DEFENSIVE AND STRATEGIC RESTRUCTURING

IN CENTRAL EUROPEAN ENTERPRISES

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I. INTRODUCTION.

Entreprise restructuring is one of the specific tasks of economic transformation in Central and Eastern European countries compared to structural adjustments, say, in Latin America. Entreprises must not only be reorganized in order to improve their productive efficiency, and thus transform their work organization and incentive structures. They must also transform their output mix by withdrawing capital from particular lines of production and investing it in new ventures. The success of stabilization and other macroeconomic policies depends upon the success of this process of profound microeconomic transformation. It is bound to take place in a situation characterized by an unusually high degree of uncertainty making any assessment of the long-term prospects for firms extremely risky.

The prevailing view on restructuring of state-owned enterprises (SOEs) seems to fluctuate over time. In the early phase of transition, it was largely expected that price liberalization, increased product market competition and restrictive fiscal and monetary policies would create an appropriate environment to which managers of SOEs would be forced to adjust. It was expected that the selection of healthy enterprises and the elimination of unprofitable ones would promptly start. Then, with the first evidence of inertia, expectations about firms' adjustment became rather pessimistic. The behaviour of managers of state-owned entreprises was depicted as one of large scale asset-stripping. Managers were presented as skillful in protecting themselves from pressures to change and as hardly innovative in corporate planning, the development of marketing strategies, reorganization of production, etc. Privatization was generally considered necessary and urgent in order to curb this behaviour. But although privatization has generally proved to be slower than expected (the speed being, however, very impressive in the Czech Republic and in Russia), several recent case studies, enterprise surveys and other empirical studies on enterprise adjustment seem to contradict the pessimistic view of entreprise behaviour before privatization (Pinto *et al.*, 1993, Estrin *et al.*, 1993, Dabrowski, Federowicz and Levitas, 1993, Bouin and Grosfeld, 1994). The message coming from that literature is that in the pre-privatization period of most enterprises in the Czech Republic, in Hungary and in Poland, a significant downsizing of output and employment has occurred. It appears indeed that, different national policies and regulatory framework notwithstanding, the scope of labour shedding and of output retrenchment is remarkably similar in these countries.

What kind of restructuring strategies does such downsizing imply ? How far has the restructuring process gone ? Why do firms restructure even when they are not privatized? Is privatization necessary for restructuring ? What can be said about prospects for restructuring in the three countries ?

In order to answer these questions we introduce in this paper the distinction between two types of restructuring: defensive and strategic restructuring. Defensive restructuring is limited to the cost-cutting activities of enterprises whereas the strategic component of restructuring is defined by a thoughtful business project often implying a change in the production profile and a technological breakthrough, usually necessitating investments in new activities. These concepts are defined more precisely in section 2 where we state the focus of enterprise restructuring. In section 3, we review the existing evidence on enterprise restructuring. We conclude that there has been significant restructuring activity across the board in all countries under review, despite the differences in national policies. However, it appears that the adjustment measures have mainly had a defensive character, the extent of strategic restructuring being much more limited. In section 4, we look at the reasons that might have forced managers of SOE's to be more active than expected in restructuring their enterprises. We argue that this is due to the increased product market competition combined with the hardening of budget constraints. Both contributed to the change in the perceived incentive structure for managers. In section 5, we try to explain what is needed for strategic restructuring. We argue that more profound strategic restructuring requires effective corporate governance which depends upon both changes in the ownership structure and reform of the financial system. We review the progress on these fronts, stress the weak points and comparative advantage of different countries. Finally, in section 6 we formulate some policy conclusions.

II. THE FOCUS OF ENTREPRISE RESTRUCTURING.

Restructuring in transition economies has a double dimension: an economy wide and a microeconomic entreprise level dimension.

At the economy wide level, transition implies a drastic change in the composition of output and in techniques of production. Typically, socialist economies were biased toward heavy industry whereas light industry and services were underdeveloped. The change in relative prices at the initial stage of transition would make some sectors and branches shrink and others develop. However, the directions of these changes proved to be very difficult to be determined *ex ante*. [1]

An important part of output expansion in developing sectors comes from entry by new firms. Evidence so far points toward a strong dynamism of the new private firms. The end of the macroeconomic decline and the return to growth is often attributed to the new private sector (see tables 1 to 4).

The expansion of the new private sector was obviously stimulated by the liberalization of conditions for entry of new firms but also by the rapid progress of small scale privatization and by restitution. [2] An additional impetus to the development of the private sector was given by the transfer of assets from the state sector. This happens in the process of liquidation of SOEs or because the latter want to get rid (through sale or leasing) of unnecessary assets. This phenomenon has been particularly intense in Poland. In Hungary, the process of divestment of the state sector is more ambiguous but to some extent "spontaneous" privatization has also contributed to the development of the private sector ; it is even sometimes considered as the most rapid privatization method. In the Czech Republic the government preferred to leave the responsibility of restructuring decisions to new owners and decided to forbid any sale of assets before privatization by introducing the so called "blocking paragraph" in the status of enterprises privatized through vouchers.

Even though the new private sector may be called upon to play a dominant role in the economy-wide process of restructuring, it does not solve the problem of the existing state-owned entreprises (SOEs). Private firms are typically small and directly managed by the new private owners. They face hard budget constraints from the start and operate directly on markets for goods and services, labour and capital. They exercize a competitive pressure on the public sector, notably through the emerging managerial labour market, but they can also be crowded out by large loss-making SOEs : banks often prefer to lend to state enterprises rather than to private insecure firms. Also, the market power of large SOEs, especially in the non-traded goods market and in markets protected by tariffs, may hinder the entry of new firms. Consequently, the issue of the restructuring of existing firms appears a crucial one. Therefore, in this study we focus mainly on enterprises that are still state owned, are in the process of being privatized or have recently been privatized through the voucher scheme.

Two types of restructuring

The adjustment of the existing state-owned entreprises to market conditions is often discussed in terms of organizational, financial and industrial restructuring. We would like to introduce another conceptual distinction: that between "defensive" and "strategic" restructuring. This distinction proves particularly useful in the context of the available evidence.

The "defensive" part of restructuring means basically taking measures aiming to reduce costs and scale down enterprise activity : cutting the obsolete production lines, shedding labour, getting rid of non-productive assets, etc. These measures are defensive in the sense that their primary goal is the immediate survival of the enterprise. Defensive restructuring does not as such necessarily imply the existence of a strategy for reorienting the enterprise s activity under the new economic conditions. It may be done as a result of survival-oriented behaviour of managers and workers. However, it may also constitute the painful but necessary initial ingredient of a long term strategic plan aiming at maximizing the enterprise s value.

The "strategic" part of restructuring is based on a thoughtful business strategy responding to the necessity of a profound redeployment of assets. It implies the introduction of new product lines and new processes, new technologies and new investments. It necessitates a great deal of entrepreneurial skills and imagination, a good judgement about investment opportunities and adequate incentives. It also requires sources of finance for the new projects. New investments can be financed from the firm's retained earnings, or via financial markets through bank credit and/or issuing of equity and debt on the market. Even though in developed market economies most investments are financed from retained earnings (Mayer and Alexander, 1990) insufficient financial allocation across agents has adverse effects on growth and macroeconomic performance (Roubini and Sala i Martin, 1992; Levine and Zervos, 1993). In the case of Central and Eastern European countries, the adverse effects of financial misallocation are likely to be much stronger than in normal market economies because of the bigger change in the structure of output that must take place. For the same reason, accumulated debts or surpluses from the past, that directly affect entreprises capacity of self-financing, are not a good indicator of future financial prospects. Strategic restructuring inside entreprises is thus intimately linked to the degree of development of the financial sector [3] and the change in corporate governance.

Defensive restructuring must not necessarily precede strategic restructuring. Both parts can (and ideally should) be done more or less simultaneously. The conceptual distinction between these two types of restructuring is however useful because they both adress different problems and do not require the same instruments and skills to be conducted successfully. Success in defensive restructuring does not necessarily mean that the enterprise will (or even can) be able to successfully reorient its business activities. Defensive restructuring may ultimately lead to curtailing of all activities and enterprise closure. Deciding redundancies requires overcoming the resistance of workers but can be done by managers who are convinced that layoffs are necessary and cannot be prevented by bailout subsidies from government. Different skills and institutions are however required in order to ensure success in strategic restructuring. Managers with good investment projects should have opportunities to get adequate finance and investors must have adequate incentives to select and monitor the implementation of the projects.

III. COUNTRY EVIDENCE ON ENTERPRISE RESTRUCTURING

The distinction between the two types of restructuring appears particularly useful if we try to analyze the existing evidence on enterprise restructuring in the Czech Republic, Hungary and Poland. Various empirical studies - large surveys, case studies, some quantitative evidence, press reports -

produce a very contradictory picture and it is extremely difficult to evaluate the degree of actual adjustment of firms. Going carefully through such studies as Estrin et al.(1993), Pinto et al.(1993), Dabrowski et al.(1992) we are confronted with a variety of responses to the transition shock. [4]

Some enterprises are apparently doing well and try to adjust to the new market pressure: they reduce the work force, close unprofitable facilities, sell or lease nonproductive assets. On the strategic side of restructuring the measures mostly undertaken are the setting up of a marketing department (although little funds are usually allocated to it) and changes in the product mix. When investment occurs this is generally through retained earnings. Only firms sold to foreign owners have undergone major investment programmes. Table 5 showing the sources of investment finance at the economy-wide level tends to confirm these findings from enterprise surveys. A second category of firms are passively waiting for restructuring decisions "from above", unable to adopt cost-reducing measures. This is sometimes due to the resistance of workers (especially in Poland). The third group of enterprises whose behaviour is labelled as "ambiguous restructuring" by Carlin *et al.* (1994) appears active in building up different protections from pressures to change and in lobbying government officials or bank personnel in order to obtain some form of help (subsidies, preferential credits, concessions, various exemptions, etc.). Another form of rent-seeking behaviour is the creation of cross-ownership or of holding companies retaining majority stakes in their subsidiaries in order to shelter insiders from outsider control and securing monopoly power for the firm. Sometimes firms take active steps to become independent in order to prevent a break-up of the company by the state.

It is extremely difficult to identify common characteristics of the enterprises in any of these groups. First of all, it seems that sectoral differences cannot provide a *prima facie* explanation for differences in enterprise behaviour: in the same sector we find examples of active adjustment, passivity and opportunistic behaviour. [5] The impact of ownership changes on performance of enterprises is difficult to capture : most empirical studies available until now have mainly been concentrated on the state-owned enterprises [6] or on enterprises that have only recently been privatized. The legal change, i.e. the transformation of the state-owned enterprises into Treasury owned joint stock companies (so called corporatization) does not appear as an important explanatory factor of the change in performance of the enterprises. Interestingly, even in firms leased to or bought-out by the employees, the extent of lay-offs is comparable, if not bigger than in state-owned or privatized companies. From the point of view of ownership changes, the only clear conclusion that can be drawn from case studies and surveys is that a very significant restructuring effort has been undertaken in enterprises in which privatisation led to the emergence of a strategic investor, mostly foreign.

One interesting fact that seems to come out clearly is that, differences in the strategies of transition notwithstanding, on average the degree of cost-reducing restructuring in the three countries appears rather similar. Case studies and surveys consistently confirm large labour shedding. The common reaction of most enterprises in various sectors in the Czech Republic, Hungary and Poland seems to be a significant retrenchment of output and employment. In SOE's, the initiative for such cost-cutting activities comes in most cases from managers of the firms themselves. According to Bouin and Grosfeld (1994) the reduction of employment in a panel of almost 400 large industrial enterprises between 1989 and 1993 has reached 32 per cent in the Czech Republic and 37 per cent in Poland ; sales decreased by 40 per cent in both countries. This result suggests a very significant downsizing which, according to several enterprise surveys, is similar in Hungary.

With respect to enterprise restructuring the differences in policies were indeed quite striking. In the Czech Republic the government decided that privatization was the crucial prerequisite of restructuring and that the latter should be postponed until new owners assume effectively control. Consequently, during the first three years the sale of assets was forbidden and the main form of restructuring were break-ups (Zemplinerova, 1994). In Hungary and in Poland, the privatization process was much slower. Instead of relying on new equity owners, the state and creditors (banks) emerged as alternative agents of restructuring. Moreover, in Poland a number of different programmes have been designed to allow changes in control and to stimulate restructuring before privatization. For instance, in the framework of the so called programme of "restructuring and privatization" management groups were invited to submit a proposal for restructuring and to bid for the right to manage a particular company. Managers were offered a claim on the firm. The value of that claim was tied to performance (70 per cent of the increase in the value of the firm in shares at the moment of privatization). [7] This ambitious and sophisticated programme had a very limited success : only 4 management contracts have been signed. However, it is still considered as a privatization option and is going to be included in a new version of the privatization law. Another programme, called "Stabilization, restructuring, privatization" targets medium size firms in poor financial shape but with good prospects for survival. Seventy five per cent of shares of these firms will be taken over by investment companies created by the EBRD and some Polish commercial banks, who will facilitate access to new credits, improve their management and eventually privatize them. [8] This programme is a variation of the specificity of the polish mass privatization programme : establish, in contrast with the Czech approach, a strong corporate governance in enterprises that are going to be privatized, through the creation of financial intermediaries providing new capital and managerial skills.

In Poland and Hungary the government intervened also directly or through state banks in several large SOEs. In some special sectors (such as oil industry or mining) government agencies are in charge of working out restructuring programmes. The evidence shows that, despite the existence of specific government initiated restructuring programmes, there are no perceptible effects of such programmes (*Transition Report*, p.13). It should be underlined that even in the Czech Republic, despite the commitment of the government to use privatization as the main instrument of restructuring, several sectoral programmes have been elaborated for "sensitive" industries. The Czech government has also participated in financial restructuring of some large industrial firms, such as Skoda Plzen, or CKD Praha (Sojka, 1994).

In none of the three countries were bankruptcy procedures perfectly enforced and smoothly implemented but they progressively became a real threat to enterprises in Hungary and in Poland. They were certainly the most threatening in Hungary in 1992-1993 [9] ; in Poland various liquidation and bankruptcy routes have certainly contributed to harden budget constraints of illiquid firms. [10] The Czech case is an example of a spectacular softening of the constraints imposed on the enterprises by the government engaged in an unusually large scale process of the enterprise transfer from the state to the private sector. The government feared that massive bankruptcies could jeopardize the success of privatization which, for political and economic reasons, was considered essential. It therefore postponed the implementation of the bankruptcy law voted in August 1991 until April 1993. Since then, enterprises privatized through the voucher scheme are protected during two months after the transfer of more than 34 per cent of shares to the new owners has become effective. Moreover, some large enterprises can expect protection in the form of direct subsidies from the Fund of National Property.

With respect to demonopolization, differences were probably less striking. Unlike in East Germany, efforts by Central and Eastern European governments to directly break down monopolies have often met with large resistance. However, actual demonopolization has usually been concomitant with privatization where spin-offs have been taking place either through the initiative of managers or foreign investors. The Polish Anti-Monopoly office has been active in encouraging the splitting of large firms (see table 6). The Czech privatization program explicitly provided for the possibility of spin-offs or partial sales and an intense process of splitting up of firms has been observed since the beginning of the privatization program (see table 7). In Hungary, the Competition Office has more limited powers to enforce breakups of firms. Also, the privatization policy initially aimed at selling large firms to foreigners rather than break them up.

To summarize the evidence reviewed in this section, a great number of enterprises, whether state-owned or privatized, have taken initiatives in cutting costs and downsizing. Defensive restructuring is however more prevalent than strategic restructuring. New investment, aiming at reorienting and profoundly modernizing the enterprise's activity, is taking place mainly in enterprises privatized to foreign investors. Another category of enterprises are following a strategy of entrenchment and display rent-seeking or rent-protecting behaviour.

IV. HOW TO INTERPRET THE EXISTING EVIDENCE?

Three important questions are raised by the available evidence on enterprise restructuring.

First of all, why do enterprises adjust at all? Indeed, not only do managers play an active role in downsizing, but most of the redundancies and cost-cutting decisions result from the initiative of enterprise managers themselves. The extent of these managerial initiatives was unexpected by most analysts who predicted that cost-cutting activities would be taken either only after privatization of the enterprises or after reassertion of state control.

Second, how does one explain the interfirm intrasectoral differences in adjustment? Differences in restructuring behaviour can in many cases be traced back to differences in demand and supply shocks to which the enterprises were confronted after price and trade liberalization and CMEA breakdown. But how does one explain that enterprises in the same sector, confronted with similar demand and supply shocks, display substantial differences in restructuring behaviour, some remaining passive, and others restructuring actively?

Third, why has strategic restructuring been relatively modest so far and what can be done to stimulate strategic restructuring ? We shall adress the first two questions in turn. The last question, crucial for the long term performance of these economies, will be treated in section V.

Why do enterprises restructure at all?

Despite significant differences in national strategies of transition, and without notable incidence of the form of ownership transformation, downsizing and cost-cutting activities have been massively undertaken by existing management. In our view this may be explained by the combination of two elements : changes in the *market environment* and in the perceived *incentive structure* of enterprises.

Dramatic changes in the market environment of enterprises have taken place at a sweeping pace since 1989. In a matter of days and weeks, Polish enterprises, subject to the simultaneous shocks of price liberalization, trade liberalization and fiscal stabilization in January 1990, plunged from a shortage economy characterized by a sellers' market into a buyers' market where firms must compete to sell their products. Similar changes took place in Czechoslovakia in early 1991, even though fiscal stabilization was less an issue due to more balanced initial macroeconomic conditions. Even though price liberalization proceeded more gradually in Hungary, price and trade liberalization accelerated substantially between 1989 and 1991. Last but not least, the CMEA breakdown constituted a price liberalization at the level of the whole region. Together with price liberalization, efforts at demonopolization and the spectacular growth of the new private sector reinforced product market competition.

These dramatic changes in the market environment spectacularly affected both the upside and downside risks facing enterprises. On the upside, tremendous new profit opportunities were created, both on domestic and foreign markets. On the downside, wrong decisions or failure to adjust meant losing markets to domestic or foreign competitors or to new entrants, or eventually liquidation. These changes in the market environment represented a huge *potential* change in enterprise incentives. It is worth emphasizing the potential character of these incentive changes. Indeed, state-owned enterprises with low-powered incentives would not necessarily be induced to make the efforts to seize the new profit opportunites offerred by market liberalization. Similarly, SOE s losing market shares to competitors or facing market collapse for given product lines would have little incentives to adjust if they expected to face continued soft budget constraints and be bailed out by government subsidies. It is for these incentive reasons that most analysts feared that without fast and massive privatization, enterprises would fail to adjust to the changes in market environment. In practice, however, it turns out that SOEs did respond to these changes. The reason is that market liberalization, combined with restrictive monetary and fiscal policies together with privatization, reform of the financial system and the progressive enforcement of bankruptcy laws contributed to change the perceived incentive structure of firms, acting as indirect or potential constraints on enterprise behaviour, even if not present as direct constraints.

Changes in the incentive structures were of a twofold nature. First of all, enterprises perceived an increase in their *positive incentives*, that is higher potential rewards on the upside. Symmetrically, they perceived an increase in their *negative incentives*, that is the potential penalties on the downside. Managers in enterprises more subject to upside risks expected higher benefits from efforts to increase profits or to accelerate privatization and attracting private investors. Similarly, managers in enterprises facing more downside risks perceived a general hardening of their budget constraints.

Positive incentives

Privatization and, even more importantly the credibility of privatization, significantly contributed to increase positive incentives for managers. In the early phases of transition, it was believed that managers would generally be hostile to privatization. The implicit assumption was that most managers would lose their jobs after privatization. However, given the credibility of the regime change and of privatization policy, managers understood that privatization is unavoidable and that rather than oppose it, they should try to take advantage of it. A rather common feature in the three countries is the fact that most incumbent managers have retained their position. Probably the highest 'turnover' could be observed in the Czech Republic : as a consequence of the "lustration" law several top managers of SOEs have been dismissed.

The available evidence on restructuring shows that one of the reasons why managers actively restructure is that they hope to signal their managerial skills and to position themselves in the process of privatization. This evidence can be explained by career concerns of managers (Holmström, 1983), a motive that has been put forward in the context of transition in models by Roland and Sekkat (1993, 1994) and Aghion et al. (1994). [11]

This is clearly what happened in the Czech Republic. In the process of large-scale privatization managers could submit their own privatization projects proposing a particular ownership structure and a privatization method. Choosing the sale to a foreign investor or the distribution of shares through the voucher scheme, which was generally expected to give rise to a dispersed ownership, strongly increased the probability for managers to remain in place. [12]

Carlin et al. (1994) in their survey of case studies tend to downplay career concern effects because the managerial labour market is weakly developed and also because the measure of entreprise performance in transition economies is surrounded by noisiness. Performance noisiness may somewhat mitigate this career concern effect but does not eliminate it. The very imperfect managerial labour market in Central Europe is strongly fueled by the buoyant private sector. For many managers however, the costs and efforts associated with defensive restructuring are quite high relative to the payoff they may expect from privatization. In those cases, offerring stock options to managers contingent upon privatization provides them a useful incentive to increase their restructuring activity.

Negative incentives

Changes in the negative incentives have been associated with a battery of policy measures which could convince managers that budget constraints were becoming harder. Stabilization policies, significant reductions in state subsidies, the implementation of bankruptcy laws and procedures, commercialization of the financial system, the end of automatic credit by banks and again the credibility of privatization policy contributed to convince managers that gambling on bailouts was becoming increasingly risky and potentially costly. Despite evident elements of inertia, the expectational changes that have taken place have tended to mutually reinforce each other. With hindsight, it appears that the massive political and economic changes that took place between 1989 and 1991 convinced economic agents that a return to the past was excluded. This was however less obvious to Polish managers in January 1990 when the future was much more uncertain. Updating of expectations with respect to regime changes took thus place more gradually than the changes themselves. Credibility had to be built up with time. However, even gradual expectational changes tend to reinforce each other. Enterprises and banks become more reluctant to accept payment arrears by their clients if they are less sure than before that bailouts will take place, even though expectations of bailouts may remain high. A higher reluctance to accept payment arrears reinforces the general perception of a hardening of the budget constraint which leads to further changes in expectations, leading to further changes in behaviour, and so forth.

The increased financial discipline does not mean that the budget constraint suddenly became hard all of a sudden. The experience in various transition economies shows that efforts to drastically enforce hard budget constraints are often partly undone and that various measures softening budget constraints may change forms across time and countries. Drastic cuts in fiscal subsidies often leads to a deterioration of the "bad loan" problem in the banking sector, because hidden subsidization takes place in the form of bank credits. Efforts to toughen financial discipline in enterprise-bank relationships often lead to an increase in interenterprise arrears. Similarly, measures to get rid of interenterprise arrears often result in higher tax arrears. Such shifts are documented in all countries. Depending on time and country, soft budget constraints appears mostly in the form of tax arrears, non-performing loans or interenterprise arrears. Nevertheless, continued measures to impose harder financial discipline contribute to reinforce negative incentives.

Privatization policies, bankruptcy laws and financial reforms and other measures aiming at hardening budget constraints have been quite varied in the countries under review. The credibility of privatization was certainly higher in the Czech Republic than in Hungary and in Poland. However, this important difference was probably compensated by the greater softness of the Czech government on bankruptcy compared to Hungary and Poland, as shown in section III.

In summary, it appears that several indirect constraints imposed on the managers have changed their positive and negative incentives and contributed to adopt defensive restructuring measures, notably a significant reduction of output and employment. Among these constraints are : increased competitive pressure due to the development of the private sector, demonopolization and trade liberalization ; the credibility of the privatization process ; hardening of budget constraints due to restrictive monetary and policies, the hardening of bank and interfirm credit, progressive enforcement of the bankruptcy law. Although in the Czech Republic, because of the postponement in the enforcement of the bankruptcy law, negative incentives might be weaker than elsewhere, they were probably compensated by positive incentives created by the very rapid and credible privatization process. Hungarian and Polish managers, less convinced about the unavoidability of privatization, i.e. having less positive incentives for restructuring, were more constrained by negative incentives and notably by the higher risk of bankruptcy and liquidation.

How to explain intrasectoral differences in restructuring performance?

All surveys and case studies point to the differences in restructuring behaviour of firms operating in the same sector and in principle subject to similar demand shocks. How then can one explain that some firms in the same sector restructure whereas others remain passive?

It seems to us that, abstracting from idiosyncratic shocks due to good or bad luck for individual enterprises, the most likely explanation for this phenomenon is due to heterogeneity in managerial skills and also to various degrees of worker resistance to restructuring. Even though the legacy of central planning implies a general weakness in business skills of managers, there is nevertheless a marked heterogeneity in managerial competence with respect to the capacity to adjust to new circumstances and to successfully initiate various aspects of defensive restructuring. Managers also tend to differ markedly in their ability to learn. Those who are unable to adapt could function under the old rules emphasizing more bureaucratic loyalty and obedience, but are unable of independent judgement and initiative in an uncertain environment. Transition represents a huge depreciation of human capital for that category of managers. As a consequence, many managers in that category expect much less to keep their jobs under privatization, and count either on inertia to help them survive temporarily, or even engage in entrenchment strategies to avoid privatization and restructuring.

It is important to emphasize this heterogeneity in managerial competence not only because it explains differences in behaviour but also because it suggests that efficient allocation of managerial skills is of crucial importance. This heterogeneity in managerial skills also requires heterogeneity in the policy approach to managers. Positive incentives tend to work well to encourage good or relatively good managers to engage in restructuring. Similarly, negative incentives operate for managers able to adjust and avoid important mistakes. However, for those managers who expect to lose their job anyway, they find themselves in an "end game" situation where they have little to lose. Such managers have incentives to coalize with those workers who fear redundancies in order to oppose restructuring. In that case, the problem to solve is less to provide incentives for restructuring than to overcome resistance to it, and in particular to get rid of incompetent managers. The establishment of adequate corporate governance arrangements will allow to solve this problem. However, firms run by such incompetent managers are, in many cases, not likely to be privatized easily. One way of dealing with the problem of incompetent managers is to let outsiders take control of the firms through auctions for management contracts (see section III).

V. PREREQUISITES FOR DEEPER STRATEGIC RESTRUCTURING.

As seen above, restructuring in Central Europe has mostly been initiated by incumbent managers. Most of these restructuring activities have been of a defensive nature and little strategic restructuring has been undertaken so far. It has mainly been observed in firms sold to foreign investors. The general investment level remains relatively depressed (see table 8). Even though the performance of managers in the defensive part of restructuring has proved unexpectedly positive so far, the skills required for strategic restructuring are probably scarcer. Being able to cut production in loss-making units does not necessarily mean that one is good in marketing and finance, in reorganizing production and has good projects for reorienting production. Entrepreneurial skills and strategic projects can sometimes be generated within the firm but often will have to be brought in from outside the enterprise. Also funds necessary to finance good restructuring projects are often lacking and must be brought in from outside.

This points to the importance of corporate governance, that is of the establishment of adequate ownership structures together with the establishment of a well-functioning financial system. Privatization changes incentives - positive and negative - for owners and managers. Financial systems provide finance for investment but also alleviate the problem of moral hazard and asymetric information : they generate and transmit information about companies and control managerial performance. Both privatization and the development of the financial system stimulate the search for managerial excellence. Initial concerns with privatization have led analysts to focus too much on the initial transfer of State assets into private hands, and to neglect questions related to the reallocation of assets inside the private sector, i.e. to the emergence of financial markets and to financial reform. The latter is however crucial for the success of strategic restructuring.

In order to understand why strategic restructuring has not proceeded too far yet, we now look at the progress of privatization and financial reform and their contribution so far to enhanced corporate governance.

Changes in the ownership structure.

Privatization to foreign outsiders proved to be until now the best guarantee for restructuring. [13] Hungary has started the privatization process by privileging this route. It has managed to attract a relatively impressive amount of foreign investment in this process (6 billion dollar since 1989, i.e. half of total foreign investment in Eastern Europe). However, the demand for privatizable assets by foreign investors is well below their supply, and in the same time there is a growing popular resistance to this form of privatization.(Cf. the recent conflict over the HungarHotel chain). In Poland investment in firms sold to foreign investors is 10 times higher than in firms sold to domestic investors and 20 times higher than in firms having a dispersed ownership structure (Dabrowski, 1995). However, foreign investment in Poland in 1994 dropped by 19 per cent from 1.65 billion dollar in 1993. (*Warsaw Business Journal*, 20-26.1.1995)

Privatization to domestic investors - through initial public offerings, trade sales and auctions - is also limited due to low levels of private wealth. However, some forms, initially deemed as secondary, as the liquidation procedure in Poland or self-privatization in Hungary, proved to be very effective. These forms of bottom-up privatization have allowed managers and employees to purchase or lease their enterprise. Not suprisingly, bottom-up privatization proved to be very popular but it has occurred more in smaller enterprises than in larger firms. In Poland, at the end of 1993 about 600 enterprises, i.e. about 75 per cent of all privatized firms, were leased to the employees. These firms employ about 145 000 people, i.e. about 55 per cent of total employment in privatized firms. In Hungary, about one third of 412 firms sold in the framework of self-privatization programme can be considered as buy-outs (Filatochev et al., 1994). Various studies of post-privatization changes in Poland indicate that in bought-out firms defensive restructuring is on average as intense as in the whole enterprise sector (Jarosz, 1994). [14] For firms privatized to insiders, the inability to raise external finance remains however a key impediment to strategic restructuring. In cases where ownership has progressively become more concentrated mainly in the hands of managers (Hungary) and/or outsiders (Poland) the implementation of long term restructuring measures occurs more frequently. [15]

The most original and spectacular element of privatization policies in Central and Eastern Europe is mass privatization where state assets are given away to the population. In the Czech Republic, in the two waves of large-scale privatization, vouchers were sold for a relatively small fee to adult citizens, allowing them to bid for shares of any company privatized by the voucher method or entrust their investment points to one of the Investment Privatization Funds (IPFs). The main concern of the Czech voucher scheme was to privatize rapidly : other goals such as restructuring or establishing a corporate governance were supposed to be secondary and realized through privatization. Speed was considered an important objective to achieve irreversibility in the transition process, by signalling government s commitment to reforms, but also by giving stakes to the population in the success of the privatization programme. From that point of view, Czech mass privatization can be seen as a success. Vaclav Klaus has not only made clear that his political future was irreversibly tied to the success of mass privatization, but he has also managed to reinforce his own political support inside the population through mass privatization. The Czech success has favourably impressed international investors and contributed to increase foreign direct investment in the Czech republic.

The most important fear expressed vis-à-vis the Czech voucher scheme was that it would create a structure of dispersed share ownership, very bad from the corporate governance viewpoint. With dispersed ownership, owners have little incentives to monitor the firms, and do not necessarily have the funds to finance strategic restructuring. However, the fear of dispersed ownership did not materialize. Investment privatization funds (IPFs) emerged spontaneously in a regulatory vacuum and attracted about 75 per cent of all voucher points, promising Czech citizens a tenfold return on the voucher price. The typical ownership structure of a Czech company privatized through the voucher scheme appears to be as follows : two funds own 20 per cent of shares each, two other funds own 15 per cent of shares each, and individual investors own 30 per cent of shares. The question obviously remains whether IPFs will actively monitor the managers of the firms in their portfolios. It is still too early to have a clear answer to that question. Preliminary evidence suggests that funds having invested in relatively low number of companies consider that they must actively participate in the strategic management of companies in their portfolio. Although according to the Czech corporate law, based on the German-type two-tiers system, shareholders can control managers through the intermediary of supervisory board, several funds choose to be represented on the management board. For instance, the Managing Director of the Harvard Stock Exchange Company explicitly admitted that because up to one third of the board members can be elected by employees and consequently block some important decisions, Harvard preferred to sit directly on the board of directors rather than on the supervisory board (Wendelova, 1993).

The problem that however remains acute is corporate governance of the funds themselves : out of 400 IPFs that emerged spontaneously during the first wave of voucher privatization, the six biggest companies have been established by banks (partly privatized themselves through the voucher scheme) and acquired 42 per cent of shares obtained by all funds and 26 per cent of shares distributed in the first wave. Therefore banks became owners of a large part of non-financial companies but also, through the intermediary of their daughter investment companies, they came to own each other (Grosfeld, 1994 b). Another unresolved issue is the problem of corporate governance of the banks themselves in the situation where the state retained 45 per cent of shares and other shareholders remain dispersed. The Czech government seems to be worried about the fact that major commercial banks acquired such a great power in the process of voucher privatization. For the time being, its main concern however is to get rid of shares it owns in banks.

Ironically, the Polish mass privatization programme which attempted to prevent dispersed share ownership and still achieve the goal of speed has not yet come off the ground. In the Polish scheme, the shares of 444 enterprises are to be distributed to 15 investment funds set up by the state. Members of the 15 supervisory boards have been appointed by the government after a severely criticized selection procedure. The funds are to be managed by professional managers, essentially foreign but preferably in cooperation with local partners. It is expected that foreign managers will bring their expertise and will have better access to capital markets than Polish managers. Because in Poland restructuring was seen as the most urgent task, the allocation of enterprises should allow an individual fund to acquire a large block of shares (33 per cent) giving it sufficient control to initiate restructuring. [16] Also the incentive scheme for fund managers is supposed to stimulate active restructuring instead of passive trading of shares : the constant part of remuneration is supplemented with stocks (1 per cent every year plus 5 per cent at the end of the 10 year period). Every citizen can get a perfectly diversified portfolio representing one share in each fund. After the initial period this special security will be tradeable for shares of individual funds or for shares in firms. After three years of political stalemate, at the beginning of 1995 the programme eventually started to be implemented.

Clearly, initial conditions and political constraints vary across countries. Poland, like Hungary but unlike Czechoslovakia, had a history of partial reforms before transition. The last years of the socialist regime were characterized by reforms that tended to increase the autonomy of managers vis à vis the state and economic ministries without increasing their responsibilities. These reforms affected the corporate governance of firms and considerably weakened state control over enterprises (Frydman et al. 1993). This loosening of control has tended to increase the soft budget constraint syndrome and has contributed to the macroeconomic imbalances characterizing most countries at the beginning of the transition period. Since then, it has proved very difficult to reassert the state s ownership rights over enterprises in Poland and Hungary due to resistance from insiders. This problem was not present in Czechoslovakia where the State had kept a firm grip over enterprises.

To summarize our discussion of ownership changes, strategic restructuring has mainly occurred in firms privatized to foreign investors. Foreigners are usually dominant investors and have adequate incentives to monitor and eventually replace managers, and provide capital necessary for profound restructuring. In the case of enterprises sold to insiders the availability of capital is the main impediment to restructuring. In the enterprises privatized through the voucher scheme the main problem is the monitoring task that will have to be performed by financial intermediaries since dispersed shareholders have few incentives to monitor firms. The development of financial intermediation will provide screening mechanisms, allowing to separate good from bad projects, and provide finance to the former. For strategic restructuring to take place, privatization must therefore go together with the reform of the financial sector. We now briefly review the progress made, bring up current problems and policy options.

Progress with financial reform

We start by discussing progress in banking reforms. The Central European countries came a long way from the previous banking arrangements. The monobank system characteristic for the centrally planned economies has been dismantled and transformed into a two-tier system based on the separation of the central bank and of commercial banks. Also, one of the decisions taken at early stages of transformation was to allow for the entry of new banks. Nevertheless, the state commercial banks that emerged from the old system retained a large and dominant share of the market. Even in the Czech Republic, where mass privatization programme could be expected to contribute to the development of the stock market, banks, privatized themselves through the voucher scheme, paradoxically and unexpectedly emerged as very powerful actors.

In all countries under review, banks, initially burdened with bad loans, have partly cleaned up their balance sheets through various programmes of financial restructuring, consolidation or capitalisation.

In Czechoslovakia, early recapitalization took place in 1991. Also a special bank, the Consolidacni Banka was set up to deal with bad loans. In Hungary, a first recapitalization took place in 1992 and bad debts were placed in a credit consolidation fund. A second recapitalization however took place in December 1993. That recapitalization scheme seemed to punish banks who had been trying to restructure their loan portfolio as recapitalization was highest in those banks having the worst loan portfolio. Another recapitalization in May 1994 aimed to raise the capital adequacy ratio to 4 per cent.

In Poland, the rationale for the Law on Financial Restructuring of Enterprises and Banks was that the consolidation of the financial system would not succeed if the enterprise sector were not restructured at the same time. The *ex ante* recapitalization was linked with the imposition on banks of the obligation to take a decision about debts qualified as bad. Several options were available to creditors : they could sign a conciliation agreement (involving conversion of debt into equity, debt reduction and debt rescheduling) or, if a debtor was considered non viable or did not agree to a restructuring plan, banks had to sell the loan in the open market, to file for bankruptcy in the court or initiate liquidation. [17] Preliminary results of the financial restructuring undertaken in the framework of the law suggest that it turned to be quite beneficial to banks : banks have been capitalized, the share of bad credits in banks' potfolio decreased, banks acquired some expertise in dealing with bad debts and most of them are in the process of putting in place more or less independent departments or funds specialized in investment banking. On the enterprise side it is too early to assess the impact of the law. The bank conciliation procedure has been designed for dealing with large enterprises and the latter have indeed been involved in most settlements. However, the perverse effect of the law seems to be its impact on small and medium enterprises in relatively good condition. There is some evidence that they had to bear the cost of the restructuring operation : as minority creditors they had to accept reductions of their debts and could be forced into a restructuring agreement.

To be sure, there remain important problems to be solved in the banking sector, and some of these problems may partly explain the slow progress in strategic restructuring. Here again, as with entreprise restructuring, evidence of improvement of prudential behaviour does not mean that one has achieved the "normal" level of functioning which is that of a market economy. According to Dittus (1993), it would seem that banks remain relatively undercapitalized.

Paradoxically, even if one takes the optimistic view that bank behaviour is changing, it may be the case that banks are at the same time too hard and too soft . The available evidence (Dittus, 1993) shows that the improved financial health of the banking sector contributed to more cautious behaviour of banks and to the hardening of budget constraint for the enterprises. Banks in general tend to be soft on existing clients because they have an *ex post* incentive to refinance bad loans in the hope to recover their initial loan (Dewatripont and Maskin, 1992). Reforms that allow banks to get rid of bad loans and to clean up their portfolio mitigate this incentive. However, because banks seem to believe that recapitalization will not occur again (although in Hungary such expectations would probably hardly be rational) and prefer to engage in little new lending. [18]

One of the most important obstacles to new lending is the weakness of collateral, playing an analogous role to the absence of private wealth for privatization policies. As pointed out by E. Berglof (1994) the important limits to collateral finance in economies in transition are due to the absence of liquidity of capital markets. This low liquidity is due to the general lack of private wealth coupled with poor enforcement of property rights and economic depression. Because possibilities for collateral finance are limited, for strategic restructuring to take place at a sufficient level, insiders will have to accept to be monitored by outside investors.

The question is raised whether banks in Central Europe can play a role as universal banks in active screening and monitoring of strategic restructuring projects of firms. In the Czech Republic banks emerge from the process of privatization with strong industrial equity holdings. Most investment funds are held by banks. It has been an unexpected consequence of the weakly regulated privatization process. An ex post argument for letting banks becoming holders of an important part of enterprise equity was that as they were already major creditors of enterprises they are bound to have strong motivation to closely monitor the companies in their portfolio (Buchtikova and Capek, 1994). In Poland, in the law on financial restructuring debt/equity swaps were considered as the key mechanism of solving the problem of bad debts. Here, banks were encouraged and given incentives to take equity holdings of firms. However, they proved to be reluctant to swap debt into equity and to take control of enterprises : they do not feel competent enough to provide strategic guidance to enterprises and to control day to day management.

The recent literature on corporate finance stresses the complementarity of the role of debt and equity in providing incentives to insiders (see e.g. Dewatripont and Tirole, 1994). Debt is a useful way to limit moral hazard in good states, i.e. it limits the drive towards empire-building or tendencies to make excessively risky investments. On the other hand, in the presence of limited liability, equity allows to limit moral hazard in bad states, i.e. it gives incentives to restructure when the firm is in a bad shape. Given the importance of this type of moral hazard in Central Europe the emphasis should be (and is likely to be) put on equity financing with core investors exercising a high degree of monitoring and control.

These considerations suggest that ideally venture capital funds are needed as financial intermediaries. In the West, venture capital firms finance new companies or the expansion of existing operations which have a very uncertain pay off or which normally take several years before significant expected returns can materialize. This seems to be the case of a great number of firms in Central Europe, especially with respect to strategic restructuring. In venture capital firms, the provision of capital (through the purchase of stocks, options or convertible securities) is correlated with managerial expertise, monitoring and selection functions. This is notably the case of independent venture capital companies which are not owned by banks or other financial intermediaries (as opposed to "captive funds" being usually bank subsidiary (Beecroft, 1994)). The managers of such funds usually have skills that go beyond purely financial analysis : they provide strategic guidance, business expertise and experience in industrial management, marketing, etc. [19]

Few venture capital firms have yet appeared in Central Europe [20], but one may expect investment privatization funds to play the role of active institutional investors. Some of those that have spontaneously emerged in the Czech Republic have started already to actively participate in corporate restructuring. In Poland, for the time being, there are no financial intermediaries other than banks (except one mutual fund Pioneer). Investment privatization funds are likely to appear only if the mass privatization programme is implemented. Again, it would be better if they were independent from banks. If we look at financial systems as devices for generating and transmitting information necessary for the improvement of resource allocation it is important that the emerging strong investment companies have the legal form of closed end funds whose shares are traded on the stock exchange. Closed end funds seem better suited than open end funds to the conditions of emerging markets characterized by low liquidity.

If it is natural that banks participate as senior creditors in reorganizing defaulting firms, it is not sure that they have comparative advantage in working out corporate restructuring programmes or even be at the same time creditors and shareholders. But should banks be discouraged or prohibited by regulation to hold equity in firms if they wish to do so?

Although there are good reasons to be worried about banks holding equity in firms, given the uncertainty related to the emergence of financial systems in Central Europe, it is better to leave as many options open as possible. In any case, prospects for entry in the European Union and the implied consequences in terms of harmonization of legislation mean that universal banking will be allowed.

Leaving as many options open as possible does not mean that there should be a regulatory vacuum. One should strictly forbid situations like those that have appeared at the beginning of transition in Hungary for example, where enterprises became the main owners of the bank giving them loans. There is no good reason for retarding the implementation of B.I.S. rules, and especially capital adequacy ratios, necessary to reduce excessive risk taking, especially when deposit insurance is present.

Leaving as many options open as possible means that it would be wrong to encourage only one type of financial system or of financial intermediaries. An important concern in central Europe is related to the informational role of financial systems. Encouraging strong links between banks and enterprises may hinder the generation of information about different investment opportunities. Banks know well enterprises with which they have been linked for a long time. They may have privileged access to a specific type information, notably that helping to alleviate moral hazard : they may gather information on managerial slack and actual return. This knowledge, however, which is often considered as the main argument for making banks play an active role in the restructuring of the enterprise sector, does not seem to be adequate to provide a fresh view of the company's potential. Different managers and investors may have different ideas about the possible future performance of firms and they should be induced to spend time and resources on searching improvements relative to the plans of incumbent managers (Grosfeld, 1994 b). How can such external assessment by third party bidders be provided ? Is there an alternative to banks being agents of restructuring ?

The recent experience in Poland shows a spectacular development of the secondary market for debt. It is partly the result of the implementation of the law on financial restructuring of banks and enterprises. It suggests that instead of making banks swap debt into equity it may be possible, and certainly desirable, to allow them to sell debts on the market and let the buyers convert debt into equity. It would be an interesting alternative method of privatization leaving the responsibility of reorganization or liquidation to those who give the highest value to the debt of the firm.

The development of the stock exchange can also help to generate alternative valuations. We are aware of course of the limited capacities of the stock markets emerging in Central Europe to fully exercize their information and control functions : the number of listed firms is very limited in Hungary and in Poland and stock market participants are (especially on the Warsaw Stock Exchange) mostly unexperienced individuals. [21] However, there is no reason not to stimulate the development of the stock markets and stock markets and banks are called upon to play a complementary role. An advantage of mass privatization programmes from that point of view is that they bring an important number of firms to the stock exchanges. Even if the latter are initially weak in transition economies they certainly provide incentives to competitive assessment of firms' expected future performance which is crucial for high quality restructuring. They may also, in a not too distant future, provide an alternative source of finance. Although in developed countries stock markets play a marginal role in investment financing, in developing countries their contribution is important (Singh and Hamid, 1992). According to the president of the Polish Securities Commission, the Warsaw Stock Exchange has already become an important source of finance : in 1994 it provided 10 per cent of total investment finance. (*Rzeczpospolita, 22.12.1994).*

Much but not all profound, strategic restructuring need new finance. The weakness of the banking sector is often an impediment to the realization of important investment projects (for instance in Polish shipyards which have investment needs exceeding the possibility of financing of the whole banking sector). Also small and medium firms typically have difficulty in obtaining finance for their projects. But a number of improvements can be carried out without large new outside finance (Nowotarski, 1994). Buchtiková and Capek (1994) suggest that in 1992 the enterprise sector in the

Czech Republic "more than covered its investment needs". Several fund managers in Poland and in the Czech Republic stress the fact that the bottleneck of financing investment projects is not the lack of capital but the scarcity of good ideas with reasonable prospects for success (Lipinski and Dunin-Wasowicz, 1993; Andersen, 1994). It is often underlined that the most valuable element that is lacking is good judgement about strategic goals of restructuring (Wendelova, 1993). Hence, again, the potential role of venture capital.

The extent of strategic restructuring is limited by the development of financial systems. We emphasized above the limitations in managerial skills for restructuring. Here again, it is useful to emphasize the current limitations of skills in financial intermediation in Central Europe. No blueprint for a perfect financial system can replace the need for those skills to develop together with the experience accumulated through continuation of privatization policies and through the encouragement of the emergence of various sorts of financial intermediaries.

VI. WHAT REMAINS TO BE DONE.

1. The three economies have already profoundly changed due to the appearance of a large private sector. The importance of the private sector is growing and its development should be of primary concern for central European governments. The stability of rules and regulation, prices, tariffs and of the fiscal system are of paramount importance to generate a high level of private savings and investment. Progress with financial reform is also crucial to the fast development of the new private sector, and we will come to that below. The continuous growth of the private sector is also one of the most important conditions of a credible enforcement of hard budget constrains. To the extent that the new private sector and privatized enterprises are independent from government for their external finance, it becomes more difficult and more costly to unduly tax these firms to finance soft budget constraint in bad firms. The growth of the private sector also increases constituencies in favour of further reform. Moreover the growth of the private sector allows to absorb more easily the labour force laid off in the firms that are closed.

2. Many existing state-owned enterprises in the three economies have adjusted under the pressure of indirect constraints related to the general change in their market environment and to a drastic change in expectations. The credibility of this change was reinforced by the actual hardening of the budget constraint. It is obviously crucial to be careful not to destroy this credibility. Especially dangerous are various anti-competitive pressures coming from protectionism, the tendency to create sectoral lobbies, holdings, large financial-industrial groups, cross-ownership, etc. The rationale behind these developments is to recreate security, to assure protection against uncertainties of the market, and, given the weakness of the financial system, to provide finance internally. The danger however is that this will lead to recreate the perverse cross-subsidization where the poorly performing units know they will be bailed out by extraction of resources from the better-performing firms, thereby removing high-powered incentives in the latter. Another danger of large groups is that they transform into powerful lobbies engaging in rent-seeking activities to influence government policy in their favour. The commitment of the governments to maintain the transformation line should thus be credibly reassured again and again.

One cannot underestimate the importance of the perspective of entry in the European Union as instrument to stabilize expectation in the right direction. Just as the process of entry of Spain allowed to anchor expectations of democratization in the right way, the prospect of entry in the European Union provides a powerful lighthouse to focalize expectations of marketization in Central Europe. The Europe Agreements are a first step, but further steps need to be taken on the side of the EU. We are conscious of the difficulties of integrating Central European countries in the EU (see e.g. Baldwin, 1994), but we view it as absolutely crucial not to close the door of EU to these countries.

3. The continuation of privatization policies is necessary in Central Europe. Although the existing evidence with respect to restructuring confirms the increased concern with short-run costs, the quality of this restructuring can basically be described as defensive : there is little evidence that long-run prospects are the main determinants of most adjustment observed so far. The perspective for a more profound strategic restructuring depends upon the emerging corporate governance of firms which in

turn will be determined by the ownership structure and the development of the financial system.

In Poland and Hungary, the evidence of restructuring of enterprises before privatization is sometimes used to claim that privatization is not necessary and that restructuring of enterprises could take place in the absence of any privatization policy. We think this conclusion is wrong and potentially dangerous. It is wrong because it is precisely the general change in expectations and the newly created prospects for individual firms to become privatized that created the drive for manager-led defensive restructuring. It is dangerous because a loss of momentum in privatization could reduce the prospects for strategic restructuring.

Product market competition is not a substitute for the mechanism of corporate control. At the initial stage of transformation, when efficient corporate governance was lacking, increased product market competition played an important role. But for strategic restructuring to take place, both efficient corporate governance and competition are important.

The momentum of privatization must be maintained by continuing to push ahead the existing forms of privatization, reinforcing those that have proved effective and by promoting new forms of privatization. Some forms, initially deemed as secondary as the liquidation programme in Poland or Self-privatization in Hungary, proved to be very popular. In Poland, it is very important to implement and possibly extend the Mass Privatization Program.

4. It is essential to establish credible and flexible procedures allowing the elimination of non-viable firms and making possible for firms that can survive to restructure themselves. In none of the countries is excessive piecemeal liquidation a real danger. On the other hand favouring reorganization by insiders may perpetuate inertia and soften budget constraints. Outsiders should be allowed to exercize their voice.

We have suggested making use of the sale of bank and non-bank loans on the open market as an additional form to attract private investors. Those who value the debt highest may have the best reorganization ideas. Some non-bank debt-bought-on the secondary-market/equity swaps have already occurred in Poland and seem to indicate a new interesting privatization route. This instrument could be used in other countries as well.

5. It is important to leave a great number of options open for the development of the financial systems.

First of all, the development of financial markets and financial intermediation is directly correlated with progress in privatization. The Czech Republic is the most spectacular example where the privatization program has accelerated the development of the stock market. The development of markets for corporate securities cans strongly depend upon the disclosure requirements imposed on firms. In Poland, the fact that firms issuing shares to the public are required to reveal a lot of financial information, can encourage non-intermediated finance. In the Czech Republic it would be important to provide potential investors with more information than is available until now.

For the stabilization of financial markets, it is essential that institutional investors emerge. The Warsaw Stock Exchange has until now been dominated by volatile and unexperienced individual investors with only one mutual fund : Pioneer. Again, the 15 National Investment Funds created in the framework of the mass privatization programme may contribute in a significant way to the stabilization of the Warsaw Stock Exchange.

Pension funds could also be a potentially stabilizing intermediary. The reform of the social security and pension systems can strongly fuel the capital market.

Privatization of banks is also very important to develop a system of private financial intermediation that is independent from the government. This has proved to be a difficult task, as foreign banks have not been rushing to purchase domestic banks in Central Europe. Efforts to privatize banks through various means should however continue. This is especially true in the Czech Republic where the corporate governance of banks has become an acute problem due to the interlocking ownership relation with the investment funds. In Hungary, it is important to try to inject some transparency in the ownership structure and to eliminate ownership of banks by enterprises who are their main depositors. In Poland the intended consolidation of state-owned commercial banks may hinder their privatization and destroy the fragile signs of competition in the banking sector.

It is worrying that, given the very high aggregate uncertainty, banks may not be willing to extend credits to enterprises or may demand a very high risk premium. From that point of view, it is important to stimulate the emergence of less risk averse investors who are ready to take equity, such as venture capitalists.

The prudential regulation of banks and the supervision of other financial intermediaries should be carefully elaborated. The universal banking system is there and banks take equity holdings in firms. One interesting suggestion could be that banks investing in firms' equity should be obliged to satisfy tougher capital-adequacy requirements.

Many small and medium private enterprises will only be able to get finance through banks and often lack the collateral. For that reason, it may be desirable to set up partial loan guarantees to encourage lending to small and medium private enterprises. This would work in the following way. Every loan of an amount of 100 would be backed up by a guarantee of, say, 20 or 30. This guarantee does not necessarily have to be given by governments. It could come from international institutions such as EBRD who are already very active in supporting the private sector. Such partial loan guarantees provide limited insurance and risk sharing for lending, which may encourage banks to become more involved in financing the small and medium private sector.

6. For credibility reasons, it is important that governments should not be involved in the strategic restructuring of firms. Given the underdevelopment of financial markets, there is still a real danger of a return to the old practices of central planning where the allocation of investment was decided by government. Loan guarantees to state firms should be prohibited in order to encourage banks to stay away from lending to firms and sectors with little future but which, for social or political

reasons, governments are wary of closing down. The evidence in Poland for example shows that mainly mining and steel producers are taking advantage of loan guarantees.

7. What can the European Union do to encourage further progress in strategic restructuring in Central Europe?

We have already emphasized the important role of prospects for future entry to focalize expectations. From the point of view of this study, it is very important to emphasize the potential contribution of training programmes in order to help the setting up and consolidation of financial systems. As emphasized in this paper, the scarcity of managerial and of intermediation skills is a real constraint to restructuring. In Poland for example, the programmes of twinning of banks with Western banks, where the latter provided training for the 'twin' Polish bank has proved very useful, and transferred necessary know how for restructuring. Positive efforts in this direction should be intensified.

Table 1. Number of private entrepreneurs
(thousands)

	1989	1990	1991	1992	1993	1994
Poland(a)	81.1	1135.5	1420.1	1630.6	1783.9	
Hungary(a)	320.O	393.5	510.5	606.2	688.9	778.0
Czech Republic(b)		124.5	891.9	982.1	785.7	911.3(c)

Source: *Rocznik Statystyczny*, GUS, 1994; *Statistical Yearbook of Hungary*, KSH, 1994; *The Privatization Newsletter of the Czech Republic and Slovakia*, March 1995;
Notes: (a) end of the year; (b) beginning of the year; (c)october.

Table 2: Number of economic organizations by legal status

	1989	1990	1991	1992	1993	1994
HUNGARY						
SOEs (a)	2400	2363	2233	1733	1130	821
companies(b)	4792	18963	42276	58274	75272	90853
cooperatives	7076	7641	7766	8229	8668	8252
POLAND						
SOEs (a)		8454	8228	7245	5924	4955
companies(b)		36267	53771	69907	83283	95017
cooperatives		18575	18949	19372	19746	19816

(a) state-owned enterprises
(b) limited liability and shareholding companies
Source: *Rocznik Statystyczny*, GUS 1994; Statistical Yearbook of Hungary,

Table 3 :
The share of the private sector in the GDP and employment (%) in 1993

	GDP	Employment
The Czech Republic	60	47
Hungary	51	61
Poland	47	57

Source : The Czech Republic : EBRD (1994); Hungary : informal estimates of the Ministry of Finance; Poland : *Rocznik Statystyczny*, 1994.

Table 4 :
Poland : % share of the private sector in investment

	Private sector total	Private sector outside agriculture
1989	35.3	27.7
1990	41.3	33.3
1991	40.8	36.7
1992	44.0	40.2
1993	42.9	38.8

Source : *Rocznik Statystyczny*, GUS, 1993, 1994.

Table 5 :
Sources of investment finance

	Poland 1992	Poland 1993	Hungary 1993	Czech Republic 1st half 1993
internal sources	58.1	63.3	54.2	72.7
subsidies	5.6	4.7	26.1	4.8
bank credit	10.8	8.7	3.4	16.8
other (a)	25.5	23.3	16.3	5.7

Source : *Rocznik Statystyczny*, GUS, 1994 ; Magyar Statisztikai Evkönyv, Budapest, 1994 ; Buchtikova and Capek (1994).

Note : Data for Poland exclude housing cooperatives.
(a) includes for Poland incompleted investment, investment from abroad (9.8 % in 1993), etc. ; for Hungary includes credit from international financial institutions ; for the Czech Republic includes investment from abroad (2.0 %).

Table 6 :
Poland : number of industrial enterprises according to the number of employees

	Total	Number of employees			
		100 and less	101-500	501-2000	2001 and more
1990	5461	775	2985	1329	372
1991	7049	2119	3429	1204	297
1992	6783	2375	3186	968	254
1993	6784	2502	3103	1001	178
		Percentage share			
1990	100	14	55	24	7
1991	100	30	49	17	4
1992	100	35	47	14	4
1993	100	37	46	15	2

Source : Own calculations based on *Rocznik Statystyczny, GUS*, 1991, 1992, 1993, 1994.
Note : Enterprises with 50 and more employees, except in 1993 for which the numbers for energy, gaz and some other sectors include enterprises with 20 and more employees.

Table 7 :
Enterprise split-ups in the Czech republic

Industry	Number of enterprises prior to approval of privatization projects	Number of enterprises after approval of privatization projects
Ferrous metallurgy	20	51
Non-ferrous metallurgy	16	50
Chemicals and rubber	57	131
Machinery	303	676
Electronics	74	212
Building materials	119	280
Wood-processing industry	81	230
Metal products	18	41
Paper and cellulose	22	84
Glass, china and ceramic	55	159
Textiles	94	409
Apparel	23	72
Leather	19	72
Printing and publishing	31	50
Food-processing	198	683
Others	49	93
TOTAL	1179	3293

Source: Ministry of Privatization, February 1994, quoted in Zemplinerova (1994).

TABLE 8 :

Investment in the Czech Republic, Hungary and Poland

1989 = 100

	Czech Republic	Hungary	Poland
1990	108.2	90.2	89.9
1991	73.0	79.4	86.2
1992	85.1	78.2	86.8
1993	91.9	78.6	88.7
1994	80.0 (a)	87.4 (a)	93.6 (a)

Sources : Statisticka Rocenka 1994, CSU ; Prokop, L., "Investice", mimeo, Institute of Economics, Czech National Bank, 1994 ; *Statistical Yearbook of Hungary*, 1994 ; *Rocznik Statystyczny* 1993, 1994, GUS; *Statystyka Polski,* n 10, 7-11-1994.
Note : Constant prices : for the Czech Republic 1992 prices, for Poland 1990 prices.
(a) : estimates

NOTES

1. Hughes and Hare (1991) using pre-transition input-output tables revalued the value added of different branches at world prices. However some of the branches with negative value added which reasonably could be expected to shrink, have dynamically expanded for the last two or three years and are among the most appreciated by foreign investors.

2. Except in Poland where, for the last four years, despite several debates on various bills on restitution, the parliament has not succeeded in adopting any of them.

3. Mutatis Mutandis, the speed of growth in the new private sector is also affected by the development of the new financial sector. Even though retained earnings may allow a rapid growth of that sector, outside finance may yet help to substantially increase this growth.

4. The difficulty of providing a clear synthetic picture of enterprise adjustment on the basis of available qualitative studies is compounded by the unequal but on average rather weak quality of this evidence. Carlin *et al.*(1994) rightly stress this point.

5. Cf. Carlin *et al.* (1994). Perhaps the most convincing categorization has been proposed by Dabrowski *et al.*(1992) who suggest that small and medium size enterprises appear flexible enough and adjust rapidly, whereas large enterprises , especially in small town, are passive and inert.

6. Even in the Czech Republic, the enterprises privatized in the first wave of the voucher scheme, could not be considered before 1993 as being controlled by private owners.

7. See Grosfeld (1994 a) for more details.

8. The programme is still at a preliminary stage. For the time being only two Polish banks have expressed their readiness to participate and the number of enterprises is curiously shrinking (the pilot version of the programme should not exceed 30 firms). Cf. *Rzeczpospolita*, 23.9.1994.

9. 17 000 liquidations and 5 000 bankruptcy cases were filed between January 1992 and Decembre 1993, with 90 per cent of bankruptcy cases being completed and most liquidation cases still pending. Cf. Baer and Gray (1994).

10. Between 1.8.1990 and 31.12.1993 288 state-owned enterprises have been filed for liquidation or liquidated under the Bankruptcy Law and 215 have been liquidated under article 19 of the Law on State Enterprises. Cf. *Rocznik Statystyczny* 1994, GUS.

11. Aghion *et al.* (1994) who stress the importance of career motives, propose a model based on the implicit assumption that managers do not gain from privatization of their firm. Therefore they suggest that privatization should be postponed in order to give more incentives for managers to restructure. This contradicts the evidence presented by Estrin et al. (1993) showing that credible prospects for rapid privatization proved to be a powerful incentive to restructure.

12. Among the enterprises participating in the first wave of the voucher scheme 85 per cent of the privatization projects approved by the Ministry of Privatization were submitted by managers. Cf. Bouin and Grosfeld (1994).

13. One should however not necessarily paint a too rosy picture of the activity of foreign firms in Central and Eastern Europe. The first foreign investor willing to purchase a firm is not necessarily the best able to use the assets in a most efficient way. Fears have been expressed of Western firms buying up a competitor in order to reinforce a dominant position on the European market.

14. Interestingly, wages increased more in those firms where the reduction of employment was greater.

15. In Poland, for instance, in the sample of 110 firms leased to the employees in 1991, outsiders held 14.8 per cent of shares at the end of 1991 and 21.1 in the mid 1993. Cf. Jarosz (1994).

16. 27 per cent are to be distributed among other funds, 15 per cent given to the employees, the state keeping initially 25 per cent of shares.

17. The technical assistance of consulting firms to banks was partly sponsored by the PHARE programme.

18. One of the Polish state-owned commercial banks, Bank Depozytowo-Kredytowy, has a Cook ratio of 25 per cent (the minimum required by the National Bank of Poland being of 8 per cent). *Rzeczpospolita*, 7.12.1994.

19. An important condition for the development of venture capital firms seems to be the existence of divestment options : the returns required by the venture capital companies will be prohibitively high if exit routes are not flexible enough. It is interesting to note that such firms have been established in those developing countries which had an active stock market, i.e. in Taiwan, Korea, Malaysia, India. See Sagari and Guidotti (1992).

20. For the time being the major sources of venture capital in Central Europe seem to be EBRD, IFC and american pension funds.

21. Statistical analysis by Nivet (1994) suggests, however, that the quality of information generated by the Warsaw Stock Exchange improves with time : past profits play an increasingly important role in the valuation of listed firms.

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