Transition from Plan to Market

An Overview

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Niels Mygind, CEES/CBS, January 2007

Abstract

This paper gives an overview over how far transition has proceeded and what is still lacking in the process. The barriers for transition are identified. This includes an analysis of the different factors behind the steep fall in production in the first years of transition. It is shown that countries implementing a tough stabilization and a comprehensive and consequent liberalization have been most successful in the process. A fast and comprehensive privatization, on the other hand, has not been sufficient for the necessary restructuring of enterprises. Decisive for success in transition has been transformation of the state as a crucial part of the development of new market institutions implementing well functioning, clear and stable rules of the game for private enterprises. The institutional development has been important for the attractiveness of foreign investments and these FDI have been important for restructuring enterprises as part of a positive circle for the transition process.

1. Introduction - some key questions

The transition in Eastern Europe (including the former Soviet Union) has been much more difficult than expected both by experts and the population. Why has transition been so difficult? Why did production fall steeply in the first years of the transition process? These questions will be answered in the following. It will be shown that countries implementing a tough stabilization and a comprehensive and consequent liberalization have been most successful in the process. A fast and comprehensive privatization, on the other hand, has not been sufficient for the necessary restructuring of enterprises. Decisive for success in transition has been transformation of the state as a crucial part of the development of new market institutions implementing well functioning, clear and stable rules of the game for the private enterprises. Building up the new structure of institutions is still in process in all transition economies, but there are huge differences in the stages of development. The front-runners are: The Czech Republic, Estonia, Hungary, Poland and Slovenia closely followed by Latvia, Lithuania and Slovakia. The institutional development has been important for the attractiveness of foreign investments and these FDI have been important for restructuring enterprises as part of a positive circle for the transition process.

This paper gives an overview over how far transition has proceeded and what is still lacking in the process. First the barriers for transition will be identified. This includes an analysis of the different factors behind the steep fall in production in the first years of transition. Then, a short discussion follows of the necessary policies of stabilization, liberalization and privatization. The importance of a well functioning state will be emphasized and it will be explained how international cooperation and FDI have had great impact on the development in some of the frontrunner countries.

2. Barriers for transition

The political revolutions 1989-91 in the East European countries marked the start of comprehensive transformations not only of the economic institutions in the transition from command economies to market economies and of a fundamental restructuring of production and the process of production. The transition also included the creation and development of new democratic political institutions and a cultural liberation with deep changes in habits, norms and values (Mygind, 1994).

The dissolution of the old system, the breaking up of most economic networks between enterprises and between countries and steep cuts in production took place in a rather short period. On the other hand, building up new links, new products, and new production methods demanded huge resources - time, capital and human qualifications. Lack of these resources caused bottlenecks for the transition process.

Before transition, production was determined by direct orders from central planners. In a market system it is the demand by the consumers and market based costs, which determine what enterprises shall produce. Calculations for the early stage of transition based on world market prices showed that around one third of production had a negative value added. In these enterprises the value of inputs such as oil and other raw materials were higher than the market value of outputs, which could only be sold at quite low prices. Labor and capital in these enterprises were not used for production, but destruction! (Hare and Hughes, 1992). The other two thirds of production were either produced with losses or with a very low return on assets. The transition to world market prices meant that much of the huge physical capital stock and much of the human capital built up in the command economy turned out to be of very low value measured with the world market as benchmark.

Adjustment to market conditions, therefore, resulted in a drastic fall of production and after a somewhat longer period of adjustment also a fall in employment in the old industrial enterprises. However, employment was cut much faster in Central Europe compared with CIS-countries where the workers stayed in the large failing industrial enterprises although they had cut down most of the production. All over Eastern Europe labor productivity fell in the first years of transition. The turnaround based on cuts in employment happened earlier in Central Europe compared to the CIS countries (EBRD 1999, WB 1996).

Table 1 - Growth in GDP 1989-2006

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 estimate	2006 project.	2006 1989=100
Albania	9.8	-10	-28	-7.2	9.6	8.3	13.3	9.1	-10.9	8.6	13.2	*6.5	7.1	4.3	5.7	6.7	5.5	5.0	**144**
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5.0	*7.0	11.4	9.2	9.5	**133**
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.9	4.5	5.7	5.5	6.0	**99**
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	4.4	5.6	5.3	3.8	4.3	*4.6	**105**
Czech R	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.2	-0.7	-0.8	1.3	*3.6	2.5	1.9	3.6	4.2	6.1	6.2	**129**
Estonia	8.1	-6.5	-13.6	-14.2	-8.8	-1.6	4.5	4.4	11.1	4.4	0.3	10.8	7.7	8	*7.1	8.1	10.5	8.9	**142**
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	*6.0	4.3	3.8	3.4	5.2	4.1	3.5	**133**
Latvia	6.8	2.9	-10.4	-34.9	-14.9	2.2	-0.9	3.8	8.3	4.7	3.3	8.4	8.0	6.5	7.2	8.5	*10.2	9.0	**110**
Lithuania	1.5	-5	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.7	3.9	7.2	6.8	10.5	7.0	7.5	*7.0	**105**
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	*6.2	7.1	5.0	4.5	4.2	1.1	1.4	3.8	5.3	3.4	5.0	**156**
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.0	-6.1	-4.8	-1.1	2.1	5.7	5.1	5.2	8.4	*4.1	6.5	**112**
Russia	0.0	0.0	-5.0	-14.8	-8.7	-12.7	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1	6.4	6.5	**96**
Slovak R	1.4	-2.5	-15.9	-6.7	-3.7	6.2	5.8	6.1	4.6	4.2	1.5	2.0	*3.2	4.1	4.2	5.4	6.1	6.4	**132**
Slovenia	-1.8	-4.7	-8.9	-5.5	1.7	5.8	4.9	3.6	*4.8	3.6	5.6	4.1	2.7	3.5	2.7	4.4	4.0	4.5	**142**
Ukraine	4.0	-4.0	-10.6	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	2.6	6.0	**62**

Based on EBRD-2006. The year when passing the start level marked by *

The deep strategic restructuring with development of new products, access to new markets and introduction of new organizational structures and production methods in the enterprises is a much more long term and resource intensive process. It is much easier and faster to cut production and employment than to build up new systems which need capital, technological and management expertise as well as developed market institutions. Therefore, the result was a steep fall in production followed by a rather slow, but in the successful transitional economies, accelerating recovery of production. There have been important differences in how fast each transitional country has turned around. Poland was the first to show positive growth. In 1996 Poland passed the 1989-production level marked by * in table 1. Slovenia passed the starting point in 1997. Albania, the Czech Republic and Hungary passed the point in 2000; Slovakia in 2001; Belarus and Estonia in 2003, Latvia and Romania in 2005, Lithuania in 2006; while Bulgaria and Russia is expected to pass in 2007 and Ukraine still have some years to go. A weighted average for Central and Eastern Europe including the Baltic Countries shows that the 1989 level was passed in 2000 (EBRD 2000). The 2006 production level for Ukraine it is only 62% of the 1989 level, see Table 1. The level for Belarus is somewhat misleading. It is still to a high degree a command economy. If the Belarussian growth is measured in USD the index end up to be only around 50% of the 1989 level, while the Baltic countries are around the double of this.

The barriers for the development of the new political system can be found in the risk that the old elite converts its political power to new forms in the new system, and in the lack of democratic traditions and experience. An important barrier is the overwhelming burden of consolidation of the democratic institutions in a period where new legislation is needed in almost all areas. Many political decisions must be made without knowing the effects of the policies because of the high uncertainty in the early years of transition. It is impossible to implement the full market model in one step. In most areas a long transitional period will be dominated by “half solutions” leaving a lot of holes to be exploited by corrupt elements inside and in relation to the administrative system. The uncertainty in the political system is an important reason why it has taken several years to develop stable political parties, simply because it is difficult to develop and implement stable political programs in a very unstable environment.

The barriers for the cultural transition can be divided in two main types. The dissolution of the rigid Soviet system meant that the deep cultural values, that had been suppressed now flourished again. Religion and national conscience regained importance in many countries. Many of the conflicts frozen down in the Soviet system were unfrozen, and in some areas conflicts heated up further and exploded in ethnic religious wars. Such conflicts seriously delayed the transition process in Caucasus and in the former Yugoslavia.

Norms and routines from the command economies have prevailed for many groups. Especially the older generations have problems understanding and following the wave of drastic changes. On the other hand the transition gives a lot of opportunities, especially for young people. Therefore, the gap between generations has deepened in many countries of transition. Especially in the CIS-countries without a collective consciousness about the time before the command economy, there is strong inertia concerning the change of norms and habits. This is a main barrier for the development of the new market economy.

Ideally, the transition of economic institutions should be made in one step. With the exception of GDR, which was taken over by BRD and rapidly enrolled in the German institutional system, it is not possible to implement a real “big bang”. Even in countries performing a tough economic shock therapy like Poland and Estonia there is still a way to go in building up and implementing all the necessary market institutions.

The key elements in a market economy are: market-based prices as information signals and private ownership with decentralized control and decentralized incentives for the owners. There must be direct correspondence between the right to control and the financial rights to returns and capital gains. The implementation of these elements is done through stabilization, liberalization and privatization - see the next sections.

3. The necessity of stabilization

In all the command economies there was a “monetary overhang” because of constant prices combined with unbalanced expansion of purchasing power. This overhang was reflected in excess demand of goods. Queues and empty shops were not signs of too low production. They were signs of too low prices in relation to purchasing power. To implement the market mechanism the prices were liberalized in the start of transition. In countries with a huge monetary overhang like in the former Soviet Union the result was an explosion in prices. Hungary, which already had market oriented prices in the 1980s saw only a small increase in prices in 1990, see Table 2, while price liberalization in Russia in January 1992 resulted in a 300% jump in prices just for one month.

High and persistent inflation means that the price system sends uncertain signals. The functioning of the decentralized information system and thus the market mechanism is hampered. This is the reason why stabilization of prices is important. In countries such as Russia and Ukraine too lax economic policy resulted in the first half of the 1990s in a spiral of price increases combined with increasing nominal wages, continued depreciation of the currency, expansion of the monetary supply and soft credits to enterprises. The high inflation continued for several years. The Central European countries, on the contrary, implemented quite tough stabilization policies. This also happened a few years later in the Baltic countries. From table 2 it can be seen that the inflation in these countries fell under the critical level of 40-50% by 1994/95. At this time inflation was still very high in Bulgaria, Romania and the CIS countries. However, through tightening of monetary policy and currency policy with a rather stable exchange rate Russia and most other CIS countries succeeded in stabilizing inflation from 1995. The currency crisis in Russia in August 1998 gave another push to inflation, but the following tough stabilization policy gave inflation levels, which do not seriously hamper the functioning of the market mechanism.

With the Russian crisis there was a backlash in demand, which limited both growth and inflation in most transitional economies in 1998 and 1999. In the later years inflation has been quite low in Central- and Eastern Europe. With relatively fixed exchange rates and an increase in productivity this leaves room for a real appreciation - inflation can be a bit higher than inflation for the most important trading partners (the old members of EU).

Table 2 - Inflation 1990-2006 (consumer prices, change in annual average)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 esti-mate	2006 pro-jection
Albania	0.0	35.5	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.2	2.4	2.9	2.3	2.3
Belarus	4.7	94.1	970.8	1190	2221	709.3	52.7	63.8	73.2	293.8	168.9	61.4	42.6	28.4	18.1	10.3	7.0
Bulgaria	26.3	333.5	82.0	73.0	96.3	62.0	123.0	1082	22.2	0.7	9.9	7.4	5.9	2.3	6.1	5.0	3.0
Croatia	609.5	123.0	665.5	1518	97.6	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.2	1.8	2.1	3.3	3.5
Czech R.	9.7	52.0	11.1	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2	2.8	1.9	2.9
Estonia	23.1	210.5	1076	89.8	47.7	29.0	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0	4.1	3.6
Hungary	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.9	6.8	3.6	4.0
Latvia	10.5	172.2	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	2.9	6.2	6.7	6.2
Lithua-nia	8.4	224.7	1021	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-1.2	1.2	2.7	3.1
Poland	585.8	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.7	3.5	2.1	1.6
Romania	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.5	6.5
Russia	5.6	92.7	1526	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.7	11.0	11.3	9.8
Slovak R	10.8	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5	2.7	4.5
Slovenia	549.7	117.7	207.3	32.9	21.0	13.5	9.9	8.4	7.9	6.1	8.9	8.4	7.5	5.6	3.6	2.5	2.5
Ukraine	4.2	91.0	1210	4734	891.0	377.0	80.0	15.9	10.5	22.7	28.2	12.0	0.8	5.2	9.0	13.5	8.4

Based on EBRD-2006

Comparing Tables 1 and 2 there is a clear connection between lower inflation and growth in production. Countries with fast and consequent stabilization and controlled inflation had, after a few years, growth in production while the fall in production continued for several years in the CIS countries with postponed stabilization. The accession to EU is another element putting a pressure on inflation in the frontrunner transition countries. However, increasing excise taxes meant a slight increase in prices in the accession year 2004. With exchange rate fixed to the Euro and a fast catching up of productivity and GDP-levels the Baltic countries will also have a catching up of price levels. This may result in an inflation level about 3% higher than the inflation in the Euro-area for the coming years (see Mygind, 2006) meaning that they will not be able to fulfill the Euro access-criteria.

4. The necessity of liberalization - status for implementation

Liberalization - deregulation through transfer of control and incentives from the state to decentralized units - is an important element of developing the market mechanism. Successful liberalization also means stable and clear rules of the game for private enterprises and institutions monitoring competition and securing a level playing field. Price liberalization (except for specific areas such as energy, public transport and housing) was implemented rather fast in most countries. At the same time the frontrunners implemented a fast and comprehensive liberalization of foreign trade.

The opportunity for establishing new private enterprises is also an important part of the market economy. However, it is not only important to create access to entry. It is also important to implement the possibility and clear rules for exit from the market. Therefore, a well functioning legal framework for bankruptcy is important. Exit means that non-performing assets are taken over by new owners, who will have the opportunity to make better use of these assets. If exits are blocked by soft credits and subsidies inefficient state supported enterprises can block the entrance of new and potentially more efficient enterprises.

Contrary to price-liberalization, which was implemented rather fast and consequent in most countries, opening up for foreign competition showed more variation. Even larger differences could be found in the implementation of bankruptcy procedures. Countries such as Estonia and Hungary implemented tough procedures quite early in the process while countries such as the Czech Republic and Russia were more hesitant in implementing the hard budgets for their enterprises.

Table 3 Status for liberalization based on EBRD-Transition Report 2006

	Price liberalization	Liberalize foreign trade and exchange	Compe-tition policy	Bank reform liberalize interest rate	Securities market and non-bank finance inst	Bankruptcy legislation (EBRD 99)	Commercial Law (EBRD 2002)
Albania	4+	4+	2 .	3 -	2 -	1 .	3 .
Belarus	3 -	2+	2 .	2 -	2 .	2 .	3 .
Bulgaria	4+	4+	3 -	4 -	3 -	4 -	4 -
Croatia	4 .	4+	2+	4 .	3 .	4 -	3+
Czech Rep	4+	4+	3 .	4 .	4 -	3+	4 -
Estonia	4+	4+	4 -	4 .	4 -	4 -	4 -
Hungary	4+	4+	3+	4 .	4 .	4 -	4 -
Latvia	4+	4+	3 .	4 -	3 .	3+	3+
Lithuania	4+	4+	3+	4 -	3 .	3 .	4 -
Poland	4+	4+	3 .	4 -	4 -	3+	3+
Romania	4+	4+	3 -	3 .	2 .	3 .	4 -
Russia	4 .	3+	2+	3 -	3 .	3 -	3+
Slovak R	4+	4+	3+	4 -	3 .	3 .	3 .
Slovenia	4 .	4+	3 -	3+	3 -	4 .	3+
Ukraine	4 .	4 -	2+	3 .	2+	2 .	3 .

Based on EBRD-2006, index from 1 (no liberalization) to 4+ (full liberalization)

There is a strong connection between this part of liberalization and the development of market institutions related to the financial system, banks and the capital market, and to the development of institutions securing private property rights. This part of the liberalization process belongs to the second tier of institutional reforms, which takes much more time to implement.

5. Privatization and corporate governance

Privatization of enterprises is necessary for developing decentralized control and decentralized incentives such as financial ownership rights. The owners and managers need incentives to use the resources efficiently. This is closely connected to the development of efficient governance systems between owners, managers and other stakeholders related to the activities of the enterprises.

However, it is difficult to implement privatization in transitional economies because many market institutions are not fully developed - a developed banking system, a well functioning stock market, reliable information about the economic situation of enterprises etc. It is very difficult to give a fair valuation of the assets because the markets are undeveloped and volatile with high uncertainty about the future development. The population lacks information and lacks capital to buy the assets.

The solution to the last problem has in countries like the Czech Republic, Russia and Lithuania been privatization through vouchers - privatization coupons freely distributed to the population. These vouchers were used for auctions of the enterprises to be privatized. Investment funds often played an important role in this process. In this way the problem of lacking capital was solved, and it was possible to have a high equality at least in the initial round of distribution of the assets.

In other countries such as Estonia and Hungary the most important method of privatization was direct sale to the investor who could offer the best combination of price, and guarantees of future investment and employment. Direct sale favored capital owners, and especially foreign investors played an important role in countries using this method of privatization. In other countries such as Russia, Lithuania and Slovenia insiders, managers and other employees, had strong advantages for taking over their enterprises including large and medium sized enterprises. In other countries such insider takeovers were only frequent for small privatization - privatization of small enterprises and sub-units of larger enterprises.

Table 4 Status for privatization 2006 and method for large privatization

	Private sector % of GDP	Large privatization (large enterprises)	Small privatization (small enterprises)	Governance and enterprise restructuring	Primary privatization method	Secondary privatization method	Peak privatization years
Albania	75	3 .	4 .	2+	insider	voucher	1995-96
Belarus	25	1 .	2+	1 .	not privatized		
Bulgaria	75	4 .	4 .	3 -	direct sale	voucher	1997
Croatia	60	3+	4+	3 .	insider	voucher	1995
Czech Rep	80	4 .	4+	3+	voucher	direct sale	1992-94
Estonia	80	4 .	4+	4 -	direct sale	voucher	1994-95
Hungary	80	4 .	4+	4 -	direct sale	insider	1992-96
Latvia	70	4 -	4+	3 .	direct sale	voucher	1996-97
Lithuania	75	4 .	4+	3 .	insider/voucher	direct sale	1992-94
Poland	75	3+	4+	4 -	insider/voucher	direct sale	1997
Romania	70	4 -	4 -	3 -	insider	direct sale	1995
Russia	65	3 .	4 .	2+	insider/voucher	direct sale	1993-94
Slovak R.	80	4 .	4+	4 -	direct sale	voucher	1992-96
Slovenia	65	3 .	4+	3 .	insider	voucher	1995-96
Ukraine	65	3 .	4 .	2 .	insider	direct sale	1998-99

EBRD 2006 privatization-index: 1=no privatization, 4+=full privatization. Method: own estimate

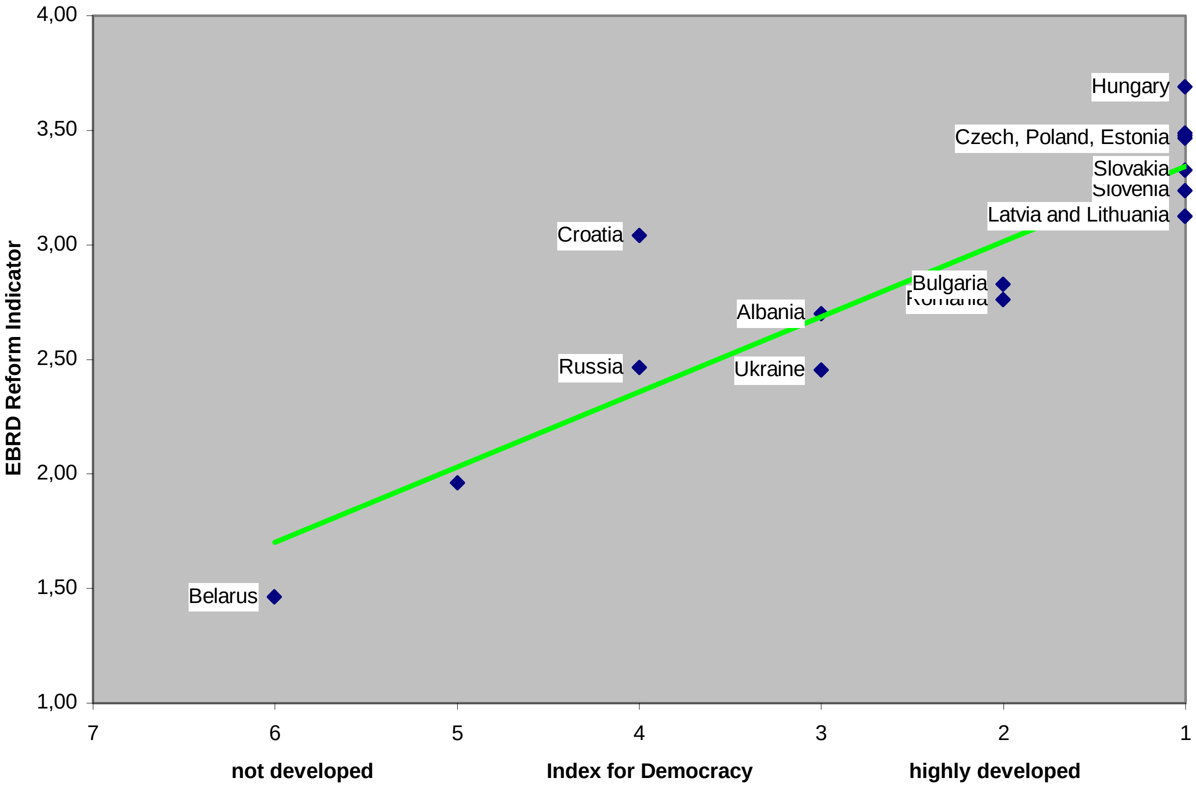
A fast and comprehensive privatization is not sufficient for developing a system of efficient corporate governance. Also a well functioning state is necessary (see next section) and it is necessary to have well functioning institutions for securing property rights, a developed capital market, access to reliable information about enterprises for existing and potential investors, and well functioning bankruptcy procedures. There are many examples of fast and comprehensive privatization, which did not lead to efficient corporate governance:

The main part of the large privatization in the Czech Republic was done through vouchers in the period 1992-94. After the privatization rounds most of the assets were controlled by investment funds again controlled by the large banks. However, state ownership dominated most of these banks. Therefore, it could be questioned whether the assets were truly privatized. The main problem, however, was that the administrators of the investment funds had de facto control with the enterprises in their portfolio. The real owners who had invested their vouchers in the investment funds were outside influence. This gap between control on one side and the financial returns on the other gave the administrators the opportunity to exploit their control and tunnel values out of the enterprises to the benefit of other enterprises directly owned by them. Similar ways of inefficient corporate governance systems resulting in tunneling are also known from Russia and other economies in transition.

6. The importance of a well functioning state

Closely connected to the quality of corporate governance of the enterprises is the quality of the governance of the state. Clear and stable rules of the game are a must for a well functioning market economy. Here we can distinguish between the development of the political dimension - the development of democratic institutions - and the administrative dimension - the quality of the state bureaucracy. The two dimensions support each other and there is a close connection between the development of democratic institutions and the progress in economic reforms. Figure 1 shows the relation between the development of democracy as measured by Freedom House on a scale from 1 (full democracy) to 7 (dictatorship) and an average of EBRD’s reform indicators from 4.3 (fully developed reforms) to 1 (no reforms). The numbers are based on 1999 data.

Figure 1. The relation between democracy and economic reforms



It is worth noting that a well functioning state is not the same as a strong state with the head of state in power for a long period. Stability of power is not a guarantee for a positive development. A "strong" state with lack of democratic institutions and lack of political competition means limited possibility for the opposition to criticize and challenge the current head of state. It is important that the government and the administration can be criticized and corrected. The old Soviet system was an example of a stable, but petrified state power, that lacked correction mechanisms and was not able to make the necessary flexible adjustments to exploit the opportunities of the technological development.

A strong opposition performing a persistent and strong monitoring of both the political elite and of the administrative bureaucracy can unveil inefficiencies, corruption and abuse of power. The free press has an important role, but is it also important to have a well functioning legislative system with clear rules and consequent and fair implementation through an efficient and independent court system. Some Central European countries have an advantage in this respect because of their roots in a well functioning court system before World War 2.

The EU-integration process supported a further development and check of the quality of the democratic institutions and especially of the administrative capacity of the state. This is another explanation why the best functioning transitional states are found among the new EU members. In the accession process the applicants had to strengthen the state functions such as a transparent and fairly implemented tax system, and efficient and fair regulation of enterprises in relation to environment and safety at the workplace.

7. Restructuring of enterprises

One of the most important problems of the command economy was the insufficient use of the human and technological resources to develop and produce competitive products. The main reason behind the steep fall in production at the beginning of transition was, as earlier mentioned, the gap between the production structure of the command economy and the new structure adjusted to the competitive market economy. This transition of production is directly linked to the restructuring of enterprises. The *defensive restructuring,* cutting away unprofitable production and cutting down the number of employees, was implemented in the first years of transition although it was implemented slower and less consequently in the CIS countries.

Deep strategic restructuring means building up the new structure of production with development of new products, new production methods, new technology, retraining of the employees, implementation of new management methods, new structures of organization, new networks to suppliers, new marketing methods and new markets. Strategic restructuring takes a long time and demands large capital inputs. At the same time new management skills must be developed – training of old and new managers in strategy, accounting, marketing, organizational behavior etc. has been a persistent bottleneck in all countries in transition.

Strategic restructuring is not only taking place in existing enterprises. Starting up new enterprises is a very important element in building up the new structure of production. This is especially important for sectors like trade and services, which had a low priority under the command economy. Closing down and/or breaking up old giant industrial enterprises and transfer of employees and physical assets to new enterprises is often the most efficient form of deep restructuring. The early success of the Polish economy is closely connected to the very dynamic development of new small and medium sized enterprises. The Polish privatization was rather slow, but new private enterprises contributed to fast growth in the private sector from the early start of the transition process.

Bureaucratic barriers, lack of transparency in legislation, uncertainty in relation to more or less criminal networks, and uncertainty about the market development in general limited the possibilities and the dynamic development for small and medium sized enterprises in most CIS countries.

The societal framework including the quality of the state is a very important factor for strategic restructuring. At the same time corporate governance of enterprises plays a crucial role. It is important which groups take over the ownership of the enterprises in the privatization process and in the post privatization change of ownership structures. The privatization and lack of regulation of investment funds in the Czech Republic is an example of a bad corporate governance system, which for some years hampered the incentives for strategic restructuring.

The Russian privatization has been criticized for the strong emphasis on insider-takeovers by management and broad groups of the other employees. Experts have called this: “half privatization” and some evidence have been presented showing that insider owned enterprises have problems getting enough capital for restructuring. However, there is contradictory evidence showing that insider owned companies often perform better that outsider owned domestic enterprises (Mygind 2000). The delay in restructuring in Russian enterprises will probably not be explained by the ownership structure. Instead, the unfavorable conditions in the institutional framework around the enterprises must be blamed. One of the leading economies in transition, Slovenia, with the highest GDP per capita in Eastern Europe, has a corporate governance system with many employee owned enterprises. Note, however, that there is quite clear evidence that enterprises owned by foreign core investors are in front concerning strategic restructuring. This will be further discussed in the following section.

8. Foreign Direct Investment - importance and development

The explanation behind the strong strategic restructuring in foreign owned enterprises shall be found in the fact that foreign investors have strong advantages concerning access to capital, management expertise, new technology and international networks. Usually the foreign investor constitutes a strong core owner with a dominant share of ownership. This means that there are no corporate governance problems under the assumption that the overall institutional framework guarantees the property rights.

The countries with the highest foreign direct investment per capita are characterized by advanced transition and a quite well functioning state with clear and transparent rules for enterprises and foreign investors. Czech, Hungary and Estonia are leading measured per capita. Already in the 1980s Hungary had opened up for foreign investments mostly in the form of joint ventures. The high level of foreign investments has been an important reason behind Hungary's advanced development in relation to strategic restructuring and in relation to the development of a competitive industry. However, some evidence points in the direction that the technological and other positive spin-offs to the domestic part of the industry were rather modest (Hunya, 1997). The fall in FDI for some of the leading countries in the later years is because the acquisitions in relation to privatizations have ended.

Table 5 Foreign Direct Investment inflows per year and accumulated 1990-2005

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	1990-2005 cumulative	
	millions USD																	$/capita
Albania			20	58	53	70	90	48	45	41	143	207	135	178	332	260	1680	525
Belarus			7	18	11	15	105	352	203	444	119	96	247	172	164	305	2256	230
Bulgaria	4	56	42	40	105	90	109	505	537	819	1002	813	905	2097	3443	2223	12789	1661
Croatia			13	120	117	114	511	538	935	1472	1087	1564	1126	2133	1262	1695	12687	2883
Czech R.				654	869	2562	1428	1300	3718	6324	4986	5641	8483	2101	4974	10991	54032	5246
Estonia			82	162	215	202	151	267	581	305	387	542	284	919	1049	2853	7998	6152
Hungary	2950	2955	4892	2286	5104	3300	4167	3335	3312	2764	3936	2994	2162	2137	4654	6699	56107	5555
Latvia			29	45	214	180	382	521	357	347	413	132	254	292	699	632	4496	1955
Lithua-			10	30	31	73	15	355	926	486	379	446	732	179	773	1009	5581	1641
Poland	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4123	6159	1287	7724	75722	1987
Romania		40	77	94	341	419	263	1215	2031	1041	1037	1157	1144	2213	6517	6388	23977	1104
Russia			1161	1211	690	2066	2579	4865	2761	3309	2714	2748	3461	7958	15444	14600	65567	455
Slovak			179	273	258	370	231	707	428	1925	1584	4094	669	756	1261	1908	13974	2588
Slovenia		111	113	117	151	174	334	216	107	136	370	1686	337	333	827	496	5169	2584
Ukraine			200	200	159	267	521	623	743	496	595	792	693	1424	1715	7808	7924	344

Based on UNCTAD (2006)

Foreign investments are often motivated by access to the market of the host country. However, there are increasing motivations based on the exploitation of competitive factor inputs, especially the cheap highly qualified labor force (Meyer, 1998). Often the two motives are combined. The host country is an important market and at the same time the foreign investor uses the factors of production to build up exports to other Eastern European countries or to export back to the West. Furthermore, there is a connection between opening foreign trade and the increase in foreign investments.

9. Status and perspectives for the remaining transition process

Has the transition been too tough? Because of the drastic fall in production and living standards the first answer could be yes. However, there is much variation in the development of production for different countries. The evidence shows that the most consequent reformers have been most successful. The majority of the population in these countries has now living conditions at least as good as before the transition started. This level has been reached after a tough period with high costs for many groups such as retired people, most employees in the public sector, workers in large failing enterprises etc. Many mistakes have been made and some countries are still well below the starting point.

Reforms must be adjusted to the specific conditions in each country. But this argument has often been used as an excuse for slow and inconsistent reforms. It is hardly too tough policies, but hesitant and contradictory reforms combined with a badly functioning state, which is to blame for the lacking, or hopefully postponed, success in several countries. There is a close connection between the success of the reforms, the quality of the state and foreign investments and opening toward the developed market in Western Europe. The countries most advanced in the transition process are also the countries most advanced in the integration process with EU and they also have the highest level of foreign investments. Foreign direct investment plays an important role in the current stage of transition with focus on restructuring at the enterprise level.

These elements points toward the future transition with further integration with Western Europe and further restructuring of enterprises and integration into international production networks. There is still some way left in restructuring production even in the most advanced transitional countries. Even though these countries have an educational level comparable to most EU countries they need to invest a lot of capital in infrastructure and a new restructured production base. The qualifications of the labor force must be further adjusted to the new needs. Further development of most institutions is crucial especially concerning financial markets, the court system and the development of the administrative capacity of the state.

In the coming years we will probably see an extension of the gap in Eastern Europe between groups of countries with different speeds in relation to transition and EU-integration. In the frontline we have Estonia, Poland, Slovenia, Czech Republic and Hungary closely followed by Latvia, Lithuania and Slovakia and soon also Croatia, Bulgaria and Romania while the remaining countries in the Balkan come in the second row. The CIS countries with Russia in front have a more uncertain future and a more peripheral participation in the integration process. Decisive for Russia and other CIS countries is the development of the state. Will they succeed in building up a well functioning democracy with a critical opposition and an independent free press, which can criticize the people in power and present alternatives to corruption and abuse of power? Will they succeed in building up an administrative capacity, which can assure clear, stable and fair rules for enterprises?

The West has great influence on this development. This concerns a positive attitude to the EU-integration process and a continued development in the economic cooperation. It also concerns the relation to the CIS countries where a development of the cooperation including support for the development of the capabilities of the state must be in focus to keep the transition process on track.

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