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Economies in Transition:
Restructuring of Large-Scale Industries

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PREFACE

It has been nearly four years since 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 economic system. Two years ago the former Soviet Union (FSU) made initial steps in the same direction. While real achievements have been made by most of the countries involved, the process has not yet delivered the hoped for significant re-orientation and restructuring of industrial structures and major improvements in economic performance and overall growth. In fact, the initial euphoria that characterized the early days of transformation has given way to guarded optimism and realization of the daunting challenges that are still to be met. While few experts and observers in the region would argue that the trend towards democracy and market-oriented economies is reversible in the CEE, most would admit that the process is going to be much more difficult, far more complex, and take far longer than they expected. And, recent events in the Russian Federation and the republics of the FSU have pointed out that the process of reform there is far from assured.

The first stage of the transformation prices - the macro-economic reforms, comprising particularly early price liberalization and stabilization reforms in many of the countries of the region appear to have been successful. But in all, this first stage of the transformation process, has been accompanied by sharp drops in output, persistent medium level (the range of 20 per cent) inflation, the emergence of budget deficits and large increases in unemployment. And, the hoped-for overall regeneration of industry and achievement of industrial competitiveness has not yet taken place.

It is now clear that the success of the transformation of the region will depend on more than macro-economic reforms. The regeneration of the industrial base, an essential element of a county's development will require the development of an integrated macro-micro policy framework with concerted, enterprise-targeted policy measures and institutional and other support. Clearly too much was expected too soon of macro-economic reforms across the region. There now must be a second phase of the transformation in which focus has to incorporate the removal of the rigidities at the micro level and greater integration of the macro economic framework with the micro-economic measures to induce an appropriate supply response. Key elements of this second phase of the transformation process will be industrial restructuring - particularly of large-scale enterprises - privatization and private sector development and industrial restructuring. An analysis, particularly in terms of case studies, of the major impediments to an adequate supply response may hold major lessons for national decision-makers within the CEE/FSU region and for their supporting international technical co-operation partners. This report addresses the key issues related to industrial restructuring and the impediments to an adequate supply response and the lessons to be learned from current experience.

In this regard, Poland has been chosen as a pilot case study. It was the first of the CEE/FSU countries to embark on a programme of fundamental economic reforms in the transition to a market economy. It is also a country whose industrial restructuring has been assisted by a major Western donor - the British Government in the form of support from its Know-How Fund through UNIDO to Polish industry. It is also a country with which UNIDO has long been associated and in which it has built up the most first-hand experience of restructuring industrial enterprises since the transformation process began in the region.

Though this report presents case studies of Polish industries, other studies of the region by UNIDO and other international organizations report similar findings. UNIDO, therefore, firmly believes that these Polish case studies provide useful experience and guidance for other countries embarking on similar restructuring exercises. The case studies are based on an on-going UNIDO restructuring project in Poland.

Beginning in 1991, US$ 2.3 million were made available by the British Government through its Know-How Fund for Central and Eastern European (CEE) countries to enable UNIDO to assist in the restructuring of 15 Polish industrial enterprises.

The report is structured as follows: Chapters 1 and 2 present the essential background against which the major issues related to industrial restructuring can be properly understood. Chapter 3 sets out the framework for long term structural change of industry. Chapter 4 discusses the important relationship between privatization and restructuring. Chapter 5 draws together the emerging methodology in the case od specific case studies of the restructuring of Polish enterprises. Chapters 7 and 8 summarize the emerging lessons from the experience of industrial restructuring in the countries in transition and presents implications for action by national authorities and their international technical co-operation partners.

CONTENTS

CONTENTS
(continued)

CONTENTS
(continued)

LIST OF TABLES, CHARTS & DIAGRAM

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. Two years ago, the former Soviet Union (FSU) made initial steps in the same direction. Although real achievements have been made by many countries, 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 re-emergence of fiscal deficits. And, the hoped-for overall regeneration of industry and achievement of industrial competitiveness has not yet taken place.

It is now clear that the success of the transformation of the region will depend on more than macro-economic 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 institutional and enterprise levels. This requires greater integration of the macroeconomic framework with micro-economic measures designed to induce the proper supply response at enterprise level.

This report 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.' UNIDO, therefore, firmly believes that an in-depth examination of the Polish experience provides useful insights and guidance for other countries embarking on similar reform programmes.

Table 1: Some indicators of initial (pre-reform) conditions

	CSF	HUNGARY	POLAND	BULGARIA	ROMANIA	Former GDR	Former USSR
Share of Public Sector in GDP	(1988) 95.9	(1988) 92.9	(1988) 81.2	(1970) 99.7	(1980) 95.5	(1988) 96.4	(1985) 96.0
Sructure of GDP (1988)							
Industry	61	31	44	61	54		48.9
Agriculture	7	15	13	10	11		9.3
Services	21	19	14	27	15		13.9
Other	11	35	29	na	20		27.7
Budgetary Subsidies (% of GDP in 1988)	(13.0)	13.8	16.0	17.8			(1989) 9.3
Inflation (% in CPI)	(1990) 18.0	(1989) 17.0	(1989) 640	(1990) 64	(1990) 14.1		(1991) 160.6
Gov't Budget Deficit (% of GDP)	(1989) 0.8	(1989) 2.8	(1989) 7.4	(1989) 0.6	(1989) -7.5		(1988) 11.0
Black Market Premia (% Agio)	(1988) 133	(1988) 56.1	(1988) 536.8				(1988) 1095.0
Trade Structure (1989) export shares							
% CMEA inc. USSR	54	39	35	83	40	42	46
% USSR	31	24	21	66	23	24	-
CMEA exports as % GDP (1990)	25	16	14	34	6		
Administered Prices (% of total)	100	15	100	100	80	100	100
Reform Dates							
Two-tier banking system	1990	1987	1990	1989	1990	1990	
Liberalisation/Stabilisation	01/1991	continuous	01/1990	02/1991	04/1991	07/1990	12/1991

Source: Neuber, A. (1993), "Adapting the economies of Eastern Europe: Behavioural and institutional aspects of flexibility", London, Overseas Development Institute, *mimeo*, Table 1.

Table 2: Sectors of origin of GDP for CPEs in 1988

Sectors of origin of GDP for CPEs in 1988 (in % of total GDP)						
	Range of Estimates		U.N.	Alton	PlanEC	WEFA
	%		%	%	%	%
G.D.R.	12-13 45-51 36-43	agriculture industry service	- - -	13 51 36	12 45 43	13 45 42
Czechoslovakia	16-18 41-48 36-43	agriculture industry services	- - -	16 48 36	16 41 43	18 44 38
Hungary	15-25 33-39 40-46	agriculture industry services	15 39 46	22 37 41	24 33 43	25 35 40
Soviet Union	18-19 32-41 40-49	agriculture industry services	- - -	19* 41* 40*	18 34 48	19 32 49
Yugoslavia	11-16 33-44 44-51	agriculture industry services	12 44 44	15 39 46	16 33 51	11 43 46
Bulgaria	14-20 41-49 33-40	agriculture industry services	- - -	20 47 33	19 41 40	14 49 37
Romania	20-27 41-48 27-32	agriculture industry services	- - -	20 48 32	27 41 32	27 46 27
Poland	15-27 31-39 40-46	agriculture industry services	- - -	27 33 40	27 31 42	15 39 46
Averages ex G.D.R.	19-21 36-41 40-43	agriculture industry services	- - -	20 37 43	21 36 43	19 41 40

* Estimates by the CIA

Source: Lancieri, E. (1993), "Dollar GNP estimates for the Central and East European Economies - 1970-90", World Development, Vol.21, 1, Table 14.

WHAT IS INDUSTRIAL RESTRUCTURING?

In the broadest sense, industrial restructuring refers to the process of reorganizing 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 liberalization, 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 cases 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, as understood in industrialized countries was little known in the centrally planned economies. 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, organizations 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 organization 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 allowing 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 current 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. In the FSU, it is estimated that as much as 75 per cent of the 6,000 or so major industrial products were manufactured in only one factory. 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 organization 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. In addition, 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 organization 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 Commonwealth of Independent States (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 fro: 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 mobilized 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 recognized that effective innovation is a decentralized 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 decentralized there were few rewards for innovation. Indeed the institutional structure was designed to separate research from production and thereby prevent rewards being recoverable from commercialization 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.

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 organizing 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 products meeting international quality standards.*

- *Inflated organization: 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 organizational structures leading to duplication of effort and administrative and production bottlenecks.*

In Hungary (since 1968) and Poland (since 1981), moves to decentralize 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 organizations (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.*

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, technology marketing, finance and organization. The efficiency of utilization 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 organizational gap between R&D, production, marketing and selling. Enterprises need to actively manage the value-added chain, from conceptualization 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.

Entrepreneurship in a Command Economy

Planned economies demonstrated the harmful consequences of overly rigid efforts to institutionalize 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.

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.

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[4] Kornai, J (1992) The Socialist System: The Political Economy of Communism, Princeton, Princeton UP, p. 128.

[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.

[8] Fischer, S and Gelb, A (1991) "The Process of Socialist Economic Transformation". Journal of Economic Perspectives, Vol 5, 5, pp. 91-105.

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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 stabilization 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.[10]

In many ways macroeconomic stabilization 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; a clear and predictable 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 an appropriate supply response: that depends very heavily on the expectations and actions of enterprise management and workers.

The basic objectives of macroeconomic stabilization 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 liberalized) 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 subsidize 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 STABILIZATION 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 sanitized 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. Also, the persistence of a significant arbitrary element in the hardness of enterprise budgets is liable to endanger the perceived legitimacy of the macroeconomic stabilization 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 stabilization 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 stabilization, 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.[11]

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 US$ 4,089 and US$ 5,122, (see Table 3).[12]

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 were 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.[13]

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.

Table 3: Estimates of per capital GNPs or GDPs for CPEs in 1990

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						

Source: Lancieri, E. (1993), "Dollar GNP estimates for the Central and East European Economies 1970-90", World Development, Vol.21, 1, Table 13.

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)

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

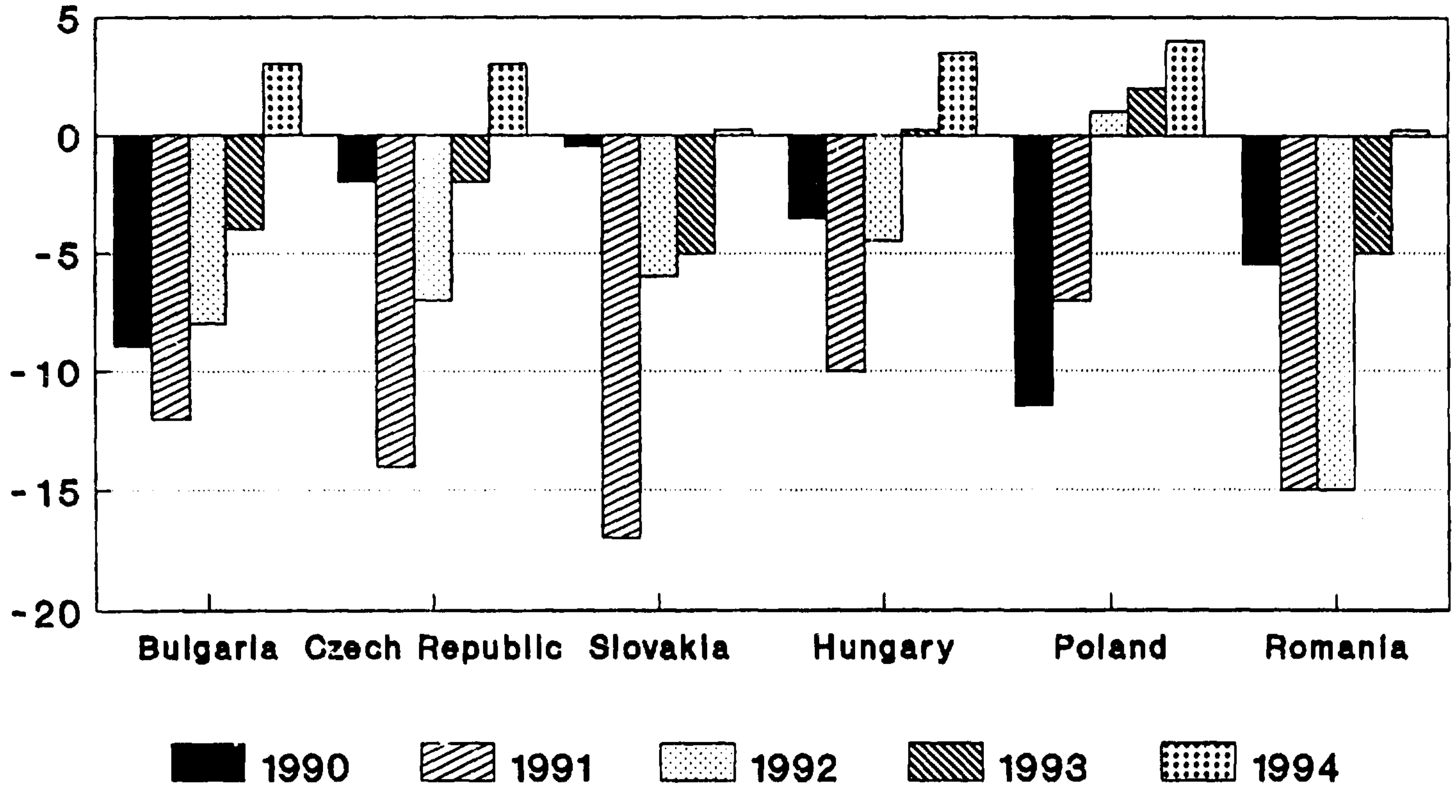
Poland started its political reform programme, the necessary precursor to economic reform, before any of the other centrally planned economies, in February 1989, through 'round-table' negotiations between reformist communists in the government and the opposition leadership of the unofficial trade union movement Solidarity.[14] 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 [15]

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 industrial 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				

<u>Source</u>: Neuber, A. (1993), "Adapting the economies of Eastern Europe: Behavioural and institutional aspects of flexibility", Lond; Overseas Development Institute, *mimeo*, Table 2.

Chart 1: Central and East Europe GDP Growth: 1990-94



Note: 1990-92 Actual Data
1993-94 Projections

Source: The AMEX Bank Review, Vol.20, No.6, 19 July 1993, p.2.

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 victimization' 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 stabilization programme with virtually no opposition.[16] 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 STABILIZATION 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':[17]

- 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 stabilization 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.[18] 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.

Liberalization 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 financial 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 liberalized 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 levied 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 liberalized. 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 STABILIZATION PROGRAMME

It has been argued that a distinction should be made between stabilization 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.[12] 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 synchronization 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 (Parliament). 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 skeptical 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 privatization, 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 liberalization 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

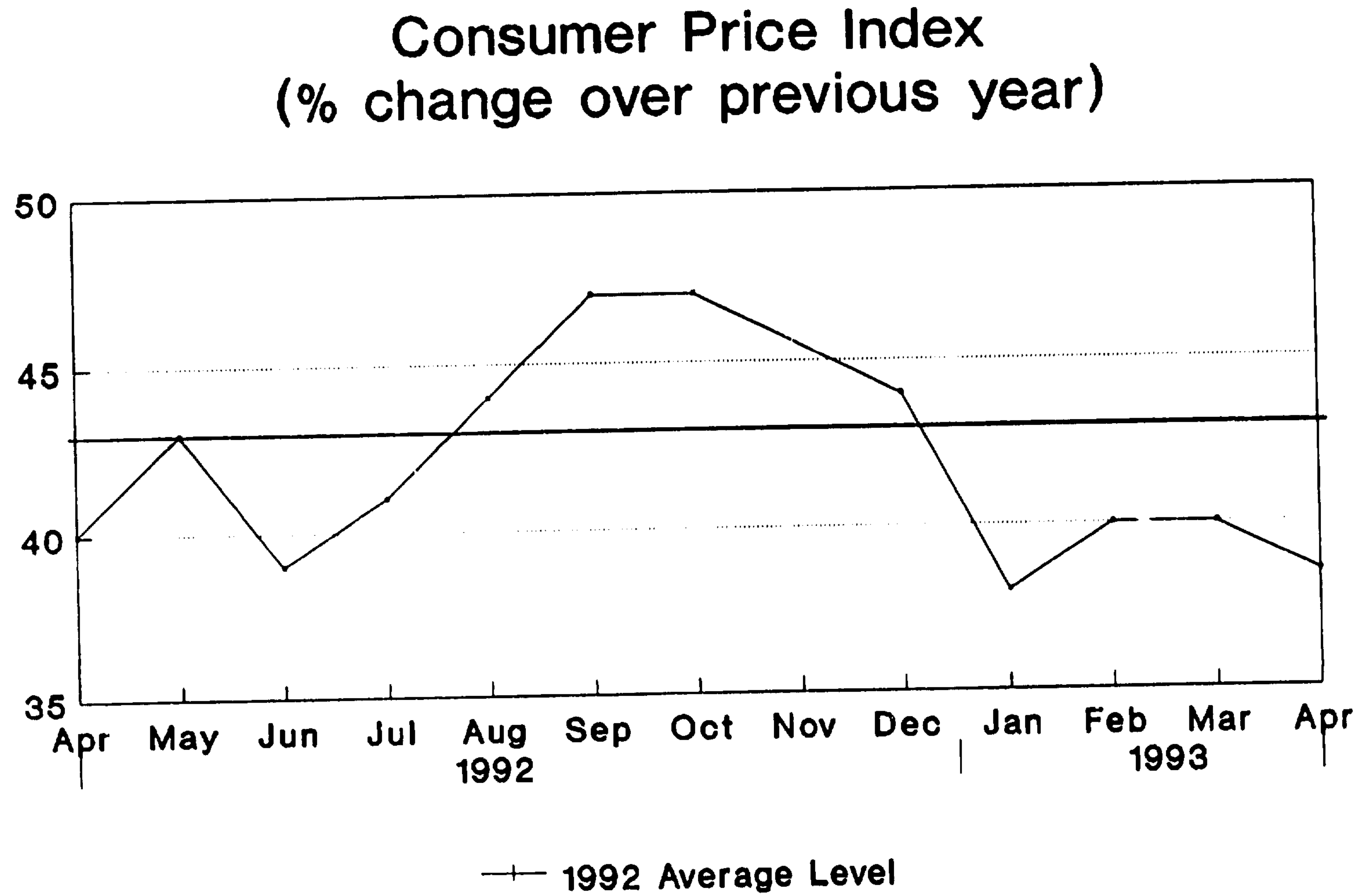
It is one of the paradoxes of most structural adjustment programmes is that there is stress on the importance of price liberalization but not of wages. This is at first sight surprising since most economists are reluctant to attempt suppressing market forces.[20] Introducing wage controls in a developed 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 commercialization and privatization, 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 privatization.

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.

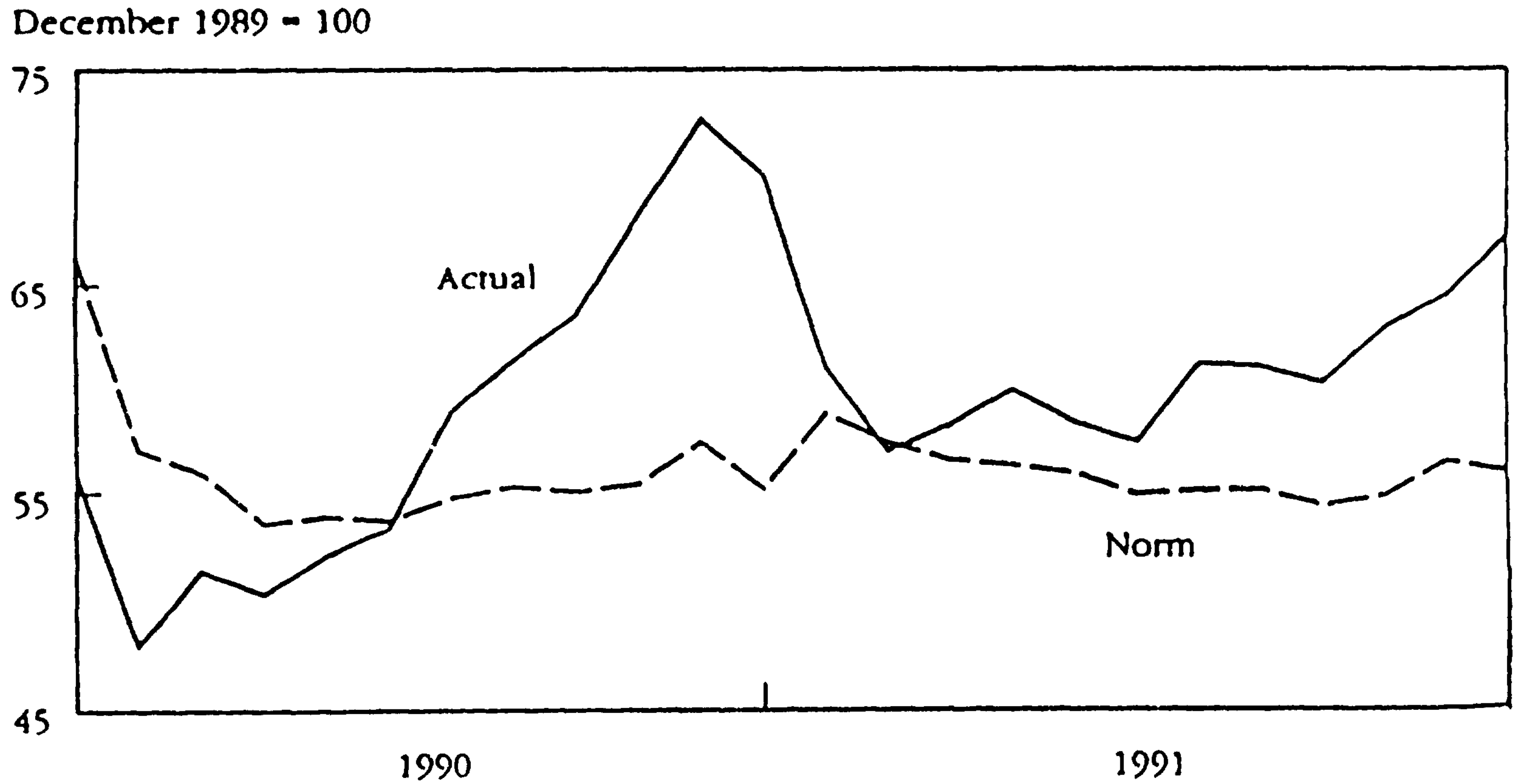
By February 1990, wages in the five main sectors - industry, construction transport, communications and trade - were less than half of their August 1989 level. Wage controls were quite successful until mid-1990 when wages climbed quite steeply above the programme ceilings. What happened was that tax 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 default 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 (see Chart 3).

Chart 2: Inflation



Source. World Bank

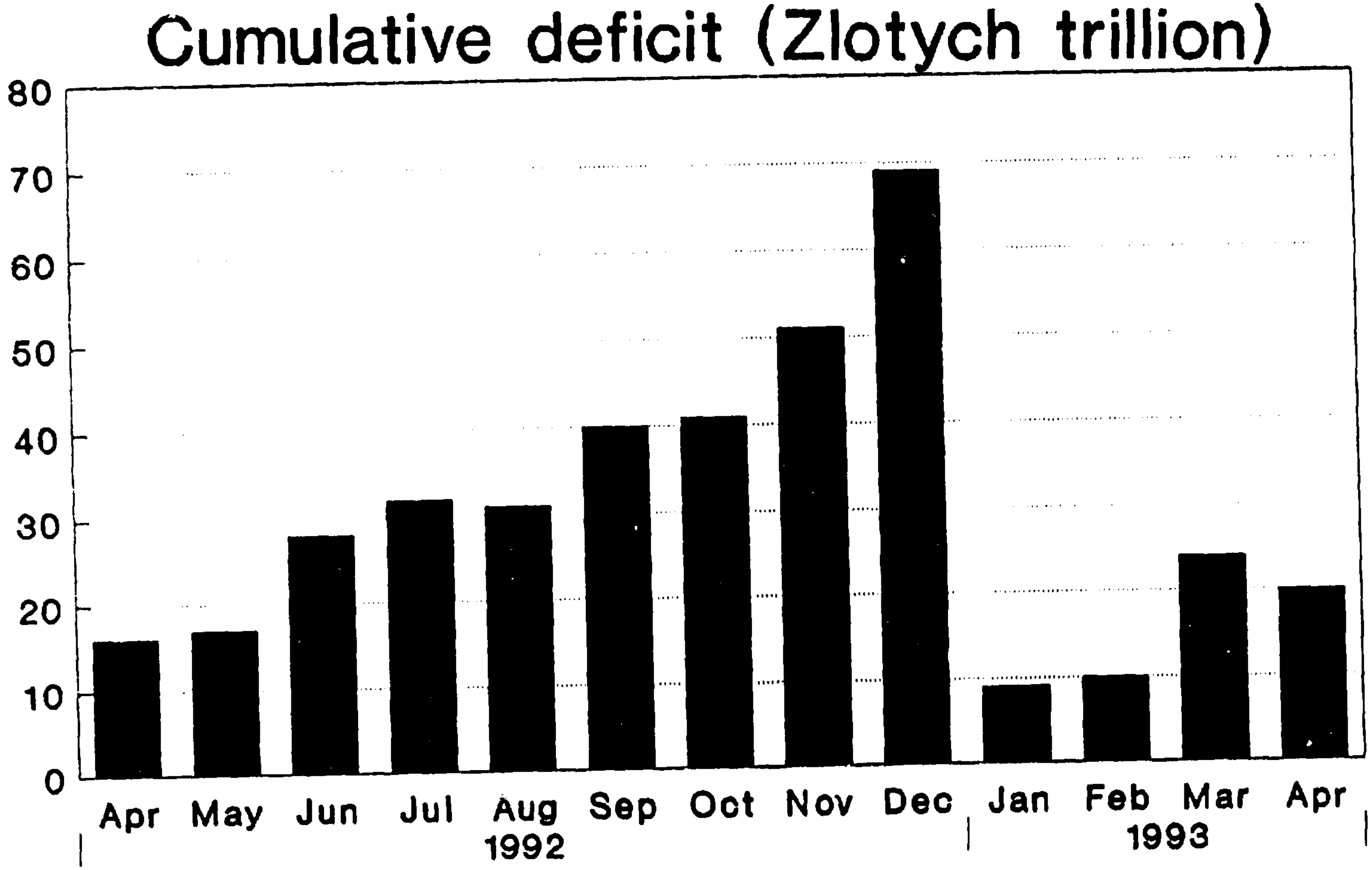
Chart 3: Average real wages in Poland, 1990-91



Note: Average wages charged to costs, deflated by the retial price index.

Source: International Monetary Fund calculations based on data from Central Statistical Office, Poland and Coricelli, F and Lane, TD (1993), "Wage controls during the transition from Central planning to a market economy", The World Bank Research Observer, Vol.8, No.2, p.206.

Chart 4: Budget deficit



Note: Average wages charged to costs, deflated by the retial price index.

Source: International Monetary Fund calculations based on data from Central Statistical Office, Poland and Coricelli, F an during the transition from Central planning to a market economy", The World Bank Research Observer, Vol 8, 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 stabilization 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.[21] 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 a projected 27 per cent in 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 utilization. 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 ned.

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 US$ 2 billion annually in addition to between US$ 500 million and US$ 600 million in interest payments on official debt of US$ 33 billion. Poland also has outstanding debts to commercial banks of US$ 12.1 billion 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 tax revenue 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. The share of state-owned enterprises in 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.[22] 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.[23] Collection is centralized 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.[34] 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.

In addition, CEE has moved from a modest trade surplus in 1989 of US$ 1 billion to a deficit of US$ 3.6 billion with the EC in 1992, and a surplus of US$ 2 billion to a deficit of over US$ 10 billion with all OECD countries during the same period. Clearly the rest of the world's trade balance has benefited from the liberalization 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).

Table 6: Booming trade with the OECD

Booming Trade with the OECD						
	Exports			Imports		
	$ billion 1989	1992	% p.a. growth 1989-92	$ billion 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

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)

A new post-1989 handicap Polish firms exporting to the West face is the absence of export credits and state guarantees.[25] 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 interested 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.[26] The countries of the CEE region point out that a US$ 1 billion 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 US$ 3.04 billion in the first quarter of 1993 and imports rose by 16.5 per cent to US$ 3.41 billion.[27] 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.[28] 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.

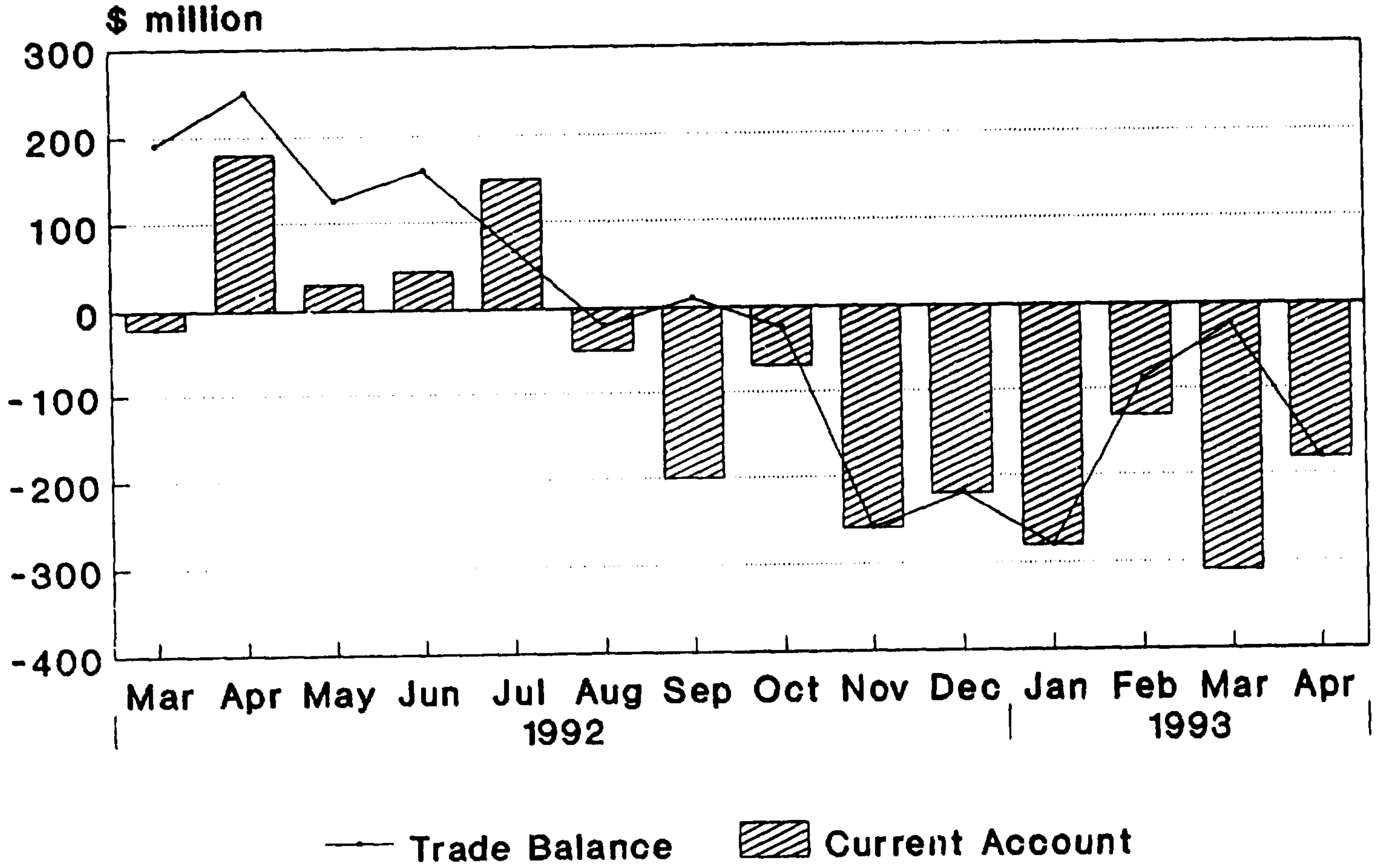
Unemployment has risen steadily from 6.1 per cent in 1990 to 14.0 per cent in 1992 and is expected to exceed 16 per cent by the end of 1993. Even at this worrying level, it still lags far behind the fall in output suggesting some labour hoarding still persists. While unemployment has been rising, aggregate 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.[29]

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.[30] 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 liberalization 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.

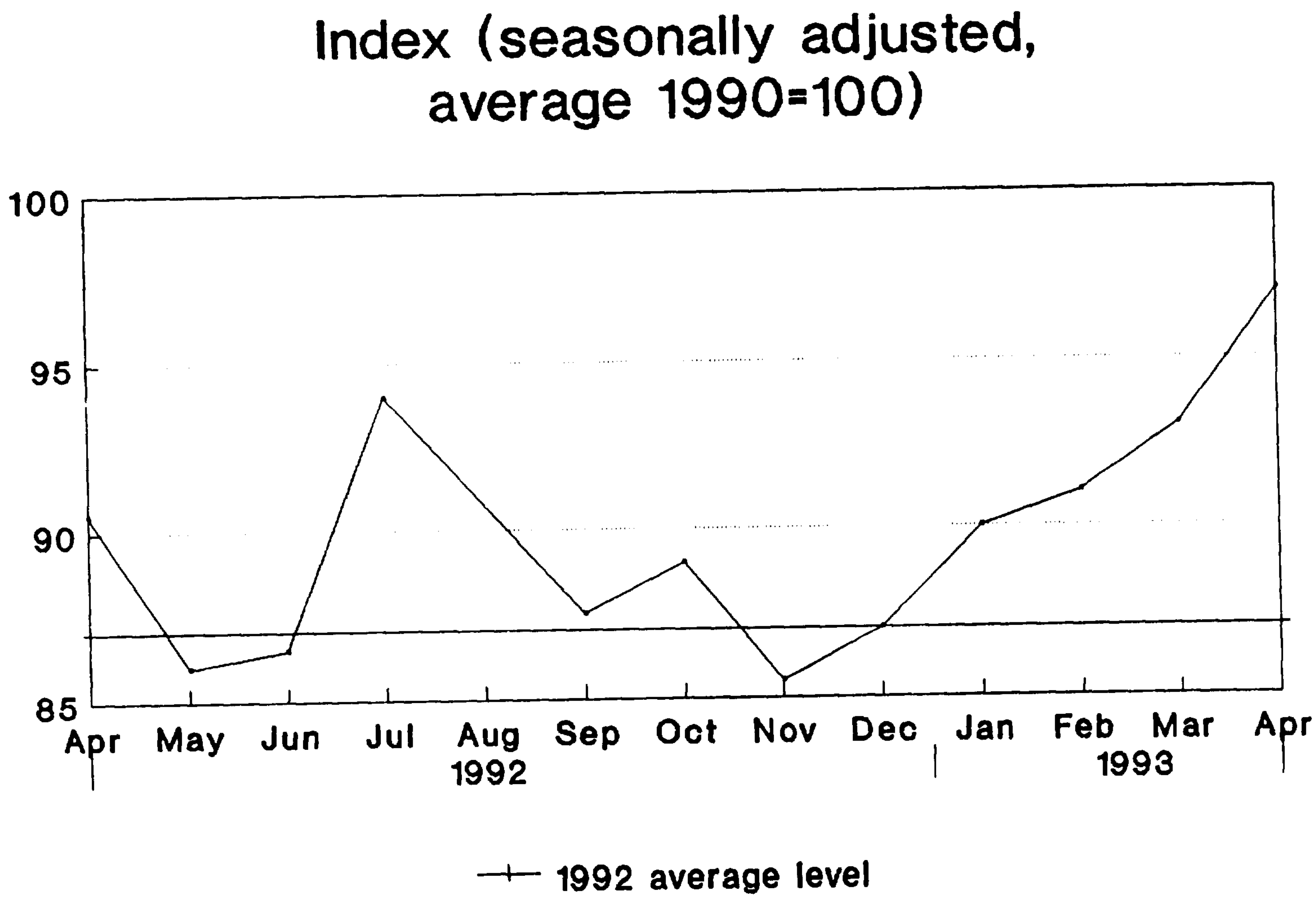
The second explanation traces the fall in output to the effect of the severe disruption of export demand following German unification in 1990 and the dollarisation of CMEA trade in January 1991. For example, it has been estimated that the loss of trade to the former Soviet Union alone can account for 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.[31] 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

Chart 5: Current account



Source: World Bank.

Chart 6: Industrial output



Source: World Bank.

Table 8: Collapse in trade with ex-COMECON

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)

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 liberalization of imports from January 1990.[22] 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.[23] The output collapse in the CEE is a function of the underdeveloped state of the region's credit markets. The proponents of this argument claim that at least 20 per cent of the output decline in Poland in the first quarter of the stabilization 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.

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.[34] But, firms were allowed to defer payment obligations and banks, in turn, were able to pile up non-performing 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 referred to as 'budget softness and hard habits'.[35] The management of state-owned enterprises, instead of struggling to introduce efficiency enhancing measures, engaged in what they know best: maximizing 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 organize 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, supplier 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.[36] In order to engineer this shift in debt, banks have dramatically cut credits available to state-owned enterprises, from Zl 147.2 trillion to Zl 117.7 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 modernize 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 recognized this weakness in the system and have exploited their connections as much as possible in order to secure their short-term survival.[37] 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 privatization investment is most pressing.

It may also have been the case that many of the above-mentioned factors contributed singly or in combination to the drop in output. However, there is a growing consensus that there may have been more fundamental structural deficiencies, particularly at the enterprise level causing the drop in output. And, by concentrating on macro-economic reforms Poland - like most of the countries in transition - did not pay enough attention to the micro level structural and institutional reforms required as well. This argument is taken up in the next chapter.

Endnotes

[10] 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.

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

[12] 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.

[13] 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.

[14] 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 organized 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 itself into a mass opposition movement attracting support from a wide spectrum of interest groups not just industrial workers.

[15] 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.

[16] No doubt the collapse of communism elsewhere in Eastern Europe in the autumn of 1989 also demoralized any remaining opposition.

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

[18] 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.

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

[20] 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.

[21] 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.

[22] Corporation tax was also necessary to prevent richer private citizens from trying to register as corporate bodies to avoid personal income tax liability!

[23] 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.

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

[25] 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.

[26] Poland, Czech Republic, Slovakia and Hungary.

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

[28] 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.

[29] 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.

[30] 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.

[31] 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.

[32] 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.

[33] 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.

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

[35] 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.

[36] 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.

[37] A recent and impressive confirmation of the persistence 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

There is a growing realization among economic commentators that macro-economic reforms alone 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. Indeed, they may have acted as a mask for more fundamental problems inherent to the region: micro-level rigidities, institutional weaknesses, 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 co-ordinated and integrated with macroeconomic reforms will be needed to attack the structural weaknesses at industry and enterprise level. Without such co-ordination, the risk arises of throwing even the best enterprises into bankruptcy and causing severe economic disruptions. There now needs to be a second stage of the transformation concentrating on removing structural deficiencies and micro-level bottlenecks to accompany the reforms which have the predominant feature of the first stage of the transformation process.

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.[38] Moreover there is a need to encourage a long term view of business relations so that investors have time to realize 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 and broader private sector development 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.[39] 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 centralization, 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.[40] Communism will simply have been privatized into a state-sponsored system of 'crony capitalism' such as that seen in Peru.[41] 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, privatization, 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 criticized 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 privatization 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.[42] 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 minimizing 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 specialized banks and eight state-owned commercial banks. These state-owned banks co-exist with two privatized banks, 80 newly registered private banks and 1,650 private co-operative banks mainly offering services to private agriculture. Many of these co-operative 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 privatization.[43]

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 specialized 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.[44]

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 like 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 privatized 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 privatized to avert the threat of a run on the deposits of a bank undergoing privatization.

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 emphasized working with and assisting enterprises. Indeed, enterprises themselves were hardly willing to co-operate 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 an enterprise'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 enterprises 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 demoralizing 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 Privatization Programme (SRP)[45] 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 write-offs and the adoption of a viable recovery programme for each enterprise.[46] 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 specialized 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 privatization of all enterprises participating in the programme within five years.

MAJOR BARRIERS TO FINANCIAL SECTOR DEVELOPMENT [47]

Poland's banks are currently facing a number of major problems that are preventing them playing an active role in industrial restructuring.[48] 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' stabilization 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 US$ 3 billion. The total capital of the 14 banks is approximately US$ 2 billion. As of 31 July 1992, there were 1888 bad loans in the portfolios of the then nine state-owned commercial banks, of which 1,229 were less than US$ 67,000. If the three specialized banks are included, the total number of bad or doubtful loans outstanding to the state-owned banking sector rises to approximately 2,500.[49] 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.[50] 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 capitalization. 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 recapitalizing 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 'corciliation' procedures for indebted firms. These arrangements are expected to include the restructuring of capital and interest payments, partial write-offs 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 recapitalization 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 US$ 500 million IBRD Stabilization 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 organizing and enforcing rigorous debt work-out regimes. A creative approach to developing this capacity at a practical operational level is the EBRD's Stabilization Restructuring and Privatization programme mentioned above.

Lack of capitalization

Polish banks are generally considered to be undercapitalized. For example, the combined capital of the seven largest Polish banks in 1992 amounted to around US$ 1.5 billion which was less than that of the Bank of Scotland, the United Kingdom's eighth largest bank at US$ 1.7 billion. The total capital in the Polish banking system as of May 1993 was somewhere between US$ 2-3.5 billion.[51] 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 US$ 60 million. 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 US$ 106.5 million 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 US$ 6 billion in new cash is required to capitalise Poland's bank to world standards.[52] 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 undercapitalized, 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 are its 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 cash flow-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 industrialized 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-privatization 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 co-operation. 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 mobilization 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 stabilization 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 privatization 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, privatization, 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 privatization and restructuring and not the other way round. The whole privatization and restructuring process in Poland is criticized 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".[33] 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 an enterprise being restructured or privatized;
- a definition of acceptable levels of layoffs;
- a government-stated view on the strategic importance of any industry or individual enterprise;

- 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 privatization and industrial restructuring programme has so far failed to define any selection criteria for targeted enterprises. Rather, enterprises appear to have been selected by chance or on the initiative of the management of the enterprises involved giving the impression that the privatization 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 privatization, the Ministry of Privatization (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.[54] 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.[55] 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".[56]

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 co-ordinated 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 privatization 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 organization but has been unable to obtain the necessary funding. The Ministry of

Privatization, however, has continued to dominate political debate as the mass privatization bill continued its slow progress through the Sejm and Senate and, on the ground, where enterprises have been successfully privatized 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) privatization 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 organized 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 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 Privatization 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.

EBRD Stabilization Restructuring and Privatization Programme

The EBRD's Stabilization Restructuring and Privatization 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 'stabilization' and longer-term 'recapitalization and reconstruction' work. Stabilization 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'. Recapitalization 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. Stabilization depends on the government, as owner, taking the necessary decisions or a new owner taking control. Reconstruction is very unlikely to happen unless stabilization 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 capitalization 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.

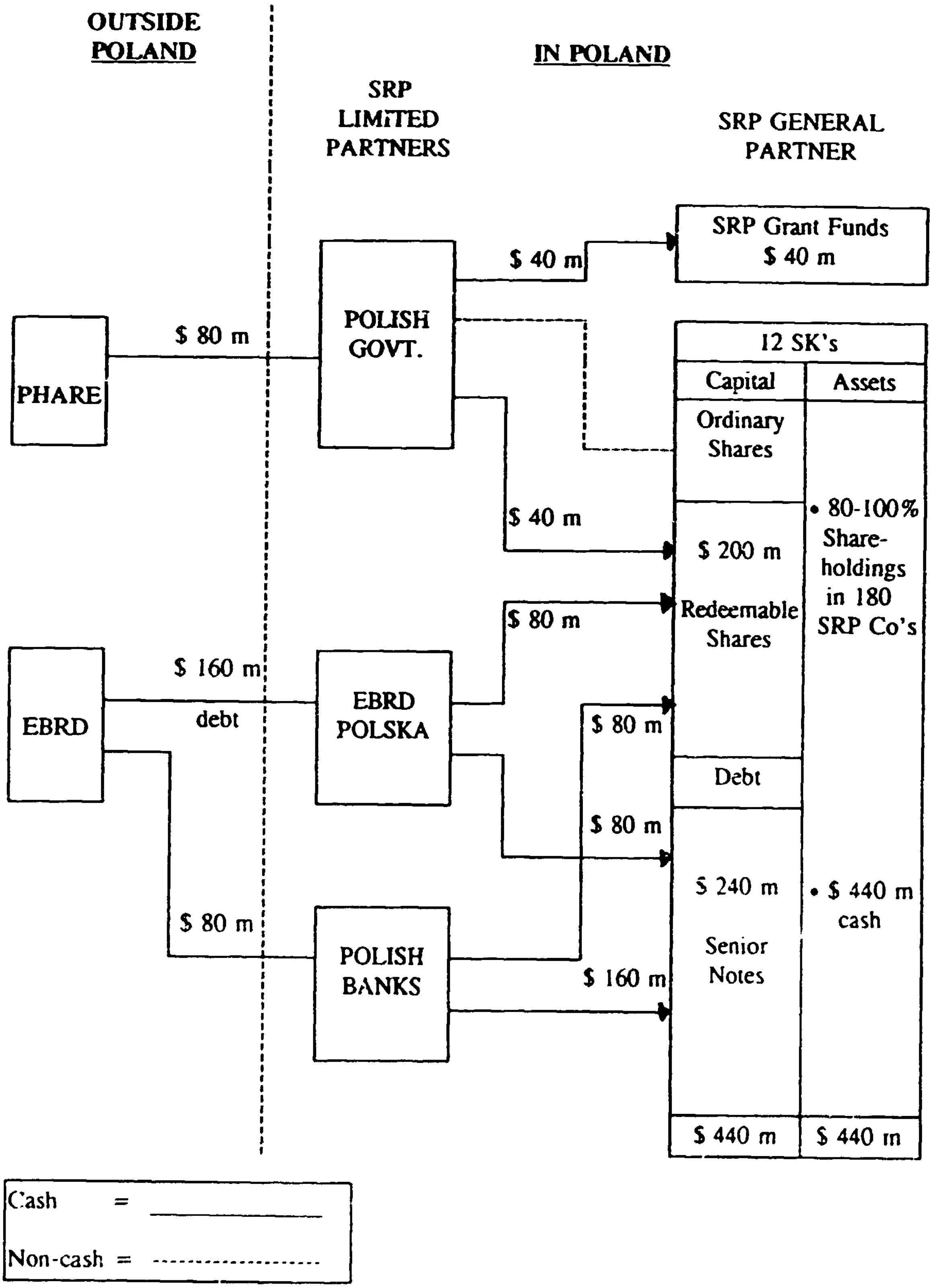
It is foreseen that the typical firms in the SRP programme will on average have a turnover of US$ 10 million and indebtedness of US$ 10 million (US$ 5 million due to the government, US$ 3 million due to banks and US$ 2 million outstanding to suppliers). It is expected that the outcome of conciliation negotiations will be a write-down of outstanding enterprise debt to, on average, US$ 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 privatization 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 US$ 480 million split between US$ 200 million of redeemable equity, US$ 240 million of debt and US$ 40 million of grant funds to assist with turning around of approximately 180 enterprises. From the EBRD's contribution of US$ 240 million, the 12 participating banks will receive US$ 80 million of new capitalization and US$ 160 million 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 US$ 80 million representing 40 per cent of the redeemable equity financing of the 12 joint ventures managing the enterprises and provide them in total with US$ 160 million 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 US$ 80 million to cover the Treasury's contribution to the costs of the exercise. The SRP programme's funding structure is described in Diagram 1.

Diagram 1

SRP FUNDING STRUCTURE



Endnotes

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

[39] 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.

[40] The Chinese communists, of course, do still exact severe penalties, including execution, on racketeers.

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

[42] 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.

[43] The process of privatization by flotation on the Warsaw stock exchange is discussed in the next chapter.

[44] While 80 private banking licenses have been issued, only 11 meet the NBP's minimum capital rule of Ecu 5 million which came into force in January 1993.

[45] 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.

[46] 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 which is 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.

[47] 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.

[48] 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,

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

[50] 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.

[51] The lack of precision in the estimates can be attributed to devaluation of the zloty, depletion of capital through write-offs and estimation errors.

[52] Quoted in the Central European, February 1993, p 32.

[53] 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.

[54] The IDA is the successor organization to the Fund for Industrial Structural Changes established in 1988 and was registered in January 1991 to support and coordinate the restructuring and privatization of Polish industry.

[55] 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.

[56] see Krawczyk and Lopez-Lopez (1993), p 183.

Chapter 4
Privatization 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 privatization allows management and labour to redefine an enterprise's future focus and identify the steps needed to create an organization capable of competing and maximizing corporate performance. As part of the overall restructuring process, privatization 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.[57]

The privatization 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. Privatization has been chosen as the primary policy instrument in the transformation process 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 Privatization has stated that due to the scale of the privatization task in Poland, they faced several unexpected issues which slowed the process considerably.[58] These issues 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 privatization strategy through a decentralized system. The Ministry of Privatization (MOP) has a series of offices throughout the country and a good deal of privatization is handled at the regional and municipal level.

- Mass privatization. There was a serious lack of consensus in the country over the type of distributional privatization that should be implemented which delayed the passing of the Mass Privatization 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 privatization in Poland also confront the other countries of the region. This raises the question as to whether privatization 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 privatize 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.[59] 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, privatization 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.[60]

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.

A major problem with this 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.[61] Certainly general enforcement of bankruptcy laws would deal with the rather strange argument in favour of privatization, namely, that privatization 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.[62] 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 - that is, the restructuring of physical assets, technologies, production processes, and organizational structures. 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 privatization 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.

Privatization 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 privatization 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. In many cases, however, there may even be a need to vet prospective buyers to ensure that the privatized enterprises will have a proper chance of survival.

The end goal is clear: to create an organization 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 privatized enterprises emerge as lean and focused entities whose management and labour are aware of the organization's strengths, weaknesses, threats and opportunities. At the end of a successful combined exercise, enterprises possess a realizable market value because they are now businesses capable of adding value across the range of their activities attracting 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 privatization 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 privatization. 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 privatizing 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 into 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, privatization entails following one of three alternative routes: liquidation, capitalization, or restructuring. In the future there will be a fourth route: the mass privatization programme.

Of the 8,441 state-owned enterprises registered in 1990, 2,385 or 28 per cent had been included in the privatization process up to 15 October 1993.[63] A total of 92 enterprises had undergone capital privatization involving over 115,000 workers, with employment guarantees provided of between 18-36 months. The State Treasury earned over US$ 200 million from the 42 enterprises privatized to 15 October 1993. Some 852 small- and medium-sized enterprises have been privatized 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 privatized and as such are supervised by the Ministry of Privatization on behalf of the State Treasury.

PRIVATIZATION THROUGH LIQUIDATION

Of all the methods of privatization 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 organizations.

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 privatization 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 Privatization, 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 privatization 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 privatizations, 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 privatization 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 privatization 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 privatization should, it is argued, encourage them to mobilize 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.[64] 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 privatizations of large state-owned enterprises in Poland 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 Privatization 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 privatization. This programme, basically an exercise in stock taking of the state's portfolio of enterprises, is sometimes misleadingly referred to as 'sectoral privatization'. 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.[65]

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 privatization under the auspices of the management consulting firm engaged by the Ministry of Privatization to advise on privatizing the sector. The remaining firms either chose not to change their ownership status or opted to pursue privatization 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 privatized 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 Privatization Programme.

CAPITAL PRIVATIZATION

As of March 1993, capital privatization had been adopted by nearly 500 enterprises, including 411 enterprises 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 privatization. Once the capitalization 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 privatize 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 privatization, 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 Privatization 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.

PRIVATIZATION BY MANAGEMENT CONTRACT

An option to privatize through restructuring has recently been added to the already well-established routes via liquidation and capitalization. Under the new programme, management teams control the restructuring and privatization process. A tendering procedure is organized 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 Privatization which then assigns responsibility for implementing the restructuring plan and privatizing the company. Two management groups have so far been selected by the Ministry to launch the programme to encompass fifteen enterprises.

CAPITAL MANAGEMENT PRIVATIZATION

A final variant of capital privatization that has been developed most recently is what is referred to as capital-management privatization. The approach is an attempt to plug the funding and management gap so apparent in many privatization efforts. The Stabilization Restructuring and Privatization (SRP) programme developed by the EBRD and described in Chapter Three has a similar purpose. Basically capital-management privatization is designed by investment fund management teams to inject capital and a new ownership and operational structure into 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 privatized 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 realize any capital gain. The SRP programme is more ambitious than the simple capital-management privatization 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 privatization and other forms of capital privatization 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. Privatization 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 privatization represents a formal recognition of the situation typically found in virtually all privatizations in the CEE region, namely, that some form of financial restructuring is required prior to privatization. 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 PRIVATIZATION

A mass privatization programme was discussed for more than four years in Poland. It was eventually approved by parliament on 11 April 1993. Mass privatization 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 its shares by increasing the value of the enterprises it owns. Logically this implies that Fund management teams will seek to maximize each enterprise'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, equivalent of US$ 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 privatized 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 per cent of the share capital will be divided among all investment funds (small shareholders) with equal numbers of shares going to each fund;
- 33 per cent of the share capital will be allocated to one fund (lead shareholder);
- 15 per cent of the share capital will be reserved for free distribution to employees; and
- 25 per cent will remain in hands of the Treasury or the Ministry of Privatization.

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 enterprise, they will then in turn select specific companies and obtain a 33 per cent block of shares in them.[66] 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 realize their gains, it will be necessary to privatize their enterprises at a good price. Real privatization 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 PRIVATIZATION

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 privatized through capital privatization by the end of 1991.[67] Of these, eight were trade sales to foreign-based companies and 14 were privatized 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 Privatization 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 privatizations 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 privatization became apparent in 1993 when no less than 42 state enterprises were privatized in just over nine months, only four were via the Warsaw Stock Exchange. In short, carefully packaged and targeted trade sales now dominate capital privatization 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.[68] 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 US$ 25 million to US$ 50 million 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 privatized 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 Privatization's persistence with sectoral reviews paid off in an increased number of strategic capital privatizations, 1994 should be the period when the first 200 mass privatizations 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 privatization which has obvious revenue benefits for the Polish Treasury and the mass privatization approach which has populist overtones. Privatization is expected to realize US$ 580 million in 1993 for the State Treasury.[69] By October, the government had received US$ 200 million in revenue and obtained investment commitments of US$ 500 million from capital privatizations 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 privatization 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 privatization.

MASS PRIVATIZATION: 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 privatization programme can hardly be described as such. However, the signs are that the privatization programme in general is continuing to gain momentum and the mass privatization programme, in particular, will start to be implemented in 1994.

A major innovation in the Polish mass privatization 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 privatization 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 privatization 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 re-nationalization of distressed companies located in sensitive regions.

In the Polish case, the success of the mass privatization programme depends explicitly on the quality of the NIF management and their ability to convert the enterprises in their portfolio into profitable investments. However, as with the Czech mass privatization 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 Privatization 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 privatization programme has probably encouraged false expectations. On the other hand, the emphasis on professional and experienced management of the NIFs will minimize the possibility of corrupt deals occurring. With an expanding domestic economy easing recessionary pressures on firms, there is a reasonable chance that the mass privatization programme will be successful in creating a new class of private property owners. The political objective of neutralizing the continuing influence of the management and workers of the state-owned sector will undoubtedly be advanced.[70] 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 privatization. The paradox is that the electorate have turned to the post-communists and their allies for relief from what are perceived as the injustices of the transition process. The mass privatization programme when it gets underway in 1994 will undoubtedly stir up further popular disquiet about the redistribution of wealth in post-communist 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 privatization 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 privatization 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 privatization.

In addition, the privatization programme has had to take into consideration the extremely complicated and decentralized ownership structure of Polish public enterprises. The Ministry of Privatization has, at one time or another, had to negotiate with over 60 different 'founding bodies' in its efforts to implement its privatization 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 privatize a particular enterprise of which it is the 'founding body', there is very little the Ministry can do other than persuasion.

THE REPRIVATIZATION CONSTRAINT

A further factor delaying privatization has been the absence of reprivatisation legislation in Poland even though it was the first country in the CEE region to launch a privatization 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 Privatization 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 privatized 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 Privatization 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.[31] 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 minimize global costs of production including seeking cheaper raw material sources. The impact of the policy environment, and privatization 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 things. 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, re-investment 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 privatization 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 recognized in Poland that privatization 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 the 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 organization.

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 privatization 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 US$ 700 million and US$ 1 billion in 1991. Commitments in 1992 were officially declared at US$ 4 billion including US$ 2 billion from Italy, US$ 600 million from the USA, and US$ 300 million each from Germany, Austria and Sweden. Table 9 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 seems to be encouraging with estimates of commitments rising to as high as US$ 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.

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, re-investment 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 global 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, efficiency, stability and predictability 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.

Table 9: List of top foreign investors in Poland

LIST OF TOP FOREIGN INVESTORS IN POLAND

	company	country of origin	area of operations	current investment (equity + debt), in millions of dollars	investment commitments in millions of dollars	main Polish partners
1	FIAT	Italy	passenger car production	180	1,800	FSM Bielsko-Biała
2	International	USA	paper products	120	175	Kwidzyn Paper Company (80 percent share)
3	Polish American Enterprise Fund	USA	capital cooperation with private business	114	29	Polservice, Wielkopolski Bank Kredytowy Cracow Industrial Association 1,700 other private enterprises
4	Warimpex	Austria	hotels	100	80	Orbis
5	Curtis International	USA	electronics, construction	100		
6	Asea Brown Boveri	Switzerland/ Sweden	power engineering equipment, turbines, electric motors	70	50	Zamech Elbląg (76 percent), Dolmel Wrocław (55 percent), ZWUS-Katowice (30 percent), Lamina-Piaseczno (61 percent), Elta (51 percent for 10.4 million dollars + investment commitments of 13 million dollars)
7	EBRD	international	banking, capital	59.6		Polish Private Equity Fund, Sandomierz Steel Mill
8	Chase Enterprises	USA	banking, media	48.5	10	joint ventures: Telewizja Kablowa (Cable Television) - 40 million dollars; Solidarność Chase Bank - 7 million dollars, Wendy's - 15 million dollars
9	Procter & Gamble	USA	hygienic articles, diapers	47.5	190	factory producing diapers in Warsaw (Targówek), the name of the joint venture: Procter and Gamble Operations Polska S.A.
10	Ameritech	USA	telecommunications	45	100	Telekomunikacja Polska S.A.
11	France Telecom	France	telecommunications	45	100	Telekomunikacja Polska S.A.
12	Private pension funds	USA	capital cooperation with Polish partners	43		Polish Private Equity Fund
13	Coca-Cola	USA	non-alcoholic drinks	42	200	Coca-Cola Gdynia, Coca-Cola Bydgoszcz
14	Vent Industries	USA	recycling (recycling of coal from waste-heaps)	37		CALEM
15	Epstein Engineering/ Golub Co.	USA	construction and development	36	100	National Bank of Poland, Constar-Starachowice Meat Processing Plant, Konspol-Słupca, Chemadex-Warszawa the total worth of projects with the above mentioned partners is 260 million dollars
16	Ringnes	Norway	non-alcoholic drinks, packages	36	100	
17	Thomson C.E.	France	picture-tubes, TV set	35	100	Polkolor Piaseczno (51 percent sshare), Adextra S.A.
18	Solco Basel	Switzerland	pharmaceutical industry	35		pharmaceutical production plant in Warsaw (Annopol)
19	Lucchini Group	Italy	metallurgy	34.8	150	Huta Warszawa (Warszawa Steel Mill)
20	AT&T	USA	telecommunications	33.6	56	Telfa Bydgoszcz (80 percent share)

Source: Warsaw Voice, 4 April 1993.

Endnotes

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

[58] 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.

[59] 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 privatization on a sufficient scale to make a significant impact.

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

[61] 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.

[62] 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.

[63] 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 Privatization in the new SLD-PSL coalition government.

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

[65] 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 Privatization in the 1989 Mazowiecki government, and sectoral privatization regained a new impetus.

[66] 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 privatization programme

[67] 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.

[68] McDonald, K R (1993) 'Why Privatization is Not Enough', Harvard Business Review, (May-June) pp 49-59.

[69] Financial Times, Special Supplement on Poland, June 17, 1993, p VI.

[70] Ewing, A and Lee B W (1993) 'Accelerating Privatization in Ex-Socialist Economics', Columbia Journal of World Business, (Spring), pp 158-167, and Thomas, S (1993) 'The Politics and Economics of Privatization 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.

[71] 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 5 million forints. The Hungarian government received 800,000 claims totalling 50 billion 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

With the background issues concerned with industrial restructuring and privatization firmly established in earlier chapters, the central issues related to the approach and experience of restructuring can now be addressed in this and subsequent chapters. In particular, this chapter examines the emerging methodology of industrial restructuring.

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 over-staffed 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.[73] 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 organizations 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 enterprise 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 enterprise. 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, enterprises 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.[74] 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 organizational 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.[75]

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 enterprises in the West. A well-functioning banking system able to supply capital to industry at globally competitive prices is essential for industrial development.[76] 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.[77] 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 recapitalize 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.[78]

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 organizing enterprise-based protests and strikes against poor wages and working conditions in the 1970s and 1980s.[79] This meant that Poland entered the reform process in 1989 with two competing trade union movements represented in most major enterprises, a post-communist union and a Solidarity affiliated union. Competition between the two trade union organizations for members has occasionally been fierce and politicized. 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 post-communist 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.[80]

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 privatization proposal exercised through the workers council, unions in Poland have often been remarkably flexible.[81] They have been drawn into the restructuring and privatization process by the promise of preferential acquisition of company shares, wage increases and guarantees of job security.[82]

An interesting example of the importance of the work force's attitude to restructuring and privatization 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 US$ 31 million, 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 US$ 40 million for 80 per cent of the equity and offered to provide a US$ 30 million investment guarantee.[83] 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 Privatization, 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 US$ 6 million 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 Zl 67 million (US$ 3,250). 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 organization; adjust products and marketing to face the new competition; reorganize 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 liberalize 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 still 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, privatization and restructuring expertise.

Given the evolutionary nature of industrial restructuring, the type and amount of assistance provided to enterprises needs to be carefully reviewed in order to reflect performance and adjustment to new economic realities. Unfortunately, cooperation and coordination between multilateral institutions to prevent duplication of effort, to share new information and experience, and to perform joint analyses of new project proposals is far from perfect. To compound the problems involved in integrating restructuring efforts, the authorities in CEE have only limited capacity to coordinate assistance programmes. Indeed technical assistance agencies have been known to compete fiercely with one another for the attentions of government decision makers. The short term nature of much technical assistance also means that there is sometimes only limited follow-up on programmes.

Technical assistance should be carefully targeted to help institutions and people adapt flexibly and efficiently to the newly emerging opportunity structures of a market economy. Thus banks should be restructured and reformed so that they have the capacity to support the changing needs of industry and commerce. Industrial relations should be refocussed, away from national political considerations and towards the needs of enterprise and productivity bargaining between management and workers. Training in the new skills required by the market economy should be freely available. Regrettably, national resource constraints, both human and financial, and the limited volume of externally funded technical assistance mean that in practice industrial restructuring exercises are usually piecemeal and rely heavily on local self-help.

SELECTION OF ENTERPRISES AND PREPARATORY ANALYSES

One of the critical steps, and perhaps the most contentious aspect of industrial restructuring, is the selection process by which enterprises are identified for assistance. Unsurprisingly, given the economic significance and sociopolitical sensitivity of certain industrial sectors, such as coal mining, steel manufacturing, shipbuilding and military industries, selection can be a highly politicized process.

A prerequisite for launching a restructuring effort is gathering information on a given market and industry. The review needs to thoroughly examine the product portfolio, its market, and industry trends including studies of the industrial sector in the world economy. From this information, a more coherent view of the enterprise's competitive position can be developed which, in turn, will inform the decision making process used to selecting enterprises for restructuring.

Disputes about which criteria to use in the selection and preparation of enterprises for restructuring arise from a variety sources. Perhaps the most controversial issue is which institutions and individuals have the capacity to select 'winners' during the transition from a centrally planned to a developed market economy. From our discussion about the deficiencies of the Polish banking system in Chapter Three, there is clear evidence of market failure in the capital market. To compensate for the absence of an efficient capital market able to satisfy the needs of the industrial sector it is necessary for multilateral and government agencies to make up for this gap by selecting enterprises that are likely to benefit from development finance and restructuring assistance.

The fundamental dispute, of course, is not about whether it is technically possible to contribute to national economic efficiency by being selective. This is, after all, a key function of financial institutions in a developed market economy - acting as intermediaries between savers and borrowers and making a profit by, among other things, correctly assessing the commercial risk attached to lending to the enterprise sector. In any lending decision there is always an element of uncertainty and risk which is normally reflected in the cost of capital to the potential borrower. There are also major financial management considerations that need to be taken into account, such as whether a particular financial institutions has a balanced loan portfolio, an adequate capital base, or carries out effective assessment of collateral. Clearly the professionalism and due diligence of the management of financial institutions is important.

The fundamental problem facing development finance institutions (DFIs) in the economies in transition, however, is not professional or technical but institutional. DFIs are simply not autonomous financial institutions but are quasi bureaucratic organizations enmeshed with the state apparatus and the political system. In short, non-economic, social and political factors are likely to come into play in varying degrees in investment decisions as client enterprises try to use their political and economic influence to attract funds to pay for the restructuring process. The inevitable subjectivity and uncertainty surrounding investment decisions in the chaotic market conditions of CEE and the FSU are exploited by various interest groups, to speed up, or slow down or block restructuring efforts.

With a history of systematic bias in the treatment of certain industrial sectors under communism and the uncertainties of the new situation, it is to be expected that restructuring is a sensitive political as well as economic process. Needless to say, it is politically difficult to admit the possibility that certain enterprises should not be included in the restructuring exercise since there is little hope of rescuing them from collapse. Naturally, as unemployment increases in many regions, few authorities are keen to shutdown enterprises. Sometimes, then, enterprises which are in fact on the verge of collapse will be thrown into a restructuring process in the vain hope that a miraculous rescue scheme can be devised in time to avert bankruptcy. This is especially likely in sensitive industrial sectors and regions where unemployment is unusually high. In these circumstances, restructuring is viewed as a cure for many years of enterprise mismanagement and neglect.

SECTORAL DISTORTIONS

The condition of many large state enterprises being restructured in Central and Eastern Europe and the FSU is a function of the particular industrial sector in which they happen to fall. Under the central planning mechanism state enterprises reported to a particular functional department or ministry responsible for that sector.[84] Almost all centrally planned economies pursued policies that favoured heavy industry and this legacy exerts a powerful influence on restructuring programmes today. Thus many enterprises classified as 'light industry' now being restructured are undercapitalized as a result of decades of neglect.

The policy of sectoral discrimination has sometimes been carried over into the reform programme, for reasons of administrative inertia and the continuing political influence of the senior management and trade unions of major heavy industries. The perpetuation of preferential treatment through tax breaks, tariffs and import protection can still impede enterprise restructuring by allowing management to postpone taking the painful steps needed to shed labour and capacity in order to improve competitiveness. Evidence from Poland's sectoral studies suggests that the persistence of a soft budget constraint creates severe disincentives for enterprises to rationalize their operations. By contrast, the most promising, that is commercially competitive candidates for privatization, often launch their own restructuring initiatives without being pressurized by government agencies.

ENTERPRISE RESTRUCTURING APPROACH AND METHODOLOGY

In Poland, schemes to restructure enterprises, as elsewhere in the CEE and the FSU, have been greatly influenced by the methodology and techniques developed in western Europe and the USA to turnaround failing companies. The ideas and concepts have mostly been brought in by foreign consultants hired in large numbers by multilateral agencies, government departments, banks and foreign and domestic investors. Inevitably some of these ideas and the assumptions behind the ideas have had to be modified in the light of experience of actual restructuring exercises, particularly the consequences of the weak legal, regulatory and financial services infrastructure typically found in CEE and the FSU. Nevertheless, many of the lessons learned from restructuring Western companies have proved a useful guide as to how to tackle the problems faced by East European state-owned enterprises.

The main difference is that restructuring in former socialist states entails major 'operations' on all parts of critically 'ill' enterprises, in comparison to the more selective approach required by the 'sick' parts of Western enterprises.[85] Another not entirely trivial consideration is that potential foreign investors, whether they work in multilateral financial institutions or for foreign companies and banks usually insist on Western standards in the presentation of business plans and financial information regardless of whether it is appropriate for the circumstances of CEE and the FSU.

Western experience indicates that the most successful restructuring strategies include significant changes in both organizational structures and processes. A primary objective is to decentralize and improve communication between management and the workforce. Improvements in marketing are common features of both successful and unsuccessful restructuring exercises. Successful turnarounds, however, are distinguished by the tendency to couple changes in marketing with a more fundamental product-market re-orientation.

Success stories are more often characterized by improved financial control than are failed recovery efforts. Failed restructuring plans usually include steps to improve control systems, but then the new systems fail to be used effectively to implement tighter financial control. Disposal of non-core and unprofitable activities and the introduction new management techniques are the most commonly used generic restructuring strategies. A new chief executive is usually necessary to effect a turnaround.

Significantly, cost-reduction strategies are frequently used as part of a successful overall restructuring strategy, but are used even more frequently by enterprises that fail to recover. This last point is of particular interest, given that much of the initial restructuring advice given to CEE and FSU enterprises centred on cost reduction. Although cost-reduction cannot be ignored, Western experience suggests that it is important not to lose sight of the requirements of the core business which may be fatally damaged by endless cost-cutting at the margins of an ever declining core. Thus a comprehensive restructuring programme needs to place a balanced emphasis on all aspects of the refocussed core business.

If it is accepted that the primary objective behind enterprise restructuring is to improve the performance of state-owned enterprises in order to prepare them for eventual privatization, what are the key stages of the restructuring process?

- **In the short term**, it is necessary to take steps to ensure that the enterprise remains operational. This means securing short term financial liquidity and carrying out a rapid review of marketing and production activities in order to establish whether there are any short term changes that can be introduced to improve the immediate cash flow situation. Without these initial steps being taken the enterprise is liable to collapse.

- **In the medium term**, a comprehensive technical and economic evaluation of the enterprises' operations needs to be carried out focusing on the human resources available, the scope for cost reduction, and an assessment of physical facilities, plant and equipment.

- **On the basis of the comprehensive evaluation** of the enterprise's operations, advice can then be provided to top management on the strategic development of the enterprise's product mix, the opportunities for diversifying product lines and markets, together with the financial implications and proposals for shedding surplus capacity and labour.

- **The final stage** is to assist top management in creating a strategic plan for the enterprise, typically encapsulated in a mission statement, that is then agreed with the trade unions and the workforce generally. Then, and perhaps most crucially of all, it is vital to agree upon an implementation programme for the strategic plan with all the stake holders in the enterprise.

All the above stages and related issues of the restructuring process are discussed in detail and illustrated with specific Polish case studies in the next chapter.

TECHNOLOGY AND TECHNICAL ISSUES

The restructuring process must take into consideration the technological base of a given enterprise. Once the strategic mission of a company has been defined, the technological review focuses on identifying the core productive assets necessary to fulfil this mission. Usually a reduction in the extent of vertical integration is a key component of the restructuring process that eventually leads to a sharply focused enterprise with a sustainable capital investment programme. Typical technological problems faced by enterprises in the region are:

- **Aged and obsolete equipment** - Given the scarcity and high cost of new capital, it is necessary to maximize use of existing assets. Disposing of surplus machinery may be a source of funds.

- **Underutilized maintenance and service departments** - The utilization of support units needs to be examined with a view to reducing costs through disposal of those that are underused and/or hiring subcontractors.

- **Inefficient materials handling and production flows** - Under the old shortage economy, capital investment was prone to arbitrary peaks and troughs so that today there is frequently a mismatch between machinery and plant of differing vintages. This results in production bottlenecks and inefficient production methods.

- **Weak plant maintenance systems** - The old culture of storming to meet externally imposed planned production targets at certain times in the year meant that the development of a regular inspection regime was hampered by the unpredictability of production schedules. Unreliable machines also gave skilled workers a powerful bargaining tool with which to negotiate special bonuses with management. The absence of a preventive maintenance culture (and obsolete and poorly matched machines) means that machine down-time tends to be much greater than in similar Western enterprises. Tight cost-control is therefore very difficult.

- **Quality control** - Without a strong tradition of cost accounting underpinning all stages of the value-added chain from research and development, to design and production, through to marketing and after-sales service, control procedures are typically confused and erratic. As a consequence, most enterprises in CEE require radical changes in their control procedures if they are to meet modern international quality assurance standards such as the norms laid down in ISO 9000 and ISO 9001.

- **Pollution** - The previous regime did little to enforce environmental protection standards. Many enterprises are currently in breach of EC environmental standards and substantial investment is required to clean up existing production technology. Many enterprises carry unknown liability for previous polluting activity, particular with respect to ground water contamination.

FINANCIAL RESTRUCTURING OF ENTERPRISES

At enterprise level, financial restructuring commences with a thorough diagnostic review. It is particularly important that top management is actively involved in the diagnostic process, for it is likely to be the first opportunity they will have had to participate in modern financial analysis. Implementation of the eventual restructuring programme will be that much surer if top management are fully conversant with the financial conditio.. of thei, enterprise. They also have to understand the financial implications of the economic reality facing their company. In Poland and elsewhere in the CEE and FSU, enterprise management face similar problems stemming from the neglect of financial management in the past:

- **Cost accounting** - Enterprises are unable to correctly estimate and control overhead costs by product group, or functional division, or the costs associated with inventory and work-in-progress.

- **Revenue breakdown** - Profit and contribution analysis is not routinely carried out so that the estimation of the gross and net profit margins of product lines is not available to the marketing department. As a result, break even prices are rarely used in developing the pricing strategy of enterprises.

- **Balance sheet and income statement analysis** - It is presently very difficult for most managements to draw quick and incisive conclusions from the financial information supplied to them by accounting departments using the old format developed under the central planning regime.[86] The management information system usually needs to be radically overhauled so that it can routinely supply up to date data on the cost-price structure of the business, inventory turnover, accounts payable and receivable, the standard financial ratios, and perform historical and future cash-flow projections

- **Financial analysis of sales** - Efficient (active) enterprise cash flow management requires a financial and business model that defines the product portfolio, identifies seasonal sales patterns, calculates historical sales trends by value and unit volume and analyses the order book. Very few state enterprises possess the capability or capacity to manage cash flow efficiently without outside assistance.

Once the management information and accounting system has been redesigned and the financial state of the enterprise been evaluated, it is usually necessary to look to financial institutions for assistance. Four years ago Poland had one bank. Today that number has reached well over 100. In far too many cases, Polish banks remain aloof from the needs of the industrial sector. If the productive sector is to expand efficiently banks must become involved in the financing of enterprise. Fortunately the international financial institutions such as the EBRD, the World Bank and IMF are making a major contribution towards restructuring and refocussing the lending operations of commercial banks, (see Chapter 3)

HUMAN RESOURCE DEVELOPMENT

Training is a crucial part of a comprehensive restructuring programme. A primary objective of industrial restructuring is building flexibility into enterprises so that they are better able to react to changing market opportunities with an appropriately profitable response. This requires selective investment in modern plant and equipment, reconfiguration of existing machinery, the introduction of management information and accounting systems, and the development of a proactive marketing function and sales force. All of these actions imply major organizational change, renewal and development. Human resource management was as much neglected as finance and marketing in state-owned enterprises, yet it is only through mobilizing the workforce that restructuring programmes can be implemented.

There is a synergy of investment in plant and equipment, in research and development, in management systems and in human resources. All four must be upgraded simultaneously, or else capital and technology will be designed around deficiencies in the labour force ("dumping down" technology, as when pictures replace numbers on the cash registers of fast food restaurants) consigning CEE and FSU countries to a comparatively capital intensive but low-wage, low-skill development trajectory. A particularly alarming implication of this latter scenario is that since the countries of the region are capital-starved, very few enterprises will have enough capital to survive restructuring. Those enterprises that do survive will have very much depleted labour forces. Thus, in the absence of abundant investment capital, industrial restructuring programmes must be premised on human resource intensification rather than major increments in hardware.

Although 90 per cent of Polish managers in large state enterprises received a university education there has been an encouraging response to new training opportunities. Many are taking advantage of management training courses to improve their knowledge and skills. Approximately 40 per cent of managers over 40 years of age and 30 per cent of those aged between 21 to 40 years have attended some form of management training course since 1990. Technical and professional training is also needed to compensate for the theoretical bias in Polish higher education caused by the shortage of modern scientific and engineering equipment in university and polytechnic laboratories. Particular needs exist in specialist engineering, computing science, management information systems and other applied sciences. Polish enterprises, for example, suffer from high level manpower shortages in the areas of production planning, work methods organization, materials flow management, machine shop scheduling, plant layout design, computerization and the application of CAD/CAM systems, management information systems development and quality control. Throughout CEE and the FSU, similar observations have been made about training deficiencies. Language training is also a top priority since less than 15 per cent of managers of Polish state enterprises know English, with even fewer being familiar with German or French.

As already mentioned above state enterprises have few funds for paying for training, so that the assistance with training provided by foreign governments and multilateral institutions is often of paramount importance in securing the successful implementation of well conceived and executed restructuring programmes. Quite often, the acceptance of restructuring programmes by management and labour is dependent on the package of training and retraining being offered. For example, after the last wave of coal mining strikes in the winter of 1993, the Polish government reached a deal with the miners by offering a restructuring programme with an enhanced training component.

SMALL BUSINESS DEVELOPMENT

Polish experience of restructuring state-owned enterprises suggests that most existing departments need to shed staff. Job losses are particularly heavy in service departments. Once laid off, these blue and white collar employees often have no choice but to enter self-employment or start up businesses. Certainly the repression of the private small and medium-sized business sector under communism has meant that all CEE and FSU economies have, by Western standards, a skewed size distribution of enterprises. Private medium, and to a lesser extent small-sized enterprises are noticeably under-represented throughout the economies of the region. On the face of it there would seem to be ample opportunities for creating new small businesses to provide subcontracting services to the remaining large enterprises.

Although the encouragement of subcontracting has a logical economic rationale, Western experience suggests that it is difficult to stimulate business formation without a well-trained pool of potential entrepreneurs. A good general level of education supplemented by practical business skills such as cost accounting, a knowledge of finance, marketing and computer literacy seems to offer the best prospect As more and more enterprises restructure by streamlining production, spinning off non-productive assets, and shedding surplus labour, redundant workers will enter an increasingly crowded labour market It thus becomes increasingly urgent that sufficient resources are devoted to supporting business start-ups, both by directly helping people find employment as owner-managers and by encouraging those who are successful to take on more employees.

A number of bilateral and multilateral agencies, such as the British Know How Fund, the World Bank, PHARE and USAID are assisting the Ministry of Industry with creating a network of business support centres and incubator units in Poland and elsewhere in CEE. Generally, these centres provide free or heavily subsidized advice to clients; assistance with developing a business plan; and a range of practical skills-based, short training courses, usually free. Some offer access to credit lines or rent out pre-start factory units at subsidized prices. The Polish Ministry of Labour also sponsors short courses for the unemployed of the variety 'Is business for me?' and 'Going into business'.

Small business training programmes have three basic functions. The first is to help would-be entrepreneurs review whether they have a viable business idea. The second is to provide more specific training for those who have gone beyond formulating an idea. The third objective is to provide further training and support to those businesses that have started up and have survived the initial period of development. One-stop small business support centres normally offer specific business advice, counselling alongside training. At least until a business has become well-established, it is not normal to charge any fee for advice or training. Clearly, for CEE and FSU governments facing a tight budget constraint, foreign assistance is essential for subsidizing the provision of training and advice services for small businesses.

There are many people all over Eastern Europe who are willing to engage in private business and it would seem that a large proportion are well able to do so. However, they still need active encouragement and the remaining legal and bureaucratic obstacles left over from the old regime must be finally swept away. They also vitally need increased access to credit to get them going, that is capital. So far governments and international organizations have not been sufficiently generous with credit lines to this sector. Even if the loan recovery rate is under 30 per cent, as it typically is, the long term social and political benefits of visibly supporting an emerging entrepreneurial class that has palpably modest capital requirements compared with a single state-owned enterprise would seem self-evident.

Endnotes

[73] see Porter, M E (1985) Competitive Advantage, New York: the Free Press.

[74] We describe the difficulties the Polish government has had in developing a national industrial policy in Chapter 3.

[75] Lieberman, for example, describes an interesting Tunisian textile case study that demonstrates the importance of a comprehensive approach to industrial restructuring. The case attributes the successful restructuring of a subsidiary of Tunisia's largest textile group, to effective linking of a combination of technical support, improved production assistance, organizational and management changes and the provision of adequate financial backing. As a result of restructuring the company has become a key supplier of denim to the EC. (See Lieberman I W (1990) 'Industrial Restructuring: Policy and practice', World Bank Policy and Research Series, 9, p.19)

[76] For example, in Japan in the 1970s and early 1980s, banks were a very important source of competitive advantage as providers of cheap industrial capital for Japanese corporations.

[77] The lack of willingness of Polish banks to become more involved in assisting enterprises has led to the threat that, if Polish banks continue to choose not to lend to industry, then the banking sector should be opened to free competition from foreign banks.

[78] See Chapter three for a fuller treatment of issues concerning the financial sector in Poland.

[79] The Polish unofficial trade union movement mounted its first major public confrontation against the communist government in Poznan in 1956.

[80] Competitive trade union federations differentiated according to political affiliation are found in many West European countries such as Italy, France and Belgium.

[81] The greatest trade union militancy has been shown in the heavy industrial sectors, mining and public transport where overcapacity and outdated equipment are widespread.

[82] The punitive tax on wage increases above the government norm discussed in Chapter Two, know as the popiwek, does not apply to private companies.

[83] Nestle had earlier failed to buy Wedel in Warsaw which fell to PepsiCo; Amino in Bydgoszcz to Knorr; Suchard (part of Philip Morris) took over Olza in Ciesyn and Bahlsen took over KSS in Skawina. Other investors in the sector include Dalgety, Cadbury Schweppes, United Biscuits, Ferrero SpA and BSN.

[84] This so-called functional structure is also replicated in the structure of higher education and research institutes. Thus a typical university faculty of economics had institutes for textile economics, light industry economics, steel and mining economics. Each industrial sector also had its central research institute.

[85] Rybczynski, Tad (1991) 'The Sequencing of Reform', Oxford Review of Economic Policy, Vol 7, No 4, pp.26-34.

[86] Polish enterprises had already been given limited decision making powers in the partial reforms of 1981-82 and 1987-88 so that there had been some modest development of investment planning and financial management before 1990. However it was at best halfhearted since state enterprises did not face real competition in a free market or the discipline of a capital market when seeking investment.

Chapter 6
Case Studies of the Restructuring of Selected Polish Enterprises

INTRODUCTION

In this chapter, the emerging methodology of industrial restructuring introduced in Chapter 5 is illustrated in the context of specific case studies. Although, this chapter presents case studies of Polish industries, other studies of the region by UNIDO and other international organizations report similar findings. There is therefore good reason to believe that these Polish case studies provide useful experience and guidance for other countries embarking on similar restructuring exercises. The case studies are based on an on-going UNIDO restructuring project in Poland. Beginning in 1991, US$ 2.3 million were made available by the British Government through its Know-How Fund for Central and Eastern European (CEE) countries to enable UNIDO to assist in the restructuring of 15 Polish enterprises.

The primary objective of the UNIDO restructuring project was to facilitate the restructuring process and eventual commercialization of the ten enterprises selected. The programme also had a series of secondary objectives:

(a) To keep the enterprises operational and maintain their financial liquidity in the short term, until a firm restructuring plan could be drawn up. Priority was thus to be given to conducting an immediate assessment of assets and liabilities, defining urgent short-term measures to improve the liquidity of the enterprises and undertaking negotiations with creditors, as well as to addressing short-term technical, marketing and financial problems.

(b) To carry out a comprehensive techno-economic evaluation of the enterprises' operations in terms of the types of plant, machinery and equipment used, skills available, the types and volumes of products currently manufactured, scope for reducing costs and rationalizing assets and any technical problems.

(c) Based on the foregoing evaluation, to provide advice to the enterprises on an ideal product mix and to recommend new or diversified product lines and markets, due consideration being given to the changing economic environment and comparative advantages, and to necessary improvements in the enterprises' managerial/technical capabilities.

(d) To help enterprise management develop a better, more coherent organizational and strategic view of their future, thus enabling the enterprises to elaborate and implement an effective restructuring plan and strengthen their position during discussions/negotiations with potential technical and/or commercial partners.

Preparatory work was needed on all these objectives in order to define a preliminary work plan for restructuring the enterprises.

On the basis of rigorous selection criteria, 15 large and medium-scale enterprises out of around 40 candidates were selected for in-depth examination. Basically, these were potentially viable enterprises which were willing to undertake major restructuring efforts themselves but still required external assistance. The enterprises selected employed between 1,000 and 20,000 employees and produced a wide variety of products ranging from linen fibre and fabric, colour and black and white television sets, screen monitors, work stations through to military tracking equipment, gear transmissions, construction cranes, locomotives and mobile cranes. To illustrate the major findings and recommendations of UNIDO's restructuring project, three representative case studies are presented in this report.

The Polish enterprises selected as case studies reflect the difficult transformation process undertaken by the former socialist states in 1989. The successes and failures of the restructuring programme are an amalgamation of macroeconomic and microeconomic decisions taken by the enterprise management and various policy making institutions. Although certain problems were unique to a given enterprise, many more were commonly shared. All of the enterprises discussed in the case studies had considerable problems adjusting their product-oriented structures into competitive market oriented operations. Besides being able to produce what the market demands, the enterprises examined encountered difficulties when faced with such strategic issues as pricing, budgeting, cost monitoring, distribution, quality control, product design, marketing, and sales. In short, the enterprises were not hitherto prepared to perform those functions necessary to create value added operations.

To compound the problem, the enterprises lacked support systems available to their Western counterparts. Without a strong banking sector well versed in risk assessment and credit and project analysis, many of the enterprises could not rely on their banks to be an active partner during the restructuring process. Lacking well developed financial skills and support, the enterprises faced a multitude of problems stemming from poorly designed management accounting systems, the non-use of basic ratio analysis, and outdated methods of overhead cost allocation. Their financial situation was further aggravated by management's insufficient knowledge of the market due to inadequate market research and inadequate understanding of market forces influencing price, promotion, and packaging of their products. The lack of expertise in the above mentioned areas underlines the importance of human resource development in CEE enterprises. Training of top and mid-level managers in modern business practices emerges as an effective means to galvanize the restructuring process.

In addition, it has to be noted that a restructuring process in the CEE and FSU states is not the same as in the West. To begin with, the human resource base is completely different with basic skills in such crucial areas as sales and marketing being greatly neglected or absent. The correct assessment of the enterprise such as an in-depth diagnostic analysis required in fact a decoding operation of past performance figures, to adjust them to free market concepts and criteria of a free market. One has to also keep in mind that in fact the issue was not restructuring, but a profound transformation of one type of organization into a completely different one with distinct functions and aims operating in a trade union dominated atmosphere.

To provide assistance during the transformation process, a four-step restructuring programme was developed aimed at stabilizing an enterprise's deteriorating competitive position, that often bordered on catastrophic, and developing a revenue generating strategy. A major objective, therefore, of the restructuring programme was to improve the competitiveness and the operational efficiency of the enterprises. Considering the characteristics of former SOEs, the foremost task was to rationalize the level of employment and reduce the asset base, as well as increase sales. Specifically, the four step restructuring programme reviewed an enterprise's business environment, performed a company diagnostic, developed restructuring options, and together with the management, implemented an action plan. Each of these subpoints are described below:

I. Step One - Data Review

* In step one, market and industry data was collected and analyzed to define the competitive environment and to identify possible development opportunities for the enterprise being restructured. An analysis of the enterprise's product, price, place, and promotion was performed which asked the following questions:

1. Product - Is the product mature and facing new entrants or substitutes? Have better technologies been developed? Has the competition established local operations? Who is the competition and how are they positioned in comparison to the enterprise?

2. Price - Are there any developments in complimentary products or services? What are the competitive pressures and policies that effect pricing? What pricing/purchase financing could be used to retain customers? What pricing should be designed for wholesalers, retailers, and final customers?

3. Place - What are the distribution channels and how are they evolving? Which channels are used by the competition and why? What regulatory policies influence the market place and the industry?

4. Promotion - What selling techniques are used and how is the sales force organized? How and by whom is promotion organized and executed? Are there any industrial organizations or lobbies to promote their common interests?

II. Step Two - Diagnostic

* Consisted of a full diagnostic to define the enterprise's competitive positioning and to prepare a financial business plan based on a competitive market and industry review. The diagnostic stage asked specific questions regarding five areas of the enterprise's operations that are described below:

1. Revenue - What is the biggest source of revenue? Who are the enterprise's clients? Do the enterprises have a clearly defined product portfolio? Is the method of distribution effective?

2. Finances - What is the current cash position of the enterprises? What is the enterprise's level of debt and how does it compare to the competition? How effective is the enterprises' method of exacting their receivables from their debtors?

3. Management - What is the organizational structure and is it appropriate? What are the management's capabilities? What are the workforce's strengths and weaknesses?

4. Cost - How effectively are costs controlled? What steps are being taken to reduce costs? What is being done to maintain a rational level of stocks? Are raw materials purchased of requisite quality at the lowest price?

5. Production and Assets - Are assets well utilized? Are there any redundant fixed assets which may be disposed? Are work methods and production technologies used effectively?

III. Step Three - Options For Restructuring

* Based on the diagnostic and competitive positioning conclusions, restructuring options were developed to place top priority on the enterprise's strategy, corporate mission, business plan development, reorganization, and training. To develop a full spectrum of restructuring options, additional questions were asked focusing on the following:

1. Mission - What is the goal of the enterprise's operations? What are the tasks of the management and employees? How will the enterprise's organizational structure assist them?

2. Strategy - How should the enterprise be positioned in the market relative to its domestic and foreign competitors? Which products should be delivered to which market segment and at what cost? How is internal business performance control defined? What organizational structures and assets are needed to carry out the strategy?

3. Business Plan - What are the external and internal factors influencing the enterprise's performance? Which scenarios should be taken into consideration? What are the range of possible results?

4. Reorganization - What organizational structure is the most competitive? What assets should be sold and/or liquidated? Which departments should be reduced in size or spun-off? What are the enterprise's core business activities? What should be done with the ancillary services such as schools, health clinics, recreational facilities? Which employment structure is the most efficient?

5. Training - What assistance is needed to develop human resources in the enterprise? What training is needed to improve the enterprise's product/market strategy, competitive positioning and strategic planning. What training should be provided to address the enterprise's internal needs such as revenue, financial performance, cost and asset structure, and organizational management. How can the enterprise effectively utilize professional partners and advisors, communication, motivation and public relations that influences the business environment.

IV. Step Four - Implementation

* After the restructuring options were addressed and consensus reached by the management, implementation plans tailored to the enterprise's needs were developed. This entailed implementing an action plan based on the points described above, while emphasizing the need for project financing and recapitalization of the enterprise. Of specific concern were sources of available capital, the creation of a consortium to reduce risk and cost of capital, the selection of financial partners, liquidation of state shares, and privatization.

The basic purpose of the four phase restructuring programme was the development of a stabilization programme for the enterprise. Such a stabilization programme was intended to gain management control over the enterprise, establish and communicate credibility with institutions possessing a stake in the enterprise, and assess the existing management structure. These three objectives are further developed below:

Stabilization

- **Gain management control** - This may entail bringing in a new financial director, developing a cash flow forecast, and implementing centralized cash control. The implementation of controls over both capital and revenue expenditures may entail freezing employment, rejecting suppliers' price increases, and having the general manager approving all renewed or new contracts. Inventory control and debtor control are also areas where management control is of importance.

- **Establish and communicate credibility with stakeholders** - Enterprise stabilization entails developing a close working relationship between the enterprise and its key creditors by explaining the main ideas of a restructuring plan and the length of time it may take. Improved communication also entails talking to suppliers, trade creditors, customers, and trade unions and outlining the urgency of the situation and the enterprise's commitment to restructure while continuing to provide service.

- **Assess existing management structure** - Provide for face to face meetings and assign specific tasks or projects. An outside technical expert may be needed to assist in the areas of personnel replacement, recruitment, and compensation.

As in the West, enterprise stabilization provides a window of opportunity to launch a cash-generation effort. These concepts focus on the revenue generating strategy that has three basic elements:

Revenue Generating Strategy

- **Product-market change** - Based on a detailed marketing plan, this entails defining strategic business units (SBUs) and analyzing their growth and profit potential. To assist in the change, responsibility should be shifted to profit centres while simultaneously improving control and quality systems.

- **Improve sales effort** - Increased revenues for the enterprises forces the creation of planning and the controlling of selling efforts that often means managing the time sales representatives devoted to clients. In addition, motivating and training the sales force is a top priority. Monitoring of the sales force should include judging sales performance on the basis of a comparison of actual versus budget performance, key accounts, sales targets per sales representative, sales trends, and the impact of special promotion. Improved efforts should be closely followed by evaluating and, if necessary, replacing sales representatives.

- **Price strategy changes** - A review of the enterprise's pricing strategy entails performing a customer profitability review. Raising list price on all or some of the products should be considered based on a well worked policy of how much of an increase can the products stand. The enterprise's discount policy may need to be altered as well to make an impact on the pricing strategy.

A summary diagram of steps involved in the restructuring programme points out the relatively lengthy and expensive process awaiting an enterprise engaged in such an exercise. Besides time, internal and external factors influence the enterprise and play an important role in the success or failure of such an undertaking. With each step requiring full commitment and perseverance from the enterprise's staff, the human factor must be seen as one of the most decisive contributors to a successful restructuring process. Resistance to change is a serious obstacle to any restructuring programme regardless of whether it is undertaken in Eastern or Western Europe. Change is even more difficult in an environment which for nearly 50 years operated on totally different economic premises.

As the case studies point out, the success of a restructuring project hinges on many factors; however, the attitude of the management toward change, an integral element of all restructuring programmes, emerges as a dominant force.

COMPANY A

DESCRIPTION AND HISTORY OF THE ENTERPRISE

Company A consists of two divisions specializing in equipment production and construction/installation services. The equipment production division assembles low and high voltage switchgears and transformer stations, while the construction/ installation division provides electrical services for the industrial and commercial sectors. The vast majority of switchgears and transformers were produced for the former Soviet Union, while the construction/installation services were primarily oriented toward the domestic market.

Company A was established as a state owned enterprise immediately after World War II along with 12 other similar operations making electromechanical products and providing construction/installation services. The central planning authorities assigned the type and the amount of goods to be produced by each company, while allowing each to maintain a monopolistic construction/installation hold over a specified geographic area. A more detailed summary of employment and financial developments in Company A from 1989 to 1992 is provided below.

COMPANY A

In million US$	1989	1990	1991	SOE 1992	JSC 1992
Employees*	988	867	770	770	693
Capital	-	-	-	-	0.01
Fixed assets	-	3.73	3.50	2.83	3.12
Current assets	-	3.08	5.51	5.69	6.54
Liabilities	-	1.08	1.18	2.17	1.13
Total sales	-	11.35	16.54	2.10	8.13
Gross profit	-	3.84	4.86	0.04	1.13
Net profit	-	1.97	2.51	0.01	0.67

Source: Company data
* Number of Employees
SOE - State Owned Enterprise
JSC - Joint Stock Company

MAJOR PROBLEMS AND CONSTRAINTS

Marketing and sales orientation

Ineffective marketing and sales efforts due to a lack of requisite skills by the department's personnel caused formidable barriers to the creation of a market oriented company. This problem was quite universal among large state owned enterprises in Poland which typically relied on the engineering staff to develop and manage marketing and sales efforts. In the case of Company A, both of the sales and marketing managers for the equipment production and construction/ installation divisions were electrical engineers who for approximately 20 years were involved in production. Both of them were promoted to Sales and Marketing with little training or experience in the discipline of industrial marketing. As such, prior to the organized training offered during the restructuring process, most of the learning was done by trial and error.

For example, the manager of sales and marketing for the equipment production division treated transformers as a consumer product and did little to stimulate sales using industrial marketing methods. In addition, the two sales and marketing positions for the equipment production and construction/installation divisions did not coordinate their actions. Their cooperation seemed natural since the construction/installation division provided electrical services for industrial and commercial projects throughout Poland, while the equipment production division assembled transformers and switchgears used by the industrial and commercial facilities. The systematic collection and sharing of information between the two departments and database development received little attention.

One of the major reasons for this distance between the two divisions stemmed from the equipment production division's ongoing sales of transformer stations to the former USSR which was bringing unrealistically high profit margins of 31 per cent. Given this success, the equipment production division became complacent and did very little to pursue sales leads on the domestic market where margins were in the single digits and where competition from domestic and foreign producers continued to intensify. It should be noted that the old arrangement where Poland was divided on geographic basis among 13 enterprises, all performing the same services and capable of producing the same range of products, collapsed after 1989. The 13 enterprises commenced encroaching on each others territories, product range, and services leading to stiff competition for the recession hit Polish client base.

RECOMMENDATIONS

Marketing and sales improvements

As Western products supported by government export schemes made inroads into traditional East European export markets of the former USSR, Company A's unit sales of transformers were reduced from 815 in 1988 to 350 by 1992. In addition, other Polish producers started competing head on with Company A in the former USSR. This competition forced Company A's equipment production division to refocus the domestic strategy and review its reliance on foreign trade organizations (FTO's) responsible for exporting transformers. The FTOs were in an advantageous position to select one producer over another depending on the personal and/or historical ties between the producer and the trader, financial incentives offered by the producer, and technological capabilities of the enterprise.

Given these developments, new emphasis was placed on creating alternative means of selling Company A's products in the former USSR and other foreign markets. Due to the FTO's strong bargaining position in relationship to the producers, Company A's selling costs jumped dramatically from approximately 7 per cent in 1990 to 23 per cent in 1991. Company A addressed this and other marketing problems by giving the marketing department increased training to meet new market challenges and responsibilities. In addition, intensive search commenced to locate an alternative private, state, and/or foreign agent to sell the products in foreign markets as a counterweight to the traditional FTO assigned to Company A under the old system by central planning authorities.

Due to Company A's weak marketing and sales skills exemplified by the department's attempt to advertise industrial products and services using consumer goods techniques, intensive training commenced to develop a vibrant marketing department employing 18 specialists. Training of the new personnel in modern business practices entailed developing new skills for each section of the department such as the market research and analysis sector, research and development, and promotion and sales sections of the department. Under the previous organization, the department acted as one body duplicating its efforts without developing a systematic way of locating clients or collecting information on market trends or the competition. Special emphasis was placed on improving Company A's market survey and data collecting capabilities that were underdeveloped due to the historical reliance on the FTOs in foreign markets and an agreement to the domestic market split among the 13 enterprises.

Human resource development

Increased training of Company A's staff in marketing and cost accounting resulted in cost reduction and monitoring systems being implemented. The need for such improvements was exemplified by the discovery that an identical product made by domestic competition was substantially less expensive. To correct the problem, a detailed cost analysis and pricing policy review was performed by the marketing, accounting, and design and technology specialists. Through this cooperation, it was revealed that the cost of sheet metal used in production was overstated resulting in a higher final price when compared to the competition. The improvements led to a rapid turn around in Company A's fortunes. As a result, Company A's sales rebounded due to lower production costs and an effective pricing strategy.

Company A's limited exposure to modern cost accounting and financial systems illustrated many of the problems faced by state-owned enterprises. What made Company A's situation unique was the separate equipment production and construction/installation divisions that operated in two different areas, making the enterprise an ideal candidate for profit centres. However, despite many advantageous of profit centres, this concept was rejected by the management who claimed that it would destroy the historical bonds between the two divisions and also jeopardize the consensus about privatization among employees. Many examples were given showing how the divisions helped each other during times of economic difficulties. As such, explanations that the profit centres intended to improve accounting procedures and reduce cost structures, and did not necessarily threaten the "special" relationship between the two divisions, had limited influence on the management. More specifically, employees feared that profit centres would be the first step toward layoffs and further asset reductions when one of the division's sales decreased. Each division's direct accountability was sacrificed for social harmony resulting in a less efficient overall operation; whereas fixed, variable, and overhead costs could have been more tightly controlled.

Company A needed to streamline its operation since approximately one-third of the assets with a net book value of US$ 15 million were either non-productive and/or non-core. Such ratio is common among state owned enterprises being restructured as a large portion of their assets consist of buildings and aged equipment and past investment on social services and assets such as nurseries and holiday homes. In the case of Company A, the equipment production division had 90 per cent of assets in buildings and the remaining 10 per cent in equipment. However, the equipment was 84 per cent depreciated while the buildings were only [illegible] per cent depreciated. This was in line with the trend among East European enterprises which were often located in relatively new buildings but operated with obsolescent machinery. The construction/installation division with 23 per cent of its assets consisting of buildings and 77 per cent of equipment faced a similar problem. In their case, buildings and equipment were 42 per cent and 67 per cent depreciated, respectively. The level of depreciation reached staggering proportion which directly influenced Company A's product quality and overall efficiency For example, the enterprise's welding machines, turret lathes, cutting machines, and presses that all had an important impact on final product quality, were 100 per cent depreciated.

Finance

The company was in a relatively healthy financial shape due to the continuing sales of products to former USSR markets. Company A's internal cost controls needed to be improved. Although being able to breakdown the overhead costs into energy, wages, taxes, depreciation, interest and bank charges, and materials, Company A could not point out exactly which of the divisions were responsible for higher overhead costs. Between 1989 and 1991, growing overhead costs nearly doubled and became very difficult to allocate between the two divisions. To correct this dilemma, profit centres were proposed to determine which division needed to improve its performance. Although advantages of having the equipment production division operate as a profit centre were outlined and presented to the management and the workers council, it was not accepted as the best financial alternative to improve performance as well as to maintain the historical tie between the two divisions.

Production

Company A was characterized by inefficient production methods which exacerbated the enterprise's quality and cost control problems. In addition, the plan layout and material flow was not conducive to a rational and efficient work flow. Although production planning and control identified start dates which led to correct priority for loading time, the overall effect was reduced by the poor discipline in ensuring that progressive actions were taken. The production planning and control system in operation was manual. This had the effect of extending the lead time required to ensure the proper sequence of events from receipt of order to issuing the appropriate drawing, specification and production plan, and so on. This often resulted in needed components being bought either too late or too early leading to bottlenecks and increased inventory costs. To compound the problem, the enterprise's inventory control system was inadequate in comparison to modern practices employed by Western firms.

Ways to improve Company A's productive efficiency included combining various operations, purchasing standard parts and rationalizing designs. To improve quality, a quality trail was developed consisting of eight steps revolving around an improved documentation flow. Recommendations were made to create a properly functioning self regulating perpetual inventory control system to lower inventory costs.

It should be noted that Company A in calculating the costs connected with the direct purchase of a given product or part, include a transportation costs and the wages of employees working in storage facilities. On the other hand, the company did not calculate costs associated with inventory, such as average capital tied down in inventory or cost of inventory control. As such, active measures were recommended to reduce surplus stock through an accurate calculation of inventory needed to support ongoing production which subsequently led to drastic stock reductions.

RESULTS AND CONCLUSIONS

Company A's restructuring process led to improved financial performance as a result of increased human resource development, operational streamlining and employment reduction. In addition, Company A successfully implemented its privatization programme and is currently operating as a private firm in which 20 per cent of the shares are held by workers.

Due to historical reasons, Company A did not create profit centres revealing that traditional bonds and associations often prevail over economic and financial rationale. The management, in order not to antagonize the workers during sensitive privatization negotiations, decided to overlook the matter. After the enterprise's privatization, the issue remained very contentious and to date, no progress has been made to implement profit centres for the two divisions.

COMPANY B

DESCRIPTION AND HISTORY OF THE ENTERPRISE

Company B, a producer of pure linen and linen blend fabrics, was founded before World War II and nationalized in 1949. The enterprise, selling its products principally in bulk for use in the clothing industry, operates one manufacturing plant in the southeast part of Poland. The manufacturing plant consists of old and poorly maintained specialised machines and equipment that are 80 per cent depreciated and aging buildings that are nearly 50 per cent depreciated. At the beginning of the restructuring project Company B employed 1,160 workers which was lowered to 880 in 1992 and reduced again to 680 in 1993.

Company B produces and sells a wide range of finished and semi-finished linen products. Over the years it has become the fourth largest producer of linen by volume. Among the various products sold, tablecloths and decorative tablecloth fabric accounted for approximately 55 per cent of total sales in 1991 and nearly the same percentage in 1992. Company B focused most of its production on the domestic and the former USSR markets. In 1989 approximately 63 per cent of Company B's sales were for the domestic and former CMEA markets; however in 1990 exports to the Western markets increased sharply from 37 per cent to nearly 79 per cent of the enterprise's total sales. In 199ı, Company B and six other Polish linen producers accounted for 90 per cent of the nation's total production in a sector consisting of 26 enterprises. A more detailed summary of Company B's employment and financial developments from 1988 to 1992 is given below.

COMPANY B

In million US$	1988	1989	1990	1991	1992
Employees*	1,775	1,728	1,314	1,155	880
Capital employed	-	-	10.35	9.16	5.72
Fixed assets	-	-	10.68	8.88	6.56
Current assets	-	-	3.66	4.50	3.17
Liabilities	-	-	4.11	5.53	5.04
Total sales	-	-	7.84	5.80	4.37
Net profit	-	-	-0.98	-1.94	-1.88

Source: Company data

* Number of Employees.

MAJOR PROBLEMS AND CONSTRAINTS

Impact of selection criteria

The selection criteria adopted by the policy making institutions in Poland in identifying suitable restructuring candidates quite often done by mixing socio-political considerations with economic rationale. This was the case with Company B which was located in a region where unemployment is of over 20 per cent (well above the national level) and where regional development lags behind the rest of the country due to the fact that the region is predominantly agricultural.

Selected by a government agency for restructuring, Company B was already viewed as an enterprise with little prospect of survival. Indeed, this was pointed out in a subsequent government commissioned linen sectoral study. According to the study, the linen industry could become profitable; however, only eight out of 26 linen enterprises were considered viable and worthy of support. These eight enterprises were selected on the basis of size and potential to stimulate growth, which in turn would have a positive impact on the remaining linen enterprises. Among the eight enterprises, six are the largest producers of linen in Poland. All together, the eight enterprises account for 70 per cent of Poland's potential linen production.

Other factors taken into consideration by the sectoral study in selecting enterprises included the following: linen production making up over 50 per cent of total production, ability to produce finished goods, ecological safety, and ability to improve financial position of the firm with limited interventions. Given Company B's size and lack of strategic value, the firm was not among the eight firms selected by the sectoral study. Compounding the problem, over the last few years linen production in Poland decreased by approximately one-half. Most enterprises lacked money for raw materials, and, with the exception of one plant, all had large operating losses. These losses resulted from decreasing domestic demand, low profits from exports, and declining quality of linen due to low levels of technology and under investment in the capital stock.

Human resource development

Company B's ineffective management that lacked well qualified managers, presented a major constraint during the restructuring process. Lacking skills and awareness of the changing market conditions, the overall attitude of the management and the employees was pessimistic towards the transformation process. Despite a 40 per cent workforce reduction, Company B continued to engage in far too many non-productive activities. The preliminary recommendations made during the diagnostic phase were ignored by the management that perceived the main goal of restructuring was to obtain additional financing for the enterprise via the contacts to be made and influence to be exerted by consulting company assisting in the restructuring, despite its poor financial performance. Such a simplified view of restructuring by the management signalled not only a low level of awareness, but also revealed a lack of communication between the government institutions and the enterprise regarding the type of assistance being provided. Throughout the restructuring process, the weak and ineffective management that was dominated by powerful trade unions did little to increase sales, improve production levels and efficiency, and streamline organizational performance.

Company B's staff and management proved incapable of addressing the enterprise's financial and revenue problems. Besides the fact that Company B's internal organization was not well-suited to operating in a market economy, the management lacked experience in cost accounting, sales and marketing, production planning, and quality control. An excessive amount of support staff, an acute lack of initiative among workers, union insistence on wage egalitarianism, and generally low levels of pay that systematically discouraged potential workers and led to a brain drain of senior staff, contributed to the organizational malaise. As such, Company B was a passive partner during the implementation phase with the management placing all of its hope on outside government assistance.

Finance

Company B's revenues declined from $6.8 million in 1990 to $5.7 million in 1991, with the main source of revenue being linen cloth sold in bulk. In terms of volume, projected sales for 1991 totalled only 40 per cent of sales in 1989, and 85 per cent of sales in 1990. The main reason for the poor financial performance was the collapse of the domestic and former USSR markets. Approximately 80 per cent of Company B's products are sold for export, mostly in bulk, with the United States being the largest export market. However, profit margins are very small and in far too many cases, Company B signed unprofitable contracts with foreign partners due to inadequate cost accounting information.

Since 1990, Company B's financial position has deteriorated due to a radical drop in domestic sales and sales to the former USSR, as well as the enterprise's inability to decrease fixed costs. Company B's financial problems were also revealed by low levels of liquidity with accounts payable exceeding receivables by more than 100 per cent. In addition, interest penalties have had to be paid on overdue accounts payable, a full 86 per cent of which have stood for at least 90 days since delivery. Compounding the financial problems were the excessively high inventory levels for work in progress and finished product inventories that are kept as bank collateral. Obtaining financing was extremely difficult given that Company B was burdened by a government decision in 1987 forcing the enterprise to involuntarily acquire a bankrupt linen factory in another region of Poland. Because of the factory's poor financial condition, the bankrupt plant's all fixed assets and factory's debt were taken over by Company B.

Organization

The role of the labour unions within the organization contributed to the internal paralysis of the company. Despite the deteriorating financial situation, the trade unions dismissed the radical plan to reduce employment. Instead, the unions presented an alternative plan in which the level of employment was to remain basically unchanged. To keep production going, the unions also agreed to continue signing unprofitable contracts which were to be balanced through overhead and support cost reductions. These cost reduction measures were: creation of a voluntary fire department, reduction of energy costs by installing energy control measuring devices, eliminating the middlemen when buying raw materials, and not hiring outside service and maintenance firms. Simply put, the unions proposed a plan to do everything internally which, contrary to the unions belief, would only reinforce vertical integration. The lack of a strong management counterweight to the unions effectively blocked the restructuring process.

RECOMMENDATIONS

Organization

During the restructuring project, it was initially proposed that Company B's workforce be reduced by at least 185 individuals to a more manageable total of 880. As the general situation deteriorated, an emergency plan was developed to further reduce employment from 880 to 682 by reorienting activity towards the core business. The radical restructuring plan to save Company B was ignored by the management and the founding body that feared an increase in unemployment. The plan was also opposed by the Trade Unions. However, the real risk of total collapse of the company forced a re-consideration of the plan. At that point, the founding body allowed Company B to be administered by a management contract in which the old management's decision making powers were drastically reduced. However, by the time the top management was changed, approximately 18 months passed and Company B's financial situation reached a critical state.

When it was proposed by outside consultants that the organizational structure be changed, very little was done. Lack of action on Company B's behalf also contributed to poor strategic decisions. Recommendations to change the General Manager and hire a new sales and marketing director as well as a new economic director were ignored. As such, the General Manager retained all three functions leading to a vertical decision making process. The General Manager had so much power concentrated in his hands that little counterweight existed to challenge his decisions to sign unprofitable contracts. This was especially evident in the area of marketing and sales which made up a large portion of the strategic recommendations.

Human resource development

Recommendations were made to train Company B's staff to acquire skills to develop a strict and more sophisticated financial management and cost control measures. Lack of an effective cost accounting system prevented Company B from correctly calculating the costs of each product being produced. As such, the enterprise was poorly prepared for developing a pricing strategy. In addition, the lack of business planning, feasibility studies and economic modelling did not allow the enterprise to quickly calculate the breakeven point and adjust to rapidly changing markets. These weaknesses had far ranging consequences as demonstrated by Company B's financially disastrous decisions. When time arrived to negotiate new contracts, the management made strategic blunders which resulted in money losing contracts being negotiated. For example, the General Manager, who also acted as the sales and marketing director as well as production director, signed a series of export contracts of which an incredible 96 per cent were unprofitable. When confronted and asked to justify his decisions, the General Manager claimed that the foreign markets were so important to the future of the enterprise that they had to be held at any cost. Consequently, in an effort to save Company B, financial decisions arrived at without the support of sound cost accounting systems only exacerbated the enterprise's already weak financial position.

It was also recommended that a Marketing and Sales department be developed to improve Company B's ability to monitor foreign and domestic markets. Emphasis was placed on defining the main tasks for each section of the department and each employee and the identification of export markets in the US, EEC, and Southeast Asia. In addition, an effective domestic distribution strategy had to be developed.

Production

Little emphasis was placed by the unions and the management on quality control issues which were seen as one of Company B's greatest weaknesses. As such, the reorganization of the Quality Control section was recommended that entailed making the Head of Quality Control directly accountable to the Managing Director. In addition, specific outlines of responsibilities for each inspection manager and specialist were made. However, these recommendations were ignored and Company B continued to have problems with quality. Consequently, only 77 per cent of produced linen fabric fulfilled international export quality standards, while the remaining 23 per cent of production was generally processed into simple finished products and sold domestically for a very low price.

RESULTS AND CONCLUSIONS

Despite a strong resistance to change during the restructuring and implementation phase, certain improvements were achieved. For example, employment was reduced and approximately 24 per cent non-productive assets were separated or eliminated. In addition, 26 per cent of non-core assets, such as the nursery and kindergarten, were sold. However, only when the financial situation of Company B degenerated to a point of bankruptcy were additional steps taken towards reducing assets by a new management team hired by the founding body.

Recommendations presented to Company B during the diagnostic phase addressed the most urgent problems encountered during those three months. As the financial situation continued to deteriorate over the next six months, additional recommendations were made to reflect Company B's changing realities. More drastic steps were recommended that encompassed defining a new profitable product mix, implementing a new sales and marketing strategy, reducing the organizational structure, dividing responsibilities among the top management, and identifying the main sources of profit and cost. Three new financial business plans were created based on future product mix scenarios and assets that would maximise machine and labour efficiency. Recommendations were also made to develop a better working relationship with Company B's debtors and creditors, with particular attention given to the enterprise's sources of finance available at that time.

During the implementation phase, yet more stringent recommendations were made purely as a last resort due to the collapsing financial situation of the enterprise. As a result of indecisive and delayed decision-making by the management, few options remained that did not include drastic steps. Final recommendations to the management, unions and founding body focused on creating a new entity based on core production units. Various financial and organizational simulations were presented to the enterprise in order to accelerate the implementation process needed to reduce the company to core production units. Despite these appeals, Company B's unions rejected the plan which they perceived to be too drastic in the area of staff reductions. Instead, an alternative plan was offered by the unions which also failed to correct the enterprise's problems.

Due to the intransigent attitude of the trade unions, weak management, and lack of exposure by the staff to modern business practices, the restructuring process encountered formidable obstacles. The deteriorating financial situation reached a point where, without debt reduction and an active involvement from institutional policy making bodies,little hope of survival was given to the enterprise despite the belated arrival of a new management team willing and able to implement a drastic restructuring programme.

COMPANY C

DESCRIPTION AND HISTORY OF THE ENTERPRISE

Established in the mid-1950s as one of Poland's leading manufacturers of television sets, Company C under the old system enjoyed prosperity up till 1989. However, the open market policies adopted in 1989 by the Government in the transition to a competitive market economy resulted in increased imports from Western Europe and Asia threatened Company C's domination of the Polish market. From 1989 to 1992, Company C's market share decreased at a rate of approximately 5 per cent per year. In 1991, Company C controlled 16.5 per cent of the nearly 1 million units per year Polish market for television sets. Although the systematic decline in sales stopped at the end of 1992 due to organizational changes and an increased market focus, Company C remains in financial difficulty. Besides the core plant producing television units, three other affiliated production facilities have operated under the same umbrella. These included:

- a production facility for television components
- a production facility for professional television equipment
- a production facility for wooden TV chassis

Throughout its history, Company C has been plagued by an organizational structure that included too many non-core production assets such as maintenance, chemical plating, and recreational services - along with an overgrown employment structure. A detailed summary of Company C's employment from 1988 to 1992 and financial developments from 1990 to 1992 is provided below, revealing its worsening financial condition as a result of lost domestic and foreign markets.

COMPANY C

In million US$	1988	1989	1990	1991	1992
Employees*	3,429	3,777	3,248	3,165	2,123
Fixed assets	-	-	21.46	24.87	19.57
Current assets	-	-	26.94	20.31	13.67
Liabilities	-	-	8.79	32.11	32.06
Total sales	-	-	101.20	57.35	37.39
Gross profit	-	-	10.14	-14.28	-7.22
Net profit	-	-	5.01	-14.49	-7.32

Source: Company data.

* Number of Employees.

MAJOR PROBLEMS AND CONSTRAINTS

Financial problems

One of Company C's major problems stemmed from the financial difficulties caused by declining sales of television units from $101 million in 1990 to $37 million in 1992 due to increased import penetration. Due to the rising losses, financial negotiations commenced with the main creditors: a state bank and the State Treasury. However, the management lacked skills in business planning, financial modelling, and feasibility analysis. Company C's other major problem was the lack of exposure and familiarity with modern business practices that encompassed not only financial areas but also marketing and organizational fields.

Company C relied on manual simulations of potential business scenarios that were time consuming and cumbersome. Once calculated, lack of computerization prevented quick adjustments to changing market conditions and new counter-proposals presented by the main creditors. As such, Company C was at a disadvantage when negotiating with creditors who could quickly develop an alternative position. This problem is endemic in Poland where financial institutions hold a great advantage over enterprises such as Company C in terms of knowledge, business tools at their disposal, and negotiating flexibility.

Marketing and sales

Company C's underdeveloped marketing and sales departments also contributed to its problems. Behaving more as a passive sales order processor rather than an active collector, analyzer, and disseminator of market information, these departments possessed limited knowledge of the competition and were completely unable to quickly spot trends such as the entrance of foreign producers. Overall, modern marketing and sales skills were lacking which required immediate corrective action in the form of increased and intensive training.

Organizational deficiencies

In addition to financial and marketing problems, Company C's bloated organizational structure arising from vertical integration and the previous regime's rigid employment policies made staff reductions extremely difficult. This in turn led to inefficient production, poorly motivated personnel, and tensions among the ranks. Internal conflicts were common within the management, regarding the short and long-term restructuring goals, and between the top management and lower level employees pertaining to the course and speed of needed changes. The top management was replaced three times as a result of disputes among the management and trade union opposition. This struggle and accompanying commotion over the future shape and strategic direction of Company C revealed that restructuring is perceived to be many things to many individuals and the emergence of consensus among the staff to undertake expeditious action is long and difficult.

Company C's production and asset management proved inadequate for modern television manufacturing. With a total of 2215 employees in 1991, only 885 were directly involved in production. The remaining 1330 provided indirect support consisting of facilities involved in injection moulding, stamping, plating, varnishing, holiday resorts, training, shops and service, design (construction), maintenance, and security services. Despite the presence of 62 security guards, major incidents of theft plagued Company C. Despite an overblown organizational structure, certain strategic positions were not staffed. These included the positions of a Purchasing Manager - a critical function in the industry - which resulted in limited awareness of the market for supplies. As was done under the old system, supplies were purchased from state producers with little effort devoted to reduce costs through alternative suppliers. Such organizational paradoxes point to the limited cost awareness culture in Company C at that time.

RECOMMENDATIONS

Human resource development

To improve Company C's competitive position, one of the leading recommendations focused on human resource development. Reducing the knowledge gap between Western firms and their Polish counterparts became an urgent issue in creating a market oriented enterprise. Top priority was assigned for improvements in marketing and sales, financial planning, cost accounting, organizational efficiency, and quality awareness. Consequently, the creation of a management team well versed in modern business methods and supported by an energetic marketing and accounting departments became the top priority of the restructuring programme.

Organization

Organizational restructuring focused on streamlining the operation by concentrating on Company C's core business activities producing only television sets. As such, reduction in excessive support activities taking-up approximately 80,000 square meters became the top priority with such departments as chemical plating, tool shop, transportation, maintenance, and recreation being liquidated or spun-off. The slow process of implementing restructuring recommendations is still continuing and so far has reduced the operation to its core production units utilizing half the amount of space as before. Shedding surplus assets was not only needed to improve organizational efficiency and competitiveness of Company C, but was also a prerequisite to negotiate debt reductions with its main creditors.

Finance

As the first logical step to improve Company C's internal performance, the management tried to improve its debt negotiating position with the bank and the State Treasury. Creditors were invited to take part in a partnership that would take over those of Company C's assets which were essential for manufacturing television units. Partnership options involved debt to equity swaps based on market value, debt-to-equity swaps based on book value, and/or cash contributions by the bank or the State Treasury. As with other enterprises in the region, success or failure of a restructuring programme does not depend only on internal changes, but is influenced by the actions of many external institutions

Company C due to its growing financial problems needed intensive assistance from government ministries, agencies, and the state banking sector during the restructuring process. Previous attempts by Company C to involve these institutions were ignored due to Company C's declining financial position, the instability of management, and the apparent inability to launch internal changes. As such, it was up to Company C to first show positive results of the restructuring programme before active involvement could be expected from the external institutions. This happened in the fourth quarter of 1992 when sales of television units increased noticeably due to internal reorganization, improved marketing and sales efforts, and increased financial awareness of the staff as a result of intensive training efforts. At that point, the bank approved Company C's new business plan. To help the company, the bank also agreed to defer part of Company C's payments (approximately 50 per cent) until the company improved its financial position.

Flexibility shown by the bank also reflects the company's improved sales as well as on-going negotiations between the EBRD and the Polish government to restructure the bad debt portfolios of Poland's leading banks. With the assistance of the leading Polish Banks, EBRD will select approximately 20 potentially viable enterprises to form a holding company. Company C is likely to be included in this group of promising companies. The holding company will take over all debts of the participating enterprises and with financial resources from EBRD and EEC's PHARE Programme will renegotiate loan terms, debts, and credit agreements. Participating Polish enterprises will have their bank debt restructured in order to open new opportunities, which were previously impossible to realize due to crushing financial obligations

Production

Recommendations also focused on production process improvements that were costly and obfuscated. For example, in 1991 production planning was based on the level of stocked materials and components and attention to quality played an insignificant role. To improve production planning, recommendations were made to develop monthly production plans, order material and components to match the plan, collect information on sales, and moniter television stock levels. Implementation of these steps resulted in improved scheduling of volume and assortment of production by the production and procurement departments.

RESULTS AND CONCLUSIONS

The third change of management in Company C produced a stable and dedicated staff of managers actively supporting the restructuring process that led to a creation of a core organizational structure focused on television production. Company C's orientation on core business activities led to separating or liquidating support activities, and redefining plant layout and redesigning production process on a more rational basis.

The implementation of a new motivational system to retain experienced staff was a major success for the company. The main elements of the new motivational system consisted of the Managing Director earning 5.8 times more compared to a manual worker. Other differences in pay included:

- Chief Accountant - 5.2 times more
- Chief Designer - 4.2 times more
- Department Manager - 3.0 times more
- Deputy Manager - 2.4 times more
- Skilled worker - 1.5 times more

This pay scale was forced thorough despite objections from the trade unions who preferred an egalitarian pay system. The management justified pay increases on the basis of more responsibility being given to each worker within the hierarchy. Although such pay differentials may seem small by Western standards, they are a great step forward for an enterprise where previously salary scales were roughly the same regardless of functions performed and skills possessed.

Restructuring also entailed developing an active policy to work with Company C's founding body to commence ownership transformation. In the case of television manufacturing, all legal questions regarding ownership required the founding body's approval. Due to institutional inertia, decisions concerning such vital issues as the definition of and agreement on Company C's core business were addressed very slowly which in turn influenced the speed of the restructuring programme. As such, management's drive to create a new legal entity on the basis of core production units has been slower than expected due to external factors.

Emphasis on training improved the management's financial skills in business plan development, placing the company on a more equal footing with its creditors. New financial business plan initiatives took into consideration Company C's restructuring achievements and a market study was organized by staff newly trained in market research and analysis. Based on the new business plan, Company C commenced implementing a debt restructuring programme involving the bank and the relevant government institutions. To restructure the firm's debt, the company agreed to pay the bank 10 milliard PZL in interest by the end of 1992 (approximately $ 500,000) in order to continue the debt reduction discussions. For more than one-half of Company C's supplier debt, an agreement was reached to repay the debt in instalments without additional penalty interest being charged. Company C also agreed to make regular payments to the state budget for social security. However, no decision was reached regarding back payments for turnover tax.

The management actively supported restructuring that focused on production and technological improvements. Using its own technology and relying on cooperation with Western firms led to major product improvements in technology, quality and in the aesthetic appeal of television units produced. As a result, sales of television sets increased in 1992 and 1993. In addition, marketing improvements helped to boost sales through a better pricing strategy and an aggressive promotional campaign. Company C also offered discounts during key period of the year such as at Christmas and targeted key consumer segments. Information regarding Company C's consumers was obtained through a systematic analysis of collected information. Development of a market data bank helped greatly in this area.

CONCLUSIONS

Based on UNIDO's experience in Poland, restructuring of the enterprises, in general, reduced employment by around 33 per cent, and assets by around 40 per cent. Sales in the enterprises remained around the same level as before the transformation process in Poland began, but these sales figures reflect market prices rather than agreed COMECON contracts.

Although the management and labour of the enterprises initially perceived restructuring to be a vehicle to reach new financing and investment sources to improve production, the integrated restructuring process proved to be quite different. Restructuring as shown in the three cases consisted of a series of actions needed to improve the enterprises' immediate domestic competitive position, and in the longer term meet international performance standards. In most cases, these actions entailed organizational changes pertaining to personnel and physical assets, human resource development, financial restructuring such as debt write- offs, debt/equity swaps, refinancing, technological improvements, and ownership transformation. In certain specific cases, as in Company B, restructuring also included analyzing bankruptcy options in order to minimize losses.

All three cases revealed that the restructuring process is a lengthy and complex undertaking demanding enormous commitment and perseverance from the management, expertise from advisory institutions, financial support from state and banking sectors, and active involvement and support of the founding bodies and other relevant Government bodies. This constellation of factors must also take into consideration the legal, political and regulatory environment that influences the progress and success of restructuring programmes. To be successful, the cases have shown that restructuring should be a dynamic comprehensive and integrated programme that examines both the internal and external environments influencing the enterprise's immediate, short, and long term prospects.

In the successful cases, enterprises were able to increase their competitive stand by improving modern business skills, introducing a market oriented organizational structure, and adjusting their product mix and cost structures as required by new market conditions. Training provided for the enterprises became an important agent of change as the management improved its managerial capacities necessary to survive in a new economic environment. Also, active participation by policy making institutions in the restructuring process emerged as a critical factor for success. In difficult cases, the management and the employees provided little support for industrial rehabilitation and systematically opposed the structural changes needed to improve the enterprise's competitive position. Compounding the problem was the passivity of various policy making bodies in the restructuring programmes as witnessed in the cases of Companies B and C.

External business environment

The overall shortcomings of the Polish business environment in which the enterprises operated created formidable obstacles for the restructuring process. These were especially evident in the areas of banking and financial services, capital markets, institutional policy making bodies, legal/taxation issues, and physical infrastructure, particularly inadequate telecommunication and road systems. The influence of an external policy environment became that much more relevant since restructuring entailed integrating the objectives of industrial policies with micro-level enterprise decisions. The clear implication is that it becomes imperative that national decision makers should make much greater effort to understand and appreciate the difficulties faced by enterprises and their needs during the restructuring process. Assistance by well informed and concerned institutions, proved to be a significant boost for enterprises struggling to improve their competitiveness.

Enterprise level restructuring constraints

The economic viability of the three enterprises was endangered by the new and unfamiliar pressures and challenges of the transformation process from centrally planned to a market oriented economy. In all cases, the enterprises encountered deficiencies in terms of knowledge of modern business practice and management skills, especially related to financial engineering, cost accounting, marketing, improved technologies, and distribution. Furthermore, the enterprises needed immediate attention to reduce non-productive assets and improve activities covering the entire spectrum of managerial functions.

The ability to quickly diagnose an ailing enterprise and recommend immediate short term changes was an important catalyst for hard pressed enterprises. The diagnostic formulation of restructuring programmes was a first, and relatively easy step, since most of the work was done by an outside expert. However, the next step was much more difficult since it entailed persuading the management to commence implementing changes in the shortest possible time. The diagnostic and implementation steps demanded a change of mentality among the management and workers which, in certain cases, required creating a completely new management team to overcome built-in resistance to the restructuring process. For example, in the case of the Polish television plant, three management teams were changed before a restructuring programme was launched.

As a result of divergent management attitudes, the diagnostic phase of restructuring produced recommendations that were sometimes accepted and sometimes rejected by the management and workers of the enterprises. Thus, although immediate decisions were needed to develop a turnaround plan and arrest Company C's and Company B's decline, management and worker inertia prevented immediate actions from being taken. In the case of the linen factory, both management and labour opposed restructuring plans to establish a new basis for viable production and overall growth. Contributing to the difficulties was management's inability to understand the implications of the ongoing economic transformation process and their direct and indirect impact on the linen manufacturing sector. The strong opposition of Trade Unions to reductions in employment also proved to be a major constraint, particularly for Company B.

Furthermore, there were difficulties in implementing differentiated pay scales commensurate with skill differentials, as there were also difficulties experienced in introducing incentive schemes.

Industrial human resource development

The enterprises faced a number of new and challenging problems related to human resource development. Given the gap between the skills of enterprise managements and those required for managing efficient and competitive enterprises, training became a pivotal element of the restructuring process. In the particular case of the Polish linen plant, the skills of the management and labour were far behind those required to meet the emerging needs of the market economy. Consequently, this enterprise's management team produced organizational paralysis and ultimately were unable to carry out restructuring.

In addition, all of the enterprises had an underdeveloped mid-level management team resulting in an unwieldy decision-making structure that stifled creativity, undermined motivation, and diluted responsibility. Although a better trained top management team did compensate for some of the inadequacies of lower level management, the implementation of restructuring at the mid-level and below frequently encountered resistance. These problems were exacerbated by the unskilled labour force and by the trade unions and self-management groups that viewed restructuring with trepidation. In general, the success of the restructuring programmes was dependent on the skills and knowledge within the organization. Looking from the top of the organizational pyramid downwards, modern business skills and knowledge typically decreased, responsibilities were more diffuse, and resistance to restructuring became more fierce.

In many ways, training can be a powerful tool for consensus building among a enterprise's personnel by the way it creates a business culture based on shared and understood principles. The general lack of a broad set of cultural and behavioral standards among enterprise managements and labour is a considerable obstacle in the way of building corporate identity, mission, and strategy. In addition, technological change launched by the restructuring process demands a better trained and flexible workforce. Training and improved competitiveness are inextricably linked, especially as knowledge based industries evolve in CEE and the FSU countries.

The experience of the three industrial restructuring cases showed that improved competitive performance is directly tied to defining and then better utilizing the critical human, financial, and physical assets of the enterprise. The case studies indicate clearly that investment in human resource development should be made a top priority. For it is the human resources of the enterprise that will decide how efficiently and productively assets will be used and how skilfully financial engineering will be applied to improve cost reduction measures and debt negotiations with main creditors. Successful restructuring programmes depend primarily on the skills of enterprise management. It was noticeable that management teams that had been exposed to modern business practices provided more active and effective support for restructuring. By contrast, enterprises where management teams functioned as an administrative body for disseminating commands, restructuring was much more difficult to implement.

Physical and organizational restructuring

All three enterprises in the case studies suffered from common problems of misallocation of resources, overmanning, and bloated organizational structures surrounding the core business unit. Enterprises were all vertically integrated. How to become more "horizontal" took on a new dimension: staff accustomed to taking orders from the central planners suddenly had to adapt to radically different economic priorities. Such drastic change requires time to allow improvements in the capabilities of enterprise management before they operate with similar business skills, knowledge, and information as their Western competitors. Unfortunately, time has been a very scarce commodity in Poland.

Besides establishing a proactive marketing and sales department which all of the enterprises lacked, a market orientation required departments to refocus and coordinate their activities and make the customers' needs their top priority. Creating a network of interactive departments sharing information and defining common objectives is thus a vital element in restructuring enterprises as market oriented business entities.

Financial restructuring

In all three cases, the restructuring programmes revealed that Poland's banking and financial sector needs training to develop skills and improve capabilities in supporting enterprises being restructured. Corporate finance requires a sophisticated cadre of working specialists well trained in risk management, forecasting, and familiar with the general objectives of restructuring programme. The shortages of experienced and trained staff in both the banking and financial service sector and in enterprises themselves, had in the case of Company B, a deleterious influence on the pace and the eventual outcome of the restructuring programme. To alleviate this problem, it is essential to develop joint bank and corporate client training programmes so that both sides recognise they are really partners. In the long term, Poland will need a well functioning banking system to monitor, assess, and where necessary, control the behaviour of those enterprises currently being restructured.

In the more difficult cases of Company B and Company C, the banking sector's reluctance to engage in financial restructuring was tied to the dangers of the banks existing non-performing loan portfolios. Consequently, restructuring efforts that could have included such financing options as debt-equity swaps, debt consolidation, and maturity extension were not even considered by an illiquid and undercapitalised banking system. As the balance sheets of the enterprises and the loan portfolios of banks deteriorated in parallel, the political and economic pressure increased on state government to intervene and recapitalize the banks and clean up the enterprise balance sheets.

Poland's underdeveloped capital markets have also proved of limited use as a source of financial support for restructuring and privatization programmes. In the case studies, all enterprises experienced financial difficulties. Financial restructuring and privatization continues to be dependent on the pace of development of the Polish banking system, the strength of the emerging stock market, and the availability of specialized financial engineering expertise for enterprises.

As capital markets develop, financial institutions will undoubtedly play an influential role in corporate control and thus in the corporate governance of restructured and privatized enterprises. With the anticipated growth of investment funds based on a diluted system of ownership, capital market institutions will be in a powerful position to monitor and instill discipline in the interests of improved corporate governance of privatized enterprises.

Privatization and corporate governance

A key element of restructuring, and some would argue the most important, is privatization. The importance of ownership change at the macro-economic level is related to the critical mass of private owners that CEE states desire to create in the shortest possible time. An expanding private sector is, it is argued, an indispensable ingredient of an efficiently operating market economy. At the micro-economic level, privatization is seen as the most effective method to create an innovative managerial class familiar with modern business practices and, driven by incentives, to increase the enterprise's competitive position by improving cost efficiency and allocation of human and capital resources, and to establish a flexible organization capable of adjusting to market changes.

The case studies are a fair reflection of the uneven pace of privatization among state owned enterprises. For example, Company A privatized using one of the most popular methods, the purchase of an enterprise by the managers and employees. However, to run a newly privatized operation successfully, the managers and the employees still needed a crash course to improve their skills in such critical areas as financial management, cost accounting, marketing, and modern technological methods. Generally, the higher the skill level of the management and employees, the more likely the enterprise is to become private and compete effectively in a market oriented economic system. In short, human resource development, or lack of it, can be as much a constraint on privatization as shortages of capital.

The issue of corporate governance is also important in privatization. In the cases of Company B and Company C, the lack of active involvement by the state founding bodies, the legal owners of the two enterprises, slowed the restructuring process and subsequent privatization efforts. The absence of a corporate governance culture where, the owner takes the necessary time to ensure that the enterprise is well managed and profitable, resulted in confusion and contradiction in those enterprises experiencing serious financial difficulties. Thus, Company C failed to receive quick support from the founding body necessary to permit timely liquidation of non-productive assets and re-organization of the enterprise around a core production unit focusing solely on the main product. In the case of Company B, the founding body feared increasing regional unemployment and failed to support the painful restructuring steps needed to be taken in the shortest possible time to save the collapsing enterprise.

Chapter 7
The Restructuring of Industry: Emerging Lessons and Implications for Action

INTRODUCTION

As noted throughout this report, a key element of the transformation of the economies of Central and Eastern Europe and the former Soviet Union is the rebuilding of industrial competitiveness. At the beginning of the process the emphasis was quite rightly on macroeconomic stabilization. As discussed in Chapter 2, without immediate introduction of stabilization measures the economies of the region would have faced hyperinflation and economic chaos. Indeed the failure of some of the countries of the FSU, most notably the Russian Federation and the Ukraine, to move sufficiently quickly or comprehensively has resulted in hyperinflation which has inevitably damaged the general credibility of the reform programme and political stability. The results of the parliamentary elections in Russia, in December 1993, indicate rather starkly the political downside of economic failure.

Rapid, relatively successful economic transformation may also threaten political and social stability. A populist slogan in the Polish parliamentary election campaign of September 1993 was 'less shock: more therapy', while the result of the Russian general election was heralded as 'the end of market romanticism' by incoming Prime Minister Chernomyrdin. Both of these slogans play on the underlying social tensions that arise when the familiar economic and social landmarks of central planning are swept away by reform.

Those countries that have managed to achieve a measure of macroeconomic stability are now actively expanding the economic reform programme to embrace the whole industrial sector. The lessons learnt from early experimentation with industrial restructuring now need to be widely disseminated. Otherwise, there is a serious risk that the very real gains of macroeconomic stabilization will be eroded by the endless demands of unreformed state-owned enterprises for wage increases, new credit, debt forgiveness and postponement of tax payments and dividends.

The erosion of macroeconomic gains may be slow but will manifest itself through an expanding government budget and current account deficit and rising inflation. It is easy to sketch out a plausible sequence of events. The top management of state enterprises will use their political connections to soften their budget constraint by negotiating special concessions in the form of tax breaks or soft loans. The central banks will be forced to expand the money supply by relaxing control of credit in order to accommodate the concessions. In due course this will provoke the IMF to suspend its support of the transformation process and inevitably the Paris Club will follow suit. Of course, this regressive scenario could not occur in CEE, only in the developing countries of Africa and Latin America? But indeed this is what has happened in Russia. The IMF Managing Director Michel Camdessus stated on 1 February 1994 that without adequately strong (Russian) monetary policies no efforts to reduce inflation and stabilize the rouble will be successful for long. The IMF considered it to be vital to speed up the stabilization and reform process to create the necessary preconditions for sustained growth and improved living standards. A substantial reduction in the government deficit relative to the size of the Russian economy was, according to the IMF, essential to reduce inflation.

In many ways structural adjustment in developing countries has not needed to be as comprehensive as in CEE and the FSU. The underlying economic structure is usually market oriented, and private property rights are reasonably well defined, yet structural adjustment programmes have only had limited success in developing countries.[87] Government budgets and the balance of payments have remained stubbornly in deficit, despite massive exchange rate depreciation, high interest rates and low overall economic growth. Why should reform efforts in centrally planned economies be any more successful than in developing countries?

A major difference in the reform programmes in CEE and FSU is that unlike structural adjustment programmes in developing countries, they were initially self-imposed. Or perhaps it would be more accurate to say that leading reformers and their advisers anticipated the conditionality of IMF/World Bank structural adjustment programmes. The policy frameworks adopted have generally been more drastic and comprehensive than those initiated by the IMF in developing countries in the South. Yet many of the countries of central and eastern Europe and the FSU have only limited or no history of a national civil administration. For example, Poland was carved out of the Russian, Austrian and German empires, and Hungary and the Czech and Slovakian republics out of the Austrian empire at the end of the First World War. Belarus and the Ukraine have had no modern experience of political independence.

At the outset, reform programmes in CEE and FSU had relatively widespread support, though recent election results and opinion polls in the Russian Federation, Lithuania, Belarus and Poland suggest that the electorate is now skeptical about the ability of incumbent governments to deliver the benefits of reform. The latter is a dangerous trend if continued. Evidence from elsewhere in the developing world demonstrates the importance of: the strength and stability of the government, the credibility of government policies and reform programmes in general, the integrity of the civil administration and the ability to enforce decisions - in achieving high rates of economic growth and, more importantly, sustainable economic growth.

THE POLISH EXPERIENCE OF FOUR YEARS IN TRANSITION

Like all command economies, Poland entered the transformation process with an economy dominated by the state. 81.2 per cent of GDP was attributable to the state-owned sector in 1988, all prices were officially administered and budgetary subsidies amounted to 16 per cent of GDP. It was also suffering from hyperinflation: some estimates put the annualized rate at 2000 per cent in the second half of 1989.[48] A market-based economy had all but been destroyed by over forty years of central planning. The reform programme therefore had to embrace not only macroeconomic stabilization but, given the crucial need to restructure the industrial sector towards greater efficiency and competitiveness, the very much slower, complex and less well-understood process of institutional restructuring, and where no comparable institutions existed at all, construction from scratch.

It is now a matter of history that Poland opted for 'shock therapy' at the end of 1989. As the former Finance Minister Leszek Balcerowicz observed, 'Postponing the struggle against high inflation until the economy had basically been privatized would have been like abandoning putting out a fire while trying to rebuild the house with the fire still burning inside.'[49] Even so, the stabilization-liberalisation package of policy measures had to be introduced within, an as yet non-market, based economy.

An immediate and abiding problem has been that of co-ordination and synchronization of the reform process between different central government ministries and agencies, regional and city authorities. Yet the whole transformation programme depends crucially on the interdependence of macroeconomic policy reform and micro level initiatives. Put simply, the supply response intended by macroeconomic policy depends on the behaviour of individual decision makers, be they government officials, managers of enterprises (state or privately owned), trade unionists, workers or consumers. Most people have had to discard norms of behaviour systematically inculcated and sanctioned by an all-enveloping state for over forty years and learn new ways of doing things. Personal careers of many public servants were destroyed overnight, while for others, vastly expanded opportunities have been opened up.

The arbitrariness and suddenness of much of the social change has, not unnaturally, led to bitterness and resentment amongst the losers. The winners have not always been modest about their good fortune either: the visible cult of the large motor car and extravagant lifestyle is well publicized in the Polish media and in many other countries of CEE and the FSU region, particularly, the Russian Federation. Economic reform, in short, is not only about altering rational expectations and price signals and stabilizing macroeconomic relationships to better reflect those prevailing in the world economy. It is also about social change and maintaining social cohesion and trust between the political and economic elite and the populace as a whole. Without social stability and trust, the complex economic transactions characteristic of a modern industrial economy are impossible. This is an important lesson for the reforming governments of the region and their supporting international technical co-operation partners to bear in mind.

THE ACHIEVEMENTS IN POLAND SO FAR

- Hyperinflation was quickly eliminated. Inflation in the annualized consumer price index in the second half of 1989 stood at about 2000 per cent. In 1992, it was 43 per cent and by 1993, the annual inflation rate was 35 per cent. This is still higher than the Polish authorities want: an inflation rate of 23 per cent is the target for the end of 1994. However, taking into account a 'crawling peg' devaluation of the zloty of 32.6 per cent against foreign currencies in 1993;[90] and major changes in formerly heavily subsidized prices, particularly for energy, telecommunications and insurance that have had to be absorbed in production costs, and directly by domestic consumers, progress in combating inflation has been considerable. Further adjustments remain to be made in rents for apartments and domestic energy costs.

- Shortages and queues have been eradicated, and there has been a dramatic improvement in the range and quality of goods available to consumers. Initially, this improvement was due to imports but over time domestic products have begun to regain their share of the domestic market. A modest increase in tariffs to 6 per cent on all imported goods from the very low 'shock' levels set in January 1990 has assisted this process. The latest adjustment to the tariff structure that seeks to discriminate more sharply between semi-finished and finished goods, introduced on 1 January 1994 by the post-communist government, is an unwelcomed move towards protectionism.[91] It also implies a shift in trade policy towards import substitution and away from encouraging export competitiveness. The crawling peg system of devaluation of the zloty and an 8 per cent adjustment in August 1993 have nevertheless helped to maintain export competitiveness.

- The break up of the monolithic and inefficient state-owned distribution system for consumer goods has been an important contributory factor in improving consumer choice and price competitiveness. Ownership and size distribution of enterprises in the wholesale, retail and road transportation sectors has changed out of all recognition from the situation prevailing before 1989. There remains a major requirement for new investment and some re-configuration into modern national networks. Improvements in the distribution system are not only important for consumers but also for enterprises, as it enables them to get closer to customer needs. The rewards for product innovation that meet these needs, both in terms of price and quality, now go direct to the enterprise, thus providing strong incentives for enterprises to develop their product portfolios in tandem with marketing activities.

- Poland was the first country in the region to introduce currency convertibility within current account operations. As the Polish zloty became freely convertible into goods and other currencies, the role of money as a medium of exchange increased significantly and the old system of inter-enterprise barter shrunk. The reduction in inflation and the sharp rise in real interest rates greatly reduced capital flight and dollarisation, and increased the role of the zloty as a medium for savings. However the ease with which household savings can now be switched between zloty deposits and foreign currency deposits imposes an unfamiliar constraint on the Polish monetary authorities. For example, in February 1993, the National Bank of Poland decided to reduce zloty interest rates charged to commercial banks from 38 to 35 per cent on refinancing credits, from 32 to 29 per cent on rediscount credits and from 37 to 33 per cent on collateral credit.[92] Households responded to the reduction in the yield of zloty deposits by increasing convertible currency deposits by 57.5 per cent to $7.52 billion: by the end of the year 28 per cent of household savings were held in convertible currencies, up from 25 per cent. In the Polish banking system as a whole, zloty deposits dropped 7 per cent while hard-currency deposits rose 14 per cent (in zloty terms) in 1993. Part of the decline in zloty deposits is a reflection of the boom conditions prevailing on the Warsaw Stock Exchange sucking in spare zlotys: the index increased fourteen fold in 1993, the largest percentage increase in value of any stock exchange in the world.

- The private sector has been growing very rapidly since 1989. Its share of employment, excluding agriculture and co-operatives, grew from 13.2 per cent of the total workforce in 1989 to 34.4 per cent in 1992. If agriculture and co-operatives are included, the share of employment in the private sector had risen to 60 per cent by the end of 1992 and accounted for over half of GDP. Growth of the private sector, apart from through ownership transfers, has been mainly in SMEs in the retail and service industries. There has been relatively little growth in the private manufacturing sector.

- As a result of rapid growth of the private sector and an increasing number of state enterprises undergoing restructuring, Poland became the first of the post-socialist countries to record positive GDP growth in 1992. The growth of GDP in 1993 is estimated at over 4 per cent which would make Poland the fastest growing economy in Europe. Manufacturing output increased by 7 per cent and labour productivity grew by 10 per cent. By 30 September 1993, 3,637 state-owned enterprises had been privatized (41 per cent of the total number of state-owned companies in June 1990); 6,118 enterprises remained in the state sector. Half were privatized by liquidation; of these, three-quarters have been leased to employee partnerships. A further 490 enterprises have completed the first stage of privatization through transformation into companies held in trust by the State Treasury and await full privatization. The fast growth in the number of small- and medium-sized private enterprises,[93] many the results of breaking up state monopolies through privatization and restructuring exercises, has gone some way towards reducing the excessive concentration of industry and commerce, thereby improving the flexibility and adaptability of the Polish economy.

- The structure of economic activity has also changed substantially. At the most aggregate level, the share of the previously neglected service sector in GDP has expanded rapidly from 38.4 per cent in 1990 to 46 per cent in 1992. By contrast, the industrial sector has declined from 53.1 per cent of GDP in 1990 to 47 per cent in 1992. Modernization of plant and equipment is accelerating after the stagnation of investment in the 1980s. The purchase of investment goods from OECD countries in 1990-92 rose by over 150 per cent. Nevertheless the highest rates of investment are being recorded in construction, trade, telecommunications and municipal infrastructure.[94]

- Together with changes in the structure of ownership, industrial concentration and composition of output, there has been a radical reorientation of Poland's trade relations. Macroeconomic policy has been transformed from supporting an inward-looking, import substitution strategy to encouraging an outward-looking, export oriented and import competitive strategy. The supply side response has been dramatic. Exports to OECD countries expanded rapidly between 1990 and 1992, at an average annual rate of 28 per cent, but have grown much more slowly in 1993 as a result of the recession in Western Europe and the growth of protectionism. Imports from OECD countries have recently sharply out paced exports from Poland. Over the whole of 1993, exports grew by 4 per cent and imports by 19 per cent. By the end of 1993 Poland had accumulated a current account deficit of US$ 2.33 billion, from the small negative balance of US$ 269 million in 1992.

- Although the destination and value of Polish exports has changed significantly (about 87 per cent is now exported to the West up from 65 per cent in 1989 and the total value of exports has increased from US$ 7.5 billion to $14 billion over the last three years), the composition has not. Top Polish exports in 1992 were coal (US$ 900 million), copper and copper products ($600 million), steel products (US$ 500 million), ships (US$ 300 million), furniture (US$ 280 million) and cars (mostly Fiat Cinquecento models - US$ 250 million). The value of exports per head in 1991 in Poland was US$ 390, compared with more than US$ 700 in the former Czechoslovakia and US$ 1,000 in Hungary.

- Despite the popular belief that the European Union is restricting access to Polish exports (which is true for many traditional commodity exports such as coal, steel and agricultural products), many quotas for manufactured goods are not being met. For example, by the end of August 1993, Polish exporters had filled only 12.5 per cent of the quota for synthetic fabrics, 7 per cent for men's coats, 9 per cent for men's clothing and 17 per cent for dresses. The issue of market access including effective export promotion, especially to the European Union, is paramount to the acceleration and ultimate success of Poland's industrial regeneration and revitalization.

- Foreign direct investment (FDI) in Poland has been slow to expand to meet the countries long term needs for capital, modern technology and management systems. This is unexpected since Poland has a large domestic market (38 million consumers), and is highly rated in terms of political stability, market growth and policy stance towards foreign investment. The value of equity paid for in cash and in kind by foreign investors had reached around US$ 2.8 billion by the end of 1993 with further future investment commitments estimated to total US$ 5.7 billion.[25] The United States accounts for $1.02 billion (36.4 per cent) of all capital invested, with Italy ranked second with 11 per cent of FDI, while Germany only accounts for 6 per cent of FDI. The majority of large-scale inward investment has been geared towards the needs of the domestic market. Disappointingly, less than 100 state enterprises have found strategic foreign investors to participate in their equity after privatization. The recession in Western Europe has probably discouraged large-scale export oriented investment by foreign companies seeking a low cost production platform. Creeping protectionism in Europe in so far as it prevents exporting from Poland to the West has also not helped matters. Another factor may have been the failure of the authorities to settle with the London Club of commercial banks to reduce Poland's debt, until mid-March 1994, thereby excluding investors from borrowing directly from commercial banks.[26/]

- Poland has a large number of foreign small-scale investors with equity investments of less than $300,000 (more than three-quarters of all foreign investors), mostly from Germany, who despite the limited scope of their financial commitment are very influential in the resurgence of Polish manufactured exports. The clothing industry is a particularly dynamic recipient of largely non-equity investment, the majority from Germany and Scandinavia. According to the Ministry of Industry and Trade, exports account for 47.5 per cent of total clothing production from enterprises involving some foreign participation. Non-equity investment, crucial but not recorded in official statistics, may come in the form of loan finance, designs, supplies of fabrics and accessories, management systems and advisers, and access to marketing channels.

- On the negative side, a major social cost of structural change in the Polish economy has been a sharp rise in open unemployment which had reached 16 per cent of the labour force at the end of 1993. Nationwide, the number of jobless was 2,959,128, the highest figure in Poland's postwar history. The rate of increase has now levelled off thanks primarily to growth in the private sector. The Central Statistical Office claims that employment is now slowly but steadily rising.[27] Further restructuring and privatization, particularly of heavy industry including mining and steel, is bound to add to unemployment levels. A special cause for concern is not only the level of unemployment but also the structure of unemployment. Regional differences in the unemployment rate and income disparities are considerable with regions around Lodz, Rzeszow, Walbrzych, Katowice, Suwalki and Olsztyn having unemployment rates of between 24-26 per cent. The incidence of unemployment is strongly correlated with the younger age groups - almost two-thirds of the unemployed are under 35 years of age. What is worse, about half of all those unable to find work have been looking for a job for more than six months. Moreover, Poland's chronic shortage of housing does not permit geographical mobility in search of work. Unemployment and the lack of an adequate social safety net remains a prime social and political constraint on attempts to restructure state enterprises.

- Related to, but distinct from rising unemployment is rising income inequality. The wealth created by the initial freeing of the economy was concentrated in only a few hands; and secondly, policies to control inflation and soak up excess demand (taxes, elimination of subsidies, rising prices) had an adverse effect on a large part of the population. Popular concern about both rising unemployment and income inequality are generally regarded as major factors underpinning the victory of the post-communist parties in Poland's general election of September 1993.

- Another severe problem that remains unsolved is the government budgetary deficit. Partly, this is a temporal difficulty caused by changes in the sources of government revenue: particularly the drop in revenues caused by the adjustment problems of state enterprises; and insufficient compensating flows from the changeover to personal income tax and VAT in combination with extension of the tax net to encompass all activities of the burgeoning private sector. Over time, once teething difficulties have been eliminated from the new system, the government's tax take should improve.

The more intractable problem has been the sharp rise in certain social expenditures - notably pensions. Subsidies to social security funds have increased from 4 per cent of total budgetary expenditure in 1988 to almost 24 per cent in 1992. Pension expenditures alone were absorbing close to 15 per cent of GDP by 1992. This dangerous tendency has been caused by two factors. Largely due to ease of access, the brunt of reform-induced increases in social expenditure was borne by pensions and unemployment compensation rather than social assistance schemes targeted to the vulnerable. This lack of selectivity was compounded by (over) generous indexing of state pensions. Some reforms have been introduced including limiting the duration of benefits but more needs to be done to expand support programme for the long-term unemployed. Generally, the social expenditure budget has to be targeted more precisely and capped if macroeconomic stability is to be maintained in the future.[28] However, if government-sector workers are included, some 10 million people are dependent on the state budget which is a large group of voters. Consequently, the social and political influence of this state-dependent group is an important factor in government attempts to control the state budget. If economic recovery is not fast enough to create more wealth, revenue for the state and new jobs then further social and political problems can be anticipated as the government struggles to control budgetary expansion.[99]

PROSPECTS FOR THE ECONOMY AND THE RESTRUCTURING PROCESS

Polish enterprises produced better financial results in 1993 than in 1992. Incomes rose faster than costs so that the overall profitability index grew from 2.2 per cent in 1992 to 3.8 per cent in 1993, the greatest improvements being recorded in industrial enterprises. Overall production grew by 7 per cent and labour productivity by 10 per cent. The number of enterprises showing losses decreased and the number of those with net profits increased. However the liquidity situation remained unchanged with inter-enterprise credits remaining the main source of financing. Total enterprise debts rose from 410.9 trillion zlotys to 518.2 trillion zlotys, a rise of 26 per cent compared to a 32.6 per cent devaluation of the zloty and price inflation of 35.3 per cent over the year, indicating a useful improvement in the debt burden of enterprises.

There is mounting evidence, then, that under the impact of the tough stabilization and liberalisation policy measures introduced by the Polish government since 1989, an increasing number of state enterprises have started to restructure and adjust to the increasingly market based economy. Four stimuli have been paramount in inducing enterprises to adjust.[100] First, trade liberalisation has forced enterprises to abandon cost-plus pricing and pay attention to costs and efficiency - with some success. Second, the government's determination to eliminate manufacturing subsidies and other external support has forced enterprises to consider taking the initiative for change using their own resources.

Third, tighter supervision of the lending operations of state-owned banks has led to increased reluctance to make loans to state enterprises. In turn, financially sound enterprises have become unwilling to lend to weaker ones. Leakage of state funds, however, still occurs through accumulation of tax arrears and some working capital loans. Overall the budget constraint for enterprises has hardened substantially. Fourth, many managers of state enterprises appear to have decided that their best prospects remain with their current enterprises, as they are, or when they are privatized. Often after a period of acute demoralization, managers have increasingly come to realize that they are a key resource: good performance and reputation today will be rewarded through improved compensation at the time of privatization. The number of concrete examples has grown considerably as the number of capital privatizations has increased, particularly in 1993.

Despite the hopeful signs, restructuring and the restoration of competitiveness to Polish industry has hardly begun. Many major tasks remain. For example, in the Silesian region, 16 hard-coal mines (out of 70 still operating), sulphur mines at Machow and Grzybow and salt mines at Bochnia, Lezkowice and Moszczenica will be subject to liquidation proceeding in 1994. Mining restructuring is estimated to cost 3.4 trillion zlotys ($150 million) and 120,000 people will have to change jobs. Although more than 40 per cent of state-owned enterprises have been restructured and privatized, the ones that remain tend to be larger; are more heavily indebted; are concentrated in heavy industrial sectors and located in regions already facing above average (16 per cent) unemployment.

In summary, the restructuring and investment needs of Polish industry, whether to make up for deficiencies in capital provision, technology, management systems or human resource development, are still immense.

EMERGING LESSONS AND ADVICE

Advice to Governments

The human resource constraint

Economic relationships between people are more than just discrete exchange relationships (as between buyer and seller), they may also involve production relationships, power (hierarchical relationships), socialization and commitment (workplace psychological and social relationships), competitive behaviour (between intra-enterprise groups and with other enterprises), and learning new skills (through training and using new technologies). Even relationships between buyers and sellers often involve long term social relationships not reflected in a sales contract.[101]

To say, then, that economic behaviour takes place in a social setting is to imply that a social context exists in which that behaviour is possible. In the economies of Eastern Europe, the social context has and is changing rapidly; it is turbulent and often far from transparent. High levels of uncertainty, and therefore risk, are commonplace in economic transactions. Economic agents are generally not well versed in the appropriate behaviour - the duties, expectations and mutual interdependency - typically required to sustain a mature and complex market based economy. The real pace of reform is in many ways limited by the existing social structure and the capacity of people to learn new economic roles.

- At the national level, a clear and stable political leadership with a long term perspective is required with an explicit and abiding commitment to economic affairs. It also means that governments have to devote a considerable amount of resources to communicating this commitment and inspiring those charged with implementation. While ordinary citizens need to have policy explained in an understandable manner, what matters much more is the quality of day to day contact with government officials. People need to be convinced of the integrity of public servants. So far civil service reform and training in the region has been limited, yet the tasks of the administration have changed out of all recognition. In the next phase of economic transformation, substantial resources must be devoted to the reform of public administration and the retraining of officials at middle and lower levels responsible for economic affairs and guiding the reform process.

- At the micro-level, given the requisite material resources, it is the ability of individuals to learn new behavioral patterns that sets the pace of change. Clearly, human resource development at the enterprise level through training must continue to be a key component in any industrial restructuring programme. Human resource management was a neglected professional activity under the central planning system. Ministries of industry and employment need to initiate a management training programme specifically focused on creating a professional cadre of personnel and training managers in state owned enterprises. Once in place, this cadre will be an important internal resource that can be drawn on to organize human resource development programmes (and layoffs) in support of marketisation and privatization. The emphasis needs to be on people and skills development not simply the number of jobs. These skills need to be created or strengthened in Polish industries and sectors with existing or potential comparative advantage.

- There is an important need to expose polish managers and supervisors - particularly middle managers - to modern Western business practices through carefully designed study tours to appropriately selected enterprises in similar lines of activities in the industrialized countries. A key requirement in this regard is to ensure that participants in the study tours disseminate their experiences widely upon their return home. Such carefully targeted study tours were used to great effect in the context of the Marshal Plan after World War II.

- Another aspect of human resource management which requires attention both at national institutional level and enterprise level is the management of industrial relations. Polish labour law and industrial relations institutions need reviewing to make sure that they are appropriate for the new pattern of private corporate ownership and governance. The Labour Code of 1974 as amended by ministerial decrees and the Law of 28 December 1989 on redundancy spell out individual rights and two Laws of 23 May 1991 cover collective rights: the freedom to organize trade unions and the law relating to the resolution of collective disputes.[102] There is no provision for compulsory conciliation, mediation or arbitration. The reluctance of the government to become directly involved in the industrial relations of the workplace is understandable given recent Polish labour history. However, many would argue that in a rapidly growing economy labour relations are simply too important to be left to the good will of employers and trade unions.[103]

Industrial policy

In OECD countries, the recent development of industrial policy has been characterized essentially by the movement towards trade liberalisation, counterbalanced by a whole series of measures intended to slow the decline of industries, enterprises or regions in difficulty. This strategy has been the most popular with governments since it reconciles the electorates' desire to 'see a happy marriage between progress and stability'.[104] While the market economy is most likely to ensure economic growth, it is also likely to bring with it uneven development and unequal sharing of costs and benefits of growth, at least in the short term, as resources are reallocated between economic activities.

Politicians are generally well aware of the tradeoffs between rapid economic growth and major social upheavals. A participatory economic system requires no less. Thus, as elsewhere, the economic performance of governments in CEE and the FSU is constrained by political considerations and electoral calculation. To the extent that reelection depends in large part on the performance of the economy, governments in the region have every interest in seeing that their interventions promote stable growth of the economy.

- Much of the political debate about the collapse of communism and the inevitability of capitalism, widely reported in the media, has focused particularly on the economic benefits to be had from the transition to a market based economy. This has heightened popular awareness of the economic objectives, potential benefits and social costs of reform. To reflect this political reality, industrial policy objectives have to embrace more than simply enhanced allocative and technical efficiency, they also have to take account of safeguarding jobs. In the context of Eastern Europe, this generally means managing industrial decline in a humane and sustainable manner: a politically sensitive activity, not least because of the overdeveloped industrial structure inherited from communism.

- On the growth side, attention has to be paid to policies to encourage the development of an efficient services sector. Services exports worldwide are growing faster than manufacturing exports and although still smaller than manufacturing exports for nearly all countries, services are rapidly catching up. It also has to be borne in mind that the distinction between manufactures and services is also becoming much less clear as the various activities that go to make up the value-added chain of typical manufactured goods are increasingly dispersed both organizationally and geographically.

- Industrial policy is not just about managing the orderly closure of surplus industrial capacity. It is also about enhancing the comparative advantage of domestic industry. The classical or static notion of comparative advantage referred to differences in various natural endowments among economies that were supposed to produce a global division of labour. The newer dynamic concept of comparative advantage focuses on the conditioning forces in the home market, of which industrial policy is an important component. Elements, such as human creativity and foresight, a highly educated workforce, organizational talent and the ability to adapt are now recognized as important aspects of the competitiveness of nations in an increasingly knowledge-based global economy. A policy environment that encourages the support services is also crucial in developing world-class industrial competitiveness. These attributes should not be conceived of as natural endowments but as qualities achieved through government policies and investment in education, organized research, physical and social welfare infrastructure and support for an active antimonopoly agency.[105] It also means legal and bureaucratic reform and the elimination of personal patronage and corruption.

■ The implications for governments are clear, as are the high short term costs:

- Education and training institutions require urgent reform and investment so that they are able to produce the cadres of high level and intermediate level personnel required by newly restructured, market-oriented enterprises. Industry requires manpower with new attitudes and skills: above all a flexibility and willingness to take on the challenges of new approaches, new organizational structures, new markets, new competition and new technologies.

- The civil service where it interfaces with industry and commerce has to be thoroughly overhauled to reflect the new structure and needs of industry. Grafting on new agencies while leaving the old departments in tact is no long term solution.

- Industrial policy should embrace aspects of the development of an efficient services sector, including: financial and consultancy services, transportation, telecommunications, hotels and recreation provision, housing and health services.

- Technology transfer is necessary at all levels within a modern economy in order to improve on the quality, consistency, flexibility, innovativeness and cost competitiveness of goods and services. Government policy can only indirectly stimulate technological progress and change in industry through, for instance, legislation to protect intellectual property rights and investment in research and educational institutes. Fiscal incentives are likely to be politically highly contentious with rising unemployment: they need to be targeted very carefully.

- Governments should intensify their efforts to provide an economic and political environment conducive to the building-up of industrial efficiency and competitiveness in support of overall industrial restructuring and private sector development.

- The reform of industrial relations institutions and labour law is now essential to stabilize and focus labour relations on the enterprise level where productivity enhancing decisions are made. The state needs to develop a comprehensive system of disputes conciliation and labour courts to arbitrate, where necessary, between employers and their employees in matters relating to trade union recognition, wage negotiating rights and wage negotiations and other collective issues in dispute. A tribunal system for the expeditious settlement of individual grievances outside and subordinate to the civil court is also urgently required.

Investment promotion

Surveys of foreign investors confirm that the motivation for investment in Poland is similar to that elsewhere in the world. The four most important factors are: prospects for economic growth, the size of the Polish market, trends in unit labour costs and the availability of trained manpower. Of the countries of eastern Europe and the FSU, Poland falls into the group considered to offer the most favourable conditions for foreign investors along with Hungary and the Czech Republic. Most export activity associated with foreign investors involves sourcing the foreign partner's home operations.

- Government vigilance continues to be required to maintain the transparency and stability of the policy environment and interactions between the administration and foreign investors. Competing enterprises must be treated in the same way by the authorities regardless of who owns them. The Antimonopoly Office, in particular, must be accessible and responsive to investors with complaints about collusive, anti-competitive behaviour on the part of Polish state-owned or private enterprises, including those involving foreign partners. The recent introduction of discriminatory tariffs and quotas also needs to be actively monitored by the Antimonopoly Office to highlight any effective rates of protection that are excessive and undermine competition.[106]

- The recent change in the scope of the operations of the State Agency for Foreign Investment (PAIZ) is to be welcomed. As Poland's investment promotion effort matures so do the interests and requirements of investors. Thus it is appropriate that PAIZ is shifting the emphasis of its activities from general promotion of Poland as a prospective investment destination to the provision of specific advice for serious investors. In a contemporary world characterized by fierce global competition for inward investment, investors expect sophisticated assistance from government agencies and clear cut procedural and operational ground rules governing foreign investment.[107] At the same time, the needs of domestic investors should not be ignored. Ultimately, they will be the most powerful forces for sustained economic growth.

Export promotion

Polish export performance is not adequate to finance the necessary imports of capital equipment required to modernize industry. Without a substantial improvement, economic growth based on enhanced industrial production is not sustainable in the long term. While the primary responsibility for improving export performance lies with the managements of individual enterprises, government assistance is still crucial. Indeed, almost every country in the world has a government supported export promotion agency. In CEE and the FSU generally, the old system of state-owned foreign trade companies that held the monopoly for exports from particular sectors has been abandoned but not yet replaced by fully functioning national export promotion agencies that work with individual companies.

- Government policy is vital in sustaining sufficiently strong incentives for exporters to mitigate the risks attached to exporting. The most important policy instruments are, of course, a competitive exchange rate and a tariff regime that does not over reward (and protect) domestic sales. The government is limited in what it can do to stimulate demand for exports beyond negotiating favourable access conditions in export markets, organizing promotional activities in foreign markets and publicizing export opportunities to domestic producers.

- In Poland, the first steps have been taken towards developing a national export promotion policy but it is severely underfunded.[108] The Teraz Polska (Poland Now) promotional campaign, launched in 1993, which gives awards to companies whose products meet world quality standards is one useful but limited component of the policy. Basically, the national export promotion infrastructure needs reconstruction to reflect the new enterprise-driven system of exporting. Since exporting is an unfamiliar activity for most enterprises, there needs to be a vast improvement in the dissemination of information about export market opportunities, quality standards required in overseas markets, trade financing, insurance and documentation. However, even more important than improving the flow of information to enterprises, is the provision of tailor-made training in export development and marketing for those enterprises with export potential.[109] In this regard, the assistance of various international - UNCTAD and ITC - could be sought for relevant expertise and experience.

ADVICE TO ENTERPRISES UNDERGOING RESTRUCTURING AND COMMERCIALIZATION

Restructuring of large state owned enterprises constitutes one of the key aspects of industrial reform taking place in CEE and FSU countries. Whereas the choice of speed and sequence of required policy reforms has been the subject of much debate, there has been little disagreement about the need to support the restructuring process. Without assistance, many enterprises in the region do not have the internal financial or managerial resources with which to mount a restructuring exercise. Many are located in regions where unemployment is already high and political stability so fragile that total closure without some form of assistance is unacceptable. At the same time, however, shedding some capacity is almost always necessary at the outset of restructuring as part of the process of working out a new basis for viable production.

The case studies presented in Chapter 6 illuminate some of the typical problems found at enterprise level. None, by themselves, require particularly radical solutions, but like all organizational change, necessitate people taking risks with no guarantee of improvement in their personal situation. In this circumstance, the diagnostic phase is the easiest part of restructuring. The real difficulties arise during implementation, for state-owned enterprises are imbued with a bureaucratic organizational culture which is designed to be resistant to change. A history of central direction of operations via the central planning mechanism has, over time, denuded enterprise management of responsibility for business planning and strategic decision making.[110] Macroeconomic stabilization programmes since 1989 have saddled enterprises with levels of debt over which they have little control; cut off access to new working capital; disrupted established supply chains and product markets; and placed corporate governance in a state of limbo.

In Poland, there have been a number of enterprises in which managements have been able to seize the initiative. These have mostly been in light consumer goods sectors such as garment manufacture, personal care products and food processing where capital and technology requirements are relatively modest and a market orientation was already well established before 1989. Foreign connections have also been important in opening up opportunities. For example, manufacturing under license or subcontract exposes enterprise management to the discipline of producing to international quality standards and supply schedules. As usual in business, much of the growth has been opportunistic and associated with the entrepreneurial flare of a few individuals leveraging their connections and contacts.

The more intractable problems have been associated with enterprises that formed the backbone of the centrally planned economy, namely heavy and general engineering companies and those engaged in commodity production typified by the textile industry. It is these types of companies that form the focus of the case studies of restructuring in Chapter 6. They have typically needed the intervention of outside change agents to bring about reform. Restructuring proposals tend to centre on a number of recurring problems.

Organizational structure, corporate governance and integration

A key problem of enterprises stems from their bureaucratic organizational culture. Managerial functions are fragmented and underdeveloped. There is poor co-ordination between departments. Boundary relationships with outside organizations are not managed effectively. Supply chain management, production control, marketing, management accounting and human resource management are poor. In the absence of powerful stakeholders in the enterprise (and a bureaucratic state subject to a tight budgetary constraint is rarely a powerful entity at the micro level), change can only be energized by the board of directors and senior management taking the initiative on their own account with, or without assistance from external change agents, or through a change in ownership.

- The primary function of enterprise restructuring is to define, and then integrate the fragmented bundle of activities that go to make up the enterprise in order to produce a focused and properly managed entity. To achieve this objective, the system of corporate governance usually has to be restructured to ensure top management responsibility and accountability for the development of three key functional departments: finance and accounting, marketing and human resource management. Each department should be represented at board level by an executive director so that these three functional areas, in addition to the technical departments, are properly represented in the strategic development of the enterprise.

- Privatization can be an important energizing process in industrial restructuring: it provides a sharp focus and set of incentives for the change effort; the new owners are unlikely to tolerate any attempt to obscure the responsibilities and accountability of management; and debt restructuring is a prerequisite. However, privatization is usually a relatively expensive (and slow) extra component of restructuring, not least because of the additional costs of specialist consultancy and legal services and the need to provide financial sweeteners to prospective buyers and existing employees. Unless the enterprise involved has a particularly strong balance sheet and market niche, privatization is unlikely to be a short term outcome.

The Pol h Ministry of Privatization has recently introduced a low-cost process of 'privatization through restructuring' for smaller enterprises which it is hoped will accelerate both processes. The programme invites management groups to manage, restructure and privatize selected state enterprises in return for a fee, an annual profit share and a commission upon successful transfer of ownership to private investors. It remains to be seen whether the scheme is successful in coupling restructuring and privatization cheaply and effectively. There are obvious dangers of asset stripping and a 'fire sale'.

Asset review and supply chain management

A physical asset usage review is required in order to assess building use and the arrangement of production operations. Because of the relatively low price of land and low cost of construction under the central planning system, most enterprises have too much real estate on their books relative to their productive assets. By contrast, capital equipment, particularly where it has been imported, is often antiquated and obsolete. Buildings usage and production layout can usually be streamlined significantly. This is because equipment purchases in the past were driven by the vagaries of the central planning system. Equipment was purchased incrementally according to bureaucratic logic rather than systematic project appraisal and planning techniques. As a result, production flow lines are poorly organized and machines often do not fit very well with each other. Surplus buildings, land and machinery can be disposed of once their utility has been assessed.

- Improved supply chain management procedures are essential to enhance cash flow and reduce working capital requirements. Sources of additional liquidity are derived from stopping the tradition of supplying materials to subcontractors; tightening inventory control so that component purchases are closely co-ordinated with assembly operations; inspecting and certifying approved suppliers; and introducing penalties for suppliers who fail to meet quality or supply schedules.[111]

- The traceability of product through each stage of production is frequently inadequate and variation orders are introduced without going through a systematically managed authorization procedure as required by international standards organizations. Machine maintenance standards have to be improved to meet international standards such as ISO 9000 and 9001. Under the old system, machine down time was an important source of bonus earnings for maintenance engineers who were the 'aristocrats' of the workforce. Socialist managers were heavily dependent on the goodwill of their skilled maintenance engineers. Many enterprises today still have no routine maintenance system in operation; standby equipment is often faulty; and there is no system of certification of machine repairs as required by international standards.[112]

- Quality control systems need to be strengthened and/or instituted all round in order to meet ISO 9000 and 9001 requirements for exports, particularly to the EU.

Financial management and accounting

In so far as the underdeveloped state of corporate finance and management accounting functions described in the case studies is typical of enterprises in CEE and the FSU, then the financial services sector, including banks, has no choice other than to accept active involvement with major industrial customers. This is necessary in order to ensure proper application of investment capital in the pre-restructuring and post-restructuring process. Advice with property disposals is also likely to be needed. The appropriate financial and general management expertise is presently a scarce commodity.[113]

- Enterprises involved in debt workout regimes and/or seeking new capital in the form of loans or equity stakes will have to accept a new partnership with financial institutions, including their right to nominate non-executive directors. Equally, banks and other financial intermediaries will have to learn to appreciate the mutual benefits that flow from securing a customer base founded on stakes in strong and profitable industrial enterprises. In any case, selling off enterprise assets or debt, even at a deep discount, is not easy against political resistance, uncertainties about property title and in a thin market.

- The management accounting system normally requires completely overhauling so that the enterprise has an efficient and accurate method of allocating costs. Without this capacity, management is unable to calculate the direct costs of products or allocate overheads and control unplanned cross-subsidizing of product lines. A priority has been the introduction of a system of cost centres so that top management is able to take a strategic view of the company's product portfolio and pricing strategies. A system for managing the enterprise's creditors and debtors is also vital in the high inflation and real interest rate environment of the region.

The banking sector's role in industrial restructuring

The banking sector cannot avoid an active and leading role in the restructuring process over the next few years. Current pressure for involvement stems from the urgent need to deal with the non-performing loans of state enterprises inherited from the communist era and the requirement to strengthen the balance sheet of most banks. The international financial institutions, such as the World Bank and the EBRD, that are supplying much of the new capital to the banking sector are doing so on condition that the banks establish active debt workout departments. Technical assistance to the sector is, among other things, designed to make sure that banks do not remain passive lenders.

National governments are also unlikely, in the long run, to be able to ignore a situation developing in which commercial banks do not lend to the industrial sector, even though many authorities in the region are presently content to sell large volumes of government paper to the banking industry to fund budgetary deficits. The case of eastern Germany is instructive as regards the potential of equity markets as an alternative source of capital for restructuring. The German government believed that the equity market would act as a significant source of finance capital. In the event, less than 1 per cent of financing came from venture capital funds. Instead, the banking sector became the main source of funding with the government providing necessary guarantees.

- An urgent priority is to develop a competitive banking system in CEE and the FSU. However, the prevalence of weak balance sheets in the banking industry of the region and the underdeveloped skills base of bank staffs, particularly in risk and credit management, project appraisal and evaluation, means that there is an enormous requirement for technical assistance and training in banking. The demand is beyond the capacity of national institutions and requires substantial inputs from foreign institutions such as EBRD, the PHARE programme, UNIDO, and from London and Paris Club members.

- Important financial functions that must be developed and strengthened in commercial banks include providing credit to existing enterprise management teams to pay for necessary restructuring; funds for management buyouts and loans to enable private interests to acquire part of, or complete state-owned enterprises. Beyond strictly banking matters related to commercial appraisal and design of appropriate financing packages for projects, the sector will need to develop and provide management advisory services to enterprises and entrepreneurs in receipt of loans.

- Along with the banking sector, capital markets have to be strengthened and deepened so that a wide variety of financial instruments is readily available to companies. It is vital that the cost of corporate finance for domestic customers is kept competitive with that available to foreign competitors. To reach this stage, a critical mass has to be reached in the level of liquidity and organization of capital markets. Policy makers in the region need to concentrate on improvements in trading infrastructure, training of personnel, and the creation of a fiscal regime that encourages the wider participation of investors in capital markets. By stimulating the development of more sophisticated banking, capital, and secondary markets, the authorities allow investors to diversify their portfolios and attain desired risk and liquidity features. This, in turn, attracts more capital which can be used to restructure enterprises being privatized.

Changing the organizational culture of state enterprises

Restructuring, unfortunately, does not necessarily stimulate entrepreneurial behaviour though one of the main objectives is to develop an organizational culture in which it can flourish. Perhaps the aspect of state-owned enterprises most resistant to change is the organization's bureaucratic and risk averse culture.

Managers in the region usually have a relatively high level of technical education so they have less difficulty in appreciating the technical benefits to be had from a rational calculative approach to production management and cost control: they have much greater difficulty in understanding the need for a people-centred approach to organizational development that emphasizes managerial responsibility for human resource development. The tradition of trade union (and formerly Party) participation in managerial decision making is also strong in the region which tends to encourage a conservative egalitarianism in much discussion about restructuring. Perhaps inevitably, organizational cultures are more easily reconstructed at the technical level: too often behavioral change is left to flow from changes in structures and power relationships.

- To make sure that the social and psychological adjustment of employees to the new business culture is as smooth as possible, it is important to invest heavily in modern human resource development techniques such as organizational development (OD), staff appraisal, training needs analysis and a comprehensive training programme that includes interpersonal and business skills training. In order to reflect the new results-oriented organizational culture and to provide strong financial incentives for staff to adjust, the salary and wage structure has to be redesigned to reward improved performance: differentials should reflect real responsibility and achievement not age. Otherwise, younger able managers (who have usually benefited from the training programmes associated with restructuring exercises) will leave to join better paying private companies.

- Restructuring and refocussing complex organizations is inherently a stressful experience for the people involved, particularly when fear of unemployment is high. Conflict over objectives and who will lose employment is inevitable. When the restructuring advice has been given and action is on the agenda is the time at which the leadership and commitment of top management is put to the test. Without good top management implementation of change is impossible.

- The role of trade unions at enterprise level has to be reshaped: from being overtly political and confrontational to become the loyal opposition concerned primarily with representing the work force's interests in the economic well-being of the enterprise. Enterprise-focused trade union recognition and wage negotiating procedures are now required together with a system for handling individual grievances and disputes, in the first instance, within the enterprise. Employers would be well advised to form regional and national associations to co-ordinate industrial relations and wages policy between enterprises and to represent the employers' interest in discussions with the government.

Endnotes

[87] Michael Bruno makes this point, (op. cit. p. 743).

[88] In 1989, this rate of inflation was unusual in a command economy though it has become commonplace in the countries of the former Soviet Union.

[89] Quoted in the Warsaw Voice, December 12, 1993.

[90] The 'crawling peg' system of devaluing the zloty against a basket of five major trading currencies to maintain purchasing power parity was introduced in May 1991. The rate of devaluation of the zloty for 1993-94 was set at 1.6 per cent per month or 24 per cent over one year. In addition, there was an 8 per cent devaluation on 27 August 1993.

[91] From the 1 January 1994, a new customs tariff has been introduced that gives preferences to semi-finished products and components while restricting imports of high value-added goods. Thus the quota for computer components was increased by $100 million, while the customs duty on radios, tape recorders and similar items was raised from 15 per cent to 30 per cent. Importers are also now required to pay compensation on foodstuffs that are cheaper than domestic food. Both of these discriminatory measures are in breach of GATT and will have to be phased out when Poland becomes a full signatory in mid-1995.

[92] The rate of expansion of the money supply was kept in line with inflation at 35 per cent in 1993.

[93] Nearly 1.7 million individuals were registered as sole proprietors as of 30 June 1993, more than double the number registered on 31 December 1989.

[94] Regrettably, the construction of new housing has been in decline for a number of years. In 1993 it declined by 30 percent on 1992 and a 50 per cent drop is expected in 1994 despite the fact that 2 million people are waiting for an apartment. Poland's first factory adaptation project was launched in Lodz to convert an abandoned nineteenth century factory building into 30 housing units.

[95] Measures of foreign equity flows and stocks are poor guides to the significance or otherwise of foreign investors in medium to high risk economies such as Poland and other countries of the region. Official statistics do not capture the benefits of loan finance, and other forms of non-equity investment, such as transfers of proprietary technology, commercial know how and access to marketing channels through subcontracting relationships.

[96] The agreement allows Poland to reduce its commercial debt of $13.2 billions by 45 per cent and to spread the repayment of the rest of the restructured debt over 30 years.

[97] The number of new jobs being offered rose from 28,200 in December 1993 to 41,200 in January 1994.

[98] The average old-age and disability pension is 63 per cent of the average national wage before tax. Retirees were allowed to continue close to full-time work without loss of benefit. The average age of retirement dropped by two year though legislation introduced in 1991-92 somewhat limited pensions for early retirees.

[99] Although the present SLD-PSL has an overwhelming majority in parliament, each of the two coalition partners is itself a coalition. Already in the debate about the first budget of the SLD-PSL coalition, a faction of 10 SLD-OPZZ members representing the post-communist trade union movement threatened to vote against the budget if their demand for increased government spending was not met.

[100] Pinto, B; Belka, M and Krajewski, S (1993) 'Transforming State Enterprises in Poland: Evidence on Adjustment by Manufacturing Firms', Brookings Papers on Economic Activity, 1, pp. 213-270.

[101] Albert, M and Hahnel, R (1991) The Political Economy of Participatory Economics, Princeton: Princeton University Press.

[102] The Polish law on the freedom of association is unusually liberal: only 10 people are required to establish a trade union and court registration is virtually automatic.

[103] Polish trade unions continue to maintain political affiliations and there are no legal restrictions on political activity by trade unions. With the changeover from a Solidarity-led coalition to a post-communist government in September 1993, political unionism is on the increase amongst the affiliates of the various fragments of Solidarity and other opposition parties as each tries to capitalise on the grievances of employees.

[104] Blais, A (1986) 'Industrial Policy in Advanced Capitalist Democracies', in A Blais (ed.) Industrial Policy, Toronto: University of Toronto Press, p. 41.

[105] Porter, M E (1990) The Competitive Advantage of Nations, New York: Free Press.

[106] **Effective rate of protection =**
{(Finished good tariff) - [(components share of imports) X (tariff on components)]} / {1 - share of imported components}

[107] The European Union's PHARE programme agreed on ECU 10 million technical assistance to PAIZ through INVESTPROM in January 1994, to help with promoting foreign investment in Poland.

[108] In 1993, the total national budget for export promotion was 90 billion zlotys ($450,000), while the budget allocation for 1994 is 206 billion zlotys ($960,000).

[109] The EU-PHARE Polish Export Programme (EXPROM) launched in June 1993 is an innovative attempt to stimulate non-traditional exports from Poland through carefully targeted training of marketing personnel in selected enterprises.

[110] The various attempts to increase enterprise autonomy in decision making in the countries of the region before 1989, all fell foul of the lack of a properly functioning price mechanism. Without the hard budget constraint of real prices and enterprise responsibility for profits and losses there was never a significant incentive for market oriented reform.

[111] The objective is to move towards just-in-time supply chain management but present production uncertainties in the region usually preclude this stage being reached.

[112] In Poland, only 8 companies had achieved ISO 9000 quality assurance certification by 31 December 1993, despite the fact that an ISO 9000 certificate is vital if Polish firms are to cooperate successfully with foreign firms. In many export markets an ISO 9000 quality assurance certificate is, or will soon become compulsory.

[113] The Polish Ministry of Privatization has gone some way towards filling this manpower gap by establishing a programme for training non-executive directors of state enterprises that have started the first stage of the privatization process by becoming incorporated. Unfortunately management training, however good, is no substitute for experience and it will be sometime before this cadre has the necessary hands-on experience of corporate governance to be effective in this new role.

Chapter 8
The Restructuring of Industry: Implications for Technical Assistance

ASSISTANCE IN THE SECOND STAGE OF TRANSFORMATION: THE INTEGRATED MICRO POLICY FRAMEWORK STAGE

The task ahead for the international community in helping the CEE/FSU region is great. Funds must be mobilized in an environment of recession in the Western driver economies of Germany and Japan and anemic recovery in the United States when budget makers are already being pressured by increasing deficits and other competing interests. Thus, it is vitally important that what limited funds are available be put to the most effective use and that assistance is coordinated and prioritized to limit duplication and waste.

In the context of the broader macro-economic framework, donors also must re-assess the focus of their programmes to take into account the need for micro-level reforms. As noted, focus must now turn to this second stage of transformation and target the enterprise level, address the issue of distorted incentive structures and create an environment in which private enterprise can flourish. Attention and efforts must therefore address the key issues of privatization, promotion of foreign direct investment and private enterprise, industrial restructuring, and the development of adequate social safety nets, and human resource development.

PRIVATIZATION

Privatization is a major instrument of the transformation, and particularly, the restructuring process. Indeed, one of the first reform tasks the CEE/FSU countries have undertaken is the redefinition of the role of the state and promotion of the private sector. For most, this involves the widespread transference of ownership from state to private hands. In the CEE/FSU region, privatizing the economy also will mean the development of new small and medium-sized enterprises (SMEs). Government will have to increasingly play the role of facilitator rather than regulator, and a more competent and skilled bureaucracy will be necessary.

On the policy level the issues to be addressed are not easy. What should be privatized? How fast? Should foreigners be allowed to participate? To what extent? How can the process be safe-guarded from the nomenclature to ensure that they cannot take unfair advantage of their positions to profit from transformation? To what extent should workers, management and the general populace be allowed to participate? At what price?

Institutions to support the process must be developed and those regulating it (the state property agencies and ministries) will look to acquire the skills to do so properly. Support may also include public education programs to promote the process and lend it popular backing and the design of public programmes to ameliorate its negative effects.

At the enterprise level, the mechanics of privatization also must be understood. Proper enterprise valuations must be prepared and audits performed. Even for those enterprises that receive infusions of foreign management and know-how, enterprise directors and management must be trained in the workings of a market economy and its business methods and concepts. It also will be important to develop restructuring plans.

Although small-scale privatization - particularly in the retail and services sector (shops, restaurants and so on) appears to have progressed well - it is not without problems in many countries. In Lithuania, for example, the current failure of almost 50 per cent of privatized businesses within 6 months of privatization might be alarming evidence of inadequate preparation of the privatization process in terms of the proper writing and evaluation of business plans, the vetting and even preparation of prospective buyers. Many countries are now being forced to consider how the privatized businesses will be run and by whom in order to ensure successful privatization.

In general there has been great disappointment in the speed with which the privatization of large enterprises is taking place in much of the CEE/FSU region In many cases, particularly in Poland, the privatization of large enterprises has been fraught with delays or has been side-tracked. Not only have there been political delays over such issues as who should be permitted to participate in the process, part of the reason for the lack of speed has been the difficulty involved in readying large enterprises for the process. Performing adequate valuations and devising business plans have been particularly difficult. There is, therefore, a particular and pressing need for international assistance to kick-start the large-scale privatization process in terms of the policy framework and also the numerous instruments and/or types of privatization schemes (mass privatization vouchers, shares, public offering, financial intermediaries and so on). Given the difficulties in privatizing large-scale state-owned enterprises (SOEs), many will remain in the pubic sector for some time. Increasingly, the countries of the region are considering or taking action to increase the competitiveness and efficiency of SOEs in the intermediate period before ultimate privatization. This has been done, apparently successfully in China's reform process. China has greatly increased the profitability and efficiency of its SOEs - usually without resorting to full scale privatization - by gradually turning them into semi-private enterprises. The Government has done this in a number of ways. It has introduced auctions for top managerial posts where potential candidates have to submit bids which promise minimum performance targets for the future. It has given SOEs greater autonomy over production decisions and allowed them to retain a greater fraction of the profits they generate.

Many countries also have to find a way to remove a major obstacle that prevents qualified domestic managers and entrepreneurs from participating in large-scale privatization due to lack of funds. A number of innovative approaches could be considered, none of which are perfect. Consideration could be given to auctions with cash and non-cash bids.[114] These auctions would allow appropriately qualified entrepreneurs to bid cash and also promises of income from future profits. The problem here is how to evaluate the array of cash and non-cash bids that will be presented. Clearly a committee with relevant expertise to vet bids - probably provided or certainly assisted by the international community - would be needed. in addition, leasing SOEs could be tried in some form.

In terms of the speed of the privatization process, it is important to stress that if the underlying institutional framework creates a competitive environment, the degree or speed with which privatization is carried out may not be critical. If the free entry and exit (working 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. However, it is important to point out that privatization is not the panacea of all ills. In a significant number of countries, privatization has yet to achieve the desired results. Among other things, this has occurred because privatization has not been properly incorporated into the broader framework of industrial restructuring and overall private sector development. Also, in many countries, privatization will require far more than the simple transfer of state-owned property to private entrepreneurs. Successful privatization is not merely change of ownership. The ultimate goal of privatization should be increased competition and efficiency. To ensure that there are long-term efficiency gains to an economy following privatization, it is important that past monopolistic privileges are not simply transferred to new owners. This will generally require the development of a competitive market environment with supporting institutions and infrastructure; the promotion of new businesses and entrepreneurship, and the creation of an appropriate and stable legal framework conducive to such activity. As mentioned earlier, the large-scale redundancies that may result from rehabilitation and/or privatization are key considerations that also must be addressed. Small- and medium-scale industries - new and existing - may need to be promoted more vigorously to provide an outlet for redundant workers and a major source of job creation. In all of the above, the international community needs to build-up and/or strengthen its assistance.

THE ROLE OF FOREIGN DIRECT INVESTMENT (FDI)

Privatization alone will not ensure the successful transformation of the economics of the region. Massive amounts of restructuring and new technology will be required. The savings of the region will not be enough to finance this, even when combined with the aid flows to the region. As a result, the promotion of FDI is given major attention by all the countries of the CEE/FSU region. Not only does FDI bring in the needed funds for purchasing new machinery and equipment and updated technology, it brings in the knowledge of the workings of a market economy and access to new markets. These are some of the most important elements required for the success of the region.

In response to the opening up of their economies since 1989, there has been a significant increase in the flow of FDI to the CEE/FSU countries. Cumulative FDI in Hungary, the country to first initiate reforms encouraging foreign investment, reached US$4.5 billion at the end of 1992, one-third of which was from the US. Over the same period, the Czech Republic saw US$1.59 billion, Slovakia US$229 million, Poland close to US$2 billion, Romania US$560 million, Bulgaria US$94 million and Slovenia $100 million. The republics of the former Soviet Union saw total FDI in the neighborhood of US$9 billion, the vast majority of which has gone to the Russian Federation. If investment in the oil sector takes place as hoped, the Russian Federation could see US$6 billion over the next ten years in that sector and Kazakhstan, a staggering US$24 billion. In contrast, FDI to one developing country, Mexico, was US$17 billion in 1991.[115]

The primary reason for FDI in the CEE/FSU region is to establish domestic market share. This is followed by tapping the regional CEE/FSU market, low cost sourcing and tapping the EC market.[116]

Recent studies by UNIDO and the Commission of the European Communities have found that potential investors to the region expect to face many obstacles and difficulties including: a lack of both physical and service infrastructure; uncertain property rights; inadequate financial information on which to value a target enterprise; and a lack of sufficiently trained personnel.[117] But the most critical areas of concern are the economic and political outlook of the country for investment and the existing regulatory and legal framework, especially investment protection laws. Looking to establish market share, investors are concerned about the prospects for growth, employment, inflation and the other factors that will effect domestic purchasing power and social unrest.

Quite expectedly, potential investors are also wary of political uncertainty and areas of potential turmoil or open hostilities.[118] And they look for a proper functioning, predictable and stable legal environment. Investors need the reassurance that their investments will be adequately protected by a legal framework which is sufficiently comprehensive and most importantly, enforced. It is not just the presence or absence of relevant laws which are the key determinants of investment, but rather how these laws are implemented and interpreted.

A further hindrance to FDI in the region is finding a suitable partner or target enterprise in which to invest. Most foreign investors in the region would like to join forces with a domestic entity when making their first investment in a country. Most are of the opinion that the local partner can bring a knowledge and expertise of the local environment to the venture that the foreign investor can not easily provide. Locating a partner and assessing his financial position remains extremely difficult, however.

Several international agencies, especially UNIDO with its world-wide network of Investment Promotion Service (IPS) offices, are in the position to help the countries of this region promote inward investment flows as an "honest brokers", neutral bridges between the technical, managerial and financial resources of foreign investors and the development potential offered by the countries of the region.

Technical assistance also should be focused to help governments ensure that they have created an environment which is conducive to attracting investment by helping to strengthen or create the institutions necessary to support the process and assisting in the generation of specific investment opportunities. Assessments of the existing climate for investment and foreign perception of that climate can be taken and recommendations of where governments should focus their attention and initiate change made.

Assistance can be given to hold investment forums in which potential foreign investors are invited to review investment projects and negotiate directly with the local parties involved. Investment promotion forums provide a proven catalyst for FDI and help alleviate the often heard complaint of the difficulty finding suitable partners in the region. Agencies can help in the preparation of project proposals and pre-screen the various projects offered by the host country.

Foreign investment should not be the only concern, however. In the long run it is the domestic investor who will play the largest role in the process of transformation. Governments and the international agencies lending them support must also work to develop the domestic investor base. Capital markets must be created and encouraged and legislation put in place to encourage savings and investment by private individuals.

PROMOTION OF THE PRIVATE SECTOR

While FDI will play a crucial role in the transformation of these economies, it is only part of what is required. Most importantly, the development of the private sector, particularly in the form of SMEs must be encouraged. The most important source of economic growth in the region is likely to be new businesses, especially SMEs. Not only does large-scale industry rely on them heavily for subcontracting networks and supplies of essential inputs and services. They also form the nucleus for future industrial growth since they are the most flexible and responsive sector to the external challenges in a changing market economy.

As mentioned earlier, one of the major structural flaws of these former command economies is the lack of SMEs and support industries on which large scale industries rely, which are so prevalent in the West and in the Asian NICs and so important for building up competitiveness and attracting FDI. SME development is an important way to alleviate much of the dislocation and unemployment problems resulting from the transformation of the region. SME's account for the majority of employment in developed economies; 70 per cent of the employment in Western Europe, 67 per cent in Japan and create 98 per cent of all new jobs in the US.[119]

Giving the private sector a lead role in industrial development must not be seen as requiring a minimal role for the state. On the contrary, it presupposes an efficient and competent government machinery with qualified capable staff which can work closely with the private sector. In order for SMEs to develop and flourish, the macro economy must be in a state of relative stability, to the extent that interest and inflation rates and trade as well as foreign exchange policies are not causing distortions. The legal framework and tax and labour policies also must allow for the easy entry of new entrepreneurs and encourage their growth. Prices must be able to be freely set and there must be free access to inputs, including imports. It is also important that infrastructure, especially telecommunications and banking services, be adequate. Governments of the region must carefully analyze existing legislation and policy and change it where necessary to see that it encourages and not hinders the development and success of SMEs.

Promoting the development of the private sector, particularly through the encouragement of SMEs is one of the most important areas where international institutions and bilateral donors can play a role. International institutions such as UNIDO and the EBRD can offer critical help in the initial policy review by the governments of the region to help them assess existing legislation and policy and to develop a coherent strategy for the encouragement of SME growth. They can advise and support legislative, planning and executive bodies in their efforts to develop a sustainable environment conducive to promoting the growth of SMEs by advising on the formulation and implementation of strategies to facilitate the access of SMEs to financial, technical and technological resources.

At the institutional level, agencies can support the development of both public and private sector institutions that promote entrepreneurship and SME development such as NGOs, trade associations and ministries. At the enterprise level, they can aid in the encouragement of SMEs through the enhancement of entrepreneurship and facilitating access to information and essential resources (finance, marketing and technology). Several agencies and donors are also is in a position to provide valuable training assistance to entrepreneurs.

It is interesting to note that the EBRD has placed new emphasis on the encouragement of SMEs. They consider themselves best suited to provide financial advice and assistance in locating financing, and make grants to local institutions to help defray the costs of technical assistance from outside consultants. This new emphasis by the EBRD presents a good potential for a fruitful partnership arrangement with other international institutions and NGOs.

RESTRUCTURING AND INDUSTRIAL REHABILITATION

Existing industry in the CEE/FSU region is currently facing severe difficulties. The transition from a command to competitive market economy and regulated CMEA trade to liberalized trade and prices has resulted in many industries being cut off from traditional sources of raw materials and supplies, a loss of markets and sharply declining domestic demand. Above all, the reduction or suspension of government subsidies coupled with competition from imports has revealed an extremely low level of product competitiveness and shortcomings in production processes and enterprise structures. Some industrial sub-sectors such as those which were primarily supplying goods to the CMEA markets have been particularly affected. The efforts to pave the way for industrial rehabilitation and recovery will require policy reforms, sub-sector restructuring programmes, privatization, FDI, modernization of enterprises, technology and skill upgrading, and retraining in technical skills and management practices.

Whereas the choice of speed and sequence of required policy reforms has been the subject of great debate, there has been little disagreement about the need to support the restructuring process with specific measures and assistance. Without restructuring, many enterprises in the region will not be viable and none of the countries in the region is in a position to absorb high levels of unemployment. Political stability in the region is too fragile to withstand the heightened social pressure that would result. At the same time, however, plant closure should be a part of an industrial rehabilitation strategy. Restructuring should avoid re-establishing previous conditions for inefficient production, establishing instead, a new basis for viable production and overall growth.

Any restructuring strategy needs to combine an understanding of both macro-economic forces (the policy and institutional environment) and the real problems at the enterprise level.

The CEE/FSU region will want to approach its industrial restructuring at national, regional and enterprise levels. A policy must be devised in each of the countries, tailored to its specific needs which analyses the strengths and weaknesses of the existing structure of the industrial sector and employment patterns and targets the encouragement of sub-sectors in which it has a comparative advantage. Consideration of the regional distribution of industry and employment as well as the encouragement of the distribution of the benefits of transformation on a more balanced geographical basis are being emphasized by those beginning the process.

Declining performance and eventual bankruptcy of some industrial enterprises are inherent features of a dynamic industrial development process. However, this also can be an indication of inadequate economic/industrial policies and other shortcomings in the economic environment or the result of abrupt changes in key parameters - such as the abrupt loss of input and output markets, increases in the price of previously subsidized energy inputs - particularly in international markets. Introducing new industrial policy measures, drawing up special structural adjustment programmes at the sectoral and sub-sectoral levels and building up greater resilience in industry are among the major problems that many of the CEE/FSU countries are addressing.

International organizations can help accelerate this process through support and advice at national and regional policy levels, helping to devise a "vision" of likely investment requirements and anticipated closures, and in aiding in the establishment and/or strengthening of institutions.

Analytical country reports on the overall competitiveness and policy framework of the industrial sector can be performed which will identify sub-sectors in need of rehabilitation. This sectoral approach has been tried extensively in Poland. Sub-sector development prospects can be assessed and programme proposals drawn and programmes for building up industrial services, including consulting and financing can be developed. An analysis of the human resource base can be made and training programmes developed in the areas of skill shortage. And guidelines can be drawn to improve industrial standardization, quality control, technology development and environmental protection To meet international requirements.

A word should be said about the relationship between restructuring and privatization. Should privatization precede restructuring or vice versa? There is no universally applicable answer to this question. The answer will depend on the country, its stage of development and subsector or industry concerned, and most importantly, the individual enterprise in question. For example, in the Czech Republic and the former East Germany, the approach is that there should be no restructuring prior to privatization. Whereas Poland and some of the other CEE/FSU countries have generally recognized the need for some restructuring prior to privatization. However, there is now a growing consensus that organizational and operational restructuring should be left to new owners. By organizational restructuring it is meant that restructuring which focuses on the structure of enterprises, departments, internal hierarchies, manpower and management structure. Operational restructuring refers to production processes, technology issues, sources of materials, products, marketing and informational systems.[120] Nonetheless, individual enterprises may want assistance in devising plans for restructuring before privatization. In many cases, such pre-privatization intervention will be necessary, if only to keep them going long enough to find a private investor. These pre-privatization generally include legal restructuring (the transformation of SOEs into limited liability or joint stock companies), and creating viable core business units by breaking up combines and spinning off non-core activities or social services. In some cases, financial restructuring will be required in order to make an otherwise viable enterprise attractive to private investment. However, with the exception of former East Germany, this has been found too costly for most CEE/FSU governments. Many enterprises would viable were it not for heavy debt-servicing requirements. In countries where industries are highly vertically integrated, large monopolistic enterprises often will need to be split up, and horizontal specialization pursued prior to privatization. It is considerably more difficult to de-monopolize or split up large enterprises and introduce the required structural changes after privatization than before it.

In several of the countries, a focus on the specific problems of military conversion will also be appropriate and critical to their transformation, particularly the Russian Federation, Ukraine and Slovakia.

In addition, the international community can assist the CEE/FSU governments and their nascent private sectors by providing support for pre-privatization restructuring activities to ascertain the commercial viability of enterprises, assess core assets, value assets, spin-off non-core assets at the enterprise level; and pre-privatization intervention to restructure enterprises that will not be attractive to private investors in their current state. Useful post-privatization assistance can also be given, particularly in terms of training and capacity-building programmes to strengthen the institutional framework, the introduction of cleaner more environmentally harmonious and energy efficient technologies. "Model restructurings" of selected enterprises can also be under taken and the experience used to draw lessons for other similar enterprises that also need to be restructured. The dissemination of lessons learned can be accomplished through in-country restructuring workshops.

In the context of industrial restructuring, because of the past distribution of economic growth and investment which neglected many regions and the closing of dominant facilities in other "one-enterprise" regions, the CEE/FSU region is in particular need of appropriate regional development programmes. Structural change in the CEE/FSU region should be seen not only as a general problem of the given national economy but as a set of specific problems characteristic of the different regions within a country. It is expected, and indeed already becoming evident, that governments in the region will need to build up active regional development policies to support industrial restructuring and privatization. Indeed, many of the international donors are increasingly becoming involved in regional development programmes and can assist in the encouragement of more balanced regional development in the CEE/FSU region by first conducting surveys of the current and required institutional and administrative framework for economic restructuring and development, and analyses of the resource base (including agricultural production for industrial development) as well as the structure and performance of industry in individual regions/provinces to ascertain structural weaknesses, development prospects and constraints. They also can assess the need for rehabilitating and modernizing industrial enterprises and identify industrial activities which need to be phased out, including a determination of the general technological status of current industry in terms of productivity, energy consumption, environmental effects and so on, and the need to upgrade technologies. Increasingly, specific attention must be paid to the environmental and employment effects of restructuring.

On this basis, donors can be of assistance in identifying investment projects in connection with rehabilitation, modernization and diversification of existing enterprises, and identifying and facilitating investment in new opportunities for industrial activities. And, they can assess the existing and required institutional infrastructure and administrative framework for regional development, as well as assist in the design of appropriate institutional approaches (including possible industrial zones, incubators and science parks). They also can conduct studies to assess the viability of establishing and operating Regional Development Corporations.[121]

Finally, the clear lesson from polish experience of the challenges involved in establishing a dynamic process of industrial renewal is that the resources avoidable are severely limited and hard choices continue to have to be made between key activities. Well-directed foreign technical assistance can be a significant catalyst for industrial restructuring but self-help is likely to remain the most important resource of Poland. The situation appears similar in other countries in the region, indeed, in several cases the flow of technical assistance is even more limited than to Poland. The key technical co-operation question thus becomes one of how best to mobilize domestic resources to foster industrial competitiveness: to make the hard choices and to avoid policy drift and a descent into socially and economically wasteful de-industrialization.

SOCIAL SAFETY NETS

One of the major accomplishments of the socialist system in the CEE/FSU region was the relatively equal distribution of income (in the mid 1980s Eastern Europe as a region had a Gini co-efficient[122] of 25.4 versus 31.4 for Western Europe and 32.6 for the United States.[123] Guaranteed employment and low wage differentials were key reasons for this. The transition to a market economy - particularly widespread industrial restructuring - with high differentiation in wages and no job guarantees is certain to lead to a shift in income distribution. Open unemployment has already increased significantly, from an average across the region of zero, to an average close to 15 per cent (excluding the FSU). There is also an alarming concentration of unemployment in particular regions and towns. For example, in Poland, regional differences in unemployment are considerable, with regions around Koszalin, Suwalki and Olsztyn having unemployment rates of between 24-226 per cent. Currently, the North-east of the country suffers from a 22 per cent unemployment rate. Also, many more people will be put out of work in the restructuring process as inefficient enterprises are allowed to go bankrupt and entire industries are found to be uneconomic when subsidies are removed. The uneven nature of the existing distribution of industry will make the effect of such closings even more disruptive. Certain segments of society will also be more vulnerable than others: those on fixed incomes are particularly hurt by rising prices, older workers will find it far harder to adjust to new work practices or develop new skills in what are the high job growth areas of marketing and finance, and women and children will be effected as childcare facilities, traditional at most CEE/FSU enterprises, come under the new heading of inefficient ancillary activities and are closed or spun-off into separate, fee-charging, enterprises.

The recent Russian, Lithuanian and Polish election results may be to a significant extent a reflection of the growing social discontent caused by high unemployment rates. In order to prevent the widespread outbreak of social unrest, the governments of the region must attempt to redefine and/or build up the social safety net, unbundling the economic and social roles previously assigned to enterprises and equalize the distribution of the benefits of transformation and protect those who are the most vulnerable to its adverse effects. A system of adequate social security, including unemployment insurance, and old age and disability pensions, must be devised to replace the former social welfare system.

Several international institutions such as the ILO, UNDP and the World Bank are in a position to directly address the general problems of poverty and unemployment through development and support of social safety net programmes. Others, such as UNIDO and the OECD, also can be of assistance by helping the governments of the region assess what the effects of industrial policy and transformation will be and devise a scheme to ameliorate the most negative ones. For example, industrial studies that identify enterprises to be restructured or closed, could also identify groups of employees and geographic areas to be the most effected. From this, the need for retraining and job creation programmes can be pin-pointed.

Along with helping to identify the areas of need, technical assistance also can support the development of such institutions as retraining centers and technical schools. Support to new business development and SME promotion will also help to create jobs for those displaced due to the transition. This may be the most important aspect for the success of the social safety net concept and ultimately for the success of the transformation process.

In fact, most of the areas in which donor organizations can offer assistance and support to the process of industrial development will help indirectly in the alleviation of poverty and the easing of the adverse effects of the transformation process.

HUMAN RESOURCE DEVELOPMENT

One of the recurring themes of this report has been the crucial importance of devoting adequate resources to the proper advancement of human resources for industrial development. There is, unfortunately, a common bias in many investment and technical assistance projects: most effort is devoted to funding, financial engineering and hardware procurement and installation. By contrast, the resources required for systematic training needs analysis and implementing training proposals are often poorly provided for or neglected. This bias, where it occurs, is particularly damaging in industrial restructuring exercises in CEE and the FSU. Despite a large pool of manpower with vocational skills and basic scientific and technological knowledge, the lack of proficiency in management, product development, supply chain management, financial management and accounting, marketing, salesmanship, distribution and international trade means that the lack of human resource development at enterprise level is one of the most serious impediments to enterprise competitiveness and efficiency.

Three main human resource development issues have been identified in this report: managing layoffs, closing the skills and experience gap, and mobilizing the existing high level of technical and scientific knowledge in the workforce. The labour force can be divided into many groups each of which has its own distinct set of problems: within large enterprises - top management, middle management and line workers; within SMEs - owner-managers and employees; and within the government apparatus - senior civil servants, middle level executives and support staff. Particular industrial sectors also have their own special requirements depending on the magnitude of any downsizing required, the dynamism, or otherwise of the local labour market, the distance of the sector from world-class technology and productivity frontiers, and previous exposure of managers to world markets.

The training and retraining task at first glance seems infinite in scale and scope. In reality, the key issue, as elsewhere in the world, is targeting scarce resources at top management in the civil service and enterprises so that they fully appreciate the need for and support the systematic training of subordinate personnel. Stripped to its bare essentials, industrial restructuring, and restoring competitiveness and efficiency is about re-engineering the corporate culture of enterprises and government agencies. Training the trainers is necessary but without a top management committed to training and developing human resources throughout the enterprise reform will be partial.

UNIDO and other UN agencies , particularly the ILO, may be in a position to assist governments with assessing the best methods for targeting top bureaucrats and industrial leaders for management development and training. UNIDO could assist with closing the experience gap through the development of study tours and work attachment programmes whereby managers and others are brought to similar facilities in the West and receive formal and on-the-job training in best practice and are exposed to the practical workings of a market economy. As the transformation accelerates in Eastern Europe, there will also be scope for arranging workshops and study tours for management from the FSU to CEE. Another area for improving human resource utilization is in developing linkages between enterprises and research institutes, an aspect almost totally neglected under the central planning system.

Many large enterprises in the West, private and state-owned, have extensive experience of the problems of managing layoffs. For example, the British Know How Fund on behalf of the Polish government has contracted British Coal Enterprises, the subsidiary of British Coal responsible for assisting with redeploying British mine workers following pit closures, to supply SME start-up training and advice in eastern Poland, an area of high unemployment. Similar expertise existing elsewhere in OECD countries could be mobilized by international agencies for the benefit of the CEE/FSU region.

THE PROBLEM OF FINANCING TECHNICAL ASSISTANCE

It is often recognized that a switch from capital to technical assistance may be more beneficial for the CEE/FSU countries at the present time.[124] It is also relatively easy to point the critical need in the CEE/FSU region for technical assistance from the international community as evidenced by the requests received by the OECD Register of technical assistance to the region and directly to the various providers. It is, however, much more difficult to suggest where the money might be found to fund needed technical assistance. There are clearly limited resources available and a reluctance on the part of Western nations, many of which are facing recessions at home, to provide the necessary funds. But, as mentioned earlier, the nations of the West must recognize that it is in their own self interest to help these countries and the challenge is to develop an immediate and substantial programme of assistance. As reported by Mr. Michel Camdessus, Managing Director of the IMF to members of the US congress, the IMF is projecting an achievable growth rate for the states of the former CMEA of 4 per cent in the medium term. This compares to a decline in income of 17 per cent in 1991-92. To put this in perspective, if the rate had been achieved in the CMEA countries, it would have meant a global growth rate of almost 2 per cent in 1992 instead of the actual rate of 1.4 per cent. This is the equivalent of an annual income increase of US$20 billion per annum. Thus the success of these countries before the end of the 1990s could make the difference between prosperity and recession in many regions of the world, particularly in the developing countries. Without foreign assistance, the risk is run that the reform process will halt if not reverse with severe consequences to global security, income, trade growth, migration, unemployment and political instability.

CONCLUSION

In conclusion, this report has covered a lot of ground but in essence it has pointed out that the major challenge facing the countries of Eastern Europe and the international community is how to sustain moves towards democracy and at the same time to design and successfully implement an economic reform programme that accelerates the transformation to a market economy but avoids being undermined by economic and political problems due to the failure of the micro-economy to respond swiftly and appropriately to the large-scale macro-economic changes taking place. The road ahead for the Central and East European countries is uncertain and precarious, but with greater commitment from the countries themselves and support from the international community the transformation to democratic market economies with viable competitive structures can be realized.

Endnotes

[114] In this connection, see the interesting article by Patrick Bolton and Gérard Roland, "Privatization policies in Central and Eastern Europe", Economic Policy, Vol.15, October 1992, pp.275-311.

[115] UNDP, Human Development Report 1992, p.69.

[116] EIU, Foreign Investment in Eastern Europe and the CIS, 1993, Chpt.1, London, 1993.

[117] UNIDO, Foreign Direct investment in Central and Eastern European Countries, PPD.210, 16 June 1992.

[118] Companies surveyed in the EIU study said their biggest concern about investing in the former Yugoslavia was the political outlook. In contrast, it was ranked as the ninth (of eleven) greatest concern for Hungary, which had experienced one-and-a-half years of a stable democratically-elected government at the time of the survey (July-August 1992). EIU, Foreign Investment in Eastern Europe and the CIS, London, 1993, Chpt.2.

[119] EBRD, Paper for the closed session of the Board of Governors, Small and Medium Enterprises, London, 14 April 1993.

[120] See W. Richard Frederick, "Enterprise restructuring in the context of privatization: Background and issue papers", OECD Advisory Group on Privatization, Fourth Plenary Session, Prague, 29 September-1 October, 1993.

[121] UNIDO, Toward Regional Developing in Central and Eastern Europe, PPD.217, 19 February 1992.

[122] A Gini co-efficient is a measure of the relative degree of inequality in a country. Zero is total equality, 100 is total inequality.

[123] World Bank, The Transformation of Economies in Central and Eastern Europe, 1991, Washington, D.C., p.53.

[124] It should not also be forgotten that technical assistance also provides new opportunities for donor country consulting firms, private and commercial bands, not to mention law firms.