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# Economies in Transition: Restructuring of Large-Scale Industries

Consultant

John S Henley and Peter Chudy

31 December 1993

# Chapter 1

## The Communist Legacy and the Objectives of Restructuring Industry

### Introduction

Nearly four years after the countries of Central and Eastern Europe (CEE) began the unique and historic process of transformation from a command to a predominantly competitive market-based system, it is now evident that macro-economic reforms will not in-and-of-themselves result in the needed micro-level reforms to ensure the success of the process. The transition has yet to deliver the hoped for significant re-orientation and restructuring of industrial structures, or major improvements in economic performance and overall growth. The initial euphoria that characterized the early days of 1989 has now given way to a more guarded optimism and realization that significant challenges are still ahead. It is now clear to all that the process will be much more difficult and take far longer than expected.

While the early price liberalization and stabilization reforms in many of the countries of the region appear to have been successful, in all the countries, this first stage of the process has been accompanied by severe drops in output, large increases in unemployment, persistent medium level (in the 20-50 per cent range) inflation and the

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It is now clear that the success of the transformation of the region will depend on more than macro-reforms. The regeneration of the industrial base, an essential element of a country's development and UNIDO's particular concern, will require the development of an integrated micro policy framework with concerted, enterprise-targeted policy measures and institutional and other support. Too much was expected too soon across the region. There must now be a second phase of the transformation in which the focus has to incorporate the removal of rigidities at the enterprise level. This requires greater integration of the macroeconomic framework with measures designed to induce the proper supply response at enterprise level.

This paper will show how the macroeconomic environment and the institutional, legal and regulatory infrastructure effect the transition process and in particular the role industrial restructuring and enterprise-targeted policies play in it. The focus will be primarily on the experience of Poland. It was the first of the countries of Central and Eastern Europe to embark on a programme of fundamental market reform under a non-communist government. It is also the country in which UNIDO has had the most first-hand experience of restructuring industrial enterprises.

A case study approach has been chosen because the transition process in the CEE region has demonstrated the importance of the particular history of the political and social system and the institutional structure of individual nation states in determining the direction and speed of economic change. Decisive political leadership in combination with a well-designed and executed set of policy instruments is also crucial. Particular attention will be paid to the features of the Polish experience over the last four years that appear to be of relevance to other economies in the transition process. Comparative statistics from other CEE countries are provided where available, to help locate Polish experience within a comparative framework, (see Tables 1 and 2 for summaries of pre-reform conditions in CEE.[1]

### What is Industrial Restructuring?

In the broadest sense, industrial restructuring refers to the process of reorganising the relationship between a nation's industry and the world economic system so as to increase international competitiveness.

Thus, industrial restructuring involves the economic, legal and political reforms necessary to create the appropriate policy environment and supporting institutions as well as the process of restructuring individual enterprises.

Industrial restructuring, in fact, encompasses many types of restructuring: organizational and operational; financial; legal; and the creation of strategic business units (SBUs). When developing an industrial restructuring policy, several questions must addressed: will restructuring be technical or broad-brushed?; will restructuring be passive or active?; when should it occur, short-term or long term and pre or post privatization?; and should the process be decentralized or overseen by central authorities.[2]

Organizational restructuring focuses on the structure of the enterprise while operational restructuring focuses on production processes. Financial restructuring refers to the restructuring of the enterprise's balance sheet - its debt and equity. Legal restructuring is also known as "corporatization", or the transformation of the enterprise into a joint stock company run by a board of directors. Creating strategic business units refers to the splitting up of large integrated enterprises into smaller more viable units, particularly the spinning off of ancillary activities and non-core product lines into separate "privatized" businesses.

Passive restructuring means creating an environment (increasing competitive pressures through trade liberalisation, hardening budget constraints and threatening bankruptcy) in which restructuring is initiated and undertaken by the enterprises themselves. Active restructuring would be initiated and carried out by government authorities in enterprises that remain in the state sector.

A broad-brush restructuring would include legal and financial restructuring as well as splitting up enterprises, while technical restructuring focuses on the restructuring of production processes. Pre and post-privatization simply refers to whether an enterprise is restructured prior to privatization by the existing management or government, or after privatization by the new owners (domestic or foreign).

**The Legacy of the Command Economy**

Almost all enterprises in Central and Eastern Europe and the republics of the former Soviet Union need to undergo some form of industrial restructuring before being viable in a competitive market economy. In some case it will be simply the production layout that needs changing, in others it may be the balance sheet. Most, however, will need major broad-brush as well as technical restructuring because, having been created and developed under a command system, they are fundamentally inappropriate for successful functioning in a competitive environment.

The classical centrally planned economy relied on material balances planning using input-output matrices to match available resources and the desired supply of final goods. Demand was imputed from the outcome of previous iterations of the planning process and was a marginal consideration in arriving at output targets. The main emphasis was on quantitative measures and indicators of output to the detriment of other considerations, especially cost effectiveness and quality. For the management of enterprises the two key considerations were: securing sufficient inputs, and meeting quantitative plan targets. It was not usual for state-owned enterprises to be constrained by demand. Marketing departments, such as they were, were primarily concerned with distribution of product and often rationing, not sales. Marketing was about order processing.

The hard constraint on management was the availability of resources which were perennially in short supply due to inadequacies in the 'plan' and the insatiable demand by state-owned enterprises for inputs in order to create some cushion for themselves in their efforts to meet planned output.[3] In the absence of market determined prices, organisations focused on output. Even in the case of foreign trade there was very

little connection between export prices and real costs where a variable tax-subsidy system severed the link between foreign currency prices and ex-factory prices. Foreign trade was also conducted by a separate organisation from the production unit so that market intelligence from export markets rarely had an input into a producer's decision-making processes.

The central planning mechanism was an inflexible system. As the Hungarian economist Janos Kornai observed, "The plan direct[ed] those responsible for implementation, but it also tie[d] their hands, making it one of the sources of economic rigidity and lack of flexible adaptation."[4] In turn, the system predisposed planners to favour very large integrated units thereby reducing the number of agents they had to deal with. Governments followed the practice of bailing out ailing enterprises through the banking system by providing credit or allowed tax rollovers or debt repayment deferrals or sometimes even total forgiveness of debt. This led to expectations by enterprise managers that government planners would always ultimately come to their rescue if they ran into financial difficulties, creating what Janos Kornai termed 'the soft budget constraint'. The effect was a corrupting influence on economic efficiency by reducing a firm's sensitivity to the price of money, whether measured in terms of interest rates or exchange rates.

The whole system of financial and fiscal regulation of state enterprises was permeated by discretionary considerations. The skilled negotiator with sufficient political connections could always obtain a bail-out. Hence the importance of breaking this discretionary link between the state and its enterprises in reform programmes across the region. Without a credible threat of no bail-outs, governments simply will never bring their budgets under control. State banks will continue to accumulate non-performing loans, taxes will not be collected, wage bills will expand out of control and inflation will spiral upwards.

**The Structure of Industry**

In terms of industrial structure, a major difference between the CEE/FSU countries and the market economies of Europe, is the size of enterprises and the degree of industrial concentration within each industry. There is a relative absence of small and medium-sized enterprises in the region. Where enterprises were privately owned, they were merely tolerated, not encouraged or supported. The service sector was underdeveloped representing around 40 per cent of GDP compared with over 60 per cent in the advanced industrial economies. Distribution and retailing were particularly under developed sectors.

The industrial structure of the region reflects the fact that industry was developed to serve the needs of the command economy, and to a large degree, the market of the FSU. The average Soviet-type enterprise is more than 10 times the size of the average firm in the same industry in a developed market economy. Often one or two large enterprises dominate an industry or a product line. Enterprises also were highly dependent on input and output markets in the FSU. With the disintegration of the FSU, many countries of the region lost both input and output markets which has resulted in severe dislocation and adjustment problems. Demand was guaranteed and in many cases still is. Industrial enterprises across the region were highly integrated, both horizontally and vertically. As a result, it was common for an airplane factory, for example, to produce everything from bolts to seat covers. In Western Europe it is common for firms to be either horizontally or vertically integrated, but rarely are they both.

Product ranges tended to be limited and life cycles were much longer than in market economies. Investment in product development and innovation was limited. Marketing and salesmanship consisted mostly of passive order processing and or rationing. Products were engineered to cope with capricious supplies of capital and material inputs endemic in a command economy. There were few incentives to design products to meet consumer needs. Systematic market research was almost unknown and was virtually precluded by the organisation of industry.

Because energy prices were highly subsidized for such a long period in much of the region, the energy and material consumption of most CEE/FSU enterprises is well above the international norm for the given level of technology. And the technology level is generally outmoded and energy-inefficient. Recent investment has been concentrated only in certain sectors, primarily military. And, while some of the countries of the region had very strict environmental protection codes in place regulating air and water emissions, until recently little if any enforcement has taken place.

The structure of production, especially in the republics of the FSU, Bulgaria and Romania, was extremely complex, consisting of specialized monopolies manufacturing products in a very sophisticated division of labour across the region. For example, within the Soviet Union, the Baltic states were given the role of producing many of the high technology goods, particularly for the Soviet military industrial complex. Of the nearly 600 'all Union' enterprises built in Lithuania, most produce or produced relatively sophisticated electrical, chemical, computer and other knowledge-intensive products. Kazakhstan, on the other hand, was almost exclusively a mineral supplier, with most processing taking place in the Russian Federation. Despite having very large gas, oil and coal reserves, Kazakhstan had virtually no refinery or power generating capacity of its own in 1991.

The concept of profit centers and core businesses was and still is not central to economic life. As noted, resources were not invested on the basis of potential return, but rather to fill a production plan. As a result, many enterprises in the region are left with product lines that are generally unrelated. With no systems of cost-accounting, rarely are they able to clearly determine which products are profitable and which are not. Communist ideology and the organisation of industrial relations encouraged enterprises to pursue a cradle-to-the-grave social welfare view of employment relationships so that large enterprises typically operated a complete range of welfare facilities including nurseries, schools, hospitals and holiday homes for

employees. Enterprises also often had to provide for ancillary activities such as fire brigades and large maintenance shops which further strained their already limited economic viability.

Where the budget constraint has become hard as a result of reform, CEE/FSU enterprises have found alternative financing methods: forced borrowing from suppliers and non-payment of taxes. As a result most CEE/FSU enterprises have large amounts of inter-enterprise debt. As credit was tightened in the early days of transformation, enterprises began to fund themselves through the process of non-payment. Enterprise A would not pay enterprise B until it was paid by enterprise C. But enterprise C often went bankrupt. The level of such debt is now staggering, particularly in the CIS. In the Russian Federation for example, inter-enterprise debt rose from R40 billion at the end of 1991 to R751 billion at the end of March 1992, more than twice the amount of bank credit during the same period.[5]

Certain regions such as the Russian Federation, Ukraine and Slovakia also have high concentrations of military enterprises and their restructuring will require a conversion to civil production. This will be a formidable task and large amounts of foreign assistance from the policy to enterprise level will be necessary.

The question naturally arises as to how this centrally planned economic system managed to survive as long as it did. While there has been a good deal of debate over this question, the current consensus is that until the early 1970s, socialist economies achieved reasonable growth rates of GDP and, to a lesser extent, productivity growth, mainly as a result of increased inputs rather than improvements in the productivity of existing investments. From the 1970s the dearth of endogenous technological innovation became an increasingly onerous constraint on further growth.[6] Much of the growth from 1970 onwards was financed by borrowing from Western banks, hence the accumulation of debt by most of the CEE countries. Growth was also of the high cost variety: achieved through lowering consumption and a fully mobilised labour force.

The accelerating diffusion of new technologies in the OECD economies, particularly the use of microprocessors and computers, and the development of information technology more generally, has revealed the true magnitude and widening gap in the innovative capacity of CEE state-owned enterprises and their competitors in the market economies. It is now generally recognised that effective innovation is a decentralised process requiring an adequate 'selection environment'.[7] This environment was noticeably absent in the command economies. Even in countries such as Hungary and Yugoslavia where enterprise management was decentralised there were few rewards for innovation. Indeed the institutional structure was designed to separate research from production and thereby prevent rewards being recoverable from commercialisation by the innovators. Perhaps worse, the synergy between inventor/producer and customer was lost. In the 1990s, comparative advantage in industrial R&D no longer guarantees that this is translated into advantages in the production of goods. Rather it is the relative efficiency with which ideas are converted into marketable products and services that determines profitability and growth.

BOX

**Characteristics of a CEE/FSU Enterprise**

Restructuring exercises sponsored by institutions such as UNIDO, the British Know-How Fund, the European Community (EC)-Phare Programme, the European Bank for Reconstruction and Development (EBRD) and various other assistance programmes, have identified seven broad areas in which typical CEE/FSU enterprises lag behind their competitors operating in competitive commercial markets elsewhere in the world. These
areas are:

* Marketing: The centrally planned economic system stifled the incentive for enterprises to develop new products and conduct systematic market research. As a result, many managements today lack a thorough understanding of market trends and changes, pricing, and organising a sales force and modern distribution

channels.

* Management function: In command economies the management function is underdeveloped. Financial management and accounting arose from the emphasis placed by central planners on meeting annual production quotas. Capital and credit was supplied entirely passively to meet plan targets. As a consequence, financial and accounting systems were designed primarily as record keeping tools rather than as fully developed management accounting systems delivering the information required for rapid decision making or as a basis for negotiating credit with a commercial bank. The 'soft budgetary constraint' meant a lack of emphasis on precise cost tracking and very limited application of the standard accounting concepts of profit and cost centres. Further, there was no efficient and accurate system for calculating overhead costs. Basically, managers had very little incentive to use conventional market-oriented financial analysis to assess their enterprise's competitive position since it could, and often was subject to arbitrary administrative change.

* Obsolete technology: Despite the production orientation of enterprise management, product and process technology was often obsolete. Many enterprises relied on outdated equipment operating in an unsuitable production environment with inefficient production methods. This often compounded problems by creating supply bottlenecks, reinforcing the perennial shortages endemic in the command economy. The absence of commercial incentives to maintain equipment properly or to manage inventory efficiently also meant that quality control procedures were erratic and certainly could not be relied upon to deliver product meeting international quality standards.

* Inflated organisation: The typical result of endless struggles by management to develop self-sufficiency as a way of countering the vagaries of the planning mechanism, output quotas and shortages of physical inputs was the growth of non-core activities and a loss of business focus. This was reflected in ambiguous organisational structures leading to duplication of effort and administrative and production bottlenecks.

In Hungary (since 1968) and Poland (since 1981), moves to decentralise management control of capital, while still retaining the soft budget constraint, also resulted in growing demands from the workforce to increase wages to counter inflation and at the expense of capital. Reformers faced the prospect of reasserting bottom line discipline over powerful and previously relatively independent firms and usually, the need to downsize both the payroll and assets.[8]

* Ineffective and inappropriate management: In the typical state-owned enterprise the cadre of top management was appointed by the state bureaucracy usually with little attention paid to the appropriateness of the professional skills of the manager concerned. Party membership was an important consideration in career success. With few incentives for concentrating on the core business and the lack of an effective enterprise-oriented management information system and training options in such fields as finance, marketing, sales, distribution and quality control, very few top managers were able to break away from the quantitative bias of the ubiquitous plan targets and develop a market-oriented managerial culture.

* Lack of experience in identifying and negotiating with reliable commercial partners: The state bureaucracy managed all external transactions with the enterprise so that enterprise management had no real responsibility for cultivating commercial relationships with banks and financial institutions, potential foreign joint venture partners or major customers. Banks were not much more than an administrative extension of the central planning mechanism. Marketing was often about rationing the distribution of product. Exporting was managed by separate foreign trade organisations (FTOs).

* Political system of industrial relations. Under communism, the party was responsible for solving disputes between enterprise management and trade unions. Trade unions were restricted to representing worker interests in the social conditions of employment and welfare benefits. Wage rates were set centrally so that the basic wage structure was determined politically. There was no official recognition of the notion of an

efficiency wage or the idea that wages should be related to labour productivity at the enterprise level. Many pressing problems at the enterprise level were simply ignored by the central party, while management had very limited powers to do anything constructive. For example, in the 1970s and 1980s calls by Poland's workers for improved working conditions and increased wages were simply brushed aside by the government and party. Worker outrage led to strikes, violence and bloodshed which then encouraged Lech Walesa and others to found Solidarity, an unofficial trade union movement that operated parallel to the official one. Thus, failure to deal with deteriorating industrial relations at enterprise level in the 1970s and 1980s contributed substantially to the collapse of communism in Poland.
END BOX

**Economic Restructuring: Introducing Flexibility**

In a world of constant change, economic restructuring is centrally concerned with improving the efficiency with which an economy adapts to changing constraints and opportunities. Centrally planned economies were, above all else, inflexible. Outcomes did not accurately reflect economic conditions. Demand for goods and services rarely matched supply. Government policies were insensitive to real resource costs and resources were only reallocated slowly in response to changing economic conditions.

In restructuring the economies of the CEE/FSU region, the objective is to improve adaptability and therefore reduce the cost of moving resources between one activity and another: to build the capacity to change technologies and the composition of output more rapidly in response to changing market conditions. On the demand side, this implies that consumers will be responsive to changes in prices and shift between consumption and saving. Clearly under conditions of very high levels of inflation and negative real interest rates, consumption will take precedence over saving. In a flexible restructured economy the costs of shifting resources between consumption and saving or vice versa should be relatively low. Enterprises should develop the ability to rapidly incorporate new technologies into products and production processes. They should be able to carry out effective market research and marketing to take advantage of new market opportunities. Governments should be able to manage macroeconomic policy such that there is no sustained imbalance between supply and demand conditions in the domestic market and the world market.

The primary policy objective of enterprise restructuring is to improve international competitiveness. This notion implies a 'frontier' to which enterprises orient their behaviour that embodies the latest developments in product and process design, marketing, finance and organisation. The efficiency of utilisation of each factor of production evolves at different rates and according to different dynamics but it is the combination of factors that produces a winning product or service. There is no necessary ideal combination of factors that produces competitiveness, though current 'best practice' is a good guide as to the direction in which restructuring efforts should go. Hence the vast amount of resources being devoted to 'catching up with the Japanese' by European and US car-makers.

The CEE economies have had to adjust first to the shock of the initial liberalization programme after 1989. As this shock therapy wears off and the first stage of adjustment is completed, the maintenance of international competitiveness will increasingly depend on deeper levels of flexibility and adaptability at the enterprise level. The policy environment and role of government are important facilitating factors, but success ultimately depends on entrepreneurial creativity at the level of the firm. Managements of individual enterprises need to keep ahead of changes in patterns of demand for their products through market research and marketing. Global trends also need to be carefully monitored. For example, the rise in the proportion of manufactures in merchandise trade and the decline in demand for raw materials has serious consequences for countries such as Poland with substantial exports of coal, steel and agricultural products. Many CEE countries thus possess structural rigidities that are characteristic of developing countries such as primary product export dependency, in addition to the special rigidities of the communist legacy.

Technological progress has a powerful influence on the way firms grow. Under communism, research and development activities were divorced from production, while marketing and selling activities were divorced from both R&D and production. Closing the technological gap between CEE/FSU enterprises and leading edge industrial enterprises of the rest of the world, requires first closing the organisational gap between R&D, production, marketing and selling. Enterprises need to actively manage the value-added chain, from conceptualisation to the point of sale and beyond to the provision of after-sales service. This means building flexibility into management information system so that product and process designers are kept abreast of changes in demand as measured by market research, feedback from customers and after-sales servicing operations.

Technological progress is not independent of market forces. It is the outcome of investment in R&D which in turn is sensitive to market conditions. Institutional bottlenecks need to be removed to permit the free interaction of R&D and the market place. Command economies were notably poor in facilitating this interaction.

BOX

**Entrepreneurship in a Command Economy**

Planned economies demonstrated the harmful consequences of overly rigid efforts to institutionalise economic activity. The powerful planning mechanism that created a system that prevented the flexible adjustment of the production of goods and services to the changing economic environment and kept enterprise risk aversion high and innovation low, also stifled individual creativity and entrepreneurship.

But despite the determined efforts of party ideologues to channel any entrepreneurial drive of the population into planned economic activity, they were never fully successful. Many individuals responded to the manifest failures of the centrally planned economy with considerable entrepreneurial flare. Many learnt impressive survival skills in trying to cope with the constraints imposed by the central planning mechanism. They established small businesses and trading operations that filled niches in the system. Informal groups of individuals often combined their talents to build housing for group members or provide welfare facilities otherwise not adequately supplied by the state.

In the 1980s, the Hungarian state sanctioned an elaborate system of internal subcontracting in state-owned enterprises whereby self-selected groups of employees were encouraged to work on their own account on subcontracts to the state-owned enterprise outside normal working hours. In Poland, agriculture was never subject to collectivisation and a small business sector was tolerated by the authorities.

Another pervasive form of adaptation was to join the shadow or grey economy by acting as a go-between or barter dealer between different state-owned enterprises.[9] For example, complex interfirm networks were prevalent in Eastern Europe before 1989. The primary function of these networks was to help people cope with the rigidities of the centrally planned economy either as managers required to meet plan targets while having to seek vital inputs in a shortage situation, or as consumers seeking to purchase goods not available in sufficient quantities at official prices.

One danger of the process of transition in these countries to a fully developed market is that these skills will be deployed to create large-scale rackets in the chaotic conditions before the establishment of a functioning legal and regulatory system.

END BOX

**Endnotes**

1. Table 1 is taken from Neuber, A (1993) 'Adapting the Economies of Eastern Europe: Behavioral and Institutional Aspects of Flexibility', paper prepared for the conference on 'The Nature, Significance and Determinants of the Flexibility of National Economies, Overseas Development Institute, Bisham Abbey, UK, July. Table 2 is taken from Lancieri, E (1993) 'Dollar GNP Estimates for the Central and East European Economies - 1970-90' World Development Vol 21, 1, p. 171.

2. Frederick, W. Richard, , Background and issue paper presented to the "Enterprise Restructuring in the Context of Privatization" panel of the OECD Advisory Group on Privatization, Prague September 29 - October 1, 1993.

3. Kornai, J (1980) Economics of Shortage, Amsterdam: North Holland.

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5. Economic Survey of Europe in 1992-93 (1993) The Economic Commission for Europe, Geneva and New York, pp. 3-91.

6. Gomulka, S (1990) The Theory of Technological Change and Economic Growth, London: Routledge, 1990. Poland had a particularly weak history of patent activity. What activity there was, was mostly confined to the field of industrial machinery with few inventions in high growth industries such as electronics and consumer durables, (see OECD (1992) Industry in Poland, Paris: OECD, pp. 62-3.

7. Nelson, R and Winter S (1982) An Evolutionary Theory of Economic Change, Cambridge: Harvard UP.

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## Chapter 2

## Setting the Macroeconomic Framework for Transition

### Introduction

The transition from a command to a market based economy involves a complex inter-connecting network of changes. At the outset macroeconomic stabilisation is required. Industrial restructuring cannot work without a working price system; a working price system cannot function without eliminating excess demand and introducing currency convertibility; and a credit squeeze and tight macroeconomic policy cannot be kept in place unless domestic prices reflect world prices; otherwise there can be no rational basis for allocating resources between the competing claims of enterprises. Clearly the reform process must be comprehensive.[1]

In many ways macroeconomic stabilisation is the easy part: it is dramatic and relatively quick to introduce. The more difficult part is making sure that real structural adjustment occurs: state assets are sold off; tax reforms are introduced; legal and regulatory infrastructure is put in place to support the emergence of competitive markets; and a social safety net is developed to support those thrown out of work by structural change. Ultimately, of course, the goal of the reform process is to engineer a supply response: that depends very heavily on the expectations and actions of enterprise management and workers.

The basic objectives of macroeconomic stabilisation are to prevent hyperinflation; to eliminate price distortions caused by subsidies and lack of competition; and to establish monetary and fiscal balance in a market based economy. To do this, governments need to reduce budget deficits, mainly by cutting subsidies; and the central bank has to close off the supply of direct and indirect credit to state enterprises. Both actions are designed to substantially harden the budget constraint of the state-owned sector. Other action is required to harden the fiscal system and the operations of second tier banks but tax and banking sector reform are complex and take time to put in place. By contrast, freeing up imports through tariff reductions and abolition of quotas increases competition very quickly, thereby exerting downward pressure on domestic prices.

With the removal of subsidies, the imposition of a credit crunch and increased competition from imports, most enterprises can no longer use cost-plus pricing behaviour, hence removing a major source of inflationary pressure and macroeconomic instability. Another potential weapon in the fight to secure the initial goal of stable prices during the interregnum between the dissolution of central planning controls and the introduction of a hard budget constraint is a punitive tax-based incomes policy to control wage expansion.

With the threat of domestic hyperinflation lifted, it is then feasible to establish a stable exchange rate and unrestricted current account convertibility. Fixing the exchange rate helps bring inflation down rapidly for, among other things, state enterprises unfamiliar with competitive pricing strategies are provided with foreign prices as a nominal reference point for domestic prices. These prices provide accessible and clear criteria for monitoring improvements in efficiency and cost performance, essential for surviving with a hard budget constraint.

Plainly it is crucial for the authorities to set the 'correct' exchange rate. This normally means undervaluing the currency initially, to provide incentives for exports; and to leave scope for upward revision of wages and prices that are bound to be required in the first few months of the stabilization programme. At some point in time, overvaluation will occur as not all domestic price adjustments are tied to world prices and not all budget constraints will be hardened immediately. Policy makers, therefore, need to beware of and prepare for excessive real appreciation otherwise domestic production will be overwhelmed by cheaper imports (now liberalised) and export markets will be lost, perhaps for ever.

Of course, the nominal exchange rate cannot determine the real exchange rate; the issue is more one of consistency between fiscal policy, inflation and exchange rate policy which can certainly influence expectations about the real exchange rate. Necessarily, if the government pursues a tight monetary policy, because of its commitment to a stable exchange rate, it has few spare resources with which to subsidise state enterprises. A tight monetary policy, in short, imposes a hard budget constraint on the progenitor of all soft budget constraints (the government) at enterprise level.

**Macroeconomic stabilisation and structural adjustment**

Unfortunately, what might be described as the monetary route to macroeconomic stability relies on a rather simplistic notion of an easily manageable and sanitised government machine protected from political pressure and overseen by an all-powerful ministry of finance. Reality in CEE and the FSU is rather different. Monetary and budgetary discipline can only be introduced slowly and by stealth. Accumulations of tax arrears, unserviced debts to banks and inter-enterprise credits have to be systematically worked-out of the system, otherwise the severity of the effects of budgetary discipline will remain substantially dependent on chance. Otherwise, the persistence of a significant arbitrary element in the hardness of enterprise budgets is liable to endanger the perceived legitimacy of the macroeconomic stabilisation process. Transparency and consistency in policy implementation should be an essential feature of the new policy regime that differentiates it from the previous regime.

The very existence of a variety of different soft budget constraints opens up the possibility that entrepreneurial management will seek to replace soft but hardening constraints with relatively softer constraints; so if banks get tough over non-performing loans, firms may create working capital by non-payment of taxes, or demand an expansion of supplier credit. The possible number of permutations are considerable. Eventually, as every constraint becomes hard firms will have to restructure and refocus their activities, or collapse, unless the top management (and the trade unions) can use their political connections to achieve a bail out.

The process of progressively hardening the budgets of the state sector is not simply a matter of macroeconomic policy, it is also about institutional reform and legal and regulatory infrastructure. At the most prosaic level, bank loan officers need to know what to do with defaulters, tax collectors have to be able to read accounts and prosecute for non-payment. The practical ramifications of macroeconomic policy are virtually endless. Each element has to be put in place virtually de novo in most countries of CEE and the FSU.

While high real interest rates are usually part of the credit crunch at the beginning of a macroeconomic stabilisation programme, the very rapidity with which they are introduced means that their impact is often arbitrary and unrelated to an enterprise's performance. High interest rates can seriously damage even moderately indebted but otherwise sound firms if they are maintained for too long. They also inhibit new investment. Governments, therefore, have to maintain tight control on the state budget deficit and fiscal policy, to make sure real interest rates are brought down without reviving inflation.

If the government is serious about macroeconomic stabilisation, no bail outs will be forthcoming for distressed firms. This raises wider political questions about the stability of governments, the sharing of the social costs of economic restructuring and the capacity and capability of institutions to alleviate hardship.

**Poland as an exemplar of the restructuring process**

The rest of this chapter will focus on the Polish experience as an exemplar of the restructuring

process in Central and Eastern Europe (CEE). Poland was the very first CEE country to renounce communism and the central planning mechanism, in July 1989. It thus has the longest history of attempting to introduce comprehensive structural adjustment in CEE.[2]

Poland is one of the larger countries of the CEE/FSU region, with a population of over 38 million. Only the Ukraine and the Russian Federation are larger. Before 1989, it had a relatively well developed private sector which accounted for 18.8 per cent of GDP, mainly because most of agriculture remained in private ownership during the communist period. Agriculture constituted between 15 and 27 per cent of GDP in 1988 and remains relatively underdeveloped. Poland is also one of the poorer CEE economies with a per capita GNP in 1990 somewhere between $4089 and $5122, (see Table 3).[3]

In 1989, inflation had reached an annual rate of 640 per cent and government budgetary subsidies were the equivalent of 16 per cent of GDP, yet by 1993 inflation was down to an annual rate of 34 per cent and GDP registered growth of 1 per cent in 1992 and is projected to achieve 4.5 per cent growth in 1993. Industrial production contracted by 41.3 per cent between 1989 and 1992, about average for CEE economies during the period (see Tables 4 and 5 and Chart 1). In 1993, industrial production is projected to rise by 7 per cent.

Poland has a relatively large foreign debt representing 68.5 per cent of GNP, though somewhat better placed than Hungary at 77 per cent of GNP. Its debt service obligations as a proportion of export earnings are modest at 5.4 per cent in 1991 compared to Hungary's at 32.5 per cent of export earnings. Income distribution in 1989 was comparable to one of the Scandinavian countries. The wealthiest 20 per cent received 36.1 per cent of income.[4]

There are clearly considerable difficulties in assessing changes in the industrial structure and performance of Poland only four years after the government's historical decision to break with more than forty years as a centrally planned economy. The natural inclination of economists is to attribute all change to changes in relative prices but clearly this is inadequate. In any society, economic decision makers face a variety of historical, political and cultural factors which contribute to the available opportunity structures. All societies are to some extent 'path dependent': history exerts a powerful influence on current capabilities. Unlike foreign exchange rates or price controls, history can not be easily reversed.

Few would dispute that the scale and scope of the changes in the distribution of property rights and the structure of economic decision making implicit in the notion of transition from a predominantly state-owned centrally planned economy to a predominantly privately-owned market driven economy represents a radical disjuncture in the economic history of any CEE state. Yet the citizenry can still remember the old regime, its vicissitudes and its certainties. When the future is uncertain, nostalgia has a way of softening memories of the past.

While the originators of policy instruments may have radical agendas, this does not necessarily entail radical outcomes, especially when functionaries of the state charged with implementation are steeped in a different tradition. In any case, bureaucrats are likely to struggle for positional advantage within the new administrative structure, so that if the structure has not been simultaneously reformed to mesh with the new policy regime, policy execution may be slow and unpredictable. Nor does it necessarily mean that the populace is patient enough to wait for the longer term benefits of change to emerge. As the liberal governments of Lithuania, in October 1992, and of Poland, in September 1993, have discovered, the newly enfranchised electorate will only tolerate a certain level of economic and social change before voting for a different, apparently more gradual approach to economic management.

**The Polish Political and Economic Reform Programme**

Poland started its political reform programme, the necessary precursor to economic reform, before any of the other centrally planned economies, in February 1989, through 'round-table' negotiations between reformist communists in the government and the opposition leadership of the unofficial trade union movement Solidarity.[5] While the process could be considered to be a negotiated revolution from above, compared with the more overt influence of 'people power' in the other countries of CEE, most notably Czechoslovakia and Romania, there was undoubtedly considerable pressure on the Solidarity negotiators from below. After all, Solidarity had its origins in the mass popular discontent of 1980-81 that led up to the imposition of martial law from 1982-83. By 1989, the strikes of 1988 and general recognition of the failure of the government of General Jaruzelski to introduce marketisation by decree from above had already fatally damaged the legitimacy of communism in Poland.[6]

The round-table deal of February 1989 struck between the Solidarity team led by Lech Walesa and the communist team led by Mr. Kiszczak secured General Jaruzelski's election as the new state president and reserved 65 per cent of the seats in the Sejm (the dominant lower house of parliament) for the communist party. In the partially free election of June 1989, Solidarity Civic Committee candidates won all the seats they were allowed to contest. The communists accepted political defeat when their previous allies in the Peasant Alliance (ZSL) and Democratic Union (SD) parties swung round to support the appointment of Tadeusz Mazowiecki as Poland's first non-communist prime minister since 1939. In exchange, prominent communists were allowed to retain control of the Interior and Defence ministries for a year and an unwritten 'no victimisation' understanding was accepted. This was to last until the first fully free elections of October 1991.

The political space the various informal understandings created, and the threat of hyperinflation in late 1989, enabled Finance Minister Leszek Balcerowicz to introduce the 'shock therapy' of a stabilisation programme with virtually no opposition.[7] Reform of the state apparatus and the legal and regulatory infrastructure, by contrast, was left to follow much more gradualist and legal-constitutional procedures, sometimes much to the annoyance of radical reformers. This has meant any lack of strong recovery tendencies can be blamed on either the reform programme or institutional inertia depending on political convictions.

**The Polish Stabilisation Programme**

A new policy era began when the government of Mr. Mazowiecki implemented a radical economic reform programme immediately after assuming office in August 1989. The incoming government inherited a hybrid of a planned and a market economy, with many of the worst characteristics of each. The most immediate problem was acute stagflation: collapsing industrial output and inflation running at an annual rate of over 600 per cent. A number of emergency measures were introduced in the last quarter of 1989 as a form of 'shock therapy':[8]

* major price adjustments and dismantling of controls;

* accelerated tax payments and cuts in subsidies and expenditure to reduce the budgetary deficit;

* tighter enforcement of the allowable norm for wage increases. The norm was set at 80 per cent of the previous year's wage fund with a punitive tax of 100-200 per cent on increases in excess of the norm;

* strict credit restraint such that credit to the non-government sector fell in the second half of 1989 by almost two-thirds;

* accelerated depreciation of the official exchange rate to better reflect real purchasing power and inflation.

A full stabilisation programme - prepared with the advice of the IMF - was introduced from 1 January 1990. The longer term structural adjustment component was aimed at transforming the supply side of the economy. The short term objective was to bring inflation under control from almost 80 per cent per month in January 1990.

## Monetary and fiscal policy

With the abandonment of the central planning mechanism in 1989, there was an immediate danger of government revenues disappearing unless they were replaced with business taxes typical of a market economy. The old socialist financial system had two essential features that differentiated it from its capitalist counterpart. First, taxation was largely implicit and uncodefied and, second, the system of money and credit for enterprises was entirely passive.[9] The government gained (or lost) revenue via the price control system. Individuals had their incomes managed through the centrally controlled wage structure. Enterprise surpluses reverted to the state via turnover tax or as profit reversion.

Liberalisation meant that the authorities lost effective control of the enterprises' ability to bid for financial resources and of their investment behaviour. In particular, there was a serious risk of decapitalisation, for inevitably under conditions of rapid inflation, enterprise managements were subject to strong pressure from the workforce to increase wages regardless of profitability. Naturally, if a market-oriented system of corporate governance had been in place this risk would not have occurred. The lack of a reliable and active finance and banking sector made it impossible to rely on conventional instruments of monetary policy alone. Some direct controls were required to prevent wage inflation and a credit explosion.

Credit restrictions in the form of ceilings were imposed on government and enterprise borrowings from the National Bank of Poland (NBP), the central bank. As a first step in the process of creating a modern financial market, loan ceilings for individual banks were progressively abolished as interest rate management became the principle means for determining the volume and distribution of credit. Preferential rates for agricultural credit, exports and some investment were abolished from the beginning of 1990. In January 1990, the Warsaw inter-bank interest rate (WIBOR) was set by the NBP at 36 per cent per month, but by April 1990 had been reduced to 8 per cent per month though it still exceeded inflation by 5.7 per cent. This was probably the first time that positive real interest rates were charged to borrowers for more than forty years.

## Wages and prices

Prices were liberalised so that only 3 - 5 per cent of sales of consumer goods and services remained controlled. Subsidies were cut sharply and prices raised: coal by 600 per cent; and gas, heat and electricity by 400 percent, followed by another 100 per cent on 1 July 1990. Coal mines became free to set their own prices. Wages continued to be squeezed severely in the state-owned sector through excess payments taxes on state-owned enterprises paying above the government-set norm for wages and bonuses. The private sector was exempt from the incomes policy.

## Exchange rates and trade

The official exchange rate was devalued successively from Zl 1,800 per US dollar in September 1989 to Zl 9,500 per US dollar in January 1990, closing the gap between the grey and the official market and administrative rationing of foreign exchange to enterprises was abolished. The US dollar-zlotych exchange rate remained fixed at this rate until May 1991 when the NBP introduced a 'crawling peg' system of exchange

rate adjustment. Although enterprises were required to surrender convertible currency receipts to the National Bank of Poland, they also could buy convertible currencies from the NBP for most current transactions. Trade was liberalised. All quantitative restrictions were abolished on imports and a new unified customs tariff for personal and commercial importers was introduced.

Government budget

The target for 1990 was the achievement of broad budgetary balance through reduction of subsidies from 31 per cent of the 1989 budget to a maximum of 15 per cent in 1990; wage reductions in the civil service; squeezing defence expenditure; elimination of tax relief to enterprises thereby raising profit tax from around 30 per cent to 37 per cent and nearer to the nominal rate of 40 per cent. Offsetting these gains to the budget were a new 'social safety net' to protect the poorest and the unemployed, new funds for structural change and retraining and some increase in the real spending on health and education.

**Results of the Stabilisation Programme**

It has been argued that a distinction should be made between stabilisation of prices and exchange rates which it is claimed can be achieved fairly rapidly and the responses of the production structure, investment and ownership patterns.[10] All of the latter patterns tend to adjust extremely slowly even when there are very sharp changes in relative prices as has been the case in Poland since 1989. The fact that the effects of monetary and fiscal policy only appear after sometime is an important feature of the realities of policy making. This time lag is due to lack of synchronisation between financial processes and the production of goods and services. Moreover changes in the financial and banking systems are also constrained by the pace of reform of legislation and the capacity of personnel to operate the new regime.

Political impact

The particular mixture of liberal economics and gradualist institutional reform adopted by the Mazowiecki and Bielecki governments worked remarkably successfully until popular unrest began to emerge in the summer of 1991. As indicated above, the unrest was largely provoked by failure of longer term positive effects to come through in 1991. Mr. Walesa, now President, chose not to call an election until October 1991 by which time the opposition parties had developed a base. The net result was fragmentation of the political power structure and the return of twenty-seven different parties to the Sejm. This meant that there was subsequently more open political conflict over the pace and social cost of reform in Poland than in other countries such as Hungary and Bulgaria where less subtle means of introducing reform have to date been acceptable.

The basic framework of the Balcerowicz programme has remained the central plank of economic policy of all coalition governments since October 1991. Nevertheless, much of the electorate has remained sceptical of the benefits derived from the programme. Thus in the most recent general election of September 1993, the reformed communist party, the Democratic Left Alliance (SLD) won the largest share of the popular vote (20.6 per cent) and the Liberal Democratic Congress (KLD), the party most closely identified with the structural adjustment programme, was eliminated from the Sejm. Even so, the political leadership of the current coalition government made up of the SLD and the Peasant Party (PSL) led by Prime Minister Waldemar Pawlak of the PSL, continues to proclaim the irreversibility of the reform programme. In his opening speech to the Sejm on 8 November 1993, Mr. Pawlak promised to pursue policies supporting privatisation, free trade, and keeping the government's budget deficit within 5 per cent of GDP as agreed with the IMF by the previous government.

Price Inflation

The period of hyperinflation in 1989 and price liberalisation had the beneficial effect of virtually eliminating a large monetary overhang thereby reducing the government's debt service obligations to manageable proportions. Inflation declined very rapidly in the first half of 1990 from 80 per cent in January alone to 1.8 per cent per month in August. Progress since then in squeezing inflation down to acceptable levels has been less impressive (Chart 2). At the end of the first half of 1993 inflation was still unacceptably high at 34 per cent per annum but was projected to decline further to 26 per cent in 1994.

Wages

It is one of the paradoxes of most structural adjustment programmes that there is stress on the importance of price liberalisation but not of wages. This is at first sight surprising since most economists are reluctant to attempt suppressing market forces.[11] Introducing wage controls in a developed market economy is usually associated with exacerbating rigidities in the structure of wages, they are typically costly to administer, and in many cases are circumvented by powerful occupational groups. However, in an economy in transition there is a period between the abandonment of the central planning mechanism and the establishment of a hard budget constraint for state-owned enterprises when there is a real danger of rapid wage inflation fed by price increases, lower profits and tax revenues, and decapitalisation. In this interim period before market forces have become effective and financial discipline is provided by commercialisation and privatisation, managers have few incentives to protect the profitability or capital stock of state-owned enterprises. Any benefits from wage stringency go to the state treasury or the new owners upon privatisation.

Controls were introduced in 1990 through monthly indexation of state-owned enterprises' wage bills. This was altered to indexation of the average wage in 1991. The target for wages in 1990, which was met, was designed to achieve a reduction in the wage bill of 30 per cent. The wage ceiling was imposed through a system of punitive taxes on enterprises that broke the norm. For example, if the wage bill went above the norm by no more than 3 per cent, the enterprise faced a 100 per cent tax surcharge on the additional payments. Payments more than 5 per cent above the norm attracted a tax surcharge set at 500 per cent.

The private sector was exempted from wage controls. Firms were generally smaller therefore administrative costs of controls would have been relatively high. Many were owner-managed so it was assumed management would be unlikely to grant excessive wage increases. The decision to discriminate in favour of private firms was also a radical departure from the previous regime's bias in policy instruments against the private sector.

By February 1990, wages in the five main sectors - industry, construction transport, communications and trade - were less than half of their August 1989 level. Wage controls were quite successful until mid-1990 when wages climbed quite steeply above the programme ceilings. What happened was that tax penalties became largely irrelevant as firms simply failed to pay. Many firms were by then making losses on a before-tax basis and decapitalisation became widespread. The more managers (and workers) of individual firms thought that their firms would go bankrupt the stronger the incentive to pay increased wages and +efault on tax payments confident that they would never be collected once the enterprise collapsed. By December 1991, real wages had risen by 15 per cent but were on average still more than 30 per cent lower than December 1989 (Chart 3).

The moderation of wage increases in the early stages of the reform programme may plausibly be explained in term of the stringency of a range of macroeconomic policies, not just wage controls but also tight credit controls. Nevertheless, the threat of tax penalties on inflationary wage payments certainly had considerable rhetorical value at the beginning of the stabilisation programme when nobody had worked out the weaknesses in the new policy regime. Wage controls are at best a temporary measure, in the Polish case, to fill the gap between the abolition of the central planning mechanism and the introduction of the discipline of market forces for enterprise management. They do not tackle more fundamental issues related to the

competence and objectives of top management of state-owned enterprises and the root cause of the problem - lax financial discipline.

## The budget deficit

A dominant factor in macroeconomic policy management since 1989 has remained the government's budget deficit rather than the balance of payments. The government's management of the budget was initially much better than expected. A surplus in the budget appeared in 1990 for the first time for ten years (3.5 per cent of GDP). By 1992 the situation had deteriorated to -7.0 per cent of GDP partly reflecting the sharp decline in output and therefore of the government's revenue base, (see Chart 4). The IMF agreement of March 1993 imposed a ceiling of 5.5 per cent of GDP on the budget deficit. Indeed Hana Suchocka's coalition government collapsed in May 1993 as a result of its unwillingness to compromise with opposition groups demanding substantial pay increases for public employees.[12] It remains to be seen whether the outcome of the September 1993 election will weaken the new government's determination to stay within the IMF ceiling.

The government's freedom of action on the budget remains severely limited by social security costs and by debt service obligations inherited from previous communist regimes. In 1992, social security payments absorbed 19 per cent of the budget and debt service 8 per cent. Official projections for the 1993 budget envisage 21.7 per cent for social security and 15.4 per cent for debt servicing obligations (12.2 per cent domestic and 3.2 per cent foreign). No less than 37.1 per cent of the 1993 budget is accounted for by 'fixed' commitments. As many as 40 per cent of voters in Poland are said to be state pensioners so that the political pressure to expand rather than contract the 'fixed' element of the budget is not trivial.

In addition, the shift from an enterprise-based system of taxation to a more complex system of indirect taxation has reduced government revenues from 35 per cent of GDP in 1989-90 to 27 per cent projected for 1993. Clearly the capacity of the government to fund major industrial restructuring programmes is very limited without external support. The situation should improve as the tax reforms begin to bite and enterprise profitability recovers with increased capacity utilisation. However, in the short to medium term the Polish government must attract new capital to help fund necessary investment in infrastructure and productive capacity if the reform programme is to be sustained.

At present, Poland is paying only reduced interest on its Paris Club debt but in 1994 it will have to pay full interest and in 1995 will have to resume capital repayment of around $2 bn annually in addition to between $500 m and $600 m in interest payments on official debt of $33 bn. Poland also has outstanding debts to commercial banks of $12.1 bn which are currently not being serviced. Negotiations with the London Club failed to reach agreement on the Polish government's proposal for a 50 per cent reduction in debt in June 1993. Only Latin American terms of 35 per cent debt reduction were offered. Settlement with the London Club is important for two reasons. First, the 50 per cent reduction in official debt is conditional on an agreement with the London Club. Second, and perhaps more importantly, as the world moves towards a low interest regime the additional credit risk premium Poland pays of 4 per cent or more can now be higher than the base rate itself, hardly an encouragement to badly needed foreign investment.

Government expenditure in 1993 and for the foreseeable future is thus severely constrained by existing commitments. Very little is likely to be available for new development expenditure without foreign assistance and debt relief. Unless output, sales and corporate profitability rebound quickly and rather strongly, or politically acceptable new taxes are imposed, successive Polish governments face the prospect of a permanent budget deficit.

## Taxes

Before the reform programme, the proportion of GDP accounted for by taxation was relatively high for a middle income economy at around 45-50 per cent of GDP. Enterprises were the main source of government revenue. Almost 80 per cent of the total tax revenue in Poland in the pre-reform years came from turnover and enterprise income taxes. Most was derived from large state-owned enterprises. Moreover, the application of the taxes was highly discretionary so that enterprises in financial difficulty could seek tax relief. Wages and salaries were kept low - 4 per cent of GDP in 1989 - while subsidies to consumers, producers and exporters totalled no less than 16 per cent of GDP in 1989. Capital expenditures by the government were low - 3 per cent of GDP - because state-owned enterprises were the main investors not only in productive capacity but providers of such social welfare as schools and medical and recreation facilities. Their share of investment was 80 per cent (20 per cent of GDP).

Consumer and producer subsidies have declined dramatically from 16 per cent of GDP in 1988 to 5 per cent in 1991 and 4 per cent in 1992. The only remaining significant subsidies are for housing finance and residential construction. In 1993, subsidies are estimated to have fallen to around 1 per cent of GDP. Although the cut in subsidies may account for a saving of anything up to 15 per cent of GDP on the expenditure side, additional safety net expenditures and unemployment benefits are likely to be required as labour shedding deepens. On the revenue side of the budget, there has been a sharp fall in profit tax receipts, partly as a result of the sharp drop in output but also as a temporary result of the changeover to a progressive income and value-added tax regime.

Until 1992, it was the sole responsibility of firms to file tax returns. This was one of the times when enterprise management were able to bargain with the state authorities over their tax take and its relationship with the resources necessary to meet plan targets. The introduction of a global personal income tax on 1 January 1992 with a top marginal rate of 40 per cent and a standard rate value-added tax (VAT) of 22 per cent in July 1993, finally broke the complex system of discretionary taxation that accounted for a large part of the soft budget constraint of the old system. An enterprise income or corporation tax rate was also set at 40 per cent in line with the EC norm.[13] Furthermore, excise duties were simplified and restricted to a uniform rate on a limited number of items principally petroleum fuels, tobacco and alcohol. Some discretionary tax preferences remain on such items as imported capital equipment and materials for particular projects approved by the government.

Poland now has a progressive taxation system in place which spreads the tax burden throughout the economy including the service sector and the possibilities of tax avoidance have been substantially reduced.[14] Collection is centralised and is now completely divorced from the relationship between a state-owned enterprise has with its supervisory ministry.

Clearly it will take time to develop the tax assessment and collection system and there will be a continuing requirement for technical assistance with managing a taxation system that facilitates the development of a market economy. In the meantime it will be difficult for the government to predict tax revenue with any great accuracy thus adding further uncertainty to the budget management task.

Trade

The redirection of CEE trade towards Western Europe has been impressive.[15] The pessimists who proclaimed that CEE products would never find buyers in competitive world markets have been proved wrong. Exports from CEE to the OECD have grown at a rate of 17 per cent p.a. between 1989 and 1992 while import demand has expanded by 27 per cent annually. Prices have clearly been kept competitive following the deep devaluations introduced at the outset of the reforms and downward pressure on wages from weak domestic demand.

General protectionist sentiments against trade with CEE are also misplaced. CEE has moved from a

modest trade surplus in 1989 of $1 bn to a deficit of $3.6 bn with the EC in 1992, and a surplus of $2 bn to a deficit of over $10 bn with all OECD countries during the same period. Clearly the rest of the world's trade balance has benefited from the liberalisation of markets in the CEE. Trade with the EC has expanded rapidly since 1989. Overall, CEE exports to the EC grew by an average of 22 per cent between 1990 and 1992, while Poland managed to expand its exports at 28 per cent p.a. Imports into the region grew by over 30 per cent p.a. while Poland's expanded at nearly 35 per cent p.a., (see Tables 6 and 7)

A new post-1989 handicap Polish firms exporting to the West face is the absence of export credits and state guarantees.[16] On average 90 per cent of world trade payments are made on the basis of settlement within three months, while only five to six per cent of Polish export trade payments are made on this basis. Immediate cash payments are currently demanded on over 90 per cent of Polish exports which reflects both the chronic cash flow problems of exporters and the lack of willingness of the banks to fund trade credits at affordable prices. In the markets of the FSU, conditions are even less favourable. Hyperinflation. lack of convertibility of the rouble and a lack of foreign exchange at the enterprise level makes trade very difficult. The authorities also prohibit countertrade on 80 per cent of the goods Poland is intersted in (oil and gas). Intergovernmental agreements to swap food and medicines for oil and gas have proved ineffective in practice. The fundamental problem inhibiting trade recovery with the republics of the FSU, is the absence of a secure payments system between them and Poland.

In spite of the surplus in favour of EC countries, there has been significant trade friction in the so-called sensitive sectors - steel, textiles, coal, chemicals and agricultural products - which constitute around 40 per cent of exports from the Visegrad countries.[17] The countries of the CEE region point out that a $1 bn increase in their exports to the EC adds 25 per cent to their total exports, but only 0.2 per cent to total EC imports. The problem, of course, lies with specific products.

Protectionist sentiment is unfortunately also beginning to creep back into the CEE countries themselves as governments struggle with their budget deficits and balance of payments constraints. For example, the recession in Europe appears to be damaging Poland's export performance in 1993 - exports declined by 8 per cent to $3.04 bn in the first quarter of 1993 and imports rose by 16.5 per cent to $3.41 bn.[18] It remains to be seen how long a current account deficit of this size is sustainable, (see Chart 5). Not surprisingly there have been calls from some domestic producers to restrict imports to raw materials, intermediates and capital goods.

Output and employment

Despite the relatively optimistic trade performance of CEE described above, possibly the most critical and debated feature of the reform programme in Poland, as in all CEE countries, has been the sharp fall in recorded national output.[19] Industrial production fell in 1990 on average by 22 per cent compared with the year earlier, by 17 per cent in 1991 and by 10 per cent in 1992. By contrast, using January-to-August 1993 figures, industrial production is projected to rise by 7 per cent in 1993 on 1992.

Unemployment has risen steadily from 6.1 per cent in 1990 to 14.0 per cent in 1992 and is expected to exceed 16 per cent by the end of 1993. Even at this worrying level, it still lags far behind the fall in output suggesting some labour hoarding still persists. While unemployment has been rising, aggregate output has begun to slowly recover from a much reduced baseline, (see Chart 6). In April 1992, Poland recorded its first increase in output on a year earlier and was the first CEE country to record growth in GDP of 1.0 per cent in 1992. The outlook for the rest of the CEE remains bleak. It has been the buoyancy of private industry which recorded a 32 per cent increase in output in 1992 (bringing its share of industrial production to a third of the total) that has made Poland the exception to the rule.[20]

**Why the Decline in Output?**

Four different explanations for the large declines in output recorded in the CEE in the immediate post-reform period of 1989-92 have been given.[21] The first explanation is the notion that the CEE has been subjected to a structural shock similar to that administered to the industrial sector in the West following the second oil price hike in 1979. Some have rejected this theory on the grounds that the effect should be sector specific but output falls were recorded in even the most efficient industries and labour productivity and profitability remain remarkably uniform. Price liberalisation has not resulted in any discernible reallocation of resources to the most efficient industries. However, given the very severe data limitations noted above and the very short time series involved it may be too early to reject this hypothesis out of hand.

The second explanation traces the fall in output to the effect of the severe disruption of export demand following German unification in 1990 and the dollarisation of CMEA trade in January 1991. For example, it has been estimated that the loss of trade to the former Soviet Union alone can account for all the loss of income in Hungary in 1991 and 1992 and almost all of the loss in Czechoslovakia and up to a third of the income loss in Poland.[22] Certainly the collapse of trade within the CMEA was dramatic. For example, Poland lost 36 per cent of its exports to CMEA countries during this period 1991-92. By 1993, CMEA trade had been reduced from over half of the total trade of the region in 1989 to only 20 per cent (see Table 8). However, some commentators also seek to account for most of the fall in Polish output in terms of a sharp reduction in domestic consumer demand caused by the large fall in real wages and the rapid increase in competition as a result of the liberalisation of imports from January 1990.[23] Undoubtedly there was a strong repressed demand for Western goods in all the countries of the CEE prior to the beginning of the reform programmes. Despite the dramatic fall in domestic demand, medium levels of inflation (20-50 per cent p.a.) are remarkably resilient in Poland as elsewhere in the CEE apart from the Czech Republic.

The third explanation for the collapse in output is the 'credit crunch' hypothesis.[24] The output collapse in the CEE is a function of the underdeveloped state of the region's credit markets. The proponents of this arguement claim that at least 20 per cent of the output decline in Poland in the first quarter of the stabilisation programme can be attributed to the initial contraction of credit. This 'trade implosion' is created by a situation in which trade is destroyed for lack of market institutions, the key market being the credit market.

At the start of the reform programme, enterprises held few liquid assets since under the planning mechanism they could rely on a stream of short term bank credit to finance their operations. Almost overnight, a high interest rate regime was introduced by the central bank together with strict credit ceilings on enterprise borrowings in order to control the growth of the money supply and the threat of hyperinflation: perfectly reasonable objectives if the banks had been fully developed as active financial intermediaries. Unfortunately the net result was that the entire Polish industrial system was subject to an indiscriminate credit crunch. Faced with no credit or only credit at a prohibitive cost, firms sold off inventory, closed production capacity, cut wages and tried to force suppliers to provide trade credit.

Within a short time inter-firm credit chains were spreading everywhere threatening the stability of whole industries, for if the banks had been active in pursuing bad debts large parts of Polish industry could have been dragged down into a bankruptcy spiral.[25] But, firms were allowed to defer payment obligations and banks, in turn, were able to pile up non-perfoming loans without Central Bank regulators intervening to enforce capital adequacy ratios and bad debt provisions. In other words, despite the credit crunch, a soft budget 'constraint' was allowed to operate selectively, whereby the authorities chose not to enforce a sufficiently systematic and tight credit policy on large state-owned enterprises to ensure efficient restructuring. Presumably this was because the political and social costs were considered to be too large to countenance. At the margins, a few weak and politically inconsequential enterprises were allowed to go into liquidation but the vast majority were allowed to adopt a wait-and-see-attitude in the short to medium term.

A fourth explanation for the drop in output without large-scale bankruptcies and industrial restructuring in CEE is the persistence of what have been refered to as 'budget softness and hard habits'.[26] The management of state-owned enterprises, instead of struggling to introduce efficiency enhancing measures, engaged in what they know best: maximising their chances of immediate survival in the prevailing circumstances of legal and regulatory confusion. Thus the majority that survived the initial imposition of a credit squeeze, coped by searching for softness in the credit system. They leveraged inter-enterprise credits and stopped servicing loans from state banks or paying taxes to the state treasury. State enterprises were able to behave this way because of the continuing passivity of banks and the general belief that at some future date the government would organise a bail-out. In effect, governments have continued to fund state enterprises through the national budget and the banking system, albeit on a reduced scale in comparison to the pre-reform command economy.

In the case of Poland, the rapid expansion of supplier credits was quickly brought under control as enterprise managements were made painfully aware of the seriousness of the authorities attentions in introducing a credit squeeze. Thus, in 1990-91, suppplier credits represented approximately 35 per cent of state enterprise debt, but had dropped to less than 12 per cent by 1992-93. Banks also have managed to substantially reduce their balance sheet exposure to state enterprise debt, from close to 30 per cent of all state enterprise debt in 1990-91, to less than 12 per cent in 1992-93. The debt has not evaporated, however, it has been transferred to the state budget.

The budgetary sector share of total state enterprise debt has risen from the 30 per cent range in 1990-91, to 65 per cent in 1992-93.[27] In order to engineer this shift in debt, banks have dramatically cut credits available to state-owned enterprises, from Zl147.2 trillion to Zl117.7 trillion between 1991 and 1992, a real drop of 28 per cent. In an economy in which there is obvious demand for investment to retool and modernise virtually all state-owned enterprises, this sharp decline in allocation of credit to enterprises implies a serious and potentially damaging withdrawal of the banking industry from the role of intermediary between investors and the business sector.

What has happened is that the political leadership in the CEE/FSU countries has been generally unwilling to force through radical restructuring of large state-owned enterprises through full application of a hard credit crunch. Managers of enterprises have recognised this weakness in the system and have exploited their connections as much as possible in order to secure their short-term survival.[28] The net result, at least in Poland, is that state-owned enterprises now find themselves dangerously underfinanced just at the moment when their need for new restructuring and privatisation investment is most pressing.

**Endnotes**

1. Lipton, D and Sachs, J (1990) 'Creating a Market Economy in Central Europe: The Case of Poland', Brookings Papers on Economic Activity, No 1, pp. 75-147.

2. Of course, many other developing countries attempted to institute structural adjustment programmes under the aegis of the IMF and World Bank in the 1980s.

3. Many of the statistics for CEE economies prior to the move to a market-based economy are unreliable and need to be interpreted with extreme caution. See for example, Lancieri, E (1993) 'Dollar Estimates for the Central and East European Economies - 1970-90', World Development, Vol 21, 1 pp 161-175, for examples of some of the definitional problems and difficulties involved in estimating basic economic parameters in CEE.

4. There will need to be a substantial redistribution of income in Poland if inequality is to match Latin American standards. For example, in Brazil, the wealthiest 20 per cent's share of income was 67.5 per cent in 1989 and in Mexico their share was 55.9 per cent.

5. Solidarity began life as an unofficial trade union movement in the 1970s campaigning for improved working conditions. Its strength lay mostly in heavy industry and it was organised in opposition to the official communist trade unions. Solidarity came to international prominence in 1980-81 in a confrontation with the government which eventually led to the imposition of martial law in December 1981. By daring to challenge communist rule, Solidarity succeeded in transforming iteself into a mass opposition movement attracting support from a wide spectrum of interest groups not just industrial workers.

6. Sanford, G (1993) 'Delay and Disappointment: The Fully Free Polish Election of 27 October 1991' Journal of Communist Studies, Vol 9, 2, pp 107-118.

7. No doubt the collapse of communism elsewhere in Eastern Europe in the autumn of 1989 also demoralised any remaining opposition.

8. The early period of the stabilisation programme is comprehensively summarised in UNIDO (1991) Poland: Managing the Transition to a Market Economy, Oxford: Blackwell for UNIDO's Industrial Development Review Series.

9. Mckinnon, R I (1991) 'Financial Control in the Transition from Classical Socialism to a Market Economy', Journal of Economic Perspectives, Vol 5, 1, pp 107-122.

10. Bruno, M (1992) 'Stabilisation and Reform in Eastern Europe - A Preliminary Evaluation', IMF Staff Papers Vol 39, 4, pp 741-777.

11. Coricelli, F and Lane, T D (1993) 'Wage Controls during the Transition from Central Planning to a Market Economy', World Bank Research Observer, Vol 28, 2, pp 195-210.

12. Ms Suchocka (Democratic Union) formed a seven-party coalition government in July 1992. The Suchocka coalition included such ideologically disparate groups as the three pro-market parties of the Democratic Union, the Liberal Democratic Congress and the Polish Economic Programme together with four Catholic and agrarian parties.

13. Strictly speaking corporation tax should be unnecessary but in practice it is necessary to prevent richer private citizens from trying to register as corporate bodies to avoid personal income tax liability!

14. Value added tax has the advantage of being quicker to collect and is less easy to avoid than a sales tax since each enterprise in the value added chain, apart from the last, has a vested interest in declaring the tax liability of the previous link.

15. AMEX (1993) 'Central and East Europe: Myths and Realities', AMEX Bank Review, Vol 20, 6, (19 July) pp 1-7.

16. Before 1989, when all export trade was handled by foreign trade organizations (FTOs), producers did not have to worry about export guarantees (or the profitability of export deals) since they were automatically provided for by the state budget through the operations of the FTOs. Poland used to be a leading supplier of turn-key industrial plants to developing countries for cement and basic chemicals manufacturing and sugar processing. These projects typically required concessionary finance and two- to three-year credit lines but today the government cannot afford them and the contractors are going out of business.

17. Poland, Czech Republic, Slovakia and Hungary.

18. The import statistics are partly distorted by grain imports of 7m tonnes needed to compensate for the effects of the 1992 drought on domestic output which fell to 20m tonnes.

19. The statistical problems in this area are immense due to underreporting of private activities and the omission of services in the computation of net material product under the socialist accounting system. Hence the fall in GDP may be overstated by several percentage points.

20. It is likely that this increase in private sector activity is overstated as much private activity before 1990 was unrecorded to avoid punitive taxes. The introduction of VAT in July 1993 with time should begin to rectify the situation.

21. Raiser, M (1993) 'Old Habits Die Hard - A Note on the Nature of the Crisis in Central Eastern Europe', Intereconomics July/August, pp 170-177.

22. Rodrik, D (1993) 'Making Sense of the Soviet Trade Shock in Eastern Europe in Transition: From Recession to Growth?' World Bank Discussion Paper No 196.

23. Brada, J and King, A (1992) 'Is There a J-Curve for the Economic Transition from Socialism to Capitalism?', Economics of Planning, Vol 25, pp 37-53.

24. Calvo, G A and Coricelli, F (1993) 'Output Collapse in Eastern Europe: The Role of Credit', IMF Staff Papers, Vol 40, 1, pp 32-52.

25. Begg, D and Portes, R (1993) 'Enterprise Debt and Financial Restructuring in Central and Eastern Europe', European Economic Review, Vol 37, pp 396-407.

26. Raiser, M (1993) "Old habits Die Hard- A Note on the Nature of the Crisis in Central and Eastern Europe", Intereconomics, July/August, pp. 170-177.

27. According to Begg and Portes' estimate, the total budgetary cost of servicing state-owned enterprise loans was around 2-3 per cent of Polish GDP in 1991.

28. A recent and impressive confirmation of the persistance of the old system in Poland has been the success of several top managers of state enterprises running as members of the post-communist SLD party in the September 1993 general election.

## Chapter 3
## A Framework for the Long Term Structural Change of Industry

### Introduction

Macro-economic reforms in the CEE/FSU region have not, and are not likely to lead to the necessary supply response to ensure the successful transformation of the region's economies. None of the several factors described in the previous chapter as reasons for the collapse of output across the region are in and of themselves a sufficient explanation for what has occurred. In fact, they have acted as a mask for more fundamental problems inherent to the region: micro-level rigidities and structural imbalances, particularly inefficiencies at the enterprise level which have resulted in an anemic supply response to the incentives that should have been induced by macro-
economic reforms.

It is now clear that macroeconomic reforms can do little for the inadequacies of industrial structure and performance so characteristic of the command economies: the lack of an entrepreneurial cadre and thriving private sector, inadequate technology, a lack of managerial and supervisory personnel, and a shortage of financial institutions to ensure the proper monitoring of enterprise performance. They do little to ensure that accounting and financial management, marketing, quality control and management information systems are adequate. These are the real impediments to the economic development of the countries of the region. Clearly focused micro level industrial policy closely coordinated with macroeconomic reforms will be needed to attack the structural weaknesses at industry and enterprise level. Without such coordination, the risk arises of throwing even the best enterprises into bankruptcy and causing severe economic disruptions.

The countries of the region need to develop economic governance. They need to build institutions to support market reforms and to nurture a civic culture that rejects the trading of influence, bribery and corruption. This is the most difficult task they will have to do and will take the longest time. It must include a well developed legal and regulatory infrastructure which ensures that contracts between economic agents are based on credible commitments in order for a market economy to function efficiently. Anyone breaking a contract and causing material damage must be punished in a cost effective manner in order to deter others contemplating breaking their contractual obligations. Sanctions are required thus not as the normal motive for obedience but to provide a guarantee to those who voluntarily abide by their obligations that they will not lose out to those do not.[1] Moreover there is a need to encourage a long term view of business relations so that investors have time to realise the benefits of their investments. This also means restraining the predatory tendencies of a determined minority be they government agents or private individuals.

A government may permit a capitalist market to develop within its borders, but that market will not flourish unless legal institutions secure, define and adjudicate property rights and provide for the enforceability of contracts. These institutions are essential in order to protect the material incentives available to a country's citizens, to motivate them to work to the best of their abilities, to engage in trade, and to save and invest for the future in productive capacity.

Also essential to the efficient functioning of a market economy is a well developed financial sector that acts as an intermediary between investors and the business sector. Such a system has been grossly lacking in the CEE/FSU region where banks functioned primarily as channels for state funds and accounting units. The idea of a money market was alien until reforms began and banks were not responsible for making evaluations of creditworthiness.

Finally, it is important to the success of the region's transformation that it begins to deliver as much as possible as quickly as possible in order to retain public support and keep on track. To accomplish this it is important industrial restructuring be addressed directly. Macroeconomic reforms are not enough in and of themselves to achieve the desired reallocation of resources away from inefficient industries and towards profitable ones. It is vitally important given the serious budget constraints facing the region, that these policies and efforts do not encourage waste and duplication. Thus, a comprehensive industrial strategy should be developed which considers a given country's current weaknesses and strengths, together with its potential and the socioeconomic consequences of industrial restructuring for the population at large and individual sections within it.

**Legal and regulatory infrastructure for industrial restructuring**

There are a number of key elements in the legal and regulatory infrastructure needed to support the introduction of a market economy.[2] The first and basic element is an efficient constitutional mechanism for establishing the rules of conduct of the economic system - the rules by which rules are made. This requires a constitution that defines the degree of centralisation, those interests that have access to the policy-making process and the way in which consensus is achieved on policy. Like so many other aspects of the transition process, constitutional reform has high start up costs but should increase economic growth in the medium term. It is, of course, still too early to evaluate the economic impact of constitutional reforms introduced from 1990 onwards in the CEE region. The message is clear enough - patience with the teething problems of democratic pluralism will payoff eventually. The alternative is loss of fiscal legitimacy and a descent into spiralling budget deficits, corruption and capital flight

In the economic sphere, of more immediate interest to businessmen and financiers, however, is the construction of the legal and regulatory infrastructure rather than the necessary process that leads to its creation. As a basic minimum it should provide every market economy with security of private property (particularly important with regard to the financial sector as described below); enforcement of contracts; assignment of liability for wrongful damage. Without clearly defined and defensible property rights there can be no incentive for economic activity. Governments must be powerful enough to be able to enforce private property rights yet be willing to be restrained by the judiciary to respect those rights. Predatory officials can be as much a threat to property rights as private individuals. A system of property rights is economically efficient if these rights are universal, exclusive and transferable. The contribution of the judiciary hinges on the efficiency and transparency of enforcement of property rights and the settlement of disputes. The capstone to a market-oriented legal infrastructure is a commercial code, competition and anti-monopoly laws, and company and bankruptcy laws.

The absence of an operational, transparent and credible set of rules of the game defining property rights, makes the transition to an efficient market economy impossible. It does not matter how brilliant economic policy prescriptions are, at the end of the day, it is the efficiency of the implementation process that matters. Without an effective regulatory framework in place, powerful interest groups will seek endless concessions for monopolistic privileges from the state which will eventually drown the lofty ideals of a free and vibrant market in a morass of corruption. Old habits of the command economy will reassert themselves in a new and virulent form, uninhibited by fear of the economic police who used to control the wilder excesses of the communist system.[3] Communism will simply have been privatised into a state-sponsored system of 'crony capitalism' such as that seen in Peru.[4] In the typical CEE/FSU country, as elsewhere, there is undoubtedly a fierce struggle going on between those promoting rent-seeking coalitions and those who wish to promote an efficient and competitive open market.

Unfortunately the design, negotiation and implementation of a fully operational legal and regulatory infrastructure takes time and makes heavy demands on the scarce human resources of the state apparatus. Assuming that a viable coalition can be sustained long enough in government to design the necessary laws, the limitations of the administrative capabilities of CEE/FSU countries are severe. A top echelon inexperienced in managing a civil service geared to the needs of a market economy and the steady erosion of talent by recruitment to the private sector are the two most obvious constraints on institutional reform.

In Poland, the government has established agencies for developing and implementing anti-monopoly legislation, privatisation, and promoting inward foreign investment with varying degrees of success. Each agency has been constrained by the protracted legislative process required to develop the necessary legal and regulatory instruments and by the lack of experienced personnel. Technical assistance programmes have only partially compensated for the lack of professional expertise. Starting de novo, all personnel are on a steep learning curve: Polish professionals may be familiar with the previous regime but have very limited knowledge of the legal and regulatory infrastructure of a modern market economy; expatriate advisers have very little knowledge of the detailed workings of the Polish bureaucracy. Often situations in which officials have had insufficient experience and foreign advisers have had inappropriate experience of the problems being dealt with have led to the now common complaint that officials seem too passive and are unable to arbitrate between the sometimes conflicting advice proffered by so-called foreign experts. Expatriate advisers, in turn, are criticised for producing erudite analytical reports but without provision for implementation. Both locals and foreigners, of course, all too often lack the specific operational skills required to turn analysis into action.

Working practices, case law, and that most important of all commodities, credibility, can only be developed slowly. Inevitably mistakes have and will be made. Since one of the principle objectives of industrial restructuring is to enhance the adaptability and flexibility of enterprises, it is important that the introduction and development of a new legal and regulatory infrastructure is carried out in a sensitive and flexible manner. However, policy invariably evolves in increments and mistakes are difficult to wipe out. For example, in the Czech Republic the government was eager to dispose of the state tobacco monopoly as a way of raising revenue and of boosting its privatisation programme, but in its haste it ignored competition policy. Today the government faces the difficult task of unravelling a foreign-owned private monopoly without offending the investment community.

In Poland, one of the main tasks of the Anti-Monopoly Office is to supervise the division of dominant, usually vertically integrated, state-owned enterprises.[5] In practice, it is very hard to define a proper balance between a more competitive structure and possible loss of advantages of scale and scope. Each example has to be evaluated on a case-by-case basis, yet the Office is expected to cover the whole of Poland with less than 80 professionals with no experience in the field prior to 1989. Thus, one professional is responsible for supervising the liberalisation of the telephone monopoly, while in the United Kingdom, Oftel employs a staff

of 300 solely concerned with monitoring the telecommunications industry.

Fortunately, in Poland liberalisation of imports has dissolved the previously dominant position of many state-owned monopolies so that the work load of the Anti-Monopoly Office has not been as onerous in many sectors as once expected. At the same time, politicians and other commentators complain that the structural transformation of large enterprises is taking place too slowly. Competition means more difficulties for enterprises. In a situation in which many state-owned enterprises are in a seriously weakened condition and are frequently facing bankruptcy, the enforcement of a strict anti-trust policy is not practical.

The most important implication of the experience of the Polish Anti-Monopoly Office is that an effective and efficient legal and regulatory infrastructure cannot be created in one 'big bang'. The economic transformation process in Poland is unique. The experience and lessons from Western market economies can be a useful guide to policy development, but no one has detailed knowledge of implementation in the Polish context. This knowledge has to be accumulated piecemeal through experimentation and in interaction with economic decision makers. Well thought out and timely advice delivered at the highest levels to those responsible for enterprise restructuring, tariffs, and import and price controls, is more important in minimising the accumulation of policy errors leading to loss of economic efficiency than resorting to reactive legislation and litigation. Litigation is always time consuming, intensive in the use of scarce professional resources and decisions are ultimately based on legal criteria rather than considerations of economic efficiency.

**Financial sector reform**

Undoubtedly the most unfamiliar aspects of a market economy for those used to a centrally planned economy is the financial system. The notion of a money market was previously unknown. Banks served as channels for state funds and as accounting units. They were not responsible for assessing creditworthiness and there was no necessity to establish sophisticated trading linkages with other banks. There was no bad-debt problem of any consequence: credits to state-owned enterprises were automatically generated when required by firms to meet the production targets set by the central plan. If the amount of the loan was insufficient, enterprise management negotiated for an addition with the relevant functional ministry. If the negotiations were successful the state bank would be instructed to release the new credit.

The first major reform to the Polish banking system was instituted in 1989 when the National Bank of Poland was split along geographic lines into nine 'commercial' banks based in the major industrial centres of Poland. There is currently a two-tier structure of state-owned banks, with a central bank, four specialised banks and eight state-owned commercial banks. These co-exist with two privatised banks, 80 newly registered private banks and 1650 private cooperative banks mainly offering services to private agriculture. Many of these cooperative banks are affiliated with the state-owned Bank of Food Economy (BFE), and to this extent are not fully private. The eight commercial state-owned banks are joint stock companies wholly-owned by the State Treasury. While ultimate ownership is unchanged, the transformation into joint stock companies is a significant step towards full privatisation.[6]

While the banking sector is mixed, the state-owned banks retain by far the dominant share. Thus, state-owned banks account for almost 80 per cent of the total banking system. In addition, the four specialised banks: Powszechna Kasa Oszczednosci-Bank Panstwowy (PKO BP), the country's largest savings bank; Bank Handlowy w Warszawie (Bank for Foreign Trade); Polski Bank Rozwoju (Polish Development Bank); and Bank Gospodarki (Bank for Food Economy) which specializes in lending to the agriculrural and food processing sectors, together account for half of the total assets. In short, the contribution of the new private banks to overall resource flows is quite modest.[7]

The National Bank of Poland continues in its role as the country's central bank, clearing house and banking regulatory authority. It is relatively independent of political influence as is the Bundesbank in Germany, for example. The 1989 Banking Act permits all banks to engage in what has come to be known as 'universal banking'. This means that Polish banks, in addition to the usual commercial and private banking activities, can trade in domestic and foreign securities and underwrite and issue securities. They are not, however, permitted to give investment advice to clients. The deposits of all banks, except private banks, are still fully guaranteed by the government. Even when the first commercial bank, Wielkopolski Bank Kredytowy (WBK), was privatised in July 1993, it retained the full backing of the government for its deposits. Not surprisingly, other private banks have protested, claiming unfair competition. The government will probably keep the guarantee in place until all the other state-owned banks are privatised to avert the threat of a run on the deposits of a bank undergoing privatisation.

**Banks and industrial restructuring**

In market economies, banks traditionally play a pivotal role in the restructuring process through their intimate knowledge of the intricacies of corporate finance. Working with the management, banks introduce financial instruments necessary to support expenditures compatible with the needs of the enterprise. By contrast, under the system of central planning, banks were entirely passive so today they lack experience of commercial project appraisal techniques. Perhaps more damaging, the central planning mechanism discouraged the development of a banking culture that emphasised working with and assisting enterprises. Indeed, enterprises themselves were hardly willing to cooperate with banks. The communist party command and reporting structure tended to foster a 'cloak and dagger' attitude towards giving and sharing information with outside bodies.

The consequences of previous policies are vividly seen today when Polish enterprises seek financial assistance from their banking partners. Instead of becoming actively involved, many banks and financial institutions remain aloof, often unaware of an enterprise's needs and are hence unwilling (and unable) to play an active role in addressing real commercial problems. An active role often requires daily involvement and certainly continuous review of a company's financial performance during the turnaround phase. Regrettably, Polish banks too often seem to see their role more as a judge who periodically reviews the progress made by firms but almost never gets engaged or tough as an active partner would. With few institutions to turn to for assistance, restructuring enterprises are usually forced to return to their founding bodies or the State Treasury. Thus, at the critical moment in enterprise restructuring when hard decisions have to be made, the role of financial institutions becomes trivial.

It is demoralising for managers working in state enterprises to find that the owner, the Polish government, is unable to provide any new resources, however necessary. Paradoxically, the same owner is also generally known to be keen to sell, but rarely at prices offered by the market for fear of a political backlash against selling at a heavy 'discount'. With bankers and suppliers apparently conspiring to deprive managers of even a basic level of working capital and with no authority to take unilateral action to try to improve things, managers of state-owned enterprises have few alternatives other than to adopt a 'care and maintenance' style of management.

The passivity of banks in the CEE/FSU region has to be tackled both in terms of developing efficient capital markets and at the operational level. In Poland, reform has tended to concentrate on the capital market. Faced with very strong demand for capital from the budgetary sector, the business and enterprise sector has been squeezed out of credit allocations. The EBRD has devised a programme for the country, the Stabilization Restructuring and Privatisation Programme (SRP)[8] designed to fill the current void in the corporate governance of around 180 selected medium-sized state-owned enterprises with bad loans and arrest their decline by providing their creditor banks with new capital and professional help to force the pace of debt

writeoffs and the adoption of a viable recovery programme for each enterprise.[9] But the programme can only partially compensate for the structural problems of Polish capital markets. However, by being specifically targeted at the operational level, it should make a major contribution towards establishing a healthy flow of funds and ideas between the banking industry and the corporate business sector, the sector on which ultimately the budgetary sector is substantially dependent.

The EBRD's SRP programme also is noteworthy as a practical solution to the problem of how to simultaneously inject new capital into heavily indebted banks and state-owned enterprises in a way that enhances their mutual interdependence yet does not reintroduce an element of the 'soft budget' syndrome into either's thinking. The SRP programme is not simply clever financial engineering, it also provides overall management and direction, business and financial advisory services and specialised training programmes in order to raise the standards of management expertise at participating company level and to help them reduce their present levels of indebtedness. In addition, there is a specific commitment to achieve full privatisation of all enterprises participating in the programme within five years.

**Major barriers to financial sector development: [10]**

Poland's banks are currently facing a number of major problems that are preventing them playing an active role in industrial restructuring.[11] Broken off from the National Bank of Poland, almost all of the newly independent commercial banks inherited large amounts of bad, or questionable, debt and a staff unprepared to evaluate a potential customers creditworthiness even in the best of circumstances. Before a significant change will take place in the way the sector functions, not only will large amounts of training have to take place, most banks will have to undergo some sort of recapitalization. Only then can the banks be expected to make the necessary judgements on calls for new loans within an established, clearly defined and enforceable legal and regulatory environment.

**Non-performing loans**

Polish, and most other CEE/FSU banks are burdened with non-performing loans. This situation is particularly bad for state-owned banks who inherited many bad loans from the break up of the old mono-bank when they were established in 1989. The new banks were saddled with debts that could not be serviced by borrowing firms reeling from Mr. Balcerowicz's 'shock therapy' stabilisation programme, the credit crunch and the collapse of the CMEA markets. This debt burden - its complexity and sheer magnitude - has made it all the more difficult for loan officers, inexperienced in credit and risk analysis, to decide which prospective borrowers are creditworthy.

It is estimated that the total amount of 'bad' and 'doubtful' loans in the portfolios of the 14 state-owned banks in Poland is approximately $3 bn. The total capital of the 14 banks is approximately $2 bn. As of 31 July 1992, there were 1888 bad loans in the portfolios of the then nine state-owned commercial banks, of which 1229 were less than $67,000. If the three specialised banks are included, the total number of bad or doubtful loans outstanding to the state-owned banking sector rises to approximately 2500.[12] Probably no more than 20 of the loans represent exposure to large, politically sensitive enterprises and around 1000 could be considered to be medium sized.

One conservative estimate was that at the end of 1991, bad loans constituted 30 per cent of total loans to the business sector.[13] By 1 July 1993, the National Bank of Poland considered 32 per cent of loans to commercial businesses (private and state-owned) to be shaky or in default. These firms were absorbing 40 per cent of bank credit which implies that most new lending to state-owned enterprises was being directed towards already loss-making firms, most probably for overdue interest capitalisation. It also implies that banks felt powerless to institute bankruptcy proceedings using the existing legal and regulatory infrastructure.

Stanislaw Gomulka, then an advisor to the Minister of Finance, was quoted in Rzeczpospolita, in April 1993, as suggesting that probably between 50 and 60 per cent of the business sector's cumulative indebtedness is represented by bad debts. Not surprisingly, as noted in Chapter Two, commercial banks are very reluctant to lend to the state-owned business sector. Thus, allocations of credit to companies declined by some 14 per cent in real terms from 1991 to 1992.

To deal with this damaging situation, the Polish government is pursuing a policy of encouraging banks to make full provision against their bad debts, and of restructuring and recapitalising the banks. In response to the evident need to establish work-out procedures for bad loans, the government passed a new banking act, the Law on Financial Restructuring of Enterprises and Banks of March 1993. The Act created a framework for the disposal and trading of bad debt and included a new loan classification system. Under the new guidelines, banks are required to establish a work-out department and to place within such department's responsibility the bad loan portfolio of the bank. Special management teams have been designated to run and monitor these portfolios. Management performance is being helped by a World Bank sponsored 'twinning 'arrangement under which seven of the state banks are twinned with different Western banks. These Western banks provide managerial expertise for a fee but do not bear asset risk.

The ultimate aim of the work-out departments is to turn non-performing assets into performing ones and to liquidate non-viable assets. As previously mentioned, enterprises that find their debts allocated to work-out departments are obliged to formulate restructuring proposals for review within four months. This means the banks are now able to initiate out-of-court 'conciliation' procedures for indebted firms. These arrangements are expected to include the restructuring of capital and interest payments, partial writeoffs of accrued interest and/or principal, and debt-to-equity conversion. In the event that proposals are not accepted, the banks are expected to foreclose on the enterprise's assets or initiate liquidation.

A key aspect of the bank restructuring programme then is the way in which it fits in with and is contingent on wider industrial restructuring initiatives. Another important component is the recapitalisation of the banks. The government is seeking to achieve this by injecting government bonds into the balance sheets of the banks in return for additional equity with the support of the IBRD and other IFIs. Part of the $500m IBRD Stabilisation Fund is to be used to buy back some of these bonds thereby injecting additional liquidity into the banking system but on condition that debt work-outs have been completed by March 1994. Until restructuring is completed, the banks cannot make new loans to debtor firms except in the context of a specific restructuring plan. If the banks fail to complete the necessary restructuring by 31 March 1994, the government under the act has power to force banks to sell off their bad debts at a deep discount. A major weakness of the proposed debt work-out and conciliation procedures, however, is that no new funds will be released to the already capital starved state-owned enterprises. Various programmes are being introduced under the auspices of the IFIs to mitigate this situation.

The intention of the authorities in providing very strong incentives to banks to establish effective debt work-out procedures is to persuade the banks to take an active interest in the commercial viability of their debtors. Unfortunately, there is a danger that inexperienced but over zealous bank officers may drive already enfeebled firms into bankruptcy or to cut too deeply into the retained earnings required to finance new investment and growth. Alternatively, if the banks remain passive, enterprises will continue to try to borrow to survive and this will eventually lead to another banking crisis. Clearly, the ideal solution is a careful case-by-case approach based on a well developed recovery plan, with strict conditionality and a strictly enforced budget constraint.

In common with the task of creating an appropriate fully functioning legal and regulatory infrastructure for a market economy, the major constraint on cleaning up bad loan portfolios is the lack of relevant expertise in the banking sector in organising and enforcing rigorous debt work-out regimes. A creative approach to developing this capacity at a practical operational level is the EBRD's Stabilisation

Restructuring and Privatisation programme mentioned above.

**Lack of capitalisation**

Polish banks are generally considered to be undercapitalised. For example, the combined capital of the seven largest Polish banks in 1992 amounted to around $1.5 bn which was less than that of the Bank of Scotland, the United Kingdom's eighth largest bank at $1.7 bn. The total capital in the Polish banking system as of May 1993 was somewhere between $2-3.5 bn.[14] By law, Polish banks are not permitted to lend more than 15 per cent of their total capital to any one borrower, so the maximum loan that Poland's largest bank - Bank Handlowy - can make to any one borrower is $60 m. While a prudent lender might not wish to expose themselves beyond this level in any event, it means that no Polish bank has the financial capacity to enter into large projects except on a syndication basis. Even then, foreign bank participation would most likely still be necessary.

For example, when the British company Pilkington plc was seeking finance to fund its investment in a float glass factory in Sandomierz in 1993, the loan of $106.5 m was syndicated by the Polish Development Bank with the EBRD and the IFC as well as with Polish banks. The latter took 30 per cent of the loan. While this is one of the largest private investments in Poland to date, hopefully it will soon not be exceptional. Without more capital Polish banks will remain restricted in their ability to contribute significantly to economic expansion. Henryk Sobkowiak, Vice President of the Komercyjny Bank Posnania has suggested that at least $6 bn in new cash is required to capitalise Poland's bank to world standards.[15] The situation appears to be getting worse. The National Bank of Poland reported that net funds available in all Polish banks had declined by a staggering 67 per cent between December 1992 and the end of June 1993 and bank profitability had declined on average by almost 30 percentage points in real terms between June 1992 and June 1993.

Although Polish banks are mostly undercapitalised, this is currently not causing a restriction in the supply of credit to businesses. High interest rates - in the range 45 to 55 per cent per annum and higher (with inflation at 36 per cent per annum) - are discouraging borrowers except for short-term trade finance. As noted above, many large state-owned enterprises are illiquid, are not servicing their existing debts and face nonexistent demand. The more dynamic private sector is reluctant to borrow for investment purposes given the uncertain demand situation and high interest rates. With Treasury bonds carrying zero risk and nominal yields of 36 per cent to 52 per cent (in 1992) banks are not surprisingly more attracted to government paper than the much higher risks (with similar nominal yields) attached to lending to enterprises. Banks are therefore investing mostly in government securities.

**Credit and risk management**

Another feature of the Polish banking system that is inhibiting proper development of the financial services sector is the credit and risk management policies. Generally banks are quite conservative when deciding how much of an asset's value can be used as collateral against a loan. On the other hand when it comes to assigning lending limits to managers; or the minimum amount of financial information that is required from a prospective borrower, they seem to be rather lax. Because there is a lack of information concerning either the financial position or creditworthiness of enterprises and owners there is a tendency to rely heavily on past experience. While the character of a borrower is one of the five C's of sound lending practice - it gives an indication of willingness to repay a debt - capability, collateral, capacity and condition of the business are also important.

The risk-aversion of Polish banks is understandable given their own balance sheet weakness and debt portfolio problems. A contributory factor is undoubtedly the present lack of adequate collateral security laws. There have recently been some welcomed moves towards cashflow-based lending, in particular to projects to develop Poland's antiquated telecommunications infrastructure. Probably the involvement of prestigious foreign partners such as Siemens, Alcatel and A T & T in these projects has weakened the traditional risk averseness of the banks.

**Collateral security and bankruptcy laws**

Clearly, one of the major limitations on the development of the financial sector in Poland is the inadequate legal infrastructure relating to property rights. This is seriously inhibiting the expansion of credit. In industrialised economies a charge over real estate is sometimes used as secondary collateral in the purchase of machinery and equipment. It can also be used as collateral to secure short term operating lines of credit. This is often much cheaper than securing credit against inventory and accounts receivable. In Poland, the continued uncertainty over property rights usually precludes the use of property as collateral. This is particularly damaging for small and medium-sized private enterprises that lack a financial 'character' reference. The possibility of post-privatisation claims also weakens the value of property rights for collateral purposes, for example, claims from previous owners against the state for improper seizure of assets. By contrast with Poland, the Czech and Hungarian governments have introduced legislation to limit compensation. In Poland, it is virtually impossible to identify such hidden property rights through a search of title because of the chaotic state of the property registration system.

An essential part of the legal system relating to property rights is the procedure for registering a 'pledge', or the assignment of a right in a certain asset. In Poland, there are two types of pledges: a possession pledge and a bank pledge. In the first case, the creditor cannot gain possession of the asset in the event of a loan default without formal transfer of ownership which implies the debtor's cooperation. The second type of pledge, as the name implies, can only be taken by banks. This means that firms are unable to enter into loan arrangements amongst themselves thus preventing credit expansion. While this restriction may have been justified in the case of state-owned enterprises in order to prevent uncontrolled interfirm credit expansion in the absence of a hard budgetary constraint, it is clearly an unjustified restriction on credit expansion in the case of private enterprises subject to market discipline.

Another problem with pledges in general, is the lack of a mechanism for registering an interest in a particular asset that is accessible to anyone else contemplating taking a pledge on a given asset. The opportunity for pledging the same asset several times, and thus the potential for fraud, is considerable. This undoubtedly deters the granting of credit by banks. It is also extremely difficult for a lender to secure a floating charge against property acquired in the future, that is receivables and inventory. What lending is done on this basis is lent on the overall reputation of the firm which naturally tends to exclude new and

smaller firms.

Enforcement in the event of a default is time consuming and expensive. Invariably judicial action is required and court filing fees amount to as much as 10 per cent of the value of the asset involved.

With so many uncertainties attached to property rights in Poland, it is hardly surprising that banks are reluctant to become involved in taking action in the event of default. Lenders are sometimes accused of excessive passivity, but given the state of Polish legal infrastructure and the scarcity of professional banking expertise such inactivity may be rational. More importantly, these uncertainties act as powerful deterrents to lending in the first place.

**The role of industrial policy in Poland**

A modern industrial economy needs the state as an active participant in defining the main goals and priorities of industrial development. A national industrial policy is required to guide the processes of effective integration of the CEE/FSU economies into the global economy. The general population also needs to be convinced of the validity of the strategy being adopted to raise industrial efficiency to world standards. Clearly, strategy needs to face Janus-like in two directions, inward to the domestic population and outward to current and potential foreign investors including, of course, the international donor community. Each of these two constituencies is important. Without the confidence in the domestic polity, capital flight will occur; and without the support of international business and financial markets, inward investment will cease. Government intervention is also necessary to deal with the various constraints on the efficient mobilisation of the factors of production caused by domestic institutional rigidities and foreign trade relations.

During the 1990-92 period, Polish government policy concentrated on the macroeconomic stabilisation programme. Industrial policy and the implementation of industrial restructuring was left largely in abeyance. It was assumed that change in prices and vigorous pursuit of privatisation would bring about necessary adjustments in industrial enterprise. It is now a matter of history that no major state-owned enterprise went into liquidation, yet industrial production dropped by 35 per cent between 1989 and 1991 with particularly large declines recorded in light industry (46 per cent), electrical and electronic engineering (42 per cent) and metallurgy (38 per cent).

In Poland, debate over the role of industrial policy has tended to concentrate on policy instruments, in particular, privatisation, while definition of a coherent industrial strategy has been ignored. Two senior officials of the Industrial Development Agency, an autonomous agency of the Ministry of Industry and Trade charged with implementing Polish industrial policy, have recently gone on record with a highly critical review of Polish industrial policy development since 1989. Their review forcefully puts forward the argument that industrial policy should provide the framework for privatisation and restructuring and not the other way round. The whole privatisation and restructuring process in Poland is criticised for being "at a juncture of different systems and values, with stop/go policies and without any clear definition of objectives, means and institutional set-ups".[16] They assert that macroeconomic adjustment has not been made compatible with microeconomic adjustment at enterprise level. The review suggests that a more balanced approach to industrial policy would give equal weight to top-down and bottom-up techniques of industrial restructuring. Such a balanced industrial policy should encompass:

*the degree of government incentives, subsidies and protection which may be expected by a company being restructured or privatised;

*a definition of acceptable levels of layoffs;

*a government-stated view on the strategic importance of any industry or individual company;

*a statement on government plans for merging similar state-owned enterprises;
*a clear statement of who is in charge and has the power to carry out the needed restructuring; and

*what inter-linked social safety net system has to be developed to handle enterprises' liabilities, laid-off employees, financial debt, pollution, buildings, equipment, land, housing, medical and pension obligations.

Specifically with respect to Poland, the review is highly critical of the failure of Polish decision makers to come to grips with an industrial strategy and the very real limitations of the state bureaucracy to execute a coherent strategy. Further, it is claimed that the privatisation and industrial restructuring programme has so far failed to define any selection criteria for targeted enterprises. Rather, firms appear to have been selected by chance or on the initiative of the management of the enterprises involved giving the impression that the privatisation process is not controlled by the government.

This situation is not encouraging for advocates of a carefully managed approach to industrial restructuring. The institutional structure created in 1990 to supervise Polish policy formulation and execution on paper looked convincing. A new ministry was formed to take overall charge of matters relating to privatisation, the Ministry of Privatisation (MOP), while the Ministry of Industry and Trade was assigned responsibility for advancing restructuring plans with two executive agencies to implement the plans. The first, the Industrial Development Agency (IDA), has responsibility for promoting and participating in major systemic reforms including technical assistance and training to facilitate the adjustment of enterprises to a market economy, for helping finance restructuring and transforming enterprises through liquidation, and providing guarantees for domestic and foreign credits specifically targeted at enterprises undertaking restructuring exercises.[17] The second agency, the Polish Development Bank, offers partnership and loan syndication capacity to other banks and, through its access to long term credit lines from international financial institutions, can act as the Polish lead financial institution in major restructuring exercises.[18] In practice the responsibilities and functions of the two ministries responsible for industrial restructuring and their executive agencies are still not well defined and there was "above all a lack of clear and precise legislation to facilitate the process of transformation and change".[19]

**The competition to control industrial policy in Poland**

While the 'no policy is good policy' attitude of Mr. Balcerowicz's 'shock therapy' regime has gradually given way to a reappraisal of the role of industrial policy, it has clearly proved difficult to establish a coordinated and integrated strategy for industrial restructuring. Policy formulation has been dogged by competing claims from different ministries and agencies. For example, the Central Planning Office published **Guidelines of Economic and Social Policy**, in 1992. It proposed developing sectoral priorities and differentiating intervention instruments according to the liquidity situation and growth potential of enterprises.

The Ministry of Industry and Trade has continued to try to assert the link between industrial restructuring and privatisation in its various policy pronouncements and through the operations of its associated institutions: the Industrial Development Agency and the Polish Development Bank. The Ministry of Foreign Economic Relations is still trying to establish an effective export credit insurance and export promotion organisation but has been unable to obtain the necessary funding. The Ministry of Privatisation, however, has continued to dominate political debate as the mass privatisation bill continued its slow progress through the Sejm and Senate and, on the ground, where enterprises have been successfully privatised and restructured within a framework negotiated by the MOP.

In the summer of 1993, the Ministry of Industry and Trade proposed an interventionist policy to correct the rapid depreciation of the capital equipment of Polish industry, estimated at 75 per cent, and to restore the fall in output of 30 per cent since 1989. The plan classified Polish industry into four sectors: strategic; enterprises producing steel, ships, cement, paper and pulp, and chemicals; higher need; and those enterprises which were already competing effectively with foreign producers (no enterprises were specified). The strategic sector included the military-industrial complex and the fuel and energy enterprises necessary to protect vital national interests. The Ministry sees little chance of the firms in the second (heavy manufacturing) sector being capable of raising the necessary capital for restructuring without government guarantees. The higher need sector included enterprises from the automotive, pharmaceutical, food processing, and light industrial sectors. Development of this sector is considered necessary in order to create a modern economic base.

The Ministry's industrial restructuring plan thus assumes that certain enterprises cannot count on the 'invisible hand of the free market' to guarantee success and others which are 'vital' to the Polish economy should not be abandoned despite poor economic performance. However, the Ministry also proposes that the government should play an active role in the restructuring process by providing lower taxes and low-interest credits and guarantees to selected enterprises and sectors. As part of the package of proposals, action should be taken to ease credit restrictions on enterprises, promote investment including foreign investment, and more generally, assign top political priority to restructuring. The proposed programme is to run for ten years, with stage one, from 1993 to 1994, estimated to cost 40 trillion zlotych. The source of government funding is unspecified though 2 trillion zlotych is expected from foreign assistance. The Ministry predicts its plan will achieve a 20-30 per cent improvement in enterprise profitability and lowered costs of production.

The Ministry of Labour also has not remained on the side line. The government responded to trade union concerns about rising unemployment and the impact of an accelerating (at last) privatisation programme through the State-Owned Enterprises Pact. This latter piece of legislation covering guarantees for employees fell with the dissolution of the Sejm in May 1993 but will be resurrected in some form by the new left-leaning coalition government. A further period of policy turmoil and industrial conflict is likely in the immediate aftermath of the election as unions test out the will of the new administration to maintain a tight budgetary position. Even with a left-of-centre administration in power, the authorities must achieve an accommodation with organised labour that also satisfies the IMF, the World Bank, and the Paris and London Clubs. To this end, a clear and explicit industrial policy would seem to be necessary in order to provide a framework for efficient restructuring at enterprise level, including adequate safety net provisions for those unfortunate enough to be made unemployed.

Whether the ambitious interventionist proposals of the Ministry of Industry and Trade will survive being ground between the demands of the Ministry of Finance and the IMF for budgetary restraint side and the demands of the trade unions for wage increases remains doubtful. A clear lesson from Polish experience with trying to develop a coherent and fundable industrial policy is that a high level agency is required, presumably under the prime minister's office, to bring together the four key players in industrial restructuring, namely the Ministries of Finance, Industry, Labour and Privatisation in order to resolve the difficult tradeoffs. The current tendency towards publishing independent, competing and often contradictory policy statements from different ministries is unlikely to produce action or attract donor support.

Some commentators argue that the failure to develop a coherent industrial policy is not surprising since it reflects deeper and more fundamental structural problems of a basically unreformed Polish civil service. Indeed, some even argue that the Treasury itself is incapable of effective execution of economic policy, that too much reliance is placed on a very small group of senior economic advisers, while implementation is left to an executive still structured according to the logic of the old central planning mechanism.

BOX

EBRD Stabilization Restructuring and Privatisation Programme

The EBRD's Stabilization Restructuring and Privatisation Programme (SRP) will create an ownership entity that can act quickly to make sure the necessary protection is provided for the essential productive assets of each business and that the required funding is available for appropriate restructuring.

A distinction is made in the programme between the requirements of what is referred to as 'stabilisation' and longer-term 'recapitalisation and reconstruction' work. Stabilisation involves a relatively small amount of capital investment - a funding level is proposed equivalent to 15-20 per cent of sales per enterprise - but large amounts of 'common sense actions, new efficiencies and change of attitudes'. Recapitalisation and reconstruction work normally involves more substantial capital investment, the design and development of new products and processes and the creation of new markets and marketing channels. Stabilisation depends on the government, as owner, taking the necessary decisions or a new owner taking control. Reconstruction is very unlikely to happen unless stabilisation has first occurred.

The SRP 'solution' is designed to quickly arrange for:

*Immediate change of ownership control without in any way reducing the eventual 'upside' in value due to the Polish Government;

*Financing equivalent to 15-25 per cent of the sales volume of the SOE's accepted into the SRP at the moment that the bulk of such SOE's indebtedness is reduced; and

*New capitalisation is provided for the Polish banks participating in the SRP programme.

A management company is being established to provide overall management of the 12 joint ventures to be created with each of the 12 participating banks and EBRD Polska. Effective control of each enterprise participating in the SRP programme will be vested in one of the joint ventures. An enterprise will only be admitted to the SRP programme when a proper due-diligence evaluation has been completed and it has been demonstrated that it conforms to basic minimum criteria of economic viability. All enterprises must undergo satisfactory conciliation negotiations on debt reduction with their creditors prior to joining the SRP.

It is foreseen that the typical firms in the SRP programme will on average have a turnover of $10 million and indebtedness of $10 million ($5 million due to the government, $3 million due to banks and $2 million outstanding to suppliers ). It is expected that the outcome of conciliation negotiations will be a write-down of outstanding enterprise debt to on average $3 million.

Perhaps most importantly of all for the viability of the programme and of Polish commercial banks, lead banks retain a direct financial interest in the success of the turnaround of the enterprises in which they have an interest. To this end, the lead bank in each case will retain a direct banker/client relationship. Advisers to the SRP will assist the banks in developing an active and broad-based involvement with enterprise management thus breaking the vicious circle of bank passivity and enterprise helplessness in the face of economic turbulence. Above all else, the emphasis in the SRP programme is on bringing quick relief to enterprises and banks drifting in a sea of debt, with privatisation of enterprises as commercially viable entities as a realistic medium term aim.

It is planned that the SRP programme will provide new debt and equity financing of up to $480 m split between $200 m of redeemable equity, $240 m of debt and $40 m of grant funds to assist with turning

around of approximately 180 enterprises. From the EBRD's contribution of $240 m, the 12 participating banks will receive $80 m of new capitalisation and $160 m will be invested directly in the 12 joint ventures set up with the banks to manage the participating enterprises. In exchange for new capital, the banks will subscribe $80 m representing 40 per cent of the redeemable equity financing of the 12 joint ventures managing the enterprises and provide them in total with $160 m in loans. The Polish Treasury will subscribe the remaining 20 per cent of the joint ventures' redeemable equity and will transfer its shareholding in the enterprises into the joint ventures in exchange for 100 per cent of the ordinary share capital. PHARE will contribute $80 m to cover the Treasury's contribution to the costs of the exercise. The SRP programme's funding structure is described in Diagram 1.

END BOX

**Endnotes**

1. Williamson , O E (1993) 'Opportunism and its Critics', Managerial and Decision Economics, Vol 14, pp 97-107.

2. Rausser, G C and Johnson S R (1993) 'State-Market-Civil Institutions: The Case of Eastern Europe and the Soviet Republics', World Development, Vol 21, 4, pp 675-689.

3. The Chinese communists, of course, do still sometimes execute racketeers.

4. de Soto, H (1989) The Other Path - The Invisible Revolution in the Third World, New York: Harper and Row.

5. see Fornalczyk, A (1993) 'Competition Policy in the Polish Economy in Transition,' in Competition and Competition Policy. A Comparative Analysis of Central and Eastern Europe, (eds S Estrin and M Cave), London. Also Fornalczyk, A (1993) 'Competition Law and Policy in Poland: A Welcome and a Warning to International Business,' Butterworths Journal of International Banking and Financial Law, July, pp 1-5.

6. The process of privatisation by flotation on the Warsaw stock exchange is discussed in the next chapter.

7. While 80 private banking licenses have been issued, only 11 meet the NBP's minimum capital rule of Ecu5 million which came into force in January 1993.

8. The SRP programme is described in the EBRD's project documents of 29 June 1993. The authors received a very helpful explanation of the SRP programme from Neil Balfour which is gratefully acknowledged. The account of the programme given in this book is, of course, the responsibility of the authors alone.

9. The 20 or so vary large Polish enterprises that are heavily in debt have too many political ramifications to enable them to be dealt with purely at a professional, technical and managerial level. The small enterprises encumbered with debt require relatively simple advice and modest financial assistance best handled at individual bank branch level. Numerous SME business support centres have been established throughout Poland under various technical assistance programmes such as PHARE, USAID and the British Know-How Fund. Undoubtedly, greater effort could be made to strengthen the link between bank-based SME debt work-out arrangements and assistance from business support centres to indebted SMEs.

10. Much of this section of the report on the Polish banking industry is taken from work carried out by S H Halvorsen which is gratefully acknowledged though the interpretation of his work is the responsibility of the authors.

11. Rosati, D (1993) 'Poland: Glass Half Empty', in R Portes (Ed.), Economic Transformation in Central Europe: A Progress Report, London: Centre for Economic Policy Research,

12. The Polish Development Bank as a new institution founded in 1991 has so far officially not accumulated any bad loans.

13. Commander, S and Coricelli, F (1993) 'Output Decline in Hungary and Poland in 1990/1991: Structural Change and Aggregate Shocks' in World Bank Discussion Paper 196, 'Eastern Europe in Transition: From Recession to Growth?' New York: International Bank for Reconstruction and Development. They suggest that firms with a negative operating surplus accounted for 27 per cent of industrial sales.

14. The lack of precision in the estimates can be attributed to devaluation of the zloty, depletion of capital through writeoffs and estimation errors.

15. Quoted in the Central European, February 1993, p 32.

16. Krawczyk, M and Lopez-Lopez, J A (1993) 'The Role of Government in Poland's Economic Transition', Columbia Journal of World Business, Vol 28, 1, p 182.

17. The IDA is the successor organisation to the Fund for Industrial Structural Changes established in 1988 and was registered in January 1991 to support and coordinate the restructuring and privatisation of Polish industry.

18. The Polish Development Bank was established in 1990 as the state bank responsible for, among other functions, managing lines of credit from international agencies such as the EIB, EBRD and the World Bank.

19. see Krawczyk and Lopez-Lopez (1993), p 183.

## Chapter 4
## Privatisation and Industrial Restructuring

### Introduction

In an area in which the vast majority of the economic base was state-owned, a major policy instrument of transformation and restructuring is the privatization of ownership. Industrial restructuring accompanied by privatisation allows management and labour to redefine an enterprise's future focus and identify the steps needed to create an organisation capable of competing and maximising corporate performance. As part of the overall restructuring process, privatisation can be a powerful catalyst that forces an enterprise to improve performance in such essential areas as cost management, design, quality control, logistics and marketing.[1]

The privatisation of land, housing and enterprises has been chosen as the primary means for introducing irreversible structural change and dynamism into the economies of the CEE region and by most of the countries of the FSU. But to date, the achievements have been rather limited in almost every CEE country. While success has been widespread in the privatization of housing and agricultural land, selling enterprises representing as much as 90 per cent of the economy to a underdeveloped private sector, with limited savings and borrowing capacity, where capital markets are nonexistent, and where reliable valuations of state assets up for sale are absent, has proved a slow and torturous process.

The Polish Ministry of Privatisation has stated that due to the scale of the privatisation task in Poland, they faced several unexpected issues which slowed the process considerably.[2] They included:

* Reprivatisation. A very sensitive issue across the entire Central and East European region, it has yet to be dealt with in Poland. The question of the extent of restitution in-kind has not been answered.

* Decentralization. The Polish government remains determined to implement its privatisation strategy through a decentralized system. The MOP has a series of offices throughout the country and a good deal of privatisation is handled at the regional and municipal level.

* Mass privatisation. There was a serious lack of consensus in the country over the type of distributional privatisation that should be implemented which delayed the passing of the Mass Privatisation Programme for two years.

* Lack of foreign investment. Poland lagged behind both Hungary and the former CSFR in attracting foreign direct investment.

Most of the barriers to privatisation in Poland also confront the other countries of the region. This raises the question as to whether privatisation is essential and unavoidable. One argument is to point out that no modern market economy has a dominant state-owned sector. It is inferred from this rather crude observation that, at the very least, radical downsizing of state investment in the enterprise sector is necessary.

But, as stressed, resources are limited in the region. No CEE/FSU country, with the exception of the special case of the old GDR and Germany, actually has the resources to privatise much of the state-owned sector in the medium term. There is also little evidence that official or private capital transfers from OECD economies will fill the resource gap.[3] Thus, a realistic industrial restructuring strategy should be formulated on the assumption that the state sector will be an important part of any CEE/FSU economy for some time to come. And, as one observer of the process argues, privatisation puts the 'cart before the horse' in so far as the authorities attempt to enlarge the private sector before the institutional infrastructure necessary to support it is in place.[4]

**How Fast to Privatize?**

If the ultimate goal of the transformation of the economies of the region from command to market based, is not merely to engineer a change in ownership, but to increase flexibility, efficiency, and competitiveness, the question arises whether the speed of privatization is really important. If the underlying institutional framework creates a competitive environment, neither the degree, nor speed with which privatization takes place may be critical. Anti-monopoly legislation and the opening of trade can encourage the development of competitiveness. If the free entry and exit (effective bankruptcy legislation) of firms is permitted, then a competitive environment can be established even if some large enterprises remain in state hands in the near term. What is most important is to ensure that public monopolies are not simply replaced by private ones.

The problem with that argument in the CEE/FSU region, however, is the speed with which it takes to create the necessary institutional framework for competition to be established and soft budget constraints to be hardened and what measures to take in the mean time. Since these economies are in such a fragile state, and the support for continued reformed is tenuous, the consequences of mass closures of inefficient enterprises (free exit) cannot be absorbed economically or politically. Many enterprises will have to be kept afloat, even if they are loss makers. Others will need to be made efficient even if they stay in state hands.

The gradualist argument then is to develop the private and the state-owned sectors in parallel while investing heavily in developing the legal and regulatory infrastructure in order to ensure the evolution of a competitive market structure. This strategy prevents the state being tempted to support losers, for rigorous enforcement of bankruptcy procedures would make sure that no enterprise, regardless of who owns it, faces a soft budget constraint.[5] Certainly general enforcement of bankruptcy laws would deal with the rather strange argument in favour of privatisation, namely, that privatisation by creating a decisive break in the government's stake in an enterprise makes sure that a one time debt write-off really is just that. Quite why the government's role as lender of last resort precludes disposing of surplus capacity is rarely explained.[6] Indeed it could be argued that the state is more likely to include safety net provisions during downsizing operations than a private owner.

**When to restructure?**

There has been a great deal of argument over the appropriate sequence of restructuring and privatization: should an enterprise be restructured prior to privatization by the government, or after privatization by the new owners?. Once again, in the CEE/FSU region there are no clear answers. There are very valid arguments for both. First as noted above, because of the political and economic fragility of these countries, many enterprises will have to be kept afloat either until buyers can be found, or until the resulting unemployment can be absorbed. In these cases, restructuring should take place if the enterprise can be made viable. Because of the degree of integration of many CEE/FSU enterprises some restructuring may be required in order to find a buyer. The enterprise may need to be broken down into more rational product groups and manageable sizes. This will the case whether the buyer is domestic or foreign. In one case, the buyer of a Hungarian firm agreed with the State Property Agency (SPA) - the body charged with overseeing the privatization process in Hungary - to sell off certain parts of the enterprise it was buying and split the proceeds with them. Financial restructuring by way of a debt write-off may also be required to make the enterprise saleable to either a foreign or domestic buyer.

While such restructuring prior to privatization may be critical in some cases, the risk is run that precious resources may be wasted in the case of technical restructuring. For example, one bottling facility in the Czech Republic received new investment in a refrigeration system just prior to beginning the

privatization process. The new system was a considerable expense and the enterprise wanted it to be reflected in its valuation. Western bottlers, however, had no use for the system since they purify water prior to bottling and thus do not need to refrigerate.

Another argument for privatisation first, stresses that the market should decide which enterprises are most suitable for acquisition by interested parties. Unfortunately, markets for existing businesses are far from perfect in the CEE/FSU region: there is invariably a paucity of reliable and freely available information about the enterprises being sold. As noted, often there are also uncertainties about ownership and the impact of national competition policies. Potential purchasers are limited in number and there is scope for collusion between buyers and existing management.

Privatisation is both a political as well as an economic process; property rights are transferred from the public to the private domain. One of the common features of politics across the region has been the rising popular disquiet about growing wealth differentials and corruption. The egalitarian ethic is perhaps the strongest surviving value from the communist era so that it is particularly important that where public property rights are being disposed of to private individuals, the process should be open to public inspection. It is therefore important that the process should be transparent otherwise public opinion may become very hostile and allegations of corruption will begin to surface making privatisation politically unsustainable.

Thus, in the CEE/FSU region, the approach to restructuring and privatization must be pragmatic and the two must proceed simultaneously. The issue of sequencing, is not one the region has time ponder. But, before scarce resources are committed to restructuring a specific enterprise, careful examination of the market and state-of-art technology must be made together with consideration of who the future owners are likely to be.

The end goal is clear: to create an organisation that uses its assets efficiently and is capable of competing effectively in an open market economy. By defining and addressing critical needs of an enterprise operating in a competitive market, restructured and privatised enterprises emerge as lean and focused entities whose management and labour are aware of the organisation's strengths, weaknesses, threats and opportunities. At the end of a successful combined exercise, firms possess a realisable market value because they are now businesses capable of adding value across the range of their activities and which attracts a sustainable and predictable revenue stream. It is also in the government's interests to be able to offer potential domestic or foreign investors an enterprise that has already been restructured or is in the process of becoming so for selling an enterprise as a competitive going concern is easier and quicker to accomplish than if it were burdened with debt and collapsing.

Some of the sharpest criticism of the privatisation process in the CEE and FSU countries stems from the lack of a coherent policy towards the large group of enterprises that are losing money and need restructuring assistance prior to their privatisation. Although profitable enterprises are likely to receive plenty of interest from investors which will benefit the state treasury, the several thousand marginal firms still accumulating debts pose a serious danger to the banking system and the state budget of the economies in transition. Hungary's introduction of a bankruptcy law that allows creditors the option of forcing firms into receivership if payments are not received within 90 days is one approach to this problem, but it ignores the likely explosive socioeconomic situation that will be created if enterprises in any large numbers are allowed to go under.

In Romania, the mass privatization programme has assistance to the weakest enterprises built into it. Thirty per cent of the shares of enterprises are controlled by five private ownership funds, the remaining 70 per cent belongs to the State Ownership Fund. The latter has the task of privatising 10 per cent of its assets per year. Profits from these annual sales are to be used to finance the restructuring of the remaining unsold enterprises in order to improve their market attractiveness. There is an inherent danger in the Romanian programme that political pressure builds and encourages the conversion of public monopolies in to private ones, or the unnecessary discounting of top-ranked enterprises. Meanwhile, weaker firms may be inclined to wait in line for cash injections without making any effort to restructure themselves. As usual with other reform measures in the CEE/FSU region, the Romanian scheme looks logical from a static perspective, but in the dynamic real world of collapsing enterprises and rising unemployment, it is plagued with sequencing problems.

**Privatization in Poland**

While each country of the region is choosing different specific methods, and have proceeded at different paces, all are attempting some sort of privatization of housing and land, privatization of small establishments via auction and often leasing schemes, a mass scheme to transfer the ownership of the bulk of medium-sized enterprises to the adult citizenry and a case-by-case approach to the sell-off of large and strategic enterprises.

For Polish state-owned enterprises, privatisation entails following one of three alternative routes: liquidation, capitalisation, or restructuring. In the future there will be a fourth route: the mass privatisation programme.

Of the 8,441 state-owned enterprises registered in 1990, 2,385 or 28 per cent had been included in the privatisation process up to 15 October 1993.[7] A total of 92 enterprises had undergone capital privatisation involving over 115,000 workers, with employment guarantees provided of between 18-36 months. The State Treasury earned over $200m from the 42 enterprises privatised to 15 October 1993. Some 852 small- and medium-sized enterprises have been privatised as going concerns: 117 by trade sale, 39 as joint ventures with

a foreign and/or domestic partners, and 633 enterprises are leased to employees or management and employ 220,000 people. Sixty-three enterprises have involved a combination of methods. In addition, 1,013 small- and medium-sized state enterprises have been declared bankrupt and their assets sold. The remainder of enterprises are in the process of being privatised and as such are supervised by the Ministry of Privatisation on behalf of the State Treasury.

**Privatisation through liquidation**

Of all the methods of privatisation available, the most successful so far, in Poland as well as elsewhere, have been schemes involving small scale establishments in the manufacturing, retail, trading, transport and construction sectors. Often supervised by municipalities, these programmes were targeted primarily at the existing employees of small- and medium-sized firms. As of March 31 1993, 1661 Polish enterprises had chosen the liquidation route: 501 from the construction sector, 490 from manufacturing, 260 from the agribusiness sector and 193 trade organisations.

The liquidation process as defined in the State Enterprise Act is subdivided into two options, covered by Article 37 and Article 19. Under **Article** 37, an enterprise can be liquidated as a legal entity in one of three ways: through a trade sale of assets; through the contribution of assets and liabilities to a joint venture with a domestic or foreign partner; and via the sale of assets and liabilities to a new firm established by management and employees (buy-out). Of the three options, the sale of assets and liabilities to a new firm has been the most popular route to privatisation under Article 37: involving 80 per cent of the 750 state enterprises liquidated under Article 37. Throughout the process of liquidation and reconstitution as a private firm, an enterprise's founding body, the Anti-Monopoly Office, and finally the Ministry of Privatisation, all play an active role with each having the right to raise objections or veto the proposal. Since any new entity assumes old liabilities, creditors, mainly banks, also need to give their approval.

As of March 1993, 911 Polish enterprises had chosen the route to privatisation defined under Article 19, sometimes referred to as 'true liquidation'. Under this option, state assets of enterprises that are no longer viable are sold off to the private sector. By contrast with Article 37 privatisations, liabilities are not taken over by the firm purchasing the assets. The process is initiated by an application from the firm's founding body or its management and workers council. An evaluation of the enterprise is then carried out by a committee of experts which is reviewed by the founding body and representatives of creditor banks. If the proposed liquidation is accepted, a liquidator is hired to sell off assets and divide the proceeds among creditors. One of the weaknesses of Article 19 procedures is that it is quite easy for an enterprise's management to defer payments to banks, use available cash for wage increases, and strip assets between the time liquidation procedures commence and the arrival of a liquidator. There have been a number of cases where enterprise managements have acted irresponsibly by accumulating additional debts before final liquidation.

**The political backlash**

In Poland, as elsewhere in CEE, the progressive ceding of control of many small- or medium-sized state-owned enterprises to their existing management has given rise to some criticism. So-called spontaneous privatisation has most commonly been initiated by the 'nomenklatura' - the socioeconomic and political grouping of former senior communist party officials and bureaucrats who managed to capitalise their waning power and connections to obtain advantages from the new market economy. This acquisition of new privileges by members of the old regime is deeply resented by much of the population but it is a feature of most societies undergoing peaceful transition from one regime to another. The old establishment uses its inside knowledge of the whereabouts and value of state assets to select the best state property and transfer ownership to itself usually within the law. In the CEE, there also has been a considerable amount of luck involved, of happening to work for a profitable or potentially profitable enterprise that suddenly becomes

available for private purchase. There has probably been less resentment about the privatisation of businesses than about some of the murkier aspects of property ownership transfers. The very obscurity of property titles in many parts of the CEE region has sometimes encouraged a voracious 'looting mentality' amongst the nomenklatura.

Some commentators argue that transferring ownership of mostly small state-owned enterprises to members of the old regime buys off their opposition. Some members of the nomenklatura are undoubtedly still very wealthy and this process of spontaneous privatisation should, it is argued, encourage them to mobilise their wealth for productive purposes. In a capital starved economy such as Poland, it is argued, no one can afford to be squeamish about the origins of the capital that is available.[8] However any short term benefits may be outweighed by longer term social, political and economic costs, in particular, the perceived injustice of this transfer of economic power to a discredited leadership. This returns the argument back to the importance of establishing effective legal and regulatory infrastructure to prevent abuse of power and connections and the issue of sequencing reforms correctly.

**The role of sectoral studies**

An increasing number of privatisations of large state-owned enterprises are the outcome of 36 detailed industrial sector studies originally commissioned during the Bielecki administration in 1991. The Ministry of Industry and Trade and the Ministry of Privatisation sponsored the review of 36 different industrial sectors, in order to assess the relative strengths and weaknesses of large enterprises in the domestic and foreign markets prior to considering privatisation. This programme, basically an exercise in stock taking of the state's portfolio of enterprises, is sometimes misleadingly referred to as 'sectoral privatisation'. It has come under a lot of criticism since it was slow to come to fruition and has involved a number of high profile foreign consultancy firms.[9]

The basic approach of the sector programme was to examine the structure of a given sector, for example, cement production or industrial gases, to make comparisons with similar western industries, examine restructuring needs, and then to set up competitive bidding procedures for potential foreign investors, if found to be appropriate.

In the confectionery sectoral study, for example, twelve enterprises were reviewed, only five expressed a desire to continue privatisation under the auspices of the management consulting firm engaged by the Ministry of Privatisation to advise on privatising the sector. The remaining firms either chose not to change their ownership status or opted to pursue privatisation through their own means. In the case of industrial gases sector, the original state-owned enterprise, Polgaz, was split up into seven companies, four companies have each been bought by different foreign investors - AGA of Norway, BOC of the United Kingdom, Liquid Carbonic of the USA and Linde of Germany, while three have opted to be privatised through management buy-outs.

In the case of the cement industry, two West European cement manufacturers have taken stakes in three Polish plants but because the technology is often obsolete and in breach of EC environmental protection standards foreign buyers are cautious and prices paid so far have been quite modest. Of the remaining sixteen, seven enterprises are covered by the Mass Privatisation Programme.

**Capital privatisation**

As of March 1993, capital privatisation had been adopted by nearly 500 enterprises, including 411 firms from the manufacturing sector and 64 from the construction sector. The approach allows several

options to be pursued including: flotation by public share offering, a management buy-out or direct sale to, for example, a foreign investor. As in other cases, the enterprise management and the workers councils have to formally initiate the process by applying to the founding body for privatisation. Once the capitalisation method and valuation of the enterprise has been approved, a joint-stock company owned by the Treasury is created. The workers council is then dissolved and a supervisory board is appointed: workers have the right to select one-third of the board members. The new State Treasury joint-stock company then has two years in which to privatise according to one of the three methods described above. The time limit is designed to prevent the state from once again becoming the de facto owner. When a sale has been agreed, employees are entitled to purchase up to 20 per cent of the shares of the new private company on preferential terms.

Of the possible methods of capital privatisation, direct sale to mainly foreign investors has emerged as the most popular option. Sales are required by law to be open to competitive bidding. It is at this juncture that the sectoral studies commissioned by the Ministry of Privatisation have proved very useful for identifying potential investors and informing the negotiating team from the Ministry dealing with interested investors. The commitment to open competition and active and informed promotion of investment opportunities is generally believed to have stimulated greater interest from foreign investors, led to a higher final sales price and better prospective investment commitments than would have been the case if enterprises had simply been put up for sale.

**Privatisation by management contract**

An option to privatise through restructuring has recently been added to the already well-established routes via liquidation and capitalisation. Under the new programme, management teams control the restructuring and privatisation process. A tendering procedure is organised for each company participating in the programme whereby management groups are invited to submit bids for the contract to manage each company. Each bid has to reflect each management groups's estimate of the value of the firm along with a viable restructuring plan. The team submitting the best proposal is then awarded a management contract by the Ministry of Privatisation which then assigns responsibility for implementing the restructuring plan and privatising the company. Two management groups have so far been selected by the Ministry to launch the programme to encompass fifteen enterprises.

**Capital-management privatisation**

A final variant of capital privatisation that has been developed most recently is what is referred to as capital-management privatisation. The approach is an attempt to plug the funding and management gap so apparent in many privatisation efforts. The Stabilisation Restructuring and Privatisation (SRP) programme developed by the EBRD and described in Chapter Three has a similar purpose. Basically capital-management privatisation is designed by investment fund management teams to inject capital and a new ownership and operational structure in to capital starved enterprises that are potentially viable. The investment fund takes on the risk of co-ownership by taking an equity stake in the enterprise being privatised but within a predetermined time horizon, usually between five and seven years. At the end of that period the investment fund(s) plan to liquidate their investment and realise any capital gain. The SRP programme is more ambitious than the simple capital-management privatisation scheme since it is also designed to assist banks manage their debt work-out regimes and conciliate with heavily indebted state enterprises.

The major difference between capital-management privatisation and other forms of capital privatisation is that the company and its management team has the opportunity to maintain its identity and independence. When shares are sold to a strategic investor, an enterprise's management usually has to subordinate its business plans to the strategic corporate objectives of the outside investor. Privatisation by management contract, on the other hand, while not doing this, may burden the company with interest repayments and lease

installments and often restricts business expansion by limiting the range of investment resources that can be tapped because in effect the company remains mortgaged to the Polish Treasury.

Basically, capital-management privatisation represents a formal recognition of the situation typically found in virtually all privatisations in the CEE region, namely, that some form of financial restructuring is required prior to privatisation. Where third parties, whether they be banks or venture funds, are contributing capital, not unreasonably, they insist on carrying out a thorough evaluation of the enterprise's management and business plan before committing funds. They also expect to retain an active, but not dominant interest, in the enterprise's affairs.

**Mass privatisation**

A mass privatisation programme was discussed for more than four years in Poland. It was eventually approved by parliament on 11 April 1993. Mass privatisation is to be achieved through the allocation of 60 per cent of the shares of over 200 state-owned enterprises to 20 financial intermediaries to be known as National Investment Funds (NIFs). The Funds will be established in or around January 1994 as joint-stock companies and will operate as closed-end investment funds with an envisaged life of ten years. Each intermediary will control between 10-20 state enterprises.

The task of each intermediary is to increase the value of the its shares by increasing the value of the enterprises it owns. Logically this implies that Fund management teams will seek to maximise each firm's value through restructuring. Fund managers will receive an annual fee topped up by performance-related bonuses and share options that can be exercised at the end of the envisaged ten year life of the funds.

The NIFs will be owned by all interested adult Poles who will be invited to buy a single share in each intermediary, purchased for a modest registration fee of the equivalent of $20 or 10 per cent of an average month's wage. The certificates will, in due course, give their holders the right to exchange them for the State Treasury's shares in the funds. As a result of this exchange the NIFs will be fully privatised and their shares traded on the Warsaw Stock Exchange.

Initially Allocation of the companies' shares among the investment funds is to be distributed as follows:

*27% of the share capital will be divided among all investment funds (small shareholders) with equal numbers of shares going to each fund;

*33% of the share capital will be allocated to one fund (lead shareholder);

*15% of the share capital will be reserved for free distribution to employees; and

*25% will remain in hands of the Treasury or the Ministry of Privatisation.

Each NIF will receive an equal portion of a first block of 27 per cent of the shares of all companies; after examining the prospects for each firm, they will then in turn select specific companies and obtain a 33 per cent block of shares in them.[10] It is assumed that the NIFs will carry out due-diligence reviews of these companies and restructure where necessary. It is assumed that the leading NIF will then play a key role in turning around the enterprises in their portfolio to improve current performance and profitability. The distribution of controlling interests may change further following subsequent trading among shareholders, subject to certain restrictions to ensure that no companies are abandoned. The objective is to encourage deepening of capital markets and the strengthening of corporate governance.

In order for the NIFs to realise their gains, it will be necessary to privatise their enterprises at a good price. Real privatisation will only be complete when the general population receive share certificates with real value in the secondary markets. In a late amendment to the legislation no firm can be included in the programme without the consent of the enterprise directors and the workers council.

The target launch date for the NIFs is 1 January 1994. Polish adults will then have six months in which to register and claim their certificates.

**A preliminary assessment of Polish privatisation**

Across the region, the privatization of large enterprises through a direct public offering (capital privatization in Poland) has been limited. In Poland, only 28 companies had been privatised through capital privatisation by the end of 1991.[11] Of these, eight were trade sales to foreign-based companies and 14 were privatised through public share offerings. In Hungary and Czechoslovakia the number of trade sales was higher, but there was still disappointment in the speed of the process.

It is now widely acknowledged that such a pure 'classical' capital approach based largely on British experience is inappropriate for the CEE/FSU situation. Selling an enterprise to a large number of small shareholders does little to improve corporate governance and revenue benefits go to the state, not the enterprise. It has now become the orthodoxy of the Polish Ministry of Privatisation and the Ministry of Industry and Trade and those in charge of privatization programmes across the region, that a strong, (usually foreign) partner, is essential to provide the capital, management and technology to turn around a typical CEE enterprise.

As a result, the emphasis in capital privatisations has turned more and more to the need to find a foreign partner looking for an entry into the Polish market and one which is prepared to make a substantial investment of management time as well as money. Hence the importance of professional and well-executed sectoral studies that provide the authorities with an appraisal of the up-to-date status of domestic state-owned enterprises, opportunities in the global marketplace and a short list of prospective investors. The impact of sectoral studies on capital privatisation became apparent in 1993 when no less than 42 state enterprises were privatised in just over nine months, only four were via the Warsaw Stock Exchange. In short, carefully packaged and targeted trade sales now dominate capital privatisation in Poland.

Foreign investors have played a key role in the successful turnaround of several former state-owned enterprises across the region. For example, the Harvard Business Review reports two case studies of Gerber, the US baby foods manufacturer, and Thomson, the French state-owned (sic.) consumer electronics company which are majority joint venture partners in, respectively, Alima and Polkolor.[12] Both companies are now competing very successfully in domestic and export markets. Thomson exports 60 per cent of its TV tubes to the West and Gerber has doubled turnover in a year from $25m to $50m and exports 20 per cent of production. These two glittering success stories are compared with the relatively dismal performance of many of the Polish companies that were privatised and remained under local ownership and management.

The key factor in the success stories comes through the way in which the foreign partner's contribution is mediated through a radical transformation and strengthening of middle management. Without this injection of management know-how, companies tend to flounder and drift into a downward spiral of layoffs that are never quite large enough to permit efficient refocussing of the enterprise because of trade union resistance and management weakness.

If 1993 was the year when the Ministry of Privatisation's persistence with sectoral reviews paid off in an increased number of strategic capital privatisations, 1994 should be the period when the first 200 mass privatisations under the aegis of 20 NIFs begin to make an impact. Clearly there is scope for conflict between

what might be called the 'cherry-picking' sectoral approach to capital privatisation which has obvious revenue benefits for the Polish Treasury and the mass privatisation approach which has populist overtones. Privatisation is expected to realise $580m in 1993 for the State Treasury.[13] By October, the government had received $200m in revenue and obtained investment commitments of $500m from capital privatisations alone. Transaction costs were 6.1 per cent of revenue down from 13.3 per cent of revenue in the first full year of capital privatisation in 1991. There must be substantial doubts as to whether there will be any firms of value left to be included in a second wave of mass privatisation.

**Mass privatisation: populist politics or good for business?**

Obviously it is impossible to make a judgment about a policy that has been talked about for more than four years but has so far not been implemented. While the Polish government's structural adjustment programme announced in the last quarter of 1989 may have been truly radical, the speed of implementation of its privatisation programme can hardly be described as such. However, the signs are that the privatisation programme in general is continuing to gain momentum and the mass privatisation programme, in particular, will start to be implemented in 1994.

A major innovation in the Polish mass privatisation scheme is the assignment of strategic, 10-year management functions to the 20 new National Investment Funds. In the Czech case, the 420 investment funds appeared spontaneously following the launch of the mass privatisation programme. The then Czechoslovakian government simply issued books of vouchers to its citizens which could be used for bidding for shares in 1,300 enterprises included in the mass privatisation programme. Most people had no idea which were good investments and chose to delegate this decision to the private funds which were mainly created by state-owned banks. The banks, of course, lacked fund management skills or experience. So far it is unclear how the different fund managers will decide on the fate of the firms they 'own' though there is likely to be a bias towards asset stripping and quick profit taking as fund managers compete fiercely against each other for business. In the Czech case, it is not impossible to imagine a severe political backlash and a government instituted renationalisation of distressed companies located in sensitive regions.

In the Polish case, the success of the mass privatisation programme depends explicitly on the quality of the NIF management and their ability to convert the enterprises in their portfolio in to profitable investments. However, as with the Czech mass privatisation programme, there are no obvious efficiency gains to be had from injections of new capital, new management or know-how. The main route to increasing the value of enterprises will be through developing and executing commercially successful restructuring plans, spinning-off peripheral activities and selling surplus assets. Any new finance will have to be raised through the existing banking system. However, because many of the managing consortia of the NIFs have banks as members the possibilities for raising finance should be less arduous than the present system. There is a real danger of insiders rigging the market. The distribution of ownership may be equitable, but shareholder property rights are ultimately diffused. However, the Ministry of Privatisation has attempted to deal with this criticism by encouraging each of the Funds to establish a controlling stake in around twenty to thirty of the enterprises in their portfolio so that the Fund management teams can drive through restructuring plans if necessary where they have ownership control.

Again populist promotion of the mass privatisation programme has probably encouraged false expectations. On the other hand, the emphasis on professional and experienced management of the NIFs will minimise the possibility of corrupt deals occurring. With an expanding domestic economy easing recessionary pressures on firms, there is a reasonable chance that the mass privatisation programme will be successful in creating a new class of private property owners. The political objective of neutralising the continuing influence of the management and workers of the state-owned sector will undoubtedly be advanced.[14] However, the outcome of the September 1993 election in Poland should be seen as a clear warning to the authorities. The electorate is unhappy about increased inequality which they rightly or wrongly identify in

part with the outcome of privatisation. The paradox is that the electorate have turned to the postcommunists and their allies for relief from what are perceived as the injustices of the transition process. The mass privatisation programme when it gets underway in 1994 will undoubtedly stir up further popular disquiet about the redistribution of wealth in postcommunist Poland.

**Constraints to Polish privatization**

As a result of the reforms introduced in the 1980s by the communist government, the succession of democratic administrations since 1989, has ironically had to face the problem of negotiating privatisation deals with self-governing state enterprises. In each Polish enterprise, the workers council has an important say in strategic decisions affecting the enterprise and can effectively veto any proposed ownership change. Thus, constitutionally, any proposal for privatisation has to be approved by the workers council. Government institutions may encourage the process through inducements such as offering special tax breaks, but ultimately the state cannot force employees to accept privatisation.

In addition, the privatisation programme has had to take into consideration the extremely complicated and decentralised ownership structure of Polish public enterprises. The Ministry of Privatisation has, at one time or another, had to negotiate with over 60 different 'founding bodies' in its efforts to implement its privatisation programme. In order to coordinate and facilitate operational activities the Ministry has a network of regional offices. Even so, sequencing problems have quite often resulted in decisions being delayed or obfuscated. If a municipal authority does not wish to privatise a particular enterprise of which it is the 'founding body', there is very little the Ministry can do other than persuasion.

**The reprivatisation constraint**

A further factor delaying privatisation has been the absence of reprivatisation legislation in Poland even though it was the first country in the CEE region to launch a privatisation programme. Poland now has the dubious distinction of being the only country in the region apart from the FSU without a law on its statute book covering the problem of property restitution. So far the only redress open to former owners deprived of their property both illegally and under former communist legislation has been to go to court to claim their rights. To date the Ministry of Privatisation has received more than 8,000 claims from former owners but there is no agreement on they way in which properties should be returned to those who lost them to communism. There have been a number of attempts to draft a reprivatisation bill starting in 1989. The latest draft bill fell with the government in September 1993.

Three ways were envisaged for meeting former owners' claims. They would have been able to either receive their properties in kind, obtain a substitute property or get reprivatisation vouchers. Such vouchers would have been bearer securities good for six years without interest which can be converted into stock in privatised enterprises. A reserve of five per cent of the stock in Treasury-controlled companies would be set aside for reprivatisation compensation purposes.

The Ministry of Privatisation estimates an overhang of around 300,000 outstanding claims though if experience elsewhere in the CEE is anything to go by, the number could be much greater.[15] The views of the new government of Mr. Pawlak on this contentious issue are unknown but it is apparent that the problem of reprivatisation has to be resolved by legislation. Current reliance on the courts is hopelessly inadequate. If a litigant wins a case, the state has no resources for paying restitution, hardly a situation likely to encourage people to put their trust in property rights, contract law and the legal and regulatory infrastructure of modern Poland.

**The contribution of foreign direct investment (FDI)**

Foreign direct investment (FDI) is motivated by one of two broad objectives: searching out new markets, or to minimise global costs of production including seeking cheaper raw material sources. The impact of the policy environment, and privatisation policies in particular, on investment decisions is clearly influenced by the objectives being pursued by the inward investor. A German mail-order catalogue company seeking a cheap subcontractor for garment manufacture is unlikely to be interested in the same issues as say a soft drinks bottler looking for a partner to service the Polish domestic market. The market-seeking bottling company is likely to be interested in projected growth of disposable income in the region, the strength of competition, the type of distribution system available and exchange rate policy amongst other items. The export-oriented garment manufacturer is primarily concerned with labour costs, the productivity of the work force and the availability of reliable but low cost transportation.

If we consider the effect of government policies on FDI, it is important to bear in mind that FDI is a multidimensional, evolutionary process. Decisions concerning initial equity, reinvestment of earnings, and long-term and short-term debt differ. They are made at different points in time and at different stages of a project. An optimal government policy needs to take account of the different parameters involved in each type of investment decision. There are also likely to be tradeoffs between attempts to attract FDI and national economic welfare. For example, some policies designed to enhance the efficiency of domestic markets such as an active anti-trust policy may discourage market-seeking investment. Specifically, market seekers are likely to favour import protection, subsidies for inbound FDI, government procurement policies that discriminate against imports but not against foreign-owned domestic firms and other non-tariff barriers to import competition. In other words, certain kinds of market imperfections are favourable to inward

investment because they enable investors to make profits secure from significant competition.

By contrast, some policies that decrease market imperfections can be attractive to FDI. Thus privatisation of state monopolies may open up new opportunities for FDI provided no private domestically-owned monopolies are created. Implementation of anti-dumping measures and simplification of import duties on essential inputs ensures local producers, whether foreign or domestically-owned, compete on equal terms with imports. Policies to decrease trade-related market imperfections such as the abolition of complex import and export regulations through the creation of manufacturing in-bond facilities are likely to be particularly important to export-oriented cost saving investments.

**The Polish experience of foreign direct investment**

It is widely recognised in Poland that privatisation alone will not ensure the efficient transformation of state enterprises to world standards of competitiveness. The savings rate of the Polish economy is insufficient to finance restructuring even when combined with aid flows. Investment in all sectors of the economy has been in decline since 1989. Scarcity of funds has delayed completion of vital infrastructure investment in contrast to the pre-1989 period when shortages of physical resources constrained investment. Perhaps more important than finance is the severe deficit in market-oriented expertise at enterprise level. Foreign direct investment comes in as a commercially viable package, not only in the form of funds to buy new equipment and modern technology but also in the form of management expertise including marketing, finance and organisation.

Poland first attempted to attract foreign investment in the late 1970s following the passing of the 1976 foreign investment law. It has been progressively amended since (1979, 1982, 1985, 1986, 1989 and 1991). The real breakthrough came after 1989 when a modern liberal investment code was introduced into the law in mid-1991.

The most important changes introduced into the law were: freedom of transfer of profits and proceeds from sales of stocks and shares; abolition of the minimum capital contribution required of foreign investors and relaxation of formalities; special tax breaks were restricted to only investments over Ecu 2 million and investments in regions of high unemployment, projects employing modern technologies or exporting at least 20 per cent of output.

In addition, the new investment law provides protection to foreign investors against political risks. Extra safeguards are provided through bilateral agreements with 17 of Poland's major economic partners. Finally, the basic privatisation law of 13 July 1990 allows for the participation of foreign investors.

**The growth of foreign investment**

There was an initial rapid growth of foreign investment in Poland. Between the end of 1990 and the end of 1991, the number of joint ventures involving foreign partners grew from 1,645 to 4,796. By the end of 1992, the number had expanded to 5,200. Part of the reason for the sharp increase in joint-venture formation was the abolition of the minimum capital requirement in mid-1991. Many of the small investments were in the service sector, a feature characteristic of the first wave of investment into the special economic zones of China. The first wave into Poland after 1989 was dominated by German investors: 30 per cent of the total number of companies. By 1992, the Americans probably took the lead in volume terms. However, foreign investment statistics are notoriously difficult to collect and trends are therefore difficult to interpret. There is no statutory obligation on foreign investors to declare their investment to the authorities.

The total volume of commitments was between $700 million and $1 billion in 1991. Commitments in 1992 were officially declared at $4 billion including $2 billion from Italy, $600 million from the USA, and

$300 million each from Germany, Austria and Sweden. Table 9 that lists the twenty largest investors in Poland as reported up to April 1993 demonstrates the wide gap between current investment (debt and equity) and investment commitments. Obviously, commitments will not become real investments unless foreign investors continue to believe the Polish economy offers profitable opportunities for their businesses.

In comparison to Hungary and the Czech Republic, Poland has been relatively slow in attracting inward investment. The prospect for 1993 and beyond seem to be encouraging with estimates of commitments rising to as high as $6 billion by 1994. Certainly Poland's rating as an investment destination amongst potential multinational investors has risen to second only to Hungary as reported in a survey commissioned by the Polish economic planning agency in 1993.

**Table 9 List of Top Foreign Investors in Poland**

Source: Warsaw Voice, 4 April 1993.

So far the Polish authorities have not conducted any systematic evaluation of the costs and benefits of inward foreign investment. The major promotion effort has focused on making Poland attractive to inward investors through one-stop promotion agencies such as the State Agency for Foreign Investment (PAIZ) and the UNIDO-sponsored Investment Promotion Service (IPS). Regional authorities at voivodship level also have set up inward investment promotion agencies. The exact nature of the deals struck with investors are, of course, closely guarded commercial secrets. At some future date, it is important that the authorities evaluate foreign investment projects in terms of: initial equity investment, loan inflows and repayments, reinvestment and capital repatriation. This is necessary if further fine-tuning of foreign investment policies and avoidance of wasteful duplication of promotion activities is to be achieved. There are also the fears of certain political groups to be allayed as regards exploitation of Poland by foreigners.

Above all governments have to be realistic in their expectations about promotion efforts. Investment and reinvestment decisions are always going to be primarily driven by internal enterprise considerations. There is therefore a limit to what can be achieved with glossy brochures and well-appointed office suites of promotion agencies. Investors operate in a competitive environment and are usually well aware of alternative investment locations. Of much greater importance than general promotion efforts, are carefully targeted introductions to local investment opportunities. These always need to be highly specific, well-informed and honest. However, all surveys of investors concerns reveal the primacy of prospects for economic growth, political and therefore policy stability, and the transparency and efficiency of the legal and regulatory infrastructure.

Of course, there are differences in specific concerns that relate to investor motivation but the lesson for governments and policy-makers is clear: it is the general political and economic health of the host nation that matters most. No amount of promotion can disguise a hostile economic environment. It is also very important to remember that prospective investors invariably consult existing investors so keeping established investors satisfied is a wise policy. Not only are they the most important source of promotional information for new investors but if they are positive about the host economy they will and honour their initial investment commitment and maintain their reinvestment rate beyond that.

**Endnotes**

1. Lieberman, I W (1990) 'Industrial Restructuring: Policy and Practice', World Bank Policy and Research Series, 9, p 7.

2. Ministry of Privatization, "Country Privatization Report - 1992: Poland" presented to the Third Annual Conference on Privatization in Central and Eastern Europe, December 4-5, 1992, Ljubljana, SLovenia.

3. The various unfulfilled pledges to the Russian President, Boris Yeltsin, are symptomatic of the lack of willingness on the part of OECD countries to provide adequate funds to support restructuring and privatisation on a sufficient scale to make a significant impact.

4. Green, E J (1993) 'Privatisation, the Entrepreneurial Sector and Growth in Post-Comecon Economies', Journal of Comparative Economics Vol 17, pp 407-417.

5. This, of course, assumes that tight budgetary conditions prevail for CEE governments, a not unreasonable assumption given, the debt power of the IMF and the World Bank to enforce a hard constraint on CEE governments.

6. The British and Swedish governments do not seemed to have felt inhibited in closing down the entire state-owned civilian shipbuilding industry. The British government continues to close state-owned coal mines.

7. The significance of 15 October 1993 is that it was the day on which the government changed. Mr. Lewandowski handed over to Mr. Kaczmarek, the incoming Minister of Privatisation in the new SLD-PSL coalition government.

8. Sondhof, H and Stahl, M (1992) 'Management Buy-Outs as an Instrument of Privatisation in Eastern Europe', Intereconomics, September-October, pp 210-214.

9. Thus the Olszewski administration (December 1991 - June 1992) claimed that the sectoral studies were merely making recommendations that were never implemented. This administration downgraded the sectoral programme. Mrs Suchocka's in-coming administration (July 1992 to October 1993) reappointed Mr Lewandowski, Poland's first Minister for Privatisation in the 1989 Mazowiecki government, and sectoral privatisation regained a new impetus.

10. It is assumed that neither the State Treasury with 25 per cent of equity or a block of employees as shareholders with an initial allocation of 15 per cent of equity, will attempt to exercise control over any of the enterprises involved in the mass privatisation programme.

11. Gomulka, S (1993) 'Poland: A Glass Half Full', in R Portes (ed.) Economic Transformation in Central Europe: A Progress Report, London: European Communities and Centre for Economic Policy Research.

12. McDonald, K R (1993) 'Why Privatisation is Not Enough', Harvard Business Review, (May-June) pp 49-59.

13. Financial Times, Special Supplement on Poland, June 17, 1993, p VI.

14. Ewing, A and Lee B W (1993) 'Accelerating Privatisation in Ex-Socialist Economies', Columbia Journal of World Business, (Spring), pp 158-167, and Thomas, S (1993) 'The Politics and Economics of Privatisation in Central and Eastern Europe', Columbia Journal of World Business, (Spring), pp 168-179. It is not clear how the incoming government will deal with the conflicts that will inevitably arise.

15. For example, in Bulgaria there have been over a million claims under reprivatisation laws. Only 3 per cent of urban property has been returned to its former owners or their heirs. In the Czech Republic and Slovakia, there were some 300,000 applications by the deadline at the end of 1992. In this latter case only citizens who lived permanently in either of the two countries were eligible for restitution. In eastern Germany there have been over a million claims on real estate and 10,000 on enterprises. Reprivatisation in Hungary is limited to individuals only and essentially consists of granting reprivatisation bonds. The maximum value per individual is set at 5m forints. The Hungarian government received 800,000 claims totalling 50bn forints by its deadline of the end of 1991. 4000 people are working for the agency handling claims.

## Chapter 5
## The Emerging Methodology of Industrial Restructuring

### Introduction

The majority of Central and Eastern Europe's industry was developed on the principle of providing local employment or supplying a missing link for other industrial enterprises, sometimes on a transnational basis within the CMEA. Enterprises were rarely founded on the basis of conventional market-based investment appraisal techniques such as estimations of the return on the planned investment, profitability and net present value (NPV) calculations, or cash flow projections. In any case relative prices were so distorted as to render estimates meaningless in any economic sense. The management culture fostered by the central planning mechanism tended to be inward-looking and production-oriented. Despite possessing relatively high technical skills, managers felt little pressure to develop the necessary overall management systems required to run a modern, competitive enterprise. Instead, enterprises were typically over administered and overstaffed and peripheral activities were allowed to proliferate unchecked by consideration of their contribution to profitability. Once the central planning mechanism was abolished, managers of large state-owned enterprises quickly discovered that they were ill-equipped to meet the new challenges posed by an economy in transition.

The rapid introduction of a liberal market economy, meant that management in the CEE and FSU, unused to open competition, suddenly discovered they lacked the necessary skills to compete on an equal footing against a growing volume of Western imports. All companies have had considerable problems adjusting their production oriented structure to market oriented operations. Such changes mean more than producing what the market demands and delivering it successfully to a client. It also involves such strategic management issues as choice of pricing techniques, budgeting, cost monitoring and the overall concept of value added operations.[1] Weaknesses in the area of marketing, finance, cost accounting, technology, production and general management became all too apparent as sales of manufactured goods dropped dramatically. This problem was further compounded by the collapse of established markets in the CMEA necessitating a rapid reorientation of marketing activities towards Western Europe.

A growing number of enterprises, no longer able to service their loans and starved of even working capital, sought restructuring assistance from CEE government agencies to help them survive in the newly emerging market economy, to compete with Western companies, to capture new markets and attract investors. Most companies placed their initial revival hopes on a multitude of uncoordinated efforts such as small joint venture schemes, instead of concentrating on a few core issues and persisting until success was attained.

As quickly as output collapsed, CEE and FSU governments were subject to immense political pressure to do something by establishing new agencies to support industrial restructuring. Since this was a new phenomenon in world economic history, there were no obvious role models or experience on which to draw. New alliances have had to be forged between government bodies, banks, enterprises, and multilateral institutions in order to experiment with and develop appropriate support mechanisms.

### Restructuring as an integrated exercise

The process of industrial restructuring in CEE and the FSU involves a systemic change. Having removed the familiar landmarks and imperatives of the communist system, a new institutional geography has to be created along with a supporting legal and regulatory infrastructure. During the transition process from the old central planning mechanism-based system to the new market-oriented flexible system, it is necessary to

evolve a network of linked change-supporting processes.

In an ideal world, government policy development should be integrated with the changing needs of the productive sector but in the real world policy makers are subject to cross-cutting pressures from a multitude of different constituencies. Many of these interest groups are far from sympathetic to the needs of an efficient and competitive industrial sector, particularly where loss of jobs is involved. This highlights the paramount importance of policy makers, consultants and top management not only being able to spell out the strategies and techniques being used in industrial restructuring exercises in terms that can be widely understood, but also being willing to sell them in public to managers, trade unions and workers

The role of government policy

Large state-owned enterprises as complex organisations with many stake holders possess a considerable inertia and resistance to change. Radical changes in business strategy and operating procedures can only be introduced if a sufficiently powerful group has the incentive and the means to take action to improve efficiency and overhaul standard operating procedures.

Part of the incentive is derived from the policy environment in which the firm operates. Policies introduced to reform subsidies, price controls, taxation, monopolistic and restrictive trade practices, company and property law, the availability of corporate finance and foreign exchange rates, all have a bearing on behaviour of the firm. One of the main purposes behind policy reform is to expose previously protected state-owned enterprises to greater competitive pressure in order to force enterprises to take steps to rectify their internal weaknesses. Unfortunately, there is no simple cause-and-effect relationship between policy instruments and enterprise reform. Indeed, reforms interact and produce unintended consequences, firms take evasive action or simply do not have the resources to respond to the new opportunity structures created by policy reform.

An integrated industrial restructuring programme entails not only coordination of economic policy outputs with enterprise needs, but also of intermediary agencies and institutions whose active involvement is often crucial. The sheer number of agencies that can be involved in a restructuring exercise:- a multitude of different government departments that may operate both at national and regional levels; municipal authorities; financial institutions; multilateral agencies - all make it difficult to develop a coherent strategy and implementation plan.[2] This is especially true if the typical level of preparation of enterprise management is taken into consideration; the level of internal inertia that appears during organisational reform; the lack of sophistication of financial institutions; the differing objectives of government institutions in the restructuring process; and the varying degrees of support from multilateral institutions. These are only a few of the possible interest groups that may be involved in any restructuring exercise. Each interest has to be taken into account in a comprehensive restructuring exercise.[3]

The role of banks

As we noted in Chapter 3, financial institutions traditionally play a pivotal role in supervising the financial and more general management aspects of restructuring of companies in the West. A well-functioning banking system able to supply capital to industry at globally competitive prices is essential for industrial development.[4] Market-oriented enterprises rely on their financial advisers' intimate knowledge of the intricacies of corporate finance.

In CEE and the FSU, the underdeveloped state of the financial sector has had a deadening influence on enterprise restructuring. Under the central planning system, strict state control prevented banks and other financial institutions from developing the skills and knowledge necessary to select, monitor and calculate the profitability of an investment project and properly assess credit risk. The culture of working with and

assisting enterprises was never encouraged, leaving banks completely unprepared to assist with restructuring enterprises so that they are able to prosper in a market economy.

While bank staff were unprepared for loan portfolio management and commercial risk assessment activities, enterprise managers were also not trained to negotiate with banks and other lending institutions. They, like their opposite numbers in the banks, had little opportunity to learn and develop financial skills. Thus, in Poland, most enterprises still lack the knowledge and experience to independently evaluate new financing options. This deficiency inhibits enterprises from seeking finance for restructuring plans in the emerging capital markets. To make matters worse, when Polish enterprises seek financial assistance from their banking partners, instead of becoming actively involved, most banks and financial institutions remain aloof often unaware of an enterprise's needs.[5] The inadequacy of the financial assistance that can delay or stop restructuring efforts, is defended by the banks on the grounds of their own needs to recapitalise their balance sheet ravaged by non-performing loans inherited from the pre-reform period. The bank refinancing act passed in February 1993 should soon clear away this excuse for Polish bank passivity.[6]

Industrial relations

In Poland, Solidarity, originally created as an unofficial trade union, very effectively challenged the passivity of the official Polish trade union movement by organising enterprise-based protests and strikes against poor wages and working conditions in the 1970s and 1980s.[7] This meant that Poland entered the reform process in 1989 with two competing trade union movements represented in most major enterprises, a postcommunist union and a Solidarity affiliated union. Competition between the two trade union organisations for members has occasionally been fierce and politicised. Needless to say, ordinary members have more pragmatic wage-related interests than their leadership but it does mean that Polish workers tend to be represented by trade unions that have a history of independence and activism. Ironically, in the general election of September 1993, the postcommunist trade union-sponsored party in the Sejm joined the governing coalition while the Solidarity-affiliated party left office. The consequences for enterprise labour relations is unclear.[8]

Enterprise restructuring often creates a period of considerable anxiety in the workforce as people worry about job security. Reconciliation of real or potential differences between management and workers is an important key to successful restructuring so that early involvement of both parties in formulating an integrated restructuring plan and implementation process is important. An enlightened management can help to alleviate the inevitable tensions by offering the unions an opportunity to make a real contribution to the final solution. While unions in Poland have a constitutional right to be consulted in state-owned enterprises and retain the power of veto over any privatisation proposal exercised through the workers council, unions in Poland have often been remarkably flexible.[9] They have been drawn into the restructuring and privatisation process by the promise of preferential acquisition of company shares, wage increases and guarantees of job security.[10]

An interesting example of the importance of the work force's attitude to restructuring and privatisation was demonstrated in the case of the Goplana confectionery factory in Poznan. The company has purchased cocoa beans from a British company, the Ed and F Man Group, since 1991 and also formed a joint venture with it to distribute Goplana products. Late in 1992, MAN offered to buy 47 per cent of Goplana shares for $31m, the two companies signed a letter of intent with the provincial head, the legal owner, and MAN deposited the necessary funds in the bank. In August 1993, Nestle began to show an interest and made a counter bid of $40m for 80 per cent of the equity and offered to provide a $30m investment guarantee.[11] Goplana's employees refused to accept majority foreign ownership. The Board of Employees and the Staff General Assembly, as well as the directors, opted for the joint venture proposal by MAN.

Under pressure from the Ministry of Privatisation, the provincial head as the legal owner of the factory announced a public auction, in October 1993. Five bids were submitted but only those by Nestle and MAN were considered seriously. Nestle's bid was $6m higher than that by MAN but the work force rejected the

bid. Nestle eventually carried the day by vigorous campaigning in the media and by coming up with the offer of a 36-month employment guarantee, a 30 per cent wage rise and an increase of employees' shares up from 6 to 10 per cent. Employees were offered a cash alternative to shares equivalent to Zl67m ($3250). Nestle's offer was distributed in an open letter to employees at the factory gates of Goplana by Nestle-Polska's general manager in person. At the final meeting of the factory delegates, there were 54 votes 'for' and two 'against' the Nestle offer.

Human resource development

The ability of a state-owned enterprise to react to a changing environment is to a large degree dependent on the capacity and capabilities of its work force and of its management cadre, in particular. Thus the provision of management training and retraining in aspects of competitive market realities, new financial options and assistance available to enterprises is an important component of the restructuring process. Without proper training and systematic management development it is very difficult for the management team to begin to focus on the necessary changes in business strategy required to improve technology and organisation; adjust products and marketing to face the new competition; reorganise production to increase efficiency; access appropriate financing to fund restructuring; and streamline operations through the disposal of peripheral operations.

Options for developing employees through training are still very limited. Training provision is rarely coordinated with government policy yet without adequate preparation through training, well in advance of policy changes, the results can be devastating at enterprise level. For example, in Poland, the decision to liberalise prices and trade policies in 1990 or the decision to introduce VAT in July 1993 both had an immediate impact on enterprises but insufficient resources have been devoted to training people how to cope with the new system.

Apart from the disruption this caused to normal business activity, there is a serious danger of encouraging criminality. Thus the sudden introduction of VAT levied at 22 per cent provided a strong incentive for smaller Polish businesses to disappear into the grey economy especially. Without careful training it is unrealistic to expect to expect businesses to file four complicated tax returns a month. The VAT form has about 60 boxes to tick compared with 11 in the United Kingdom. Worse still, the honest businessman who makes a mistaken claim which is not backed by an invoice faces a 400 per cent penalty rate. By contrast, the United Kingdom penalty rate is 15 per cent which many businesses find too much to bear.

Time for proper consideration and sequencing of training in support of reforms have tended to be limited by the immediate economic situation. While there are always likely to be teething problems when complex economic legislation is introduced, ultimately the legitimacy of new systems depends on the quality of the implementation process which in turn relies heavily on the professionalism and training of the personnel responsible. Without adequate training of officials and business people the reform process is likely to be at best incomplete and at worst chaotic and immensely disruptive of economic activities.

The role of technical assistance

Technical assistance programmes developed by multilateral institutions such as the EC-PHARE programme, the World Bank, IMF, EBRD, EIB and UNIDO can play an important role in the industrial restructuring process of former communist countries. Many have wide knowledge of the CEE and FSU region and have accumulated a wealth of experience in various industries. Unlike many domestic institutions, they are often viewed as relatively unbiased partners in the reform process. Assistance provided by multilateral institutions for enterprises is normally channelled through government agencies; programmes include training support, technology transfers, financial support, development investment schemes, regional development, legal advice, small business centres, privatisation and restructuring expertise.

Table 3

| Estimates of per capital GNPs or GDPs for CPEs in 1990 | | | | | | |
|---|---|---|---|---|---|---|
| Country | PlanEcon | | Alton/CIA | | WEFA | |
| | $ | % | $ | % | $ | % |
| United States | 21,863 | 100.0 | 21,863 | 100.0 | 21,863 | 100.0 |
| G.D.R. | 8,500 | 38.9 | 9,718* | 48.1* | 9,314 | 42.6 |
| Soviet Union | 5,700 | 26.0 | 9,144 | 41.9 | 7,122 | 32.0 |
| Czechoslovakia | 7,816 | 35.8 | 7,938 | 36.3 | 7,822 | 35.8 |
| Hungary | 6,017 | 27.5 | 6,119 | 28.0 | 6,888 | 31.5 |
| Yugoslavia | 5,259 | 24.1 | 5,223 | 23.9 | 3,744 | 17.1 |
| Bulgaria | 5,104 | 23.3 | 5,314 | 24.3 | 5,579 | 25.5 |
| Romania | 4,214 | 19.3 | 3,987 | 18.2 | 3,697 | 16.9 |
| Poland | 4,089 | 18.7 | 4,352 | 19.9 | 5,122 | 23.4 |
| Average excluding Soviet Union & G.D.R. | 5,417 | 24.8 | 5,489 | 25.1 | 5,475 | 25.0 |
| * This figure by Alton refers to 1989 | | | | | | |

Table 4

Poland: Key Economic Indicators

| | 1989 | 1990 | 1991 | 1992 | 1993[1] |
|---|---|---|---|---|---|
| Growth in GDP (%) | 0.2 | -11.6 | -7.0 | 1.0 | 2.2[2] |
| Inflation (% end year) | 640 | 250 | 60 | 44 | 32 |
| Unemployment (% end year) | 0.1 | 6.1 | 11.8 | 14.0 | 16.0 |
| General government balance (% GDP) As % GDP | -7.4 | 3.5 | -6.2 | -7.0 | -4.8 |
| Exports | 15.6 | 22.8 | 20.3 | 18.7 | - |
| Imports | 12.0 | 17.1 | 23.0 | 22.5 | - |
| Current Account | -1.7 | 1.3 | -3.0 | -0.3 | - |

[1]official projections
[2]OECD

Source: Quarterly Economic Review (EBRD April 1993)

# Table 5

## Some Macro-Indicators of Adjustment

| | CSF | HUNGARY | POLAND | BULGARIA | ROMANIA | Former GDR | Former USSR |
|---|---|---|---|---|---|---|---|
| GDP 1989 | 1.0 | -0.2 | 0.5 | -0.4 | -7.9 | na | 3.0 |
| 1990 | -0.4 | -4.0 | -11.6 | -10.6 | -7.4 | -15 | -2.0 |
| 1991 | -16.4 | -7.5 | -8.0 | -25.0 | -12.0 | -34 | -17.0 |
| Cumulative 1988-91 | -20 | -15 | -25 | -30 | -30 | | -25 |
| 1992 | -7.1 | | 1.0 | -7.7 | | | |
| cumulative industial output 1989-92 | -34.6 | -37.5 | -41.3 | -46.0 | -45.3 | -44.2 | -28.3 (Russia) |
| Unemployment (end of year) 1990 | 1.0 | 1.8 | 6.3 | 1.4 | | | 2.0 |
| 1991 | 6.6 | 9.1 | 11.8 | 10.5 | 2.5 | 16 (30+) | 1.8 |
| 1992 | 6.0 | | 14.0 | | | | |
| Inflation 1990 | 18 | 29 | 538 | 64 | 14.1 | | |
| 1991 | 54 | 35 | 48 | 271 | 238 | na | 160.6 |
| 1992 | 12 | | 44 | | | | 900+ |
| Budget Deficit 1990 | 0.3 | 0.1 | -3.5 | 9.2 | 0.3 | | |
| 1991 | 2.1 | 3.9 | 6.2 | 4.3 | 1.4 | 45 (transfers) | 19.9 |
| 1992 | | | 7.0 | | | | 8 |
| Private Sector | (1992) | | (1992) | (1992) | (1992) | | (1992) |
| %of GDP | 19.5 | na | 50 | 15.6 | >25 | na | 25 |
| % of industrial output | 14.5 | na | 31 | | | | |

Table 6

| Booming Trade with the OECD | | | | | | |
|---|---|---|---|---|---|---|
| | Exports | | | Imports | | |
| | $ billion<br>1989 | 1992 | % p.a. growth 1989-92 | $ billion<br>1989 | 1992 | % p.a. growth 1989-92 |
| Poland | 6.1 | 11.2 | 22.3 | 6.2 | 13.6 | 30.0 |
| Czechoslovakia[1] | 4.2 | 9.2 | 30.3 | 3.7 | 10.8 | 43.4 |
| Hungary | 4.5 | 7.4 | 17.6 | 4.7 | 7.8 | 18.8 |
| Visegrad 4[2] | 14.8 | 27.8 | 23.3 | 14.5 | 32.3 | 30.4 |
| Romania | 3.9 | 2.4 | -15.3 | 1.2 | 3.1 | 36.0 |
| Bulgaria | 0.8 | 1.6 | 24.7 | 2.4 | 1.9 | 7.4 |
| TOTAL | 19.6 | 31.8 | 17.5 | 18.2 | 37.3 | 27.0 |

1 Now Czech Republic and Slovakia
2 Poland, Czech Republic Slovakia and Hungary

Source: Monthly Statistics of Foreign Trade (OECD)

Table 7

| Trade with the EC | | | | | | |
|---|---|---|---|---|---|---|
| | EC Imports | | EC Exports | | Trade Balances with EC $billion | |
| | % total from non-EC | % p.a. growth 1989-92 | % total to non EC | % p.a. growth 1989-92 | 1989 | 1992 |
| Poland | 1.4 | 27.7 | 1.9 | 34.5 | 0.0 | -1.4 |
| Czechoslovakia[1] | 1.1 | 35.7 | 1.5 | 45.6 | 0.2 | -1.0 |
| Hungary | 0.8 | 21.3 | 0.9 | 16.6 | -0.4 | -0.1 |
| Visegrad 4[2] | 3.4 | 28.4 | 4.3 | 32.5 | -0.1 | -2.5 |
| Romania | 0.3 | -13.6 | 0.4 | 47.0 | 2.1 | -0.6 |
| Bulgaria | 0.2 | 24.7 | 0.3 | -4.3 | -1.0 | -0.3 |
| Comecon Europe | 3.9 | 21.8 | 5.1 | 30.4 | 0.9 | -3.6 |
| FSU | 3.5 | 9.5 | 3.1 | 7.6 | 2.9 | 4.7 |
| TOTAL Comecon | 7.4 | 15.3 | 8.2 | 19.6 | 3.8 | 1.1 |
| TOTAL | 100% (£632 billion) | 9.1 | 100% ($557 billion) | 8.5 | 48.0 | 75.0 |

1 Now Czech Republic and Slovakia
2 Poland, Czech Republic, Slovakia and Hungary

Source: Monthly Statistics of Foreign Trade (OECD)

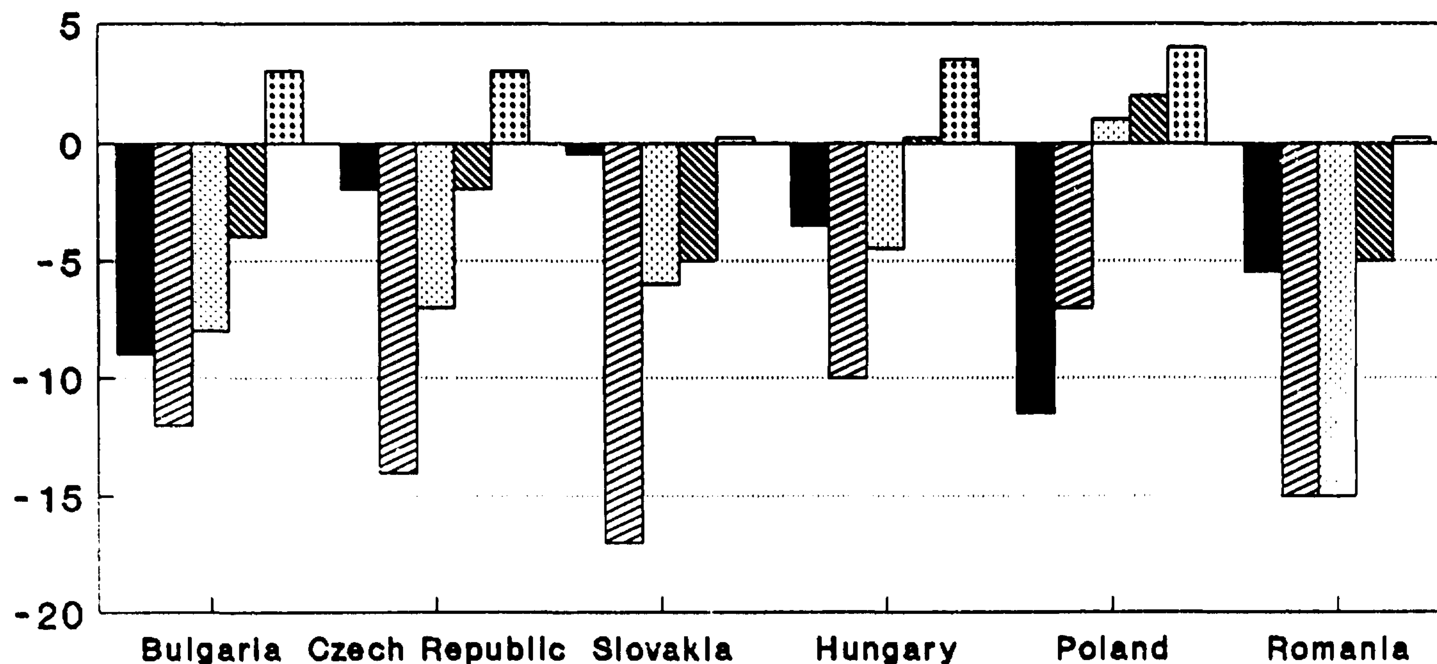
Table 8

| Collapse in Trade with ex-Comecon | | | | | | |
|---|---|---|---|---|---|---|
| | Exports | | | Imports | | |
| | $ billion 1992 | % total | % change 1991-92 | $ billion 1992 | % total | % change 1991-92 |
| Bulgaria | 1.2 | 24 | -75 | 1.3 | 29 | -66 |
| Czechoslovakia[1] | 4.3 | 31 | -5 | 3.6 | 20 | -32 |
| Hungary | 2.2 | 21 | -17 | 3.0 | 23 | +25 |
| Poland | 3.5 | 22 | -36 | 3.1 | 16 | +2 |
| Romania | 1.2 | 26 | -40 | 1.3 | 20 | -61 |
| TOTAL | 12.4 | 25 | -35 | 12.4 | 20 | -35 |

[1] Now Czech Republic and Slovakia

Source: Direction of Trade Statistics (MF)

# Central and East Europe
# GDP Growth: 1990-94




1990 1991 1992 1993 1994

Note: 1990-92 Actual Data
1993-94 Projections
Chart 1

# Inflation

## Consumer Price Index
## (% change over previous year)

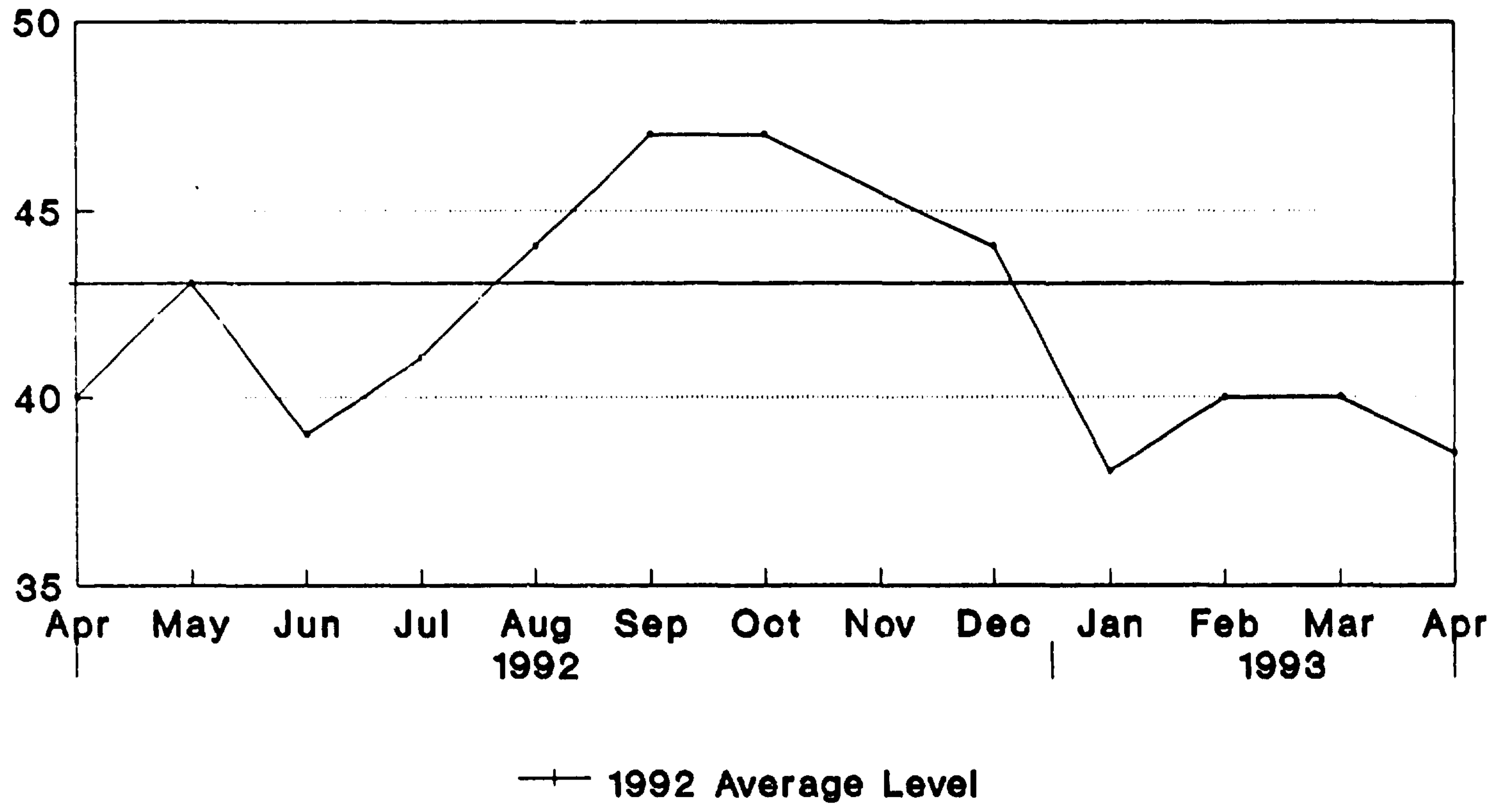
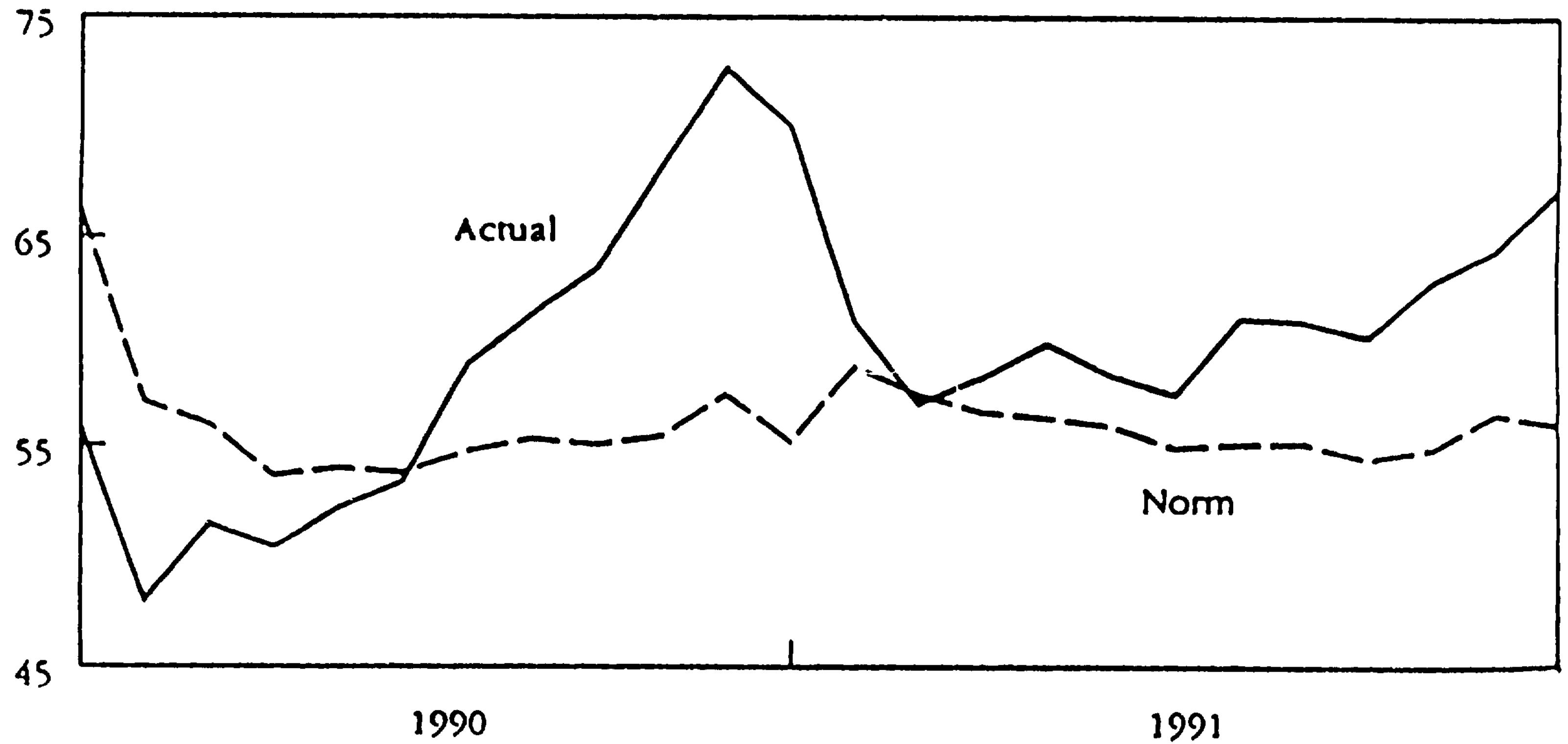



Chart 2

*Average Real Wages in Poland, 1990–91*




*Note:* Average wages charged to costs, deflated by the retail price index.
*Source:* International Monetary Fund calculations based on data from Central Statistical Office, Poland.

CHART 3

# Budget deficit

## Cumulative deficit (Zlotych trillion)

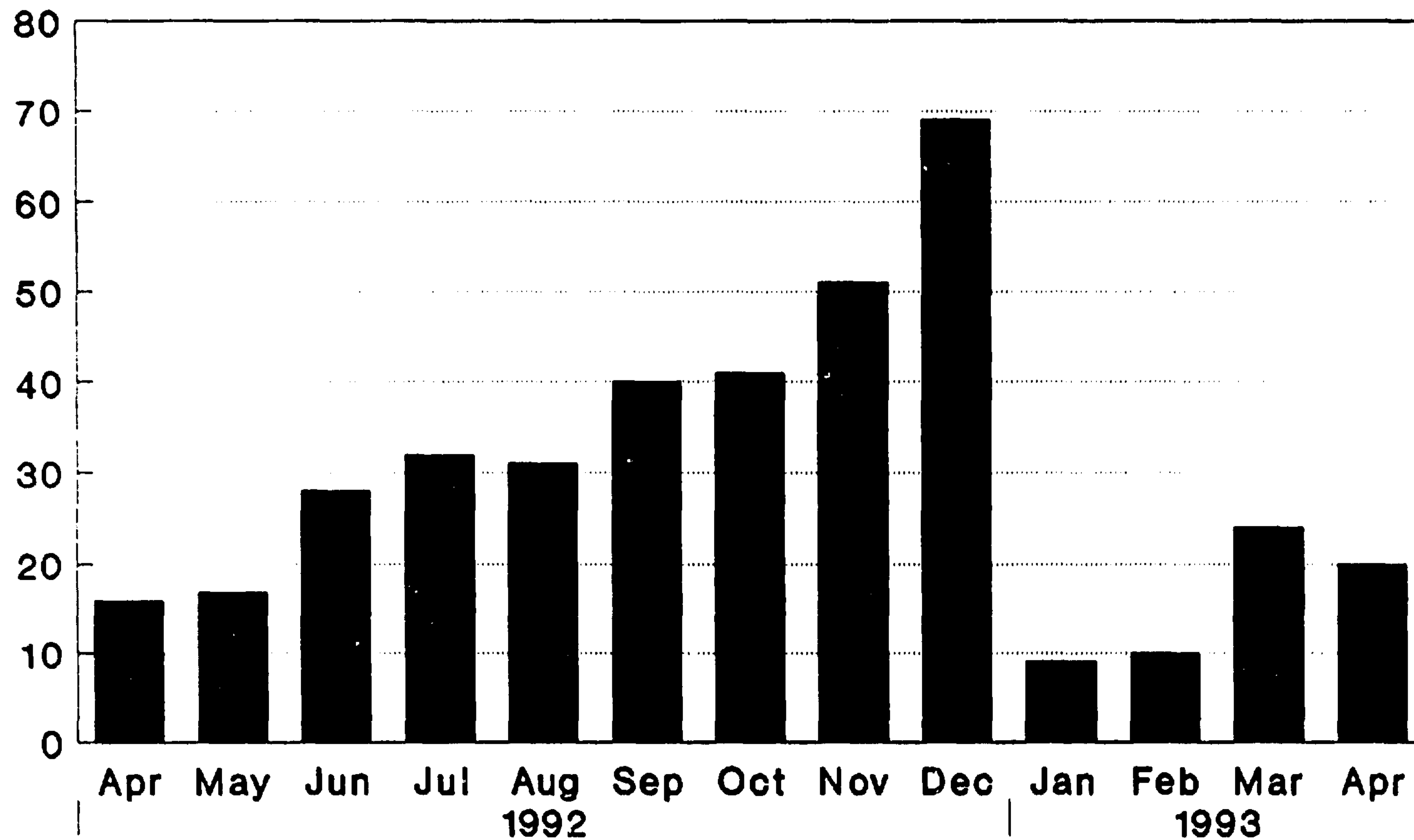



Chart 4

# Current Account

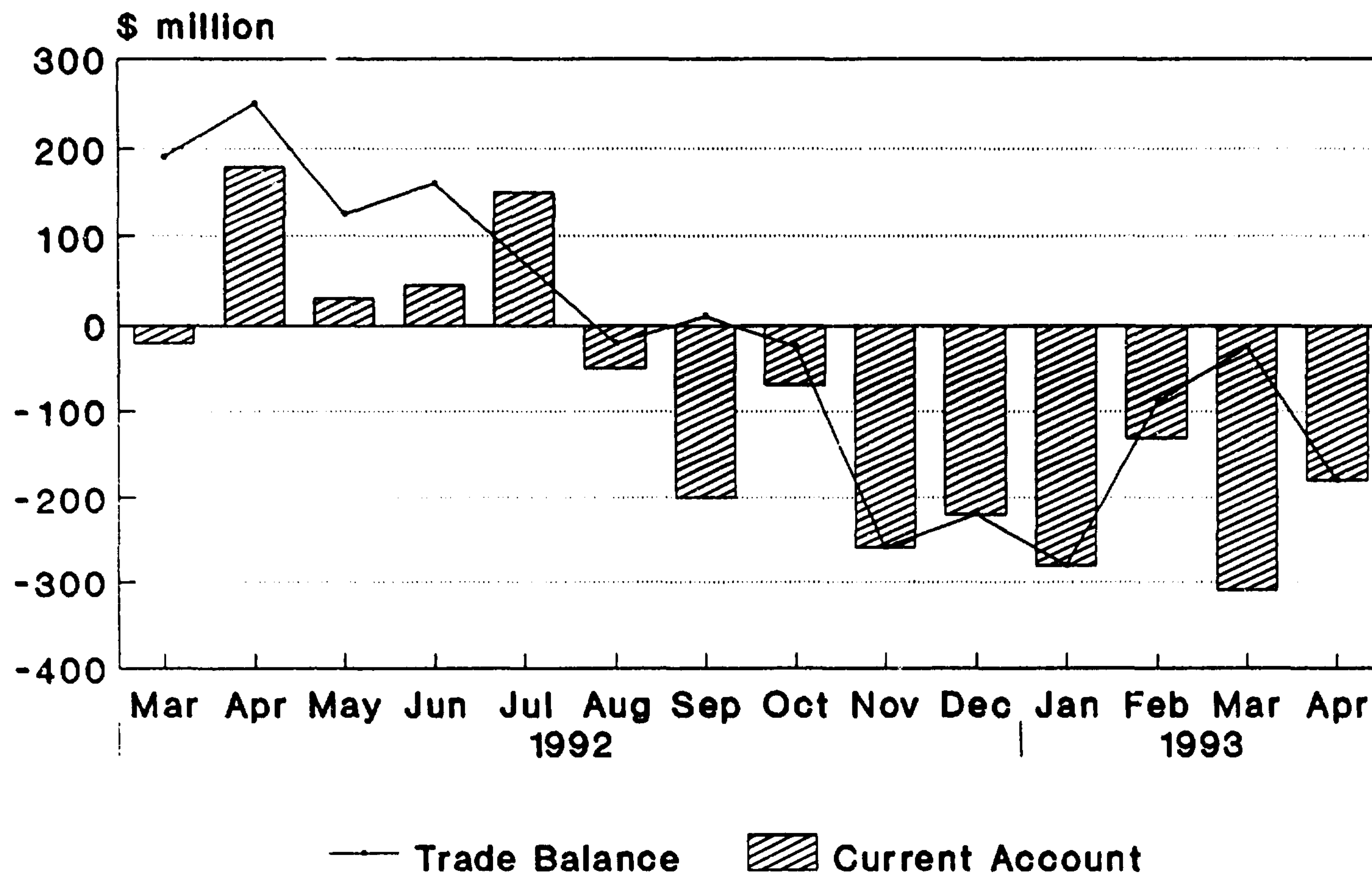



Chart 5

# Industrial Output

Index (seasonally adjusted, average 1990=100)

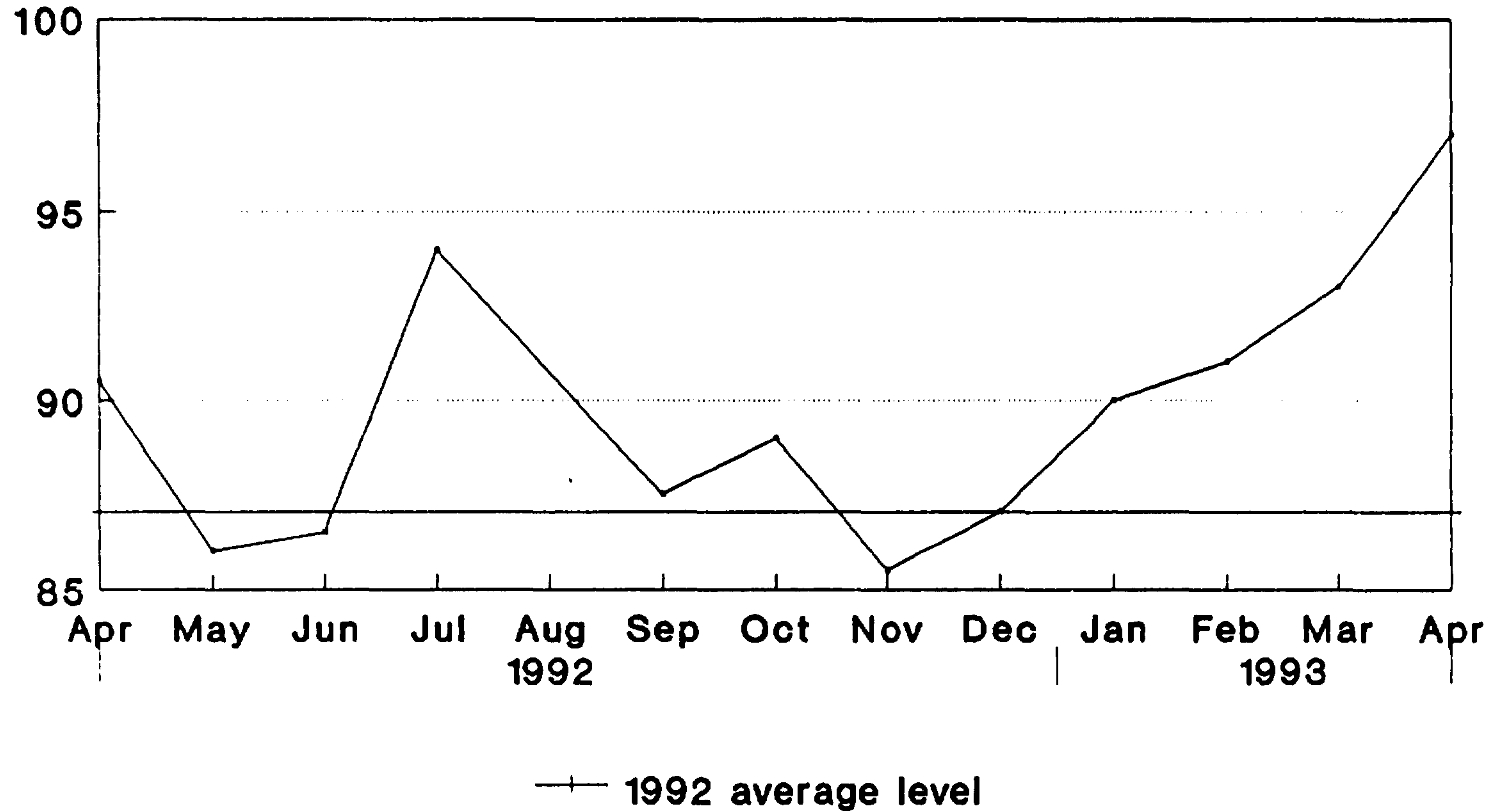
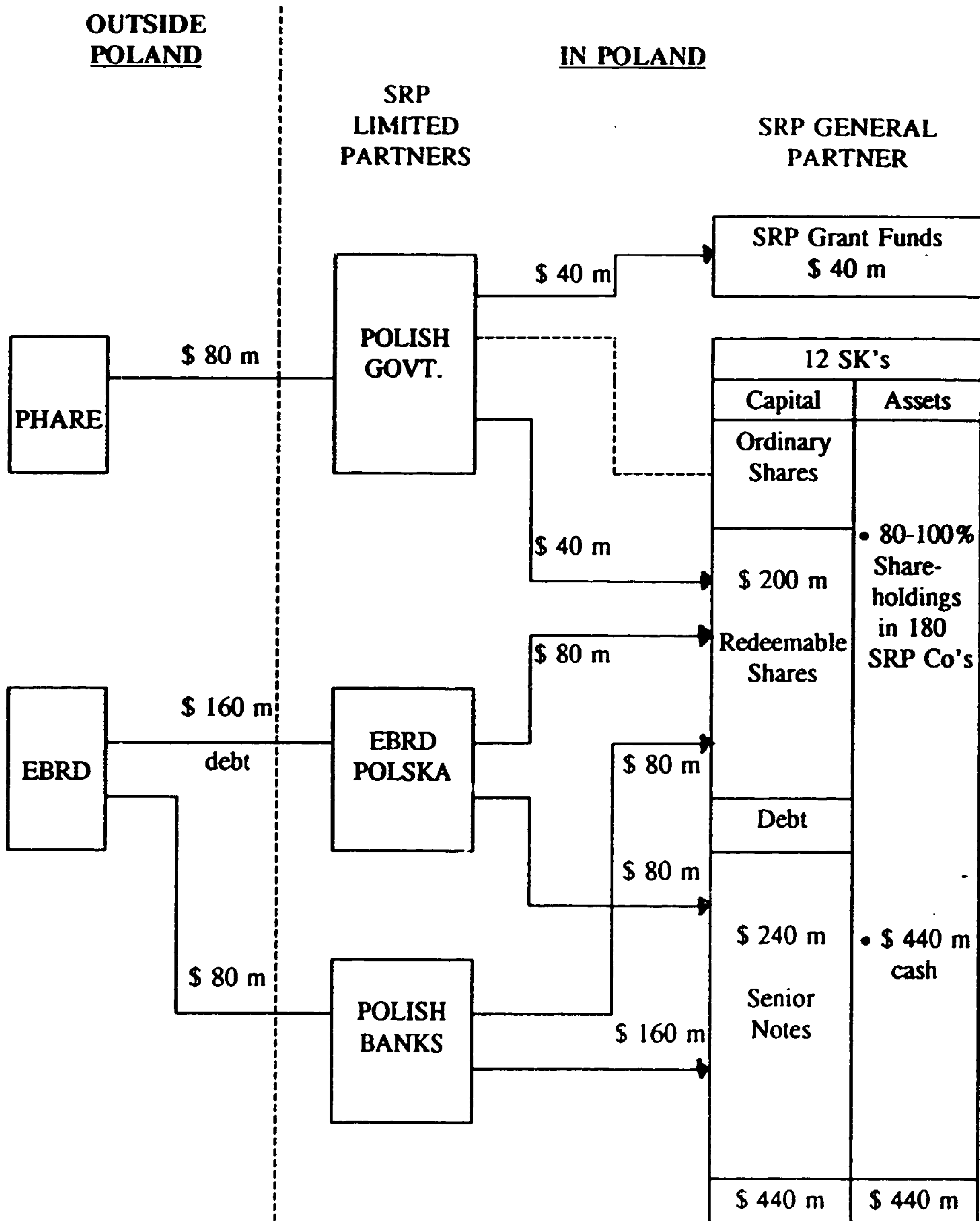



Chart 6

DIAGRAM 1

## SRP FUNDING STRUCTURE




Cash = ————————

Non-cash = - - - - - - - - - - - -