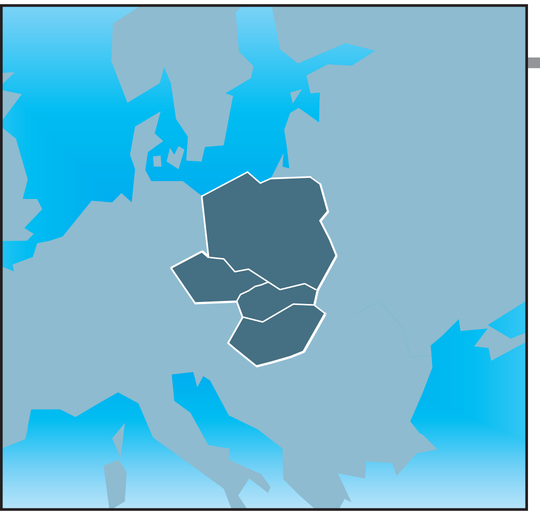

Private Sector Development in the Visegrad Countries

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The Visegrad countries are enjoying solid economic growth driven by vibrant new private sectors. To make a successful transition to a market economy, however, they will need to push ahead with financial, legal, and regulatory reforms.

THE FOUR Visegrad countries—the Czech and Slovak Republics, Hungary, and Poland—have made the development of a strong private sector an essential component of their strategies for achieving sustainable economic growth. To varying degrees, they have privatized state enterprises, broadened and deepened financial markets, and liberalized legal and regulatory frameworks. And, to a large extent, their strategies have succeeded. Total GDP has increased significantly in all four countries since 1989, fueled by the growing private sector.

To ensure continued private sector growth, however, the Visegrad countries need to push forward with reforms. State ownership is significant in the banking and industrial sectors in all four countries, and Poland and the Slovak Republic, in particular, need to accelerate privatization. The Czech and Slovak Republics have achieved stable macroeconomic frameworks, and Poland and Hungary have recently made significant progress toward this goal. However, the legal and regulatory frameworks in the Visegrad countries, although much improved, are plagued by weaknesses in critical areas such as property rights, contract enforcement, bankruptcy and liquidation procedures, and bank supervision.

Progress to date

The private sector has grown steadily since transition began and now accounts, in all four countries, for larger shares of GDP and employment than the public sector (see chart). Although state ownership still dominates the industrial sector, private ownership prevails in the light manufacturing and services sectors, and virtually all small and medium-sized enterprises are now privately owned. Both output and employment in the state-dominated heavy industry and agricultural sectors have shown a pattern of decline, but this has been more than offset by the growing economic ascendancy of small, owner-operated firms in light manufacturing and services.

In the Czech Republic, private sector growth has been due largely to the rapid privatization of the state sector—more than three-fourths of state-owned assets have already been privatized. Private sector growth in the other three countries, where the pace of privatization has been slower, can be attributed largely to start-ups of new—mainly small and medium-sized—private enterprises. These enterprises account for a disproportionately large share of GDP and export growth in all four countries. Hungary accelerated large-scale privatization in 1995, setting precise targets to divest itself of 80 percent of remaining state-held assets by 1997. In Poland and the Slovak Republic, which have been reluctant to sell off their largest industrial enterprises

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and financial institutions, the state still has a large ownership stake in the industrial and financial sectors.

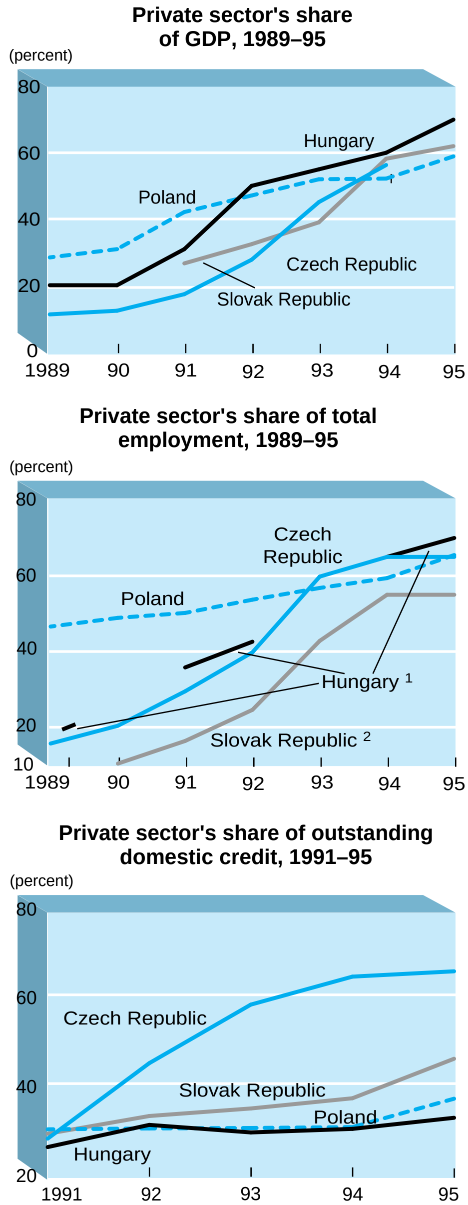
The Czech Republic. The Czech Republic's private sector increased its economic presence from 11 percent of GDP in 1989 to about 60 percent in 1995. Private sector output grew nearly sevenfold over this period, from $4 billion to $27 billion, and the private sector now dominates industry, construction, and transport. It has also been the driving force behind the booming services sector.

Private sector employment jumped from 16 percent of the Czech workforce in 1989 to 65 percent in 1995—the number of private sector jobs nearly quadrupled, from 865,000 in 1989 to about 3.2 million in 1995. This growth, combined with modest unemployment benefits and low labor costs, has helped keep the unemployment rate down to about 3 percent. Many of the new jobs are in small, owner-operated firms in the light manufacturing and services sectors. The sectoral shift in employment is due to an explosion in the number of small firms (640,000 in 1993, compared with 20,000 in 1989), as well as to the restructuring of state enterprises, which has resulted in the loss of many industrial jobs since 1990.

Hungary. In Hungary, the share of the private sector in GDP climbed from 20 percent in 1989 to 70 percent in 1995, as private sector output more than quintupled, from almost $6 billion to more than $31 billion. Nearly 75 percent of Hungary's GDP is now generated by financial, legal, consulting, tourism, entertainment, and other "nonmaterial" services. The services sector has benefited from an open trade and investment regime and the steady inflow of investment and remittances from abroad. Private sector growth in Hungary was stunted, however, by macroeconomic weaknesses (high tax rates and high inflation), as well as by heavy government borrowing. Recent policy reforms should encourage enhanced private sector growth.

About two-thirds of the Hungarian labor force now works in the private sector, up from 20 percent in 1989; private sector jobs have more than doubled, from 1.1 million in 1989 to 2.6 million in 1995. There has been a striking increase in self-employment, and, since 1990, more than 400,000 small private businesses have been established. However, despite a tripling of the number of formally registered firms between 1990 and 1993, total employment in these firms declined by about one-third because of state enterprise restructuring. With manufacturing employment down 27 percent and agricultural output declining, official unemployment has increased from 1.6 percent of the total workforce in 1990 to 11–12 percent since 1991. Nonetheless, about three-fourths of the 2 million jobs lost since 1989 have been replaced by new jobs in the private sector, and, if informal employment is taken into account, Hungary's real unemployment rate would probably be about 7–8 percent.

The private sector in the Visegrad countries is growing



Source: World Bank.
[1] Figures represent estimates.
[2] Data not available for 1989.

Poland. The private sector accounted for 59 percent of Poland's GDP in 1995, up from 28 percent in 1989, as private sector output grew from $23 billion to $70 billion. Private sector output was higher in Poland than in the other Visegrad countries at the start of transition because the agricultural sector was primarily private; nationalization during the central planning era had focused on industry and related services. Poland still has nearly 4,000 state-owned enterprises, which dominate the heavy industry, mining, and transport sectors, but it also has nearly five million owner-operated businesses—more than any other Visegrad country.

The private sector accounted for 66 percent of the country's labor force in 1995, compared with 47 percent in 1989. Poland's official unemployment rate is about 14 percent, but this figure may mask a more serious unemployment problem because it does not reflect either the number of redundant employees still working in state enterprises or the mechanisms that have been used to maintain employment (i.e., wage arrears, part-time work). Moreover, the loss of more than two million jobs since 1989 has made it politically difficult to accelerate privatization. Informal sector activity, however, may have accounted for the creation of one million jobs; the official unemployment rate may therefore overstate the severity of the problem. In any event, the unemployment rate is likely to decline, given Poland's current annual real growth rate of 6 percent.

The Slovak Republic. In the Slovak Republic, the private sector accounted for 62 percent of GDP in 1995, up from 27 percent in 1991, and private sector output grew from less than $3 billion in 1991 to nearly $11 billion in 1995. Under the mass privatization program, the number of private enterprises grew from about 9,400 in 1991 to 26,400 in 1994. Microenterprises numbered 500,000 at the end of 1994, up from 200,000 just three years earlier. Nonetheless, private sector growth has been concentrated in one sector—services—and in one region—Bratislava—and, since 1994, has been slowed by policies that, despite the growth of export industries, have encouraged a gradualist approach to privatization and a diminished role for Investment Privatization Funds (mutual funds that invest in privatized companies).

The private sector accounted for 55 percent of the country's jobs in 1995, up from 10 percent in 1990. Between 1990 and 1995, the number of private sector jobs nearly quintupled, from 250,000 to 1.2 million. However, more than 1.3 million jobs in the state sector disappeared during this period. As in the other Visegrad countries, the average number of employees in industrial enterprises dropped because of labor shedding by state firms; manufacturing employment fell 24 percent between 1989 and 1994. The unemployment rate, which was only 1.5 percent in 1990, has ranged between 13 and 14 percent since 1993, but is expected to decline if the Slovak economy continues to grow at current estimates of 6–7 percent (in real terms) annually.

Macroeconomic stability

In the Czech and Slovak Republics, the private sector has benefited from a stable macroeconomic environment, with low fiscal deficits, declining inflation, and relatively stable exchange rates. In recent years, exports from both countries have boomed, and the Czech Republic has attracted considerable foreign direct investment. Gross domestic investment has ranged between 25 and 27 percent of GDP.

Hungary and Poland, however, have been slower to achieve macroeconomic stability. Hungary has been troubled by large debt loads and fiscal deficits, high inflation, declining domestic investment, and steady erosion of the current account, although the situation began to improve in 1995. Poland has succeeded in bringing down inflation rates, maintaining hard budget constraints to contain fiscal deficits, and increasing exports. However, it has experienced a run-up of arrears on trade debt, wages, and social security payments that has had a ripple effect on the economy—decreasing private sector liquidity, adding to upward pricing pressure, and weakening the tax base.

Legal frameworks

The Visegrad countries have made progress in equalizing the status of private and public property and improving protection of property rights. Because most property was previously state-owned, legal reforms establishing private property have included the transfer of ownership to private parties through privatization, restitution, and rentals.

However, property rights continue to be undermined by tenancy laws that restrict the rights of property owners, incomplete property registries, and weak legislation governing collateral. In all four countries, tenancy laws distort rental markets and make repossession of mortgaged property difficult. Title to urban and agricultural property is often uncertain because of incomplete and inaccurate records, multiple pledges on the same property, and unsettled claims arising from demands for restitution and from transfers of property to or among state entities. The collateral use of mortgages is still limited in the Czech and Slovak Republics and is cumbersome in Poland. Lenders in the Visegrad countries are reluctant to provide mortgage-backed loans because arrears on wages, severance pay, and tax claims are considered superior to—that is, to have a stronger claim on a creditor's assets than—registered mortgage liens.

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All of the Visegrad countries have improved their commercial codes, but institutional weaknesses still undermine contract enforcement. Court capacity is inadequate, and procedures for resolving contract disputes out of court are not fully developed; also lacking are market-based liquidation companies and secondary markets for pledged assets. Social pressures as well as problems with collateral claims, seizure (credit hierarchy), and resale inhibit the use of bankruptcy and liquidation procedures. In Poland, debt disputes tend to be settled out of court. In Hungary, in contrast, bankruptcy and liquidation procedures are automatically applied to companies that default on loans. The Czech and Slovak Republics have preferred less formal methods for restructuring large enterprises unless liquidation is necessary.

The Visegrad countries have made progress with bank supervision in recent years. They have adopted new banking laws and prudential regulations, internationally accepted accounting standards, and stricter disclosure requirements. But information systems need to be improved, and bank supervisors need more experience and training in risk management.

Financial intermediation

Performance in the Visegrad countries has been mixed with regard to credit flows to the private sector, deposit mobilization, and overall financial intermediation. New lending flows to the private sector appear to be increasing in all four countries, although public sector borrowing is growing faster than private sector borrowing in all countries except the Czech Republic, where, in 1995, the private sector accounted for 65 percent of total outstanding credit (see chart). Manufacturers and traders have received the largest share of loans, while lending to most other sectors has been comparatively flat (agriculture, mining, power) or has risen only modestly (construction, transport).

The private sector's share of the total stock of credit in Hungary, Poland, and the Slovak Republic was still low at the end of 1995, ranging between 32 and 46 percent. In Hungary, government borrowing has grown because of large fiscal deficits; net lending to households, small enterprises, and formal private enterprises began to decline in the early 1990s, just as the number of small and formal enterprises began to increase. Most observers expect this trend to be reversed, however, as fiscal deficits shrink and hard budget constraints are imposed on state enterprises. In Poland, banks are taking advantage of high net spreads on government securities to recapitalize, rather than lending to the private sector, which found it difficult to obtain bank credit until 1995. And even though the stock of credit to the private sector more than doubled between 1990 and 1995, from 16 percent to 37 percent, credit is still scarce and costly—the average loan to private sector nonfarm enterprises was only about $25,000 in 1995, enough to provide small-scale working capital but not to meet the longer-term investment needs of larger enterprises. In the Slovak Republic, lending to the private sector has been increasing as bank managements continue to impose hard budget constraints on loss-making enterprises.

On the whole, the deposit base has grown in all of the Visegrad countries as savings have increased. State banks continue to hold most deposits because of the sluggish pace of bank privatization and the importance of state savings banks in the interbank markets. However, private banks should see their deposit base expand in the coming years as the banking sector is privatized and deposit insurance becomes more widespread; this will lower their funding costs and make lending markets more efficient.

Financial intermediation rates (broad money as a share of GDP) in Hungary and Poland are low—41 and 36 percent, respectively—compared with 90 percent in the Czech Republic and 77 percent in the Slovak Republic. Some of these differences may have to do with differences in their borrow-back ratios (loan-to-deposit ratios). The gap between private sector deposits and loans is smaller in the Czech Republic than in the other three countries; in Hungary, Poland, and the Slovak Republic, government securities still represent a large share of total bank assets.

The future

The Visegrad countries have come a long way toward establishing healthy market economies, but they are not there yet. Whether the Czech and Slovak Republics succeed in making the transition hinges on their maintaining a stable macroeconomic environment; whether Hungary and Poland succeed depends on their making continued progress toward a stable macroeconomic environment. All four countries need to accelerate the privatization of large industrial companies and financial institutions, as is currently happening in Hungary. Hungary and Poland also need to improve their financial intermediation rates. Most signs are positive, however, particularly since all four countries are aiming at membership in the European Union. Their steadily improving economic performances suggest they will succeed. F&D

This article is drawn largely from the authors' Private Sector Development During Transition: The Visegrad Countries*, World Bank Discussion Paper No. 318 (Washington, 1996).*