II. AKTUALNE TEME

1. POST-SOCIALIST BANK CRISES AND THE PROBLEMS OF INSTITUTION-BUILDING

Bank crises have become a common feature of economic life world-wide in the 1980s and 1990s, engulfing the banking systems of Chile, Argentina, Uruguay, Thailand, the Philippines, Spain, the U.S., Japan and Turkey, among others.

Bank crises are usually the result of dramatic swings in the value of assets held by the banking system. When asset values fall relative to liabilities, banks net worth is eroded, resulting in crisis. Minsky (1977) argues that such asset devaluations are a normal feature of the business cycle in market economies. As confidence builds during the business cycle, more and more agents engage in speculative finance, creating an increasingly fragile financial structure. Adverse movements in interest rates at the top of the business cycle can make these positions untenable, leading to financial crisis. Kindleburger (1978), in his historical retrospective on financial crises, emphasizes the role of shifts in confidence at the peak of the cycle. Financial crisis, he contends, is precipitated by a self-fulfilling perception that the market has hit its peak.

Recent bank crises have included another theme: the role of deregulation. In many cases, bank crises have followed the lifting of regulations previously enacted precisely in order to maintain stable conditions in the banking industry. Deregulation creates new profit-making opportunities while devaluing others. This leads to financial crisis both because of the devaluation of old assets and because of the euphoric swing into new assets, *which tends to overshoot.*[1]

This picture of the causes and origins of bank crises has to be reformulated before it can be applied to the former Communist countries. Under the old system, banks were "repressed" to a far greater extent than in regulated market economies. Credit allocation was determined by plan/political requirements, and repayment of obligations was erratic. Under this "soft-budget constraint", banks accumulated large portfolios of non-performing loans, failed to master the art of assessing credit risk, and failed to develop either the financial structures or business practices needed in a market economy.

Because of this, the transition to market economy in and of itself implied that this hidden banking crisis would come into the open. Furthermore, changes in the composition of demand, exacerbated by the end of planning and the withdrawal of government subsidies, radically changed the profitability of individual projects and the relative values of assets. These shifts, coupled with unfavorable shocks coming from stabilization programs and disintegration of trade networks such as COMECON and the market of ex-Yugoslavia, in some cases led to large-scale bank crises.

To make matters more complicated, this bank crisis befell banks that were poorly prepared to function in a market context. These banks now had to learn credit appraisal, provisioning, competition for deposits, and all the other business practices of capitalist banking. Furthermore, the Central Banks of post-communist countries, having previously relied on such mechanisms as direct allocation of credit, now had to create appropriate instruments for controlling the money supply and for supervising and regulating independent banking entities.

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[1] *An important question about recent banking crises in market economies, then, is whether deregulation is the cause of banking crises, and, if so, whether the beneficial effects of liberalization are outweighed by the costs of bank crisis.*

Because of the complex environment within which it occurred, post-Communist bank crises were (and are) significantly different than such crises in market economies. Post-Communist bank crises are not the result of temporary euphoria, nor are they the consequences of deregulation-induced excesses.[2] *Instead, they are the consequence of long-standing institutional arrangements from the old system. Only deep institutional changes can solve post-Communist bank crises. These institutional changes, however, have to occur simultaneously with bank crisis, itself occurring in the midst of the "transition depression" as well as the restructuring/privatization of the real sector.*

The reward for institution-building in the banking sector will be, first and foremost, greater allocative efficiency. Healthy, market-oriented banks will play a major role in the rational use of funds. Moreover, such banks will allow investment to be made by private firms and entrepreneurs, rather than mainly by the government (whether directly through the government budget or indirectly via political pressure on banks).[3]

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[2] *Of course, the* **next** *financial crisis in post-Communist could be due to speculative excesses.*

[3] *The "financial repression" school has argued that restrictions on banks depress the level of savings, and thereby the level of investment (McKinnon (1973), Shaw (1973)). However, socialist economies showed high investment rates when measured by investment/output, but low levels of investment efficiency. In this sense, the "financial repression" argument about investment is simply not relevant here.*

Regarding savings, the evidence from developing economies on the relationship between financial repression and savings rates is unclear (see Velasco, (1991) and Giovannini, (1985)). Furthermore, in socialist economies, the monetary overhang and forced savings are usually considered problems, not a lack of savings.

For these reasons, I place emphasis on healthy banks as raising investment efficiency, and do not consider effects on the level of aggregate savings or investment.

Rehabilitation of individual banks plays a key role because the burden of bad loans in the banking system prevents banks from functioning normally. Banks with large stocks of non-preforming loans are forced to service their "bad" customers, since the only hope of collecting anything from these loans is to help the client survive. Meanwhile, the high costs of these loans are passed on to "good" customers, raising deposit-lending spreads and depressing economic activity in the rest of the economy.

Where the bad loan problem is not too big, decentralized means of solving the problem may be pursued. For example, in Poland, banks were given explicit instructions about how to treat bad loans, and were faced with firm deadlines for dealing with the loans. The banks themselves, however, had to resolve the problems.

But when the bad loan problem reaches a critical point, systemic risk becomes too great, and government is forced to remove the bad loans from the banking sector. Such a critical point was reached in Slovenia and Croatia, where bad loans ranged as high as 30-40% of assets.

Since, as Borak (1994) points out, government plays a central role both in organizing and financing rehabilitation and in assuming temporary ownership and management of banks, it faces important choices. Should the banks themselves be entrusted with the workout of the bad loans? Considering the negative experiences of former Yugoslavia, Turkey, Chile and others with ownership of banks by real sector firms, what restrictions should be placed on cross-ownership? How can bank rehabilitation be combined with privatization, considering that debt write-offs are often an important feature of privatization? These questions will be considered below.

Bank rehabilitation has a high opportunity cost, both in terms of the demands it puts on the government budget, and in terms of its requirements for skilled personnel. Nonetheless, there are strong reasons for undertaking bank rehabilitation as early as *possible in the transition. For one thing, if banks are left with a large stock of non-performing assets, they will be forced to charge high rates on loans to paying customers, which will depress investment. For another, if enterprises are rehabilitated before banks, there will be a temptation to write-off debts without consideration of the eventual effect on the banking system.*

Bank rehabilitation has two fundamental prerequisites: bringing inflation under control,[4] and progress in restructuring and adjustment in the real-sector. Controlling inflation is crucial because otherwise funds spent on recapitalization are immediately devalued; restructuring and adjustment are crucial to creating a sound customer base and avoiding new flow problems.

This paper will examine bank crises and rehabilitation efforts in Slovenia and Croatia. These cases provide an interesting contrast, since the two countries began with the same institutional legacy from former Yugoslavia, but, partly due to differing political and military circumstances, have followed different paths. Also, both countries have been rather successful in macroeconomic stabilization. Evidence introduced below points to important similarities in the two countries' banking crises, including the significant role of distress borrowing in demand for credit. At the same time, the cases strongly support the contention that real sector adjustment and restructuring--even without privatization--are crucial to the success of bank rehabilitation.

The paper is organized as follows. First, the institutional background of Yugoslav banking, which shaped the initial conditions for Slovene and Croat banks, is outlined. Second, a brief examination of stabilization efforts and economic trends, including the emergence of bank crisis, is offered. Third, the

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[4] As I will discuss below, an alternative is to avoid bank rehabilitation altogether, relying on high inflation and bank privatization to consolidate the banking system.

reform efforts of both countries are examined. Fourth, the relationship between bank rehabilitation and real sector restructuring and privatization is discussed. Fifth and last are concluding observations.

BACKGROUND: BANKING IN EX-YUGOSLAVIA

Slovenia and Croatia are in a favorable position compared to some former Communist countries in that commercial banks have been separated from the Central Bank for almost three decades. Socialist Yugoslavia introduced a two-tier banking system in the 1960s.

Yugoslav banks had a great deal of operational autonomy, and much experience dealing directly with Western banks. Unfortunately, they also functioned in a legal and institutional environment that severely weakened them. A strict interpretation of Marxian theory was institutionalized, according to which banks did not actually create profit, but only redistributed it. To prevent banks from "exploiting" the productive economy, banks were not allowed to make profits; any surpluses were distributed to the real-sector enterprises who founded the bank. Profits could not be used to create reserves or provisions, either. The founders of Yugoslav banks were their main loan customers, creating a built-in conflict of interest.

Furthermore, interest rates were set below inflation rates. Banks also assumed exchange rate risk, frequently ending up with open foreign exchange positions. This occurred either because the banks sold foreign currency deposited by households to enterprises, or because banks lent the proceeds of hard-currency loans from abroad in local currency (Mates 1986, 1989).

On top of this, banks were under enormous political pressures to lend without rigorous assessment of credit risk. Such pressures created an environment of extremely loose banking practices.

These practices were made possible by the availability of bail-outs from the Central Bank. The National Bank of Yugoslavia ratified the soft-money policy created by political and economic agents throughout the system. The banks were regularly rescued from the losses resulting from exchange rate depreciation, creating an enormous parafiscal debt (called "The Black Hole in the National Bank" (Mates, 1986)).

In addition, banks were given so-called "documentary credits" (sometimes referred to as "selective rediscounting"--see Dyker (1992)): once they showed documents proving they had loaned money to designated priority sectors, they were granted National Bank of Yugoslavia credits at the discount rate, which was negative in real terms. By this means, banks could always gain as much liquidity as they wanted. The only control the National Bank of Yugoslavia maintained was the ceiling on commercial banks' credit, but usually these ceilings were set high enough that they had no limiting effect. (See Mates (1986), Škreb (1994) and Jankov (1994) for more details).

The Effects of National Independence

In 1989, as part of its efforts to move towards a market economy, the government refounded banks as joint-stock companies. Banks were audited in 1990, and bad loans were found to be 30% of total assets (Grličkov, 1990). But the ensuing political chaos prevented any real resolution of the bad debt problems.

After Slovenia and Croatia declared independence in June 1991, their economies were hit by the effects of war, the break-up of Yugoslav institutions, and the collapse of the Yugoslav market. In the case of Croatia, which found 28% of its territory occupied by the end of 1991, the war meant a fall in GDP of perhaps a third.

In addition, all the foreign exchange reserves of Yugoslavia were taken by the National Bank of Yugoslavia. The National Banks of Slovenia and Croatia had no reserves to speak of after June

1991.[5] The government of Yugoslavia had already frozen citizens' hard-currency accounts on April 27. Both governments assumed the burden of these liabilities as public debt--a first step towards rehabilitating the banking system.[6]

As the crisis unfolded and trade among the ex-Yugoslav republics shriveled, liquidity problems multiplied. Bad debts rose rapidly, reaching about 40% of assets in Slovenia in 1992 (Cvikl, Kraft and Vodopivec, 1993). In both countries, inter-enterprise arrears also grew rapidly. In Croatia, arrears amounted to 8% of monthly GDP at the beginning of 1993, and had grown to some 27% by mid-1994 (Jurković and Škreb, 1994, p. 9).

Given the prevalence of illiquidity and the fear of social unrest, both countries avoided pushing illiquid firms through bankruptcy procedures. Slovenia put a moratorium on bankruptcies in the Summer of 1991; Croatia, informally, did something similar, not forcing any significant state firms into bankruptcy through 1994.[7] In 1995, the problem remains actual in Croatia: the government set a deadline of June 30, 1995 for state-owned companies to clear up all obligations, or face the possibility of bankruptcy procedures.

The timing of bank rehabilitation was also affected by the stance of monetary policy and stabilization measures in general. While inflation played an important role in decreasing the real value of

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[5] Commercial banks did have some foreign exchange holdings--approximately $200 million in the case of Croatia.

[6] Two schools of thinking exist about the assumption of the burden of hard-currency savings. One school argues that this was a part of the resolution of the issues of succession following the new states' exit from former Yugoslavia. The other school argues that making these liabilities public debt in fact was a form of bank rehabilitation. The first school focuses more on the legal aspects of the assumption, the other on the economic effects.

[7] The first major bankruptcy was the firm Bakar, which was actually completely shut down starting in early 1995.

bad loans from the old system, high inflation made bank rehabilitation through recapitalization unwise. Any capital injected would have been immediately eroded. And simply allowing inflation to erode debts was far cheaper than assuming the debts through a "carve-out".

Also, under conditions of high inflation, banks benefitted from very high spreads and used these to rebuild their balance-sheets. Thus, as the Croatian case shows, a degree of self-rehabilitation was possible.

Some countries, particularly Russia and some of the other former Soviet republics, have chosen to simply privatize banks under conditions of high inflation, figuring that inflation would remove the stock problem, while rapid privatization would end the flow problem (Borish, Long and Noël, 1995). However, given the cautious approach to bankruptcy adopted in Slovenia and Croatia, and both countries' aversion to rapid privatization, such a solution was not advisable.

For these reasons, bank rehabilitation in Slovenia and Croatia really only made sense once a stable macroeconomic environment had been achieved. In Slovenia, this was true by late 1992; in Croatia, mid-1994 would probably have been the earliest date that bank restructuring could have been on the agenda.

The Bank Restructuring Program in Slovenia

INSTITUTIONAL AND LEGAL ASPECTS OF RESTRUCTURING

A Slovene Bank Restructuring Agency was set up in 1992. Initial legislation was passed on October 1991, and follow-up legislation was passed in August 1992.

The establishment of the BRA was part of a broad effort to create the legal and regulatory structure for a market-oriented banking sector. This effort includes the following legislation:

--The establishment of the Bank of Slovenia as the country's central bank. The Governor of the Bank of Slovenia is appointed for a six-year term, and is responsible to a board of experts independent of political affiliation. The Bank can only lend to government on a temporary basis in an amount up to 5% of the government budget.

--Laws on bank supervision giving the Bank of Slovenia authority to exercise oversight on the basis of internationally-accepted principles.

--Regulation of bank ownership and lending practices prohibiting any one owner from holding more than 30% of a bank's capital, and prohibiting banks from making loans to any client in excess of 30% of the bank's total guaranteed capital.

--Regulations establishing the BIS capital-adequacy standards, and setting minimum capital requirements.

Within this framework, the Agency had the mandate of managing banks that were declared insolvent by the Bank of Slovenia. Insolvency occurred automatically if a banks losses exceeded 50% of its capital. In such cases, the Bank was taken-over by the government. The Agency would then bring in new management, and replace the bad loan portfolio of the bank with government bonds. Not all the banks bad debts would be assumed, however. Current losses would be written off against bank equity, and the minimum level of capital would be restored by the Agency. Some DEM 2.2 billion were allocated for this purpose, with the bad debts replaced by 30-year bonds paying 8%, denominated in DEM (Voljč, 1994).

In addition, the Government issued bonds with to cover frozen hard-currency accounts. Some 836.6 million DEM worth of bonds were given to banks, paying 5% interest annually and with 30-year maturity, while citizens were issued some 96.5 million DEM, again with 5% interest but only a 10-year maturity (Borak, 1995).

Finally, the Government also issued bonds to banks that had loans to the Slovenian steel industry. While this was not part of the formal bank rehabilitation program, it provided important help to 4 banks not under rehabilitation. The bonds were worth 250 million DEM, with the same terms as the rehabilitation bonds (8% interest in Deutschmarks, 30-year maturity).

REHABILITATION EXPERIENCE

The first bank taken over by the agency was Slovenia's largest, Ljubljanska Banka. The take-over began on January 1, 1993. A new President and CEO was appointed. Some 1 billion DEM of bad loans were replaced by government bonds. A program of divestment was begun, seeking to sell off real estate holdings and overseas branches deemed unnecessary to the banks strategy. The bank began to consolidated its lending portfolios, improved collection efforts, and reoriented its lending towards prime clients (Voljč, 1994).

Ljubljanska Banka's liabilities stemming from the old hard-currency savings were cleared up. Customers of the bank were offered a choice of government bonds, LB bonds, or eventual repayment. Accounts worth some 280 million DEM were dealt with in this way (Ljubljanska Banka, 1993).

Help also came from the Bank of Slovenia and Ministry of Finance. Ljubljanska Banka received liquidity credits at special rates (4.5 index points lower than the inter-bank rate), had its statutory foreign exchange minimum lowered, and was relieved of its reserve requirements. These concessions were gradually reduced as the rehabilitation process went on (BRA 1994, p. 11).

The extent of the BRAs involvement in the affairs of banks under rehabilitated was quite great. Any credits over 3% of guaranteed capital had to be approved by the Agency. The Agency has also become involved in the restructuring of real sector non-paying bank clients. Slovenia's bank restructuring program relies very heavily on government guidance.

Two smaller, regionally important banks--Kreditna Banka Maribor and Kreditna Banka Nova Gorica, were also taken over by the agency in 1993, receiving similar aid and concessions. Together, the three banks in rehabilitation accounted for some 50% of the Slovene banking industry's total assets, and 40% of total deposits (Voljč, 1994, p. 7).

An important issue within the bank rehabilitation process was the conflict between the Privatization Agency, which had started to work before the BRA, and the BRA. The PA tried to get maximum debt write-offs for its firms, while the BRA counselled banks not to accept write-offs. An Agency council was set up in summer 1993, including the Minister of Finance, Governor of the Bank of Slovenia, Minister of Economy, and head of the BRA, to try to coordinate Agency policy with monetary policy in particular and economic policy in general. This structure, however, did not really overcome the tensions between the privatization authorities and the BRA.

Another issue in the Slovene program was the question of who should be responsible for the work-out of the bad loans. Officials of the BRA were interested in forming their own loan recovery department (author interview with BRA, Ljubljana, July 1993), while others favored allowing the banks themselves to set up loan recovery departments. The solution adopted, which requires the banks themselves to establish "Emergency Care Units", had the attraction of giving banks experience in work-out. As Sundararajan and Balino (1993, p. 32) point out, this solution also provides stronger incentives for debtors to repay, since they have an ongoing relation with the bank. Furthermore, the bank possess more information about the debtor, and therefore be in a better position to reach a work-out plan.

On the other hand, the same banks that had failed to accomplish work-out in the past were now entrusted with it again, critics could argue. Furthermore, since one of the key problems of Slovene (and former Yugoslav) banking had been the overly close relationship between banks and enterprises, this solution *had the drawback of allowing such relations to continue to some extent.*

RESULTS OF THE PROGRAM

Overall, the Slovenian program appears to have been successful. Both banks in rehabilitation achieved positive profits in 1993, and all three appear to have achieved positive profits in 1994. However, preliminary analysis of cash flow showed losses for both Ljubljanska Banka and Kreditna Banka Maribor in 1993 (BRA, 1994, p. 13-14).

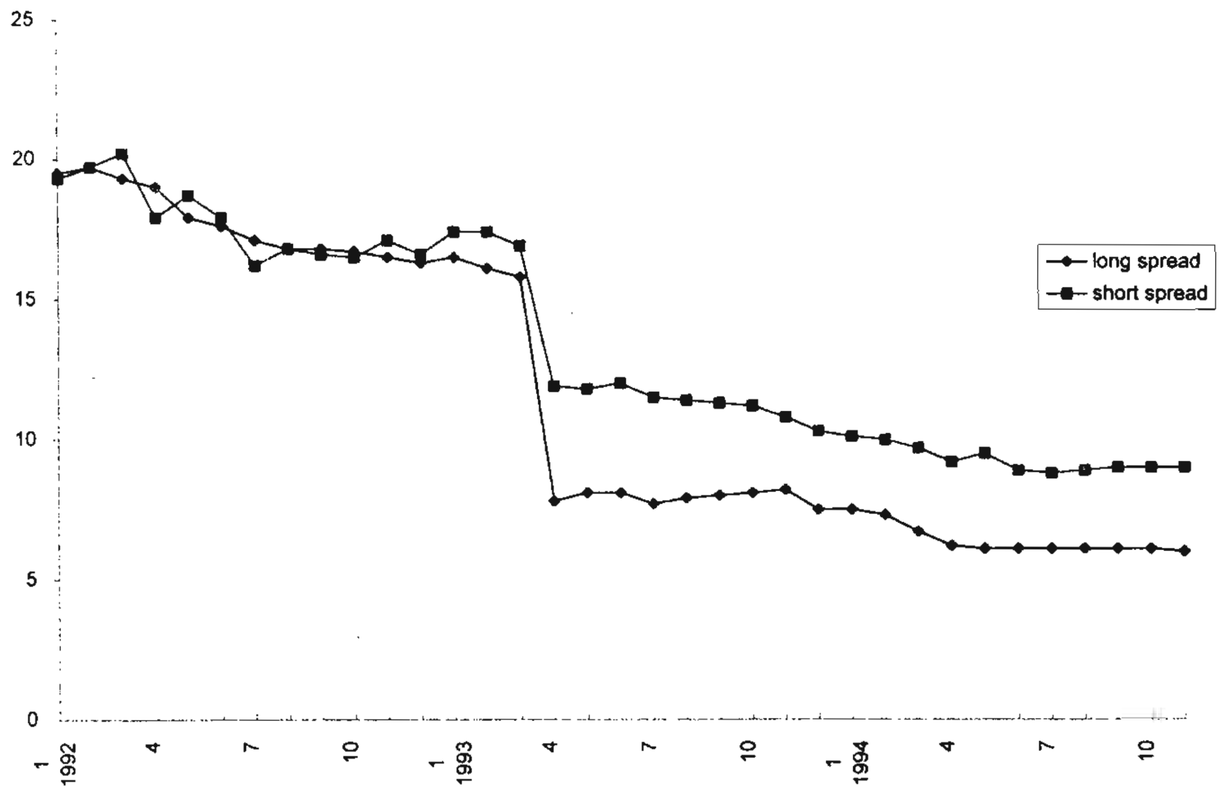
The rehabilitated banks also achieved acceptable capital-adequacy levels. Ljubljanska Banka's capital adequacy level of 5.4% remained below the 8% BIS standard at the end of 1993, but by late 1994, after LB had been divested of remaining claims on former Yugoslavia and relaunched as "Nova Ljubljanska Banka", capital adequacy reached 9.2% (Lah, 1994). Kreditna Banka Maribor achieved 13% by the end of 1993. When the BRA proposed merging KBM with the other bank under rehabilitation, KBNG, the merger was expected to result in a bank with 12% capital adequacy (BRA, 1994b).

Another positive indicator is the improvement in the quality of the loan portfolios of LB and KBM. In the period from July 19 to December 31, 1993, some 88.8% of credits approved by LB could be classified as grade A or B, and 89.0% of KBM credits could be so classified (BRA, 1994, p. 8). Considering that at the end of 1992, only 59% of LB assets merited such classification, this is a major step forward. (Interview with Mića Karpe, Ljubljanska Banka, June 1993).

In addition, interest rates have fallen noticeably since early 1993. LB interest rates on credits fell from 20.0% in January 1993 to 12.5% in December 1993 in real terms, while KBM rates fell from 16.0% to 13.0% (BRA, p. 10). The impact of this decrease is seen in Bank of Slovenia data, which show interest rates for all *banks falling from 24.6% (real) in January 1993 to 16.3% in November 1994 for short-term loans, and from 27.2% to 17% for long-term loans (Bank of Slovenia Bulletin, November 1994).*

The positive results of lower interest rates can be seen in lower spreads between deposit and lending rate. As graph 1 shows, spreads fell substantially in April 1993, and continued to fall throughout 1993 and 1994. Starting at a very high level of 20 percent, spreads have moved to the 6-8 percent range, indicating a far more bearable cost of credit.

Graph 1: Interest rate spreads, Slovenia



Data source: Bank of Slovenia Bulletin

Efforts to collect bad debts have also been a significant part of the rehabilitation program. Štiblar notes that LB has successfully used the method of debt-equity swap in several instances. (Štiblar, 1994a, p. 7-8) This approach has its drawbacks: as Borish, Long and Noël (1995, p. 21-22) note, such swaps put *future liquidity at risk, and may further tie the bank to bad customers. However, as the same authors indicate, such swaps may offer promising enough returns in the cases where they do turn out well to justify the risk. And, as Štiblar indicates, the alternatives are few.*

Despite the success of rehabilitation, there has been a significant amount of disintermediation in Slovenia. The real value of bank credits to enterprises increased only 1.9% between December 1991 and December 1994, and it even fell 7.4% between December 1993 and December 1994.[8] *Looking at graph 2, it appeared that disintermediation was especially strong in the first half of 1992, when the demand shocks of stabilization and the loss of markets in former Yugoslavia hit enterprises hard. Lending resumed in the second half of 1992 and grew steadily in until the second half of 1993. Lending grew slowly in the second half of 1993, and actually fell in real terms in 1994.*

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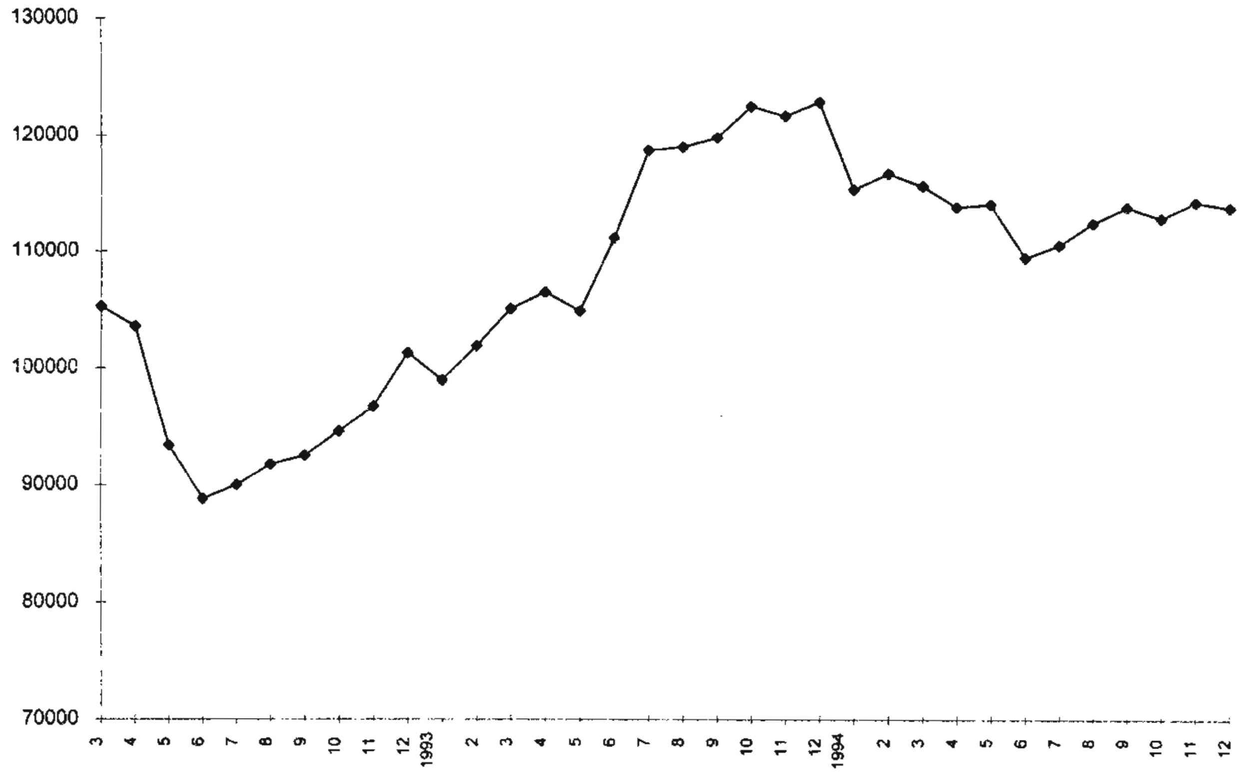
[8] *Author's calculation based on data from Bank of Slovenia Bulletin. Bernanke and Lown (1991) dispute the usefulness of measures of real credit, arguing that the increase in nominal credits is a better indicator of new credit activity. By this measure, there was some credit expansion in Slovenia in 1994: credits to the non-bank sector expanded from 291,370 million tolars to 319,113 million tolars (9.5% growth).*

However, this measure presumes that enterprises needs for funds are not constant in real terms. If, as seems more likely, enterprises need funds in order to meet expenses that also grow with inflation, this measure may only tell us that banks were lending, but not whether enterprises were keeping up their financial positions. Hence, the two measures in the text are to be preferred.

Graph 2: Real bank credit to enterprises, Slovenia



Data source: Bank of Slovenia Bulletin

A similar story can be told by calculating changes in the stock of credit as a fraction of GDP. In relation to GDP, the net change in bank credits to the enterprise sector fell from 8.3% of GDP in 1992 to 6.7% in 1993 to 1.5% in 1994.[9] The growth in this measure in 1992 is clearly due to increases in the second half of the year.

A decrease in the extension of credit is to be expected as banks become aware of the need to stand on their own. With harder budget constraints, banks should avoid making questionable loans. In a recessionary economic environment, good customers are hard to find, and the volume of loans declines. Dittus (1994) argues that similar decreases in credit extension signalled changes in bank behavior in Hungary, Poland and former

[9] This calculation takes the difference between total stocks of credit on December 31 of the year in question and December 31 of the previous year divided by nominal GDP. Data from Bank of Slovenia Bulletin.

Czechoslovakia after the bad debt problem was made a topic of public discussion and action in 1992.

Before concluding that banks changed behavior, we should examine whether the decrease in lending to enterprises could be due to the government budget attracting bank funds away from enterprise lending. The table below suggests that this may have been the case in the first half of 1992, when government savings fell by 2.4% of GDP. However, government borrowing cannot account for the fall in lending in 1994, since government savings only decreases by .6% of GDP, while borrowing falls by 5.2% of GDP from 1993.

Further evidence on the demand for credit can be gleaned from the behavior of investment. Investment fell by 1.6% of GDP in 1992, before bank restructuring, in the course of the twin stabilization and separation demand shocks. Investment actually increased .5% of GDP in 1993, even with government savings steady. And in 1994, investment moved ahead again by 1.8% of GDP, while government savings decreased only .5% of GDP.

Table 1
Investment and savings in Slovenia, 1991-1994

	1991	*1992*	*1993*	*1994*
Investment	*19.2*	*17.6*	*18.1*	*19.8*
Government budget surplus	*2.6*	*0.3*	*0.3*	*-0.2*
Current account surplus	*1.0*	*7.6*	*1.2*	*3.3*
Savings	*17.6*	*24.9*	*19.0*	*23.3*

Data source: Bank of Slovenia Bulletin. Savings calculated by author.

Table 2 provides some basic indicators of the performance of Slovene banks that shed more light on the behavior of real credit. The behavior of ROA shows the heavy impact of the loss of the Yugoslav market on Slovene banks in 1992. Decreasing loans in relation to deposits, increasing provisions, and large write-offs in

1992 show the banks' reaction to the crisis. Note that is only in 1993 that provisioning really jumps, indicating again a change in behavior.

The growth indicators are in nominal terms. Since inflation was 201% in 1992, and 32.3% in 1993, it becomes clear that assets, loans and deposits actually decreased in real terms in 1992, but grew again in 1993. On the other hand, securities holdings grew very rapidly in both years, becoming a major part of the balance sheet. Here the stories of 1992 and 1993 are different: in 1992, banks invested in marketable short-term securities. This supports the crowding-out hypothesis to a degree. But in 1993, the growth in securities is mainly due to the issuing of long-term rehabilitation bonds, and does not in any way contribute to crowding-out.

Table 2
BASIC INDICATORS OF THE SLOVENE BANKING SYSTEM, 1991-1993

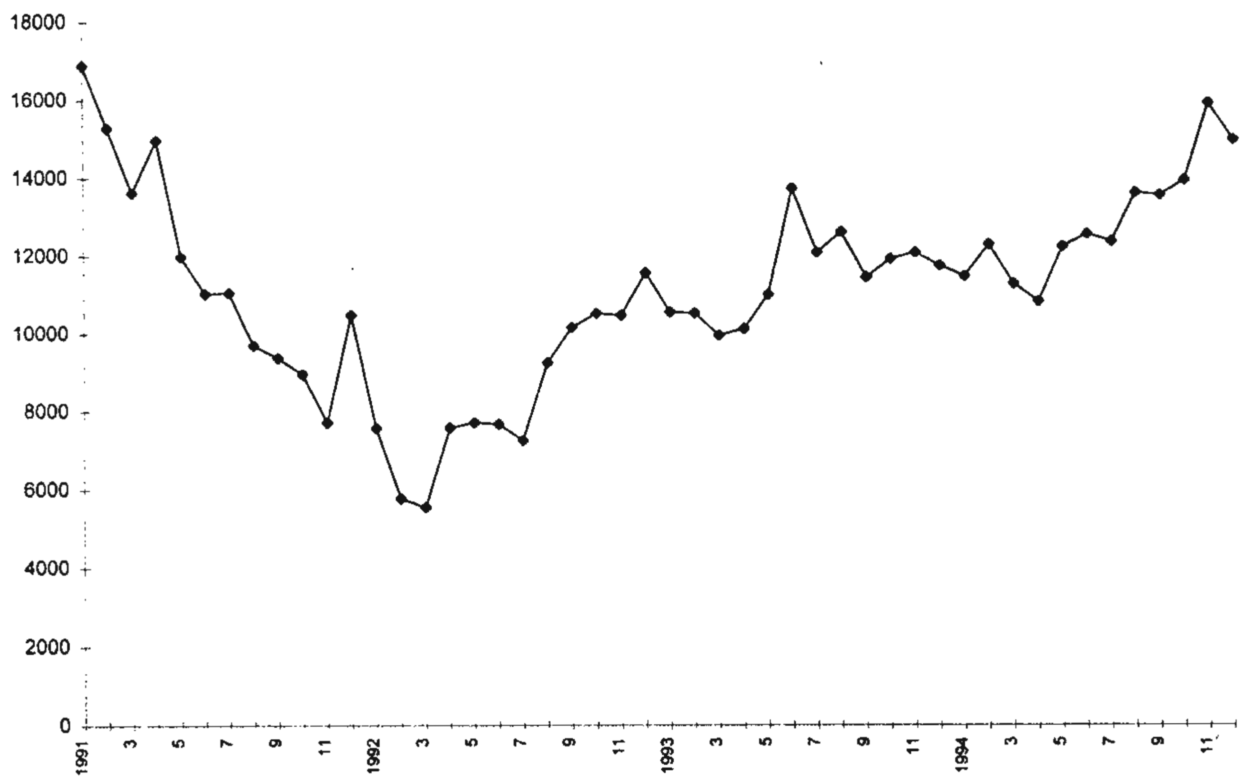
	1991	1992	1993
Return on Assets	0.77	-2.41	0.15
Net/Total Income	1.01	2.99	3.37
Loans/Deposits	130.49	112.55	92.45
Provisions/Loans	0.56	1.09	4.59
Write-offs/loans	6.56	14.58	7.66
Asset Growth		93.94	50.53
Loans Growth		99.79	37.46
Deposit Growth		131.64	67.35
Securities Growth		360.25	296.59
Securities/total assets	5.01	11.90	31.35

Source: SDK Bilten, March 1993 and March 1994.

Hence, although there is some evidence for "crowding-out" in the first half of 1992, it seems unlikely that the slowdown in lending in 1993 and the fall in lending in 1994 can be explained either by "crowding-out" or by declining investment demand. In fact, it seems that decreased lending occurred hand-in-hand with *increased investment, indicating that firms were better able to finance current needs from their own resources.*

Graph 3, which shows the real value of liquid funds available to enterprises, sheds some light on this phenomenon. It appears that as enterprise liquidity improved significantly in 1994, enterprises became less reliant on credit. The simultaneous increase in fixed investment indicates greater use of credit for long-term needs.

Graph 3: Real liquidity (funds on giro account) Slovenia



Data source: SDK Bulletin

A more precise explanation of changes in credit can be gleaned from econometric modelling of the demand for real credit. Using a simple partial adjustment model based on Sundararajan and Balino (1991) (see Appendix for details), the following results are obtained for the period April 1992 to December 1994:

Table 3:
DEMAND FOR REAL CREDIT, SLOVENIA

Constant	-39035.48
	(2.13)
Inflation	-2245.55**
	(-5.36)
Lagged real credits	.91**
	(18.23)
Lending rate	4.50
	(.47)
Real GDP	571.40
	(1.26)
Dummy for 1994	-4765.35*
	(-2.49)

Adjusted R-squared: .944
F=108.67

t-statistics in parentheses
** significant at 1% * significant at 5%

As expected, demand for real credit depends strongly on inflation and the stock of lagged real credits. More importantly, these results show the insensitivity of loan demand in Slovenia to interest rates. The very low t-value is a strong sign of the presence of distress borrowing. In addition, the weak link between borrowing and real GDP reinforces the importance of distress borrowing. Finally, the dummy for 1994 clearly shows a decrease in loan demand following bank rehabilitation.

An alternative specification using a slope dummy for interest rates in 1994 were examined. However, the results revealed that regressions with an intercept dummy, rather than a slope dummy, performed better. The interpretation must be that the demand curve shifted down in 1994, indicating a tighter attitude towards lending by banks, and more caution in borrowing by enterprises. In other words, the econometric evidence supports the conclusion drawn from the decrease in net credits/GDP from

1992 to 1993, and from 1993 to 1994, that hardening of budget constraints on banks and enterprises has taken place, along with greater reliance on self-finance by enterprises, especially in 1994.

CONCENTRATION AND COMPETITION

In addition to the problems dealt with by rehabilitation, Slovenia's banking sector faces problems of high concentration, both in the aggregate and at the regional levels. The five largest banks control 63% of total assets, 32% of capital, and 59% of deposits (Štiblar, 1994c). A new regulation requiring that banks have a minimum capital of DEM 50 million for a full international license goes into effect in September 1995; this will have the effect of increasing concentration even further. Štiblar worries that this will put Slovenia beyond the upper bound of acceptable concentration.

The Bank of Slovenia believes, however, that this law is necessary to strengthen banks for European competition, given the presence of strong scale economies and the disadvantages of "excessive" competition. In addition, a Bank of Slovenia official interviewed by the author cautioned that traditional concentration indices may be misleading, given Slovenia's small size and high degree of openness.[10]

In this regard, it is important to ask whether the competition brought about by the entry of new banks has proved helpful. In fact, it seems that newly formed, private or socially-owned smaller banks have chosen to be "free-riders", taking advantage of high spreads rather than exerting competitive pressure to reduce spreads (Voljč, 1994). Furthermore, the fact that spreads have been so high have probably reduced incentives to cut costs

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[10] *Interview with Marko Kranjec, Vice-Governor of the Bank of Slovenia, Ljubljana, May 1995.*

or develop a broader range of bank services (Cetinski, 1994). The question, however, is what happens as spreads decrease. It seems reasonable to expect that the new entrants would provide continued competitive pressure, help introduce new services, and keep the big banks on their toes. Glogovšek (1994), criticizing the Bank of Slovenia's decision to raise minimum capital requirements beyond the levels required by the EU, argues that in fact the playing field is already tilted in favor of the banks in rehabilitation. These banks receive preferential treatment via the BRA and concessions on interest rates from the BOS.

On the other hand, the belief in scale economies in banking remains strong. And Cetinski, analyzing the reasons behind the Slovene banking system's relatively high costs, argues that the system possesses significant excess capacity due to the large number of banks and bank branches. Cetinski also mentions poor use of bank technology, overstaffed accounting departments (a legacy of the accounting complications of socialism), flight of savings to foreign banks, and poor use of cadre in development and information systems departments as reasons for high costs (Cetinski, 1994).

Given these problems, alliances with foreign partners may be more helpful than competition from many new banks. Foreign partners could play a major role in introducing new technology, improving management methods, increasing public confidence, and giving Slovene banks access to international financial markets (Štiblar, 1994b).

A final factor in the equation may simply be the desire to secure the position of the rehabilitated banks. After the merger of KBM and KBNG, there will only be 2 rehabilitated banks, but there will also very likely be only 4 or 5 banks surviving the minimum capital level increase.

It will be interesting to compare the cost-effectiveness of Slovene banks after the minimum capital requirement goes into effect to *other banking systems. It seems that Slovenia will have to decisively open its banking system to strong competition from the EU to justify its somewhat unusual approach.*

Finally, Slovenia hopes to pass a new, expanded banking law in 1995. The law is part of a larger effort to ensure a clear and rigorous regulatory framework for banking in Slovenia. For the most part, the draft law appears to fill out and improve existing law without making major new innovations.

ISSUES FOR THE FUTURE

With regard to the success of bank rehabilitation, the final proof of the pudding will be the privatization of the three failed banks. The original intention was to privatize the banks by 1996. It remains to be seen whether this will be possible. There are three major question marks:

(1) Have the banks improved their current operations and their balance-sheets enough to be attractive to investors? Continued questions about contingent liabilities and limited liquidity are especially crucial here.

Also, the rehabilitated banks have enormous disparities between the time structures of assets and liabilities which make them vulnerable to market shocks (BRA, 1994, p. 7). In particular, Štiblar argues that the 30-year bonds are not adequate assets, and should be refinanced with shorter instruments denominated in tolars (Štiblar, 1994c).

(2) The second big question is who will buy the shares of these banks. Slovene authorities will probably keep some shares. They would like to find shareholders among enterprises and citizens, avoiding the old problem of bank clients owning the banks. Slovene authorities have been wary of foreign banks, and probably would not permit them to gain control of any of the three rehabilitated banks. More attractive would be the idea of

finding strategic foreign partners, who would hold a minority interest (Borak, 1994). Five banks with majority foreign ownership functioned in Slovenia by the end of 1993, and foreign banks held about 9% of total bank capital (Štiblar, 1994b).

(3) Currently, Slovenian banks are highly liquid in foreign exchange, but often illiquid in tolars. The Bank of Slovenia, faced with the need to keep control of monetary aggregates so as to continue to reduce inflation, cannot afford to provide too much tolar liquidity. But there is no other source: the interbank market is simply inadequate. This may simply be a structural problem of a small monetary area that can only be partially alleviated by economic growth and recovery.

Bank Crisis and Restructuring in Croatia

INSTITUTIONAL AND LEGAL ASPECTS

Croatia made a promising start cleaning up its banking system in 1991. In that year, loss-making enterprises were given government bonds (the so-called "big bonds") which they used in part to pay off their bad debts to banks. (Enterprises could also sell the bonds to the government in exchange for equity positions in the enterprises.) The total sum of bonds was near $1 billion--a rather significant sum in comparison with total company assets of $7-8 billion.

In addition, the freezing of citizens' foreign exchange accounts, and the promise that the government would ultimately be responsible for these liabilities, greatly eased the situation of the banks. Some $2 billion of bonds were issued for this purpose, with repayment beginning in mid-1992 in local currency or mid-1995 in foreign currency. Repayment by bond would occur over a 10-year period, with 5% interest. The bonds were held by the banks, but depositors could exchange their deposits for the bonds, which could then be used to buy socially-owned housing or shares in state-owned enterprises.

As Škreb remarks, these steps improved the situation on paper quite rapidly: enterprises were able to remove their bad debts and raise their capital, banks removed bad loans and had safe assets in their portfolio, and in principle did not have to worry about a large fraction of their liabilities (Škreb, 1994). However, since the government often did not pay its obligations to the banks on time, and sometimes did not pay them in cash, the actual liquidity and solvency of the banks could be questioned. The irony here is that the National Bank rated Croatian Banks extremely healthy, basing its appraisal on the fact that nearly 50% of bank assets were government securities (Jankov, 1994, p. 134).

Inflation also helped rehabilitate Croatian banks to a degree. Inflation decreased the real value of bad loans, and brought the percentage of bad loans in the balance sheet down. Furthermore, deposit rates did not keep up with inflation, and spreads rose tremendously during the high inflation of 1992 and 1993. (See below for more details on spreads.)

During 1994, credits of some 240 million kuna (nearly 60 million DEM) were given to three regional banks. These credits were repaid at the end of 1994. Repayment was facilitated by the Ministry of Finance's repurchase of an equivalent sum of outstanding big bonds. This move was deemed necessary as an interim step to avoid bank failures during the period of preparation for rehabilitation. However, there is a danger of moral hazard, and of expectations that future bailouts will be forthcoming.

Recent legal initiatives in Croatia have established a broad operational framework for banks, and have laid much of the legal groundwork for rehabilitation. They include the following:

--the law on the National Bank of Croatia, which gives the Governor a six-year term, creates a Board of Experts independent of political parties, and limits lending to the government to "bridging loans" that must be repaid within the fiscal year and cannot exceed 5% of the budget.

--the law on Banks and Savings Banks, which sets a minimum equity capital of 5 million DEM in domestic currency equivalent for a domestic license, and 15 million DEM in domestic currency equivalent for an unlimited license, defines capital-adequacy standards compatible with BIS requirements, limits any single loan to 30% of liable capital (tier 1 plus tier 2 capital), limits loans to any single borrower to 30% of liable capital, and limits investments in land, buildings, equipment, and ownership stakes in other banks and enterprises to 70% of liable capital. Amendments in February 1995 limit loans to any client with shareholding stakes above 10% in the bank to 5% of liable capital.[11] (Škreb, 1994, p. 10-11)

--the law on the State Agency for Deposit Insurance and Bank Rehabilitation was passed in May 1994, but the government only announced its choice to head the agency in March 1995. With the help of a World Bank loan, the agency is expected to be functioning in the second half of 1995.

Two other recent measures taken by the National Bank of Croatia have intensified pressure on banks to conform to market discipline. The first, called "dvostruka pokrića" (double coverage), requires that both the user making a payment and the bank in which the user holds an account be solvent. The point is that customers must be sure their bank is solvent; if not, payments will not be made. This encourages customers to worry about the solvency of their banks.

The second measure makes it impossible for banks to automatically draw on their required reserves at the National Bank. Banks that are illiquid have to take out an "Interventive Credit", which not only carries a penalty interest rate, but also

[11] In cases where loans to large shareholders exceed this limit, the law requires that no new loans be given until repayment has proceeded to the point where loans are less than 5% of liable capital. This limit will probably affect small banks more than large ones; the biggest banks currently have no shareholders with 10% shares.

cannot even be used until the banks' obligations have been settled.

What is still lacking is a clear legal framework for bankruptcy, the use of collateral, and trading in securities. Privatization legislation is also in some respects still unfinished. The latter aspect will be discussed further below.

COPING WITH A PROBLEMATIC ENVIRONMENT

Due to the war and the failure of the Croatian authorities to supervise enterprise performance after the balance sheet clean-up of 1991, flow problems re-emerged. Enterprises did not change their ways of doing business in many cases, and banks, still owned by large state-run enterprises, continued to lend to them. Below, I will discuss the reasons for the slow progress of privatization and restructuring in Croatia. In this section, I will concentrate on the performance of banks themselves.

Even though Croatian banks were formally solvent, bad loans grew again. By late 1994, the problem seemed almost as bad as before. Potential losses in the banking system were estimated at a staggering 64.2% of total capital, and four medium-sized banks were in urgent need of help (Prskalo, 1994c).

This figure belied the optimistic impression generated by the fact that overall capital-adequacy in Croatian banking was rated at 17% in 1993. The 17% capital-adequacy is misleading for several reasons. First, because much of the existing capital will have to be written-down during rehabilitation. Second, because the tactic of converting bad loans to equity has not succeeded in generating income, only in removing problems from sight. Third, because small banks are actually overcapitalized, and would be happy to increase loans if only they could increase their deposit base. Fourth, because replacing loans with bonds automatically increases risk-weighted capital adequacy, since bonds have a lower risk weight than even loans to the best customers.

The problems of Croatia's distressed banks include excessive exposure to particular loss-making industries, and problems created by war losses. Also, Croatia's banks are highly focused regionally, and certain regions--most notably Slavonia-Baranja, Dalmatia, the Croatian coast and Istria--have been especially affected by war damage, disruption of transportation links, and loss of traditional markets. As a result, the banks serving these regions have found themselves in especially difficult positions (Gracin (1994), Prskalo (1994c)).

Banks' reaction to such problems has not been completely passive; banks have adjusted to some extent. Among the survival tactics employed are:

Improved credit-risk assessment: *Many Croatian banks have made important steps forward in assessing the credit-worthiness of borrowers and attempting to improve their loan portfolios. Credit-risk assessment remains difficult, however, due to lack of credit history information, the newness of many borrowers, and the unpredictability of the economic situation.*[12]

Greater efforts to secure deposits: *Increased advertising, the introduction of ATM's, and attempts to improve bank services indicate increased efforts to woo customers. However, as the next section shows, these efforts are only beginning.*

Debt-equity swaps: *Some banks have aggressively pursued equity in place of bad loans from companies with very limited financial prospects. As was pointed out above, this tactic at least has the virtue of removing non-performing assets from the balance sheets, and it makes the likelihood of enterprise turn-around better. But trading non-performing loans for equities in distressed firms does not create much income (Prskalo, 1994a).*

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[12] *These observations are based on interviews with Croatian bankers and bank supervision officials.*

Initiation of bankruptcy: *Slavonska Banka, for example, was involved in no less than 34 bankruptcy cases between 1990 and 1993. At stake were 111 million DEM of loans. But only 3.86 million had been recovered by the beginning of 1994.*

Conversion of old hard-currency savings: *Some banks have been aggressive in their efforts to decrease their stocks of old hard-currency savings. Zagrebačka Banka, in particular, has made special efforts in this regard, including offering to buy old hard-currency savings at a discount. The bank announced in early 1995 that it had reached the point where new hard-currency savings was greater than old hard-currency savings. Other banks, too, have reduced their old hard-currency savings holdings noticeably.*

Investment banking: *The most noteworthy, and controversial investment bank is Privredna Banka Zagreb, which had holdings in some 70 enterprises with a total value of 990 million DEM as of the end of 1994. The majority of these were obtained from enterprises in bankruptcy (Drezga, 1995). However, Privredna Banka has been forced to put much of this portfolio up for sale in spring 1995, due to a sharp liquidity crisis.*

Controversy about Privredna Banka's investments has focused on its strong ties with enterprises dating back to the old system, and its close ties to politicians (Kiseljak, 1995b). Be that as it may, the point still stands that many Croatian banks are taking considerable equity positions in enterprises, and play important roles in both financial and physical restructuring of enterprises.

COMPETITION AND SPREADS

Croatia's banking system, like Slovenia's, has a high level of concentration. Although some 50 banks operate, two, Zagrebačka and Privredna, hold 39.7% of banking system capital and 70.6% of credits disbursed. When the next four banks--all *regional leaders--are added in, the figures rise to 66.1% and 88.2% respectively (Škreb, 1994).*

Regional concentration levels are very high. Hence, the aggregate concentration levels probably understate concentration levels at the regional level. Also, the high share of Zagrebačka and Privredna nationally reflects the greater economic health of Zagreb and the north-west region of the country, which have been relatively untouched by the war.[13]

An important symptom of non-competitive behavior in banking is the enormous disparities in interest rates across banks. Deposit rates on kuna savings ranged from 1 to 7% annually in early 1995 for sight deposits, and from 8 to 16% for 36-month time deposits. Deposit rates on hard-currency savings were equally varied, ranging from 1% to 7% (Privredni Vjesnik, 1995).

Similarly, there were wide differences in loan rates and conditions. Some banks required applicants not only to provide collateral and show that they had a third of the value of the loan in cash, but also to establish accounts in the bank before considering loan applications (Popović, 1994).

Stabilization has resulted in significant decreases in spreads. During the high inflation of 1992 and 1993, spreads reached astronomical levels. Stabilization reduced these, and by March 1994 spreads were down to the 15% range. By late 1994, spreads were down as low as 10.7%--still high, but a far cry from the hundreds of percentage point spreads of 1993 (see Graphs 4 and 5).

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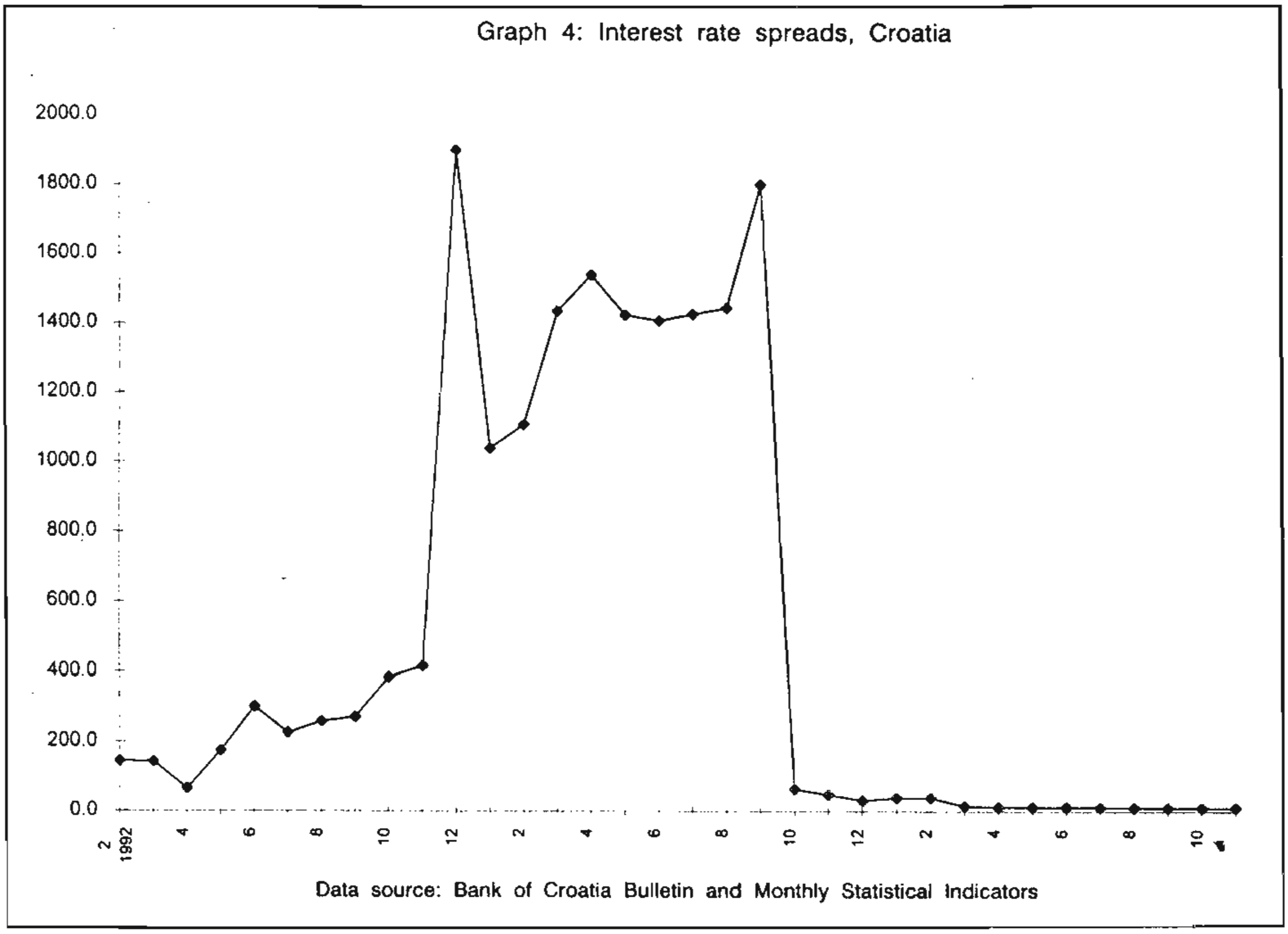
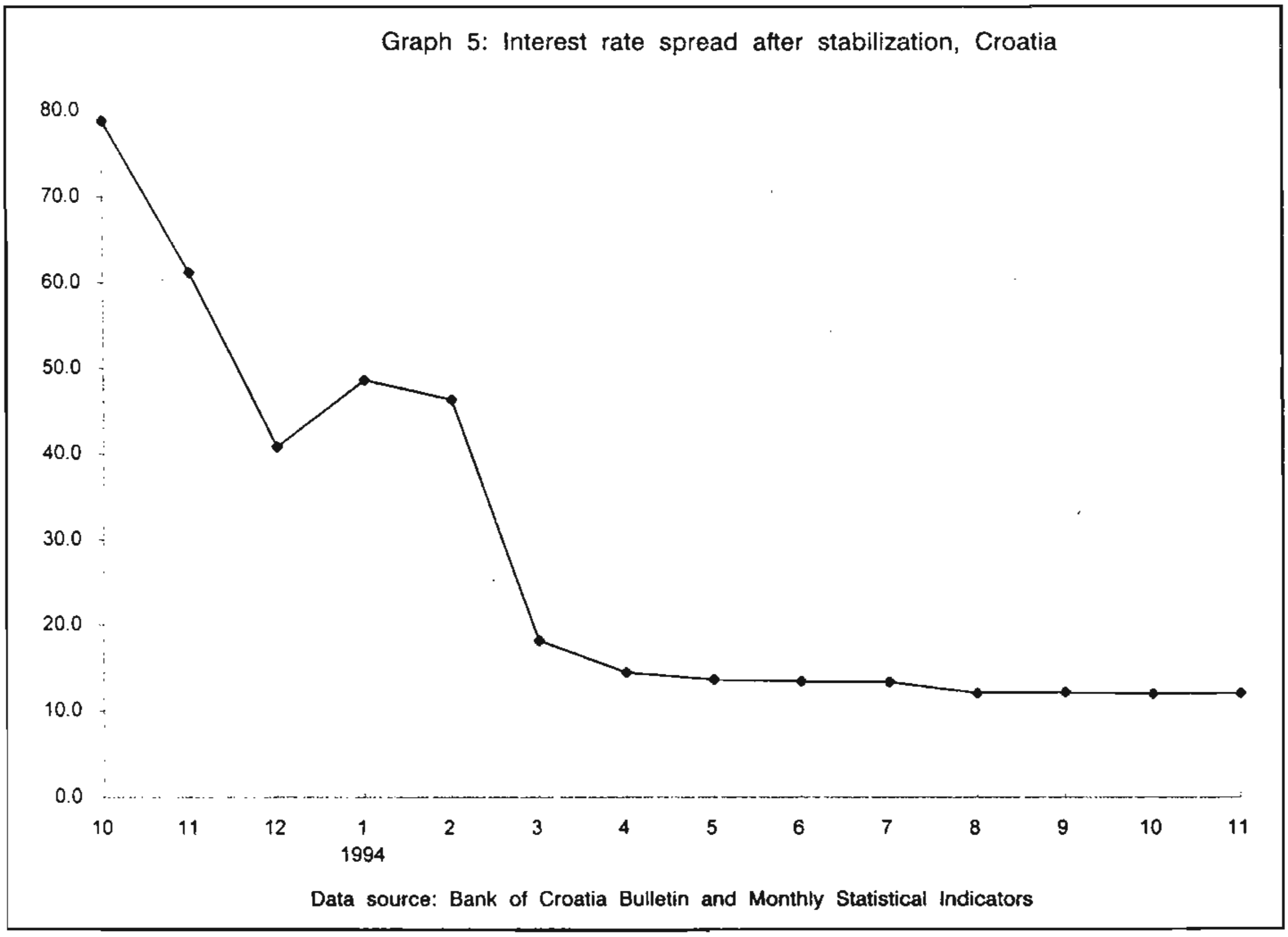
[13] *I owe this insight to Damir Odak.*


Graph 4: Interest rate spreads, Croatia
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
0.0
2
1992
4
6
8
10
12
2
4
6
8
10
12
2
4
6
8
10
Data source: Bank of Croatia Bulletin and Monthly Statistical Indicators


Graph 5: Interest rate spread after stabilization, Croatia
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
10
11
12
1
1994
2
3
4
5
6
7
8
9
10
11
Data source: Bank of Croatia Bulletin and Monthly Statistical Indicators

Spreads remain high for the following reasons: 1) large amounts of non-performing loans 2) other "inactive" assets on the balance sheet, including a relatively high reserve requirement (27%) that receives very modest interest rates (5.2% per annum in 1995) 3) high costs due to inefficient operations 4) strong legal protection of debtors, which prevents foreclosure and results in a risk premium being charged to all borrowers.[14]

Partly because of lower spreads, banking sector performance in the first half of 1994 deteriorated quite badly, despite the success of macrostabilization. Bank profits fell from 1.26 billion Kuna in the first six months of 1993 to .396 billion in the first six months of 1994, and losses rose from 14 million to 288 million. Net before tax profit fell from 1.25 billion to 107 million kuna (Privredni Vjesnik, 1994).[15]

On the one hand, the highly imperfect market conditions obtaining provided opportunities for new entries. In such a market it is relatively easy and profitable to free-ride on high spreads and build up a new bank. The continued existence of some 50 banks after 5 years of unrestricted entry supports this assertion.

On the other hand, the enormous advantages held by the existing big banks, including well-developed branch networks and significant capital resources, constitute important competitive advantages. It remains to be seen whether the new banks can continue to decrease the market share of the leading banks and establish meaningful competition.

Croatia, like Slovenia, faces the issue of to whom the banks can be sold. Croatian law, like Slovenian law, now limits the ownership role of firms in banks, and also limits the credit

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[14] Santini (1995) speculates that the risk premium explains anywhere from one-third to one-half of overall interest rates.

[15] These figures cover all banks, savings banks and other financial institutions.

exposure of banks to individual borrowers. However, the disposable savings of the population in Croatia is probably much lower than in Slovenia, due to war and the sale of socially-owned housing. And, so far, there is only one foreign bank active in Croatia. Most likely, Croatia will encourage foreign banks to enter in some form. Croatian emigres and former guestworkers may be a source of capital, but this remains to be seen.

DEMAND FOR CREDIT IN CROATIA

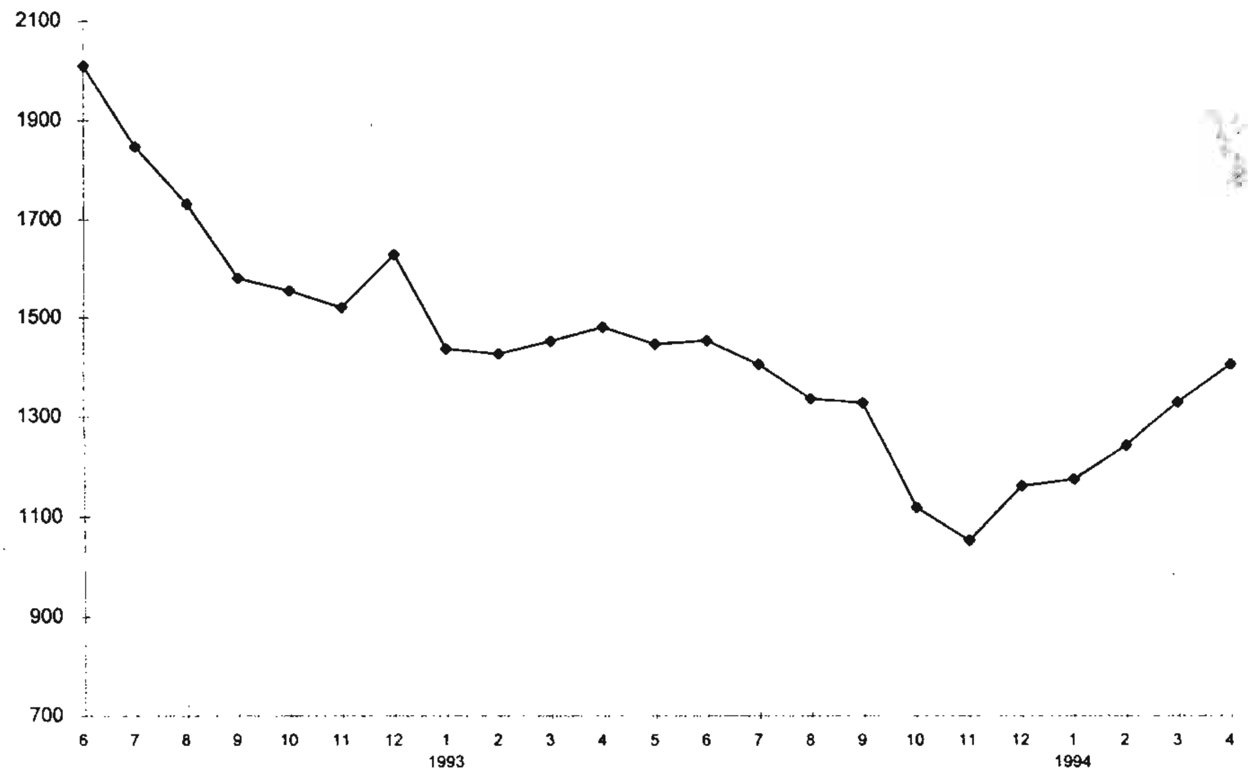
The enormous losses suffered by the Croatian economy due to war, as well as the ongoing problems of bad loans, led to a noticeable contraction of real credit, as can be seen in graph 6 below. Real credits held by enterprises fell steadily from mid-1992 until November 1993.

After stabilization, however, real credits began to rise. In part, this increase can be explained by monetary tightening. As the National Bank of Croatia stopped automatically buying up foreign currency from enterprises, the latter were forced to borrow more to finance their liquidity needs. This is seen in the fact, noted above, that inter-enterprise arrears tripled in the months after stabilization.

In addition, the faster-than-anticipated fall in inflation may have resulted in continued growth in nominal credits, as enterprises projected their liquidity needs based on higher inflation than actually obtained, leading to growth in real credits.

To study these issues further, I have estimated the demand for credit in Croatia from July 1992 to April 1994 using the same general framework employed above.

Graph 6: Real bank credit to enterprises, Croatia



Data Source: Bank of Croatia Bulletin

Table 4:
DEMAND FOR CREDIT IN CROATIA

Constant	*-6.08*
	(-.01)
Inflation	*-8.86***
	(-4.36)
Lagged real credits	*.80***
	(7.03)
Lending rate	*.01*
	(.22)
Industrial production	*8.58*
	(1.18)
Dummy after stabilization	*-161.25**
	(-1.91)

Adjusted r-squared: .868
F=44.33

t-statistics in parentheses
***significant at 1%*
** significant at 5%*
+ significant at 10%

These results give a picture of an economy characterized by distress borrowing. The coefficient on interest on loans is insignificant, indicating that rising interest rates do not curtail real demand for credits. The other coefficients are more usual: negative and significant effect of inflation and partial adjustment of lagged credits. The insignificance of the of industrial production may result from the fact that it is only a proxy for GDP.

Two things should be said about the demand curve before and after stabilization. First, separate tests showed that stabilization did not affect the interest-sensitivity of real credit demand; distress borrowing continued after stabilization. Also, although the dummy for the effect of stabilization on the constant term is negative and significant at 10%, in fact the demand curve shifted up in credit-interest rate space, because the fall in monthly inflation rates from 38 to 0, when multiplied by the coefficient on inflation, is actually greater than the shift captured by the dummy.

In conclusion, this econometric exercise indicates a credit market in Croatia dominated by distress borrowing on the demand side. Banks are forced to accommodate this. Stabilization, by reducing the inflation variable, shifted the demand curve upward.

The Relationship Between Bank Rehabilitation and Real Sector Restructuring and Privatization

Neither Slovenia nor Croatia had privatized the majority of enterprises by the beginning of 1995. In Slovenia, a drawn-out legislative debate, involving three different versions of the privatization legislation, was only settled in November 1992. (See Štiblar (1992), Cvikl, Kraft and Vodopivec (1993), Rus (1994) and Pleskovič and Sachs (1994)). Enabling legislation was passed in summer and fall 1993, and the distribution of vouchers and the formation of investment funds began in 1994. By early 1995, most enterprises had submitted privatization plans, and the process was expected to conclude in 1996.

This lag in mass privatization did not completely prevent restructuring from occurring. New private firms grew vigorously. Social ownership fell from 89% to 76% of the economy between 1990 and 1993 (Vodopivec and Korže, 1993). Social sector enterprises, expecting changes to come, created new business plans, and shed labor at a very rapid rate. Some 102,000 social sector jobs (not including government) disappeared between 1989 and 1991, and another 120,000--20.8% of the total--were eliminated between 1991 and 1994.[16] [17]

In Croatia, although enterprises went through an ownership change process, the result was often not privatization. By the end of 1994, some 2364 privatization plans had been completely carried out. Of these, 47.6% resulted in complete privatization, but completely private firms accounted for only 2 billion of the 22.1 billion DEM of total capital. On the other hand, 376 enterprises remain with majority state ownership, and these account for 9.2 billion of the 22.1 billion DEM. In addition, some 863 enterprises are minority owned by the Croatian Privatization Fund. When the CPF's holdings are combined with those of the Pension and Invalid Funds, they probably are adequate to provide the CPF effective control over these firms as well. These firms have some 10.9 billion DEM capital, with an average firm capital of 12.7 million (Data from CPF, quoted in Prošenski. 1994).

Further privatization has been attempted by limited offerings of stock on the Zagreb stock exchange. About 40 million DEM had been sold this way by late 1994, although the CPF was offering shares in some 460 firms with a total value of 1.9 billion DEM. In

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[16] *This figure is actually an understatement, since the 1994 employment figures includes private firms with more than three employees (Bank of Slovenia, November 1994).*

[17] *Berg (1994) makes a similar argument in the Polish case, suggesting that Polish enterprises began adjusting quite rapidly after the stabilization of 1990, despite the almost complete lack of privatization of larger state firms.*

addition, the CPF was selling shares in another 60 firms in exchange for old hard-currency savings. The CPF had succeeded in exchanging shares worth 360 million DEM for old hard-currency savings by late 1994 (Prošenski, 1994).

Furthermore, it can be said that the extremely low level of trading in equities on the Zagreb stock exchange remains an obstacle to debt-equity swaps and thus to restructuring efforts throughout the real sector.

BEHAVIORAL CHANGE AND RESTRUCTURING

Why did Slovene firms change their behavior more than Croatian firms? The answers probably lie in the macroeconomic and institutional environment. In Slovenia, tight monetary policy began in late 1991. Even though bankruptcy was in moratorium, it was clear that loss-makers would face great difficulties. Banks could not gain access to refinancing credits, real interest rates were extremely high, and most firms could read the writing on the wall. Only certain large and strategic loss-makers, like the steel industry, could count on loan forgiveness and other fiscal subsidies.

In Croatia, however, monetary tightness really only began with the stabilization program in late 1993. Refinancing credits, the main instrument of soft monetary policy, were only eliminated completely in May 1994. Political struggles continue over how to rehabilitate important sectors like shipbuilding, and over whether the government will reimburse enterprises for war-related losses (Kiseljak, 1995a).

In addition, the success of the old managers in keeping their positions has contributed to a "business as usual" situation in many of the largest enterprises. With war still a real possibility, and with the overwhelming majority of ownership in the hands of the government or its agencies (the Croatian Privatization Fund, *and the Health and Pension Funds), pressure on firms to change behavior is much more limited.*

Bank rehabilitation in Croatia will have a great deal of difficulty if state-run firms are not restructured. Removing bad loans from bank portfolios is little help if current loans are not being repaid (the stock problem is eliminated but not the flow problem). Also, banks already have 59% their assets as claims on government (National Bank of Croatia Bulletin, January 1995, p. 1); rehabilitation through bond for debt swaps will only increase this.

Concluding Observations

The success of bank restructuring and real sector restructuring: *Slovenia's bank rehabilitation appears to have been fairly successful. Rehabilitation seems to have contributed significantly to lowering real interest rates and spreads. It also seems to have increased the quality of bank lending, and led to important steps toward "hard-budget constraints." At the same time, it should be noticed that tightened lending criteria, continued high (but falling) interest rates, and greater reserve and capital requirements have kept banks from playing a major role in promoting growth initially. For example, even in 1994, when rehabilitation procedures were a year old in Slovenia, the real volume of credits fell over 8%.*

Some of the success of Slovenia's bank restructuring program should be attributed to the progress real-sector enterprises made in adjustment. Slovene banks were able to find some good customers, and to rebuild their loan portfolios, thanks to the significant degree of adjustment occurring in the real sector. Problems still remain, particularly the heavy weight of government paper in banks balance sheets, but the Slovene banking system has clearly made an important step forward.

Although Croatian banks show some evidence of changing their behavior, with some banks improving credit-risk assessment and lending practices, and with some using bankruptcy, debt-equity *swaps and other tactics to salvage bad debts, their room for maneuver is limited by the lack of good clients, the heavy burden of bad assets, and the excessive weight of government paper in their balance sheets.*

The Croatian case suggests that a paper operation to clean balance-sheets, even when followed by the salutary effects of inflation on any remaining bad loans, does not guarantee a healthy banking sector in the absence of restructuring of the real sector. The predominance of distress borrowing, confirmed by the econometric analysis above, points to the need to restructure the real sector at the same time as the banking sector to avoid continued flow problems.

In addition, these cases point to the importance of supporting institutions such as active real estate, equity and swap markets, and clear, usable legal guarantees of contracts and bankruptcy. The relative success of Slovene bank rehabilitation suggests that privatization per se may not be as crucial, as long as the macroeconomic and legal environment supports restructuring.

Problems of rehabilitation: *In a small monetary area with an underdeveloped interbank market, liquidity management is quite difficult. In Slovenia and Croatia this has taken a very particular form: Banks are often liquid in foreign exchange, but illiquid in local currency. Rehabilitation also gives the banks a high proportion of illiquid assets--particularly long-term government bonds and equities acquired in exchange for debt. Liquidity will remain perhaps the key issue for banks in both countries in the near future.*

Also, it is important to note that bank restructuring requires a great deal of political support and public resources. The Slovene program gave the government Agency an enormous role in the process. While the Slovene program may be criticized for being top-heavy, it is clear that the role of government in this aspect of the transition--as in many others--is quite important.

Similarly, in Croatia, bank restructuring has already required significant public resources. In Croatia, the question of the efficient use of these public resources is especially actual. One may ask: Will banks (and large real-sector enterprises) be forced to change their behavior in exchange for public funds?

Bank rehabilitation is one part of this process of creating an environment for healthy economic growth. If the other elements are in place, bank rehabilitation can create healthy, prudent banks that will be a solid source of finance for the future. But without a supportive legal and macroeconomic environment, bank rehabilitation could be a futile exercise.

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