Transition report

Part III

Enterprise development

8. Ownership, governance and restructuring

8.1 Ownership and governance patterns – *page 128*

8.2 Links between ownership, governance and restructuring performance – *page 132*

8.3 Capital markets and effective corporate governance – *page 135*

8.4 Concluding remarks – *page 137*

9. Small and medium-sized enterprises

9.1 SMEs in transition – *page 139*

9.2 Constraints facing SMEs – *page 142*

9.3 Directions for policy reform – *page 144*

9.4 Concluding remarks – *page 146*

Annex 9.1 SMEs in the transition economies – *page 147*

10. Developing financial institutions and markets

10.1 Financial reform and development – *page 153*

10.2 Challenges ahead – *page 154*

10.3 The transformation of banking – *page 154*

10.4 The emergence of securities activities – *page 164*

10.5 Concluding remarks – *page 169*

Ownership, governance and restructuring[1]

8

A standard view among academics and policy makers in the early days of the transition process was that faster privatisation would automatically lead to faster restructuring of enterprises. Several years into the transition. the relationship between privatisation and restructuring has proved to be more complex.

First, it is important to recognise that "restructuring" is multidimensional, encompassing: "reactive" policies brought about by the hardening of firms' budget constraints[2] (e.g. labour-shedding, wage reductions, plant closures); strategic aspects, including export reorientation, changes in the mix of products and changes in management structures; and "deeper restructuring", generally involving substantial new investment, that can deliver large improvements in enterprise performance and growth over the long run.

Second, it is now clear that successful enterprise restructuring depends not only upon ownership (e.g. state versus private), but also upon the structure of control and the financial constraints faced. It appears that mass privatisation programmes, which have left control either in the hands of private insiders (employees and/or managers) or diluted among private voucher holders, have so far produced only limited, primarily reactive, restructuring. However, privatisation with dominant outside ownership, especially in the form of foreign direct investment, appears to generate deeper restructuring, which leads to significant performance improvements. In other words, a change of ownership from public to private can no longer be seen as a sufficient condition for comprehensive enterprise restructuring. Attention must be focused also on effective corporate governance and how best to achieve it.[3]

This chapter examines these issues in more detail, concentrating on four countries: the Czech Republic, Hungary, Poland and Russia. This selection was motivated by the relative maturity of enterprise transformation and by the contrasting approaches to it in these four countries. Section 8.1 identifies the main ownership structures that have arisen from privatisation in the four countries. Section 8.2 establishes some relationships between ownership and governance patterns, on the one hand, and restructuring and performance outcomes on the other. Section 8.3 discusses the role of emerging capital markets in facilitating the development of "restructuring-inducing" ownership and governance structures in privatised enterprises.

The analysis indicates that a substantial proportion of firms still remains in state hands; in so far as they do not, insiders for the most part continue to be in control, except in the Czech Republic. This in turn tends to limit the scope for restructuring, caused partly by capital constraints and by the objectives of those insiders. Second, well-functioning capital markets do not yet exist, and even when outside control is significant – as in the Czech Republic – the current institutional relationships (for example, between investment funds, banks and firms) dilute effectiveness. As a consequence, restructuring has been mostly reactive and, to some extent, strategic. The exception is firms with dominant outside investors, especially foreign investors, and to a lesser extent Investment Privatisation Funds (IPFs), which have engaged in significant deeper restructuring.

8.1 Ownership and governance patterns

This section identifies the governance structures that have emerged as a result of the different privatisation processes followed in the Czech Republic, Hungary, Poland and Russia. The term governance structure here refers both to the pattern of shareholding within the firm (its ownership structure) and to the distribution of control rights among shareholders.[4] For example, a privatised firm with dispersed outside ownership (e.g. by individual voucher holders) does not have the same governance structure as a firm with a core outside owner (e.g. a foreign investor). Similarly, a privatised firm whose shares are equally distributed across all employees has a different governance structure from a firm in which the manager has been granted a large proportion of the shares.[5]

The objectives of employees, managers and outside investors vary considerably and, with them, the extent and effectiveness of restructuring. The primary objective of an employee-controlled firm is likely to be first to preserve employment and then to maximise wages, subject to the firm remaining solvent if hard budget constraints are enforced. The hardening of budget

1 This chapter draws on unpublished surveys done under the auspices of the World Bank and the EU. For Poland and Hungary, the survey data were collected as part of the World Bank Research Project on Enterprise Behaviour and Economic Reform in Central and Eastern Europe, headed by I.J. Singh in collaboration with Alan Gelb. We are very grateful to them for providing these data. Helpful comments were kindly provided by Saul Estrin and Mark Schaffer. The Russia survey was sponsored by the Europe and Central Asia Country Department III, and the Economic Development Institute at the World Bank, for a research project headed by Qimiao Fan. The Czech survey results are drawn from surveys compiled by A. Zemplinerova and funded by an EU ACE project.

2 That is, the removal of firms' access to soft credits or subsidies.

3 This important point was made early in the debate on transition by Frydman and Rapacynzski (1994). In the last two years, a number of empirical studies in this area have been completed, based on recently available enterprise survey data (see footnote 1).

4 For simplicity, in the analysis of different governance structures (see Section 8.1) we do not consider the control rights exercised by creditors. However, the observed hardening of budget constraints and its impact on restructuring even in state enterprises (see Section 8.2) constitute some evidence that creditors may in fact exert influence over the restructuring behaviour of enterprises.

5 This proportion does not have to be 50 per cent in order for the manager to exert effective control, provided that the other shareholdings are sufficiently dispersed.

constraints has been quite effective in inducing reductions in employment and real wages even in non-privatised enterprises.[6] In addition to preserving their salaries and their jobs, managers may try to establish a reputation *vis-à-vis* the outside labour market, and this would depend on their success at restructuring the enterprise. Thus, more restructuring can be expected to take place in manager-owned firms, compared with employee-owned enterprises. On the other hand, manager control may make transition from inside to outside ownership more difficult (see Section 8.3).

The primary objective of outside investors, whether individual voucher holders, investment funds or foreign investors, is expected to be the maximisation of the long-run value of the firm, subject to the financial and other constraints on the owners. Their ability to restructure will depend on whether they are able to establish control of the firm (which in turn depends to a large extent upon their shareholding concentration). Restructuring will also depend on new finance and expertise, for example to modify the marketing strategy or the product mix delivered by the enterprise, and to modernise the capital equipment. Dispersed individual voucher-holders will typically have only limited ability to induce deep restructuring policies. IPFs, even when they are core owners, may lack the access to finance and expertise, and even the internal governance structure, to implement the appropriate restructuring policies within the enterprises they own. Domestic banks may have better access to finance. Core foreign investors are likely to be strongest on all those dimensions relevant to enterprise performance, namely concentrated shareholding, finance and expertise.

Five main types of governance structure are presented in the following tables and discussed in this chapter:

1. State ownership with control exercised by insiders (managers and employees)
2. Inside ownership with control exercised by employees
3. Inside ownership with control exercised by managers[7]
4. Domestic outside ownership (e.g. individual voucher holders)[8]
5. Foreign investor ownership (foreign individual investor, firm or investment fund).[9]

[6] For example, see Pinto *et al.* (1993).

[7] Categories 2 and 3 can be distinguished empirically only in the Russia survey. In the others, the number of observations in the categories is too small to be meaningful.

[8] In the Czech Republic survey, domestic fund holders and other shareholders are also distinguished.

[9] The Russian survey does not separate out foreign ownership.

Table 8.1

Brief overview of privatisation[1]

	Privatisation method	Major players in privatisation	Private sector share in GDP (%)[2]
Czech Republic	mass voucher privatisation	investment privatisation funds	70
Hungary	direct sale to domestic and foreign investors	domestic private companies, managers and foreigners	60
Poland	liquidation mass voucher privatisation (from autumn 1995)	workers and managers	60
Russia	mass voucher privatisation	workers and managers	55

[1] Includes partial privatisations.

[2] Estimates are taken from Table 2.1 in Chapter 2.

Table 8.2

Composition of ownership in the Czech Republic, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	IPFs	Domestic outsiders (excluding IPFs)	Foreign
Number of firms	**60**	**80**	**39**	**57**	**16**
Number of employees[3]	**470**	**75**	**182**	**129**	**212**
Domestic outsiders	**4**	**1**	**76**	**59**	**17**
IPFs	2	0	51	2	2
Individual voucher holders	1	0	22	8	6
Individual investors and companies	0	0	2	33	8
Others	1	1	1	16	1
Insiders	**1**	**97**	**0**	**2**	**0**
Employees	1	35	0	0	0
Managers	0	62	0	2	0
State	**95**	**0**	**19**	**2**	**6**
NPF	62	0	17	2	4
Others	33	0	2	0	2
Foreign investors	**1**	**0**	**2**	**0**	**76**
Other	**0**	**0**	**2**	**36**	**0**

Source

Katsoulacos and Takla (1995). The 1994 Czech survey was based on a random sample of 257 manufacturing firms, and can be used to draw inferences about industrial enterprises in the Czech Republic as a whole. For details, see Zemplinerova *et al.* (1995).

Notes

Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.

[1] Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type except for IPFs. Dominant IPF ownership is defined as at least 20 per cent shareholding by IPFs collectively in those firms not otherwise majority-owned. The total number of firms classified by ownership type is 252. The remaining 5 firms were either classified as no dominant owner or unclassified.

[2] Insiders includes both employees and managers.

[3] Median number of employees.

These ownership structures (and the governance they generate) would be expected to lead to different restructuring outcomes. There follows an overview of privatisation policies and outcomes in the four countries, presenting the available data country-by-country and briefly summarising the type and scale of privatisation implemented in each.[10]

Czech Republic

Privatisation progress

The techniques and decisions most identified with the Czech privatisation programme are the use of vouchers to dispose rapidly of state property, the free entry permitted to privately formed IPFs, and the use of such IPFs as a corporate governance solution to dispersed ownership.[11] Although the Czech programme was quite flexible in terms of choosing between various privatisation methods (e.g. direct sales, auctions, restitutions and voucher privatisation), voucher privatisation turned out to be predominant, accounting for 50.7 per cent of the realised nominal stock value by December 1994 (against 7 per cent through direct sales to outsiders). This in turn has led to the predominance of private outside ownership in the Czech Republic.

Czech legislation imposes a 20 per cent ceiling on a single IPF's ownership of the "total nominal value of securities issued by the same issuer" (Section 24 of the Investment Companies and Investment Funds Act). This ceiling applies only to IPFs and is in part a protection mechanism for minority shareholders. A significant drawback of such ownership restrictions is that they may retard the reselling of shares to IPFs, which in turn would be expected to delay comprehensive restructuring. This 20 per cent restriction can also create a problem of effective supervision, in that a 20 per cent shareholder will have less incentive to monitor the firm than a 50 per cent shareholder.

To summarise, the most pervasive governance structure resulting from the mass privatisation programme in the Czech Republic is outside ownership, either dispersed among private voucher holders or more concentrated with IPFs and the National Property Fund. The incentives and governance structure of the IPFs, and in particular their financial relationship with banks, will greatly influence the restructuring outcome in the privatised sector (see Section 8.3).

Ownership

In the Czech Republic, in firms with dominant insider ownership, employees and managers between them own almost all the shares (97 per cent). The small (median) size of insider-owned firms reflects the fact that *de novo* enterprises are not separately identified in the Czech survey and will be mostly contained in the insider-owned category, in contrast to the surveys for Hungary, Poland and Russia. About 17 per cent of firms in the sample have dominant IPF ownership (as defined in the notes to Table 8.2).[12] It is notable that the IPFs hold a very small stake, only 2 per cent, in enterprises that are under dominant ownership by other (non-IPF) domestic outsiders. This is in sharp contrast to the average 51 per cent holding by IPFs in firms with dominant IPF ownership. This may suggest a focus by IPFs on gaining effective control of enterprises in which they invest. Interestingly, while the IPFs hold only a small stake in domestic outsider-owned firms, domestic outsiders (and particularly individual voucher holders) account for 22 per cent of IPF-dominated firms. Also striking is the fact that foreign investors do not hold any significant stakes in firms other than those with dominant foreign

Table 8.3

Composition of ownership in Hungary, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	Domestic outsiders	Foreign	*De novo*
Number of firms	**66**	**12**	**13**	**21**	**27**
Number of employees[3]	**699**	**293**	**74**	**364**	**32**
Domestic outsiders	**0**	**6**	**87**[4]	**7**	**53**
Banks	0	0	7	0	0
Funds	0	0	0	0	0
Companies	0	6	47	4	9
Individuals	0	0	27	3	44
Insiders	**1**[5]	**81**	**2**	**1**[5]	**28**
Employees	0	46	1	0	11
Managers	0	35	1	0	17
State	**95**	**14**	**8**	**21**	**4**
Ministries/financial institutions	79	10	6	13	1
SOEs	16	4	2	8	3
Foreign investors	**3**	**3**	**2**	**71**	**16**

Source

Computed from the 1993 World Bank Hungarian enterprise survey. This survey was based on a sample of 200 manufacturing firms, excluding certain legal forms of organisation. Thus, it should not be used to draw inferences about the ownership composition of the Hungarian manufacturing sector as a whole. Other comparisons across ownership types are valid, however.

Notes

Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.

1 Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type.

2 Insiders includes both employees and managers.

3 Median number of employees.

4 Sub-total differs from sum of the components because sample size varies for each sub-category.

5 Sub-total differs from sum of the components because of rounding.

[10] All of the figures presented in the tables are unweighted averages across enterprises. An analysis using firm-size weighted averages yields somewhat different figures, but the broad conclusions remain intact.

[11] Coffee (1994).

[12] In reading this table, two points should be noted. First, the relatively low proportion of IPF-dominated firms in this table (39/230 = 17 per cent) is largely due to the fact that the sample is not limited to privatised enterprises and includes *de novo* firms (above the minimum cut-off level in the sample of 25 employees). The survey does not separately identify these firms, so they would largely fall in the insider-owned category. This is evidenced by the much smaller median number of employees for insider firms in the Czech table. By contrast, the Hungarian, Polish and Russian enterprise surveys (and the tables in the text) identify *de novo* firms separately. Second, if one restricts attention to privatised firms, the proportion of IPF-dominated firms in the Czech Republic increases substantially. In particular, out of the 1,491 firms that were privatised in the first wave of voucher privatisation, IPFs (collectively) hold more than 50 per cent of shares in 22 per cent of these enterprises. See Laštovička, Marcinčin and Mejstřik (1995).

ownership. By contrast, in Hungary and Poland, foreign firms hold minority stakes in *de novo* (newly-created) firms. While the Czech survey does not distinguish *de novo* firms, they would be mostly included in the insider-owned category.

Hungary

Privatisation progress

Privatisations in Hungary have essentially been implemented through the sale of state property by privatisation agencies. As a legacy of the decentralisation measures introduced under the old system (from the late 1960s and accelerated in the late 1980s), the state has found it very hard to set up a centralised privatisation process or to sell to outsiders without insider cooperation.[13] The current ownership structures of companies is one where foreign owners and domestic outside owners had acquired the majority of sold property by the end of March 1995. Over 30 per cent of total property sold is now in foreign hands. However, the state still holds a large percentage of companies.

Ownership

Outside ownership has been a striking feature of the Hungarian privatisation process, and this is reflected in the enterprise survey data. This feature also characterises *de novo* firms. Well over three-quarters of all *de novo* firms are owned domestically, with the majority of shares held by domestic outsiders. Outside owners, in general, are identified as being other companies and individuals including foreign investors. Also remarkable is the absence of banks and funds as private outside owners in the Hungarian survey evidence. In firms dominated by insiders, employees and managers have roughly equal ownership shares.

Poland

Privatisation progress

In the face of strong resistance from enterprise insiders, successive Polish governments opted for a multi-track approach to privatisation. Polish enterprises were largely free to choose between privatising "by liquidation" and privatising through a direct sale of equity. The former method involved selling the company's assets either to outside investors or to the existing insiders who could then form a new private company. Employees were treated preferentially, both in terms of access to the firm's assets and because only a small proportion of the share price was demanded in cash.

To date, Polish privatisation efforts have resulted in very few enterprises being sold directly to outside investors, domestic or foreign. Privatisations have been mostly through liquidations, which are *de facto* employee buy-outs.[14] Delays in the implementation of mass privatisation have also left a large proportion of the enterprise sectors remaining in "state hands", which in practice has left control with managers and employees.

Ownership

The average combined shareholding of managers and other employees in insider-dominated firms is 88 per cent; that of managers alone is 27 per cent and that of other employees alone is 61 per cent. Employees are also important minority shareholders in foreign and outside-owned firms. In the sample, the state holds on average a quarter of the equity in firms with majority foreign investor ownership. Where the state retains a majority holding, it appears that no dispersion of ownership at all has taken place.

Ownership by funds and banks is still marginal. The average shareholdings of banks and funds in enterprises with dominant outside ownership are only 3 per cent and 8 per cent, respectively. Insiders have very small shareholdings in firms with majority ownership by either domestic outsiders or foreign investors, less than 10 per cent in both cases. As in Russia, *de novo* firms are examples of concentrated ownership and management. Management and "outsider individuals" together own nearly 60 per cent.

Table 8.4

Composition of ownership in Poland, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	Domestic outsiders	Foreign	*De novo*
Number of firms	**122**	**16**	**7**	**8**	**41**
Number of employees	**548**	**273**	**132**	**423**	**68**
Domestic outsiders	**0**	**6**	**79**	**2**	**32**
Banks	0	0	3	0	0
Funds	0	0	8	0	0
Companies	0	1	31	2	7
Individuals	0	5	37	0	25
Insiders	**0**	**88**	**10**	**7**	**31**
Employees	0	61	6	5	8
Managers	0	27	4	2	23
State	**100**	**3**	**11**	**25**	**0**
Ministries/financial institutions	100	0	3	19	0
SOEs	0	3	8	6	0
Foreign investors	**0**	**0**	**0**	**66**	**15**
Others	**0**	**3**	**0**	**0**	**22**

Source

Computed from the 1993 World Bank Polish enterprise survey. This survey was based on a sample of 208 manufacturing firms (minimum employment size of 10) stratified by broad ownership category. Because the ownership composition was fixed by sample design, it provides no information about the ownership structure for manufacturing enterprises in Poland as a whole. The sample under-represents *de novo* firms and over-represents privatised firms. The proportion that is in state ownership is approximately correct. For details, see Belka *et al.* (1994). Other comparisons across ownership types on the basis of the sample are valid, however.

Notes

Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.

1 Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type.

2 Insiders includes both employees and managers.

Russia

Privatisation progress

Between December 1992 and February 1994, nearly 9,500 large-scale enterprises employing 11 million workers were privatised,

13 See Stark (1993).

14 See Gomulka and Jasinski (1994).

Table 8.5

Composition of ownership in Russia, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Workers	Managers	Outsiders[2]	*De novo*
Number of firms[3]	110	140	40	35	45
Outsiders	2	15	9	53	29
Workers	7	63	14	26	5
Managers	2	12	63	14	56
State	89	10	13	12	1
Others	0	0	1	0	9

Source

Earle, Estrin and Leshchenko (1995). The 1994 World Bank Russia survey, on which this table is based, was conducted on a random sample of 439 industrial firms (minimum employment size of 15). Thus, the composition of the sample provides valid information about the ownership structure in the population of industrial enterprises in Russia. For details, see Richter and Schaffer (1994).

Notes

Figures refer to average percentage ownership shares.

1 Dominant ownership type has a majority stake (either greater than 50 per cent or the largest share if ownership is dispersed), whether concentrated or dispersed among members of that type.

2 Includes both domestic and foreign outside ownership, excluding *de novo* firms.

3 The number of firms classified by ownership type is 370. The remaining 69 firms were unclassified.

creating 40 million new shareholders. The Russian mass privatisation scheme was "bottom up", with managers and workers selecting the privatisation process they wished to follow. The hardly surprising result of the scheme is that insiders – workers and managers – hold over 51 per cent of ordinary shares in nearly 70 per cent of all privatised firms. Insider ownership has thus clearly emerged as the dominant ownership structure in Russia.

Ownership

The survey evidence for Russia presented in Table 8.5 is derived from a random survey of 439 enterprises. It therefore provides evidence of the scale of ownership transformation which has taken place. Workers and managers together are now dominant owners in half of all enterprises and in over 75 per cent of these the workers predominate. Despite the large-scale privatisation programme, the state retains a majority stake in about 30 per cent holding of the enterprises in the sample (which are classifiable by dominant ownership type). However, within those firms where the state is no longer the dominant owner, the state's shareholding has fallen to very low levels, at a little over 10 per cent. In *de novo* firms, ownership is concentrated among managers and private individuals (outsiders). Since there may be little distinction between these categories in such firms, it may be said that *de novo* firms are a leading example of owner-managed firms.[15]

Summary

The four countries examined have adopted very different approaches to privatisation, and this has yielded different governance structures within the privatised enterprise sector. Several tentative conclusions, largely confirmed by the evidence presented above, can be drawn about these structures. First, state ownership, with large insider ownership, has remained important in most countries. Second, insider ownership with dominant employee stakes and reportedly managerial control is extensive in Russia, and to a lesser extent in Poland. Third, outside ownership has emerged on a large scale in the Czech Republic, and to a smaller scale in Hungary, but dominant foreign ownership is more common in Hungary and this is more likely to be concentrated ownership with stronger control rights.

8.2 Links between ownership, governance and restructuring performance

This section discusses the relationship between different types of ownership and the consequences that these have for restructuring.[16] Restructuring is influenced by four main considerations: the owners' aims,[17] the distribution of control rights among owners, the availability of new funding and the hardness of enterprise budget constraints.

Economic analysis suggests several outcomes. First, firms remaining in state hands will have the least incentive to restructure. None the less, the hardening of budget constraints may induce some reactive restructuring in those firms, mainly in the form of real wage cutting and some labour shedding. Second, insider-owned firms will go somewhat further than state-owned firms when deciding wage and employment reductions or plant closure. This is because they can exert less pressure on the government, and also because of the increased authority of managers motivated by both profit-maximisation and career concerns. Third, to the extent that deeper restructuring requires additional capital, it is most likely to occur in firms with outside ownership concentrated in the hands of investors with access to finance (such as foreign investors or well-financed domestic institutions). Only such an investor is likely to have both the incentives and the financial ability to incur the new investments involved in deeper restructuring.

The performance of firms (measured by indicators of profitability, growth in sales or labour productivity) should accordingly be highest in outside-controlled firms. Insider-owned firms, especially when controlled by managers, should come second, and state firms "in limbo" should presumably come last. In other words, the initial labelling of governance structures from 1 to 5 given in Section 8.1 should be inversely related to restructuring

15 There are two reasons the distinction between manager and outside individual ownership is unclear in such firms. First, especially in small *de novo* firms, the survey may not distinguish well between the managerial and ownership role of the entrepreneur. Second, the outside individuals holding shares are likely to be family or friends who exercise more influence than dispersed outsiders.

16 There is one important caveat that needs to be borne in mind in interpreting the survey data. There may be a systematic "selection" that affects which types of privatised enterprises fall into different dominant ownership categories. This is probably most serious with respect to insider-owned firms. It is typically the case that management and employee buy-outs involve substantial leveraging (large debt finance) because of the limited assets available to insiders. Insiders would only choose to buy (and banks would only finance) firms with sufficiently high and stable net income capable of covering the debt servicing costs. Thus, insider privatisation may be more likely to occur in the more profitable enterprises. This point is recognised in the recent literature, but the empirical importance of such "selection" has not yet been identified.

17 As will be argued in the following two sections, these aims are themselves influenced by the economic environment, in particular by the state of labour and capital markets.

Table 8.6

Indicators of enterprise restructuring and performance in the Czech Republic, 1993

	Dominant ownership type				
	State	Insiders	IPFs	Domestic outsiders (excluding IPFs)	Foreign
Number of employees	470	75	182	129	212
Profit/sales (%)	3.7	6.1	4.1	2.4	11.4
Reactive restructuring					
Real wage (% change) 1991-93[1]	10.3	8.2	6.1	5.1	44.0
Employment (% change) 1991-93	-23.8	-8.3	-24.2	-14.5	-2.8
Sales (% change) 1991-93	-30.8	-4.1	-33.6	-26.0	3.2
Labour productivity (% change) 1991-93	-15.4	4.0	-12.0	-6.2	1.2
Strategic restructuring					
Exports/sales (%) 1993[2]	20.4 (27.8)	12.0 (20.8)	20.0 (27.6)	20.0 (27.7)	45.0 (46.5)
Exports/sales (%) 1991	12.3 (17.7)	4.7 (14.5)	8.0 (16.4)	4.0 (14.0)	15.0 (24.3)
Deep restructuring					
Investment/sales (%) 1991-93[3]	1.1 (4.2)	0.7 (2.1)	1.1 (2.0)	1.0 (2.9)	2.1 (3.8)
Technology and equipment investment (% total investment) 1993[4]	76.0	80.0	76.0	80.0	79.5

Source
Katsoulacos and Takla (1995). For details, see Table 8.2.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 All growth rates in this table are cumulative for the period 1991-93 because the Czech survey only provides data for 1991 and 1993.

2 Exports here includes CMEA exports. Figures in parentheses are unweighted averages.

3 The Czech survey only provides cumulative investment for 1991-93. The figure in the table is estimated as the ratio of cumulative deflated investment to cumulative deflated sales for 1991-93.

4 Percentage of total enterprise investment directed at technology and equipment.

Table 8.7

Indicators of enterprise restructuring and performance in Hungary, 1993

	Dominant ownership type				
	State	Insiders	Domestic outsiders	Foreign	*De novo*
Number of employees	699	293	74[1]	364	32
Profit/sales (%)	0.9	0.3	2.3[1]	0.2	4.4
Reactive restructuring					
Real wage (% change) 1992-93	1.6	-12.9[1]	-26.3[1]	20.6[1]	-6.3
Employment (% change) 1992-93	-12.1	-7.4[1]	-14.3[1]	0.0	6.9
Sales (% change) 1992-93	-5.2	-9.9	-25.3[1]	16.5	17.1
Labour productivity (% change) 1992-93	5.1	-6.7	11.4[1]	22.2	15.2
Strategic restructuring					
Non-CMEA exports/sales 1993 (%)[2]	12.0 (22.9)	19.6 (37.1)	23.0 (22.7)	10.0 (31.5)	0.0 (18.3)
Non-CMEA exports/sales 1989 (%)[2]	10.0 (17.8)	2.3 (12.9)	0.0 (11.4)	10.0 (20.5)	0.0 (6.2)
Deep restructuring					
Investment/sales (%)[2] 1993	0.6 (2.1)	0.2[1] (0.5)	1.1[3] (2.4)	1.1 (5.7)	1.1[3] (1.6)
Firms introducing major new technology (%)[4]	13.9	16.7	23.1	42.9	34.6

Source
Computed from the 1993 World Bank Hungarian enterprise survey. For details, see Table 8.3.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 Computed on the basis of between five and ten firms.

2 Figures in parenthesis are unweighted averages.

3 Computed on the basis of fewer than five firms.

4 Percentage of enterprises in each dominant ownership category reporting major investment in new technology within the last two years.

activity and performance. The firms with the most outside ownership should have restructured most deeply and performed best. The performance of firms in the Czech Republic, Hungary and Poland broadly appears to confirm this relationship (Russia, which started privatisation later, has not been included). Tables 8.6-8.8 provide indicators on restructuring and performance for the firms surveyed, including profitability, the growth in wages, employment, sales and labour productivity, export orientation, investment and new technology adoption.

Restructuring and performance

Reactive restructuring

Reactive restructuring is likely to be most clearly reflected in the form of labour shedding and real wage cuts. The tables show that all but one ownership types are shedding labour. Indeed, somewhat surprisingly, the extent of labour shedding appears (from Tables 8.6-8.8) to be largest in state-owned enterprises (SOEs), presumably reflecting the hardening of their budget constraints which impinge most severely on that ownership category. The exception is the Czech Republic, where dominant IPF-owned and state firms have reduced employment to about the same extent. Real wages are falling, except for foreign firms and for all ownership categories in the Czech Republic. That foreign-owned firms increased real wages on average can be explained by the foreign-investors' incentive and financial ability to attract or keep high-quality workers. In marked contrast to

Table 8.8

Indicators of enterprise restructuring and performance in Poland, 1993

	Dominant ownership type				
	State	Insiders	Domestic outsiders	Foreign	*De novo*
Number of employees	548	273	132[1]	423[1]	68
Profit/sales (%)	-0.7	5.5	3.5[1]	-3.2[1]	2.6
Reactive restructuring					
Real wage (% change) 1992-93	-0.5	0.6	-3.8[1]	14.6[1]	-0.8
Employment (% change) 1992-93	-5.5	-0.7	0.8[1]	-5.5[1]	13.6
Sales (% change) 1992-93	5.0	12.5	10.0[1]	19.8[1]	30.0
Labour productivity (% change) 1992-93	14.4	28.2	2.4[1]	33.4[1]	28.1
Strategic restructuring					
Non-CMEA exports/sales 1993 (%)[2]	6.5 (18.7)	0.0 (4.7)	0.0[1] (4.7)	8.7[1] (15.0)	0.0 (16.1)
Non-CMEA exports/sales 1989 (%)[2]	5.0 (10.4)	1.0 (6.3)	0.0[1] (5.0)	8.4[1] (12.5)	0.0 (9.9)
Deep restructuring					
Investment/sales (%)[2] 1993	1.2 (2.4)	2.8 (4.1)	0.0[1] (6.3)	5.8[1] (6.2)	2.6 (5.8)
Firms introducing major new technology (%)[3]	51.6	75.0	71.4	87.5	73.2

Source
Computed from the 1993 World Bank Polish enterprise survey. For details, see Table 8.4.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 Computed on the basis of between five and ten firms.

2 Figures in parentheses are unweighted averages.

3 Percentage of enterprises in each dominant ownership category reporting major investment in new technology within the last two years.

all other ownership types, *de novo* firms are increasing employment, which reflects the strong growth experienced by those enterprises.

Strategic restructuring

No clear-cut pattern emerges from the data in Tables 8.6-8.8. A majority of the *de novo* firms in Hungary and Poland, as well as insider- and domestic outsider-owned firms in Poland, do not export to non-CMEA countries (as indicated by the zero median values). As might be expected in a relatively small and increasingly open economy, it appears that in Hungary all dominant ownership types increased the ratio of exports to sales in the period 1989-93. Curiously, in Poland export reorientation appears more common among state-owned enterprises. In the Czech Republic the reorientation of exports is significantly larger in foreign-owned firms and IPF-controlled firms, compared with SOEs and non-IPF outsider-owned firms (presumably with more dispersed shareholding).

Deep restructuring

The investment to sales ratios shown in the tables indicate that foreign-owned firms have been most active in new investment. In Hungary this is particularly striking, while in Poland a generally high investment rate is maintained in all dominant ownership categories except state firms. In the Czech Republic, investment is stronger in foreign firms and lowest in insider-dominated firms, while no systematic differences in investment patterns can be identified between SOEs, insider-owned firms, and non-IPF outside-owned firms. A strikingly large percentage of firms, of all ownership types and in all countries, reported introducing major new technology within the past two years. In Hungary and Poland, the lowest performers in this dimension of restructuring were firms with dominant state ownership.

Performance

As shown by the tables, there are clear differences in some dimensions of enterprise performance across ownership types. Sales growth is nearly twice as high for majority foreign-owned and *de novo* firms than for the other ownership categories both in Hungary and Poland. The differences in labour productivity growth are also quite sharp. In Poland, labour productivity growth is again highest in foreign-owned and *de novo* firms, at about 30 per cent for 1992-93. This is much higher than in domestic outsider-owned and state firms, but insider-owned firms also do well. In Hungary, there is much stronger labour productivity growth in foreign-owned, *de novo*, and domestic outsider-owned firms (in that order) than in the other two categories. It is particularly striking that foreign-owned and *de novo* firms achieve this productivity while increasing employment.

There is no clear-cut pattern across ownership categories in the indicator of enterprise profitability. This is probably due both to the difficulties in measuring profitability accurately (including accounting properly for differences in tax regimes; see Chapter 4) and to the likelihood that insider privatisation was positively related to the profitability of the enterprise. In Hungary, *de novo* firms appear to be doing best, followed by domestic outsiders, whereas in Poland domestic insiders perform best, followed by domestic outsiders and *de novo* firms. In the Czech Republic, profitability is highest in outsider-owned firms with majority stakes held by foreign investors.

There are at least three explanations for the superior performance of *de novo* firms. The first and most elementary explanation is that ownership and management are concentrated in such firms, minimising the incentive ("agency") problems that arise when they are separated, as in most other enterprises.[18] A more compelling explanation is that *de novo* firms typically involve new, market-oriented human capital, which accounts for their superior performance. This is an example of the "selection" process referred to in note 16: entrepreneurs (former workers or managers)

[18] However, this hypothesis fails to explain why *de novo* firms perform distinctly better than dominant manager-owned firms in Russia (the only survey with enough information to distinguish the latter meaningfully). In fact, manager-owned firms are more similar to worker-owned firms than they are to *de novo* enterprises in terms of performance.

Table 8.9

Summary of restructuring outcomes

	Reactive restructuring	Deep restructuring
Czech Republic	High in IPF- and other domestic outsider-owned and state-owned firms	Highest in foreign-owned and lowest in insider-owned firms
Hungary	High in all types of companies	Higher in foreign- and domestic outsider-owned and *de novo* firms. Lower in insider- and state-owned firms
Poland	Significant labour shedding in state- and foreign-owned firms	High in foreign-owned and *de novo* firms, uneven in domestic outsider- and insider-owned firms
Russia[1]	No difference across types of firms	Little deep restructuring across all types of firms

[1] The currently available survey data do not allow any sharp distinctions in restructuring activity across ownership types. See the discussion in Earle, Estrin and Leshchenko (1995).

with such skills are more inclined to create new firms in the first place.[19] The third explanation is that *de novo* enterprises are not burdened with the initial challenge of restructuring, including shedding existing workers and reorienting production.

Summary

There were three propositions, based on economic analysis, suggested in the introduction to Section 8.2. First, all firms are expected to engage in some form of restructuring, if only because of the hardening of enterprise budget constraints. Second, restructuring would be primarily reactive (i.e., limited to reductions in real wages and/or employment), except in firms with concentrated outside ownership where deeper restructuring was expected (e.g., with a foreign investor or, possibly, IPFs if they hold concentrated stakes). The third proposition was that more reactive restructuring would take place in insider-owned firms than in state firms "in limbo". Table 8.9 provides a short summary of the findings.

While the first two propositions appear to be enjoy some support from the available data, there is no clear evidence that more reactive (or strategic) restructuring is taking place in insider-owned firms as compared with state-owned firms.

The findings in this and the previous section are preliminary and should not be over-interpreted. Privatisation has only recently been achieved and, even where restructuring has occurred, it is too early to expect systematic and strong evidence of this in the observed changes in performance. This caveat is relevant for all of the countries examined here. It is particularly relevant for Russia which, partly for this reason, was excluded from the performance section of the survey.[20]

Despite these caveats, the relationships between ownership, governance and restructuring discussed in this section have important policy implications. First, in countries that have not yet engaged in mass privatisation programmes, the design of the privatisation scheme should be aimed at producing governance structures conducive to deep restructuring. Much can be learned from the "models" provided by the Czech, Hungarian, Polish and Russian experiences, not least that privatisation which leads to insider control or dispersed outside ownership may not be sufficient to achieve these aims. Second, privatisations are likely to be much more effective where complementary macroeconomic policies and institutional reforms that facilitate comprehensive enterprise restructuring are also put in place. The next section elaborates this point, focusing on the impact of labour market conditions and emerging capital markets on both the evolution of governance structures and the restructuring behaviour of privatised enterprises.

8.3 Capital markets and effective corporate governance

The first two sections have provided some tentative evidence to suggest that mass privatisation programmes to date may not yet have generated ownership structures that are conducive to effective corporate governance and deep restructuring. There are, however, other factors influencing the implementation of such restructuring. A buoyant labour market can facilitate restructuring by providing alternative activity, and new private sector start-ups can be an important source of such alternative opportunities (see Chapter 9).

An active labour market can play an important role in promoting the dilution of insider control of privatised firms. In choosing to sell their shares, insiders will take into account the prospects for re-employment. Even if they do decide to sell, they will demand a premium to reflect the possibility of an unemployment spell or unattractive earnings prospects, and this will reduce the amount of trading in shares that occurs. By reducing this premium and encouraging insiders to trade their shares, buoyant labour markets can facilitate changes in the ownership pattern that deliver more effective corporate governance. In the Czech Republic, Hungary and Poland, labour market conditions are improving in many respects, largely due to strong growth of new private enterprises. Available information does not indicate any clear improvement in labour market conditions in Russia. On this basis, the insider positions in Hungary and Poland are more likely to be unwound if good labour market prospects persist, but this appears unlikely to be an effective mechanism in the short term in Russia.

[19] While this explanation is plausible, there is no systematic evidence yet to support it. For discussion and preliminary evidence, see Barberis, Boycko, Schleifer and Tsukanova (1995); and see Richter and Schaffer (1995).

[20] The available survey evidence for Russia indicates that only limited reactive restructuring has taken place, and there is no evidence linking it to dominant ownership type. Moreover, there is no correlation between the form of dominant ownership and rankings by managers of the importance of different dimensions of restructuring (such as reducing employment, wages, social benefits, etc.). See Earle, Estrin and Leshchenko (1995), and Fan and Fang (1994).

In any event, the evolution from insider to concentrated outsider ownership will require well-functioning securities markets to facilitate share trading. This section of the chapter briefly summarises some of the main economic issues involved in assessing whether such secondary markets are likely to bring about changes in ownership that improve governance. The analysis focuses on whether restrictions on secondary trading in shares are significant enough to inhibit restructuring, the incentives of insiders and investment funds to trade, and on whether the emerging capital markets are sufficiently well developed for this purpose (see Chapter 10).

Incentives for trading in shares

The distinction made throughout this chapter between insider and outsider ownership is static. Neither initial insider nor diluted outside ownership should be treated as a final outcome. In principle, shareholders of all types can trade their shares and thereby alter the composition of ownership. However, the optimal amount of reselling of shares, and thus eventually of restructuring, may not automatically take place. This may not occur because of restrictions on the tradability of shares and because of limitations on the incentives of current owners to trade.

There are some restrictions on incumbent shareholders in privatised enterprises in selling their shares and on market transactions. Management and employee buy-outs in Hungary and Romania involve restrictions on the tradability of shares, at least until the debts associated with the transactions have been repaid. In the Czech Republic, restrictions on tradability stem from the legal structure of the investment funds that intermediated the allocation of most vouchers in the two phases of privatisation. These funds have largely been converted to unit trusts from joint-stock companies, a legal form that helps to protect the fund managers from the threat of take-over. Restrictions on the tradability of shares of privatised enterprises pose serious obstacles to markets for enterprise control and thus to restructuring.

Insider-owned firms

Insider privatisation might not lead to a desirable level of resale of shares. There is first the "free-rider problem", a major source of inefficiency of the take-over mechanisms implemented in Western countries. Unless constrained to do so because of liquidity problems, no small worker-shareholder will find it profitable to sell his or her shares to an outside investor before the restructuring process brought about by outside privatisation has been completed because it is the restructuring itself which is likely to increase the value of the firm. Furthermore, the price at which worker-shareholders will agree to sell their shares might make it unprofitable for potential outsiders to purchase a controlling stake in the firm.

Second, workers might be more reluctant to sell their shares to an outsider if they anticipate they might lose their jobs as a result of restructuring following outside privatisation. This fear of losing their jobs could, in principle, be used by incumbent management to impede take-overs by outsiders. However, in deciding whether or not to sell shares, individual worker-shareholders are aware of having only a negligible influence on the overall success or failure of the outside takeover process and therefore on the probability of losing a job. Hence, in the absence of coordinated decision-making by insiders, bids by outsiders are unlikely to be blocked effectively. In addition, there have been many cases of manager-owners manipulating the resale process, both directly through threats of dismissal of workers and through illegal refusal to record ownership changes in shareholder registers, and indirectly by withholding information about the firm. A recent survey showed that only 10 per cent of Russian voucher funds reported having regular access to financial data on companies in which they hold large equity stakes, 36.8 per cent reported having casual access to information and 12.5 per cent reported having no information at all.[21]

Investment funds as owners

Investment funds have been used as part of mass privatisation programmes to foster effective outside ownership and governance of privatised enterprises. Their role has been particularly significant in mass privatisation programmes, where the scale and, in some cases, speed of implementation raised concerns about the quality of post-privatisation ownership structures. Such funds have featured prominently in the Czech Republic and, to a smaller extent, in Poland and Russia. However, the inherent risk of this approach to solving the governance problem at the enterprise level is the possibility of simply recreating the same problem at the level of the investment funds. In other words, for the investment funds to perform an effective governance role, they must themselves be subject to effective control by their shareholders.

There have been two approaches to fostering the development of investments funds in the context of mass privatisation programmes. One relies on private initiatives to establish the intermediaries, while in the other the state oversees the formation of the funds.

In Russia and the former Czechoslovakia, the governments created the legal and regulatory framework necessary for the operation of the investment funds and then allowed their relatively free formation. In both countries, there was a rapid formation of large numbers of investment funds: 516 in Russia and over 420 active funds in the former Czechoslovakia. In both countries the top 10-20 investment funds account for the bulk of funds' overall shareholdings. In the Czech and Slovak Republics, about 70 per cent of vouchers issued are in the hands of the investment funds. The main investment funds are themselves indirectly owned by the major banks.[22] The Russian investment funds have played a much smaller role, mobilising about 6 per cent of the vouchers allocated to households, and the majority of these funds do not have close ties with banks.

[21] See Pistor, Frydman and Rapaczynski (1994).

[22] The close and reciprocal ownership ties between the investment funds and banks itself raises some concern about the governance and performance of funds.

The approach to the formation of privatisation intermediaries in Poland was very different. The Polish mass privatisation programme is being implemented through 15 investment funds for which the state has selected the management teams by international tender. The allocation of the 413 enterprises to these funds is being implemented through a series of selection rounds in which each fund manager can select individual firms to be included in the fund's portfolio. The selection procedures ensure that effective control will be exercised by one "leading" fund and that the remaining shares in each enterprise will be held on a broadly diversified basis among the other funds. Once the enterprise shares have been fully allocated to the investment funds (scheduled for November 1995), Polish citizens will receive shares in the investment funds for a small fee. The shares of the investment funds are to be listed on the Warsaw Stock Exchange within two years, which would then allow investors to rebalance their stakes in the various funds. The Polish approach to mass privatisation relies upon extensive oversight by the government to achieve effective ownership and control of both the participating enterprises and of the investment funds themselves. To the extent that these goals have been achieved, however, the cost in terms of delay due to extensive political controversy and opposition has been considerable. The scheme was first proposed in 1991, but adopted only in 1995.

The experience in the region thus points to a choice between the "Czech (or Russian) approach", that is, the rapid creation of investment funds that play a significant role in privatisation (in particular through their affiliation with banks and the use of their branch networks), and the "Polish approach", which is based on the careful structuring of investment funds by the state to ensure effective governance of both enterprises and funds. While the evidence on the effectiveness of the two approaches is sparse, there is some indication that the Czech approach may have somewhat limited the potential effectiveness of the funds as a source of enterprise governance. A recent study of the share price performance of Czech and Slovak enterprises found that, while the stock market valuation of enterprises is higher for firms with concentrated outside ownership, this premium is largely lost if that outside owner is an investment fund.[23] This may be due to the limited ability of investment funds to exercise effective control under existing voting rules in "enterprise charters". It may also reflect an unwillingness by the funds to exercise effective governance due to the potential conflicts of interest between the banks and their affiliated investment funds. On the other hand, the Polish approach also poses problems – the greater state involvement raises the considerable risk of delay.

The development of more liquid secondary markets for shares can also facilitate the concentration of outside ownership in enterprises. The volume of securities market activity, both on-exchange and off-exchange, has expanded rapidly in the Czech Republic, Hungary, Poland, Russia, the Slovak Republic and Slovenia (see Chapter 10). However, these markets remain relatively illiquid compared with those in advanced industrial and high-growth East Asian countries. While liquid and properly regulated securities markets can facilitate an efficient reallocation of ownership and control of enterprises, a legal framework which safeguards property rights in securities is also required in order for this to proceed on a significant scale (see Chapter 6).[24]

8.4 Concluding remarks

The analysis of the early evidence on privatisation and restructuring of former state-owned enterprises in the Czech Republic, Hungary, Poland and Russia yields several important findings. First, the mass privatisation programmes have led, for the most part, either to insider ownership (by workers and managers) or dispersed outsider ownership, at least initially. Second, on the whole the same kind and extent of "reactive restructuring" (involving reductions in real wages and employment) have taken place in state-owned, insider-owned, and dispersed outsider-owned enterprises, mainly as a consequence of the hardening of enterprise budget constraints. This finding underlines the importance of macroeconomic stabilisation, price and trade liberalisation, and reform of banks and other financial institutions as means of enforcing market-oriented financial discipline on enterprises. Third, there is some suggestive evidence that effective corporate governance is necessary to deliver "deeper restructuring", and particularly new capital investment. It seems that more such restructuring may have been undertaken by firms with concentrated outside ownership, especially those owned by foreign investors and, to a smaller extent, firms controlled by investment funds or banks.

These findings have policy implications both for countries that have already implemented mass privatisation programmes and for the design of privatisation schemes in transition countries where a large proportion of enterprises remain in state hands. In the former case, further improvements to corporate governance may require the evolution of more concentrated outsider ownership of enterprises. This in turn depends on the development of strong and liquid capital markets to facilitate the resale of shares by insiders, and on active non-bank financial institutions (including investment funds) participating as investors and potential core owners in those markets. Appropriate institutional and regulatory infrastructure will need to be put into place to support these capital markets. Some limited progress has already been made on these issues in the region (see Chapter 10).

For the majority of countries in the region, which have not yet undertaken comprehensive privatisation, the analysis in this chapter underlines the importance of improving the design of privatisation schemes to deliver more effective enterprise governance, as well as strengthening governance of the investment funds involved in the privatisation programme.[25] It is becoming clear, as

[23] See Claessens (1995). The positive impact of concentrated outsider ownership on the share prices of privatised enterprises is also documented by van Wijnbergen and Marcinčin (1995).

[24] In Russia, for example, the only evidence of share ownership is the physical register of an enterprise. The enterprise manager often controls this, directly or indirectly. The management of at least one Russian enterprise has, apparently legally, deleted the name from its register of a shareholder who was suspected of mounting an acquisition bid.

[25] This may involve a broader range of instruments, including shares with differentiated control rights (such as voting and non-voting shares) and leasing rights for employees and managers.

economic analysis suggests, that the choice of the method of privatisation has a significant impact on corporate governance and hence restructuring. This choice appears to influence both the depth and the pace of restructuring, at least initially. It is too early to tell whether the apparent divergence of restructuring outcomes will be sustained in the long run. Much will depend on the maintenance of hard budget constraints through competition in product and banking markets, and the parallel development of capital markets with sufficient liquidity and transparency to deliver restructuring. The economic performance and viability of enterprises, and thus the prospects for successful transition and growth, will depend critically on whether effective, market-oriented restructuring takes place.

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Small and medium-sized enterprises

9

In a well-functioning market economy there is no *a priori* reason for encouraging any particular type of enterprise or activity. The market provides the guidance. However, there are two reasons why small and medium-sized enterprises (SMEs)[1] deserve special attention in the context of transition. The first is that they generate economic benefits, beyond the boundary of the individual enterprise, that are not reflected fully in the enterprise's own profitability ("positive externalities"). These benefits are likely to be especially strong in economies undergoing radical transformation, where experimentation, learning and adaptability are particularly important. The second reason is that SMEs were severely discriminated against in centrally planned economies and continue to operate under a number of handicaps and restrictions during the transition. If effective policies to remove these restrictions are put in place, SMEs can become an engine for transition and growth.

Before the rise of communism, SMEs played a vital role in the economies of eastern Europe. In the early 1930s over two-thirds of the labour force of the former Czechoslovakia and Hungary were employed in SMEs. However, by 1989 they accounted for less than a third of employment in these countries, and the average enterprise size had grown to about 2,000 workers, compared with an average of only seven workers in the European Union.

The creativity that characterises SME development posed a fundamental threat to command economies. SMEs were often actively suppressed, or outlawed, as the antithesis of central planning. Squeezed into peripheral economic activities, they survived, often informally, despite the overwhelming bias in favour of large state-owned enterprises (SOEs). The restrictions placed on SME activity often limited entrepreneurship to illegal activities. This served to increase political antagonism to SMEs and to compound the negative image and the difficulties facing private entrepreneurs. SMEs continue to suffer from negative biases in government policy and from discrimination in the regulations and incentives that govern enterprise formation and growth. To realise the social and private benefits offered by SMEs, the systematic bias in favour of large enterprises must be replaced by a "level playing field" on which all forms of business activity are treated equally by the state, particularly with respect to taxation and the regulatory framework.

SMEs have played a particularly important role in periods following economic and political dislocation. In West Germany, for example, the development of SMEs was integral to post-war recovery, and in OECD and developing economies SMEs are credited with providing the dynamism that underpinned the recovery in employment and output in the 1980s. SMEs may be the first to suffer during downturns, but they can also be the first to seize on improved opportunities. The motivation and flexibility of SMEs in responding to economic opportunities can be a stabilising influence. SMEs provide alternative employment options for workers threatened by unemployment in the process of enterprise restructuring. Moreover, SMEs tend to recruit from SOEs, and in so doing facilitate the rationalisation of the public sector.

The discussion of their role in transition is organised as follows. Section 9.1 (and Box 9.1) provides a summary of the evidence on the formation and growth of SMEs. It draws on available surveys and research, and examines their particular contribution to transition. Section 9.2 examines the constraints facing SME development, which often include discriminatory taxation and regulation, macroeconomic instability, and shortage of capital and suitable skilled labour. Section 9.3 concludes by examining the scope and limitations of policy reform in assisting SME development.

9.1 SMEs in transition

The analysis of the role of SMEs in the transition economies is frustrated by the virtual absence of reliable information. The problems of measurement and the lessons that may be drawn from comparative perspectives are summarised in Box 9.1. This box shows that, in general, the contribution of SMEs to output and employment rises as the transition advances. In all OECD economies, SMEs account for over half of employment and output and the bulk of private sector activity. Through their constant search for new market opportunities SMEs provide a competitive challenge underpinning market economies.

The special role of SMEs in the transition to a market economy partly derives from the positive "spill-overs" or externalities they generate. These include the benefits that new entrants offer by invigorating markets, providing innovative products and introducing processes that challenge existing production patterns. SMEs are the seed-bed for the emergence of competitive (and the destruction of uncompetitive) larger firms. The greater the number and more fertile the ground, the more dynamic the economy.

SME growth in transition economies is dominated by the entry of new small firms. In the Czech Republic and Poland, where relatively good empirical evidence is available, the transition period

[1] In transition economies the legal definition of SMEs tends to have a lower ceiling than in OECD countries, reflecting the fact that the majority of SMEs were very young at the time the legislation in transition economies was drafted. The ceiling for medium enterprises is generally 500 employees in OECD countries but 200 in transition economies; this chapter uses the latter definition. According to Eurostat, the ceiling for small enterprises is 49 and for micro-enterprises nine employees.

Box 9.1

Measuring SMEs

Analysis of the formation and growth of SMEs in transition economies is difficult because of a lack of reliable information. The available information is summarised in Annex 9.1. Interpreting the data is hazardous. Official data typically cover only registered enterprises, excluding the informal sector, which in transition economies may be large (for example, in Hungary it is estimated at 26 per cent of GDP, in Bulgaria 17 per cent of gross value added, and in Estonia 35 per cent of private sector activity).[1]

The official data also fail to identify inactive enterprises, which are very numerous in some countries. For example, an EBRD survey of Bulgarian SMEs in 1995 found that only 20 per cent of registered private enterprises in manufacturing were active, while the rest had gone bankrupt, relocated, changed their activities, or had never operated as enterprises, but simply registered as an indication of intent or for other reasons. Registration requirements vary greatly. In Albania, enterprises are no longer required to register at all. In most of Central Asia registration does not include any measure of firm size. High-inflation environments make measuring firm size by asset value or sales problematic. Employment is the most reliable basis for measurement, but this can be misleading if it is not differentiated by economic sector. For example, within the service sector 20 employees is relatively large, while in the manufacturing sector it is relatively small. Unfortunately, only Belarus, Russia and Slovenia provide sectoral breakdowns of their enterprise census data.

These limitations lead to both an under-reporting of unsuccessful firms and to a failure to measure success, in that as firms grow they are not reregistered. Meanwhile, firms that are very successful cease to appear on the register of SMEs as they become large enterprises. In transition economies, relatively few enterprises would have already exceeded the ceiling for SME classification. Overall, official statistics provide at best a rough indication of the structure and growth of the SME sector.

Table 9.1 shows that, in general, countries in the earlier stages of transition display the lowest share of employment in SMEs (Belarus, Kyrgyzstan, Tajikistan) and, as is to be expected, SMEs are more important in the more advanced transition economies (the Czech Republic, Estonia, Poland) and OECD countries. Equally, as is indicated in Annex 9.1, countries in the earlier stages of transition tend to have the weakest institutional environment for SMEs (Belarus), while the more advanced countries (the Czech Republic, Hungary, Poland) have a more comprehensive policy framework for SMEs. The sectoral distribution of SME activities also reflects the wider economic context. Initially, SME activity is concentrated in the retail and commercial sectors but, as the transition proceeds, a significant SME presence is established in manufacturing. In countries where this has happened, such as Poland, the evidence suggests that SMEs (particularly newly created, or *de novo*, private firms) in the manufacturing sector provide the "engine of growth" for the whole economy.

[1] One would expect that nearly all of informal sector activity is associated with (private and state) SMEs. See Annex 2.1 in Chapter 2 for a discussion of the sizes of the private and informal sectors.

has been marked by a sudden surge of small-scale start-ups. The SME sector is already a strong domestic force for economic development.[2] In all transition economies, the average size of SMEs is related to the number of years private sector activity has been legal in the country.

[2] See, for example, Belka *et al.* (1994).

Table 9.1

Comparative perspectives

Country	Percentage of employment in SMEs
Belarus	6
Croatia	30
Czech Republic	37
Estonia	45
FYR Macedonia	37
Georgia	58
Hungary	24
Kyrgyzstan	3
Poland	23
Romania	27
Russia	10
Slovak Republic	23
Slovenia	19
Tajikistan	2
EUR 12	69
Belgium	72
France	69
Germany	64
Italy	80
Japan	73
UK	76
USA	53

Sources
Globalisation of Economic Activities and the Development of SMEs, Country Reports, Enterprises in Europe, EBRD *Transition Report* 1994.
Note
The table covers those countries for which relevant data are available.

Small firms contribute importantly to experimentation with new ideas and products. The prospect of uncovering the best ideas is increased as more of these ideas are tried. They are best tried on a small scale at first so that successful ideas can be revealed, imitated and diffused. From an individual point of view, it may be better to wait and be an imitator of a successful idea rather than to pioneer and risk failure and the loss of one's savings. This disincentive to enter the market is offset, however, by the fact that, between the time of success and imitation, the successful entrant will enjoy a special market position that compensates for the risk taken. This incentive is particularly great in transition economies where the upside potential of a successful venture may be relatively high, given both the likely lack of close competitors in any given product or service market and the large number of possible markets that new firms can choose to enter.

Given the immature state of product markets in transition economies, new ideas often take the form of untried market niches and/or speculative trading, as well as the adoption of new advanced technologies to enhance existing products or services. Here, the temporary monopoly and other advantages that a successful new entrant can hope to enjoy can be a strong incentive, overriding the inclination to wait and imitate a rival firm's successful venture. SME formation has in part been based on transplanting existing products and services on offer in the West, with the necessary modifications and adjustments to meet the

consumer requirements in a transition economy. Uncertainty as to tastes and incomes of customers, and the suitability of the product, mean that experimentation can have strong returns, and SMEs provide a test-bed.

For privatised retail businesses in the Czech Republic, Hungary and Poland, post-privatisation investment was found to be highest in cases involving the entry of a new entrepreneur, unrelated to pre-privatisation performance.[3] In transition economies, since small firms will naturally locate in promising new market niches, they are likely to take away market share from the typically older and staler products offered by state-owned enterprises. This also has the benefit of increasing competition and consumer welfare in the short term by extending the range of products available, bringing the mix of products closer to consumer tastes and lowering prices. In the longer term, SMEs advance the transformation process in state-owned enterprises by hardening their budget constraint through product market competition.[4]

For an established firm, which might already hold a very large market share, the introduction of any new lines of business is bound to displace some of the profits being earned on existing lines and therefore the incentive for making improvements may be lower. However, a willingness to make radical and rapid responses is at a premium in transition economies where business opportunities appear and disappear with great speed. That SMEs are flexible is indicated by evidence that when new firms register in eastern Europe, they list a wide range of often unrelated business activities, which may suggest a prior determination to keep options open and try new approaches where old ones fail.

The high volatility of small firms in terms of entry, survival and growth reflects the nature of the risks and uncertainties facing SMEs. There is a steep learning curve associated with understanding risks and making judgements regarding location, product specification and management. In the early years, this leads to a large number of failures and also explains the high growth rate among survivors who have, on average, made better choices.[5]

The emergence of entrepreneurial small firms in distribution and retailing can, by breaking monopolistic trading structures, enhance the productivity of domestic firms and create an atmosphere conducive to the entry of foreign firms. In Russia, for example, even though a private commercial sector has developed, the state-owned sector still plays a major role in the supply of inputs and outputs.[6] The broadening of the private sector dilutes the concentration of economic power and reduces the risk of rent-seeking.

A major problem in the transition is the mismatch between existing and market-compatible skills. By providing opportunities for employment to employees and managers of state-owned enterprises, SMEs mitigate the employment losses that are inevitable in the process of restructuring. The evidence suggests that private firms in transition economies tend to recruit from the state sector, rather than from the pool of unemployed.[7] Thus, even if SMEs do not generate any net new jobs, they reduce the erosion of human capital by providing alternative employment opportunities for relatively skilled workers. This role of the private sector, and SMEs specifically, is likely to be more important in the early and middle stages of transition when the state sector is still dominant.

In the small-scale privatisation of enterprises that are labour-intensive, the key asset of value that has been transferred to the private sector is typically the premises in which the business is located. One survey of the Czech Republic, Hungary and Poland found that 70 per cent of privatised firms did not take over any movable assets from their predecessors. To the extent that privatisation in this context represents a simple "conveyance of ownership or user rights in real estate", the distinction between privatised firms and start-up businesses becomes blurred.[8] In other countries, such as in the former Soviet Union, privatisation contracts have often included the tied sale of any remaining assets and an enforced continuation of the old line of business, sometimes reducing the value of the land and fixed assets. Earlier surveys indicated that, in the first years of transition, *de novo* SMEs bought their equipment second-hand from SOEs.[9] More recent surveys show that the average age of the capital stock of start-up SMEs has dropped considerably, suggesting rapid modernisation and a higher level of investment.[10] The surveys also show, as summarised in Box 9.2, that there are significant differences between SMEs that are created *de novo* and those that are spin-offs from SOEs.

Given the imperfect nature of capital markets in transition economies, there is often a reliance of start-up SMEs on funding by friends and relatives of the entrepreneur. The small firm sector then creates an incentive for savings that might not otherwise occur.[11] This arises from the fact that the banking sectors in these countries do not typically offer very attractive rates on consumer deposits, and banks also tend to be biased against lending to the

[3] Earle *et al.* (1994).

[4] This is one of the important lessons from the transition experience in China during the last decade. SMEs have played a key role in forcing state-owned enterprises to restructure by providing effective competition in domestic product markets (and increasingly, export) markets. See Jefferson and Rawski (1994).

[5] This "learning" model of firm growth and survival was originally presented in Jovanovic (1982). The idea has been developed extensively and tested empirically in the more recent literature. See, for example, Cabral (1995), Evans (1987a,b), Hall (1987), Dunne *et al.* (1989), and Acs and Audretsch (1993).

[6] Sheppard (1994), p. 189.

[7] Boeri (1995) provides statistical evidence for Bulgaria, the Czech Republic, Hungary, Poland and the Slovak Republic for 1991 and 1992.

[8] See Belka *et al.* (1994); Gomulka (1994); Earle, Estrin and Leschchenko (1995); and Earle *et al.* (1994).

[9] See Webster (1992), and Webster and Charap (1993).

[10] See Earle and Estrin (1995) and Richter and Schaffer (1995). See also the evidence on *de novo* firms in Chapter 8.

[11] See Arrow (1995).

Box 9.2

Comparing start-ups and spin-offs

The overwhelming majority of new firms are created *de novo*.[1] By entering sectors where sunk costs are lower, they also tend to reduce their risks; this is an explanation for the concentration in Poland, Russia and a number of other transition economies of *de novo* entry in the retail trade and service sectors. In transition economies, in addition to the creation of new firms, a considerable portion of new entry may occur through the process of unbundling or *spin-off* of state-owned enterprises.[2] This involves the break-up of larger, formerly state-owned enterprises into smaller, privately run firms. In addition, the privatisation of former state-owned small enterprises (such as bakeries or restaurants) leads to the change of ownership status of SMEs.

The relative size of the *de novo* part of the private sector is affected by the stage of transition of the country. It is generally larger in countries that allowed some private sector activity prior to transition than in countries which did not. For example, in Russia it is much smaller than in those countries that initiated their transition earlier (the Czech Republic, Hungary, Poland). In Poland, spin-offs from state enterprises barely contributed to the formation of the private industrial sector, whereas in the Czech Republic, Hungary and Kazakstan spin-offs were particularly important in the earlier stages of transition due to large-scale enterprise restructuring.

Profitability is notoriously difficult to assess, in part because firms tend to "hide profits" (hence the self-declared loss-makers can be very profitable firms). Russian investment figures point to robust growth, with a higher percentage of start-ups investing (85 per cent) or expecting to do so in the future (62 per cent), compared to their spin-off counterparts (57 per cent and 32 per cent respectively). Much of this investment is debt financed, with a high percentage of start-ups and spin-offs benefiting from a bank loan (64 and 74 per cent, respectively, in the study of Russia) . Although spin-offs rely more heavily on bank loans, the terms offered by banks to start-ups appear to be better than those offered to their privatised/state sector counterparts. This has important implications for policy, discussed below.

In terms of performance, the study of Russia indicates that the *de novo* SMEs recorded an increase in real sales of 17 per cent in 1994 over 1993, versus a drop of 5 per cent recorded by privatised and state-owned SMEs. In terms of capacity utilisation, *de novo* firms operate at a much higher level than privatised and state-owned firms. Striking differences are also recorded as far as employment growth is concerned (30 per cent growth in the last year for start-ups versus a 13 per cent decline for privatised and state-owned SMEs), which partly reflects labour shedding connected with the restructuring of the latter group. Twice as many privatised and state-owned firms than start-ups report excess employment.

In Russia, over 20 per cent of start-ups and 9 per cent of state-owned, privatised SMEs reported that they need more workers. The presence of a high vacancy rate (8 per cent of employment) in *de novo* firms (versus 2 per cent of employment in privatised and state-owned SMEs) points to growth and expansion. Both start-up and spin-off SMEs attributed their high vacancy rates to the lack of qualified applicants; whereas two-thirds of privatised and state-owned SMEs blamed their inability to pay attractive wages as the main reason for vacancies, only one-third of the *de novo* firms identified this reason.

Spin-offs have not yet been the focus of extensive investigation, despite the fact that, in countries such as former Czechoslovakia, Hungary and Kazakstan, massive break-ups of SOEs took place even before the government formulated a privatisation policy. In 1990 in former Czechoslovakia, there were 700 private enterprises employing more than 25 workers; by mid-1992, 2,000 enterprises belonged to this category, with a substantial part of the difference composed of the break-up of state enterprises. The government played a passive role in this process and it may be argued that the decision to split from a parent company was taken by the managers of the spun-off enterprises in the expectation of a benefit, although not necessarily of a pecuniary nature. In the Czech Republic, the evidence indicated that the spun-off enterprises do not generally outperform their parent SOEs. The performance of the parent SOE was nevertheless enhanced by the unbundling, so that this remains the preferred option to the previous status quo. Start-ups outperform the whole set of state and privatised enterprises (including spin-offs).[3]

[1] The available data on private sector enterprises (including SMEs) are not usually broken down according to the way enterprises were created, so we cannot easily compare the characteristics (including size and performance) of spin-offs, start-ups and enterprises privatised as a single unit.

[2] These proportions vary across countries. Johnson and Loveman (1994) found that the rapid growth in the Polish private sector stemmed more from the entry of new firms than privatisation. In the Czech Republic privatisation was more significant, with about 19,000 of the 68,000 trade and services establishments sold off in the small-scale privatisation programme (Earle *et al.* 1994, p. 63).

[3] Lizal, Singer and Svejnar (1995).

more risky and less established entrepreneurial establishments. Friends and relatives often have private knowledge of the abilities of entrepreneurs which make them more amenable than commercial banks to lending funds to these firms. Thus, these individuals save more than they would have saved if they had only the option of depositing funds with commercial banks. In the more advanced transition economies, where investment funds specialising in privatisation vouchers are present and the banking sector is more developed, this savings effect is likely to be lower since access to more risk-diversified sources of savings that offer sufficiently high (risk-adjusted) rates of return will be available. To the extent that SMEs remain outside the traditional state credit ring, their demand for finance will continue to provide an impetus for the development of a commercial banking sector.

9.2 Constraints facing SMEs

Surveys of the Czech Republic, Hungary, Poland and Russia in the very early years of transition showed SMEs to be subject to a common set of constraints, many of which are associated with transition itself.[12] The following discussion draws on these surveys.

Among the most significant obstacles to the formation and growth of SMEs were the high level of taxes, the frequently changing regulatory environment, delinquent payment by SOEs, weak demand for domestic products, instability created by high inflation and credit-related problems. More recent surveys reveal a different set of constraints, suggesting that these evolve with the transition process. For example, reforms of the taxation system have reduced the extent to which taxes are seen as a constraint. Delinquent payments and weak demand also became less of a problem as the transition has advanced because, whereas initially SMEs were tightly linked with SOEs, alternative networks and

[12] References to the surveys are provided above (see Belka *et al.* (1994); Earle and Estrin (1994); Gomulka (1994); Lizal, Singer and Svejnar (1995); Richter and Schaffer (1995); Webster (1993a, b); Webster and Charap (1993); and Webster and Swanson (1993).

products were gradually established. As transition progresses, SMEs depend less on large SOEs in order to purchase inputs of production and sell their own products. Similarly, whereas at the beginning of transition almost all firms utilised cast-off, obsolete equipment from SOEs, more recent research has shown that the average age of equipment utilised by privately owned SMEs has decreased substantially, reflecting the growth in investment and innovation.[13] Macroeconomic factors also appear as less important constraints on SME activity over time because, as the transition progresses, economic stabilisation reduces inflation and economic uncertainty.

Firms generally relied on their own savings and private sources for starting up and then, once they were established, appeared to have access to short-term (less than one-year) bank loans. The high level of interest rates, rather than access to credit, is regarded by them as a constraint that constitutes an obstacle to growth and investment. SMEs reported that they first had to identify a niche in the market in which high returns could be obtained before they could take out a loan and pay the high interest rates. Overcoming this obstacle requires improvements in the banking sector but it will also require changes in enterprise behaviour. The underreporting of profits and turnover for tax avoidance purposes penalises SMEs' borrowing, as does their failure to register ownership of assets.

Except in Russia, where less than half the firms surveyed had received a short-term loan, the dearth of longer-term financing, rather than the availability of short-term credit, appears to be a constraint. Start-up capital in Russia, more than in other countries, was mostly provided by own savings and advance credit from customers.[14] In other surveyed transition economies, SMEs had access to short-term loans but longer maturity loans were available to SMEs only in the Czech Republic and Hungary. In the Czech Republic, four out of five loans had a duration longer than one year and in Hungary one-third of entrepreneurs had received long-term loans.

Many firms highlighted the constraints connected with the functioning of the labour market. Vacancies appear to be difficult to fill. Skilled workers are difficult to find. Labour mobility is poor and the lack of job centres or similar structures makes it difficult to mobilise workers who live far away from the vacancy location. Such constraints, although not peculiar to SMEs, nevertheless can have a more immediate and severe effect on SMEs and are less easily circumvented by them.

In the early stages of transition, SMEs are particularly constrained by hostile social environments. Private entrepreneurial activity was regarded as anti-social behaviour and seen to be at the expense of other members of the community and derived from connections to the "nomenklatura" and/or illicit activities. This hostile perception of entrepreneurs provides a considerable psychological barrier to the entry and growth of the SME sector. It dissipates, however, as social acceptance of the market deepens and a critical mass of entrepreneurs who provide peer support is established.

Other constraints that are associated with a relatively early stage of transition include those relating to the macroeconomic climate of the individual country, to gaps and imperfections in the regulatory environment, to the state of the local infrastructure and to the domestic economic environment in general. The flexibility of SMEs allows them to adapt to difficult conditions imposed by substandard infrastructure or imperfections in the regulatory environment. Nevertheless, their performance and efficiency are diminished by the hostile environment, particularly in so far as this disadvantages newcomers and weak enterprises that have neither the internal resources nor necessary networks to overcome obstacles. Large firms can use non-market mechanisms to internalise many of the technical, legal and commercial functions that they need to conduct business. SMEs, by contrast, lack the resources and diversity and so are forced to rely more on external sources for these services. This implies transaction costs. The less developed the external services, the higher the transaction costs to the SME, suggesting that the competitive disadvantage for SMEs will be greater at earlier stages of transition.

The social and many other constraints on SME development appear to be associated with the early stages of transition and are overcome as the transition evolves. In the first phases of transition, the enterprises themselves and the economic and institutional environment as a whole are immature, and levels of uncertainty are acute. During this phase, SMEs face a formidable array of obstacles, many of which diminish over time as enterprises learn by doing and as the foundations of a market economy are laid. SMEs are particularly susceptible to the uncertainty that characterises the first phases of transition and, unlike large enterprises, do not have the experience, internal resources or leverage to compensate for many of the weaknesses apparent in the external environment. Their lack of resources and influence can make them fragile but their small size and agility gives them compensating advantages in an uncertain world which demands the rapid adoption of innovatory practices and products.

The establishment of a mature market economy requires the establishment of a level playing field where SMEs may have access to inputs, goods, services and capital markets on a similar basis to large firms. Past practices that favoured large firms mean that specific policies are required to facilitate SME development. Centrally planned economies tended to marginalise the activities of SMEs, and countries in the initial stages of transition tend to be dominated by large SOEs. This domination by large firms is mirrored in the capital markets, where access to credit can be

[13] The average age of equipment in SMEs (weighted by value) varied between eight and 10 years in eastern Europe (the Czech and Slovak Republics, Hungary and Poland), and between 10 and 20 years in Russia. See Webster (1993a, b); Webster and Charap (1993); and Webster *et al.* (1993).

[14] See citations in the preceding footnote.

based on historically determined working practices and networks that closely link state banks with state and other large enterprises.

In the context of transition, all the problems of uncertainty facing Western firms exist. In addition, SMEs are faced by a wide range of new sources of unpredictable factors which potentially affect their activities. These include uncertainty over macroeconomic factors (such as future price levels, exchange rates and fiscal policy), the absence of a stable legal infrastructure, and competition issues (such as government policy towards horizontal and vertical integration, entry barriers and restrictive trade practices). To the extent that this uncertainty is greater than in market economies, one would expect the growth and survival patterns of firms in transition, and particularly small and start-up firms in transition, to be more turbulent than in developed market economies.

9.3 Directions for policy reform

Policies in support of SME development in OECD countries tend to be based on specific targets or local priorities, often partly non-economic in origin. For example, in many OECD countries, support for SMEs is considered to be a means of enhancing inner-city or minority group employment, by offering jobs to the long-term unemployed. The policies may also have purely economic objectives based on "externalities" arguments, for example encouraging the development of particular segments of the economy, such as high-technology companies. In transition economies, the objectives of SME policies go beyond those in the OECD countries because the level of discrimination against SMEs has been more acute and because SMEs provide externalities that are of special significance in the transition process. In particular, the success or failure of SMEs provide demonstration effects that are stronger in transition economies than advanced market economies, and the growth of SMEs can ease the burdens of subsidy and adjustment associated with large and obsolete state-owned enterprises.

The most important policy reforms that facilitate SME development, whether in OECD or transition economies, are those that influence the overall enterprise environment. Macroeconomic stabilisation and price reforms that bring stable and freely determined market prices are essential to ensure correct signalling and to reduce the uncertainty facing SMEs. Trade reforms, which allow domestic prices to reflect international competitiveness and which end the effective protection of the status quo, will foster sustainable SME development. The government framework for business and for enterprise restructuring and a commitment to privatisation are also vital as, taken together, they determine the potential for private sector development. SME development is facilitated by a stable legal system that allows newcomers to compete with established firms on the basis of a transparent set of rules and without fear of intimidation. Corruption, nepotism and crime tend to discriminate against newcomers and smaller, weaker firms, and thus to stifle competition.

By giving priority to overall economic management and to laying the foundations for a market economy, governments in transition economies are simultaneously providing the appropriate seed-bed for SME development. Within the context of the probable need to reduce overall levels of public spending, measures taken by governments to reform social expenditures and refocus infrastructure investments can benefit the whole economy and not least SMEs. For example, the demand for a skilled workforce is met through improved education, mobility problems are eased by the provision of housing, communications are facilitated by improvements to the regulatory framework for telecommunications, and the social cost to the firm of health benefits and pensions is eased by improved provision of social services. Without economy-wide policy reforms, narrowly targeted micro policy reforms in favour of SMEs will be frustrated.

By assisting in the development of the basic financial and service institutions of the market economy, governments (and supportive international agencies) render great assistance to SMEs. They also avoid the pitfalls of many schemes which support SMEs through intricately targeted interventions and subsidies. Programmes that are defined by bureaucrats and not those in business, and that protect well-connected but often less efficient entrepreneurs from the market, have been failures. In transition economies, therefore, it is critically important not to recreate a culture of public selection, subsidy and dependence in which efficient businesses are taxed to finance less successful ones.

For external agencies, such as IFIs, there are particular difficulties in seeking to intervene at the micro level: just as entrepreneurs and experts in transition economies have an inadequate knowledge of Western market economies, Western experts and entrepreneurs only have a partial knowledge of the business environment and the constraints and opportunities in transition economies. The risks for Western agencies of inappropriate policy design are therefore especially significant in the SME area where, even in the mature OECD economies, policy successes are elusive and tend to depend on extensive groundwork and local knowledge and participation.

Policies to support SMEs should be tailored according to the ranking of constraints to their development. These will reflect the stage of transition as well as the initial conditions in each country. A knowledge of the severity of the different constraints is necessary to allow government policy makers, IFIs and others to focus their efforts. However, there is virtually no recent evidence that ranks these constraints.

SME-specific reforms may include measures to assist in the financing of SMEs and the provision of "one-stop" business centres, networking and the establishment of commercial associations, or the provision of suitable locations with the appropriate utilities to encourage the establishment of SME clusters, for example business parks.

Financial sector activities may include the establishment of specific credit lines for SMEs, facilitating equity participation and reinforcing the capacity of the financial sector to appraise and

Box 9.3
The EBRD and SMEs

There are various forms of EBRD support for SMEs:

1. equity participation in investment and venture capital funds, and investment or commercial banks that are either regional or country-specific
2. funding of local banks which are used for local lending under guidelines established by the EBRD
3. co-financing with local banks or local offices of foreign banks, with project preparation, evaluation, monitoring and supervision delegated to the co-financing bank.

By the end of 1994, the EBRD had contributed ECU 382 million towards projects, with a total value of close to ECU 1 billion, covering SME development in most of its countries of operations. Bank lending resulted in on-lending for over 700 subprojects, with an average unweighted value of around ECU 260,000. In the medium-sized enterprise category this was mainly accounted for by equity participation, and in the small category (below ECU 500,000) by lending to banks that then provided about 500 beneficiaries with loans averaging ECU 116,000. Micro-loans averaged around ECU 2,300 and benefited 115 enterprises.

The approach of the EBRD to supporting SMEs tries to take into account the stage of transition and the ability of the local financial intermediaries to assume key responsibilities. In the early transition economies, because of the weakness of the intermediaries, "apex" lines are generally provided with government guarantees. Examples of such loans include the loans to National Banks in Kazakstan, Ukraine and Uzbekistan for on-lending to local banks for financing small and medium-sized projects. Given the early stage of development of the banking systems in these countries, the projects are characterised by a high degree of risk which is mitigated by sovereign guarantees. In more advanced stages of transition, government guarantees are generally not required and the EBRD can perform the role of a finance wholesaler, reaching SMEs through carefully identified financial intermediaries. Examples of such credit lines include those arranged with the SKB Bank in Slovenia, and the Estonia and Latvia Investment Bank projects.

Regional or country-specific venture capital and investment funds cover the full range of transition economies, with the demand for these funds increasing as the transition progresses. The funds make independent decisions about the projects they invest in, although the main investment criteria are consistent with the EBRD's overall investment policy. The size of each investment varies from fund to fund and is typically in the range of US$ 100,000 to US$ 2 million, so that the funds support mainly SMEs.

Institution building is one of the main goals of the EBRD's SME programmes; a notable example is the **Russia Small Business Fund (RSBF).** This Fund was initiated by the EBRD and the G-7, with expected contributions of US$ 150 million from the G-7 matched by US$ 150 million of the EBRD's ordinary capital resources. A major objective is to bring within the scope of the formal finance system firms whose financing needs had not been previously met by the banking system, notably "micro-enterprises" and small firms requiring investment capital. These firms face numerous barriers to obtaining formal sector finance to meet their needs – lack of credit history, lack of "bankable" collateral and, for those firms requiring medium-term inputs for investment purposes, an absence of available funds with more than a three-month maturity. Because banks have little or no experience of lending to these target groups, substantial technical assistance funds are necessary for training and implementation of such programmes.

The RSBF has three main products: Small Loans (up to US$ 75,000), Micro-Credit (up to US$ 25,000), and Small Equity. In addition, it increasingly provides business advisory services. The loans are extended to firms employing up to 50 people (20 in the case of Micro-Credit) that are majority-owned by Russian residents and under private ownership and control. Micro loans generally start out short term (average is 5 months) and, as the borrower establishes a repayment record, subsequent loans can be larger and extended to terms of up to two years. Small Loans are generally 2-3 years.

The Small Equity component provides investment capital through equity participations, often in combination with debt and various other risk participation instruments. The investments are of up to five years' duration, with a targeted average investment size of US$ 75,000 and a size range of US$ 25,000-200,000. The equity stake is being complemented with business advisory assistance for the Fund's targeted production and service sector firms. In most cases, financing constitutes 25-75 per cent of the total capital of the enterprise after investment, but management control remains in the hands of the Russian owners. The Small Equity component seeks both to invest in local small enterprises and to design effective instruments that can be replicated. In 1995, 2,500 firms are expected to benefit from RSBF loans and investment agreements.

support SMEs. Equity finance for SMEs can provide an important advantage because it reduces the debt service risk. This can be particularly important for small, young enterprises which are going through a learning phase and have volatile revenues. Equity finance in the form of minority holding also preserves control over key decision-making in the hands of the entrepreneur. Equity stakes also confer advantages on financial intermediaries by enabling the financial institutions (both private and public) to share in the upside potential of SMEs. This is especially important because SMEs are characterised by relatively high failure rates together with some successes showing very high returns. By sharing in the potential for high returns, equity finance can permit the financial intermediary to reduce the interest spread on the debt component that is required to cover the commercial risk and the cost of doing business with SMEs. The establishment of funds and other intermediaries for equity finance provide the opportunity to contribute to SME development, both through the provision of capital and by providing access to the technical expertise of the fund managers. The role of the EBRD in supporting equity funds and its other support for SMEs are discussed in Box 9.3.

Policies designed to assist SMEs in OECD economies typically include technical assistance for the provision of a range of services. Training programmes can be particularly useful interventions, although the preliminary evidence from surveys suggests that this has often been poorly matched with entrepreneurs' needs. For example, a World Bank review of its experience concluded: "With few exceptions, Bank-supported SME technical assistance programs implemented by public agencies have failed to achieve their stated objectives. There are some success stories, but many technical assistance programs have been chronically dysfunctional, only partially implemented, subverted their original objectives, or never initiated".[15]

[15] Webster (1991).

To be successful, technical assistance must be tailored to specific local needs and be demand driven, responding to the actual rather than externally perceived needs of the client group. In many cases, training is too sophisticated or inadequately adapted to the requirements and skills of the beneficiaries. A primary objective of the technical assistance is to provide the basic skills needed by new and aspiring businesses to allow them to devise business plans, undertake market studies, assess risk and secure finance. Initial orientation training should be available to aspiring or new entrepreneurs before they commit large amounts of their savings or time to ventures. Further training with industry-specific guidance, which includes information regarding the larger competitive environment, networking with suppliers, exporters and others, and which provides information regarding new technologies, also appears to be highly valued. The centralisation of technical assistance in an SME business centre that provides one-stop information, training and legal and regulatory services has at times proved to be a successful policy initiative in OECD countries. However, the experience in developing countries of one-stop or integrated initiatives is mixed. When skills and resources are scarce, it may be better to draw on specific specialists in areas such as law, accounting or marketing, rather than grouping or attempting to centralise these skills within one SME-focused institution.

9.4 Concluding remarks

In competitive market economies, SMEs flourish. In order to do so in transition economies, SMEs require, first and foremost, sound macroeconomic and competitive market structures. The establishment of the macroeconomic and competitive foundations of a market economy, including measures that reduce barriers to entry, provides the seed-bed in which SMEs will succeed. Special privileges are not necessary and can recreate distortionary practices.

None the less, SMEs have a special role to play in transition economies and they face severe constraints. In some cases, a focused effort can help mitigate those constraints. In attempting to do so, the response of governments and IFIs will need to take account of the stage of transition and have firmly in mind lessons from the mixed record of official support for SMEs in both OECD and developing countries.

The crowded reform agenda and scarce resources in transition economies require that any policy interventions to assist SMEs be well targeted. This requires detailed information regarding the ranking of constraints faced by SMEs in each country, and these constraints will evolve with the transition. Effective policies will have to be adaptive and reflect the particular constraints and the capacity to implement such SME programmes, in order to ensure that they are demand-led and market-friendly.

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Annex 9.1
SMEs in the transition economies

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: None available as enterprises are no longer required to register. *Additional information:* Evidence of thriving private, small-scale activities in urban areas. The majority of these enterprises are involved in more than one activity, but primarily in retail trade, repair, construction and food-processing. Most small enterprises are financed through remittances from abroad.	No data available.	Decree 938 of June 1993 provides a legal definition of small firms (employing fewer than 50 workers) in the context of privatisation of SOEs. A number of international donors (both national governments and international agencies) are currently engaged in the provision of subsidised credit and technical assistance to SMEs. Regional Business Agencies established with Phare support.	**Albania**
Official data: Enterprise registration requirements do not include information on the number of employees. 13,300 individual businessmen are on the State Register, of whom over 60 per cent operate in the service sector and retail trade and 20 per cent in agriculture.	No data available.	No government policy is specifically targeted at SMEs. However, start-up firms in the manufacturing and agricultural sectors benefit from tax holidays in the first two years. Technical assistance is provided by Tacis, targeted primarily to medium and large firms, rather than to smaller units which are mainly engaged in local retail trade.	**Armenia**
Official data: 44,750 SMEs are currently registered with the Central Statistical Board, 70 per cent of which are private and more than half of which are self-employed entrepreneurs. Most SMEs operate in the service and retail sectors and only 8 per cent in industry. *Additional information:* Many enterprises register for the purpose of one-day transactions (and never deregister) and many of the existing ones are registered for a number of activities. A survey by the SME Development Agency of their members indicated 32 per cent micro-sized, 62 per cent small, and that 60 per cent operated in manufacturing, 50 per cent in trade and 20 per cent in other services. Micro-sized enterprises are on average 3.12 years old, with a turnover of US$ 64,260 (4.17 years and US$ 318,540 for small ones – six years and US$ 1,833,000 for medium-sized ones); over 60 per cent of the sample were registered as sole proprietors and 15 per cent as limited liability companies.	A survey by the SME Development Agency of their members found 60 per cent of employment in small units and 34 per cent in medium-sized firms.	Profits reinvested in machinery, technology and training are tax free. A tax holiday for the first two years of activity is available for SMEs in most productive sectors (three years for small firms). Duty exemptions are available for small joint ventures importing foodstuff from abroad.	**Azerbaijan**
Official data: At the end of 1993, 43 per cent of all registered enterprises were small.	128,000 workers were employed in registered small firms in 1994, 22 per cent of which in the private sector. 154,000 self-employed workers were registered by the end of 1994, 6 per cent of total employment.	A tax-free period of three years for start-up firms and 50 per cent of profits untaxed if reinvested. A state co-funded Business Support Services and Financial Fund for Entrepreneurs provides support services.	**Belarus**
Official data: 460,000 private enterprises registered by mid-1994 (96 per cent of which were micro-sized) and around 8,000 joint ventures with foreigners or foreign firms (mostly engaged in retail trade) – around 6,000 active state-owned SMEs. *Additional information:* A recent survey found that as few as 20 per cent of registered enterprises in the manufacturing sector are active.	No data available.	The Ministry of Industry's Small Business Fund was established in 1991 to assist the setting up of small, completely private firms in industrial production or industrial services. The Fund lends money to small enterprises (with up to 30 employees or Lev 3 million equity) for investment purposes (up to 70 per cent of a project) for a maximum maturity of five years with favourable interest rates. So far, only 12 firms have received loans, and seven firms have been given grants.	**Bulgaria**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Croatia	*Official data:* 21,180 SMEs were registered by April 1995, 57 per cent of which were micro-sized, 28 per cent small and 15 per cent medium-sized.	By April 1995, 500,000 workers were employed in registered SMEs, accounting for 30 per cent of total employment. 8 per cent of all employment in SMEs is in micro-sized units, 29 per cent in small firms (65 per cent of which in services and 29 per cent in industry) and 34 per cent in medium-sized units.	A department of the Ministry of Economic Affairs oversees the promotion of the handicraft and small business sector, coordinating its activity with that of other ministries. Financial assistance to entrepreneurs employing fewer than 100 workers is channelled through the commercial banking sector and supported by the Croatian Guarantee Agency for Private SMEs (primarily for investment in fixed material assets). Local assistance programmes are available through municipalities.
Czech Republic	*Official data:* By April 1995, 20 per cent of all registered enterprises were SMEs, 87 per cent of which were micro-sized. 36 per cent of SMEs operate in retail or wholesale trade, 17 per cent in manufacturing and 8 per cent in agriculture. The majority of SMEs are privately owned, of which two-thirds are sole proprietors and one-third limited liability. *Additional information:* Registered enterprises account for 75 per cent of active enterprises. Their size distribution in the manufacturing sector is rapidly approaching that of neighbouring Western economies.	By April 1995, 37 per cent of total employment was in SMEs, 29 per cent of which in micro-firms, 35 per cent in small firms and 36 per cent in medium-sized firms.	Support for SMEs, financed by the Czech National Council Act 28 April 1992, is available in the areas of training, credit subsidies, consultancy and applied research, with priority given to the capital goods sector and depressed areas. In 1993 the introduction of VAT and abolition of tax breaks for new entrants removed some of the incentives for SMEs. In January 1994, new measures were taken to support SMEs, including price-supported guarantees, contribution to interest payments for bank credits and interest free loans for projects involving technology transfer (financial support is provided jointly by Phare and the Czech government).
Estonia	*Official data:* By May 1995, 36 per cent of all registered enterprises were SMEs, including self-employed workers. Of these, 70 per cent are micro-sized and 25 per cent small. 39 per cent of all SMEs operate in retail and wholesale trade and 17 per cent in manufacturing.	By 26 May 1995, 45 per cent of total employment was in the SME sector, 53 per cent of which was in the retail and wholesale trades.	Governmental institutions supporting SMEs are the SME Office at the Ministry of Economy and the Department of Local Government and Regional Development at the Ministry of Internal Affairs. Non-governmental bodies include the Estonian Small Business Association, the Chamber of Commerce and Industry, and the Phare-established Business Advisory Centre. Financial support is channelled through a number of public funds with a new SME Fund established in January 1995. No specific tax incentives are targeted to SMEs. The main legislative instrument is the Law for State Support for Entrepreneurship (30 May 1994).
FYR Macedonia	*Official data:* Nearly 70,000 SMEs were registered by the end of 1994, mostly private, 66 per cent of which were in retail trade, 9 per cent in industry; more than half concentrated in the two largest cities; most SMEs were less than four years old. At the end of 1993 the SME sector was estimated to account for 40-50 per cent of total GDP. *Additional information:* Around one-third of SMEs were reported as being actually active in early 1995.	SMEs account for 37 per cent of total employment. About 10 per cent of the labour force was estimated to be active within the informal sector by the end of 1993.	No data available.
Georgia	*Official data:* None available. *Additional information:* Tacis estimates that 46,000 enterprises are currently active (including the self-employed and primary sector), two-thirds of which are micro-sized and over half of which are in the service sector (30 per cent among medium-sized units). 60 per cent of all SMEs are privately owned.	Estimates by the Tacis-supported Business Communication Service suggest that 58 per cent of the labour force is employed in the SME sector, one-third of which in small enterprises and more than half in medium-sized ones.	No data available.

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: By January 1995, 99 per cent of all registered enterprises were SMEs, 73 per cent of which are micro-sized, 22 per cent small and 5 per cent medium. 80 per cent of all SMEs are registered as sole proprietors. Nearly all SMEs are private. 40 per cent of all micro-enterprises operate in the trade and retail sectors, 21 per cent in business-related services and 15 per cent in manufacturing. 36 per cent of all medium-sized enterprises operate in manufacturing, 15 per cent in trade and repair and 7 per cent in business-related services.	The 1994 Labour Force Survey found one million workers in SMEs (24 per cent of employment), 21 per cent of whom in units employing between 10 and 19 workers, 22 per cent in units employing between 20 and 50 and 57 per cent in units employing between 51 and 300.	A large number of specialised state funds address the financial needs of enterprises with fewer than 150 employees over a very broad range of activities. Subsidised credit is available both from national and international sources (both bilateral and multilateral), often mediated by local ad hoc foundations. Credit guarantees and export insurance schemes for small enterprises are also available. Technical assistance for small enterprises is available from a number of national private foundations, often financed by the state and Phare. Small entrepreneurs can choose to register either as a "sole trader" or as a "business". Sole traders have no limit on the number of workers employed or on turnover but ownership must be in the hands of a sole proprietor. Corporate legislation does not differentiate between small and large firms. Corporate taxation, both on profit and on value added, local taxes and insurance contributions are the same for small and large firms. Sole traders benefit from simpler accounting procedures and are not required to pay profit tax.	**Hungary**
Official data: 600 medium-sized enterprises – primarily in retail trade – are reported as active. *Additional information:* The vast majority of SMEs were created through the unbundling of state-owned enterprises and are still in state hands.	No data available.	No data available.	**Kazakstan**
Official data: Most recent estimates refer to the end of 1991 and report 4,300 small enterprises under state control (81 per cent of all state enterprises), primarily in the retail trade and service sector. *Additional information:* A labour force survey in 1994 found that 26.6 per cent of industrial establishments employ under 100 workers; that on average these enterprises suffered at least a 30 per cent decline in sales between the end of 1991 and April 1994; that they buy 85 per cent of their input locally and export less than 10 per cent of their output, with a capacity utilisation of 45 per cent. Roughly 60 per cent of such enterprises are private.	Most recent estimates refer to the end of 1991 and report 220,000 workers employed in small enterprises under state control (24 per cent of employment is in the state sector). A survey of Kyrgyz industry found that 3.4 per cent of the total labour force was employed in firms with up to 100 workers in March 1994 (up from 1.1 per cent before reforms). In 1993, 38 per cent of these workers were reported on leave.	No data available.	**Kyrgyzstan**
Official data: No data available. *Additional information:* 46 per cent of all SMEs are micro-sized, 35 per cent small and 19 per cent medium. Micro and small enterprises are mainly in retail and services; medium-sized enterprises in manufacturing. 40 per cent of micro-firms are owned by sole proprietors. Three-quarters of small firms were registered as limited liability. The majority of micro-firms were established after 1991 (but only 55 per cent of medium-sized ones), according to a Phare-funded survey.	No data available.	SMEs have the possibility of not registering for VAT if their turnover is below Lat 10,000. Profit tax reliefs (80 per cent discount on profit tax) and simplified auditing and accounting standards are also offered to SMEs. Subsidised loans (4.5 per cent interest rate per month) and training programmes have been set up by donors including Phare.	**Latvia**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Lithuania	*Official data:* 44,700 small enterprises were registered by March 1995, the majority of which are private. 40 per cent of SMEs are registered as involved in more than one sphere of activity, 44 per cent are uniquely involved in trade and 13 per cent in manufacturing.	No data available.	The recently amended Law on Small Enterprises (20 April 1995) grants a tax reduction of 70 per cent for the first two years of operation (50 per cent afterwards) to firms employing up to 50 workers and with an annual income of less than Litas 500,000. The SME Development Programme, approved on 9 March 1995, provides a wide range of services (promotion of SMEs' exports, training, incentives for foreign capital). Six Phare co-funded Business Advisory Service Centres provide counselling and training to start-up SMEs and self-employed.
Moldova	*Official data:* In July 1995, out of a total of 71,000 registered enterprises, 29,000 were registered as individual companies with no more than five employees (a 10-fold increase since 1993), 2,400 as cooperatives, and 14,000 as farms (most of these are small). *Additional information:* Estimates indicate that 57 per cent of active enterprises employ fewer than 200 workers. 23 per cent of all SMEs are micro-sized, 39 per cent small and 42 per cent medium. The majority of active SMEs are in the capital city. 21 per cent reported some activity in agriculture and fishing, 20 per cent in distribution and sales, 9 per cent in construction, 5 per cent in transport and 24 per cent in manufacturing (but multiple activities are common). 10 per cent of all surveyed enterprises were established before 1989.	No data available.	State policies for SMEs are framed within the Law on Support and Protection of Small Business adopted on 20 May 1994. A programme to support private entrepreneurship and small businesses for the 1994-97 period was approved on 26 October 1994. A Small Business Support and Development Fund was created on 21 October 1993 and allocated Lei 128,500 in 1994. Micro-enterprises are not subject to profit tax for the first five years of activity (three years if in the service sector) and pay a reduced tax rate for a further two years if they reinvest at least 80 per cent of the tax loan in the SME activity. Donations to the SME Fund are free from tax up to 1 per cent of total tax bill. Export and import duties are reduced by 50 per cent of the base rate for the first three years after registration. Soft loans (from 25 per cent to 90 per cent of interest rate) and grants are available to SMEs for a three-year period. Further facilities are open to small-scale private farmers.
Poland	*Official data:* By the end of 1993, 1,382,000 micro-sized firms accounted for 93 per cent of all registered enterprises and medium firms accounted for 6 per cent. 19 per cent of micro-sized units operated in industry, 48 per cent in retail trade and 11 per cent in building. 35 per cent of micro-sized units were established between 1971 and 1990 (50 per cent of those engaged in industry). 52 per cent of micro-sized units had one employee *Additional information:* There are currently about two million SMEs operating in Poland, which generate almost 50 per cent of GDP.	By the end of 1993, there were 2,427,000 workers employed in micro-sized firms and 970,000 in medium-sized firms, accounting for 23 per cent of total employment. 55 per cent of employment in micro-sized firms is in the retail trade, 20 per cent in industry and 9 per cent in building. 38 per cent of all workers in micro-sized units are employed in firms created before 1990. Currently, about 60 per cent of total employment is in SMEs.	A policy document, "Small and Medium Enterprises in the National Economy", was adopted by the Council of Ministers on 6 June 1995. The document envisages amendments and changes to legislation favourable to SMEs. A local network system of credit guarantee funds for SMEs will be organised. The amount of budget resources allocated primarily to the credit guarantee fund in 1995 is equal to Zl 25 million. The Polish Foundation for the Promotion and Development of Small and Medium Enterprises is in the process of being established. It will provide information support to SMEs and organise training and education courses for entrepreneurs.
Romania	*Official data:* 98 per cent of all enterprises registered by the end of 1994 were SMEs (including self-employed). 85 per cent of all SMEs are micro-sized, the majority of which are private. 70 per cent of all SMEs are engaged in retail or wholesale trade (21 per cent of medium-sized enterprises) and 11 per cent in industry (25 per cent in manufacturing). *Additional information:* Data on distribution is broadly in line with a survey of small firms where 73 per cent employed up to nine workers, 20 per cent between 10 and 99 and 7 per cent between 100 and 499. 56 per cent of all SMEs surveyed were active in commerce, 22 per cent in industry and 8 per cent in construction.	About one million workers (approximately 20.5 per cent of enterprise employment) are employed in small enterprises (fewer than 200 employees) and 650,000 workers (approximately 12.7 per cent of enterprise employment) are employed in medium-sized enterprises. 57 per cent of SME workers are employed in the private sector, 38 per cent in the public sector and 5 per cent in the so-called mixed sector.	The Romanian Agency for Development with the support of non-governmental institutions (foundations, chambers of commerce, associations) and often with international assistance (primarily Phare) has prepared specific measures to assist SMEs, including a simplified computation of profit tax base for small enterprises, VAT exemption for firms with a turnover below US$ 100,000, deduction of investment costs up to 50 per cent of total profit tax liability, SME credit lines 50 per cent below market interest rate and heavily subsidised technical assistance delivered through SME Development Centres.

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: 480,000 active small enterprises were reported at the beginning of 1994, one-third of which in retail and wholesale trade, nearly 40 per cent in industry or construction and one-tenth under state or municipal ownership (but nearly one-quarter of units in agriculture). 30 per cent of all small enterprises are registered in the Moscow area. *Additional information:* Recent study of GOSKOMSTAT data found severe underestimation of the number of active small units and put the number closer to one million units. Official estimates ranged from 600,000 (Anti-Monopoly Committee) to 700,000 (Union of Private and Privatised Enterprises).	6,830,000 workers were officially employed in small enterprises at the beginning of 1994, of which a third were in industry, another third in construction and a quarter in state or municipal enterprises. The 1994 ILO Russian Labour Flexibility Survey of 384 enterprises employing 303,000 workers, found 35 per cent of employment in small enterprises (with fewer than 250 workers); labour surplus estimated at 25 per cent; 11 per cent of workforce on leave.	State legislation supporting small enterprises was introduced in early 1993, coordinated by the Ministry of Economy and implemented by several agencies in different ministries. Rb 25 billion were initially set aside as an incentive to small enterprises in the Support Fund for Entrepreneurs (by the end of 1994, only Rb 7.5 billion had been made available). Short-term credit and infrastructure for small enterprises in technical sectors is available within the federal innovation programme. A profit tax holiday is available for small enterprises in the first two years and discounts in the next two years. The tax base is unchanged for the first five years (but other tax incentives were severely curtailed in early 1995). 58 regional or municipal funds supporting SMEs locally were active by early 1995. Technical assistance for entrepreneurs is available through international agencies (e.g. Tacis) and a number of bilateral programmes. Technical assistance for financial institutions is available through the EBRD Russian Small Business Fund. The new federal law, Support of Small Enterprises, came into force on 22 June 1995. The law imposed additional restrictions on the form of ownership of SMEs. Upper limits on the number of employees were changed (these limits differ among industries – the highest limit is 100 employees). The law broadened the rights of small businesses to use accelerated amortisation and introduced some non-tax privileges.	**Russia**
Official data: 35,000 SMEs were registered in 1994, 80 per cent of which are micro-sized and 12 per cent medium-sized. 5 per cent of all SMEs are under some form of state control, 20 per cent with some form of foreign ownership, and they are evenly distributed around the country with 30 per cent in Bratislava. Their average age is three years.	At the end of 1994, there were 425,400 registered SME employees (23 per cent of total employment) but only 14 per cent of all SME workers in micro and small firms.	The Act on the State Support of Small and Medium Enterprises of 3 May 1995 defines a small entrepreneur as a person who employs a maximum of 24 employees, and a medium entrepreneur as a person who employs a maximum of 500 employees. The main forms of support to SMEs are the provision of loans, loan guarantees, reimbursement of interest or part of interest and subsidies.	**Slovak Republic**
Official data: By the end of 1994, there were 28,000 small enterprises (+286 per cent over 1990; +7 per cent over 1993) and 1,158 medium firms (+105 per cent over 1990; -1 per cent over 1993), altogether accounting for 98 per cent of all registered enterprises (13 per cent medium and 81 per cent small in 1990; 4 per cent medium and 94 per cent small in 1993); 42 per cent of small enterprises engaged in business-related services (37 per cent in 1990); 23 per cent in retail and wholesale trade (24 per cent in 1900) and 13 per cent in industry (16 per cent in 1990). Small firms generated 22 per cent of total revenue and 31 per cent of total recorded profit while employing 12 per cent of total capital. Medium sized firms generated 15 per cent of total revenue, 13 per cent of profits and 16 per cent of total capital. *Additional information:* A survey of 156 small firms carried out in 1993 (excluding agriculture) found that 30 per cent had been set-up before 1989 as "craft" enterprises, primarily in the manufacturing sector. Nearly all units set-up after 1989 are private, limited liability companies and primarily in the retail trade and service sector. Nearly 10 per cent of the total are spin-offs.	By the end of 1994, there were 88,350 workers employed in small enterprises (employing fewer than 50 workers) which submitted financial reports accounting for 19 per cent of employment in the enterprise sector (6.1 per cent in 1991 and 17.9 in 1993) and 10 per cent of the labour force. 35 per cent of all workers in small firms are engaged in commerce, 30 per cent in the retail and wholesale trade and 16 per cent in industry. A further 105,000 people registered as self-employed.	The Small Business Development Centre (Ministry of Economy) is the governmental agency that supports SMEs and coordinates international assistance. The implementation of policy measures to support SMEs is in the hands of the Small Business Development Network (co-funded by Ministry of Economy, Labour and Technology and independent Chamber of Commerce and Craft). Main policy measures include profit tax relief for start-ups and small enterprises for the first four years and rebates for the import of foreign machines and raw materials (especially for export-oriented firms). Credit guarantees are arranged through a Fund for SMEs and locally by municipal funds, training and international promotion (primarily through trade fairs), and links with small business associations of neighbouring countries.	**Slovenia**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Tajikistan	*Official data:* No data available *Additional information:* A study carried out in July 1993 found around 3,000 active small enterprises (employing fewer than 200 workers), 60 per cent of which were state-owned, 21 per cent producing consumer goods (14 per cent among privately owned private firms) and 14 per cent in retail trade (35 per cent among privately owned private firms). A further 4,300 persons are self-employed, more than half of whom in consumer goods production. 40 per cent of all enterprises are in the Leninabad region.	Roughly 40,000 employees in small sector by mid-1993, 62 per cent of which in state-owned units, a third in consumer goods production and over a quarter in construction.	No data available.
Turkmenistan	*Official data:* In 1993, 9,000 SMEs were registered, of which 3,000 were privately owned. In addition, 300 retail and small-scale production facilities operate within the parastatal Turkmenistan State Cooperative Alliance. In 1995, 21,000 private companies were officially registered.	No data available.	No data available.
Ukraine	*Official data:* Nearly 80,000 small enterprises (employing on average fewer than 200 workers) operated at the end of 1994. Privately owned enterprises accounted for 43 per cent of all small firms, 50 per cent of sales and 53 per cent of profits. Collectively owned small enterprises accounted for 51 per cent of all small firms, 42 per cent of sales and 40 per cent of profits. 42 per cent of all small firms are engaged in commerce, 16 per cent in industry and 15 per cent in construction.	The 1994 ILO Ukraine Labour Force Survey of 350 enterprises employing 370,000 workers found 27 per cent of all workers in units with up to 250 employees. One-third reported excess labour force in spite of 6 per cent of reported employees being on partially paid leave and employment cuts of roughly 8 per cent over the previous year. Capacity utilisation declined over previous years by around 60 per cent. Wages and earnings are higher in SMEs than in other enterprises.	Government support measures focus on newly established firms and newly privatised ones (most of which are small). Tax exemptions have recently been withdrawn. A number of programmes targeted to small business and credit and technical assistance are funded by international agencies.
Uzbekistan	*Official data:* 60,000 small scale enterprises were privatised by the beginning of 1995. By mid-1993, the construction and retail trade were the two most significant SME activities. On 1 April 1995, there were 1,348 small enterprises. 1,472 small enterprises (with fewer than 300 employees) and 291 medium (300-1,000 employees) are scheduled for privatisation in 1995.	No data available.	A Presidential Decree dated 5 January 1995 simplifies registration procedures for start-up firms (mostly small), provides tax incentives for start-ups and new investment (but not on value-added taxation) and channels 50 per cent of privatisation income to support SMEs (subsidised credit and loan guarantees). A recent survey of small entrepreneurs, however, found that none had ever had access to these funds. On 26 July 1995 the Agency for Insurance Protection of Private Enterpreneurship and Small Business was created together with the Fund for Support of Private Enterpreneurship and Small Business Support (partly funded through receipts from privatisation and from the Employment Assistance Fund, and partly by domestic and foreign donors).

Developing financial institutions and markets

10

The financial sectors in eastern Europe, the Baltics and the CIS must perform two vital roles in the transition toward a market-oriented economy: the mobilisation and allocation of savings and the exercise of financial discipline over enterprises. This chapter assesses progress in reform and development in the region, gauging the capacity of the financial sectors to perform these roles. The analysis proceeds along two largely separate strands: one examines the transformation of banking and the other the emergence of securities activities. Consideration is given both to the role of government and its effectiveness, and to the performance of financial institutions and markets themselves. Although banking and securities activities are analysed separately, potential interactions between these two spheres are also suggested.

Information on the financial sectors in 12 countries in the region provides the analytical basis for this chapter.[1] These countries form a representative cross-section of those in the region in terms of both starting points and progress in transition. The role of government in the financial sector is assessed by examining the laws and regulations applied to banking and securities activities, as well as their enforcement. The performance of financial institutions and markets is gauged by measuring the scale of banking and securities activities relative to the overall size of the economy in which they take place. Market structure and profitability in banking are also examined.

10.1 Financial reform and development

Under central planning, a single state bank effectively performed both commercial and central banking functions.[2] This "monobank" typically played a passive role in the allocation of credit, providing book-entry credits to state enterprises for investment projects approved under the central plan. Since credit could only be created and spent with government approval, this lending by the monobank was not guided by the opportunity cost of funds or by the ability to repay. Moreover, there were virtually no securities markets and the only non-bank financial institutions were a few state insurance companies.

The comparatively marginal and tranquil existence of bankers in the region changed abruptly with the introduction of market reforms. Two-tier banking systems were created, separating central and commercial banking functions. The newly created state-owned commercial banks gained more autonomy in credit allocation decisions. At the same time, however, the enterprise sector experienced considerable upheavals, with liberalisation of prices and trade, cutbacks in state procurement and the collapse of intra-regional trade. Many outstanding loans soured and the quality of new lending became difficult to judge. In addition, the reforms necessary to impart clear incentives for the prudent management of state banks and new private banks took time to implement, allowing the initial spate of bad loans to proliferate in many countries.

Despite the initial setbacks, headway has since been made in overhauling the banking systems in the region. Many countries have enacted legal and regulatory frameworks for banks that draw upon international standards. Procedures for working out bad loans have been implemented in a number of countries in eastern Europe, while others in the Baltics and the CIS have relied on high inflation and negative real interest rates to shrink the asset quality problem. In some eastern European countries, the authorities have recapitalised state-owned commercial banks, raising their capital ratios towards minimum international standards while committing to their privatisation. The actual pace of privatisation of state banks has been slow, however. Some countries, particularly in the Baltics and the CIS, have allowed the extensive, if not excessive, creation of new private banks. Regardless of the chosen reform path, the scale of lending by banks, particularly to the private sector, remains small relative to the size of the economies in which they operate.

Securities activities in the region are typically less developed than banking. The authorities in a number of countries have moved to create the basic legal and regulatory framework for securities activities. Development of the securities markets themselves, though, has been largely shaped by broader developments, in particular the nature of privatisation programmes. In those countries that have pursued a selective approach to privatisation and to listing companies on the stock exchange, such as Poland, the capitalisation of the market remains small relative to the size of the economy, but the liquidity of the stocks is high relative to total capitalisation. In those countries that have pursued mass privatisations, such as the Czech and Slovak Republics, the total stock market capitalisation is high relative to the size of the economy, but the liquidity of these markets is low relative to their total capitalisation. The lack of market liquidity in those countries that pursued mass privatisation programmes can pose a serious impediment to the post-privatisation restructuring of enterprises (Chapter 8).

[1] The countries are Belarus, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Russia, the Slovak Republic, Slovenia and Ukraine.

[2] Kornai (1992) contains an overview of banking under central planning.

10.2 Challenges ahead

The relatively small scale of the financial sectors in the region poses a potentially serious impediment to enterprise restructuring and investment finance, especially in view of the emerging recovery in demand and growth in most of the region. The further development of banking and securities activities requires both the continued transformation of the role of government in the financial sector, particularly in enforcing laws and regulations in this area, and the strengthening of the financial institutions and markets themselves.

The particular priorities in individual countries depend on the reform paths being pursued. In eastern Europe, where the emphasis has been on transformation of state banks, a barrier to sustained progress is the difficulty in their privatisation, which is necessary to strengthen incentives in the sector and to attract the resources required for expansion. In the Baltics and the CIS, new private banks have gained significant market shares following a period of liberal entry. However, the risks in these banking systems are considerable, and their consolidation will require careful management. Indicators of bank profitability point to healthy returns once the asset quality problems are resolved, reflecting in part the small scale and concentration of these markets. This suggests that banks will be able to attract the financial and staff resources required for their expansion and possible deconcentration, although support from the EBRD and other IFIs can accelerate this process both by assisting governments to transform their role and by investing in banks to strengthen their operations. One form that this investment can take is technical cooperation. Since securities activities in the region remain in their formative stages, the building of institutional infrastructure for these markets is required, along with improvements in the amount and quality of financial disclosure, greater protection of shareholder interests, and more transparent markets. Since securities activities are undertaken largely in the private sector, support from the EBRD and the IFC can play an important role in strengthening these institutions and markets.

10.3 The transformation of banking

The importance attached to the transformation of banking in transition economies reflects its fundamental role in a market economy, providing not only finance for investments by enterprises and financial discipline over their operations but also vital transaction services for commerce and securities activities.[3] This section on banking is divided into two parts: the first is on the changing role of government, while the second focuses on the concentration, relative size and profitability of banks.[4]

Changing role of government

The changing role of government in banking involves a number of dimensions, apart from the basic creation of a two-tier banking system and credit market liberalisation (Chapter 2).[5] These include the introduction and strengthening of prudential regulation and supervision, recapitalisation and privatisation of state banks, and policies toward entry and exit of private banks. Some countries in eastern Europe have attempted to move along these various dimensions in a deliberative manner, while others in the Baltics and the CIS have engineered a more rapid break with the past by allowing a period of liberal entry of new private banks as very high inflation reduced the size of state banks and former state banks.

Reform of prudential regulation and supervision

Most countries considered in this chapter have moved to enact a basic framework for prudential regulation, which aims to provide incentives for the prudent management of banks and to limit specific types of risk exposures.[6] Given the bad loan problems in most countries, capital adequacy standards and rules on the classification of assets by quality and on the provision against identified loan losses have assumed a particularly important role. Other regulations that take on added significance in transition economies are limits on concentrated or connected lending and on equity investments.

Capital adequacy regulations have been introduced throughout much of the region. Belarus, Bulgaria, the Czech Republic, Estonia, Latvia, Hungary, Poland, Romania, the Slovak Republic and Slovenia have introduced regulations that draw upon the Basle Committee or EU standards for capital adequacy (Table 10.1). In some countries, such as Bulgaria, the Czech Republic, the Slovak Republic and Ukraine, these standards are being phased in over a fixed period to allow for a smooth adjustment by banks. Procedures for classifying assets and for making specific provisions against doubtful and unrecoverable loans have also been introduced in most of the countries. However, there remain in some of these countries significant departures from Basle Committee or EU standards in the definition of regulatory capital, as well as scope for discretion in application of loan classification and provisioning rules. Effective supervision is required to ensure that asset quality is accurately reflected in financial accounts.

[3] King and Levine (1993) and Blommestein and Spencer (1994).

[4] A number of studies have begun to examine the evidence on performance of the financial systems in eastern Europe. See, for example, Abel and Szekely (1994), Dittus (1994), Dittus and Prowse (1994) and Hrncír (1994).

[5] A legal reform vital to the banking development is the law on secured transactions. See Chapter 6, as well as the 1994 *Transition Report* and Baer and Gray (1994).

[6] The Group of Banking Supervisors from Central and Eastern European Countries, which is supported by the Basle Committee on Banking Supervision, provides a forum for the development of basic principles of banking supervision in the region and for technical assistance in this area. See BIS (1995).

Table 10.1
Prudential regulations for the banking sector

	Capital adequacy ratio	Classification of non-performing assets	Limits on large exposures	Limits on equity investments
Belarus	An 8 per cent standard calculated in broad accordance with international rules as the ratio between a bank's capital and its risk-weighted assets.	The National Bank has a five-category risk classification of loans, in relation to the risk on the investment rate of return and the possible partial loss of asset value. There is no classification of non-performing loans.	Maximum risk exposure to a single borrower may not exceed 30 per cent of a bank's own funds (25 per cent in case of shareholders of the bank); total large exposures portfolio may not exceed 800 per cent of own funds.	A bank's investment in the capital of enterprises is limited to an amount equal to 15 per cent of the bank's own equity.
Bulgaria	An 8 per cent standard for the ratio of total capital to risk-weighted assets, and 4 per cent for the core capital ratio.	Loan classification system includes three classes of asset quality and levels of provisions: doubtful (group A) at 20 per cent, doubtful (group B) at 50 per cent, and uncollectable at 100 per cent.	If a large loan exceeds 25 per cent of the shareholder's equity, the bank must form a special credit reserve to cover the risk of the overexposure to the client, to an amount equal to the excess. Banks are required to notify the BNB within 15 days of being exposed. Total large loans may not exceed eight times shareholders' capital.	Banks need authorisation by the Bulgarian National Bank in order to invest in more than 10 per cent of the equity of a non-financial enterprise. Investments exceeding this limit should be brought in line within three years.
Czech Republic	Since the end of 1993, a transitional solvency ratio of 6.25 per cent drawing upon BIS rules has applied. Banks must reach the target ratio of 8 per cent by the end of 1996.	Regulation on classifying loans and provisioning against doubtful assets establishes five categories: standard, watch, substandard, doubtful and loss.	Exposures to any counterparty or group of economically connected counterparties may not exceed 40 per cent in capital since the end of 1993 and 25 per cent from the end of 1995.	Certain restrictions and conditions are imposed on equity investments with the aim of limiting their size and maintaining transparency of equity holdings in bank and non-bank institutions connected with the investing bank.
Estonia	An 8 per cent standard for the ratio of own funds to risk-weighted assets.	Since December 1993, the Bank of Estonia has required banks to write off loans that are more than 159 days overdue. The Bank has also issued a directive on the assessment of loan quality and the constitution of reserves which were replaced by the relevant provisions of the 1995 Credit Institution Law.	The maximum total exposure to a single customer or connected counterparties is 25 per cent of own funds. Where supervision is not on a consolidated basis, the maximum ratio is 20 per cent. There is also a 20 per cent limit of total lending to managers, employees and shareholders of the bank. Total large exposures may not exceed 800 per cent of own funds.	A regulation issued on 26 July 1994 imposes restrictions and conditions on certain types of loans and investments in equity participations.
Hungary	The 1991 Banking Act prescribes that an 8 per cent weighted asset risk reserve ratio be reached by the end of 1994.	The 1991 Banking Act prescribes that non-performing loans be classified as doubtful, substandard and bad, with regard to delay in repayment and to the financial state of the borrower. Provisions varying from 20 to 100 per cent are accordingly mandated. Banks are allowed to accumulate loan loss reserves over a period of three years and to provision on pre-tax, rather than post-tax, profits.	A large loan is defined as the total amount of placements to a single borrower which exceed individually or on aggregate 15 per cent of the adjusted capital of the financial institution. The total amount of large loans cannot exceed eight times the adjusted capital. The total amount of loans extended to a single borrower cannot exceed 25 per cent of the adjusted capital.	Financial institutions may generally not hold a direct or indirect proportion of ownership in an enterprise exceeding 40 per cent and 15 per cent, respectively, of their adjusted capital. Also they can hold more than 51 per cent ownership only in other financial institutions, similar businesses or activities related to the bank's own activities. In the latter case, ownership cannot exceed 60 per cent of the adjusted capital of the owner financial institution.
Poland	The solvency ratio was established on the basis of BIS standards with some slight adjustments to allow for country-specific circumstances. An 8 per cent standard for the ratio of risk weighted to assets to own funds applies.	Loan quality is appraised with regard to the borrower's overall financial position and delays in repaying the loan. Loans are classified as substandard, doubtful and loss, when the delay is respectively 1, 3 or 9 months. Provisions respectively of 20, 50 and 100 per cent are then required.	Under an amendment to the Banking Act, proposed in May 1994, total large exposures (i.e. of amount over 10 per cent of bank's own funds) may not exceed 800 per cent of own funds.	The Banking Act prescribes a ceiling of 25 per cent of own funds to investment in securities and other companies' equity. Treasury Bonds are exempt.

Table 10.1 (continued)
Prudential regulations for the banking sector

	Capital adequacy ratio	Classification of non-performing assets	Limits on large exposures	Limits on equity investments
Romania	An 8 per cent standard applies to the ratio of own funds to risk-weighted assets. Own funds includes both core capital and supplementary capital (largely subordinated debt).	Banks must classify their assets and make specific provisions on the following basis: standard at 0 per cent, watch at 5 per cent, substandard at 20 per cent, doubtful at 50 per cent and loss at 100 per cent.	Loans to a single borrower and bank staff may not exceed 20 and 5 per cent of own funds respectively. All exposures above 10 per cent of own funds must be reported to the National Bank. The total of large exposures may not exceed 800 per cent of own funds.	An investment in a non-bank company may not exceed 20 per cent of that company's capital.
Russia	Commercial banks are required to satisfy the following minimum requirements: a 4 per cent ratio of bank's capital to assets; a 4-5 per cent ratio of bank's capital to bank's risk-weighted assets.	Instruction 17 of the Central Bank sets five categories of risky assets: pass, watch, unsatisfactory, charge-off and lost.	Commercial banks must satisfy a minimum ratio of one-borrower exposure to bank's capital of 0.5-1.0, which does not apply in the case of loans secured by tangible collateral or third-party guarantees.	At present there are no limits on equity investment of banks into other companies.
Slovak Republic	Since the end of 1994, a transitional ratio of risk-weighted assets to capital of 6.75 per cent applies. Banks must reach the ratio of 7.25 per cent by the end of 1995 and the final target ratio of 8 per cent by the end of 1996.	NBS has issued a regulation on the classification of bad, doubtful and non-standard loans. The classifications are based on past due status. Banks are required to make quarterly reports on their liquidity positions as measured by matching assets and liabilities of similar maturities. The matching of maturities of assets and liabilities may be regulated. Banks are required to establish measures to ensure liquidity in Slovak and foreign currencies.	Commercial banks are required to submit monthly reports on the credit exposures of debtors representing more than 10 per cent of the bank's capital. The credit exposures of the 10 largest debtors cannot exceed 25 per cent of the bank's adjusted capital. Banks are required to reduce any inherited exposures that exceed the new limits to 40 per cent by the end of 1993 and to 25 per cent by the end of 1995. Banks are required to report large exposures to particular sectors of the economy.	Banks may not enter into transactions with their major shareholders if such transactions would limit the bank's activities with other lenders. Investments of a participative nature are not allowed to exceed 25 per cent of the bank's capital. Banks can acquire capital interests of up to 10 per cent of a company's capital. Transfers of more than 15 per cent of a bank's basic capital must be approved by NBS.
Slovenia	Capital adequacy is measured as the ratio of capital to risk-weighted assets, the minimum requirement for which is 8 per cent, in line with BIS standards.	Bank must classify assets into five categories according to the likelihood of repayment, ranging from A (no problem expected) to E (365 days overdue). On this basis, banks must set specific provision against the identified potential loss: 10 per cent for claims in class B, 25 per cent for those in class C, 50 per cent for those in class D, and 100 per cent for those in class E.	A large exposure is defined as an overall exposure (loans, other claims and guarantees) to a single borrower in excess of 15 per cent of a bank's capital. The overall exposure to a single borrower may not exceed 25 per cent of a banks capital. Loans to a bank's directors, managers and owners in excess of certain threshold must be reported to the central bank.	A bank's equity investment in another bank or non-bank company may not exceed 60 per cent of that company's capital. Holdings in any one non-banking company may not exceed 15 per cent of the bank's capital without central bank approval.
Ukraine	The present capital to assets adequacy ratio is 8 per cent. Assets are risk weighted. The major difference as of May 1995 between the Ukrainian legislation and the Basle rules is the interpretation of the terms used. An example of this is the treatment of on and off balance sheet items. There is also some obscurity about the treatment of foreign exchange holdings by the NBU.	In a new regulation of January 1995, banks are required to provision for possible credit losses. The provision amounts are zero for a standard credit, 5 per cent for satisfactory credits, 30 per cent for marginal credits, 80 per cent for doubtful and 100 per cent for irretrievable credits. Only irretrievable credits will be directly written off against profits for the year.	Large exposures are debts to a single borrower that exceed 10 per cent of the bank's own funds. This includes 50 per cent of any off balance sheet exposure. The first guideline is that large exposures should not exceed eight times the bank's own funds. Breaches of this ratio result in first a doubling, and then a tripling, of the solvency ratio. The upper limit on credit to any single borrower is set at 40 per cent of own capital, but is expected to be reduced to more conservative levels, such as 20 per cent.	

Sources: BIS (1995), EBRD, IMF and World Bank.

Restrictions on large exposures to a single borrower (or economically connected group of persons or entities) range from 20 per cent of a bank's own funds in Romania to 40 per cent in Ukraine. In addition, some countries impose a tighter ceiling if the large exposure is to a person or entity connected with the bank (director, manager, employee or shareholder). The Basle Committee recommendation and the EU Directive call for a single large exposure limit amounting to 25 per cent of a bank's capital. The strict enforcement of large exposure limits is particularly important in transition economies because of the close ties between enterprises and (former) state banks and the widespread ownership of banks by enterprises in some countries.

Restrictions on equity holdings typically take one of two forms. The first limits equity investments to a percentage of a bank's capital and reflects the need for portfolio diversification and limits on high-risk exposures. The second restricts equity investments to a share of the investment company's capital, which serves to limit controlling ownership stakes by a bank in non-bank entities. These regulations can have a significant impact in shaping the role of banks in enterprise restructuring and privatisation, for example by determining the scope for debt-equity swaps.[7]

While well-conceived regulations are important, they do not ensure that the prudential regulations achieve the objective of a safe and sound banking system. Realisation of that objective requires adequate supervision of banks to monitor compliance and to enforce the applicable laws and regulations. Effective bank supervision, in turn, hinges upon the development of staff and the provision of accurate information to the regulatory authorities.

A significant challenge for implementing effective supervision is to attract and to train bank examiners. In Hungary and Poland, where there are large numbers of small savings and cooperative banks, the ratio of bank examiners to the number of banks ranges from about 1:4 to 1:3. In the Czech Republic, which has fewer banks, the ratio is around 1:1. The comparable ratios for France and Germany, which also have large numbers of small banks, are around 1:5. The ratio is 3:5 in the United Kingdom, where there are fewer banks. However, these simple comparisons do not take into account the considerable variation in supervisory staff skills and financial accounting and reporting systems among the countries. The regulatory authorities in these countries have also implemented training programmes in banking supervision, which in many cases have received considerable bilateral and multilateral support.[8] However, throughout most of the region, much remains to be done in terms of both recruiting and training supervisory staff.

Apart from adequate staff resources, the other basic input into banking supervision is the financial accounts of banks, which in turn rely on those of the enterprises to form the credit assessments of commercial lending. The accounting practices in much of the region, however, still reflect in part the information requirements of central planning rather than those of depositors and banking supervisors, creditors and other outside investors in banks and enterprises. Under central planning, accounting was designed to enable the government to control the allocation of credit and production in quantitative terms. In banking, there were no accounting standards for bad loans, while enterprise transactions were scored on a cash rather than an accrual basis, so the calculation of profits was not comparable to international standards. While considerable efforts have been made in the region to adapt accounting practices and financial disclosures, the demands for accurate financial information by banking supervisors, creditors and outside investors in enterprises have yet to be fully satisfied.[9]

Overall, while prudential regulations in banking have developed towards international standards, and continue to do so, the capacity to enforce these regulations has expanded at a slower pace. Early weaknesses in regulations and continued gaps in their enforcement have allowed a number of banking troubles to emerge in the region. More effective enforcement will require the sustained development of supervisory staff skills, recruitment of additional staff, and improvements in accounting standards. Moreover, the regulations themselves must be broadly consistent with the stage of development of the banks. If the gap between regulations and banking conditions becomes too great, either the regulations will be ignored or the banks will be forced to adjust in a way that diminishes their role in financing investment. Transitional standards have been used in some countries, such as Bulgaria, the Czech Republic, the Slovak Republic and Ukraine, to ease the adjustment of banks to international standards, while retaining a firm commitment to them.

Recapitalisation and privatisation of state banks

While effective prudential regulation and supervision aim to prevent banking troubles from emerging, an important aspect of the incentive framework for banks is the regulatory authorities' approach toward bank recapitalisation or closure if difficulties do arise. Instilling discipline while recapitalising state banks in eastern Europe has proven to be particularly challenging, however.[10] Governments were essentially unlimited liability shareholders in the dominant state banks, and the behaviour of bank managers was not, at least in the first instance, the primary cause of the bad loan problem. Moreover, the fiscal consequences can curb the scope for direct bank recapitalisations, leading to partial recapitalisation and in some cases to heavy reliance on the inflation tax.

[7] The appropriate role of banks in enterprise restructuring and privatisation has been the subject of extensive debate. See, for example, Corbett and Mayer (1993), and Claessens and Pohl (1994).

[8] EU-Phare and the World Bank have provided extensive support for the development of banking supervision in eastern Europe and the Baltics, while in the Baltics and the CIS the IMF has taken a lead in coordinating assistance. On the latter, see Zulu *et al.* (1994).

[9] The OECD has served as a focal point for technical cooperation on accounting issues. See OECD (1991, 1993 and 1994).

[10] Fries and Lane (1994) and Aghion, Bolton and Fries (1995).

There have been two broad approaches to direct bank recapitalisation, both of which aim to create the conditions under which discipline can be imposed should future difficulties arise. One approach focuses on creating strong incentives for the commercial operation of banks through full recapitalisations, efficient frameworks for resolving bad loans and commitments to bank privatisation. In this approach, the extent of a bank's loan losses is broadly ascertained through an independent audit or other means of verification, with the recapitalisation of a bank designed to restore its capital adequacy after writing down these loans. To resolve the debt overhang in the enterprise sector and to enhance the recovery of problem loans, the approach strongly encourages the work-out of bad loans through direct negotiations between creditors and debtors or through legal bankruptcy proceedings. This is often supported by a commitment on the part of the government to the bank's privatisation, in which its managers may be invited to participate as owners. Following privatisation, any bank failure in principle could be handled in a more conventional way,

Box 10.1

Approaches to the recapitalisation and privatisation of state banks

There follows here a summary of several bank recapitalisation and privatisation programmes in the region, expanding upon the description provided in Annex 2.2 in Chapter 2.

Comprehensive approaches

In April 1993, a second attempt to recapitalise the state-owned commercial banks was launched in ***Hungary*** with the aim of raising their capital ratios to the 8 per cent standard in three steps. The targets under the programme were slightly more than zero by the end of 1993, 4 per cent in May 1994 and 8 per cent in December of that year. In the first phase, the capital of eight banks was raised by an amount equivalent to 3.1 per cent of GDP, of which 77 per cent affected the two largest banks. This was largely implemented by the state purchasing newly issued shares with consolidation bonds. The banks that benefited from these recapitalisations were required to enter into consolidation contracts with the state. Under these contracts, the banks committed to preparing modernisation programmes for their own management, ownership (privatisation) and operating systems, and to taking part in reconciliation proceedings with their troubled debtors. This recapitalisation was followed by two additional ones, both of which amounted to about 0.4 per cent of GDP. As a condition for the May 1994 recapitalisation, each bank was required to submit a detailed consolidation programme, which it had committed to prepare in December 1993. The programmes of some of the banks did not fully meet the requirements, and their programmes were delayed.

The second Hungarian recapitalisation programme was preceded by a hastily arranged bail-out of the banks in 1992 which was deliberately partial. This programme covered banks with a capital adequacy ratio below 7.25 per cent, which were given the opportunity to sell their non-performing loans to the government in exchange for so-called loan consolidation bonds. The government verified whether the loans were non-performing. Claims against specific companies were exchanged at varying discounts for government bonds. The incomplete recapitalisation and surge in the financial reporting of bad loans in 1993 as stricter prudential regulations came into force made necessary the second recapitalisation scheme.

The bank recapitalisation and debt conciliation programme in ***Poland*** was implemented in the course of 1993-94. Seven of the nine state banks created from the former monobank received recapitalisation bonds amounting to about 0.8 per cent of GDP in September 1993 to compensate for bad loans identified through independent audits and to raise their capital ratios to meet regulatory standards, while the state savings bank and agricultural bank were partially recapitalised with bonds totalling 0.7 per cent of GDP in December of that year. At the same time, the authorities committed to privatising the nine state-owned commercial banks by the end of 1996. To encourage the banks to pass on the benefits of their capitalisation to the overburdened enterprises, a fixed deadline was set for reaching conciliation agreements between them (April 1994 for the seven state-owned commercial banks). The agreements reached by the seven commercial banks covered 792 enterprises with total non-performing debts amounting to 0.7 per cent of GDP. By April 1994, these banks had reached conciliation agreements on about half of the loans, while a further one-third either resumed debt service payments or were repaid. Most of the remainder were liquidated under court bankruptcy proceedings. As of mid-1995, three of the nine state commercial banks have been privatised.

The Bank Rehabilitation Agency (BRA) in ***Slovenia*** has, since its establishment in 1992, initiated the rehabilitation of three state-owned commercial banks, two of which have been merged. Rehabilitation procedures can involve conditions imposed on bank operations, as well as transferring doubtful assets to the BRA, which seeks to recover on the claims. The Agency then injects capital in the form of government bonds to meet the minimum requirement and takes over ownership of the bank. The final stage of rehabilitation is bank privatisation. The legislation on bank rehabilitation capped the total amount of government funding available for this purpose. The rehabilitation of the three banks in Slovenia has required the issuance of government-backed bonds equivalent to 6.3 per cent of GDP. These bonds, which are denominated in Deutschmarks, yield an 8 per cent return. Not all of the troubled banks' bad loans were transferred to the BRA, however, owing to the fiscal constraint. The BRA attempted to recover on the loans that it did take over through their sale at a discount, debt rescheduling and debt-equity swaps. For those loans that were retained by the banks, at least one institution has set up a work-out unit to manage these assets. The rehabilitation procedures, including the significant reduction in operating costs, appear to have turned around the operating performance of the banks, and their privatisation is now under consideration.

Quick breaks with the past

In ***Bulgaria***, banks were allowed in 1994 to exchange with the government non-performing, policy-directed loans made before the end of 1990 for state bonds. The face value of these debts amounted to 6 per cent of GDP; however, the bonds received by the banks carry below-market interest rates. Work-out units within the banks are required to recover on non-performing loans made after the end of 1990. No state banks in Bulgaria have yet been privatised.

The former ***Czechoslovakia*** initiated the recapitalisation of its banks in March 1991 by creating the Consolidation Bank, the role of which was to take over special credits for inventories that carried low interest rates. These credits amounted to 11 per cent of GDP, but were not necessarily non-performing. The Consolidation Bank has subsequently recovered much of the debt. A second recapitalisation of the banks occurred in October 1991, equivalent to 5 per cent of GDP. About three-quarters of this amount was allocated to the write-offs of non-performing loans to those firms that, according to the banks' appraisal, had a good chance to survive after the bail-out. Since 1991, the role of the Consolidation Bank has gradually evolved to include participation in enterprise restructuring by purchasing debts of enterprises in bankruptcy proceedings at a discount, easing the adverse impact on the creditor banks. Most existing Czech and Slovak banks were privatised in the first round of voucher privatisations in 1992.

with both shareholders and managers exposed to some form of discipline. Examples of this approach can be found in Poland and Slovenia, as well as in the 1993-94 recapitalisation programme in Hungary (Box 10.1).

The second approach to bank recapitalisation aims to creates a quick break with the past by limiting compensation for losses on loans to those that were in some way clearly linked with the previous regime. This approach typically restricts the types of loans on which compensation for losses would be available. This restriction has taken the form of either a cut-off date, so that losses on loans made after a particular point in time would not be eligible, or a restriction to loans made for a particular purpose. Losses on any loans not covered by the scheme remain the responsibility of the bank and must thus be met out of its earnings or capital. In some cases, this clear break with the past has been reinforced by rapid privatisation of banks. The virtues of this approach are the simplicity of conditions imposed on the recapitalisation and the potential speed in implementation. However, it requires that banks either have sufficient capital to absorb any uncompensated loan losses or have the ability to earn their way out of any remaining difficulties. Examples of this second approach can be found in Bulgaria and the former Czechoslovakia (Box 10.1).

There is a serious risk of distorting incentives for prudent and commercial bank operations from inadequate recapitalisation schemes. In this case, even if there is a commitment to privatisation of the troubled state bank, the inadequate recapitalisation could limit the credibility of the commitment, or it could encourage bank managers to take excessive risks to gamble on the payoff from privatisation. For those recapitalisations that attempt to achieve a quick break with the past, the potential for an inadequate recapitalisation is present. Loan losses are unlikely to be confined to particular types of loans or those made before a cut-off date. The potential pitfalls from inadequate recapitalisations are illustrated by the deliberately partial recapitalisation of the Hungarian banks in 1992, which may have contributed to the surge in bad loans in that country in the following year.[11]

In those countries that have pursued a comprehensive approach to bank recapitalisation, with a clear framework for the work-out of bad loans and commitment to bank privatisation to strengthen incentives, implementation of these relatively complicated programmes has been slow, including the pace of bank privatisation. Of the five state banks that have been privatised in Hungary and Poland in 1993-95, four did not require recapitalisation prior to their sale. Thus, only one state bank that has been recapitalised has, in fact, been privatised. Of the five state banks in the region that have been privatised, the EBRD has been a significant investor in three (Box 10.2). The keys to successful and enduring bank privatisations are both high-quality strategic investors and an effective framework of prudential regulation and supervision.

Box 10.2

EBRD support for bank privatisation

Privatisation of banks in transition economics can be complicated by the lack of a qualified strategic investor, such as a reputable foreign bank. While countries in transition usually lack a sufficient base of domestic investors, foreign investors are often reluctant to buy shares in banks due to the overall country risk and uncertainty about their credit portfolios. To facilitate bank privatisation in these circumstances, the EBRD often purchases a comparatively large share in a bank, normally accompanied by a restructuring and training programme and other technical support. Thus, the EBRD's participation helps not only to strengthen a privatising bank's capital base, but also to improve the quality of the bank's operations and to set the stage for private investors.

For example, the EBRD took part in the privatisation of Wielkopolski Bank Kreditowy (WBK) in 1993 (see also Box 7.7). WBK was one of nine state-owned commercial banks created from the National Bank of Poland. Before privatisation, WBK had increased its private sector loans from zero to 40 per cent of exposure by value and had also begun the task of reserving against its non-performing credits; loan reserves amounted to almost 30 per cent of gross customer credits. None the less, at the time of privatisation no single strategic investor wanted to take the lead. Two western European banks indicated interest, but were not prepared to invest because of their view of the risks involved. The EBRD injected new capital into WBK, acquiring a 28.5 per cent stake of the bank's enlarged capital, and was then instrumental in implementing a comprehensive restructuring and technical cooperation programme.

In 1994, Magyar Külkereskedelmi Bank Rt. (MKB or Hungarian Foreign Trade Bank) was the first Hungarian commercial bank to be privatised. MKB is the fourth-largest Hungarian bank in terms of total assets, but first in terms of its capital ratio. It is a full-service commercial bank that targets multinationals, joint ventures and blue-chip Hungarian companies. MKB managed to avoid the severe problems that faced other Hungarian banks after implementation of banking and bankruptcy reforms. In the unfavourable lending environment of the past few years, it has limited its lending and provisioned heavily against bad loans. MKB was considered the only Hungarian bank able to attract foreign investors in the immediate future. Bayerische Landesbank, a major German institution, showed a strong interest in MKB. However, Hungarian legislation requires reduction of the state ownership to 25 per cent plus one share, and Bayerische Landesbank was not able to take alone the full commitment necessary to privatise the bank. Together, Bayerische Landesbank and the EBRD diluted the state's direct shareholding to the required level. Prior to MKB's privatisation, the EBRD had supported an international bond issue by the bank (see also Box 7.10).

The EBRD also participated in the privatisation of Bank Prezemyslowo-Handlowy w Krakowie (BPH) in early 1995. The bank's credit process, organisation and information system had all been significantly improved since 1989 as a result of staff efforts and technical assistance from a major Dutch bank, ABN-AMRO. Again, however, with the absence of a strategic investor, and under difficult conditions in the local and other emerging markets, the privatisation of BPH could not have been carried out successfully without EBRD support. The EBRD purchased a large proportion of shares in BPH through a stand-by agreement before the offering, boosting the confidence of other potential investors in the bank. As a condition for the stand-by arrangement, the management board and bank council of BPH agreed to a policy statement with the EBRD on additional measures to improve the bank's operations.

[11] Bonin and Schaffer (1995).

Liberal entry and exit of private banks

A number of countries in the region have, at least for a period, allowed the liberal entry of new private banks to help transform banking. This strategy partly reflected the aim of reducing the role of the state banks through not only their eventual privatisation but also the emergence of viable private banks.[12] These new institutions, in principle, can provide a source of competitive pressure on the state banks to hasten the transformation of the sector. However, the entry of banks must be disciplined by adequate minimum capital and licensing requirements. The liberal entry of banks will almost inevitably raise the issue of how to manage exit from the industry.

For example, in the former Czechoslovakia and Poland a substantial number of new private banks were licensed in 1990-92 (43 and 60, respectively). At that time, the minimum capital requirements for banks were quite low and the granting of new licences liberal. As a result, while many new banks were established, a significant proportion of these were weakly capitalised and poorly managed. The emerging difficulties in some private banks led the authorities in both the Czech Republic and Poland to tighten significantly the entry conditions for private banks in 1993-94, including the substantial increase in minimum capital requirements and the eventual suspension in granting new banking licences. There is now an ongoing process of consolidating troubled private banks in both countries. Despite the large number of private banks in these two countries, their share of domestic banking remains quite small relative to that of the state institutions.

Estonia and Latvia have relied even more extensively on the entry of new private banks. Between 1989 and 1992, 42 commercial banks were established in Estonia. Entry was much facilitated by the erosion of minimum capital requirements through the high inflation of 1991-92, when three-quarters of the new banks were established. Most of these banks were small and weakly capitalised. The turning point in Estonian banking occurred in late 1992, when the authorities simultaneously closed the three largest commercial banks in response to a growing liquidity crisis. One of the Estonian banks was liquidated and the other two were merged, with depositors receiving only an equity claim on a fund designed to recover on assets. There were subsequent failures of a number of smaller private banks in early 1993 largely due to connected lending. Many of these banks were closed or merged, halving the number of banks in the system. Banking troubles resurfaced in Estonia in mid-1994 with the failure of two more banks, again due to extensive connected lending and, in one case, over-aggressive expansion. The two banks were merged and sustained as a going concern with government support.

The number of private banks in Latvia also expanded rapidly following the initiation of banking reforms in 1992 and reached 58 by the end of 1993. All but three of these banks were privately owned. Prudential regulations and licensing procedures were tightened significantly in 1994, including stricter minimum capital requirements and professional standards for bank managers. The authorities in 1994 revoked the licences of several banks, and stepped up their surveillance of many others. In the initial months of 1995 a further 10 banks either went bankrupt or lost their licences, and in May the government, at considerable expense, took over Banka Baltija, a private bank which had grown rapidly to become the largest in the country. A cocktail of weak capitalisation, aggressive expansion, widespread connected lending and high-risk loans to finance commodity exports from Russia led to the bank's collapse.

Some countries in the CIS have also relied extensively on the liberal entry of new private banks to help transform the banking systems. In Russia, the number of commercial banks has proliferated since the start of reforms, reaching almost 2,600 by mid-1995. However, most of these banks are quite small, with over 40 per cent of them having capital of less than Rb 500 million (less than ECU 100,000). While the largest three banks are formerly state owned, with their prominence sustained in part by their continued role in channelling directed credits, a number of private commercial banks are gaining significant market positions.[13] The total assets of each of the seven largest private banks now amount to about one-third to one-half of the total assets of the two smaller former state banks. The Financial Institutions Development Programme (FIDP) in Russia, which is supported by the World Bank and the EBRD, is aimed at creating a group of sound and commercially effective private commercial banks to form the new core of the banking system. The core components of the FIDP, which is restricted to those banks meeting certain financial criteria, are twinning programmes with foreign banks, investments in information technology and other operational equipment and assistance to the Central Bank of Russia on regulatory reforms (see Box 7.1 in Chapter 7).

In Ukraine and Belarus, there has been a rapid expansion in the number of newly created private banks, some of which have achieved significant shares of the domestic markets. In Ukraine the number has risen to over 220 by mid-1995. While all but two of these institutions are owned by non-governmental entities, most of the larger banks remain under the influence of the state or state enterprises. The savings bank and foreign trade banks remain state owned, while the three former state banks have retained their ties to particular economic sectors.[14] However, five private banks have grown rapidly, and the total assets of each of these banks are now about one-quarter to one-third of the size of the smaller state and former state banks. In Belarus, the number of banks expanded rapidly in 1994 with the liberal licensing policy of the National

[12] Phelps *et al.* (1994).

[13] The three largest banks in Russia are the Sberbank (savings), Vneshtorgbank (foreign trade) and Agroprombank.

[14] The former state banks are Prominvest (industry), Ukraina (agriculture) and Ukrosotsbank (housing and cooperatives).

Bank, reaching 52 by mid-1995. While the banking system is dominated by the specialised former state banks, the assets of each of the two largest new private banks now exceed those of the smaller former state banks.

To summarise, a number of countries in the region have allowed a period of liberal entry of new private banks to help transform their banking systems. In some cases, this entry has not been disciplined by adequate minimum capital and licensing requirements, although most countries have now moved to tighten these entry conditions. As has happened in the Czech Republic, Estonia, Latvia and Poland, a consolidation of the new private banks in some of the CIS countries will almost inevitably be required.[15] The management of any financial distress will require a careful balancing of concerns about financial stability and protection of household deposits against possible adverse impacts of support for banks on public finances and monetary control. This trade-off can become more difficult to manage as private banks gain a more prominent role in the domestic financial systems. If government support is provided for a troubled private bank that is perceived as too big to fail, it is important that the conditions imposed by the authorities on the bank's shareholders, managers and depositors create strong discipline. For those countries that do choose to rely heavily on new private banks to transform their banking systems, it is crucial that their entry into the market is disciplined by minimum capital and licensing requirements and that these banks are subject to adequate prudential regulation and supervision.

Market structure and profitability in banking

Three distinguishing features tend to characterise the structure and performance of banking in transition economies: the high concentration of banking markets, which is often a direct legacy from the structure of pre-reform banking; the relatively small scale of banking in most countries, which has been largely caused by high inflation and banks' limited capacity to expand their balance sheets in real terms; and the adverse impact of asset quality problems on bank profitability. Nevertheless, there are indications that the industry has the potential to become profitable and to attract the resources necessary for its expansion.

Market structure

The high level of market concentration in many countries stems from the way in which two-tier banking systems were created. Typically, this reform has involved splitting the monobank into several large banks, which are specialised by activity (such as savings banks for household deposits, and foreign trade banks), by key economic sectors (such as agriculture, industry and mining) or by geographical region. The extent of entry of new private banks has also had an impact on market concentration.

Table 10.2

Concentration of banking markets in selected countries in transition

Shares of total banking assets held by top banks and top five banks, by ownership

	State	Former state (privatised)	Private banks	Total
Belarus				
Top banks	5	62	21	88
Top five banks	0	54	21	75
Czech Republic				
Top banks	4	67	0	71
Top five banks	0	65	0	65
Hungary				
Top banks	54	8	6	68
Top five banks	49	8	6	63
Latvia[1]				
Top banks	6	0	24	30
Top five banks	6	0	21	27
Poland				
Top banks	66	5	0	71
Top five banks	66	0	0	66
Romania				
Top banks	74	0	5	79
Top five banks	74	0	0	74
Russia				
Top banks	21	6	16	43
Top five banks	21	6	6	33
Slovak Republic				
Top banks	36	40	3	79
Top five banks	36	40	3	79
Slovenia				
Top banks	52	37	0	89
Top five banks	48	22	0	70
Ukraine				
Top banks	11	59	12	82
Top five banks	11	59	0	70

Sources
BREE Ltd, EBRD and World Bank.

Notes
Ownership classification: A state bank is defined by state ownership of at least 51 per cent of shares by the state (direct or indirect). Former state banks are privatised state banks. Private banks are banks that have never been state-owned.
Figures in the table are shares of total banking assets in a given country. The figure for the top banks is the sum of the asset shares of banks with individual asset share of more than 3 per cent. The figure for the top five banks is the sum of the five largest banks, ranked by asset share.

[1] In 1994, four of the largest Latvian banks failed or were taken over in conditions of illiquidity. The reported figures are computed excluding the four banks that failed.

[15] The temporary halt to lending in the Moscow interbank market in late August 1995 is an illustration of the fragility of the Russian banking system.

Table 10.3

Outstanding bank claims (as percentage of GDP)

	1990	1991	1992	1993	1994
Bulgaria					
Total claims	148.5	127.5	120.3	–	–
Claims on private sector	15.9	7.2	5.4	–	–
Czech Republic					
Total claims	–	–	–	89.0	94.8
Claims on private enterprises	–	–	–	55.9	64.7
Former Czechoslovakia					
Total claims	78.9	77.3	106.9	–	–
Claims on private sector	6.2	6.2	10.7	–	–
Estonia					
Total claims	–	65.5	11.5	13.7	15.6
Claims on private enterprises	–	18.8	6.9	10.5	13.2
Hungary					
Total claims	77.0	79.8	72.5	72.3	62.8
Poland					
Total claims	22.2	32.5	32.1	28.0	32.8
Claims on private enterprises	2.9	10.9	11.4	6.4	11.9
Romania					
Total claims	79.7	68.0	35.3	28.1	21.2
Russia					
Total claims	–	29.6	28.2	18.5	13.3
Slovak Republic					
Total claims	–	–	–	76.9	63.0
Claims on private sector	–	–	–	34.9	26.9
Slovenia					
Total claims	–	22.6	18.0	30.0	31.6
Ukraine					
Total claims	–	–	55.0	14.0	18.0
Bank claims in industrial countries					
France					
Total claims	107.1	106.4	106.3	101.5	100.1
Claims on private sector	97.1	97.3	97.3	93.0	83.3
Germany[1]					
Total claims	117.6	118.6	124.4	134.5	140.2
Claims on private sector	95.2	96.7	99.1	106.7	110.2
Portugal					
Total claims	82.3	86.5	90.2	–	–
Claims on private sector	46.7	50.5	54.5	–	–
Spain					
Total claims	105.2	102.8	100.9	98.2	104.3
Claims on private sector	70.0	71.6	70.9	70.7	69.5
United Kingdom					
Total claims	122.6	120.2	120.4	119.4	118.1
Claims on private sector	117.1	115.3	114.7	112.3	109.6

Sources
IMF, *International Financial Statistics*, National Bank of Hungary, Central Bank of Slovenia, Government of the Russian Federation, *Russian Economic Trends* and *Ukrainian Economic Trends*.

Notes
Estimates for 1994 except [1] (= actual values).

The market structures in banking in much of the region are highly concentrated, with the exception of Russia. Market shares accounted for by the top five banks in Belarus, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia and Ukraine ranged from 63 per cent to 79 per cent in 1994 (Table 10.2). In contrast, the market shares of the top five banks in Latvia and Russia are 27 per cent and 33 per cent, respectively. The high market concentration in a number of east European countries reflects the continued dominance of state banks and former state banks. There are no new private banks among the major banks in these countries. Moreover, many banking markets in that region are segmented along industrial sector or geographical lines, in which case the aggregate concentration ratios understate effective market power. The banking markets in Latvia and Russia are distinguished by their low concentration, reflecting the impact of high inflation on the size of the state banks and former state banks and of liberal policies toward the entry of new private banks (see above).

Another distinguishing feature of banking systems in much of the region is their small relative size. In some countries in eastern Europe (Poland, Romania and Slovenia), the Baltics and the CIS, high inflation and negative real interest rates have limited the relative size of bank credits. The ratio of domestic credit to GDP in these countries was roughly between 20 and 40 per cent in 1994, and even less in previous years (Table 10.3). With the easing of inflation and transformation of banking, there has been some recovery in bank credit, but the relative size of the systems remains small. However, in Bulgaria, the Czech Republic, Hungary and the Slovak Republic, where (in the last three countries at least) periods of high inflation have been avoided, the ratio of total domestic credit to GDP ranges between 70 and 120 per cent. In advanced industrial countries the share ranges from 90 to 120 per cent.

Not only is the scale of bank credit relatively small, in most countries of the region the dominant share of the outstanding bank credits is to the government and state enterprises (Table 10.3). The ratio of outstanding private sector credits to GDP in Bulgaria, Estonia, Poland and the Slovak Republic ranges from close to zero per cent to less than 30 per cent. Only in the Czech Republic does the share of private sector credit approach levels found in industrial countries, reflecting the impact of the mass privatisation programme. The comparable shares in some advanced industrial countries range from about 60 to 110 per cent of GDP.

In the Czech Republic, however, the bulk of bank lending, 73 per cent in 1993-94, had a maturity of 1 year or less (short-term lending), with 18 per cent having a maturity of between 1 and 4 years. In terms of the outstanding stock of bank credits, there is a significantly higher proportion of medium- and long- term credits, but, in view of the composition and volume of new lending, most of these credits must have been made prior to the reforms. In advanced industrial countries, only about 20 per cent of

Table 10.4

Inputs in banking

Country	Employment per 100,000
Bulgaria	178
Czech Republic	517
Estonia	408
Hungary	266
Poland	337
Slovenia	481
Industrial countries	
France	704
Portugal[1]	605
Spain	631
United Kingdom[2]	640

Sources
BREE Ltd and OECD, *Bank Profitability, 1984-93.*

Notes
1994 figures for transition economies.
1993 figures for industrial countries.

1 All banks.

2 Commercial banks only.

Table 10.5

Bank profitability (selected banks)

Percentage of balance sheet totals, average 1990-93

	Income	Operating expenses	Provisions	Pre-tax profit
Bulgaria	1.0	0.5	0.2	0.3
Czech Republic	4.9	1.1	2.0	1.5
Hungary	7.1	4.8	3.1	0.0
Poland	8.3	2.0	2.4	3.9
Romania	7.2	1.3	2.5	3.4
Russia	3.9	1.6	0.4	1.9
Slovenia	7.4	3.3	5.8	-1.7
Industrial countries (commercial banks)				
France	2.1	1.5	0.5	0.1
Germany	3.2	2.0	0.6	0.6
Portugal[1, 2]	5.5	2.8	1.5	1.2
Spain[1]	4.7	2.8	0.8	1.0
United Kingdom	4.7	3.1	1.1	0.5

Sources
BREE Ltd and OECD, *Bank Profitability, 1984-93.*

Notes
Savings banks are excluded.

1 All banks.

2 Excludes 1990 figures.

outstanding bank credits have short-term maturities.[16] The capacity of Czech banks to finance fixed investment by private enterprises thus remains seriously constrained by the maturity structure of bank lending, and this feature characterises most countries in the region.

The scarcity of banking services in the region can be gauged not only by examining bank outputs such as loans, but also by the scale of inputs to the provision of bank services. For example, employment in the banking industry ranges from about 170 to 520 per 100,000 of population across the region (Table 10.4). The comparable figures in some advanced industrial countries range from 600 to over 700. This rough comparison makes no allowance for differences in banking skills across countries. Since total employment in banking in the region has grown very rapidly in recent years, and since these employees typically must learn the necessary skills on the job, quality-adjusted banking inputs are probably more scarce than the basic employment figures would suggest.

This analysis of the concentration and scale of banking activities in the region points to markets that are dominated by a handful of banks, but the scale of these banks is small relative to the size of the economies in which they operate. These market structures create conditions under which the exercise of market power becomes possible. This can retard the provision of banking services through high net interest margins and lack of innovation, in the absence of competitive discipline from entry of new banks.

Bank profitability

Selective data on bank profitability is available from a bank rating agency specialising in eastern Europe, the Baltics and the CIS, which compiles this data from the annual reports of selected banks.[16] Most of the annual reports have been subject to an independent audit, and many comply with international accounting standards. The countries covered by the agency include Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Slovenia. While the data do not cover all institutions, they include for most countries the major commercial and savings banks as measured by their total assets. Apart from Russia, the data typically include the major state-owned commercial and savings banks in each country, along with the better-performing private banks. In Russia, the agency covers only the top-performing private banks.

The financial performance of the selected banks in the region has been dominated by asset quality problems (Table 10.5). In Slovenia, the reporting banks provisioned at an average rate of about 6 per cent of total assets in each of the years 1990-93, and 2-3 per cent in the Czech Republic, Hungary, Poland and Romania. In Bulgaria the average provisioning rate was less than 1 per cent of total assets over the years 1990-93, but a loan conciliation scheme was implemented in 1994 which is likely to have boosted provisions. The typical loan loss provision rate in advanced industrial countries is no more than 1 per cent of total assets.

While loan loss provisions have been considerable, the net interest and other income of banks have also been quite high, with Hungarian, Polish, Romanian and Slovene banks earning between

16 The figures quoted in the text are taken from the Czech National Bank and Borio (1995).

17 The Agency is BREE Ltd, which is based in Cyprus.

7 and 9 per cent of total assets over the period 1990-93. To some extent, the high average income margins reflect periods of high inflation (1990-91 in both Poland and Slovenia and 1992-93 in Romania), when net interest margins typically widen, partly to preserve the real value of banks' capital. The income of banks in the Czech Republic and Russia have averaged between 4 and 5 per cent of total assets. The income of banks in advanced industrial countries is typically in the range 2 to 5 per cent of total assets.

The operating expenses of banks in Hungary have been the highest among those in the region, averaging about 5 per cent of total assets over the period 1990-93. In Poland and Slovenia, bank operating expenses have averaged 2-3 per cent. The average figure for the Czech Republic is rather low, but operating costs have increased steadily over the period, exceeding 2 per cent per cent of assets in 1993. The average operating expenses of Bulgarian and Romanian banks are low, possibly reflecting shortfalls in staff levels and experience. The operating expenses of banks in advanced industrial countries are typically in the 2-3 per cent range.

Two considerations thus point to the potential profitability of banking once the asset quality problems have been resolved, at least among the major institutions in these markets. The net interest and other income of the banks is relatively high, although this may reflect in part the impact of high inflation. Except for Hungary, operating costs appear to be in line with or below those observed in some advanced industrial countries. The concentrated market structures, small scale and high margins in banking in the region point to the need for new entry, including by foreign banks, which can bring much needed technical expertise. However, this new entry must be disciplined by adequate minimum capital requirements and effective prudential regulations.

10.4 The emergence of securities activities

The securities exchanges and non-bank financial institutions in transition economies have the potential to complement the banking sector in mobilising and channelling domestic savings to investment and in imposing financial control on enterprises.[18] A wide range of institutions actually make up a securities market, including the physical or electronic exchanges and their market-makers, clearance and settlement organisations, agents for the issuers of securities (share registrars and transfer and payment agents), and agents for investors (depositories, custodians, proxy services and brokers). Effective regulations are also required to ensure an organised and stable environment for securities activities. These include rules governing the eligibility to issue and to list securities, such as those on financial disclosures, and prohibitions on insider trading. Moreover, investors in securities often rely on vehicles such as investment companies, pension funds and insurance companies, which are typically subject to some prudential regulation.

A number of countries in the region have moved to enact the basic laws and regulations for the creation of securities and the exchanges on which they trade, as well as for the trading of these instruments (Chapter 2). The legal framework necessary to support extensive securities activities extends, however, beyond the narrow confines of securities laws to include reforms in areas such as property rights, bankruptcy and company law (Chapter 6).

Formation of securities markets

The development of securities markets in the region has so far been shaped largely by the nature of privatisation programmes. The formation of securities markets began in 1990-91 with the re-establishment of exchanges in Bulgaria, Croatia, Hungary, Poland and Slovenia. The implementation of mass privatisation programmes in the Czech and Slovak Republics propelled the reopening of the Prague and Bratislava Stock Exchanges in 1993. Similarly, in Lithuania the National Stock Exchange was established in 1993 to support the voucher privatisation programme. In Russia, the completion of the first phase of mass privatisation in mid-1994 fuelled the development of securities activities on a number of exchanges which had been established in the early 1990s, primarily for the trading of commodities. Latvia opened a stock exchange in mid-1995.

In Hungary, Poland and Slovenia, the institutions that make up a securities market have been able to develop in step with the expansion of the markets. This reflects a selective approach to privatisation and demanding disclosure requirements, which have limited the rate of increase in listed equities. In the Czech Republic, Slovak Republic and Russia, however, the mass privatisation programmes have contributed to a surge in equities that has outstripped the capabilities of the market to handle them. In the Czech Republic, the liquidity of the organised market remains low, in part because of problems in trade settlement and non-transparent trade on the organised exchanges. Also, an estimated 80-90 per cent of all share transactions take place outside of the organised exchanges in the Securities Centre, which was originally established to register securities holders. In Russia, the mismatch between volume of securities and capacities of the markets to handle them is even greater, and there are fundamental weaknesses in the systems for the registration of shares and for the clearance and settlement of trades. The EBRD and the IFC are supporting projects in these areas to help develop institutions for securities markets (see Box 7.2). The weak legal protection of shareholder interests and securities fraud are also significant problems in Russia and elsewhere.

Role of government, self-regulation and financial disclosure

Those countries that have at least modest levels of cash-based securities activities, either in the form of new issues or of trading in outstanding securities, have typically enacted a range of regulations and rules applied to securities activities (Table 10.6). These include regulations governing financial disclosure requirements for publicly offered securities and investor protection codes related to insider trading. Such regulations are complemented by listing requirements imposed by the exchanges themselves.

[18] Levine and Zevros (1995), for example, provide empirical evidence of a positive and significant impact of development of securities activities on growth (see also Box 5.2).

The quality of financial disclosure is determined not only by regulatory requirements but also by accounting practices. As with banking supervision, a critical input into the investment decisions of investors are the accounts of listed companies. The accounting practices of many enterprises continue to reflect more the requirements of central planners than of outside investors. However, the overhaul of accounting practices is under way in most countries throughout the region.

In addition to disclosure and accounting requirements, the state has moved to implement investor protection codes, by making illegal the trade of securities based on information that is not in the public domain. However, the extent of enforcement appears limited.

Performance of securities markets

The role of securities in financial intermediation is typically summarised by three indicators: the ratio of market capitalisation to GNP, the market turnover ratio and the ratio of total value traded to GNP. The market capitalisation ratio typically indicates the extent to which securities markets are used to mobilise capital and to diversify risks, but in transition economies this ratio largely captures progress in privatisation. The market turnover is the ratio of total value of traded equities to their market capitalisation. This measure provides an indication of market liquidity and transactions costs. The ratio of total value traded to GNP indicates the extent of liquidity available on an economy-wide basis.

The Czech and Slovak Republics have achieved, in the wake of their mass privatisation programmes, the highest ratios of stock market capitalisation to GNP in the region (Chart 10.1). The 1994 capitalisation ratio in the Czech Republic is roughly the same as that in France, while the ratio in the Slovak Republic is comparable to those in Germany, Greece and Portugal. The capitalisation ratios in Hungary, Poland and Slovenia are similar to that in China, while Bulgaria lags well behind the other countries. It is particularly noteworthy that a number of fast-growing Asian economies have achieved particularly high ratios of stock market capitalisation to GNP.

The stock markets in the region with relatively high market capitalisation typically have less market liquidity (and vice versa). The Warsaw Stock Exchange compares favourably with the stock markets in France, Germany and the United Kingdom in terms of the ratio of total valued trade to market capitalisation (Chart 10.2). The markets in the Czech and Slovak Republics, however, are relatively illiquid compared with other markets. The exchanges in Hungary and Slovenia occupy the middle ground.

In transition economies, there thus appears to be a trade-off between the scale and speed of privatisation and the liquidity of shares in the privatised enterprises. Moreover, the nature of the trade-off is such that no stock exchange in the region performs satisfactorily when performance is measured in terms of the ratio of total market turnover to GNP (Chart 10.3). The liquidity provided in transition economies is well below the levels achieved in the selected industrial and fast-growing developing countries. This lack of liquidity can significantly restrict the ability of companies to raise capital through securities issues and impede the emergence of a market for enterprise control, retarding growth and restricting the restructuring of enterprises. Empirical studies of comparative long-term growth across countries indicate that it is total market liquidity relative to GNP that is empirically associated with higher long-run growth (Chapter 5).[19]

[19] See Box 5.2.

Table 10.6
Securities markets regulations

	Reporting requirements for listed companies	Investor protection codes	Pricing and settlement systems
Bulgaria	The issuance of and the trading in securities are regulated and controlled by the Securities and Stock Exchange Commission. The Commission also grants and revokes any licences for the conduct of business in the Stock Exchange capacity. For admission of a public offering of securities, a prospectus must be published containing any information about the issuer and the offered securities.	As of end-1994 the First Bulgarian Stock Exchange (FBSE) is in the process of completing rules and regulations to protect investors.	The trading instruments now available are stocks of members, shares of different banks and public joint-stock companies. The exchange is organised along the lines of a traditional open outcry system, assisted by a computerised system. Orders are matched according to their priority (price, time and volume) and the trades are registered automatically by the system. The present system of settlement and clearance is based on physical settlement of individual trades. Commission rates on share transactions are fixed at 2.2 per cent.
Czech Republic	The state exercises supervision over the Prague Stock Exchange (PSE) and the capital markets through the Ministry of Finance. Upon request and submission of appropriate documents, from the issuers, it provides licences authorising the public trading of securities. The business and financial results of the issuers of publicly tradable debt are monitored continuously. An Exchange Commissioner appointed by the Ministry of Finance operates on the Stock Exchange.	The stock exchange maintains a list on information insiders, who are only allowed to buy and sell securities through the exchange with the consent of the exchange management. Under the Czech National Council Securities Act of 1992, any use of confidential information in securities trading is prohibited. Members of the exchange have established a Guarantee Fund that covers the risks arising from exchanged trades. The exchange guarantees compensation and settlement of all trades conducted through it.	The PSE offers two types of trading: computerised and block trading. In computerised trading, the broker brings in all the orders and a pricing algorithm is used to match buy and sell orders. Exchange deals are cleared by the Securities Register, a daughter company of the PSE. Delivery of securities in exchange for cash must occur within three days.
Hungary	Public offers of securities within Hungary may be made pursuant to a prospectus being approved by the state Securities Supervision Board. Before a company can issue shares, permission from the Hungarian securities and supervision and the National Bank of Hungary must be sought. Companies must publish a file with the Bucharest Stock Exchange (BSE) quarterly, semi-annual and annual statements within 30 days of the end of each period. In addition, an annual report must be filed (by 31 May) containing the companies' annual audited statements prepared in accordance with the 1991 Accounting Act, which came into force in January 1992.	The provisions of the new Securities Act, 1990, provide for protection against insider trading. The act allows for the Securities Supervision Board or the state prosecutor to institute proceedings against persons trading in securities using insider trading practices. Minority shareholders have limited rights to bring actions against a company.	Trading is on an open outcry basis. Settlement proceeds using the Central Clearing House and Depository, set up in October 1993, operating independently of the Stock Exchange. Brokerage fees vary depending on the level of service provided, and type of security traded. Typically, fees dealing in shares or investment trusts are in the range 0.5 per cent to 1.5 per cent.
Poland	The Stock Exchange Supervision Board is responsible for the supervision of the Exchange. On the issue of new shares, it is required that an investor issue a prospectus. The prospectus is not a separate document, but is published in two national newspapers.	No law exists explicitly protecting investors. This function is carried out by the government according to miscellaneous regulations. Investors' interest are also protected by the Chairman of the Securities Commission.	All trading is computerised, and orders are entered onto a computer on the trading floor by a stock exchange member who is the specialist in that stock. The specialist is the market-maker, balancing the market if there is an imbalance between buy and sell orders. The trading system ensures liquidity and minimises fluctuations from session to session. Settlement is required by law to take place within one day from the execution of the transaction. All transactions are on a cash basis, and all accounts must have sufficient funds covering at least 80 per cent of the order value. Short selling is not permitted. Commissions vary between 0.75 per cent to 2 per cent, and are not fixed by the Exchange.

Reporting requirements for listed companies	Investor protection codes	Pricing and settlement systems	
At the Moscow Central Stock Exchange (MCSE), a company is required to present the following documents to be listed on the Exchange: a copy of a prospectus, the most recent financial statements, financial statements for the last three years or as many years as the company has been in operation, confirmation from a bank that initial capital has been paid in full, a blank copy of a shareholder's certificate and a short description of the company's investment policy. The Moscow International Stock Exchange (MISE) requires that listed companies comply with disclosure requirements for public offerings laid down by the Russian Federation. On the Siberian Stock Exchange, a listed company is required to present on a quarterly basis its financial report, profit and loss statement, and confirmation of the number of shares outstanding. In December 1991 regulations governing joint-stock companies took effect. The Ministry of Finance has set standards for financial disclosure requirements for the issue of new prospectuses. These regulations are under review. A Securities and Exchange Commission was established in November 1994, subsequently raised to ministerial status.	There is no Russian compensation fund on MCSE, MISE, the Siberian Stock Exchange or the St Petersburg Stock Exchange.	All Russian exchanges use a simple open auction system even though some, especially MCSE, have begun to use electronic trading. Few exchanges have developed satisfactory settlement procedures. Three stock exchanges were chosen to provide central clearing and settlement functions. A central register of owners is being prepared in order to speed up the process of transferring ownership. On the MCSE mutual settlement is carried out on the basis of a trade contract carried out through the clearing house of the Exchange. Each deal must be settled within three days, but special terms for settlement between brokers are possible. On the Siberian Exchange, trades are settled between brokers, and confirmed by written contracts prepared by the Exchange and signed by the brokers. Commission on the MCSE varies between 2 and 5 per cent of the value of the bargain.	**Russia**
Company securities listed on the Bratislava Stock Exchange (BSE) must be accompanied by a prospectus detailing information about the company's operations and financial position. Within 30 days of the end of each quarter, the issuers of securities listed on the main market are obliged to submit quarterly financial statements. The issuers of securities on the junior market are obliged to submit semi-annual financial statements. Listed companies are required to submit annual audited statements.	The Stock Exchange Act of 1992 contains provisions on the use of false or misleading information on the issue of shares. There are also provisions in the Securities Act of 1992 preventing persons who have acquired price-sensitive information from trading in the information to which the security relates.	The trading system initially adopted by the Exchange was open outcry. The present system is electronic with continuous matching.	**Slovak Republic**
The government introduced the Slovene Securities Market Law in January 1994, and the Investment Fund Trust Law was adopted simultaneously. However, as of end-1994, 1988 Yugoslav regulations still apply. Stock exchange listing requires that companies publish a prospectus. Listed companies are obliged to provide semi-annual reports, which must be freely available.	In July 1992 the Exchange established a guarantee fund in order to protect investors against insolvency of stock exchange members. At present only floor trades are covered by the guarantee fund up to DM 0.5 million.	The settlement of stock exchange transactions should be carried out within two working days after the bargain date (or one day, in the case of short-term transactions). An electronic system for settlement began operating in early 1994. Trading is carried out by open outcry and through a screen-based trading system. The total cost of each transaction should not exceed 1.5 per cent inclusive of brokerage fees.	**Slovenia**

Sources: *Euroclear-IFR Handbook* (1995), GT Guide and EBRD.

Chart 10.1

Stock market size (measured by capitalisation)

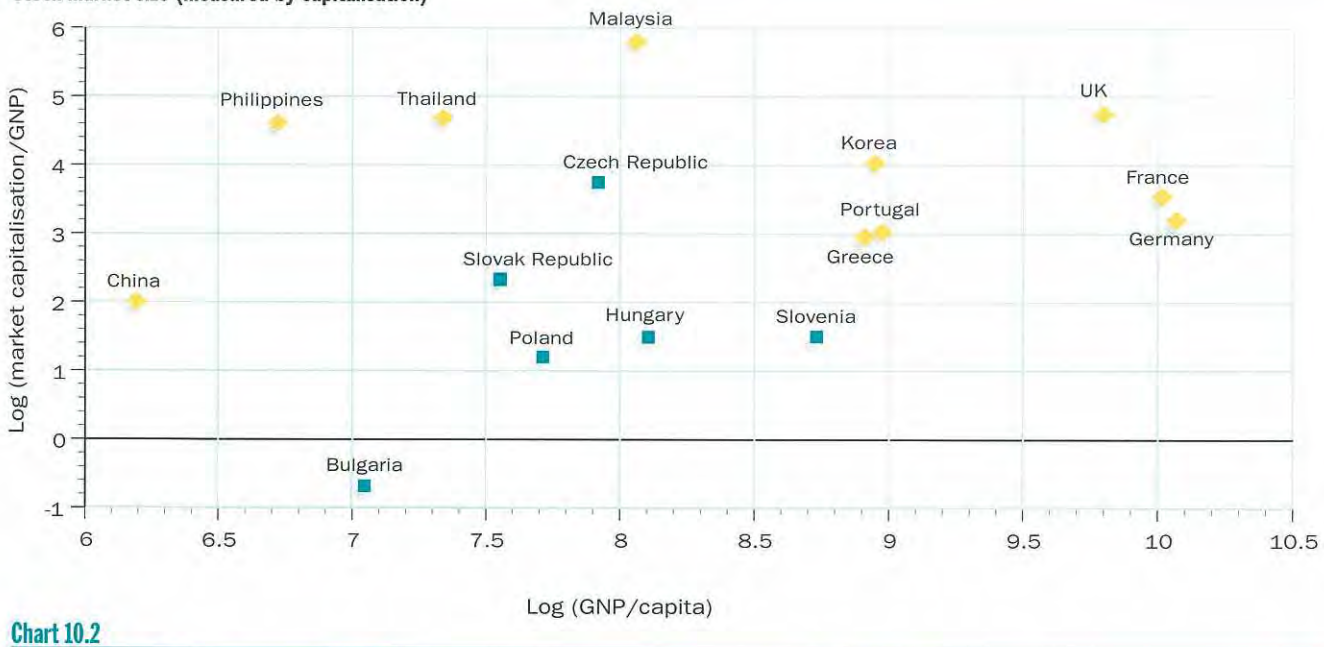


Chart 10.2

Stock market liquidity

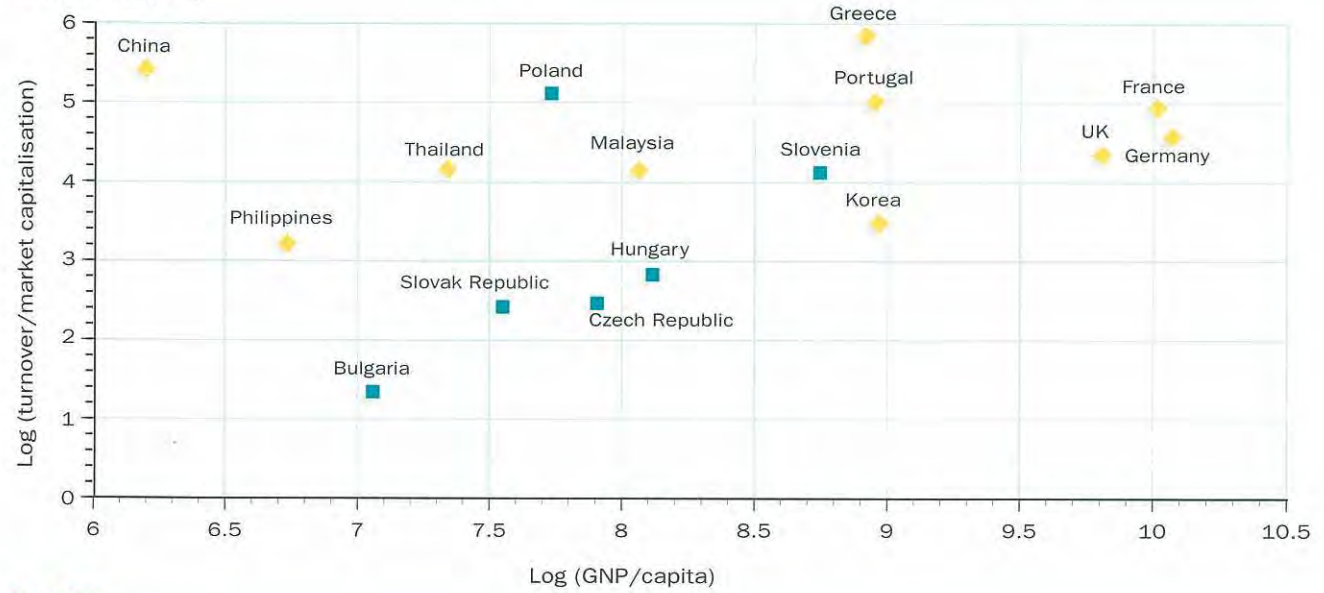
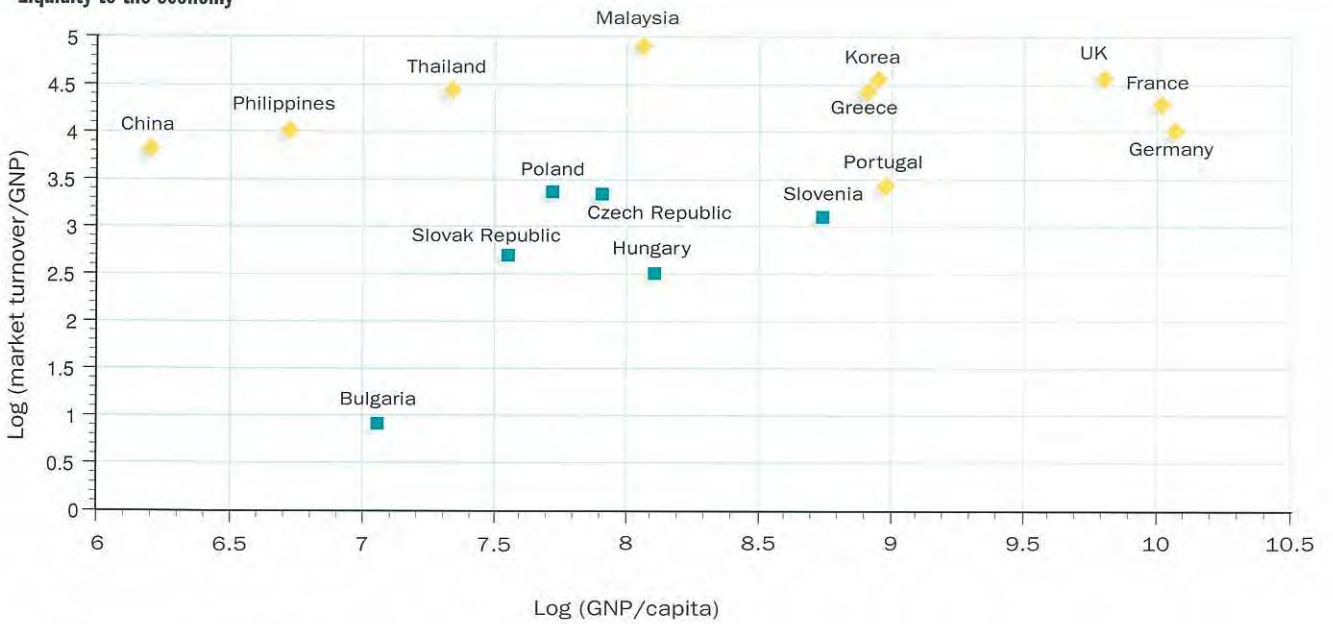


Chart 10.3

Liquidity to the economy



10.5 Concluding remarks

This chapter has shown that the relative scales of banking and securities activities in transition economies are well below the levels in advanced industrial and fast-growing developing countries. Much remains to be done in the region to transform the role of government in the financial sector, with a focus on effective enforcement of laws and regulations, and to strengthen the financial institutions and markets themselves.

Governments in a number of countries in eastern Europe have pursued a measured strategy to transform their role in banking, strengthening prudential regulation and supervision while recapitalising and privatising state banks. Further progress along this reform path will require more stringent enforcement of prudential regulations that approach Basle Committee or EU standards, along with more rapid progress in bank privatisation to strengthen incentives and to attract the resources necessary for the expansion of services. The support of the EBRD and other IFIs for bank privatisation can be instrumental in advancing this process. It must be recognised, however, that movement along this reform path is likely to reduce the capacity of banking systems to bear risks, at least for a period. The Basle Committee EU regulatory standards were designed in the context of advanced industrial countries to reduce risks in banking to low levels and to limit the government's exposure to loss through the official safety net for banks. Stringent application of these regulations in the environment of transition economies may well curb the commercial lending of banks, at least while risks remain high. Development of effective securities markets can help to ease the trade-off between progress toward sound, market-oriented banking and the capacity to intermediate risk capital in the economy.

The transformation of banking in some countries of the Baltics and the CIS has occurred through the extensive entry of new private banks, together with the erosion of assets of the state and former state banks through very high inflation. As the new private banks begin to play a more dominant role in banking markets, the willingness of the authorities to close distressed banks may be constrained by concerns with systemic financial instability. This is illustrated by the recent government bail-outs of large private banks in Estonia and Latvia. If recapitalisations of private banks do become necessary, it is vitally important that the conditions imposed by the authorities on the banks' managers and shareholders impose financial discipline. At the same time, the EBRD and other IFIs can help to strengthen a core of private banks that can serve as the nucleus of a viable banking system.

Banking sectors in the region tend to be highly concentrated and small. At present, the financial performance of banks is dominated by the overhang of bad loans and risks in new commercial lending, but other aspects of banks' financial performance (including net interest margins and operating costs) appear satisfactory, at least for the top tier of institutions in the countries surveyed. As the asset quality problems become resolved, entry into banking should be encouraged, but this must be disciplined by appropriate minimum capital requirements and licensing requirements.

For securities activities, the challenge is to achieve both high capitalisation and liquidity. This will require development of effective regulations and institutions, more accurate and fuller financial disclosure, and greater transparency of trades. The EBRD and other IFIs have an important role to play in fostering the development of the necessary institutional infrastructure, and in supporting the issuance of securities by enterprises in local markets.

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