

# Viewpoint

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## The Macedonian Gambit— Enterprise cum Bank Restructuring

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The former Yugoslav Republic of Macedonia suffers from more than the well-known problems of an economy in transition from central planning. Until recently, this small, landlocked country (2 million people and a per capita GDP of US\$790 in 1994) traded mostly with other Yugoslav republics. Then Serbia became subject to a United Nations boycott and Greece cut access to the convenient port of Thessaloníki. Macedonia shares mountainous borders with Albania and Bulgaria, but there is no east-west railroad and the roads are not designed for heavy truck traffic. In such isolation, the country's economic situation has been precarious since its independence in 1992. Despite—or perhaps because of—its desperate straits, the country's leaders have grasped the nettle and begun reforming with little procrastination.

Usually in transition economies, there has been a tendency to leave enterprise restructuring to those with the incentive to restructure efficiently—the new private owners. Until privatization, the government simply subjects each enterprise to a cash (“hard budget”) constraint. Sometimes the government tries to enforce the hard budget constraint by isolating the enterprises from banks. Often there are mixed and muddled criteria—for example, the status of largest debtor or of lossmaker—“qualifying” enterprises for isolation. In practice, this approach has rarely been successful because powerful enterprises tend to lean on politicians to relax the cash constraint—usually through banks but with government connivance. Relaxing the cash constraint for some enterprises, especially when done on the sly, undercuts the rules—and the leak soon turns into a flood as other borrowers demand similar lax treatment.

### Transparency

Supported by a World Bank policy-based loan, Macedonia is trying an approach with subtle but important differences. Enterprises will still be privatized as soon as possible, but the government frankly acknowledges that a few enterprises have considerable clout and must be subsidized for political, not economic, reasons. These politically powerful enterprises are isolated from vulnerable banks, but given a direct subsidy in exchange for undertaking monitorable reforms.

When subsidies to the “political” enterprises are made transparent in this way, the cabinet can equalize the marginal political benefits of such expenditures. In exchange for the subsidies, the politically powerful enterprises have to end value-subtracting activities, break off their relations with banks to prevent any slackening of the constraints, and immediately take steps to liquidate or privatize constituent units at a pace determined by the cabinet, where political tradeoffs are best made.

Banking reform proceeds in tandem. Freezing the debts of the political enterprises frees banks from the pressure to make more bad loans. But the incentive to make good loans only comes when banks are effectively privatized. Because the government cannot deny implicit deposit insurance to a dominant bank, effectively privatizing the large but poorly run Stopanska Banka meant that it had to be broken up and sold in pieces so none would be “too large to fail.”

This isolation technique is still risky: although transparent subsidies allow the cabinet to make





informed choices, they do not dissipate political pressures and indeed could increase them.<sup>1</sup> But so far the technique is working well. Although it is too early to declare victory, the Macedonian gambit shows signs of success—and it could usefully be adapted by other transforming economies.

### Fleshing out enterprise reform

By the time the World Bank became involved, Macedonia's privatization law had already been passed and the salient features could not be altered without reopening a parliamentary Pandora's box. Social ownership of enterprises—a unique Yugoslav arrangement under which workers had nontransferable usufructuary rights over assets—would end under the 1989 Yugoslav law that gave workers first dibs on buying their enterprise. Macedonia's privatization law only added some new wrinkles. The main awkward feature was a reservation price based on "company valuation"—a slow and pointless exercise, but necessary to make amends for an earlier scandal in which workers bought firms "too cheaply" using untaxed funds. Although privatization is slower than what might have been technically possible, the process is credible because the political battles have already been won.

#### "... I have a little list"

Identifying enterprises with political clout required no elaborate analysis. As the then Minister of Finance put it, "I know who they are, for they always bother me over the phone." These enterprises may also have the largest losses, arrears, and indebtedness—though these were not the criteria for selection. They have operating cash deficits and need additional funds, not merely rollovers of existing debts. Even state-owned banks already saddled with bad loans are loath to throw good money after bad by lending to these enterprises. So enterprise managers pressure politicians, who in turn lean on the central bank or directly on the banks to lend more money.

As it turned out, the list of politically powerful enterprises was drawn up through a fortuitous and inadvertent "bait and switch." Under an earlier Economic Recovery Credit, the World Bank had backed the use of government guarantees of loans to the "twenty-five largest loss-making enterprises" in a vain effort to improve bank balance sheets and lending behavior. Enterprise debtors and creditor banks quickly realized that obtaining a guarantee was far easier than pressuring the central bank to misclassify the loans as sound. So enterprises seeking the government-guaranteed loans lobbied hard to skew the "objective" criteria—size of losses, indebtedness, and the attached weights—in their favor.

Although the guarantees were abandoned, the list included enterprises with political clout, the criterion for isolation. But the volte-face understandably provoked resentment and made it impossible to increase the arbitrarily chosen number of twenty-five. To the government's credit, those on the list remained on it, but some enterprises that perhaps should have been in the group were left out. And two that were included were state-owned utilities (electric utility and railways) that the government had decided to neither sell nor close down—creating a special subgroup.

#### The political safety valve

Restructuring the enterprises involved no new investment. It was really a liquidation (of all but two) overseen by the cabinet rather than by creditors or the bankruptcy court. Some argued that the government should agree to a declining schedule of future subsidies to these enterprises, to aid reformers dealing with avaricious firms. The risk in specifying the subsidy amounts was that enterprise managers could push for subsidies not easily detected (for example, through loan write-offs or purchases of goods at inflated prices). Worse, such subterfuges make it harder for the cabinet to see the implications of any political tradeoff—which is the main reason for transparency in the first place. Besides, if the government wants

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to increase enterprise subsidies at the expense of, say, teachers' salaries, why hamstringing it by disconnecting a political safety valve?

### **Quid pro quo for the subsidies**

At the same time, the government needed objective advice on what to ask of the twenty-five enterprises as a quid pro quo for the subsidies. Bilateral aid grants financed outside consultants to provide that advice, and the government agreed to adopt the consultants' recommendations on the necessary measures for breakup or liquidation before the World Bank released the first tranche of the loan. The government quickly passed a law eliminating the social ownership of the chosen enterprises and, with its new legal authority, appointed a trustee to oversee the managers of the firms.

### **Fixing the banks**

With incomes and thus savings having fallen so drastically, efficient intermediation is a concern for the medium term. Privatizing banks is normally tricky.<sup>2</sup> But two circumstances have made it especially so in Macedonia. First, most household deposits were denominated in foreign currency and were explicitly the government's liability, although they were frozen. Rampant inflation in the former Yugoslavia and incipient capital outflows forced the government to allow banks to accept household deposits denominated in foreign currency (mostly in deutsche mark). Banks had to match assets and liabilities by currency, and the central bank in Belgrade obtained and held the corresponding foreign exchange assets through surrender requirements. Serbia kept the foreign exchange reserves when Yugoslavia broke up in 1992, but although the newly independent republics (Croatia, Macedonia, and Slovenia) had no foreign exchange reserves initially, they froze—but did not explicitly repudiate—their liabilities to depositors. Second, Stopanska Banka, which held the bulk of frozen deposits, was the bank in worst shape. So it had to be broken up, the stock of deposits dealt with, and the pieces privatized.

### **Thawing frozen foreign exchange deposits**

The Macedonian government assumed the former Yugoslav central bank's obligations to its commercial banks, but as long as funds in the old foreign exchange accounts could not be withdrawn, interest continued to accrue. Some 60 percent of the frozen foreign exchange deposits were in Stopanska Banka, which traditionally lent to big state and socially owned enterprises. As Macedonia earned foreign exchange through exports, individual banks with available funds permitted ad hoc withdrawals, technically in defiance of the official freeze, which began to be formally relaxed only for hardship cases. The government also sought, with some success, to extinguish these foreign exchange liabilities by allowing them to be used as payment in the privatization of apartments and enterprises.

As banks competed for additional deposits, new deposits naturally gravitated to those banks that, formal restrictions notwithstanding, thawed their deposits. Stopanska, despite its insolvency, therefore thawed its deposits too. But because it had the most nonperforming loans, it had to tap the central bank with growing frequency and for increasing amounts. By March 1994, Stopanska's cash flow demands were becoming unmanageable and jeopardized the government's attempts to reduce inflation.

### **Stopping Stopanska**

Stopanska had to be broken up before privatization to avoid (implicitly) insuring deposits in a large bank. Breaking up Stopanska immediately and deferring recapitalization until its parts were privatized were both difficult and controversial moves. The International Monetary Fund was anxious that a breakup not derail its impending standby arrangement.<sup>3</sup> The European Bank for Reconstruction and Development (EBRD), although unwilling to bid immediately, seemed interested in buying Stopanska whole, and Stopanska's senior officers were understandably resisting its dismemberment. Fortunately, the government was



persuaded that breaking up Stopanska was important, and because Stopanska was an agglomeration of regional banks that retained their identity, the breakup was technically simple. The managers of the five regional clusters were eager to buy their parts, leaving the problem core (the Skopje cluster) for the government to tackle. In this way, more than 40 percent of Stopanska's assets will be privatized before the World Bank loan's second tranche is released.

### An interim report

Macedonia is not out of the woods yet, but the signs are encouraging. After being reelected in November 1994, the government immediately began whittling down the twenty-five political enterprises. Some 15,000 of the 20,000 surplus workers have been laid off. The conglomerates among the political enterprises are being broken into independent units, many of which look quite promising and are privatizable. The next test of the government's resolve comes at the end of 1995, when the unsold units must be liquidated. Privatization of the other enterprises is creeping along.

There are also some worrying signs. Ten of the twenty-five enterprises have together accumulated US\$200,000 in arrears to the electric utility, which, along with three other companies, demanded and obtained government-guaranteed loans of US\$3 million. The electricity and rail utilities have not shed excess staff or assets (for example, idle land and sports facilities). Although Stopanska Banka has already been broken into five regional banks that have been bought by their managers, unresolved interbank claims make the banks' financial position precarious. There is also a dispute with the government over DM 160 million in withdrawals from frozen deposits that might not have met the hardship criterion. The interest of the EBRD and the International Finance Corporation in the remaining core of Stopanska (the Skopje branches, with more than half the assets) has waned, and no other prospective buyers are in sight. Resolving these

issues requires the continued attention of both the government and the World Bank.

In contrast to the apparently similar enterprise isolation practices ("jails" or "hospitals") tried in some other countries (such as Albania and Romania), the Macedonian gambit seems to be working—although it is premature to declare success. The Macedonian approach delegates each decision to those with the right information and incentives to act. Subsidies—because they are inherently political, not economic—are determined exclusively by the cabinet. Yugoslav banks, despite their poor portfolios, were generally capable of sound credit analysis, so isolating them from deadbeat borrowers with political clout has restored their morale and functioning. Although many banks were owned by socially owned enterprises, bank privatization is proceeding apace. Breaking up Stopanska has given a clear and resounding signal of the government's resolve and adeptness. Although it would be unwise for countries with quite different characteristics to simply copy the Macedonian approach, the principles in its design may be worth adopting.

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Comments are welcome. Please call the FPD Note line to leave a message (202-458-1111) or contact Suzanne Smith, editor, Room G8105, The World Bank, 1818 H Street, NW, Washington, D.C. 20433, or Internet address [ssmith7@worldbank.org](mailto:ssmith7@worldbank.org).

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- <sup>1</sup> With transparent subsidies, the enterprises could collude and collectively demand more, rather than compete among themselves for the amount the government sets. So the superiority of transparency is not axiomatic. The subsidies were expected to be lower than the present-value costs to the budget of unemployment benefits to laid-off workers, but were not specified in this manner because discussions were under way to reduce unemployment and other benefits and the sums were not added up until the consultant studies on each enterprise were available.
- <sup>2</sup> Ramachandran outlines why bank privatization is necessary but difficult in "Bettering Banking: Privatize Flows and Let Sleeping Stocks Lie" (FPD Note 39, March 1995).
- <sup>3</sup> Increases in total central bank credits are tightly controlled to reduce inflation. The IMF was more concerned about the rate of nominal increase in central bank credits than about how they were allocated among banks, but pro rata increases, while simple to administer, implied that the banks' market shares were unchanging. If banks are to have an incentive to improve their operations, each bank should be allowed to increase its share at the expense of others.

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