Deloitte Touche Tohmatsu

Deloitte Touche Tohmatsu
ILA Group Ltd.
Suite 350N
1001 Pennsylvania Avenue, N.W.
Washington, DC 20004-2594, USA

Telephone: (202) 879-5600
Facsimile: (202) 879-5607

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 -- Summary and Conclusions*. This report summarizes the conclusions of the complete report, entitled *The Long-Term Impact of Bad-Debt and Alternatives to Resolve the Bad-Debt Problem*, which is being submitted under separate cover. These reports elaborate 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.

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

SUMMARY AND CONCLUSIONS: SLOVAKIA, 1995 - 2004

PREPARED FOR:	**USAID**
CONTRACT:	**EUR-0014-I-00-1056-00**
DELIVERY ORDER:	**33**
SUBMITTED BY:	**MILES WORTMAN**
DATE:	**DECEMBER 1995**

DELOITTE TOUCHE TOHMATSU INTERNATIONAL

PREFACE

This paper summarizes the complete report, *Slovakia, 1995 - 2004: The Long-Term Impact of Bad-Debt and Alternatives to Resolve the Bad-Debt Problem.* It 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.

Analysis was carried out in the period 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.

Statistics

Statistical sources for data in Slovakia are imperfect and should be used with great care. **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, U.S. Treasury, International Monetary Fund, the United Nations Economic Commission for Europe, Deutsche Bank, Bank Nomura, Deloitte Touche Tohmatsu International, Symsite, and the annual reports from Slovak banks and insurance companies.

OVERVIEW

The Issue. The critical issue facing Slovakia today is not whether the nation needs reform but the best manner to liberalize the economy and financial markets. Some critical questions related to this issue are:

- How to support those areas of the economy that show dynamic growth by reducing drags such as high interest rates, weak financial institutions, a dearth of investment capital and overregulation by government?
- How to evolve the macroeconomy from reliance upon a few heavy industrial sectors to one that is innovative, competitive, highly diversified, and able to withstand global market shocks?
- Will Slovakia emerge as a strong sovereign economy or will its economic development be hindered by a legacy of antiquated factories, and outdated management and regulatory institutions?

The Problem: **Bad-Debt**. The bad-debt situation is one of the key drags on future growth. Estimated at anywhere from Sk 45 billion to Sk 110 billion, it constrains financial market growth, corrupts bank reform attempts and distorts efforts to modernize industry. Financial resources to sustain bad-debts crowd out private sector development, thus limiting job creation and modernization.

The Opportunity. 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 financially and operationally to fit into the new, modern and world economy. However, either now or in the future, this Sk 45-120 billion burden must be paid, through financial and regulatory restructuring, writing off bad-debts, and, eventually, encouragement of new investments.

It is in the interest of banks, companies and the nation as a whole to develop a clear approach to financial restructuring that maximizes performing assets while eliminating loss-making or moribund activities. The development of an open capital market, free from political interference, is essential to efficient allocation of financial resources which will lead to a competitive and prosperous nation. Alternatively, a continuation of the current system leaves Slovakia vulnerable to foreign competition and exogenous economic fluctuations over the mid-term.

The Current Situation. The Government continues to use of financial institutions to subsidize ongoing industrial losses. Rather than facing the extremely difficult task of rationalizing unproductive and outdated enterprises, the government has imposed a patchwork solution in an effort to maintain employment and social peace. This approach has negative long-term implications including:

- "Privatized" companies are, in reality, state firms that continue to rely upon government coffers for assistance and protection through subsidies, new investment funds, and loans;

their governing boards are a maze of interlinked directorates between government-dominated banks, insurance firms, and investment funds.

- Weak companies are merged with stronger enterprises. In essence, loss-making and ultimately insolvent enterprises absorb the profits of viable enterprises. This pattern risks developing a vicious circle of good money channeled into bad, that drains the economy and rewards poor productivity.

- Financial institutions, with the help of state oil and gas companies, and 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.

- Bank refinancings cover non-performing loans.

- A mirage is created in which IMF targets for reduction of 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.

- Over time, taxes from productive groups are used to support losing enterprises, leading to stark political divisions between those who receive subsidized salaries versus those who produce wealth.

Obstacles to solving the bad-debt problem cannot be overcome without addressing other legal, regulatory, and financial difficulties. Among these issues are:

- The lack of a repayment tradition;

- A weak legal system with inadequate bankruptcy and tax laws;

- A general lack of knowledge about the fundamentals of free market finance, to provide political support for difficult bank and capital reforms.

Misallocation of Resources: The Impact. Government institutions, quasi-state banks, and state enterprises reallocate profits from chemical, metallurgical and insurance sectors. As long as this continues, the economy will experience the following problems.

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

- **Overemployment** in the subsidized sector, leading to a lack of productivity.

- **Increased imports** in areas that should be productive (such as agriculture) but are not, because of skewed investment patterns.

- **Declining technological, marketing, and management skill** vis-à-vis competitors; increased reliance on external support and knowledge; and loss of national sovereignty.

- **Capital outflows** as money goes to countries with more predictable profits and less risk.

- **Regional bias** toward the development in western Slovakia, where government finances are centralized, at the expense of other regions.

- **Continued reliance** upon the state for sustenance.

SOLUTIONS TO RESOLVE THE BAD-DEBT CRISIS, AN ANALYSIS

Three models are analyzed based upon economic assumptions and scenarios developed in the complete report. These models 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 sustain the weak banks and increases spreads to allow banks sufficient profitability to roll-over old loans and 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 simplify and shorten the amount of time required by banks and firms to pursue bankruptcy proceedings and arbitration. There is no debt workout under this option. Financial institutions cleanse their balance sheets of non-performing loans.

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

Financial institutions workout non-performing loans with companies, under government supervision. After renegotiation of loan portfolios to determine the 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. Government-owned equity is 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.

ANALYSIS

Model One: Status Quo

While the current model 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, resulting in huge losses of savings to other government agencies and parastatal firms, the gas, insurance, and chemical sectors. The outlook for long-term employment and investment is therefore very poor.

Even without a banking crisis, the ongoing cost to the economy of sustaining bad-loans is very large. Given a moderate bad-loan problem of Sk 60 billion 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 rollovers and inter-bank refinancings of loans, that are, *de facto* if not *de jure*, insolvent, as well as a high, 20% rate of return in a fast growing economy, and the future cost to financial institutions is Sk 542.7 billion or an annual average of Sk 54 billion.

MODEL ONE: IMPLICIT COST TO FINANCIAL INSTITUTIONS 1996-2005

Bad-Debt Range (Sk billion)		60	80	110
Potential Rate of Return from Loans				
10%	five years	36.6	48.8	67.2
	ten years	95.6	127.5	175.3
15%	five years	61.0	74.0	102.0
	ten years	183.0	230.0	316.0
20%	five years	89.3	110.9	152.3
	ten years	311.5	394.7	542.7

Model Two: Projected Government and Bank Reforms

Model Two, assumes that current government proposals which force the banking system to reduce bad-loan exposure are enacted. These place the onus of company closures and bankruptcies on 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 previously estimated, risking a bank crisis, or they will write more bad-loans to finance old loans, postponing and 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 identify bad-loans is weak.

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., 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 TWO: TOTAL NEW INVESTMENTS DERIVING FROM RESTRUCTURING, 1996-2005

Total bad-loan write-offs over 3 year period	25% recovery	35% recovery	50% recovery
Current Bad-debt (Sk billions)			
Sk 60	27.8	38.9	55.6
Sk 80	37.1	51.9	74.2
Sk 110	51	71.4	101.8

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

Model Three provides government financing as an incentive to end bad loan practices while working out some loans, thus 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 bailout 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 bill.)	10%	25%	40%
Bad-Debt Scenarios			
Sk 60	37.8	31.5	25.2
Sk 80	50.0	42.0	33.6
Sk 110	77.0	57.0	46.2

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, which is extremely high.

MODEL THREE: TOTAL TREASURY INTEREST COSTS OF BANK BAILOUT: 1996-2005			
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 it first appears. If preferential financing is provided to support the total cost of bank bailouts 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 forthcoming from the creation of 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 and foreign capital. 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 same period.

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, maintain lending practices along current lines. Some of 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.
- **A shift in lending from larger towards smaller operations**. 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, spreading from Bratislava throughout 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 financial requirements of private enterprise.
- **Economic diversification/Less exposure to recession**. With more and varied businesses, Slovakia will be less exposed to vulnerabilities of current heavy industry. Trading partners will expand and the nation's sovereignty will be strengthened as Slovakia reduces its reliance upon any single country or region.

BACKGROUND: CURRENT MACROECONOMIC PERFORMANCE

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 would profit from a modernized service sector that is well-placed to transport from east to west. Experience in metallurgical and chemical sectors would lead to specialization based upon a relatively inexpensive supply of raw materials and close cooperation with European production and markets. As business and industrial skills mature, the Slovak economy would become less dependent upon traditional, heavy industries and more integrated into the Western European market.

- **Growth.** Current trends reflect economic dynamism with strong underlying weaknesses. Slovakia grows at a strong pace, averaging above 5% in 1994 and 1995 and likely again in 1996. However:
  - Current economic growth has come after years of shrinkage and derives mostly from chemical, pharmaceutical, and metallurgical sectors.
  - Subsidized industrial infrastructure and technical and educational investment of the previous socialist government, has been used to meet Western demands in the current economic expansion.
  - Artificially low energy prices subsidized chemical production.
  - Capital-intensive, rather than labor-intensive, companies performed better indicating weak productivity.
  - Production for local consumption shrank, especially in agriculture, agribusiness., military and mining.
  - Unlike other nations in transition, where economic growth is stimulating new foreign investment, Slovakia lack of new capital, technological and educational investments threaten to render the nation less competitive for years to come. Most new direct investments from abroad are limited to small contract manufacturing and metal-bending operations.
- **Macroeconomic Vulnerabilities**. Strong, developed economies are diversified. They have sufficient flexibility to overcome the 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 downturns. Slovakia remains highly exposed to these financial and economic vulnerabilities.

- **Infrastructure Demands**. Road and train networks, energy sources, primary manufacturing sources and telecommunications require maintenance, modernization, and investment.

- **Environmental Demands**. Major expenditures are required to ensure basic health standards and repair old abuses.

- **Pension Demands.** Even with gradual reform, the system faces growing demand and an inevitable crisis. The aged population will surge soon resulting in dramatically increased fiscal pressures.

- **Trade Vulnerabilities**. Slovakia's future prosperity is linked to Western Europe for trade, capital and technological improvement. This, in turn, raises major questions:

  - Do what degree will protectionist sentiment in the European Community limit Slovak markets?
  - Can Slovakia liberalize its economy to respond to expansion of the European Community?
  - Will Czech firms look elsewhere --including within the Czech Republic -- for suppliers of traditional Slovak production.

- **Energy Costs**. Chemical and metallurgical sectors rely on inexpensive and subsidized energy costs.

- **Agriculture Vulnerabilities**. The agricultural situation in Slovakia is in crisis, forcing increasing imports of foodstuffs.

- **Competitiveness**. Most foreign businesses in Slovakia agree that while the country's wage structure is low relative to Europe, its productivity is also low.

- **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. 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.

- **Protectionism**. Should the German -- and the Western European -- economies enter a cyclical recession, Slovakia will have few outlets for its manufactured exports.

- **The End of the Expansionist Cycle**. Because all international trade runs in cycles, Slovakia cannot rely solely on international markets. This is particularly true for the chemical sector, which traditionally experiences boom-bust cycles.