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## External Sector Reform and Public Enterprise Restructuring

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Middle Eastern Department

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**Abstract**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper explores the linkages between external sector reforms and public enterprise restructuring, paying attention to the role of the financial sector in ensuring the success of these reforms in the context of a comprehensive medium-term structural adjustment program. It discusses the arguments made in the academic literature on this issue, and analyzes how some countries—namely Algeria, Egypt, and Poland—have tackled reforms in these areas.

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## I. INTRODUCTION

An important requirement for a move from a multiple exchange rate regime to a unified exchange rate system to be successful is effective control over the fiscal deficit. This in turn usually requires a major restructuring of public enterprises, and in particular limiting their access to government subsidies and to subsidized commercial bank credit. And, given the predominance of the public sector in many nonindustrialized countries, success of trade reforms in promoting economic growth is linked in a crucial way to success in improving the efficiency and competitiveness of public enterprises. The central theme of this paper is that external sector reforms need to be accompanied by a sound financial reform strategy which takes careful account of the role that commercial banks—or, more generally, the financial sector—can or should play in the public enterprise restructuring process. The country studies discussed below suggest that this is an area which has—at least in some cases—not received sufficient attention from a policy perspective. This in turn may be a reflection of the vagueness of the policy recommendations in the existing literature relating to the pace and method of public enterprise restructuring, and its linkages with financial sector and trade reforms.

The second section of this paper identifies the preconditions for successful external sector reforms and public enterprise restructuring, paying particular attention to the role of the financial sector. The third section looks at how some countries have tackled structural reforms relating to the exchange rate and trade regimes and public enterprises. It compares the more gradual attempts of Algeria and Egypt at structural reforms with the ‘shock therapy’ approach adopted by Poland. The final section concludes.

## II. PRECONDITIONS FOR SUCCESSFUL EXTERNAL SECTOR REFORMS AND PUBLIC ENTERPRISE RESTRUCTURING: THE EMERGING CONSENSUS

Intense academic discussion and debate based on the liberalization experiences of a steadily increasing number of developing and transition economies have led to an emerging consensus on a number of important issues relating to the appropriate pace and sequencing of structural reforms.<sup>2</sup> There is general agreement that macroeconomic stability, mainly through control of the fiscal deficit, is the crucial first step in creating an environment conducive to sustained high growth.<sup>3</sup> There is also now a broad consensus that liberalizing the capital account of the balance-of-payments should come last in the reform process, although important distinctions can be made among different types of capital flows (for example, it makes sense to

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<sup>2</sup> See Bhattacharya (1997).

<sup>3</sup> See McKinnon (1991), Greenaway and Morrissey (1993).

liberalize foreign direct investment at an earlier stage of the reform process than portfolio capital flows).<sup>4</sup> There is further broad agreement that, when it comes to external transactions, the first order of business should be to unify the exchange rate so that all exporters and importers face the same price for foreign exchange. This should be followed by moves to convert implicit protection by direct controls and quota restrictions to explicit protection by tariffs. The academic literature also suggests that freeing foreign commodity trade should proceed in parallel with the decontrol of disequilibrium prices in the domestic trade of goods and services.<sup>5</sup>

An essential precondition for successful exchange rate unification is the establishment of a stable macroeconomic environment, and in particular control of the fiscal deficit. To the extent that large fiscal deficits and/or high rates of domestic credit expansion are driven by the needs of an inefficient public sector, imposition of harder budget constraints on public sector enterprises should precede—or at least be concomitant with—moves toward exchange rate unification. The Algerian case study (discussed below in some detail) lends empirical support to this argument.

The situation becomes more complicated when exchange rate and trade reforms have a significant impact on the financial health of public enterprises. In many countries such as Iran at present, an important rationale for multiple exchange rates, high tariff and non-tariff barriers, subsidized energy prices and other price distortions is to protect a large and inefficient public enterprise sector. In economies where a large share of the implicit subsidies associated with inappropriate prices for foreign exchange, credit and other important commodities such as energy accrue to public enterprises, their removal needs to be part of a comprehensive medium-term strategy for public enterprise restructuring and privatization. Thus price-related structural reforms, including external sector reforms, and public enterprise restructuring have to go hand-in-hand. The problem for policymakers is that sudden and simultaneous reform on all fronts is likely to impose a major shock to the economy, with adverse effects on output and employment. Thus the issue of the appropriate pace and sequencing of reforms is a complicated (and politically sensitive) one to handle in practice.

Successful management of a unified exchange rate also requires a flexible interest rate structure that is responsive to market forces. However, in most countries with a multiple exchange rate system the interest rate structure is administratively determined, supported by sectoral credit allocation guidelines for bank lending. Moreover, in many cases interest rates are negative in real terms. Consequently the banking system is unable to attract a significant share of household savings or to allocate credit based on criteria of commercial viability. In such cases

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<sup>4</sup> See Dooley (1996(a), 1996(b)), Edwards (1984a, 1984b, 1989), Eichengreen, Mussa, et. al. (1998), Frenkel (1982, 1983), Hanson (1995), Johnston, Darbar and Echeverria (1997), Lal (1984), Mathieson and Rojas-Suarez (1992), McKinnon (1982, 1984), Quinn and Inclán (1997).

<sup>5</sup> See McKinnon (1991).

exchange rate unification is unlikely to be successful unless accompanied by measures to introduce greater market sensitivity to the interest rate structure and to develop new instruments for effective monetary control. The implication is that public enterprises should stop having open-ended access to subsidized bank credit and instead compete with the private sector for financial resources based on criteria of commercial viability. Thus limiting the access of public enterprises to subsidized credit, either to continue in operation or for commercially unviable projects, would seem to be another important precondition for successful exchange rate reform.

Public enterprise reform encompasses two distinct, but complementary, approaches.<sup>6</sup> The first is the private sector development approach to public enterprise reform, which involves privatizing public enterprises and encouraging private sector development to both enhance economic efficiency and shrink the relative size of the public enterprise sector. The second is the corporatization approach, which involves enhancing managerial incentives and clarifying public enterprise budget constraints so that public enterprise performance improves without the government relinquishing ownership. The corporatization approach in turn can be of two different types:

(a) corporatization involving greater public enterprise autonomy, with the government playing less of a role in defining and imposing a budget constraint, allocating resources, and monitoring public enterprise managers;

(b) corporatization involving greater government oversight, with the government imposing tight budget constraints and explicitly limiting public enterprise access to bank credit in order to harden incentives to improve public enterprise performance.

An important consideration in the choice of approach to public enterprise restructuring is the financial health and level of development of the domestic financial sector. After looking at nine country case studies<sup>7</sup> Demirgüç-Kunt and Levine (1994, pp. 44) conclude that, in an economy with an underdeveloped financial system, public enterprise reformers "should consider a strategy that relies less on the financial system for its initial success and start developing the foundations for a well-functioning financial system. Specifically, corporatization that consists of improved direct government monitoring of enterprise managers, firm investment decisions, and public enterprise financing may contain losses and improve performance without relying excessively on the financial system. At the same time, financial reforms, especially liberalization and improvements in legal, supervisory, and regulatory systems, should be initiated to establish the financial sector basis for more comprehensive, large-scale public enterprise reform involving expanded enterprise autonomy and privatization...". The authors go on to argue that a

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<sup>6</sup> See Demirgüç-Kunt and Levine (1994).

<sup>7</sup> Of Chile, Egypt, Ghana, India, Mexico, the Philippines, the Republic of Korea, Senegal, and Turkey.

comprehensive public enterprise reform should also involve the reform of the financial sector. They note that the design of a sound financial reform strategy is crucial to the success of any large-scale public enterprise reform: just as well-designed financial sector reforms can promote public enterprise reform, poorly designed financial sector reforms can jeopardize the success of public enterprise reform.

To sum up: the arguments presented above suggest that public enterprise restructuring should be at the center of a comprehensive medium-term strategy for fiscal consolidation, trade liberalization and exchange rate unification, and financial sector reform. In this context an issue which has, at least in some cases, received insufficient attention from a policy perspective is the role of commercial banks—or, more generally, the financial sector—in the public enterprise restructuring process, as illustrated in the country studies described below; this is probably a reflection of the vagueness of the policy recommendations in the existing literature that relate to the pace and method of public enterprise restructuring, and its linkages with financial sector reform. This is a topic which has important implications from the point of view of both macroeconomic stability and economic efficiency.

### **III. COUNTRY CASE STUDIES**

This section looks at how some countries have tackled exchange rate and trade reforms and public enterprise restructuring, looking in particular at the role of the financial sector and drawing out the main policy lessons. The case studies presented in this section compare the experiences of Algeria, Egypt, and Poland in the structural reform area.

#### **A. Algeria: The Post-1993 Reforms**

In the late 1980s and early 1990s, the Algerian authorities initiated macroeconomic adjustment and structural reforms. However, the potential benefits of the liberalization and reform process were stymied by the lack of integration of the various measures into a comprehensive framework, and the absence of some key steps necessary for creating an efficient market economy. In 1993, the inconsistency between expansionary demand management policies and the reluctance to adjust the exchange rate, coupled with an external debt strategy that sought to avoid a formal debt rescheduling, resulted in severe macroeconomic imbalances. In response, the Algerian authorities formulated a comprehensive structural adjustment program that received the support of the IMF in May 1994, with a one-year Stand-by Arrangement and, from May 1995, with a three-year arrangement under the Extended Fund Facility.<sup>8</sup>

#### **External sector reforms and macroeconomic stabilization**

At the start of the 1994 reform program, a large devaluation of the Algerian dinar of

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<sup>8</sup> See Nashashibi, et. al. (1998).

about 50 percent took place in two steps, bringing the Algerian dinar to DA 41 per U.S. dollar by the end of September 1994. The devaluation was followed by a gradual shift in the exchange rate regime from a peg to a basket of major currencies to a managed float, which allowed for greater flexibility in the event of adverse terms-of-trade shocks. Overall, between 1993 and 1996, the real effective exchange rate depreciated by about 30 percent.

These exchange rate developments had an adverse impact on the balance sheets of those public sector enterprises that had borrowed heavily in foreign exchange. However, the impact was limited to the extent that these enterprises received direct financial support from the budget as part of a comprehensive program of financial rehabilitation (see below). Moreover, the debt burden of the indebted public enterprises was reduced through external balance-of-payments support which amounted to more than US\$21 billion between 1994 and March 1998, most of which came from debt rescheduling by the Paris and London Clubs in 1994 and 1995.

On the trade front, after some increase in imports following a relaxation of trade restrictions in 1989, controls and exchange restrictions had been intensified again in 1992 to ensure full servicing of external debt. By 1993, imports were only two-thirds of their 1985 level in real terms. Import rationing had a severe negative impact on the manufacturing and construction sectors, depriving them of much-needed equipment and supplies. However in 1994, along with reform of the exchange rate regime, the authorities started dismantling again the cumbersome system of controls. In particular, they abolished the administrative foreign exchange allocation that was established in 1992 for authorized imports. This gave importers free access to foreign exchange for all but a short list of imports that were temporarily prohibited. The negative list was eliminated at the end of 1994. At the same time the authorities lowered the maximum custom duty rate from 60 percent in 1994 to 45 percent in 1997, and reduced the number of tariff rates. Import prohibitions were completely abolished by the middle of 1995, and on the export side virtually all previous export prohibitions (about 20 items) were eliminated. By June 1996 Algeria's trade system was free of quantitative restrictions.

The early 1990s saw a steady worsening of the overall fiscal situation and an acceleration in the rate of growth of domestic credit, with the overall fiscal deficit reaching 8.7 percent of GDP in 1993 and domestic credit growing by almost 24 percent of beginning-of-period broad money. However, starting in early 1994 the authorities took major steps towards fiscal consolidation. This was achieved in part by a winding down of cash transfers to public enterprises channeled through the Rehabilitation Fund (see more below). This in turn reflected the government's commitment to avoiding recurrent bailouts of public enterprises and banks by accompanying financial restructuring with structural measures, including price liberalization and labor shedding. As a result of these and other measures, the overall fiscal balance shifted to a surplus of 2.4 percent of GDP in 1997.

Fiscal consolidation was accompanied by a program of gradual financial deregulation. The 20 percent a year ceiling on commercial banks' lending rates to the private sector, which had resulted in negative real interest rates in 1993, was abolished in 1994. However, the government



also temporarily imposed a cap of 5 percentage points on commercial bank interest rate spreads, with a view to preventing an excessive increase of lending rates as a result of possible collusion among the five commercial banks. This cap on banks' spreads was eliminated in December 1995. The deregulation of interest rates, together with the deceleration of inflation brought about by tighter demand management policies, eventually led to the emergence of positive real interest rates since the beginning of 1996.

### **Public enterprise restructuring**

Efforts had been made prior to 1994 toward the restructuring of public sector enterprises, through a restructuring program that granted legal and financial autonomy to most public enterprises which were no longer protected against bankruptcy. This program did not include the 23 largest loss-making public enterprises, whose acute financial difficulties were addressed by a more specific restructuring strategy supported by the World Bank's Enterprise and Financial Structural Adjustment Loan (EFSAL). As part of the overall strategy, the 1991 budget law had established the Rehabilitation Fund to financially restructure loss-making public enterprises and commercial banks.

These reforms, however, proved insufficient to prevent the accumulation of further losses by public enterprises, given that many of these enterprises could not set their prices freely and continued to enjoy easy access to commercial bank credit. In particular, the financial situation of public enterprises continued to be constrained by ongoing price controls by the Ministry of Supply, and by high severance costs for labor shedding. Insufficient prudential regulation of commercial banks led to steady deterioration in their balance sheets as nonperforming public enterprise debt to commercial banks increased.

From 1994, these shortcomings were addressed mainly by subjecting all public enterprises to harder budget constraints. Moreover, for the 23 largest loss-making enterprises that accounted for close to 15 percent of the value-added in industry and construction, a ceiling was imposed on their access to commercial bank credit. At the same time medium-term action plans were drawn to cut operating losses by imposing better inventory control and cost management procedures as part of the World Bank's EFSAL program. By the end of 1996, all 23 enterprises had been granted autonomy in conjunction with the completing of their financial restructuring and the signing of performance contracts with their managers.

Over the period 1991–96, greater legal and financial autonomy to public enterprises was accompanied by a program of financial rehabilitation. The debt burden of public enterprises, reflecting in part past government policy-induced distortions and exacerbated by exchange rate depreciation, was reduced through debt forgiveness from the treasury and the swap of government bonds for nonperforming debts to commercial banks and the housing bank CNEP (Caisse Nationale d'Épargne et de Prévoyance). In addition, public enterprises received DA 110 billion (1.3 percent of GDP) over 1991–96 in cash transfers through a Rehabilitation Fund established in 1991.

The overall restructuring strategy also involved the recapitalization of state-owned banks, accompanied for each bank by performance contracts between the government and the banks' managers. In particular, bank managers were made responsible for respecting the capital adequacy ratio established by the Bank of Algeria. In return, the banks were given increased autonomy with respect to operational decisions, notably the allocation of credit and (more importantly) the denial of credit to high risk enterprises.

These measures, however, had only limited success in promoting greater efficiency in the public enterprise sector. Public enterprises continued to lose market share, while their low productivity impaired their ability to meet future financial obligations and to make adequate use of new financial resources. In view of the rapidly mounting restructuring costs, the Algerian authorities embarked on a new strategy that moved away from financial transfers from the budget and was geared toward protecting the strength of the financial sector, while at the same time restoring the medium-term profitability and competitiveness of public enterprises.

As part of the new strategy the bank-enterprises mechanism was set up in September 1996, while the Rehabilitation Fund ceased operations at the end of 1996. The 411 large national public enterprises (EPEs) were grouped into 11 sectoral holdings, and the commercial banks and 11 holding companies established financial programs aimed at restoring the financial viability of the large public enterprises and closing down the nonviable ones. A new commercial/financial relationship was defined between the economically viable enterprises and the banks, with a large share of the overdrafts consolidated into medium-term loans at lower interest rates. At the same time stringent programs were adopted to compel enterprises to increase their productivity and to give them greater financial autonomy. Accordingly, the plan included the establishment of more than 502 subsidiary units with competitive prospects operating under tight bank supervision by the end of 1998. This was viewed by the authorities as a first step toward their privatization.

The privatization process has been slow. As of January 1999, only one EPE has been totally privatized and two others partially privatized via public offering of shares, although there have been competitive bids for a further 61 units. Despite the slow progress with privatization, a large number of nonviable public enterprises have been liquidated: of the 1,324 initial local public enterprises (EPLs) existing in April 1996, 935 were dissolved by early 1999, in addition to 76 EPEs. This has resulted in significant job losses: between November 1996 and September 1998, the workforce of the national and regional holdings was reduced from almost 800,000 to just over 480,000, a reduction of 40 percent.

To sum up, the Algerian case study shows that fiscal consolidation, public enterprise restructuring and reform of the commercial banking sector have to be part of a comprehensive medium-term structural reform program. It also provides some support for the conclusion by Demirgüç-Kunt and Levine (1994) that, in an economy with an underdeveloped financial system, public enterprise reform should focus on corporatization involving greater government oversight and monitoring rather than on corporatization involving greater autonomy for public enterprises.

In particular, there may be a case for designing financial action programs for public enterprises, with a clearly defined role for commercial banks.

### **B. Egypt: The 1991 Reforms**

In the second half of the 1980s the Egyptian authorities began streamlining their complex and segmented foreign exchange market. More radical reforms, culminating in exchange rate unification, were taken in 1991. Some reforms of public enterprises, price and trade liberalization were also initiated in the late 1980s, but major steps were not taken until the early 1990s in the context of a comprehensive stabilization and structural reform program. By the early 1990s, domestic pricing and exchange rate system reforms were virtually complete, and the authorities embarked on a major program to restructure and eventually privatize a large part of the public enterprise sector.

#### **Exchange rate developments**

Movements in the exchange rate during 1987–1991 were closely linked to moves to liberalize the exchange rate regime. Until May 1987, the interbank foreign exchange market had been organized into two official pools, the Central Bank pool and the Commercial Bank pool, each handling different foreign exchange transactions. The Central Bank pool covered export transactions for petroleum, cotton, rice and Suez Canal dues, and import transactions for essentials and most public sector capital transactions. The Commercial Bank pool covered export transactions outside the Central Bank pool, labor remittances and tourism receipts, and provided foreign exchange for public sector imports not covered by the Central Bank pool. In addition, a formally illegal nonbank free market was officially tolerated. In May 1987, a new bank foreign exchange market was introduced. The exchange rate was initially set at LE 2.165 per U.S. dollar, well below the pool rate, and subsequently allowed to slide to reach LE 3.0 at the end of 1990. The Central Bank pool rate was devalued a number of times to reach LE 2.0 on July 1, 1990. The old Commercial Bank pool ceased to exist in March 1989.

Unification of the exchange rate took place in two stages. The multiple exchange rate system was replaced by a temporary dual exchange system consisting of a primary market and a secondary (free market) in February 1991. Subsequently these markets were unified in October 1991. Since then the Egyptian pound has been freely traded in a single foreign exchange market, with the authorities intervening to maintain the rate in a tight band against the U.S. dollar. Additional elements of the reform of the exchange rate regime included the abolition of exchange rate guarantees formerly provided by the central bank, elimination of limits on exchange rate spreads for banks' customers, and the authorization of nonbank foreign exchange dealers.

Exchange rate unification was accompanied by a concerted stabilization effort. An upfront fiscal adjustment was achieved in the first year of the stabilization program in 1991/92 with a substantive revenue effort and significant expenditure restructuring and reduction. Further steady progress in deficit reduction was made in each of the five years to 1996/97. On the

revenue side the main increases were based on adjustment of the exchange rate, which boosted Suez Canal revenues and oil company profits, as well as the introduction of a general sales tax. At the same time deep cuts were made in capital expenditures and significant reductions of untargeted subsidies were achieved while other expenditures, including wages, were relatively protected. As a result of these measures the overall fiscal balance moved from a deficit of 4.2 percent of GDP in 1991/92 to a deficit of 0.9 percent of GDP in 1996/97.<sup>9</sup>

The stabilization program also included major financial sector reforms to strengthen the banking system and develop effective monetary instruments to control liquidity. Concurrently with exchange rate unification official limits on interest rates were lifted and auctions for the sale of treasury bills were introduced. During 1992 and 1993 direct credit controls were removed. To strengthen the banking system new prudential guidelines were introduced in 1991 for foreign currency exposure, capital adequacy, asset classification and provisioning, bank liquidity and auditing. This was followed in 1992 by guidelines covering investment concentration abroad, and in 1993 by regulations on credit concentration. Hence financial liberalization measures went hand-in-hand with exchange rate unification.

How were the balance sheets of the public sector enterprises affected by the 1991 exchange rate unification? As mentioned earlier, an appreciated exchange rate for most public enterprises provided an effective subsidy to their operations, although the benefits of this subsidy were eroded as foreign exchange availability became more scarce in the late 1980s. Nevertheless, the impact of exchange rate unification on the profitability of non-financial public enterprises was relatively modest. Public enterprises were at least partially protected from devaluation because debt service on foreign loans was made in local currency to the central bank (under arrangements made at the time of the 1987 Paris Club agreement). Although the central bank made large valuation losses on outstanding foreign currency liabilities during the 1991 exchange rate regime reforms, these were offset by debt cancellation (of arrears and medium-term liabilities) amounting to LE 15 billion (13.5 percent of GDP) under the Paris Club rescheduling. Some public enterprises, notably the Suez Canal Authority and EGPC (the state oil company), were direct beneficiaries of exchange reform as a large part of their income was received in foreign exchange. This gain in turn was passed on to the government in the form of higher transfer of profits and supported fiscal consolidation. However, public sector banks were particularly adversely affected by the unification of the exchange rate owing to their foreign currency exposure. Their difficulties necessitated a comprehensive recapitalization by the authorities.

### **Public enterprise restructuring**

In the mid-1980s, economic policies provided public enterprises with significant cost advantages over the private sector: the exchange rate subsidy, negative (ex post) real interest

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<sup>9</sup> See Handy, et. al. (1998).

rates, preferential access to credit, energy subsidies, automatic government loan guarantees and major trade protection. These factors supported a public sector accounting for three-quarters of manufacturing output in Egypt, while utilities, transportation and the oil sector were controlled by state monopolies and the financial system was dominated by public sector banks and insurance companies. Yet the rate of return on capital of state enterprises was disappointing, at under 5 percent. Amongst the various constraints public enterprises faced in the mid-1980s were compulsory hiring of workers at the government's direction and the maintenance of price controls while costs were rising. The deteriorating financial situation forced enterprises to rely on budget transfers and domestic bank financing for operating costs at the same time that enterprise arrears on tax payments became increasingly widespread. Moreover, very few enterprises transferred profits to the budget (apart from the enclave Suez Canal and oil sectors).

However, in 1991, the authorities committed to the restructuring and eventual privatization of a sizeable share of the public enterprise sector as a key part of the economic reform program. Shortly after exchange rate unification in 1991, many public enterprises were granted a significant increase in operating autonomy. To improve public enterprise performance, a public enterprise law was approved in 1991, known as Law 203, aimed at increasing the commercial orientation, management accountability, and autonomy of public enterprises. Most public enterprises were delinked from the line ministries and brought under 27 newly created holding companies. A further reorganization was implemented in 1993 to reduce the number of holding companies to 17 and to prevent sectoral concentration under any one holding company. The holding companies were responsible for approving the business plans of the public enterprises, assessing their restructuring needs, and initiating plans for their privatization. In addition, a Public Enterprise Office (PEO) was established in November 1991 as part of the newly created Ministry of Public Enterprises. In the first phase of the privatization effort, from 1993/94 to 1995/96, 3 companies were sold outright to the private sector, and 16 were partially divested (proportions ranging from 5 percent to 20 percent) through the stock market. The proceeds from privatization were largely earmarked for restructuring of other public enterprises through debt reduction and compensation payments to displaced workers. The second phase, running from January 1996 onwards, has seen a discernable acceleration in the pace of privatization, with the divestment of 82 nonfinancial public enterprises, representing about one-quarter of the pool of companies targeted for sale under Law 203. In addition, several sizable subsidiaries were divested (notably in the hotel sector), minority public stakes were sold in a further 12 Law 203 companies, and licenses were sold for mobile telecommunications

These measures were not, however, reflected in an improvement in the efficiency and financial performance of public sector enterprises in the five years following the passage of Law 203. Part of the reason for the relatively poor performance is that restructuring and privatization by themselves do not necessarily inject more competition into the economy; in Egypt, contestable markets depend most crucially on removal of barriers to trade, which remained high. Although the process of trade reform continued gradually through the 1990s, there was a steady decline in Egypt's share of world exports over the period 1985–1996, while regional competitors such as Morocco and Tunisia did better at maintaining their market share. Handy, et. al. (1998)

argue that Egypt's lackluster export performance has its roots in an inefficient public sector, and that stagnant public sector exports, coupled with a relatively small albeit dynamic private sector, was reflected in poor export performance in the aggregate. However, the authorities made considerable progress on the trade liberalization front during 1996/97 and 1997/98, and at the same time significantly reduced tariff evasion and exemptions.<sup>10</sup> Nevertheless, the average effective tariff rate of around 15 percent remains much higher than in many competitor countries.<sup>11</sup> At the same time there were significant nontariff barriers, with a complex system of quality controls and customs procedures. However, the authorities are taking steps to remove some of these non-tariff impediments to trade.

Another possible reason for the poor performance of the public enterprise sector was that the focus from the beginning was on rapid privatization, with relatively little emphasis on restructuring and corporatization involving greater government oversight. Public enterprises were heavily indebted to the Egyptian banking system, and a significant portion of their loans were nonperforming. However, the commercial banks were not involved in any significant way in the restructuring of public enterprises in Egypt: although a large share of the proceeds from privatization were used to settle public enterprise debts with the banking system, there was no comprehensive medium-term structural reform program involving fiscal consolidation, trade liberalization, public enterprise restructuring and financial sector reform, with a clearly defined role for the commercial banks in the public enterprise restructuring process. As mentioned elsewhere in this paper, such a comprehensive strategy had marked the later, more successful stages of reform in Algeria and Poland.

### **C. Poland: Reforms of the Early 1990s**

In the 1980s there had been several attempts to reform the economic system. However, these reforms had been limited in nature, reflecting in part an ambiguous attitude on the part of the authorities about the role of the market. For example, the first attempts to decentralize a degree of decision-making to the enterprise level took place without at the same time ensuring that new market-based instruments to enforce financial discipline would be introduced.<sup>12</sup> This lack of financial discipline contributed to the macroeconomic imbalances that emerged by the end of the decade. As hyperinflationary pressures were building up the Polish authorities in 1990 embarked on a comprehensive stabilization and structural reform program.

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<sup>10</sup> For example, the maximum tariff was reduced from 70 percent to 40 percent, while tariffs of 60 percent, 50 percent and 40 percent were reduced to 30 percent.

<sup>11</sup> For example, the average effective tariff rate is 1.8 percent in the Czech Republic, 3.3 percent in the Slovak Republic, 5.2 percent in Poland, 5.7 percent in Hungary and 7.3 percent in Romania.

<sup>12</sup> See Wolf (1991).

## **External sector developments and macroeconomic stabilization**

High inflation—bordering on hyperinflation (in the latter half of 1989 the monthly rate of inflation averaged some 30 percent)—and large external imbalances were pressing problems at the start of the economic reform program. Moreover, relative prices were severely distorted after decades of price controls, and there was the possibility of a significant monetary overhang due to output shortages and rationing, which suggested a potential inflationary outburst upon the liberalization of prices. Consequently, at the outset of the reform process in 1990, it was decided to adopt a fixed exchange rate as a nominal anchor to brake the emerging hyperinflationary pressures, while fixing the parity at a level that would restore and maintain international competitiveness. It was also hoped that a fixed exchange rate system would help in restoring appropriate relative prices.

On January 1, 1990, internal convertibility of the zloty was introduced, and the foreign exchange market for current transactions was unified at a rate of Zl 9,500 per U.S. dollar, representing a 31.6 percent devaluation of the official rate. Alongside the official fixed rate, the parallel market rate continued to be determined freely by market forces. Initially, the peg was regarded as provisional and no announcement was made concerning how long the arrangement would be maintained. The peg turned out to be more durable than expected, but soon the authorities had to deal with the tension that developed between the use of exchange rate policy as an instrument of monetary policy to reduce inflation and the desire to maintain Poland's international competitiveness. In May 1991, the peg for the zloty was switched from the U.S. dollar to a basket of currencies, and at the same time the zloty was devalued by about 14½ percent. The basket was composed of five main convertible currencies, roughly in proportion to the currency composition of Poland's trade transactions. In October 1991, the fixed exchange rate arrangement was turned into an active crawling peg arrangement with a preannounced rate of crawl of 1.8 percent per month, somewhat lower than the projected change in the producer price index; thus the exchange rate continued to operate as a nominal anchor for disinflation. In February 1992, the zloty was devalued by 10.7 percent against the basket of currencies, and in August 1993, the rate of crawl was reduced to 1.6 percent a month following another devaluation of the zloty of 7.4 percent.

This policy of using the exchange rate as a nominal anchor would not have been successful without the pursuit of financial sector reforms. In particular, from 1990 onwards commercial banks were permitted to set deposit and loan rates freely. This led at first to the emergence of very wide spreads. Initially, the commercial banks tied the level and timing of changes in their (deposit and lending) interest rates to the refinance rate charged by the National Bank of Poland (NBP). In the early years, when there was considerable macroeconomic uncertainty, bank lending rates were positive in real terms, while deposit rates by contrast were almost consistently negative in real terms. However, toward the end of 1992, with the development of the money markets and government securities markets, banks began to pay increasing attention to the cost of obtaining funds in the interbank market and to the yield on

treasury bills. Increasing competition among commercial banks helped to deepen the range of services offered by the banking sector and, importantly, to maintain confidence in Poland's financial and exchange rate system.

Initially, Poland used not just exchange rate policy but also trade policy as an instrument to combat near hyperinflation in the early reform period. Most nontariff barriers were eliminated in January 1990 and customs duties were suspended on 4,500 import items in June of that year—with the average applied tariff being only 5.5 percent—so as to use import prices as transmitters of world market prices. Thereafter, to support the budget and the balance-of-payments, the tariff was reinstated in August 1991 and the average most favored nation tariff rose to 13 percent on a 1991 trade-weighted basis. This was followed by the implementation of an across-the-board 6 percent import surcharge in December 1992, from which only alcoholic beverages, tobacco products, fuels, and automobiles were exempted.

### **Public enterprise restructuring**

State enterprises had to deal not only with a new price structure—including sharp increases in energy prices—but also with high nominal interest rates on working capital, of between 50 percent and 75 percent for the month of January 1990 alone. In addition, they were faced with a large negative aggregate demand shock, associated with the macroeconomic stabilization program and with the collapse of CMEA<sup>13</sup> trade in 1991. Moreover, during the first three years of the transition, state enterprises in Poland faced a progressively hardening budget constraint as a result of the virtual elimination of budgetary subsidies, the leveling off of interfirm arrears, and reduced access to bank loans. The fiscal austerity package involved a sharp reduction in government subsidies, which fell from 3.9 percent of GDP in 1989 to 0.5 percent of GDP in 1992. At the same time commercial banks became increasingly reluctant to lend to enterprises and concentrated instead on investing in government securities (which were regarded as safer). As a result, bank credit granted to state enterprises became increasingly tight, declining in real terms by 9 percent in 1991, by 22 percent in 1992 and by 12 percent in 1993. Initially state enterprises responded by building up interfirm arrears, which almost doubled in real terms in 1990 and 1991, but this source of liquidity rapidly leveled off and remained virtually constant in real terms in 1992 and 1993. However, the rise in arrears on taxes and social security contributions was an important means to avoiding budget constraints, especially for the larger enterprises—at the end of 1993 tax arrears and arrears on social security contributions amounted to 4½ percent of GDP.

A key element in the reform strategy for the financial sector was to prepare the state-owned commercial banks for privatization by recapitalizing them. As a first step toward their eventual privatization the banks were 'commercialized' in October 1991, that is they were transformed into joint-stock companies fully owned by the treasury, with a supervisory board as

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<sup>13</sup> Council of Mutual Economic Assistance.



the main governing body. In addition, with World Bank funding, 'twinning' arrangements with foreign banks were put in place to facilitate the transfer of banking know-how and to integrate the Polish banks into the international banking system.

At the same time the banks were given a pivotal role in the restructuring of their delinquent debtor enterprises. A Law on Financial Restructuring of Enterprises and Banks became effective in March 1993 and established the basis for a plan, supported by an EFSAL loan from the World Bank, to recapitalize banks, restructure their loan portfolios, and deal with state enterprises with nonperforming loans. As a precondition for obtaining government funds for recapitalization, banks were required to set up new internal organizational units ('workout departments') and to complete the restructuring of their bad loan portfolios by March 1994 (a deadline later extended by one month) through one of several ways stipulated in the law. State banks were told to separate out loss-category and doubtful-category loans and to create provisions amounting to 100 percent for loss-category loans and 50 percent for doubtful-category loans. The main approach for portfolio restructuring was an out-of-court settlement process known as 'conciliation proceedings', under which banks could work with the management of delinquent debtor enterprises to draw up a financial and business restructuring plan. Conciliation agreements could include a rescheduling of claims, a partial write-off, a conversion of debt into equity in the firm, or the public sale of debt. Finally, the plan included a mechanism for 'subsidiary government intervention' that was designed to provide limited access to government support for restructuring or cushioning the liquidation of firms deemed important for socio-political reasons and which were unable to reach a conciliation agreement with the banks.

Managers in state-owned enterprises responded to the steadily hardening budget constraints by emphasizing cost control, profits and marketing over production targets. At the same time wages were kept in check, partly as a result of the increasing scope for bargaining at the enterprise level, and partly in response to an excess wage tax or 'popiwiek'. The result was a significant improvement in aggregate profitability. However, the results varied greatly among sectors and subsectors, and even within subsectors (such as shipbuilding) there were examples of enterprises with similar starting conditions yet wholly different adjustment paths. In many cases those differences reflected the ability of managers to embark, with support from a majority of employees, on a comprehensive restructuring program involving the shedding of excess labor and sale of redundant assets, financial restructuring, and a medium-term strategy for full or partial privatization.

The consequence of all these shocks—domestic and external—was a sharp drop in industrial output during the early years of transition. The sharp contraction of the state enterprise sector was, however, considerably mitigated by the rapid expansion of private sector activity. The number of private businesses more than doubled between end-1989 and end-1994, from 830,000 to 1,970,000. Whereas the aggregate fall in public sector employment between end-1989 and end-1994 amounted to 3.4 million persons, private sector employment increased by nearly 1 million, reflecting mainly high numbers of enterprise start-ups rather than privatization of state enterprises. However, the impressive growth of the private sector was insufficient to prevent an

initial sharp drop in output, of 11.6 percent in 1990 and of 7.6 percent in 1991, and a sharp rise in registered unemployed, from 1.126 million (6.3 percent of the civilian labor force) in 1990 to 2.156 million (11.8 percent of the civilian labor force) in 1991.

Calvo and Kumar (1993) argue that the process of bank recapitalization and loan consolidation may have made banks excessively cautious in lending to state enterprises, at least in the early years of the transition. This was probably unavoidable, given the highly uncertain macroeconomic environment, the limited expertise of the banks in assessing the creditworthiness of enterprises, and the increasing attractiveness of investing in government securities. However, the reforms associated with the Law on Financial Restructuring of Enterprises and Banks were crucial in laying the foundations for strong growth led by the private sector, and the strategy soon yielded results: following two years of highly negative growth in 1990 and 1991, real GDP grew by 2.6 percent in 1992, by 3.8 percent in 1993, and by 5 to 7 percent per annum during 1994–97. Poland was able to weather the crisis of 1997–98 without severe contagion effects, although the collapse in exports to Russia in September 1998 contributed to a marked slowdown in growth to some 4 percent in 1999.

A study by Gray and Holle (1996) found that the restructuring and bank recapitalization program was clearly a catalyst that forced banks and enterprises to confront their problems, helped the banks to clean up their balance sheets and build institutional capacity in their workout units (though not necessarily in their credit units), furthered the process of separating economically viable from unviable firms, and allowed loan forgiveness without much of the usual moral hazard problems. This was because the recapitalization amount was calculated on the basis of a December 1991 credit portfolio analysis; since the amount of recapitalization was not dependent on the amount of bad debt to be recovered by banks, there were incentives for the banks to recover as much of the bad debt as possible. An additional element of the incentive mechanism was provided by the administrative supervision of banks' compliance with the plan. The government also made it clear that the recapitalization plan was meant to be a once-and-for-all operation, after which the banks would be fully accountable for any future losses. The share of nonperforming loans in bank portfolios declined from almost 30 percent in 1993 to just over 10 percent in 1997, in part the consequence of the 1993 Law on Enterprise and Bank Restructuring, in part the result of a steady increase in the volume of new loans, first mainly to the government and later also to households and enterprises. However, the authors also argue that the restructuring program had limited power to force major restructuring in problem debtor enterprises, and was only the first step in a long process of building strong banks capable of imposing effective corporate governance on enterprises in times of financial distress.

The lessons from the Polish case study thus echo those from the Algerian case study, namely that fiscal consolidation, public enterprise restructuring and reform of the commercial banking sector have to be part of a comprehensive medium-term structural reform program, with a clearly defined role for the commercial banks in the public enterprise restructuring process. It also suggests that, in cases where domestic commercial banks lack experience and expertise in handling credit activities in a market environment, it may be advisable to bring in the know-how

and expertise of foreign banks, for example along the lines of the 'twinning' arrangements described above under the World Bank's EFSAL program.

#### IV. CONCLUSIONS

Both the academic literature and the country case studies suggest that public enterprise restructuring needs to be part of a comprehensive medium-term strategy for fiscal consolidation, exchange rate unification and trade liberalization, and financial sector reform. The central message of this paper is that, in the design of such a strategy, it is important that careful thought be given to the role of the commercial banks in the public enterprise restructuring process; this was an important feature of the later, more successful stages of reform in Algeria and Poland. The experiences of Algeria and Poland provide some support for the conclusion by Demirgüç-Kunt and Levine (1994) that, in an economy with an underdeveloped financial system, public enterprise reform should focus on corporatization involving greater government oversight and monitoring rather than on corporatization involving greater autonomy for public enterprises—at least in the early stages of reform. In particular, there may be a case for designing financial action programs for public enterprises. These programs should, among other things, impose steadily tighter budget constraints on public enterprises, place strict limits on their access to bank credit, and address directly the role that commercial banks should play in their restructuring. In cases where domestic commercial banks lack experience and expertise in handling credit activities in a market environment, it may be advisable to bring in the know-how and expertise of foreign banks, for example along the lines of the 'twinning' arrangements described above under the World Bank's EFSAL program in Poland.

The Egyptian case study also suggests that improvement in the efficiency and financial performance of public enterprises requires exposing them steadily to the threat of foreign competition through trade liberalization measures if the domestic market fails to provide sufficient competition. The limited degree of competition from abroad was perhaps the main reason why the passage of Law 203 was not accompanied by noticeable improvements in the efficiency and financial performance of public enterprises, at least during the first five years following the passage of the law. However, another possible reason for the relatively limited success of public enterprise reform in Egypt was that the commercial banks were not involved in any significant way in the restructuring of public enterprises: although a large share of the proceeds from privatization were used to settle public enterprise debts with the banking system, there was no comprehensive medium-term structural reform program involving fiscal consolidation, trade liberalization, public enterprise restructuring and financial sector reform, with a clearly defined role for the commercial banks in the public enterprise restructuring process.

Successful management of a unified exchange rate also requires a flexible interest rate structure that is responsive to market forces. In all of the three countries discussed in this paper successful moves toward a new exchange rate regime were accompanied by measures to deregulate interest rates, and by major financial sector reforms designed to strengthen the

banking system, to provide for improved prudential regulation and supervision of the financial system, and to develop effective monetary instruments for controlling liquidity. Successful reform of the exchange rate regime needs to go hand-in-hand with measures to reform and strengthen the financial system.

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