TITLE: BANKING AND FINANCES IN EAST CENTRAL EUROPE

1. Do Bad Loans Lead to Bad Policy?
2. In Search of Capital Markets
3. Hungary’s Legislated Financial Shock (Therapy?)

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Do Bad Loans Lead to Bad Policy?

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Abstract

In the Central East European countries in transition, the commercial banking sector was formed by breaking off entire divisions of the lending department of the single central bank from the planning regime. The individual banks so created inherited concentrated (regionally and sectorally) portfolios of dubious quality. Insolvent (formally) from inception, the banks were forced to deal with a deep domestic recession, caused partly by the loss of the (former) Soviet market. At the same time, banking legislation resembling EC regulations was adopted. To comply, the commercial banks are required to accumulate provisions (loan-loss reserves) against the qualified part of the portfolio. Only one of the northern-tier countries, Czechoslovakia, made any attempt to remove bad loans from the commercial banks balance sheets. In the other countries (and in Czechoslovakia as the recession caused further deterioration of portfolios), commercial banks maintained wide spreads between deposit and lending rates to generate the gross profit necessary to accumulate the required provisions. Such a policy hampers the development of a healthy private commercial sector because of the high cost of credit for both emerging entrepreneurs and for existing companies that need injections of new capital to restructure properly. Economists in academia and at the World Bank alike argue for cancellation of debt to rid the nascent financial systems of the legacies of the past. Ignoring several key issues (e.g., debt workout), we argue that such a policy, if properly implemented, could nurture the development of indirect monetary control and take these countries further along the road to the market economy.
The Central East European (CEE) countries in transition are in the second year of a deep recession. The portfolios of the banks in these countries are weak and deteriorating. Such financial distress is not without precedence; financial systems all over the world have experienced problems in the last fifteen years (World Development Report, 1989). However, CEE banks have particular characteristics that demand special attention in designing policy solutions. Moreover, without swift resolution of the bad loans problem, the healthy segment of the commercial sector in these countries (including the emerging small private entrepreneur) will suffer unduly from the legacies of the past.

In the CEE countries\(^1\), commercial banks were created from the central (monopoly) bank by breaking off whole divisions with their assets and liabilities intact. These commercial banks are primarily state-owned (directly and indirectly through ownership participation by state-owned client companies).\(^2\) Initial portfolios were saddled with nonperforming (bad) debt with virtually no loan-loss reserves. These portfolios were inherited from a discredited political regime that, arguably, should accept responsibility for the bad loans.

\(^1\) In what follows, we focus on Hungary, Czechoslovakia, and Poland, known (at least currently) as the Visegrad troika, because banking reform is more advanced in these countries than in the southern tier countries.

\(^2\) In Hungary, the direct ownership share of the state in the three commercial banks varies between about 35\% to about 50\% but the residual in all cases consists almost entirely of ownership shares held by state-owned companies. This arrangement creates the curious situation that company privatization increases the state’s ownership share in the commercial banks as the company’s share reverts to the state when privatized.
Not only were the newly established commercial banks insolvent from inception, the manner in which the banks were spun off left them with highly concentrated (regionally and/or sectorally) portfolios. In Czechoslovakia (1990) and Poland (1989), regional divisions were maintained, two in the former and nine in the latter. In Hungary (1987), the division took place along sectoral lines. Diversification and portfolio quality became important concerns as the recession and the loss of the Soviet market added to the stock of nonperforming company debt.

One obvious solution to the problem of bad debt in CEE countries is to recognize it as inherited from the previous regime and remove it from the balance sheets of the banks. The consolidated balance sheet of the state would then contain realistic values for the assets of the companies that are or were previously state-owned. In some cases, these companies are antiquated with obsolete capital and no competitive market position. Evaluating such assets is a relatively simple task as it amounts to estimating scrap values. For most companies, the combination of a deep domestic recession and the loss of traditional CMEA markets make a medium to long term evaluation difficult. The uncertainty of future profit streams makes the realistic "market" value of the assets difficult to establish.

Ignoring the evaluation problem, Beggs and Portes recommend cancellation of the bad loans to make transparent the actual condition of the government's balance sheet and recapitalization
of the banks with an issue of short term government securities. Others have suggested linking the forgiveness of bad debts to enterprise privatization (Scott and Levine) and to bank privatization (Caprio and Levine) to avoid a recurrence of the problem. However, the policies pursued by the CEE countries have not taken the cancellation route to date.

In Hungary, Czechoslovakia and Poland, banking legislation requires that provisions against bad loans be accumulated in order to meet capital adequacy requirements. Only Czechoslovakia has adopted a program resembling cancellation. In 1991, the Consolidation Bank (CB) was created to take over about 20% of the existing commercial loans (bad debt). Komercni Banka (KB), the largest commercial bank in the Czech republic, transferred 80 billion koruna (b.k.) of revolving credit to state-owned enterprises to CB from an initial loan portfolio of 277 b.k.. Another 30 b.k. of the portfolio was estimated to be qualified and offset partially by a 15.6 b.k. government bond swap and an accumulated loan-loss reserve of 5.6 b.k. leaving KB with a shortfall in provisions of about 9 b.k. in 1991. As portfolios continue to deteriorate, Czechoslovakian commercial banks, like

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3 In the appendix, we present the simple numerical example that Beggs and Portes use to illustrate the required correction.

4 In Hungary, the government negotiated a guarantee of about 10 billion forints of doubtful loans with the large commercial banks. This supposedly represented about half of the existing bad debt in 1987 when the banks were created. Estimates of qualified loans currently in the portfolios of the commercial banks are seldom less than 100 billion forints. Hence, government guarantees do not cover a significant portion of current bad debt.
their Polish and Hungarian counterparts, will be required to accumulate reserves against bad loans to satisfy the banking act.

How does such a solution differ from debt cancellation? Profitable (and potentially profitable, private) companies bear the cost of writing down the bad loans as the cost of services and interest spreads are maintained at high enough levels to allow banks to generate sufficient earnings to accumulate the required provisions. Had Hungarian banks begun this process earlier and retained more earnings instead of funding the fiscal budget so heavily by tax and dividend payments (Abel and Bonin), the current problem would be less serious. Burdening the healthy segment of the commercial sector by taxing it indirectly with high financing costs discourages small entrepreneurial activity, inhibits entry of new firms, and invites further stagnation.

Why has the obvious solution of canceling bad debt not been embraced? Ignoring questions of proper governance and workout procedures for bad loans, a crucial reason is that someone has to pay for debt cancellation. One possibility would be to reduce deposit liabilities to offset debt cancellation. Then the bad loans would be financed by writing down the deposits of healthy profit-making companies and household savings. Given the magnitude of the problem, such confiscation of a significant portion of deposits from the private sector would most likely destroy public confidence in commercial banks.

To avoid such an unwanted outcome, Beggs and Portes recommend recapitalizing the banks with a government issue of
short term debt (a "good," highly liquid, asset that will not be eroded by inflation) equal to the value of bad loans canceled. If this policy is adopted, all bad loans should be removed from the balance sheets to avoid penalizing banks that have already accumulated significant provisions. To remove only the bad loans against which there is not sufficient loan-loss reserve, as some support, amounts to confiscating funds from healthier financial institutions and, thus, discourages proper governance.

If the banks are sufficiently independent from state control so that they can expand their deposit liabilities subject to a fractional reserve requirement, the additional liquid bank reserves created by recapitalization are potentially highly inflationary. To reduce these free reserves, the reserve requirement could be increased (temporarily) to attenuate the inflationary impact of the government issue. Such a policy moves the central bank toward indirect control of credit and affords the commercial banks the opportunity to make independent allocational decisions for which they will be held fully responsible according to the banking legislation. Bad loans need not lead to bad policy; if properly implemented, debt cancellation could take the CEE countries further along the market road by nurturing indirect monetary policy.

5 For Poland, Beggs and Portes estimate the financing implications of this policy to be between 2% and 3% of GDP. Whether or not such an addition to the fiscal deficit is feasible or warranted can be argued.
Appendix: Example of Beggs and Portes

A: Unadjusted Balance Sheets with Bad Loans

**State-Owned Company Sector**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant &amp; Equipment (book value)</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**State-Owned Banking Sector**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans (company)</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**State Sector**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity (company &amp; bank)</td>
<td>55</td>
</tr>
</tbody>
</table>
B. Corrected Balance Sheets

Assume: Market value of plant and equipment = 50.
All bad loans are removed.
Banks are recapitalized by government securities = 100.

<table>
<thead>
<tr>
<th></th>
<th>State-Owned Company Sector</th>
<th></th>
<th>State-Owned Banking Sector</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Plant &amp; Equipment</td>
<td>50</td>
<td>Loans (bank)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>(market value)</td>
<td></td>
<td>Equity</td>
<td>50</td>
<td></td>
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<tr>
<td><strong>State Sector</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>55</td>
<td>Securities</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net Worth</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td></td>
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<td></td>
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</tbody>
</table>
References


In Search of Capital Markets in Central Europe

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Abstract

The deep recessions in the Central East European (CEE) countries in transition are rooted in credit market failures. Although analysts studying the Polish recession disagree about its primary cause, all document a severe financial squeeze on state-owned enterprises. In Hungary, commercial banks are currently awash with liquidity as household savings are increasing rapidly and an influx of non-sterilized foreign exchange is swelling the supply of loanable funds. Domestic interest rate spreads are large due to the cartel nature of the financial sector and the banks' need for high earnings so as to accumulate provisions against the outstanding stock of dubious loans. However, commercial banks are turning to high-yielding, relatively safe government securities that are being issued to finance a rapidly increasing fiscal deficit rather than advancing new credit to the production sector. Adverse selection explains the banks' reluctance to play their intermediation role. Healthy profitable companies use self-financing or have access to cheaper foreign funds. The remainder of the companies (about three quarters of the production sector in Hungary) are either, struggling and in need of an injection of new capital, or are on the verge of bankruptcy. Neither group provides attractive clients for banks that are attempting to improve the quality of their loan portfolios so as to meet new banking regulations. Consequently, banks are channelling savings toward the financing of a rapidly increasing fiscal deficit while a production sector in need of new capital and new private companies is crowded out of the credit market. This credit market failure must be overcome if the recessions in CEE countries are to be terminated.
The severe decline in real output experienced in the Central East European (CEE) countries in transition since 1990 can be attributed to a credit market failure rooted in the legacies of the old system. Household and company money circuits were separated or, at best, weakly linked during the planning regime. The fiscal budget transferred liquidity from the household or external sector to the production sector. In Hungary, government money was shown to be the only causal explanation for liquidity in the business sector before the transition (Abel and Szekely). Until the banking reform in 1987, changes in the fiscal budget position and changes in interenterprise credit were inversely related. The business sector responded to any decrease in fiscal liquidity by increasing the length of the credit queue (Abel and Bonin). Subservient to the planning bureaucracy, the banking system played no active role in intermediation.

Encouraged by IMF guided and supported programs, the CEE countries created decentralized commercial banking systems and pursued tight monetary policy to stabilize their economies at the beginning of the transition period. Analyzing the Polish stabilization program, Calvo and Corriceli argue that a supply shock was the primary cause for the subsequent large drop in production. A sharp devaluation of the zloty and rapid reductions in subsidies resulted in an increase in materials prices (e.g., energy) and an increase in the cost of imported inputs. In addition, high real interest rates accompanied the fiscal and monetary austerity program leading to a financial squeeze on
state-owned enterprises (SOEs)' causing them to shed inventories and decrease production. Others argue that demand shocks (Gomulka, Schaffer) and policy mistakes (Gomulka, Kolodko) were more important contributing factors to Poland's deep recession. All analysts agree that the Balcerowicz stabilization program led to a liquidity crunch in Poland's manufacturing sector.

For the period immediately following the initiation of the stabilization program, Schaffer documents the poor cash flow (liquidity) positions of Polish SOEs. Large tax liabilities on profits that are calculated using historic cost resulted from almost hyperinflation. These tax liabilities, the sharp rise in the cost of credit, and the increase in input prices led to a severe liquidity crunch.¹ SOEs were neither receiving credit from the financial sector nor redistributing liquidity by increasing the stock of interenterprise debt. Rather, to weather the financial squeeze, SOEs held nominal wages below the ceiling imposed by the incomes policy associated with the stabilization package for most of 1990 (Kolodko). Credit market paralysis in Poland was (and is) a significant contributing factor to the (continuing) recession.

In Hungary, the newly created commercial banks were (and are) awash with liquidity. In 1990, profit margins were high

¹ Schaffer provides two indicators of the financial squeeze on SOEs. Real operating credit to all economic units in 1990 ranged monthly from 55% to 93% of its December 1989 level as real interest rates became positive in February. The stock of interenterprise debt as a percentage of sales was not much higher in nominal terms at the end of 1990 than at the end of 1989 and was actually lower in real terms.
enough for taxes and dividends from the financial sector to constitute 7.6% of fiscal receipts (Abel and Bonin). Interest rate spreads continue to be large enough to allow banks to accumulate substantial provisions against the existing stock of dubious loans. Even with inflation declining, nominal lending rates are sticky due to a tacit cartel arrangement between the commercial banks which are struggling to meet the capital adequacy requirements of the new banking legislation.²

Because of high spreads, the banking sector is not performing efficiently its intermediation role. From February 1991 to February 1992, savings deposits of households increased by more than 30% totalling 446.5 billion forint (b.f.) (NBH Monthly Report). By the end of July, total savings deposits had increased again by over 40% totalling 658.5 b.f. (preliminary figures from NBH). Interbank interest rates responded to the increase in the supply of funds from the household sector by declining rapidly during the first half of the year. Overnight rates fell from 30% to 23% while one to two week rates fell from 34% to 24%. Adding to the liquidity in the banking system are foreign exchange (FOREX) accounts opened by greenfield foreign ventures that convert to forints only upon purchase of capital

² The spread in real interest rates is even greater due to the difference (currently around 7%) between CPI and PPI inflation. Historically, margins in the retail sector had averaged about 10%. Since retail trade has become increasingly privatized, margins have increased to approach those in Western market sectors averaging 30% to 40% causing the difference in inflation rates (Riecke). Since real household deposit rates are calculated using CPI while real commercial lending rates use PPI, the spread of real rates is even larger than the spread of nominal rates.
and materials to avoid committing too much money to the venture at too early a stage (Bokros).

On the demand side, the Hungarian production sector can be divided into three tiers consisting of good, struggling, and bad companies. The first tier, currently profitable companies, is estimated to produce about 25% of total industrial output (Bokros, Giday) and comprise about 10% of the SOEs (Csillag, Giday). These companies tend to be export-oriented or in retail trade. Many generate sufficient funds for self-financing; joint ventures usually obtain credit from the mother company. Domestic companies exporting to Western markets have access to FOREX loans at LIBOR (London Interbank Offer Rate) plus two points. Hungarian banks can not match these rates and, consequently, find lending opportunities only in the second two tiers (Bokros).

The third tier consists of companies that are already heavily indebted and, due to the nature of their markets, can not continue to exist in their present form (e.g., many SOEs in heavy industry). These companies comprise about 30% to 40% of all state assets and will ultimately either be forced to enter bankruptcy proceedings or become chronically dependent on subsidies from the state budget (Csillag, Giday). In the former case, liquidation or reorganization will occur. Obviously, these are not good credit risks for a bank attempting to improve the quality of its portfolio. Hence, unless forced for political reasons, banks are no longer extending credit to this tier.

The middle tier consists of companies that are currently
struggling, due to the deterioration in the domestic economy, but
are potentially profitable in normal conditions. About 30% to 40%
of the SOEs fall into this category, e.g., food processing and
textiles (Csillag, Giday). To become profitable, a company in
this tier may need to change its market outlook or its management
and to introduce new products or new technology. In most cases,
an injection of new capital financed either by a strategic
partner (equity) or by bank credit (or both) is required to
transform it into a profitable venture. Banks seem reluctant to
take the risk involved with companies that have yet to prove
their creditworthiness; rather they are taking a wait and see
attitude. Hence, the increasing supply of household and company
deposits is not linked with the emerging demand for new capital
by bank intermediation.

Rather, banks prefer to hold government securities and
channel domestic savings into financing a fiscal budget deficit
which is currently over 210 b.f.\(^3\) Hence, investment is crowded
out with the banks' cooperation as potentially profitable SOEs
and private businesses looking for start-up capital bear the
brunt of the credit crunch. Yet these are the very companies that
must lead these countries out of recession and provide jobs for
the workers being laid off as other SOEs restructure. If banks do
not take the lead in ending the credit market paralysis, the end
to the recession in CEE countries is nowhere in sight.

\(^3\) This amount is more than three times the deficit planned
and agreed upon with the IMF for the entire year (Meti
Vilaggazdasag, August 22, 1992).
References


Interviews conducted in Budapest, Hungary: July 10 to 24, 1992

Dr. Lajos Bokros, President and CEO, Budapest Bank Ltd.

Dr. Istvan Csillag, Managing Director, Financial Research Ltd.

Mr. Andras Giday, Managing Director, Property Foundation and Institute for Privatization Studies

Dr. Werner Riecke, Head of the Monetary Research Department, National Bank of Hungary
Hungary's Legislated Financial Shock (Therapy?)

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Contract #807-07

Abstract

Hungary's gradualist approach to the transition has been buffeted by three pieces of new legislation, the Banking Act, the New Bankruptcy Law, and the Act of Accounting, that generate a significant financial shock to the economy. To date, the most evident effect is a fiscal deficit that has currently reached more than three times its planned, IMF-approved, target for the entire year. In an attempt to impose reasonably prudent regulations on commercial banks, the Banking Act requires rapid accumulation of provisions against the stock of outstanding qualified loans and the flow of interest arrears. To counter the sluggishness of creditor passivity, the New Bankruptcy Act requires any company that falls more than 90 days behind in payment of any obligation to file for bankruptcy. Furthermore, the banks must classify the loans of any company that has filed for bankruptcy as "bad" and hold provisions equal to the full value of these loans. To encourage more rapid privatization, the Act of Accounting introduces transparency (e.g., inflation-adjusted evaluation of assets) to company books and allows companies to reduce tax liability by accumulating reserves against doubtful accounts receivable from gross profit. Although individually defensible, when taken together these acts reduce significantly the tax liabilities of companies and financial institutions and, thus, put severe strain on fiscal balance. As the fiscal deficit soars out of control and IMF support is jeopardized, the policy response to this self-induced financial shock will be crucial to the success of Hungary's transition to a market economy.
Although Hungary is considered to be a (the only?) model of the gradualist approach to the transformation, recent enactment of three laws amount to the imposition of a significant financial shock in 1992. The New Banking Act, effective on December 1, 1991, introduced specific categories for rating the loan portfolios of the banks, mandated the accumulation of provisions (loan-loss reserves) against the qualified loans in the portfolio, and specified a schedule for meeting capital adequacy targets based on these components. The New Bankruptcy Law, although taking effect legally on January 1, 1992, began to have significant impact on April 8, 1992 when a company with any outstanding debt more than 90 days overdue was required to initiate bankruptcy proceedings or the responsible parties would be subject to criminal prosecution. The Act of Accounting, effective January 1, 1992, mandated that companies revise balance sheets and other business documents to bring them closer in line with international standards. Each law addressed an important economic problem, bad loans and undercapitalized commercial banks, creditor passivity in the face of a growing amount of involuntary and doubtful interenterprise debt, and the need to make the company accounts more transparent to jump start the stalled privatization program. However, taken together they amount to a self-induced financial shock in 1992. In essence, the new laws impose an immediate flow solution on a stock problem.

According to the Banking Act, banks must classify the assets in their portfolios as substandard if they are performing but involve "large economic branch risks", doubtful if the borrower
is in default in servicing principal and interest for more than 60 days or the borrower has incurred balance sheet losses in each of the two preceding years, and bad if the borrower is in default for more than one year or the claims are held against a company that is either in the process of restructuring or in liquidation proceedings. All assets not assigned to these three categories constitute the good (non-qualified) part of the portfolio.

Provisions equal to 20% of the substandard loans, 50% of the doubtful assets, and 100% of the bad debts are assessed immediately. As a consequence, banks began to accumulate risk reserves against the qualified part of their portfolios in 1991. For example, at the end of 1991, Budapest Bank (hereafter, BB), the fourth largest commercial bank in Hungary, calculated its required provisions to be 12.3 billion forints (hereafter, b.f.) and generated 10 b.f. of risk reserves from that year's income. Since provisions are funded from gross profit, tax payments and dividends declined substantially from 1990 levels. BB cut cash dividends on ordinary shares in half; its required tax payments were less than one-third their 1990 amount.

For commercial banks in the aggregate, provisions made in 1991 resulted in an overpayment of taxes by 13.4 b.f.. The government used its ownership claims in these banks to negotiate postponement of repayment as the 1992 budget deficit was rapidly increasing due, in part, to sharp decreases in current tax payments as banks continue to build up provisions. The budget deficit, currently over 210 b.f., is more than three times the
deficit planned and agreed upon with the IMF for the entire year (Heti Vilaggazdasag, August 22, 1992).

Dr. Lajos Bokros, President and CEO of BB, reported that the bank's portfolio deteriorated further in 1992; by mid-year, about 40% of the bank's loans (total about 100 b.f.) is now qualified according to the regulations in the Hungarian Banking Act. Consequently, even though it had accumulated 10 b.f. of provisions in 1991, BB has assigned to provisions all of gross profit for the first half of 1992 and plans to accumulate 5 to 6 b.f. of new provisions over the year. Unfunded provisions affect the bank's ability to meet the capital adequacy requirement of 8% imposed by the Banking Act because capital must be adjusted by subtracting unfunded provisions before calculating the ratio to risk-adjusted assets. For 1991, BB's calculated its capital/asset ratio to be 6%.  

Adding to the deterioration of the balance sheets of the commercial banks is the increasing numbers of companies filing for bankruptcy. At the time of court filing, debt payments are suspended for 90 days (a period extendable for an additional 30 days by the court). During this period, the bank must rate outstanding loans (including current and capitalized interest due) to a company that has filed for bankruptcy as bad and carry provisions equal to 100% of their value. All provision for loan

1 One American advisor suggested that an evaluation based on international standards would identify around 70% of the portfolio as qualified.

2 The details of the calculation are given in the appendix.
losses are funded from gross profit. Thus, the tax liabilities of commercial banks continue to shrink so that they can no longer be relied on to contribute significantly to fiscal receipts.\(^3\)

The New Accounting Act affects the calculation of profit tax liability for companies in two important ways. First, although earnings will continue to include accounts receivable, some portion of these will not be paid when the claims of creditors are sorted out in bankruptcy proceedings. Consequently, companies are required to accumulate reserves against doubtful receivables from gross profit on a cost basis, thus decreasing their tax liability. Dr. Istvan Csillag estimates that in about half of the companies, profits will be five to six times lower in 1992 than in 1991 due to this attempt to clean up interenterprise debt. Second, depreciation allowances will be based on replacement value rather than, as previously, on historic (book) value. Recent inflation made historic values serious underestimates of replacement value. According to Andras Giday, 65% to 70% of true depreciation has not been recorded as a cost; thus, gross profits have significantly overstated true profit (which he estimates to be negative for many companies). Consequently, the profit tax base will decrease significantly as a result of this act.

Unlike for the other two laws, the Ministry of Finance (MoF) is to determine the timing of the accounting changes over a five-year period. The MoF can phase in the new system of calculating

\(^3\) In 1990, taxes and dividend payments from the three large commercial banks alone constituted 1.7% of fiscal receipts.
profit tax liability and, thus, smooth the fiscal cost of
adjustment over the next five years. Such discretion is important
for fiscal planning. Dr. Werner Riecke, head of the Monetary
Research Department of the National Bank of Hungary, claimed that
the MoF expected banks to build up the provisions required by the
banking act over a four year period because of the grace period
allowed for meeting the capital adequacy target. However, prudent
management in a deteriorating economy argued for accumulating
provisions against outstanding qualified loans as quickly as
possible. Hence, the budgetary impact has been immediate and the
financial shock has been large.

Dr. Riecke claimed that the MoF was considering proposing a
change in the banking law to restrict the speed of creating
provisions, and thus, lessen its impact on the fiscal budget.
Many propose amending an overly harsh Bankruptcy Act to reduce
its effect on the tax liabilities of banks and companies. Mr.
Giday estimates that between 30% to 40% of the country's
production is currently "in the courts". However, credibility is
the most precious currency of policy makers in the countries in
transition. In the interest of future policy-making, the
authorities must accept the consequences of legislated shock
therapy in Hungary.
Sources

Interviews conducted in Budapest, Hungary

July 10 to July 24, 1992

Dr. Lajos Bokros, President and CEO, Budapest Bank Ltd.
Dr. Istvan Csillag, Managing Director, Financial Research Ltd.
Mr. Andras Giday, Managing Director, Property Foundation and
Institute for Privatization Studies
Dr. Werner Riecke, Head of the Monetary Research Department,
National Bank of Hungary
1. Adjusted capital = own equity = 6.2 b.f.
   = share capital + general reserves (9.9 b.f.)
   - investment in other financial institutions
   - non-generated provisions (2.3 b.f.)

2. Corrected balance sheet in which assets are weighted according to risk category using the following weights:
   0: cash, obligatory reserves and deposits at National Bank of Hungary plus receivables from the central budget,
   0.2: receivables from other financial institutions,
   0.5: bank guarantees or surety issued by financial institutions,
   1.0: all other assets.

   Corrected assets: 102.8 b.f.

4. Capital adequacy ratio = 6.2 b.f. / 102.8 b.f. = 6.0%
   (calculation accepted by State Banking Supervision, May 31, 1992.)

**Targets from Banking Act**

The intermediate targets are 7.25% by January 1, 1992 and 8% by January 1, 1993 but exemptions until December 31, 1994 may be granted for financial institutions in operation since December 1, 1991.