenges to its economic independence.

- Fifth, because all international trade runs in cycles, Slovakia cannot rely solely on international markets for its prosperity. This is particularly true for the chemical sector upon which the nation depends so much. Chemical markets and industries traditionally run through boom-bust cycles, with excess demand shifting rapidly to excess supply. To defend against itself against this eventuality, Slovakia must also develop a firm and diversified domestic economy. Capital investment must be better dispersed and production of basic consumables improved.

Box 1: Natural Resources and Development

A recent study of both historical and current trends* concluded that a strong negative correlation exists between natural and economic wealth. While natural resources should provide ample resources, positive trade balances, and fiscal income for development, countries tend to waste their oil and mineral profits instead of investing in the future. Comparing data for 97 developing countries between 1970 and 1989, Harvard University Professors Jeffrey Sachs and Andrew Warner found that nations with greater natural resources tended to grow about 1 percent slower, on average, than a country with minimal resources. Of the 18 wealthiest countries in terms of natural resources, only two, Malaysia and Mauritius, achieved even 2 percent annual growth over the period.

The study theorizes that countries lacking a resource base a forced to develop manufacturing and service industries. This process requires "learning by doing" which builds a valuable stock of manufacturing expertise which raises the country's growth potential. Those countries which remain dependent on their natural resource base become "corrupted," both literally as well as figuratively, losing knowledge and the ability to innovate.

For Slovakia, the lesson is clear: using the resource base from the gas pipeline, inexpensive natural gas, and metallurgy can have an implicit negative impact unless strong countermeasures are taken to stimulate entrepreneurial activity.

* Jeffrey Sachs and Andrew Warner, *Natural Resource Abundance and Economic Growth*, Harvard Institute for International Development. October, 1995.

State Subsidies and Bank Debt

The degree to which Slovakia accumulates capital and employs it in effective modernization of industries will determine future growth. Capital accumulation depends largely on the government's ability to enact effective reforms which facilitate its accumulation.

Slovakia, like other Eastern European nations, has undertaken major reforms to adjust its old structures to function in global market conditions. However, old habits and structures die hard. Facing the extremely difficult task of rationalizing unproductive and outmoded firms while maintaining social peace, many governments have resorted to compromises in an attempt to maintain the old ways. In many Eastern European nations, "privatized" companies are, in reality, state firms that continue to rely upon government assistance and protection. Intercorporate debt has yet to be resolved and, in some cases, is increasing. Financial institutions, with the help of insurance and pension plans, are used as quasi-funding agencies. These institutions provide loans to paralyzed industries in an effort to maintain salaries and employment levels. A mirage is created in which IMF and/or World Bank targets for reduced public sector subsidies and deficits appear to be reached. In reality, however, subsidies are moved to another sector -- the quasi-private sector banks and industries. New bad-loans are given to support worker salaries. Old bad-loans are either renegotiated or paid through new loans from other banks in what is a vicious circle of subsidies and supports. Indeed, in many Eastern European economies, the public budget and public banks perform the same function. In either case, the strategy covers short-term needs at the expense of long-term economic health.

Over time, continued statist subsidies for failed industries drain nations, causing both economic and political difficulties. Taxes from productive groups are used to support loss-making enterprises which leads to stark political divisions between those who receive subsidized salaries and those who produce wealth. In the worst cases, increased taxation causes capital flight, draining the nation.

Box 2: The Low Fiscal Deficit: An Illusion

The government has successfully reduced its fiscal deficit to minimal levels, currently less then 5% of GDP. In terms of fiscal policy, this is a positive development. However, through an intricate network of quasi-public banks, insurance firms, public utilities, and investment funds, public authorities use assets from profitable enterprises to finance loss-making enterprises and other social costs. This diverts current resources for ongoing expenses rather than for public investments and capital improvements.

Capital Markets and Economic Goals

For Slovakia, the key macroeconomic target is to adjust its antiquated productive apparatus to modern conditions. Heavy primary industries, such as chemicals and metallurgy, can to some degree use global trade finance and modernize themselves without the benefit of domestic capital. But, the remainder of the economy must improve productivity, technology, infrastructure, and management if Slovakia is to grow. The Socialist model created a plethora of small companies dispersed throughout the nation in each province, duplicating each other's function. Each region established its own farms (regardless of land arability), its own bakeries, textile mills, gravel pits, clay mines, and cement companies. Many of these are in holding companies which appear to "function," (e.g. employees are paid by the state) but they do not produce.

Consider two major economic sectors: military industries and agriculture. Since the transition, the Slovak armament industry lost most markets. The 11 leading arms firms are operating at 8% of capacity, together losing Sk 4.5 billion in 1994, not counting state subsidies and employment supports. The industry has little choice but to rationalize and drastically reduce employment levels and facilities. Highly trained and skilled workers and managers must find new industries and new sources of income. But without adequate sources of fresh credit, few companies will be able to absorb this large workforce. This results in heightened political pressures to sustain traditional employment levels through bank and government subsidies. This will force good workers and managers to become dependent on state welfare over time.

Similarly, agriculture land lacks sufficient inputs to be productive. The previous socialist government created a network of dairy and meat farms without regard to efficiencies or market demand. After price liberalization, production collapsed on many state farms, cooperatives, grain elevators and suppliers, and agricultural transport. Between 1990 and 1993, production fell 25% despite increased state subsidies, although poor weather was a factor. Farms were squeezed as the cost of fertilizer grew with energy price increases and the government maintained low price controls. Consequently, the state needed to support operations. They did this by providing bank loans to sustain basic production. Few, if any, of these loans are repayable.

For political reasons, agricultural reform is very difficult. Unproductive state farms, established under the socialist government, are a political problem. Farmers and cooperative shareholders resist rationalization. Indeed, many are farmers in name only, collecting profits from hired hands. The cost to the nation goes far beyond direct agricultural subsidies. It forces increasing imports of foodstuffs from abroad. As with the military industries, the growth of a dynamic agricultural sector relies on sources of fresh credit, applied in an efficient manner without government interference. And fresh credit will not develop without resolution of the bad-debt problem.

II. BAD-DEBT: THE KEY OBSTACLE TO FUTURE ECONOMIC VITALITY

THE POTENTIAL FOR RAPID GROWTH

The Slovak Republic is in a position to enjoy the fastest growth of any Eastern European nation and to develop a strong and balanced economy at the level of the European Union. It is well-placed to become integrated into the Common Market. The country's potential derives from its strategic geographic position vis-à-vis its trading partners, competitive advantages in metallurgical and chemical sectors, experience in manufacturing, low external debt, and a trained and competitive workforce.

A broad model for Slovakia's future is clear. It includes the development of agricultural and industrial potential, while rationalizing outmoded industries and farms. The nation can profit from a modernized service sector that is able to provide transport services from east and to west. Experience in metallurgical and chemical sectors can lead to specialization based on a relatively inexpensive supply of raw materials and close cooperation with European production and markets. As business and industrial skills mature, the Slovak economy can become less dependent on traditional, heavy industries and more integrated into the Western European market.

However, getting there from here is difficult without developing strong capital markets. Slovakia competes with at least ten countries in Eastern Europe and the former Soviet Union who have very similar potential. While Slovakia is physically closer to wealthy markets, such as Austria, than many other former Socialist nations, its advantages will erode without substantial capital and technological improvements. It is already clear that the Czech Republic and Poland are attracting large investments, as are, to a lesser degree, Hungary, Russia and Moldovia. Slovakia, in contrast, is trailing far behind.

Box 3: The Role of Financial Systems in Transition Economies

"One legacy of central planning is that financial systems in [Eastern European] transitional economies are even less developed than in many developing countries. The main goal of financial reform in these economies should be to make passive financial systems active -- to make financial systems participate actively in the economy, as they do in market economies. For this to happen, transitional economies must develop banking systems that allocate credit efficiently. Commercial banks must screen borrowers, and monitor and discipline enterprises. The role of government and the central bank should be limited to regulation and supervision"

Boris Pleskovic, *Financial Policies in Socialist Countries in Transition.* World Bank Policy Research Working Paper 1242. January 1994.

Table 1: Direct Foreign Investment (1994)

	US$billion
Czech Republic	3.10
Hungary	7.09
Poland	4.40
Slovakia	**0.50**

Source: Slovak Statistical Office

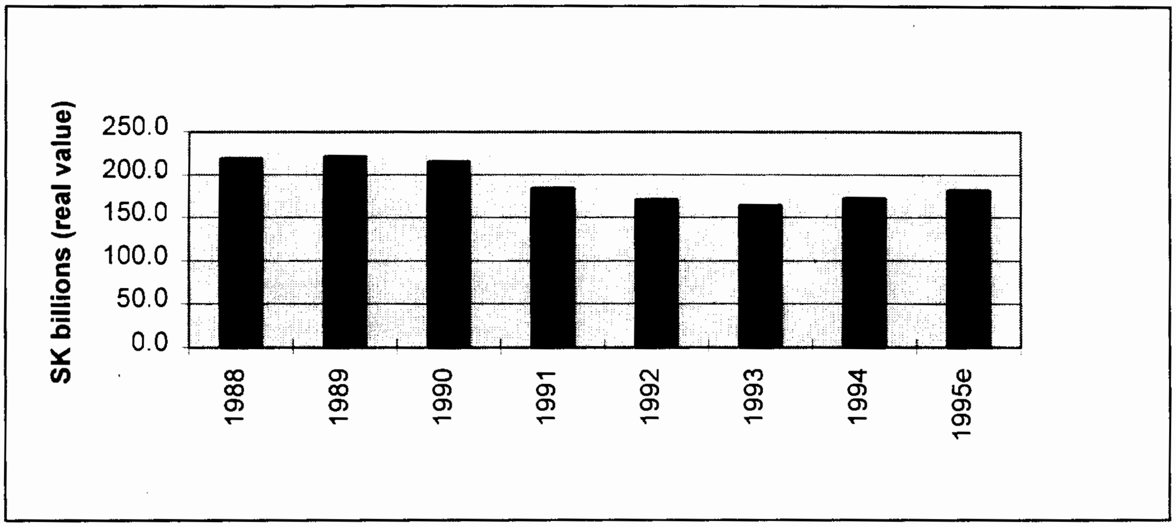
Capital markets are designed to determine where an investment will yield the best results. They are willing to finance small enterprises with great potential and without the political interference present in overregulated economies. In Slovakia today, for instance, government profits from metallurgical, natural gas, and chemical industries are being used to sustain loss-making enterprises, rather than to finance future competitive industries. These politically-influenced investments, subsidies, and loans are crowding nongovernment borrowers out of the financial system. As a result, many profitable private Slovak enterprises have been unable to invest in capital improvements because of a lack of resources or a lack of availability of long term capital . Money that should be going to capital equipment is instead going to financial markets which, in turn, finance more bad-debts

ECONOMIC GROWTH IN 1994-1996: A TEMPORARY UPTURN

Slovakia is growing at a strong pace, averaging above 5% in 1994 and 1995. It will likely grow at the same pace in 1996. Still, this vitality creates a mirage of economic progress, taking place after years of shrinkage. Indeed, the country has yet to recover to pre-1991 economic levels (see Figure 1). GDP growth declined gradually from 1985 to 1989 in the Slovak area but still remained positive. However, from 1990 to 1993, real GDP dropped each year, due chiefly to a loss in markets, reaching its low point in 1991 when GDP fell by 14.53%. In 1992, GDP dropped only by 2.44%. The split of the Czech and Slovak Federal Republic led to a reduction in GDP in 1993 of 4.12%. Since then, however, Slovakia has been able to convert some of its chemical, metallurgical, textile, and engineering processes towards the Western European market. In 1994, GDP grew for the first time, 4.7%, due chiefly to a 2.9% spurt in industrial production. The chemical sector alone contributed 23% to total Slovak industrial production and 25% to total exports.

In effect, the subsidized industrial, infrastructure, technical, and educational investment of the previous Socialist government is used to meet Western needs. In the Slovak and the Czech Republics' economies, this has been easier to accomplish than in other transition economies where more finished or agricultural production dominates. Czech and Slovak metal-bending, textile and leather processing, and basic chemical conversions were adapted to the new markets. In Slovakia, artificially low energy prices have subsidized chemical production. Other sectors, such as agriculture, military industries, and semi-conductors, have suffered severe shrinkage. Mining production dropped by almost half.

Figure 1: Slovakia GDP, 1988-1995



Production for local consumption continues to shrink, especially in agriculture and agribusiness. Once self-sufficient, Slovakia is increasing its imports of basic goods each year (see below). The tendency is clear: domestic production of primary goods dropped while conversion of imported goods (chemicals, metals) improved.

Capital-intensive companies, rather than labor-intensive, are tending to perform better, which indicates weak productivity. While the Slovak wage structure is low compared to Western Europe, labor output is very poor and shows every indication of declining. Underemployment remains high, especially among technical workers.

Strong economic growth in Western Europe, as well as the push to rationalize Western European production to meet cheaper foreign competition, facilitated the rebound in Slovak production. Many German automobile firms and Italian textile operations increased their out-sourcing of production. Furthermore, some Slovak firms continue to source materials from Czech industries that are experiencing increased investment from and trade with western markets.

Growth has helped the government improve basic economic performance. The state budget deficit has improved markedly, from Sk 22.8 billion in 1994 to near balance in 1995. After suffering from trade deficits in 1992 and 1993, Slovakia's trade balance became positive in 1994 and 1995, with a clear trend of growth in OECD markets. Inflation continues to decline, likely ending 1995 at 9%. Unemployment levels declined to about 12%. Slovakia's foreign debt is estimated at $4.4 billion, about a third of GDP, which is manageable given the nation's $3.5 billion reserves and balanced trade account. Eighty percent of the debt is medium-term and the rest long-term. In addition, Slovakia holds claims of 2.5 billion dollars with other nations. The former Soviet Union is by far the largest debtor, owing 1.7 billion dollars, half of which is in convertible currency.

Figure 2: Structure of Foreign Trade, 1994

Source: Slovak Statistical Office

Unlike other nations in transition where economic growth is stimulating new foreign investment, capital, technology and education, Slovakia is not experiencing these benefits. Their absence will render the nation less competitive for years to come. Total foreign investments are low, compared to neighboring countries in transition, about US$570 million with 2,900 fully-owned foreign firms and an additional 4,700 partially-owned. Most foreign investments were made prior to the Czechoslovak division. Official Slovak data show 46.7% (or $266 million) of all foreign investment is in the processing sectors, with 31.3% devoted to trade and consumer goods and 11.1% in the insurance sector.

Most new direct investments from abroad are limited to small contract manufacturing and metal-bending operations. Few Slovak firms with foreign participation are not export-oriented or subsidized through international aid agencies. Hardly any investments are for production in the domestic market.

FUTURE MACROECONOMIC VULNERABILITIES

Short-term economic growth is not, in itself, a sign of economic soundness. Neither does it indicate correct policies. Global experience suggests that required economic reform is postponed during periods of short-term growth, aggravating future economic crises. For instance, in times of moderate prosperity in the 1960s and 1970s, the Soviet Union postponed required economic reforms, a factor leading to its collapse. The United States enjoyed strong growth in the 1960s despite signs of structural weakness, leading to a severe recession in 1976-1980. Latin America prospered in the 1970s, despite major structural difficulties that led, eventually, to a debt crisis in the early 1980s, the consequences of which are still being felt. The Japanese economic boom of the 1980s became a major recession of the 1990s because of that nation's inability to shift strategies.

Strong, developed economies are diversified and have sufficient flexibility to overcome short-term effects of recession and unanticipated crises. They rely on liberal capital markets to finance diversified, productive enterprises for domestic and foreign markets that cushion economic downturn. Slovakia falls far short of that capability today. Furthermore, the economy remains highly vulnerable to exogenous conditions that will have a negative impact upon both the budget and current account.

Box 4: Foreign Investment in Comparison with the Czech Republic

Official data estimate total foreign investment in Slovakia in late 1995 at $570 million. In comparison, one Czech firm alone, Czech Refineries, has an agreement for an investment of $653 million ($173 million for equity and $480 for non-equity investment) from three foreign oil firms to improve its refining and petrochemical sectors.

Despite current growth, continued prosperity is far from assured, and is heavily vulnerable to economic fluctuations and protectionist pressures in Western Europe. Over the long-term, the Slovak economy will be vulnerable to:

- **Infrastructure Demands**. Most domestic infrastructure was developed in the previous, Socialist regime. During the transition to democratic rule, basic upkeep of resources was neglected. Today, road and train networks, energy sources, primary manufacturing sources, and telecommunications require maintenance, modernization, and investment. The current growth cycle increases pressures upon fiscal resources to maintain basic upkeep, further straining budgetary resources.

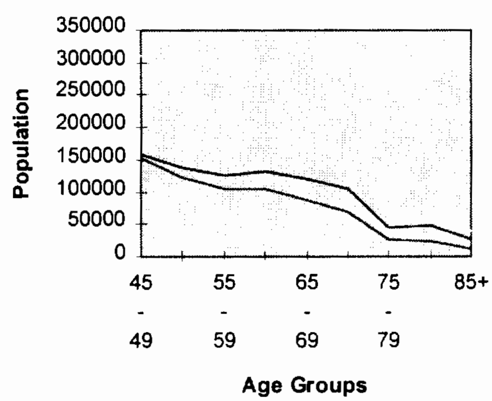
  Future growth is at issue. Transport represents a key potential source for increased national revenue. Today, the oil and gas pipelines are one of the most profitable branches of Slovak industry. Some believe that the nation can develop into a transport center between Western Europe and Russia, via the Danube and railway to the Ukraine. All this requires major infrastructure investments which Slovakia is incapable of making, given current conditions of local capital markets.

  In other Central and Eastern European countries, capital markets are financing infrastructure improvements. As long as capital markets remain closed or under tight restrictions in Slovakia, infrastructure will suffer, limiting overall economic growth.

- **Environmental Demands**. Environmental controls under earlier governments were limited and sacrificed the health and safety of the Slovak population for productive gains. Even these minimal standards deteriorated during the transition. Today, major expenditures are required to ensure basic health standards as well as to repair old abuses. This is especially true in the metallurgical sector, where water supplies and urban terrain are highly polluted. Factories must be upgraded to meet European norms as well as basic safety standards. Nuclear reactors must be upgraded and rebuilt. All these demands require long-term capital, which must now come directly from public coffers because of the lack of the capital markets.

- **Pension Demands**. The current system relies upon the public budget. Some 17% of total government spending (10% of GDP) went to pensions in 1994 and another 17% (12% GDP) of the budget went to other social programs. High pension disbursements are due, in part, to a low retirement age: fifty-seven for women and sixty for men. Even with gradual reform, the system faces growing demand and an inevitable crisis.

Figure 3. The Coming Pension Crunch: The Aging Population Slovakia, 1994



Because of high fatalities during the war years, the aged population is now relatively low. It will soon surge in numbers (see Figure 3), straining fiscal resources further. The Ministry of Labor estimates that the number of Slovaks dependent on some kind of social support will rise from 10% of the population in 1995 to 17% in the year 2000. The World Bank projects that the ratio of contributors to beneficiaries will decline from 2.42 in 1992 to 2.05 in 2010 with a consequential increase in expenditures and decline in transfers. Only vigorous GDP growth will guarantee the maintenance of the social system.

- **Trade Vulnerabilities**. Slovakia currently enjoys a slightly positive trade balance, due in part to the export of manufactured steel, the re-export of natural gas, and in part to Slovakia's earlier relationship with Czech companies. While this produces good short-term benefits, the nation is too highly dependent on trade with a few nations and heavy industry for long-term growth. In 1994, some 54% of all exports went to the Czech Republic and Germany alone. Over time, many of these arrangements will change. Already, Czech dependence upon Slovak goods is declining. Prior to their breakup, the Czech and Slovak areas had been each other's most important market for chemical products and intermediates. But after 1993, according to the U.N./Economic Commission for Europe/Working Party on the Chemical Industry, the $4 billion Czech industry has begun massive modernization, thanks to new foreign investment. Czech linkage with Slovak production is declining.

  Unless Slovak firms modernize, Czech firms will look elsewhere --including within the Czech Republic -- for suppliers. Peace in the Balkans will divert low-cost producers to the former Yugoslavia as well as reducing reliance upon Slovakia for East-West transit. Furthermore, Slovakia's trade composition is dominated by heavy industry, with most exports composed of iron and steel manufactures, nonferrous metals, metal manufactures, cement, wood and paper products, and machinery and equipment, which together accounted for 60% of 1993 exports.

- **Energy Costs**. Both the chemical and metallurgical sectors have relied on inexpensive and subsidized energy costs. With capital and infrastructure improvements required to sustain energy, the IMF and other agencies are pressuring the government to bring energy costs to international levels. Furthermore, this implicit subsidy could face trade barriers.

- **Agriculture Vulnerabilities**. Agriculture in Slovakia is in crisis. The sector reported the largest fall in workers (10%) of any in the nation. State subsidies to agriculture total about $400 million in 1995, not including informal subsidies through the credit market. Government data show a decline of food production of 25% since 1993 combined with a decline in export sales of 35%. Every year, imports of basic foodstuffs rise, especially of potatoes and beet sugar. Sugar beet farming fell from 39,700 hectares in 1989 to 32,000 hectares in 1994. The deficit continues to grow, with some 70,000 tons imported in 1994. With no reform in view, the trade balance will be under increasing pressure.

  The situation is similar in the agribusiness sector which has high rates of insolvency. Agricultural ministry estimate accounts payable at about $1 billion, some 50% higher than account receivables.

- **Raw material sources**. Slovakia's petrochemical sources appear good and well diversified. They are based in Russia, Italy, and (after peace) Yugoslavia. But the nation relies upon the Ukraine for cheap iron ore. Although Slovakia has contracts for continued provision through 1997, there is little doubt that the Ukraine will seek out more distant markets, including Russia and other former CIS nations. Other production depends upon supplies from and/or deliveries to the Czech Republic. The short-term advantage Slovakia holds will fade or come under pricing pressure.

- **Slovakia's traditional trade relationships**. Slovakia is relying upon traditional trading partners for some of its gains. The sale of military spare parts to the former Eastern Bloc has declined precipitously and will end eventually. Similarly, contract relationships with the Czech Republic will also decline.

- **Competitiveness**. Most foreign businesses in Slovakia agree that while the country's wage structure is low relative to Europe, its productivity is also low. Increasingly, foreign firms are turning to the Czech Republic rather than Slovakia to establish labor-intensive productive facilities. If the economy continues to grow through 1996, wage increases are inevitable, eliminating the nation's few remaining advantages in raw-material costs. Furthermore, Slovakia is in a race with its Eastern European neighbors to gain managerial and technological skills. Most of these skills come with new, foreign capital investment. Without sufficient reforms of the financial system, Slovakia will fall behind.

- **The Race for Skills**. Despite highly trained, manufacturing workforces, a lack of Western technological and managerial knowledge leaves Eastern Europe at a competitive disadvantage with higher cost producers. Consequently, the race to develop these skills will be a prime determinant of which Eastern European nations will prosper in the 21st century. Many of those skills will come from direct investment contact with Western firms. For the Slovak chemical sector, competitiveness will be determined by innovation and the degree to which the chemical industry is linked to Western research institutions. This, in turn, will lead to modernization of other dependent sectors, such as agriculture, textiles, and leather. Similarly, if they are to survive, the Slovak armaments, electrical, and high-tech industries will require licensing, investment, and technological partnerships with foreign firms. And a capital base is a prerequisite for partnership.

- **Protectionism**. Should the German and the Western European economies enter into a cyclical recession, Slovakia will have few outlets for its manufactured exports. Furthermore, as neighboring nations (the Czech Republic, Poland, Hungary) modernize, more technologically efficient industries will erode the small competitive advantage Slovakia holds today.

CAPITAL MARKETS, CORPORATE STRUCTURE, AND GROWTH

While increased efficiencies, profits and higher employment are being registered by some firms, while others continue to be mired in bad-debt. Most of these older firms lost their traditional export markets or saw significant declines in their domestic markets as the result of foreign and new domestic competition. In the transition from statist to market economy, the government struggles to support employment levels in loss-making state and quasi-private enterprises, the weak agricultural sector, and firms that face increasing competition from foreign sources. It employs two basic strategies: a) using cash deposits from profitable firms to roll over debt to insolvent companies; and b) merging weak companies with stronger enterprises. In essence, losing and ultimately insolvent enterprises absorb profits. This tendency risks developing into a vicious circle of good money channeled into bad, draining the economy and rewarding poor productivity. It reinforces the power of the state in economic matters and increases the number of inefficient firms.

Privatization of major public enterprises is mired in political controversy. The National Property Fund lost control of many firms in 1995 when direct responsibility passed to various ministries. Consequently, investment and employment decisions are political in "strategic sectors" that range from ironworks, power, and military equipment to coffee storage.

The government and the National Property Fund have a substantial number of loan guarantees that implicitly weigh on the national budget. Even when privatization does take place, government interference is evident. For example, the privatization of a state aluminum firm using hydroelectric power has state guarantees as well as a commitment of fixed costs for state power, an implicit subsidy.

As public and quasi-private firms become mired in a maze of cross-linked ownership and interlocking directorates and managements, loans and obligations increase because of the need to paper over losses and inefficient obligations. Recycling one firm's profits to fulfill bad loans or to support over employment drains good firms of the ability to grow, invest in capital improvements, attract foreign and domestic capital, and create jobs.

Furthermore, intercompany and, in large holding firms, intracompany debt continues to be a major problem. Natural gas, energy, telecommunications, transport and other providers and utilities suggest the problem is large. As strong and weaker firms are merged, the ability to create industrial efficiencies becomes more difficult because of these debts.

Thus, while the nation has a dire need to enhance its productivity, modernize its industry, train its managers, and introduce new technologies, resources are being drained away. In a free market economy, capital markets rather than government and political officials reward productivity, thereby financing future growth and job creation.

When the current upward economic cycle ends, as it inevitably will, good and bad firms will be dragged under. Slovakia will become more vulnerable to outside competition and come under increasing pressure from multilateral institutions. Consequently, the nation's sovereignty will suffer.

Box 5: Bank Ownership and Equity

Vseobecna Uverova Banka (VUB) is the primary lending bank in Slovakia. In 1994, it held 41% of loans outstanding to Slovak banks. It receives 80% of the deposits of the government-owned Slovak Savings Bank for lending purposes. The government holds 51% of VUB's shares and 41% are held by VUB INVEST. In 1994, VUB owned 68.9% of VUB INVEST, having divested the other 31.1% to other banks and investment funds.

In August 1995, VUB floated an issue of a Sk 1.2 billion bond on the BCPB Stock Exchange, paying an interest rate of 2.25% above the NBS discount rate. Forty one of the bonds were purchased by other (state) banks and (state) insurance firms.

THE BAD-DEBT SITUATION: THE HEART OF THE MATTER

The bad-debt situation in Slovakia is at the heart of this matter. It is here, rather than in the government budget, where support for losing industries and job maintenance sits. Quasi-public savings and insurance companies, and profitable parastatal companies (public utilities, petroleum, and gas), deposit excess cash in banks that support ongoing bad loans to losing enterprises. The Savings Bank places its deposits at the VUB. The banks, either unable or unwilling to collect, roll over most short-term loans and thus limit loan-loss provisions.

Firms borrow funds from one bank to repay another or receive cash infusions from investment funds without imposing efficiencies or restructuring. The maze of interenterprise debts, many in arrears, further complicates the problem. An extremely weak bankruptcy law, political reality, and government policy reinforces the tendency to mask rather than resolve bad-debt.

Increased interest spreads, used to finance bank profitability, impose a tax on depositors and good borrowers. However, spreads will fall with increasing bank competition that will develop with new financial institutions. Furthermore, a bailout of old loans runs a moral hazard risk: will banks continue to throw good money after bad, unable to collect loans and forcing continuing rollover? At the time this report was written, banks are reducing new loans. This suggests a curtailment of new enterprises financing until bad loans are brought under control.

The total amount of bad-debt is impossible to deduce exactly. With banks rolling over bad-debts or refinancing other banks' bad loans, the definition of "non-performing" is strained. Informed estimates of total bad-debt range from Sk 60 to Sk 120 billion. Various informed guesses include:

- A general opinion that half of all non-foreign banks' loans are or will be uncollectable. If this is true, the level of bad-debt is Sk 110 billion.

- The Slovak press reported in late 1995 that the NBS acknowledges that "...almost 50 percent of loans extended by Slovak banks are bad or doubtful."

- Some published government estimates suggest that bad loans equal Sk 90 billion, or 45% of the total loan volume of the three biggest banks.

- In mid-1995, the NBS published an estimate of the level of "dubious" debts at Sk 65.2 billion, of which Sk 35.4 billion is "uncollectable."

APPROACHING A SOLUTION: RISKS AND OPPORTUNITIES

Whether Sk 60 or Sk 110 billion, resolution of the bad-debt problem will have an immediate positive impact on Slovak economic performance, freeing capital for productive enterprises, and developing incentives for modernizing industry. Alternatively, the longer the bad-debt situation continues, the more complicated a benign and just solution becomes. A resolution implies closing insolvent firms, laying off workers, restructuring banks, eliminating the power of some government officials to support enterprises, retraining bank staffs, and creating an effective regulatory structure. A realistic appraisal of banks' loan portfolios is difficult at best, with past irregular loan refinancing schemes, intercompany debts, and cross directorships.

Table 2: Financial Structure: Leading Slovak Banks, 1994

	Capital	Reserves	Total Assets	Loans	% of total domestic loans	Placements, Other Banks	Investments
VUB	4,078	7393	156,600	86,138	41%	23,284	19,531
SBS	2,042	3698	144,300	41,295	20%	40,295	15,000
Priemyselna	10,001	183	5,689	3,425	2%	810	113
IRB	1,000	1632	47,000	36,149	17%	na	na
Pol'nobanka	800	180	16,800	10,540	5%	na	na
Total Loans, Domestic Banks				210,600	85%		
Total Loans, Dom & For. Banks				257,600			

Sources: 1994 reports: VUB, SBS, Priemyselna, IRB, Pol'nobanka, SBS Consolidated Report

While an immediate closure and dissolution of loss-making firms might be the easiest strategy, it is both wasteful and politically unrealistic. Some parastatal firms labor under a heavy debt burden incurred during the initial years of transition and now profit net of old debt. Other firms are profitable but are weighed down by unproductive units. One point is clear: it is in the interest of the banks, the companies, and the nation as a whole to develop a clear financial restructuring that maximizes performing assets while eliminating losing or moribund activities. The development of an open capital market, free from political interference, will lead to a competitive and prosperous nation. Alternatively, a continuation of the current system makes Slovakia vulnerable over the mid-term.

Table 3: Ratio of Assets to Loans, Slovak Banks

	1994	1993
VUB	60	69
Slovak Savings Bank	31	37
IRB	70	79
Pol'nobanka	66	75
Tatra Bank	53	85

Sources: Central Bank. Individual Bank Reports, 1993, 1994

But which solution? Clearly none is without difficulties, but the government must make great efforts to avoid:

- A stop-gap solution that refinances banks without debt consolidation, temporarily camouflages the depth of the problem, and maintains continuing political pressure for subsidies from losing companies.

- A solution that eliminates current bad-debts without modernizing bank institutions and allows for the creation of a new bad-debt problem in a few years' time.

- A radical solution that closes all poorly performing firms would cause both political difficulties as well as destroying performing assets.

- A solution that harms ongoing subsidiary, productive enterprises because parent companies are unable to fulfill debt service.

- A solution that increases the power of the government through harsh regulation -- in effect, increasing political and bureaucratic inputs into what should be free market decisions.

- A solution that does not provide for the retaining of bank personnel, to allow them to develop information and risk evaluation skills.

REGULATORY ISSUES

A solution to the bad-debt problem cannot be accomplished without addressing other legal, regulatory and financial difficulties. The lack of a repayment tradition, reinforced during the transition period, must be addressed through strong legal and judicial means. A weak legal system must be trained in the bases of bankruptcy, its rationale and role in a free market system. New bankruptcy laws and tax reforms are currently under consideration by the government and may resolve legal roadblocks, if implemented effectively. Finally, the population as a whole must continue to be trained in the fundamentals of free market finance, to maintain an adequate political base for bank and capital reforms.

Box 6: How Bad-Debts are Financed: Wastage of Valuable National Resources

A number of valuable state-run and quasi-public corporations deposit their earnings and assets in the state banking system. Among these are Slovnaft (the state chemical company), Solvensky plynarensky priemysel (SPP) (Slovak natural gas), and Slovenska Poist'ovna (insurance firm). In 1994, the SBB reported that state-owned enterprises (SOEs) held 35% of total deposits in the banking system and held 38% of all loans. But beyond these firms are the large number of quasi-public funds administered by the National Property Fund (NPF). Each of the NPF's holdings are listed as private companies, but are indirectly under government or political control. For instance, Slovenska Poist'ovna, the insurance firm owned by the National Property Fund, has maintained the same management since the transition and has Sk 24 billion in deposits in Savings Banks. These funds are dispersed as loans to other, quasi-public sector firms and banks or to finance ongoing deposits.

The danger is this: if the assets of insurance, utility, and gas industries are employed for bad loans and non-performing assets, eventually either the state will have to bail out these assets, or the industries will lose their capital and be rendered insolvent. Furthermore, from a macroeconomic point of view, the use of these assets for nonperforming functions (maintenance of deposits and subsidization of losing firms) is a drain on the economy; these funds could better be used in financing new enterprises.

III. DEVELOPING A MODEL FOR GROWTH

The issue for Slovakia is how to render its production more efficient and responsive to global market forces, in other words, how to ensure that its future is prosperous. This section will briefly examine the current economic model upon which future models will be built in the next section.

THE CURRENT ECONOMIC MODEL

Slovakia today is typical of many economies in transition with a strong state; bureaucratic sector in transition; large quasi-public/private enterprises, some producing, others moribund; a financial sector in crisis; a growing private commercial sector that exports natural resources and semi-processed goods in exchange for manufactured and agricultural goods; a growing private service sector and foreign investment sufficiently large to provide training as well as markets.

General macroeconomic management and reform is laying the groundwork for private sector development, with the Slovak government adhering to IMF guidelines. The budgetary deficit is declining and direct government subsidies are falling. Slovakia enjoys a relatively low and manageable external debt. The Slovak koruna remains stable, in line with IMF programs. With strong growth, the government feels little pressure to reform. Furthermore, the political bias of the current government is to sustain labor levels and salaries.

The current strong growth derives from Slovakia's fortuitous geographic position, high demand and increasing global prices for metallurgical and chemical goods, access to relatively inexpensive raw materials from the Ukraine and Russia, and competitive wage rates. Slovakia also benefits from the spillover effect of strong economic growth in Germany and elsewhere in Europe, where manufacturing capacity is fully utilized, compelling the use of Eastern European manufacturing resources.

A World Bank analysis of 1993 Slovak exports concludes that the economy is strongly dependent on only a few commodities. Sixty percent derive from manufactures such as iron and steel; nonferrous metals; metal manufactures; cement, wood, and paper products; and machinery and equipment. Even beyond this, production data (see Table 4) reveal that many other Slovak industries, such as textiles, leather, and agriculture, rely heavily upon the gas and chemical sectors for inexpensive inputs. In other words, the nation's health is based upon metals and chemicals.

Table 3: Production of Goods 1993

Good	Sk million
Crop Production	14,311
Livestock Production	13,089
Mining	9,179
Agroprocessing	47,698
Textile, Textile Products	14,033
Leather, Leather Products	5,493
Wood, Wood Products	4,892
Pulp, Paper, Paper Products	14,578
Coke, Petroleum Products, Nuclear Energy	24,589
Chemicals, Chem Products, Man-Made Fibres	24,743
Rubber and Plastic Products Manufacture	10,189
Manufacture of non-metallic mineral products	13,097
Manufacture of basic metals and fabricated metal products	50,622
Manufacture of machinery and equipment	22,620
Manufacture of electrical and optical equipment	14,232
Manufacture of transport equipment	12,354
Misc. Manufacture	7,385
Electricity, gas and water supply	41,558
Total	**344,662**

Source: Slovak Statistical Office

State bureaucracies continue to weigh on economic performance. Many state institutions in government, finance, and education are outmoded and need to be reformed. By and large, domestic-oriented industries are weak. The agriculture sector is in crisis. Despite high subsidies, production declines each year and increasingly vital foods (potatoes, sugar beets) are purchased abroad. In 1994, government statistics show that 20% of all food products being imported. The defense industry, a strong contributor to the economy in past years, is very weak, with military production at 7% of pre-transition times.

Aside from small investment for contract manufacturing, capital accumulation is very small. Compared to the rest of Eastern Europe, foreign investment in Slovakia is minuscule -- 16% of the Czech Republic, 11% of Poland and 7% of Hungary -- with most accomplished prior to the breakup of the Republic of Czechoslovakia. Most if not all of the much-proclaimed new investment has been either for contract manufacturing, or guaranteed by multilateral institutions or the Slovakian government. In fact, fixed investment has fallen. Today, private bankers will lend only for trade finance, collateralized on internationally-secured liquid assets such as oil, gas, and raw materials. In other words, Slovakia's credit rating is poor.

With the State dominating agriculture and most industry, and individual public enterprises controlling most profitable firms, there is a poor allocation of resources. For example, state petrochemical and natural gas firms receive most earnings in the nation and, after taxes, use these funds for their own sector rather than diversifying into other more-efficient economic activities, as would happen under private management. Any other surplus funds are deposited in the banking system and absorbed into the bad-loan problem.

There is minimal, if any, modernization of Slovak industries. Technology is outdated and the nation risks falling further behind in competition for new investments. This is especially critical for defense industries that lack access to Western technology.

MISALLOCATION OF RESOURCES: THE IMPACT

Government institutions, quasi-state banks, and state enterprises determine the allocation of profits from the chemical, metallurgical, and insurance sectors. As long as this continues, the economy will be skewed with:

- Distortion and skewing of investment. Areas that might grow through investment cannot because available credits go to unproductive enterprises and formal and informal state subsidies prop up inefficiencies.

- Underemployment from those outside the subsidized sector who cannot gain access to work because of a lack of capital.

- Increased imports in areas that might be productive but are not (such as agriculture).

- Declining technological, marketing, and management skill vis-à-vis competitors. Increased reliance upon outside world for support and knowledge. Loss of national sovereignty.

- Capital flight; money going to other nations where profits are more predictable with less risk; and savings that could be used for internal investments are flowing abroad.

- Regional bias, with increased development in western Slovakia, where government finances are centralized, to the detriment of other areas.

- Overemployment, leading to a lack of productivity and a culture not inclined to work.

- Continued reliance upon the state for sustenance.

BAD-DEBT AND REGIONAL DEVELOPMENT

As the capital, Bratislava is enjoying the fruits of the new system, to the detriment of other regions. It has the lowest unemployment rate in the country and the highest number of new private enterprises per 100 inhabitants. This is due, in part, to its western location and trilingual tradition. But more important, state control of capital and budgets centralizes investments. Free capital markets invest wherever the profit and potential is greatest, without bureaucratic bias. Today, the general tendency is that modern jobs are growing in western Slovakia, while antiquated industries and agriculture struggle in other parts of the country. This situation increases economic as well as political tensions.

It is true that state subsidies, either through the treasury or indirectly through the banking system, subsidizes old industries throughout the country. But it also prevents innovation in those areas that require it most. Indeed, in many ways, the government's difficulty in addressing the bad-debt situation of state firms is creating a political problem, arising from regional pressures.

A review of regional characteristics shows a constant theme of the need for new capital, modernization and technical expertise throughout :

> **Bratislava.** The capital has attracted 70% of the nation's total foreign investment and 80% of its joint ventures. Government offices, foreign donor headquarters, trade missions, and tourism all come through Bratislava. Proximity to Vienna as well as being the "first stop" in air and train connections from the West draws wealth into the region.
>
> **Trnava and Piestany.** These cities produce pharmaceutical, medical equipment, automobile parts, electronic components and semiconductors. The two cities require strong infusions of capital to modernize factories and improve technology.

Box 7: Case Study of Slavosovske Paipierne Inc.

Slavosovske Paipierne Inc. is the largest paper mill in Slovakia. In 1993, it produced 8,000 tons of paper versus 43,500 tons in 1989, losing Sk 112 million on a turnover of Sk 12 million. At the close of 1994, bank loans to the firm totaled Sk 230 million with the company unable to pay its creditors. The VUB and the Slovak Savings Bank proposed to sell the firm via public tender. Even though six potential buyers expressed some interest, the tender was declared unsuccessful. Consequently, the banks loaned the company an additional Sk 300 million.

> **Komarno and the Danube Basin.** This is a shipbuilding center, Danube port, and the richest agricultural region. The area would grow dramatically with infrastructure improvements to the port area. With modernization, inputs and new credits, the region would enjoy a broad agricultural and agroprocessing boom with ancillary effects on supportive industries.
>
> **Martin, Zilina, Zvolen, Banska Bystrica.** These towns have highly trained work forces. The center of the Slovak arms industry requires massive capital infusions to undergo transition. Large potential in machine tool and heavy manufacturing sectors. Lumber, textiles, leather, and food processing would improve dramatically with new capital and infrastructure investments. In addition, finance and tourism sectors are growing.

Poprad and the High Tatras. These are locations for winter sports, summer hiking, and camping centers with high potential in tourism. The small hotels and facilities require large infusions for infrastructure and training.

Kosice, Michalovce and Eastern Slovakia. These are centers for transport, steelworks and other metallurgical companies, chemicals, machine-tools and electronics industries, many outmoded and requiring modernization. The region, currently in deep recession, would profit greatly from infrastructure improvements on the east-west train route.

A FUTURE MODEL FOR GROWTH: THE BEST CASE SCENARIO

Ten years from now, the first transition period of the early nineties will be seen as preparation for the second -- when Slovakia enters the world economy and, more importantly, the Western Europe economic orbit. Under intensive global competition, innovation, technology, and production efficiency will determine growth. How Slovakia will respond to these challenges will determine its economic well-being.

Various scenarios are possible. A "muddling through" model would involve only cosmetic changes, accomplished for the benefit of international donors but, in effect, maintaining the status quo, with continued small-scale crises solved through government spending of scarce resources. Under this model, growth would be minimal.

A "best case" scenario proposes a shift away from complete dependence on heavy industry towards smaller, innovative industries and firms. The goal would be that of long-term, balanced growth and an economy capable of adjusting to international competitive pressures while developing and maintaining vigorous domestic industries. Slovakia would be able to use resources gained from stronger industries to develop competitive advantages in others. Innovation and capital markets would emerge as a strength in the global economy.

A new, modern, and high-tech service sector would play a major role in growth. Over the next five years, new banks would emerge in competition with current institutions, some offering specific services, such as trade or housing finance, others offering alternatives for secure savings. Lacking government backing for large deposits, the banking system must develop secure lending mechanisms. Foreign participation in the banking and insurance system will increase, further increasing competition in the financial market. It is this vital, competitive financial market that will be the lubricant for development.

Under the "best-case" model, heavy industry will continue to be the engine for growth over the next decade, A large percentage of GDP will derive from re-exports of Russian natural gas (some 70b m3 annually) for foreign partners, manufactured petrochemicals, conversion of Ukrainian iron ore into finished, processed steel exports, aluminum, and other primary metallurgical goods. However, its relative role in the overall economy will decline. Facing increased competition, some firms will close by the end of the century. Chemical fibers, paints, and plastics will all come under increasing pressure. Some export markets will end and a drop in access to cheap raw materials is likely. Forced efficiencies in production as well as a reduction in external demand for some of these products will, over time, reduce employment levels. Furthermore, cyclical recession in Western Europe will have an impact on demand.

What is more important is that the environment for new and smaller industries as well as modernization of outmoded sectors will render the Slovak economy more diversified. With improved access both to foreign capital and domestic lending, contract manufacturing will expand. Niche production will expand and take advantage of openings in the global economy, especially in Western Europe. New textile, shoes, autosupply and chemical firms will be founded, linked with foreign operations. The service sector will continue to expand. Insurance firms, investment houses, law and accounting firms, and private educational institutions will thrive and diversify, creating a huge demand for a highly educated workforce. In sum, the contribution of small and medium enterprises will triple over the ten-year period.

Trade linkages to Western Europe for specialized products -- in the automobile industry, textiles, chemicals, and machinery -- will be critical to maintain export-oriented growth. Many of these will be temporary in nature. Large export production one year of a given product will vanish the next. The strength will be in diversity of production and innovation.

Beyond this, a "best-case" scenario proposes radical reform and rejuvenation of two sectors: agriculture and tourism. With increased access to capital and a strong legal system, new ventures in agriculture and agroprocessing will take advantage of the fertile Danube valley. Rapid production growth will lead Slovakia from being a net importer of foodstuffs to a net exporter. Furthermore, farmers will begin to produce for niche markets abroad, developing processed foodstuffs for Japan, Western Europe, and the United States. Tourism will flourish as capital provides the basis for new investments in the Tatras. The indirect impact of new Western interest in overall Slovak investment will lure substantial tourism dollars to be exploited. Small and medium transport companies will grow. Trucking, freight, transshipment, and other ventures, assisted by strong banks, will help Slovakia develop into a major transport route linking Western Europe to the East.

New, revitalized industries will absorb labor and technology from outmoded sectors. A small portion of the military industry will use its talents in high-tech ventures; still others will develop small, mechanized implements. But over the long-term, this sector will decline rapidly. Similarly, the electronics and office machine sectors not linked to foreign suppliers will erode. Lacking neither modern technological skills nor access to markets, they cannot compete.

Box 8: Bad-Debt in the Developed World

Slovakia is not alone in facing a bad-debt problem. Most nations face bank crises at one time or another. Over the last decade, the United States (Savings and Loan), France (Credit Lyonnais) and Japan (Bank Crisis) have had to resolve severe financial difficulties deriving from bad-debts and support to losing firms or real estate ventures. As in Slovakia, some bad-debt developed because of government or other political interference in loan creation.

However, errors in market perception and importance precipitated these crises. Most bad bank debt developed because of downturns in specific markets and cycles, such as real estate or petroleum. Furthermore, most debts went to support new enterprises and investments, enhancing macroeconomic performance, rather than to subsidize corporate deficits or employment levels. Indeed, the debt crises indicate that free market systems are functioning, permitting destruction of poor investments along with profits for strong investments.

In Slovakia, the situation is far different. Most debt went to support ongoing activities and maintain employment levels, not for future investment. There was little expectation of repayment.

IV. THE IMPACT OF BAD-DEBT REFORMS. MODELS FOR THE NEXT TEN YEARS.

Note: The section below contains assumptions for the global economy and the Slovak economy, 1996-2005. The three models for resolution of the bad-debt problem in Slovakia which are presented at the end of this section are based upon these assumptions.

ASSUMPTIONS FOR THE GLOBAL ECONOMY, 1996-2005

- The global economy will continue to grow at a moderate pace through 1998, with moderate inflation. Cyclical recessions will take place, more sector- and region-based than nation-based, as commodities and products fluctuate in demand and price on a world basis.

- International pressures on domestic economies will compel openness to direct and indirect capital investment. Technology, innovation, improved productivity, new materials, and downsizing will continue to be key elements in national competitiveness. Over the long-term, those nations that are able to adjust their political systems to these global demands will grow; those that do not will suffer economic instability and declines in standards of living.

- The North American economy will continue moderate growth interrupted by sectoral and regional recessions. Its technological leadership will continue to dominate global industry into the next century. However, productivity in industry will come under increasing pressure from Asia. China will become a major leader in chemical, metallurgical, and heavy machinery sectors. Korea and Taiwan will improve their position in the high-tech sectors. However structural difficulties among the Asian Tigers and China will have to be addressed as they come under increasing pressures from Europe and North America to open their borders to imports.

- The Western European economy will perform below global averages as it continues to restructure to better compete with the North American and Asian economies, and the unpredictability of European Union economic policies slows investment. However, the region will continue seeking to outsource production to drive down its cost base.

- The European Union will not allow entry of Eastern European nations, at least before 2005, as current issues of currency, budget, North-South difficulties, and other problems take precedence. Nonetheless, German, Italian, and Austrian industries will continue to increase their dependence upon Eastern European sourcing, forcing a weakening of trade barriers for intermediate products.

- Russia and former C.I.S. nations will improve productivity in selected industries, thus improving their competitive positions. However, national economic cohesion for each country appears unlikely until the next century. While standards of living will continue to improve, radical differences between regions in each country will maintain economic and social tensions. Unpredictability in business dealings, high crime levels, and inexperience will continue to plague these economies.

- Eastern and Central European countries in transition will continue under strong competitive pressure from global markets, protectionist sentiment in the European Community, and problems of restructuring. Generational and ideological political schisms will harm economic planning in most nations.

  The potential for rapid growth is unlikely to be completely fulfilled as long as the European Community -- the natural market -- maintains its barriers. However, improved efficiencies in industry and agriculture, combined with lower wage bases must cause seepage in trade walls as German and Italian firms, in particular, seek cheaper sourcing in the East. Dependability in production, currency, and government regulations will govern direct investments.

  Because foreign investment will be moderate and European Union trade barriers will remain, Eastern and Central European nations will gain their greatest growth from domestic investment and productivity improvements. Only some nations will succeed in varying degrees. With highly skilled workforces, an ample industrial base, and good agricultural lands, governments will continue under pressure to deregulate while developing an environment conducive to free flows of capital. Business regulations will continue to be modified to meet international standards and will remain predictable, especially in the areas of contract law. Financial reforms -- a problem in every nation -- will be implemented with varying degrees of success.

  The nations that are able to muster sufficient political will and implement these changes will be those that will succeed. Others will muddle through. Lacking capital for modernization of infrastructure and industry, they will survive at a moderate pace into the next decade when international competitive pressures will compel either major domestic shocks or rapid and politically-unsettling reform. While the Czech Republic, Slovakia, Poland and Hungary are likely to outperform others in transition -- because of geography industrial base, and other factors -- their temporary competitive advantages will erode rapidly without completion of the transition process.

ASSUMPTIONS FOR THE SLOVAK ECONOMY, 1996-2005

- **Political normalcy**. Despite major tensions, the Slovak government will be stable. While labor and regional tensions mar economic policy, all major parties are committed to opening the economic system, developing the private sector, and improving trade and investment relations with Western Europe and neighboring nations.

- **Predictability in Economic Regulation**. Regardless of who rules, the government will continue to liberalize policies to foster improvement in private sector activities. Still, statist tendencies will remain and continued high unemployment will cause periodic political maneuvering over economic policy. Inflation will remain moderate and fiscal deficit, near balance. Tax rates will remain near current level although other increases will be forced to prop up pension and insurance funds. Currency rates vis-à-vis trading partners will come under pressure as a trade deficit increases towards the end of the century.

- **Financial Regulatory Reform**. Credit, bankruptcy and contract laws are reformed. While their enforcement in the early years is limited, the linkage between job-creation and good credit regulation is so strong that, over time, the government pressures for implementation.

- **Stability of industrial sources**. Slovakia will continue to receive a predictable, steady flow of raw materials from the Ukraine and Russia, despite internal political and economic difficulties in those nations. While price may be an issue in the latter part of this decade, normal trade relations will remain.

- **Increased Trade with Western Europe**. The general trend of production in Slovakia will continue towards increased trade with Germany, Italy, and the European Union. This will imply continued investments in contract and manufacturing facilities as well as development of Slovak laws and regulations to meet EU standards.

- **Shifting Slovak-Czech Trade**. Trade patterns with the Czech Republic will change dramatically as that nation looks to the West, rather than to its former partner, for development and markets. Former linkages between CR and SR firms will deteriorate over time, as new Czech firms develop in direct competition. This is particularly true in the metallurgical sector. More and more, the CR will be seen in Bratislava as a competitor for markets.

- **Continued Reliance Upon Heavy Industry**. The Slovak economy will continue to rely upon metallurgical, chemical, and energy sectors to maintain its competitive advantage. Therefore, improved efficiencies, technological innovation, and maintenance of adequate and predictable supplies in these heavy industries will be key determinants of how well the entire economy will perform. Management of these firms, be they private or public, will be key. Government regulation will also be important as labor, tax, infrastructure, and environmental issues will impact on price and supply. Still, these sectors will remain exposed to global sectoral fluctuations and thus must have a sufficient capital base to weather recessionary periods.

- **Downsizing**. While heavy industry will supply the intermediate materials, the remainder of the Slovak economy will become smaller, developing entrepreneurial firms to take advantage of the industrial base. Small leather, textile, and metal groups will develop linkages to the West to improve production. Their ability to innovate, design, and provide dependable product at a competitive price will be critical to economic performance.

- **Increased capital requirements**. Government, the large capital intensive industries, and new, entrepreneurial firms will require huge infusions of capital over the next decade. Infrastructure, environmental, and social costs will surge with growth and transition. Some small amounts of investment will come from foreign groups establishing processing facilities in Slovakia. Donor agencies and multilateral banks will provide additional funding. But these are not enough, and competition from other Eastern European and other developing nations will be intense. The degree to which capital is available will, to a large degree, determine competitiveness in the next century.

- **Rationalization**. Outmoded industries such as armaments or semiconductors will, for the most part, be radically restructured, increasing social costs. Other former public sector firms in more profitable sectors will face difficult decisions to radically restructure or close. Because many of these outmoded industries are in specific regions, political tensions will continue high, increasing the statist/free market debate.

- **Agricultural crisis**. Farming, farm supplies, and agroprocessing will continue in crisis until the next elections. State farms, cooperatives, and grain elevators remain in heavy debt. Some small processing facilities will develop in joint-venture with foreign capital, but, by and large, production will decline, forcing either increased imports from abroad or subsidies of unproductive facilities. Either way, demands upon government coffers will rise. After the next elections, and regardless of party, the government will have little choice but to liberalize farm production, inputs, and market conditions.

MODELS FOR RESOLUTION OF THE BAD-DEBT PROBLEM IN SLOVAKIA

Summary

The following models for the Slovak economy are based upon current options being discussed by the Slovak government to resolve the bad-debt situation. They are based on the assumptions listed above and assume that the direct cost of cleaning balance sheets and recapitalizing commercial banks will be borne by the Government (or Central Bank) and/or the concerned banks, while depositors will not be expected to share in the loss.

The three key models, in summary, are:

Model One: Status Quo

The Bad-Debt situation continues as the country attempts to muddle through and "grow out" of the difficulty. While macroeconomic targets continue to be met, structural reform is minimal. The legal framework for bankruptcy, contracts, and investment remains weak. The government continues to believe that increased profits and fiscal revenues will be sufficient to prop up the weak banks. It increases spreads to allow banks sufficient profitability to roll over old loans as well maintain adequate coverage. Long-term capital remains scarce or subsidized and expensive.

Model Two: Projected Government and Bank Reforms

Current government proposals to reform bankruptcy and tax policy on bad loans provide banks with a three-year period to identify and write-off bad loans while reforming the bankruptcy process. New procedures would simplify as well as shorten the amount of time required to pursue bankruptcy proceedings, and bring banks and firms to arbitration. There would be no workout of the debt under this option. Financial institutions would cleanse their balance sheets of nonperforming loans.

Model Three: Bank Reform with Loan Workout and Government Financial Participation

Financial institutions workout nonperforming loans with companies, under government supervision. After renegotiation of loan portfolios to determine that portion of individual loans that are operative, the remainder of the loan portfolio is declared nonperforming and sold to the government at a 30% discount in return for equity. Government-owned equity is to be sold to private investors after a three-year period. Financial institutions' balance sheets are cleansed, while functioning firms saddled with old debts are rendered healthy.

MODEL ONE SCENARIO WORKOUT: STATUS QUO

The Bad-Debt situation continues as the country attempts to muddle through and "grow out" of the difficulty. Key elements of this model include:

- Macroeconomic targets continue to be met, but structural reform is minimal.
- The legal framework for bankruptcy, contracts, and investment remains weak.
- The government continues to attempt to "grow" out of the bad-debt problem, believing that increased profits and fiscal revenues will be sufficient to prop up the weak banks.
- It increases spreads to allow banks sufficient profitability to rollover old loans as well maintain adequacy coverage.
- Long-term capital remains scarce, or subsidized and expensive.

Analysis

Throughout 1997-1998, growth masks decay. Heavy industry responds to increased global demand, sustaining weak financial institutions and domestic industries. Increased profits and foreign investments maintain bank stability through the next three years. Structural difficulties increase because of continued implicit subsidies to losing enterprises, the rolling over of bad-debt, or the merger of weak firms with good. Bad-debt grows, increasing pressure on government authorities to improve spreads for financial institutions. Thus, the "tax" on performing loans grows, weakening strong firms. Indeed, the risk is that bank weakness will grow to such levels that the government will have no choice but to step in and take over the domestic financial sector, in order to preserve deposits of insurance companies, state enterprises, and private citizens, and to avoid financial panic.

Exposed to more and more control by central bank authorities, banks' authority declines. They become increasingly reluctant to issue any loans, preferring to roll over nonperforming loans and finance them with government assistance. All long-term capital continues to come from foreign investment or trade-finance. Short-term capital is very scarce.

The national economy increasingly relies on a few state-dominated industries, particularly natural gas and chemicals, for its profit. State power over the economy grows. Credit to small and medium enterprises and other start-up firms will be restricted. Credit decisions will be influenced either by political factors (regionalism, job maintenance, corruption) or donor agencies. Regional and national tensions grow because of economic imbalances throughout the nation; state finances are incapable of papering over major differences in wealth, development, and ideas about the role of the state and of business.

GDP will continue to rise over the next three years from the low base, and will only barely reach 1991 levels by the end of the century. The natural gas and chemical industries will grow, using indirect financing and joint-venture funds from foreign sources. Some metallurgical and auto parts firms will also do well. But weak and nonperforming sectors of the economy will increasingly deter growth and prosperity. Political pressure on the government increases due to a lack of resources to maintain employment levels and pensions.

Furthermore, because profitability is centered in government-dominated industries, the power of the state over economic performance increases. Entrepreneurs and small and medium enterprises, starved of capital, will be unable to develop and innovate. Therefore, Slovakia's competitive position slowly declines. The lack of capital for small business has a negative impact on marginal sectors, such as agriculture, textiles, and pharmaceuticals, where global competitive forces are most fierce.

The business culture of Slovakia fails to develop in line with Western European models, because of high reliance upon government. The failure to develop a common understanding of contract and bankruptcy law places the nation at a disadvantage with Visegrad countries who, by the end of the century, will develop strong linkages to Western firms.

Slovakia's vulnerability to exogenous economic factors increases. Once global economic expansion weakens and regional (chemicals, shipbuilding, autoparts) and global (electronic, metallurgical, high technology) competition intensifies, bank, pension, and insurance capital will enter crisis. Overextended financing for heavy industry will erode Slovakia's ability to prop up losing sectors.

In this situation -- weak capital markets, fragile domestic industry, and heavy industry in recession -- the nation will have few choices. It can either abandon IMF targets and inflate (the Brazilian model) out of the bad-debt problem or force widespread bankruptcies and a prolonged period of recession (Chile, Indonesia). Either way, Slovakia will waste its current advantageous position. Political tensions will increase and foreign, multilateral influence over national policies will grow, compelling Slovakia to restructure. By the early 21st century, Slovakia will be in crisis.

Box 9: Basic Requirements for Effective Bank Reform

- Resolve the bad-debt situation, including elimination of nonperforming assets and maximization of performing assets.
- Recapitalize the banking system
- Develop effective bank management of ongoing resources, including loan assessment and collection.
- Institutionalize public regulatory controls over indebtedness to insure that a new bad-debt situation does not arise.
- Develop a bankruptcy law, effectively implement and enforce it.
- Increase government and public awareness of the cost of bad-debt, in order to insure growth of a loan repayment culture.
- After bank reform takes place, determine and rigidly enforce bank adequacy provisions.

Model Two Scenario Workout: Projected Government and Bank Reforms

Current government proposals to reform bankruptcy and tax policy are implemented, which include:

- Requirement that banks pay taxes on nonperforming loans will be phased out over a three-year period;
- Bad loans can be written off by banks after the liquidation of firms but not before;
- Faster bankruptcy hearings. Banks and debtors will enjoy greater flexibility in coming to out-of-court agreements and creates the office of "provisional administrator" to monitor each debtor's business operations, review accounts, evaluate property and prevent the disposition of assets without the administrator's consent. The measure also prevents the dilution of holding through the transfer of assets to other entities. The goal is to simplify the process and unify it under one jurisdiction to resolve issues rapidly;
- Banks will be required to provide more data to regulatory authorities. More stringent rules on classification of credit. Private bank auditors will be required to scrutinize more closely bank operations. Banks unable to fulfill capital adequacy requirements will be required to seek new investment.
- Obligatory deposit insurance of up to Sk 300,000.
- Legal framework created for the creation of specialized banks, e.g. export finance, regional and mortgage banks

Analysis

The government program seeks to halt the hemorrhage of good deposits to bad-loans by compelling a rapid elimination of bad-debts. Proposed legislation to facilitate bankruptcy proceedings, if enacted and implemented, will be a positive element in the creation of capital markets. Financial institutions will strengthen over the short-term because of tax reduction -- eliminating taxes on expected loan receipts from nonperforming loans -- bolstering banks' profitability while increasing their loan-loss portfolios.

Taken together with other government measures, these proposals would compel losing firms either to close or to seek partnership with profitable enterprises that would assume loan payments. Political pressure to force such mergers, already great, will either further weaken stronger companies and increase inefficiencies or risk the continued use of state resources via holding companies and investment funds to prop up the losing firms. Even if political pressure is resisted and firms are closed, social tension will grow with higher unemployment.

Slovakia's key financial institutions will be propped up by these measures, at the least for the medium-term, because the program will 1) improve bank operating costs because of reduced taxes; and 2) compel corporate mergers that will render bad-loans good, at least over the short-term, and improve payments. New short-term lending will become more expensive because of increased regulatory powers. Long-term lending will not be available. On the other hand, increased competition will develop from new banks for trade and housing financing, suggesting that Slovak firms and individuals will have other havens for their deposits.

However, downward macroeconomic pressure will continue to be felt from old, nonperforming firms, albeit under other corporate umbrellas, financed either through more successful portions of the business or through new lending that refinances loans and rolls over principle. In other words, the price has not yet been paid for transition. It has been postponed, perhaps camouflaged, but nonperforming assets remain. The failure to workout good, profitable operations from poor maintains high levels of inefficiencies .

The nation pays the cost through increased taxation in other areas (to compensate for the loss in tax revenue), higher spreads for loans, reduced availability of loans and delay in the creation of modern capital markets.

As in Model One, industrial modernization continues only in heavy industry, financed through profits and trade finance. Entrepreneurship and small and medium enterprise development is stifled, more so in this model because of continued subsidization of quasi-government and bankrupt firms (through mergers and rollovers).

Equally, government authority becomes more powerful in Model Two because of increased interference and supervision over determination of loans and of company mergers.

Thus, Slovakia remains highly vulnerable to a shift in exogenous factors, prices and demands for export products. While a financial crisis is less severe in this case than in Model One, national productivity and competitiveness remains low and exposed.

MODEL THREE SCENARIO WORKOUT: BANK REFORM WITH LOAN WORKOUT AND GOVERNMENT FINANCIAL PARTICIPATION

Key elements of this model include:

- Financial institutions workout non-performing loans with companies, under government supervision.
- After renegotiation of loan portfolios to determine that portion of individual loans that are operative, the remainder of the loan portfolio is declared non-performing and sold to the government at a 30% discount in return for equity.
- That government-owned equity would be sold to private investors after a three year period.

- Financial institution's balance sheets are cleansed while functioning firms saddled with old debts are rendered healthy.

Analysis

The elimination of structural economic distortions, either through bank write-downs of bad-debts and/or government assumption of these portfolios and restructuring of state enterprises, yields growth. The implicit fiscal drain of the bad-debt situation is reduced dramatically. Credit becomes more plentiful and stable, leading to available long-term capital for investment which will improve financial performances. However the implicit cost to the treasury versus the long-term benefit gains must be analyzed.

Under this proposal, financial institutions workout nonperforming loans with companies with government supervision. Old debts are divided into that portion which is serviceable and that to be written off. The government purchases the bad-loan portfolio at a 30% discount for equity, cleaning the balance sheets of the banks. Within a three-year period, the government would sell its equity to the market.

The immediate effect is to free up domestic capital markets, providing a spur to new lending. Firms struggling under the risk of foreclosure or the burden of heavy and unrealistic debt payments are now free to grow and improve employment. Unlike the first two models, growth in 1997-1998 is moderated as the cost of the financial reform works its way through the economy. Over the longer-term, short- and long-term capital markets will normalize and, by the end of the decade, domestic capital markets will no longer rely on profits from heavy industry. With new lending, job creation levels rise, partially compensating for the closure of nonperforming assets.

The most important impact is cultural: the growth of new, innovative, and smaller businesses that can reach capital markets and be more in line with Western business culture. Government interference in free market decisions declines along with its authority over implicit subsidies to firms. Business decisions become more efficient and responsive to market pressures, less influenced by bureaucratic interference. While heavy industry continues, per force, to provide the major source of industrial production, secondary and tertiary industries emerge faster, some with support of foreign capital and some with domestic. In other words, dependence on exogenous factors will decline as new, endogamous businesses emerge.

With increased entrepreneurship, the workings of credit and capital markets are better understood. Political and cultural resistance to contract and bankruptcy laws declines. The pressure of efficient capital markets force reform of outmoded sectors, especially agriculture and textiles, eventually leading to greater productivity and international competitiveness.

Regional and national tensions remain high, reflecting the economic imbalance throughout the nation. But business, rather than government, will decide the locale of investment, reducing pressure on politicians for subsidies or bailouts. The current trend towards a "productive" industrial environment in western Slovakia and a moribund industrial complex of subsidized, nonperforming companies with salaried workers in eastern Slovakia will decline substantially. Over the longer-term, the national economy will better integrate, as markets recognize relative comparative advantages of each region. This is particularly true for the transport and tourism sectors, which have been heavily dependent upon government support.

While banks will be forced to divest equity to the government and, perhaps, attract new investors for financing increased loan-loss coverage, the risk of failure will be virtually eliminated. Consequently, the risk that the government currently faces -- to bailout financial institutions and preserve deposits will also vanish.

GDP will rise over the next three years in line with current trends, but will remain strong through the end of the century as new capital investments take hold and with increased productivity. Heavy industry -- natural gas, chemicals, pharmaceuticals and metals -- rely more on foreign than domestic capital markets. Improved business conditions will enhance their creditworthiness in foreign markets. In an entrepreneurial environment with good credit availability, investors will see Slovakia on par with its Visegrad neighbors.

THE ISSUES: MORAL HAZARD, LAW, AND COST

Without major reform of bank lending procedures and government-bank relationships a moral hazard risk remains. Key public sector-dominated firms -- insurance, natural gas, chemicals -- as well as the public will continue to maintain their savings in the major financial institutions. Recapitalized and healthy, bankers will be tempted to loan funds to government institutions rather than entrepreneurs because of implicit guarantees of another bailout and to respond to political pressures. In other words, will banks, once freed of earlier bad loans and under political pressure, continue to subsidize losing enterprises with new bad loans laying the basis for a new bad-debt crisis a few years hence? If they do, then the high cost of this model will be multiplied and the positive effects, destroyed. The net effect will be inflationary with government financing of bad-debt to create more bad-debt. Worse, Slovakia will have lost the unique opportunity to improve its competitive advantages and will aggravate structural problems with eventual disastrous consequences. On the other hand, if bank lending practices are adequately introduced, the bad-debt issue will end. The cost of transition rather than dragging on for decades will become a government budget item which will recede in importance with growth.

Secondly, even when bank reform, unless credit, bankruptcy and contract laws are reformed and fully enforced, the business climate will deteriorate. Small and medium entrepreneurship requires not only credit access but also credit responsibility. The judicial system must be responsive.

Thirdly, given reform of bank and legal procedures and regulations, is the cost of this proposal too high? Will the macroeconomic gains from debt restructuring produce enough growth to repay the cost to the government of purchasing old debt? The trade off is between long-term, balanced economic growth with increased tax revenue and implicit subsidies to losing operations, versus a one-time budget outlay to finance bad-debt plus additional social costs associated with closing enterprises. The actual cost proposal depends on the result of the workouts as well as the actual level of bad-debt.

COMPARATIVE SCENARIO ANALYSIS

Bad-debt resolution strategy will effect the banks, national accounts, and the economy as a whole. Clearly no one model is perfect. The first attempts to muddle through, growing its way out of the bad-debt situation, the second attempts moderate reform, and the third, most comprehensive, requires large initial Treasury outlays.

Model One proposes continuing the current structure. While this offers the short-term benefit of propping up weak banks and rolling over bad loans, it provides longer-term risks. Bad-debts are understated and likely to increase, especially if Slovakia enters into recession in the latter part of the decade. In that eventuality, a major banking crisis is likely with huge losses of savings to other government agencies and parastatal firms, the gas, insurance, and chemical sectors. The consequence for long-term employment and investment is therefore very poor.

But even without a banking crisis, the ongoing cost of sustaining bad-loans to the system is very large. Given a moderate bad-loan problem of Sk 60 million and a potential minimal rate of return from loans of 10%, the compounded cost to Slovak banks is Sk 95.6 billion over a ten year period, or roughly Sk 1 billion annually. Taking the outer extreme, of all bad-loans, including roll-overs and refinancings from one bank to another of loans that are, *de facto* if not de jure, insolvent, and a high, 20% rate of return in a fast-growing economy, the future cost to financial institutions is Sk 542.7 bn or an average of Sk 54 billion annually.

Model One: Implicit Cost to Financial Institutions, 1996-2005

		Bad-Debt Range (Sk billion)		
Potential Rate of Return from Loans		60 Sk	80 Sk	110 Sk
10%	five years	37	49	67
	ten years	96	128	175
15%	five years	61	74	102
	ten years	183	230	316
20%	five years	89	111	152
	ten years	312	395	543

Model Two, based on current government proposals, forces the banking system to reduce its bad-loan exposure, placing the onus of company closures and bankruptcies upon national and regional bankers. Assuming effective management, the program risks two problems: either banks will be further weakened by writing down more bad-loans than they have previously estimated, risking a bank crisis, or they will write more bad-loans to finance old loans, postponing while increasing the eventual crisis. The program lacks both a workout provision as well as government financing to help recapitalize financial institutions. Therefore, the incentive to "find" bad-loans is weak.

Model Two: Total New Investments Deriving From Restructuring, 1996-2005

	Total bad-debt write-offs over a 3-year period		
Current Bad-debt (Sk billions)	25% recovery	35% recovery	50% recovery
Sk 60	28	39	56
Sk 80	37	52	74
Sk 110	51	71	102

Assuming, however, that banks are willing to clean up their loans and end refinancing of what are, in reality, insolvent operations, they can initiate a virtuous circle in which some firms are able to negotiate bad-loans, reschedule their obligations, and begin repaying interest and capital. Some will merge with stronger operations, yielding the same result. Others will be forced into bankruptcy.

The issue for economic growth is how much new investment will develop as a result of capital generated from renewed lending and other funds stimulated by the availability of fresh loans. If 25% of all bad-loans are renegotiated and made whole, the yield to economic growth will range between Sk 28 billion and 51 billion over a ten-year period, with consequential beneficial results for bank balance sheets.

Model Three provides government financing as an incentive to end bad loan practices while working out some loans, improving balance sheets. The government would purchase bad-loans at a 30% discount, providing resources to the bank. Any additional equity financing would come from capital markets. Current savings would be safeguarded and the risk of bank crisis, diminished. The cost, of course, is pushed to the Treasury, which must finance this bail-out with long-term bonds. The issue is therefore: would the high cost to the Treasury produce significant economic gain and improvement in banks' positions to compensate for annual financing costs to repay the initial investment?

Model Three: Treasury One-Time Cost

	Good Assets After Workout (Sk billion)		
Bad-Debt Scenarios	10%	25%	40%
Sk 60	38	32	25
Sk 80	50	42	34
Sk 110	77	57	46

The cost to the Treasury decreases with the success of loan workouts and the division of enterprises' assets into insolvent and solvent areas. This is the key difference between

Models Two and Three. Assuming a low workout of 10% and a high, bad-debt of Sk 110 billion, the one-time cost to the Treasury is Sk 77 billion, extremely high.

Model Three: Total Treasury Interest Costs of Bank Bail-Out, 1996-2005

	Total Treasury Cost (Sk billion)		
Real Interest Rates	6%	9%	12%
Bad-Debt Scenarios			
Sk 60	13.5-17.8	21.4-32.3	30.1-45.5
Sk 80	18.1-27.0	28.7-42.3	40.5-60.2
Sk 110	24.9-41.5	39.5-65.9	55.6-92.7

The on-going cost to the Treasury is not as onerous as first appears. If preferential financing is provided at a 6% interest rate with a two-year grace period, total interest costs would range from Sk 13.5 billion to Sk 41.5 billion. At high commercial rates, the model becomes less viable, with annual interest costs averaging over Sk 1 billion annually.

Model Three: Total Tax Income from New Investments Deriving from Bad-Debt Resolution, 1996-2005

Assumption: Increased Capital induced by New Loans deriving from Bad-Debt Resolution	25%	40%	50%
Current Bad-debt (Sk billions)			
SK 60	34.7	38.9	41.7
SK 80	46.4	51.9	55.6
SK 110	63.7	71.4	76.5

Assumption: 2 year grace-period; 40% tax on profits

The trade-off is economic growth. In other words, will new loans and investments made by a modern and viable banking system provide sufficient growth to repay the high cost of the bailout? The model above assumes a complete replacement of bad-loans with good, a large assumption to be sure. However, if the government provides incentive to clean up balance sheets and develops regulatory oversight to insure a minimum of new bad-loans, a large influx of credit will enter the system, supplemented with additional investment from domestic capital and abroad. These results are at the high end of estimates and to be used as a "most favorable scenario." Given, for instance, the resolution of a bad-debt situation of Sk 60 billion and restitution of banks to a healthy, performing condition, the Treasury might earn between Sk 34.7 billion and Sk 41.7 billion over the next decade while paying the following total cost in interest payments over the next decade:

Real Interest Rates	6%	9%	12%
Sk 60	13.5-17.8	21.4-32.3	30.1-45.5

In other words, the "most favorable scenario" would earn sufficient funds to repay interest on high commercial paper, to repay interest and principal at normal commercial rates, and to earn considerable income at subsidized rates.

If the "most favorable scenario" is in error by 50% , high commercial rates are out of the question, while 9% commercial rates could be sustained, and 6% subsidized rates repaid with principal.

INTANGIBLES

Model One and, to some degree, Model Two, will maintain lending practices along current lines. Perhaps the greatest advantages offered by Model Three, beyond ending the bad-loan situation, are less measurable. Experience throughout the world shows that reform of statist bank structures towards private sector, free-market banking will yield:

- **Improved international credit rating and reduced credit costs**. An end to bad-debt situation will reduce pressure on the government to overregulate bank procedures and currency, leading to normalization with Western banking institutions improvement in credit ratings, and reduced credit costs.

- **A shift away in lending away from large enterprises towards smaller operations**. Today, most loans are centralized in government operations both because of past practices as well as the belief that government is far more likely to repay than others. With increased capital sources for lending, as well as few good credit risks among larger public enterprises, banks will increasingly turn towards small and medium enterprises. Slovakia will grow as innovation is rewarded.

- **Greater decentralization of lending**. Because growth will be less influenced by government decisions, lending will be more broadly based, spread further from Bratislava to the rest of the nation.

- **Improved Understanding of Business and Banking Requirements**. As government withdraws from credit markets, Slovakia will gain, through experience, a greater understanding of the needs of business. Political resistance to reform of contract, bankruptcy, and other business-related laws will fade over time.

- **Economic Diversification/Less Exposure to Recession**. With more and different types of businesses, Slovakia will be less exposed to vulnerabilities of current heavy industry. Trading partners will expand and the nation's sovereignty will be further strengthened as Slovakia reduces its reliance upon any single country or region.