

LIBERÁLNÍ INSTITUT PRAHA

INSOLVENCY OF STATE ENTERPRISES
IN CZECHOSLOVAKIA

ROBERT HOLMAN

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Introduction

The purpose of my paper is to argue and demonstrate that the liberalization of markets and the loss of state control over enterprises will lead to considerable difficulties in financial relations between enterprises, taking the form of wide-spread insolvency. This insolvency is not similar to that which occurs in capitalist economies because it is not as frequently caused by unprofitability. Surprisingly, in the case of Czechoslovakia, state enterprises are insolvent in spite of being profitable.

In my paper I analyze financial problems of state enterprises in transformation period (transformation from centrally planned system to market system), their causes and their consequences. These financial problems are only partly inherited from the past system. The main causes of this dangerous economic phenomenon are to be found in transformation process itself. I try to demonstrate that insolvency cannot be explained primarily as a consequence of lack of profits, but rather it is caused, generally, by inappropriate structure of company assets.

It is also important to distinguish causes of insolvency in the "preparation period", when liberalization of markets is expected (in Czechoslovakia it was in the year 1990) and in "transformation period", following liberalization, but expecting privatization (in Czechoslovakia it is the year 1991).

I also focus on the role of banks they play in financial problems of enterprises and on the interrelations between inter-firm insolvency on the one hand and indebtedness of enterprises to the banks on the other hand. Behaviour of a bank subsidiary, especially with respect to its evaluation of debtors and its willingness to give them new loans, is described in the case study. In the last part of my paper I describe and explain some possible solutions of the insolvency problem, that are intensively discussed in our country.

1. Insolvency - Causes and Consequences

INTER-FIRM INSOLVENCY

Poor financial situation and financial problems of our enterprises are reflected in huge debts and insolvency. Indebtedness of enterprises to banks must be distinguished from insolvency (especially inter-firm insolvency) though these phenomena are interrelated. I want to mention the problem of bank loans and difficulties enterprises have with repaying their debts to banks in the next chapter while analyzing insolvency, which is the core issue of my paper, in this chapter.

It is important to distinguish between two different kinds of insolvency: inter-firm insolvency, which means that an enterprise is not willing or able to pay in time to other enterprises - its suppliers, and insolvency of enterprises to the banks, which means that an enterprise is not able to repay its bank loans and interest. In Czechoslovakia (as well as in other transforming ex-communist economies) inter-firm insolvency became wide-spread and serious economic problem, that endangers normal financial relations in the whole economy. While insolvency in terms of non-payment of bank loans is still not so serious problem, the inter-firm insolvency grows rapidly and its volume reaches now more than 10% of our estimated GDP.

The reason why I distinguish and separate inter-firm insolvency is, that state enterprises behave to each other quite differently from their behaviour to the banks. It is important for

them to repay bank loans because if they didn't the bank could refuse to give them new loans and they could not be able to pay out wages. It is not so important for them to pay to their supplier, also because of vertical monopoly structure of our economy (itself a relict of the previous centrally planned system) where a supplier frequently has only one customer. It is also advantageous for an enterprise, especially when it has financial troubles, to substitute inter-firm debt for bank loan because it is cheaper - economic and legal system which still prevails in inter-firm relations does not make it possible to ask a debtor to pay interest (even when his debt is outstanding), while he must pay interest from bank loans.

That is why inter-firm insolvency (as opposed to insolvency to the banks) spreads rapidly, when the enterprises suffer from the lack of cash.

Inter-firm insolvency is defined as outstanding liabilities of an enterprise to other enterprises. Total inter-firm insolvency can be discovered and calculated in two different ways: from banks, registering payment arrears of enterprises, and from book-keeper records of the enterprises.

First, the banks found out payment arrears of a respective enterprise, that was obliged to pay an invoice to its supplier. It (the customer-enterprise) sent the invoice to its bank to pay the invoice, but the bank found out that there was no (or not enough) money on the account of the enterprise to settle the invoice. Then the bank of course did not settle it and a payment arrear of the enterprise appeared which was registered by the bank. The bank waited until there was money enough on the account

of the enterprise to be able to settle the invoice.

This practice enabled the banks to supply the relevant data about inter-firm insolvency which were available monthly. But from April 1991 Czechoslovak banks decided (also because of rapid increase of payment arrears) not to accept invoices any more for which there was not enough money on the accounts of the enterprises to be settled. Thus the banks stopped to register these arrears and the data concerning inter-firm insolvency are now available only from book-keeper records of the enterprises themselves. (The data are, however, available not monthly but only quarterly).

Inter-firm insolvency arises from inter-firm debt. The aggregate data about inter-firm debt are not available, but it probably doesn't exceed aggregate inter-firm insolvency figure very much because the inter-firm credit is usually very short-term. Normal practice in the past which is still prevailing today is that suppliers require payments for delivery within two weeks. It means that outstanding liability occurs in the enterprise book two weeks after the delivery, if it is not able to pay the invoice within this time. Interfirm insolvency is not new phenomenon. It existed and troubled our economists in the course of the whole period of Communist regime and centrally planned system. In the centrally planned system it could be explained partly by soft budget constraint of state enterprises that used to rely on state paternalism and that actually were assisted by the state, whenever their financial troubles became serious, either by subsidies from the state budget or by new bank loans. It seems however, that the main cause of inter-firm insolvency in

the past centrally planned system were great production ambitions of communist planners, which sharpened shortages in markets of inputs and urged enterprises to build up big stocks of inputs. Thus great part of their assets had form of inventories (inputs) and they frequently came in troubles with paying for deliveries.

Table 1a

Insolvency in billions of crowns
(Source: Federal Ministry of Finance)

1985 Dec.	1986 Dec.	1987 Dec.	1988 Dec.	1989 Dec.
13	32,3	46,3	26,2	7,2

Table 1a shows inter-firm insolvency figures in the second half of eighties in nominal values. The sharp increase in insolvency in 1987 was a consequence of the government's decision that enterprises must be forced to reduce their huge inventories. Enterprises did not fulfil this task and therefore banks refused to give them new loans to finance inventories that exceeded the planned figures. The consequence was not the decrease in inventories but increase in inter-firm insolvency - enterprises solved their shortage of finance caused by reduction of bank loans at the expense of their suppliers, - they did not pay for deliveries. This can illustrate how easy it was, and still is, for enterprises to solve their financial problems at the expense of suppliers, thus starting dangerous process of chain reaction - spread of inter-firm insolvency.

The year 1987 was our first experience in this sense.

After overthrow of communist system in November 1989 and abolishing centrally planned economic system in 1990 the phenomenon of insolvency did not disappear, but sharpened and grew worse during 1990 and 1991. Table 1b shows development of inter-firm insolvency since June 1989 to June 1991 .

Data are stated in nominal values and because of sharp rise in prices during the first quarter 1991 the sharply growing figures of insolvency between December 1990 and March 1991 must be considered with care. Consumer prices increased during period from January to June 1991 by almost 50%, but price increase between April and June was only about 5%. The sharp rise of insolvency between March and June 1991 thus cannot be attributed to inflation, but shows that insolvency is a real phenomenon.

The size of insolvency problem can be evaluated by comparing insolvency with GNP. In 1990 GNP was 735 billion crowns and nominal GNP estimate for 1991 is about 1150 billion crowns.

If we look at Table 2, we can see that insolvency ceases to be only the problem of state sector. It spreads to newly springing private firms that are still dependend on customers from state sector and insolvency of state enterprises affects private firms when state enterprises do not pay them for deliveries. Insolvency of private firms trippled within two months - from December 1990 to January 1991.

Table 1b

Date	Insolvency (in billion Kcs)
June 89	16,3
September 89	13,7
December 89	6,5
March 90	10,9
June 90	14,0
September 90	24,5
December 90	47,1
March 91	76,4
June 91	124,3

Table 2

Insolvency in sectors and some industries, in billion crowns
(Source: Federal Ministry of Finance)

	December 1990	January 1991
Total	53,6	77,6
State sector	50,4	71,9
Co-operatives	2,7	5,1
Private firms	0,1	0,3
Fuel and energetics	1,2	1,9
Metallurgy	3,9	16,9
Transport	2,4	3,4
Engineering	24,2	22,8
Construction	3,1	2,0
Food-processing	2,9	4,4
Agriculture	2,2	3,0
Trade	0,9	1,7

If we examine insolvency in different industries, we can see that its rise was particularly dramatic in metallurgy, due to overestimation of iron and steel markets by producers. Agriculture also suffers from insolvency due to a decline in foodstuff consumption.

One of the main reasons why insolvency grows and spreads so rapidly was lack of appropriate bankruptcy legislation. Insolvent enterprises could continue their existence and their creditors had no possibility to let them go bankrupt and sell their assets.

Also strong dependence of many suppliers on their customers, resulting from vertical monopolistic structure of the economy, made it impossible for many suppliers to stop delivering to insolvent customers and to find other customers with better payment discipline. Thus insolvency spread throughout the economy as chain reaction - enterprises, that did not pay to their suppliers, made them insolvent because the latter could not pay to their suppliers etc. None went bankrupt, in fact few of them even reduced their production. They continued producing, delivering, not being payed by customers and therefore themselves not paying to their suppliers.

In search for some way of distinguishing between "guilty" (and therefore "bad") and "innocent" (and therefore maybe "good") enterprises banks and ministries tried to separate enterprises in primary insolvency from that in secondary insolvency. Primary insolvency is defined as outstanding liabilities of an enterprise exceeding its outstanding claims. Secondary insolvency means that outstanding claims of an enterprise exceed its outstanding liabi-

lities. Table 3 shows the relevant data. We can see that secondary insolvency exceeds primary insolvency and that the number of secondary insolvent enterprises exceeds the number of primary insolvent enterprises.

Table 3

(Source: Federal Ministry of Finance)

Date	Primary insolvency (billion)	Secondary insolvency (billion)	Primary insolvency (%)	Secondary insolvency (%)
12.89.	3,2	3,4	48%	52%
3.90.	6,2	5,0	55%	45%
6.90	7,8	6,7	54%	46%
9.90	12,4	12,5	50%	50%
12.90	20,0	27,8	42%	58%
3.91	27,1	49,6	35%	65%
6.91	35,0	89,3	28%	72%
June 1991				
Number of Insolvent Enterprises			Primary	Secondary
3587			1649	1938
44%			20%	24%

Of course, the relevance of this separation is questionable. Primary insolvent enterprises should go bankrupt not to spread insolvency to other enterprises. But it may be that some of primary insolvent enterprises inherited this burden from the past centrally planned system when they were forced to finance their production and investments mainly from bank credit, while much worse and less efficient enterprises, preferred by the planners from various reasons, received huge subsidies.

On the other hand the fact that an enterprise is only secondary insolvent need not be any reason for evaluating it as "good" and perspective, because it can also produce unsalable output.

Take, for example, a producer of radiators that supplies them to automobile manufacturer. If those automobiles (say, due to foreign competition) become unsalable, the automobile manufacturer may become primary insolvent, while the supplier of radiators "only" secondary insolvent. But where is the difference? Radiators are unsalable and their production should be stopped as well as automobile assembly.

Separating insolvent enterprises into primary and secondary cannot serve as criterion for distinguishing between "good" and "bad" producers.

It is striking that insolvency of our enterprises is not due to their unprofitability, at least in most cases. During 1990 and especially in 1991 profits substantially increased and the number of unprofitable enterprises dropped. Profit tax was reduced from average 75% in 1989 to 55% in 1990. From January 1990 to January 1991 total profits more than trippled and disposable profits (after tax deductions) increased more than nine times. During the first quarter of 1991 nominal profits continued rising especially due to rapid price inflation which was not accompanied by wage inflation. Real wages declined sharply and national income has been thus redistributed in favour of profits.

Table 4 shows increase in profits. The increase was remarkable especially in January 1991, when prices increased only during this month by 25,8%, following price liberalization.

Table 4

(Source: Central Bank of Czechoslovakia)

Figures in billion Crowns

	January 1990	January 1991	Index
Total revenues	201,4	306,9	152,4
Total costs	185,4	255,3	137,7
Profits	16	51,6	322,4

Table 5 shows profit index in republics and some industries. We can see that only agriculture and construction industry suffered loss, which is due to considerable decline in their volume of output and sales.

Table 5

(Source: The Central bank of Czechoslovakia)

	Index January 1991/January 1990
Total Profits	322,4
Federal enterprises	246,5
Czech enterprises	321,7
Slovak enterprises	574,2
Production	330,0
Industry	332,0
Agriculture	-100,0 (increase of loss by 100%)
Metallurgy	564,0
Construction	- 25,0 (decrease of loss by 75%)

From these data one can conclude that wide-spread insolvency was caused by something other than losses or low profits of the enterprises. This indicates that the nature of insolvency differs from that which is normally observed in market economies.

But we must also take two things into consideration. First, in spite of the increase of total profits there are still many unprofitable enterprises, the total loss of which amounts to 2,8 billion crowns. These unprofitable enterprises may well be the "focuses of the disease" from which insolvency spreads out and hits profitable enterprises as well. Second, profits are not the same as cash flows: legally enterprise has profit as soon as it ships delivery and sends the invoice to the customer (and is obliged to pay profit tax from this moment). If its customer does not pay, the profit has not form of cash flow but only of an outstanding claim. But the enterprise must still pay profit tax. Paradoxically, it may thus suffer more financial problems than if it had no profit at all and did not have to pay tax. While state budget does not suffer from inter-firm insolvency because enterprises must pay profit tax as soon as they send the invoice and not as soon as their invoice is settled, enterprises the customers of which do not pay suffer from having to pay taxes from profits they do not actually receive.

Anyway, most of our enterprises do make profits and their profitability considerably increased, it is therefore clear that increase in insolvency must have some other causes than unprofitability.

CAUSES AND CONSEQUENCES OF INSOLVENCY

The main cause of insolvency is inappropriate structure of assets of the enterprises. Too much of their assets has illiquid form, either of excessive inventories or of outstanding claims. We should distinguish between rising insolvency during the year 1990 and during the year 1991 because the causes were not the same. In 1990 sharp rise of insolvency can be explained by inflationary and partly also by devaluationary expectations of producers in this "preparatory", pretransformation period. Enterprises knew that prices would be liberalized and Czechoslovak crown would become convertible since January 1991 and under inflationary expectations they were buying and building up excessive stocks of inputs, thus converting great part of their liquid assets (deposits) into less liquid form - inventories. In the subsequent period many of them found out that structure or volume of their input stocks do not correspond to their production possibilities and faced lack of liquid financial resources. Also devaluationary expectations influenced asset structure as many enterprises hurried and bought foreign exchange to pay their liabilities abroad, thus drawing on their deposits. Rapid increase in insolvency in the second half of 1990 can be explained just this way.

Table 6 shows development of stocks during the year 1990. In the second half of the year their stocks of output began rising (also because of their speculations to sell next year for higher prices), and their stocks of inputs (except of the last quarter)

continued to rise too. It means that great deal of their profits was to be used to finance these stock increases. Profits were in fact being invested in inventories.

Table 6

(Source: Federal Ministry of Finance)
Development of stocks (billion Kčs)

	1.1.90	31.3.	30.6.	30.9.	31.10.	30.11.	31.12.91
Total stocks	398	403	409	431	444	448	437
Input stocks	251	263	269	273	280	280	279
Output stocks	147	141	140	158	165	168	158

In January 1991 insolvency sharply rose as a consequence of "price shock", following price liberalization. Consumer prices rose during January 1991 by more than 25% but prices of materials and investment goods rose by 47% during this month. This sharp rise in prices can also partly be explained by expectations that price regulations could be renewed, and this motivated producers to raise their prices as much and as quickly as possible. Such a "price shock" caused financial troubles to many enterprises, suddenly finding out that they are unable to pay their suppliers. Payment arrears and requirements on further bank loans increased and accompanied price and profit increases.

One of the main causes of sharply increasing insolvency in 1991 is economic depression. Decline in production in August 1991 (compared with August 1990) reached 29%. Many enterprises cannot sell their products because exports, investments and consumption decreased considerably.

Many enterprises were surprised and were not prepared for such a decline in their production. Time lag occurred between cut

in their sales and their input purchases because input purchases are usually contracted for three months in advance. If sales cut is not immediately accompanied by cut in input deliveries (which is the case), enterprises have financial problems, are unable to pay for deliveries and insolvency spreads to their suppliers and throughout the economy.

There are some enterprises that do not reach to cut in their sales by cut in production and hesitate to dismiss workers, because they think that problems with sales are only contemporary and short-run or that the state will help them somehow. (This behaviour is more typical for large enterprises than for smaller ones because large enterprises know that government is afraid of rising unemployment in a region and is inclined to help them). Such enterprises simply continue to produce on stock or at least keep their workers employed, although there is not enough work for them, and soon are unable to pay for deliveries and become insolvent. Because of lack of appropriate legislation as well as hesitating on the part of the ministry to close them down, such enterprises become focuses of "the disease", which spreads out to the economy. If they went bankrupt quickly, the all parts of the economy would be cut off from the relatively sound rest, "the disease" would not spread. But once it spread considerably to many other enterprises, bankruptcies of this "focuses of disease" become dangerous, as they can affect their suppliers and suppliers of their suppliers and cause their bankruptcies as well.

Reduction of our exports to the former COMECON markets and especially to the Soviet market is one of the main causes of economic depression in Czechoslovakia in 1991. The Soviet market be-

came "insolvent" for our exporters as many Soviet customers are not able to pay for our goods, especially if they would have to pay with "hard currency". During the first half of 1991 our exports to the Soviet Union dropped by more than 50%. Also many customers in the other Central and Eastern European countries are not able or not willing to pay in "hard currency" for our exports. Our exporters, that were used to export to "soft market" of the COMECON countries, have great difficulties in exporting to "hard" western markets where they face much keener competition. If they continued to export to insolvent Soviet customers they soon suffered from insolvency themselves. It is interesting that while total outstanding claims of our enterprises reached more than 124 billion crowns in June 1991, their total outstanding claims approached 190 billion crowns. This is evidence that insolvency partly comes to our enterprises from insolvent foreign buyers not paying for our exports. In the past communist regime this was typical for our deliveries to such countries as Iraq or Syria. Our exporters to these countries usually did not care very much about solvency of these foreign customers because exports to these countries, especially deliveries of armaments, were paid to our exporters by the state or they received credits from our banks (which were guaranteed by the state). Some portion of insolvency today is still due to these exports that were not paid (and probably will never be paid) by those foreign customers.

Another cause of rising insolvency is poor capability of our managers who are more inclined to relying on the state help than trying hard to solve the problems themselves - changing production programmes in accordance to demand changes, looking for bet-

ter and more solvent customers etc. Our managers still think that the state is obliged to help and solve problems of state enterprises. One of the example was Pragoinvest - the foreign trade company that exported machinery of one of our biggest machinery producers - ČKD. Pragoinvest was not able to collect payments from its customers abroad and thus it was not able to pay to ČKD, the financial problems of which became so serious that it could not pay its employees. The managers of ČKD did not hesitate to send their workers to demonstrate in front of the Czechoslovak Commercial Bank and crying they want money for their work. The bank finally agreed to give credit to ČKD.

One of main causes of rapidly rising inter-firm insolvency in Czechoslovakia are expectations of enterprises that their debts will be canceled somehow by the state, because they believe that the state cannot afford to let so many enterprises go bankrupt. Their expectations are further strenghtened by the fact that they soon will be privatized. They believe that prior to their privatization the state will settle or cancel inter-firm debts. These expectations make them be careless about their debts and insolvency. Enterprises consider it most important to survive until being privatized and they do not want to reduce production and dismiss workers, if their sales derease. Instead, they solve lack of finance at the expense of their suppliers to which they do not pay.

Rising inter-firm insolvency has serious consequences on financial relations in the economy. "The disease" spreads very quickly and it becomes more and more difficult to stop it or solve the problem simply by letting insolvent enterprises go

bankrupt. Insolvent enterprises find it more and more difficult to finance production and investments (though they are profitable). Some of them find it more and more difficult to repay bank loans and this may cause difficulties to banks. Enterprises need to restructure their production programs and equipment but because of lack of financial means they are unable to do so. Some economists say that this is a consequence of monetary policy, that monetary restriction is too severe. In fact inter-firm insolvency results from the fact that enterprises are escaping from monetary restriction - if they cannot receive new bank loans, they do not pay their suppliers, thus substituting enforced trade credit for bank credit. This is even better for them because trade credit is cheaper - they need not pay any interest (there is no law forcing an enterprise to pay interest on trade credit). But this kind of trade credit does not seem to solve financial problems of enterprises, because it is poor substitute for money. These claims and liabilities are not transferable. These money substitutes "are somewhere", but they are "frozen" and do not circulate. If they had form of transferable bills of exchange, for instance, the situation could substantially improve. Imperfections in monetary, banking and trade institutions make the situation worse.

2. Role of Banks

In the old centrally planned system the role of banks was entirely passive, and so was the role of money. Households deposited their savings to subsidiaries of the State Saving Bank, that deposited them to the State Bank of Czechoslovakia. State Bank was the central reserve bank, but at the same time it functioned as the monopoly commercial bank giving loans to enterprises, keeping deposits of enterprises and serving as a clearing center for payments. The subsidiaries of the State Bank granted credits to enterprises according to the so called planned credit limits, which were numbers enterprises had in their plans. Enterprises submitted their plans and credit requirements following from these plans to the State Bank headquarters which allocated credits to its subsidiaries and these gave loans to the enterprises up to the planned credit limits. Bank subsidiaries were completely passive in granting credits, they granted whatever followed from a credit limit of an enterprise. On the other hand they had some tools of control over enterprises. They controlled fulfilment of some indicators such as profits, volume of stocks, ratio between growth of money wages and labor productivity. Non-fulfilment of these indicators was no reason for banks to refuse credits (as these were planned), but it was a reason to issue "sanction" interest, with rate as much as five times higher than the current interest rate. But it was normal practice that if enterprises were not able to repay loans and pay interest they

persuaded their ministry (and were usually successful) to raise their credit limits in their plans for the coming year and thus they were repaying old debt with new loans.

In 1990, when the centrally planned system broke down, the banking sector underwent fundamental restructuring. In January 1990 the State Bank of Czechoslovakia was divided into Central Bank, playing the role of reserve bank and monetary authority, and Commercial Bank, operating on commercial principles. In addition, several other banks were founded and a modern banking system was encouraged to evolve. Twenty foreign banks now have their subsidiaries or offices in Czechoslovakia and from January 1991 our enterprises are permitted to take loans also from foreign banks.

The scope for decision making of commercial banks and their subsidiaries considerably increased. The Central Bank sets only basic rules: the discount rate, the upper limit of interest rate and liquidity ratio - now banks must keep 8% of deposits in reserves. Banks can choose their customers, they can refuse to give loans if they do not believe in solvency of an enterprise. On the other hand the banks can no longer control their debtors - enterprises by sanction interest rates if these fail to fulfil some indicators. In this sense enterprises are much more independent on banks than they were in the centrally planned system and their discipline concerning the inventories or wage increases may deteriorate.

Rise in inter-firm insolvency and rising difficulties of many enterprises in collecting payments from suppliers lead to rising requirement for bank loans.

But the situation of our banks is difficult from two reasons. First, they are undercapitalized - the ratio of their own capital to the total volume of assets is only 4% (in an average) whereas it should be at least 8%. Second, great part of their assets are "bad loans", the repayment of which is highly uncertain or improbable. We can see two tendencies in their behaviour. On the one hand they hesitate to grant new credits, especially long-term credits, because they consider it too risky to lend enterprises the financial situation of which is poor and the sales of which are declining. The banks are afraid that the enterprises, in the new economic system without state subsidies and state guarantees for bank loans, would not be able to repay them. That is why the total volume of banks credits in 1991 rose slower than the Central Bank expected but was prepared to allow. The requirements of the banks on loans from the Central Bank were lower than the Central Bank was prepared to meet. Surprisingly, the monetary restriction was thus caused more by commercial banks than by the Central Bank. It contrasts to the situation in Poland where the banks were keen in giving credits to Polish enterprises and where it was the Central Bank that had to keep money supply from rapid rising. This situation is also partly caused by the lack of competition in our banking sector (see table 10). On the other hand banks afraid that enterprises suffering from insolvency or even going bankrupt will not be able to repay old bank loans which could put the banks in very dangerous position or even cause their own bankruptcies. That is why the banks grant loans even to unefficient and insolvent enterprises. They also hope that the state will ultimately solve the insolvency problem and

salvage the enterprises and thus the banks too. The case study tries to demonstrate this behaviour of banks.

So the banks face the dilemma: to give or not to give credits? They prefer to cut long-term credits, because these seem to risky to them, but continue to give short-term credits, and, paradoxically (to an outside observer) they continue to give short-term credits to insolvent enterprises to prevent them from going bankrupt.

Table 7 shows development of bank credits. As we can see, bank credits increased, but if we take substantial price increases into consideration (almost 40% between January and March 1991), we see that real money supply contracted. This is one of the reasons why inter-firm insolvency rose so sharply - lack of money and bank credit forced many enterprise to "lend" from their suppliers.

Table 7
Development of bank credits (in millions of crowns)
(Source: Central bank of Czechoslovakia)

	12.89	3.90	6.90	9.90	12.90	3.91
Total						
Bank credits	707621	568962	578629	588849	583147	611597
Short-term						
(within 1 year)	121509	123489	132449	143707	161652	203448
Medium-term	37091	77664	77979	80376	97285	106646
(1-4 years)						
Long-term	249021	367809	368201	364765	324209	301503
(over 4 years)						
State sector	-	444187	448800	460248	454477	482905
Co-operatives	-	78111	82420	80077	75288	68156
Private enterprises	-	68	470	1359	3426	9304
Households	-	46596	46939	47165	49956	51232

From table 7 we can also see that it was especially short-term credits that rose, while long-term credits decreased. The banks insisted that enterprises which asked for long-term investment credits must present investment projects ensuring that the enterprise will be able to repay the loan, but most enterprises failed to do so.

The reason enterprises were unable to quickly present good investment and production projects for longer-term loans was multifaceted. The inability of their managers and the level of uncertainty about the future played a role. Awaiting privatization and preferring short to long term decision making corresponds to passive managerial behavior, a trait promoted by the past socialist structure.

Table 8 shows development of bank deposits. We can see that the deposits of state enterprises and cooperatives even declined (in spite of the rise in their profits) which is also evidence of their financial troubles.

Table 8

Development of bank deposits (in millions of crowns)
(Source: Central bank of Czechoslovakia)

	3.90	6.90	9.90	12.90	3.91
Deposits	446128	456988	453129	447136	444368
Total					
Households	280048	281081	280154	270359	266968
State sector	148189	156880	153705	153968	153208
Co-operatives	17801	17442	17686	17968	16160
Private	90	1585	1584	4841	8032

Table 9 shows unfavourable development of the ratio of bank credits to deposits. It reveals the growing dependence of enterprises on the bank credits.

Table 9

The development of the ratio bank credits: deposits

	3.90	6.90	9.90	12.90	3.91
Total	1,28	1,27	1,30	1,30	1,38
State sector	3,00	2,86	2,99	2,95	3,15
Co-operatives	4,39	4,73	4,53	4,19	4,22
Private sector	0,76	0,30	0,86	0,71	1,16
Households	0,17	0,17	0,17	0,18	0,19

The banks complain that big portion of their loans to the enterprises are "bad loans" with low (or no) probability of repayment.

They estimated that about 200 billion crowns are "bad loans", 10% of them being loans to foreign customers. The banks insist that the government must do something about it and thus they join all those who argue that the insolvency must be solved "from above" - by the state. If there were bankruptcies, they say, the "domino effect" may hurt even the banks.

But the position of our banks is strong, if we measure it by the share of each of them in the market. Table 10 shows this market share and we can see the oligopolistic structure of the banking sector.

Table 10

Market share of financial institutions
(Source: Annual Report of Commercial Bank, 1990)

Institution	Market share
Commercial Bank	48 %
General Credit Bank	20 %
Investment Bank	15 %
Czech State Savings Bank	7 %
Slovak State Savings Bank	4 %
Czechoslovak Trade Bank	5 %
The other Banks	1 %

The Commercial Bank is the strongest financial institution. It keeps deposits of the Czech State Saving Bank (which takes deposits from households) and the Czech State Insurance Company. It takes deposits from and gives loans to enterprises, and serves as the clearing center for payments between enterprises. It has 8.265 employees, 565 of them being employed at the headquarters and the remainder at 83 subsidiaries throughout the republic. As we can see from table 11, loans and deposits of Commercial Bank decreased during 1990. Its loans from Central Bank decreased from 60,65 billion crowns to 54,4 billion during the year 1990, while its total profit amounted to 8,54 billion (8,17 billion was interest on loans). Commercial Bank is afraid of the antitrust law, which requires that no company may have more than 30% market share, and if it has, it will be divided into two (or more) companies. That is why Commercial Bank continues to reduce loans-it wants to reduce its share in the market below 30%. At the same time it wants to increase its ratio of own capital to its assets to 8% (but this is the aim of all our banks), which also makes it to reduce its loans.

Table 11

Loans and Deposits of Commercial Bank (in billion crowns)
(Source: Annual Report of Commercial Bank, 1990)

	January 1990	December 1990
Loans of Commercial Bank	324,64	279,1
Loans up to 1 year	71,76	68,92
Loans up to 4 years	49,85	41,94
Loans up to 10 years	203,03	168,24
Loans to Corporations	324,64	277,73
Loans to Individuals	0	1,37
Deposits	262,4	221,9

From these reasons Commercial Bank headquarters follows policy of reducing especially long-term and medium-term loans and instructs its subsidiaries to stop giving new long-term credits at all and to reduce medium-term loans substantially, while leaving them free in giving short-term loans. This trend is reflected in table 11. The policy of cutting long-term and medium-term credits caused financial troubles to those enterprises that had started investment projects in the past and relied on continuing bank loans. Suddenly they faced lack of money to pay for deliveries necessary to complete their projects. This made inter-firm insolvency growing.

On the other hand bank subsidiaries continue granting short-term credits even to enterprises that have big outstanding liabilities to their suppliers. The banks do so because they do not want to let these enterprises to go bankrupt. This behaviour of banks (illustrated in the case study) does not help to solve the insolvency problem. On the contrary, it makes enterprises more careless and irresponsible considering their payment discipline to the suppliers. They rely on the banks continuing to

give new loans to finance older loans and payment arrears.

Subsidiaries may grant smaller credits without consulting it with the headquarters. Only if credit exceeds 5 million crowns for a state firm and 100 million for a private firm the subsidiary must consult it (in fact ask for permission) with the headquarters. Although subsidiaries are thus more free to give credits to private firms, they actually still prefer to give credits to state enterprises because they find it less risky. They expect that in case of insolvency of their debtors it is more probable that the state will help state enterprises than the private firms. That is one of the reasons why the access to bank credit is still easier for state enterprises than for private ones.

3. Possible solutions

One of the main objectives of economic reform in Czechoslovakia is to put the enterprises under hard budget constraint and to remove state paternalism, which was typical for centrally planned system, where enterprises expected and actually receive assistance of the state in case they had financial troubles. The enterprises naturally resist this change and try to preserve some "channels" through which the financial assistance of the state would continue. They put great pressure on the government to "do something" about their financial situation, especially insolvency problems and argue that their heavy debt burdens are inherited from the past system and that they are unable to solve them themselves. They argue that they are not guilty for that - they hesitate to lend because they are undercapitalized, which is also heritage of the old centrally planned system, where it was unimportant what is the own capital of the bank, and where all the bank loans were actually guaranteed by the state. The banks support requirements of the enterprises.

But it is not possible to solve all these problems by state action. Even if it were true that all the financial problems of the enterprises and the banks were inherited from the past - so were all the problems of our economy. At whose expense should they be solved now? Insolvency is not a problem of some industries of a group of enterprises, but of almost all of

them, and the same can be said about banks. That is why the government insists that there can be no once-and-forall solution "from above", but that those problems must be solved "from bellow", by enterprises themselves, by their activity, effort and inventiveness. The government also relies on privatization, especially on inflow of foreign investments. But the situation is now so serious that some solutions are discussed and searched on the government level even prior to privatization. There are two basic approaches - selective and global solution.

Global solution would require great financial injection into economy in the form of state subsidies or in the form of bank loans guaranteed by the state (e.c. by government bonds given to commercial banks). Also some non-traditional methods were discussed, like distributing state-notes among enterprises (a kind of throwing money out of helicopter). The advantage of global solution is that there is no need for authorities or banks to separate enterprises into "good" and "bad". All enterprises would receive money and we would only hope that they will use them properly. But there are great disadvantages and dangers.

First, such monetary injection should fire new round of inflation. The inflation was stopped in Czechoslovakia in July, and some economists argue that the main danger for our economy now is not inflation but depression. In July and August 1991 industrial production was almost 30% bellow the level of the same period in 1990. Some economists say, that monetary injection would only bring our economy out of depression. But it is not sure. The character of our economic contraction is somewhat different from that which can be observed in market economies in

the period of depression. Our economy and our enterprises are undergoing deep restructuring that can hardly be speeded by monetary injection. Enterprises must find new markets, raise quality of their products, reorganize themselves etc. The output decline that can be observed in transforming economies is a kind of "transformation decline" rather than decline from lack of demand. Monetary injection could therefore lead to dangerous inflation, undermining people's willingness to hold money and save.

The global solution of such kind may not be a real solution because it would not remove causes of insolvency. It would only ease financial problems of enterprises for some time and postpone some bankruptcies to the future. But it is highly probable that the indebtedness and insolvency would continue to rise, because it is not something that was inherited and can be removed by some once-and-for-all assistance action. It is something that reproduces itself and will reproduce itself until the real causes of this phenomenon are removed. It is highly probable that financial discipline of enterprises would further deteriorate in expectation of further monetary injections and state assistance actions, which would raise insolvency again in a short time. Global solution will not even separate and eliminate those enterprises that are sources of insolvency and its spreading.

Selective solution would be better in the sense that it would select and help only those enterprises that are efficient and perspective, while those which are inefficient and which are sources of insolvency would go bankrupt. But state authorities are not able to make such selection. Our ministries, especially

the Ministry of Economy and the Ministry of Industry, though they were instructed by the government to do so were unable to identify bad enterprises and liquidate a single enterprise during the period of one year. In the meantime insolvency spread so much throughout the economy, that it is impossible now to identify which enterprises are perspective and which are not, because most of them are already insolvent. If we should wait until state authorities make objective selection, it is probable that all of our enterprises would become insolvent because insolvency spreads with greater speed than state authorities could remove it by making selections.

But there is one way how to select good enterprises and help them without greater engagement of state administration. The selection can be made by banks, that, of course, would have to receive financial assistance from the state. The banks presented project of solution that would help not only the enterprises but also themselves. Their proposal is that they would receive government bonds to be able to cancel the "worst loans". In fact, this would enable them to exchange ("swap") their "bad loans" to enterprises for "good loans" - government bonds. The government refuse to solve the whole volume of inter-firm insolvency (amounting now at 124 billion crowns) or even the whole volume of "bad loans" of the banks (estimated by the banks up to 200 billion crowns) in this way, because it would mean dangerous increase in the state indebtedness (which is not allowed also by the criteria of International Monetary Fund) and heavy debt service burden for the state budget, which would convert it into deficit.

In October 1991 compromise solution was accepted. The banks will receive state bonds of total value 50 billion crowns. But these will be only convertible bonds, which means that they will not be paid in money, but exchanged for shares of privatized enterprises. The banks will be able immediately to cancel debts of or give new loans to some enterprises against receipt of the state bonds. Then, in the course of privatization, the state will reserve portfolio of shares valued at 50 billion crowns and will exchange them for bonds. This kind of debt-equity swap will enable the banks to increase their own capital and to increase their loans to enterprises.

The selection of enterprises will be left up to the banks as it is in their interest to give credits to better enterprises. At the same time state bonds will make it possible for the banks to initiate bankruptcies of bad, insolvent and inefficient enterprises. About one third of state bonds will be issued and given to the banks for writing off debt of bankrupt enterprises.

Of course, this solution is partial. It cannot and is not designed to solve financial problems of every enterprise or to prevent any bankruptcy. 50 billion crowns does not suffice to remove debt burden of our enterprises. But it will be helpful for them to survive the complicated period of transformation, to privatize and to find new investment and commercial partners.

Privatization is the way to remove causes of insolvency, to eliminate expectations that the state will always help and solve the problem and to put enterprises under the control of true owners. The behaviour of enterprises and banks must change and this is, in the long run, real solution of insolvency problem.



