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Study of the Financial Sector and SME Development in Poland

Volume One: Main Report

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GEMINI

GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS
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Study of The Financial Sector and SME Development in Poland

Volume One: Main Report

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ACRONYMS

ACDI	Agricultural Cooperative Development International
BISE	Bank for Socio Economic Initiatives
BGZ	The Food Economy Bank
CDC	Citizens Democracy Corps
COM	Council of Ministers
CUP	Central Planning Office
EBRD	European Bank for Reconstruction and Development
EC	European Economic Community
ECU	European Currency Unit
EIB	European Investment Bank
EVCC	Enterprise Venture Capital Corporation
FDPA	The Foundation for the Development of Polish Agricultu
FISE	Foundation for Socio Economic Initiatives
GDP	Gross Domestic Product
GOP	Government of Poland
IESC	International Executive Service Corps
IMF	International Monetary Fund
L/C	Letter of Credit
MBAEC	MBA Executive Corps
MEI	Market Economy Institutions Program
MOF	Ministry of Finance
NBP	National Bank of Poland/Central Bank
ODA	Overseas Development Administration
PAECC	Polish American Enterprise Credit Corporation
PAEF	Polish American Enterprise Fund
PBAS	Polish Business Advisory Service
PDB	Polish Development Bank
PIB	Polish Investment Bank
PPEF	Polish Private Equity Fund
SDR	Special Drawing Rights
SME	Small- and Medium-sized Enterprise
SOE	State-owned Enterprise
TISE	Society for Socio Economic Investments
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VOCA	Volunteers in Overseas Cooperative Assistance
WBK	Wielkopolski Bank Kreditowy

EXECUTIVE SUMMARY

Over the past four years Poland has made significant progress in the transition from a centrally planned economy to a free market system. This progress has been accomplished, in large part, by the rapid expansion of the small- and medium-sized enterprise (SME) sector. Government of Poland (GOP) policies, although not clearly defined, have nevertheless created an atmosphere for the development of private entrepreneurship unknown during the socialist period. However, this development has not yet reached its potential because of remaining constraints. Many of these constraints can be removed through policy and legislative initiatives, technical assistance, and experience. Others, the result of policies adopted by GOP to address macroeconomic issues, will be resolved only through successful realization of the economic stabilization process.

In spite of severe government restrictions on private economic activity prior to 1989, private entrepreneurship in Poland was not totally eliminated. As these restrictions were lifted, a relatively small private sector started to expand rapidly, and the number of SMEs increased from 300,000 to 1,700,000. When the privatized state-owned enterprises, small in number but significant in terms of employment, are included, the private sector accounts for an estimated one-third of nonagricultural employment. When the employment figures for the agriculture sector, which is 80 percent privately owned, are added, it becomes evident that private sector employment in the economy has passed the 50 percent mark. Private sector contribution to gross domestic product, reported to be 28 percent in 1989, has officially been estimated to have grown to more than 50 percent by the end of 1993.

Although expansion of the private sector has been dramatic, the rate of further development is likely to be slowed by remaining constraints. Some of these constraints reflect the inexperience of both private sector entrepreneurs and financial sector institutions and can be corrected over time by training and experience. Others require legislative and regulatory action. However, an important GOP constraint to SME sector development is the lack of a comprehensive national policy in support of SMEs. When adopted, an effective SME policy will express GOP recognition that a well-developed SME sector is critical to building a strong national economy, declare the government's commitment to promote and support development of the sector, and mandate coordinated action to remove barriers to SME development. Without this policy, no framework exists within which to structure the corrective initiatives GOP must take.

As advisors to the Council of Ministers, the Poland Small Business Project of the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project has assisted in the development of an umbrella policy identifying those issues that must be addressed to ensure maximum development of the SME sector. In addition, GEMINI and the Council of Ministers staff are finalizing a draft SME Act that identifies the actions to be taken and the implementing agencies responsible for setting the policy in motion.

The umbrella policy will provide guidelines for initiatives to be undertaken by the government. A Financial Sector Action Plan will also be developed by GEMINI to assist in implementing programs to address the financial sector constraints to SME development. Foremost among these constraints are the shortages of short-term credit, investment capital, asset-based financial mechanisms, and capital market facilities.

The primary concern of the SME sector is the limited access to bank credit. Entrepreneurs maintain that the banks' collateral requirements are excessive, interest rates are too high, and the financial information requested is intrusive and overly complicated. Bankers contend collateral coverage of 150-200 percent is essential to high-risk SME lending. They also maintain that the transaction cost of small loans requires higher interest rates. The banks prefer to limit their lending activities to the larger companies with established credit experience, accurate financial statements, and professional business plans. The banks also prefer to invest in GOP bonds and treasury bills that provide high returns and have neither risk nor significant transaction costs. Under current circumstances the comments of the bankers and entrepreneurs have some validity. Nevertheless, training and experience will improve entrepreneurs' ability to prepare accurate and realistic business plans, and banks, by improving the efficiency of their lending procedures, can reduce both the cost and the risk of SME lending. Proposed amendments to collateral law will reduce the amount of collateral required by reducing the attachment costs and improving the collection procedures for mortgaged assets in the event of loan default.

In recognition of limited SME access to credit and investment capital in the domestic financial system, international assistance agencies offer significant financial aid in the form of loans and grants for private sector development. Multinational support is provided by the World Bank, the European Economic Community, and the European Bank for Reconstruction and Development. Assistance is also provided by individual countries; the United States provides the most assistance of any country, through the U.S. Agency for International Development.

The larger international agencies have included in their programs specific credit or equity investment facilities directed toward SMEs. For the most part these programs have not achieved their intended objective. Reasons given include lack of interest on the part of Polish banks to participate as intermediaries, minimum loan levels that far exceed the requirements of most SMEs, complicated application procedures, extended approval processes, and borrower concerns for the foreign exchange risk inherent in these loan programs.

To address the problems that banks have in lending to small business, several international agencies have considered the feasibility of guarantee funds to reduce bank risk. To date no formal guarantee programs have been instituted in Poland, although GOP provides guarantees to state- and Treasury-owned banks that are often referred to as guarantee funds. Although a guarantee fund could result in a small increase in lending, to be successful it would have to be limited to potential borrowers whose loan proposals are close to meeting a bank's requirements, with the exception, for example, of sufficient collateral. If not, the fund would be a high-risk operation and would likely lose a substantial portion of its capital. In addition to potential guarantee losses, operating costs of a fund would necessitate fees that both banks and borrowers might find unacceptable. Under the circumstances a donor organization considering a guarantee fund would have to be prepared to lose its investment. The question arises as to whether the funds invested might better be used to remove the underlying constraints rather than to support a program designed to circumvent these constraints.

Limited SME access to credit and other constraints to SME development were the subject of a report, *Investing in the Future*, issued by the G-24 Task Force in April 1993. The task force, consisting of representatives of foreign assistance agencies, GOP ministries, private sector entrepreneurs, and the Polish Union of Banks, was established early in 1993 by the Council of Ministers with the assistance of GEMINI. The task force's primary mandate is to supervise the implementation of the recommendations of the SME report and to coordinate the SME support programs funded by its members.[1]

In June 1993 the Minister for Small Business Development formally presented the task force report to Poland's President and Prime Minister. Shortly thereafter, the government failed a vote of confidence and in September parliamentary elections brought a new government to power. At that time the office of the minister without portfolio for small business development was dissolved. Although the

[1] See Annex F for task force recommendations.

new government has not yet established a new agency to promote private sector interests, discussions are under way, and it is expected that an SME advocacy unit — the Bureau of Advocacy — will be established at the level of the Council of Ministers within a short time.

Action to correct the remaining constraints to SME development must be a combined effort of the SME and financial sectors working in conjunction with government and supported by foreign assistance agencies. GEMINI, in accordance with its project work plan, will continue to act in an advisory capacity with the new Bureau of Advocacy in implementing the recommendations included in this report, the Financial Sector Action Plan, and the G-24 Task Force Report.

This report is divided into two volumes. In Volume One, we examine the financial system in Poland, with emphasis on the banking sector, the capital market, and the nature and extent of international assistance. We then look at the SME sector, and at internal and external constraints to development. The legacy of the state-run economy is examined in some detail, as are financial and public sector constraints to SME growth. Conclusions and recommendations complete the report. Volume Two contains the appendixes to the report.

INTRODUCTION

PURPOSE OF THE STUDY

Over the past four years Poland has made significant progress in the transition from a centrally planned economy to a free market system. This progress has been accomplished, in large part, by the rapid expansion of the small- and medium-sized enterprise (SME) sector. Government of Poland (GOP) policies, although not clearly defined, have nevertheless created an atmosphere for the development of private entrepreneurship unknown during the socialist period. However, this development has not yet reached its potential because of remaining constraints. Many of these constraints can be removed through policy and legislative initiatives, technical assistance, and experience. Others, the result of policies adopted by GOP to address macroeconomic issues, will only be resolved through successful realization of the economic stabilization process.

In spite of severe government restrictions on private economic activity prior to 1989, private entrepreneurship in Poland was not totally eliminated. As these restrictions were lifted, a relatively small private sector started to expand rapidly, and the number of SMEs increased from 300,000 to 1,700,000. When the privatized state owned enterprises (SOEs), though small in number but significant in terms of employment, are included, it is estimated that the private sector accounts for nearly one-third of nonagricultural employment. When the employment figures for the agriculture sector, which is 80 percent privately owned, and the unregistered gray market are added, it becomes evident that private sector employment in the economy has passed the 50 percent mark. SME contribution to Gross Domestic Product (GDP) estimated at 28 percent in 1991 has now grown to 42 percent.

However, this figure of 42 percent in Poland contrasts sharply with developed, free market economies, to which the private sector contributes on average more than 80 percent of GDP. If the gap between Poland's private sector contribution to GDP and that of Western countries is to be closed, the remaining constraints to SME development must be eliminated.

Many studies and reports have been written about Poland's transformation to a market economy, but a comprehensive analysis of the financial sector and its relationship to SMEs has not been undertaken recently. The purpose of this report is to update those issues affecting the development of SMEs, with particular reference to the limited ability of the financial sector to support development initiatives.

This report also serves as the research base for the scheduled subproject of the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project to develop an action plan for the elimination of financial sector constraints to SME development. It also compliments the findings of the G-24 Task Force Report, *Investing in the Future* and will assist those who implement the recommendations included in that report.

METHODOLOGY

To gather a wide range of facts and perceptions, the study team conducted 60 interviews with 100 individuals in Warsaw, Gdansk, Poznan, Krakow, Katowice, and Kielce. Persons and organizations interviewed included financial institutions, foreign donor organizations, government representatives, private sector individuals, business associations, research institutions, trade associations and chambers of commerce, and academics. In addition to these meetings, the team also took advantage of existing documentation and related information on the financial system and the business sector in Poland.

THE FINANCIAL SYSTEM IN POLAND

THE BANKING SECTOR

Inadequate financial sector support to the private sector is one of the overriding issues that must be addressed if the transition from central planning to an open market economy is to be completed successfully. Before examining the constraints to private sector development, however, it is necessary to analyze the structure of the financial sector and the difficulties the sector has experienced during the transition period.

Until the collapse of the communist government in 1989, the Polish system provided only the financial services required by a centrally planned socialist economy. The financial sector consisted of the National Bank of Poland (NBP) and four state-owned specialized banks: PKO BP, the savings and housing bank; PKO SA, the foreign exchange deposit bank; Bank Handlowy, the foreign trade bank; and BGZ, the state-owned farms and agro-industry bank associated with a network of 1,600 small cooperative banks.

The Ministry of Finance (MOF) controlled the activities of NBP and of the specialized banks. NBP met the commercial banking needs of the government and state-owned enterprises based on administrative decision. Central planning required few financial market allocation mechanisms or free market banking services.

In 1989 new bank legislation declared NBP independent of the ministry and, although a connection remains between MOF and NBP, strong leadership within the central bank has done much to ensure its autonomy. Today the bank is free to pursue its primary responsibilities of monetary policy formulation and implementation and the supervision and regulation of financial sector institutions.

The financial sector in Poland includes Treasury-owned commercialized banks, both foreign and domestic private commercial banks, cooperative banks, credit unions, state-owned specialized banks, and foreign donor-funded venture capital and lending institutions.

National Bank of Poland

NBP as policy maker and implementing agent plays a fundamental role in the day-to-day operations of the banking system. In this role, NBP has a critical effect on the availability of resources and the regulations under which those resources are converted to development of the private sector. It has the responsibility not only to regulate and supervise the banking sector but also to create an atmosphere that will encourage the growth and development of the private sector.

Bank supervision became critical with the transition to an open economy and NBP's licensing of 80 new, privately owned banks, some with minimal capital and limited management experience. These new banks embarked on a reckless lending program with little regard to standard credit procedures and controls. The resulting losses emphasized the need for the policy guidelines and regulations traditionally provided by an independent central banking authority.

During this same period, an overheated economy further confirmed the need to establish effective monetary controls. The removal of MOF influence in the regulation of monetary supply provided NBP with the opportunity for more effective control of monetary policy and preservation of the value of the zloty, thus reducing the threat of higher inflation.

At first, however, the central bank was slow to affirm its autonomy in monetary policy and regulation. A period of institutional instability persisted until 1992. The bank was without a permanent president from mid-1991 until March 1992 and the director of the Supervision Department was not appointed until late May of that year. With these two positions vacant, the effectiveness of NBP was severely restricted. The lack of senior management and the need to resolve the precarious position of many banks resulted in short-term decisions, while long-term solutions were postponed.

With the appointment of its current president, the central bank moved decisively to develop the policies and regulations needed to carry out its primary mandate. To date the bank has resisted successfully the call for increased government spending and a higher deficit, which could increase inflation and interest rates. The banking reform program concentrates on two initiatives:

- Creation of a favorable environment for the banking system through development of a legal, regulatory, supervisory, and accounting framework; transition to indirect monetary controls; reduction in the volume of directed credit; and clarification of past financial links with the state; and

- Fostering the institutional development of nine state-owned commercial banks through reforms and Western technical assistance.

Treasury-Owned Commercialized Banks

To satisfy the credit requirements of an open market economy, the nine branches of NBP were converted to joint stock commercial banks with the State Treasury retaining a 100 percent equity position. This first step toward private ownership is referred to as commercialization. As these banks are recapitalized or otherwise relieved of their nonperforming loans, the Treasury is expected to sell its controlling interest to foreign or domestic investors. When the Treasury has reduced its position to less than 50 percent, these banks will be considered fully privatized and will be included in the private bank category. To date, 2 of the 9 Treasury-owned banks have been or are in the process of being privatized. Wielkopolski Bank Kreditowy (WBK) was privatized in March 1993, when the European Bank for Reconstruction and Development (EBRD) agreed to take a 23 percent position. Treasury retained 30 percent equity, and WBK 20 percent. The remaining 27 percent was sold in a public offering. Bank Śląski is in the process of privatization. NBP anticipates the sale of the Treasury's controlling interest in the remaining banks by 1996.

Commercialized banks provide most of the traditional services of a commercial bank, including demand and time deposit, interbank transfers, short- and long-term credit, and foreign currency transactions (although not all banks are licensed for foreign currency lending). Checking accounts are available but not in wide use, necessitating payment of most trade obligations by cash or by interbank transfer.

Treasury-owned banks continue to carry loans to SOEs granted before the breakup of the NBP's branch system. Many of these loans are of doubtful quality and endanger the banks' capital structure. In recognition of the precarious financial condition of many SOEs and the problems thus created for the Treasury-owned banks, the government enacted the Enterprise and Bank Restructuring Law in early 1993. The purpose of the law is to facilitate bank-SOE agreements to restructure debt, reschedule loans payments, or arrange debt-for-equity swaps. Use of these procedures has been limited because tax considerations may make forced liquidation preferable to restructuring. Nevertheless, increased activity is expected prior to the March 1994 deadline for the banks' loan workout departments to identify which procedure they intend to follow with each of 2,000 debtor enterprises.

Private Banks

Like the commercialized Treasury-owned banks, private banks offer most of the traditional services of commercial banks including demand and time deposits, interbank transfers, short- and long-term loans, and, if licensed, foreign currency transactions.

Approximately 61 privately owned banks with no foreign ownership have been established since 1989. Liberal licensing policies between 1990 and 1992 resulted in the establishment of many banks with limited capital, inexperienced management, and limited credit analysis expertise. Consequently these banks are undergoing significant problems in meeting the capital requirements of NBP.

The quality of loan portfolios deteriorated sharply during 1990-1991, as a result of poor lending practices and the effect of the business recession. According to loan portfolio reviews carried out by Western auditors as of June 1991, the number of nonperforming loans increased on average from 15-20 percent to 40 percent of loan portfolios between the end of 1990 and June 1991. Portfolio reviews as of June 1992 indicate that this deterioration bottomed out in mid-1991, reflecting the stabilization in economic activity and the banks' more restrained lending practices. Although average nonperforming loan ratios have improved, several banks are still managing ratios as high as 30 percent of their total exposure.

Included in the private bank category are the two recently privatized Treasury banks, 14 institutions owned wholly or in part by foreign banks, and 10 representative offices. These include such well-known names as Citibank, Banque Nationale de Paris, Crédit Lyonnais, Banco Commerciale Italiana, Dresdner Bank, and Deutsche Bank. For the most part their markets are multinational businesses and the largest Polish companies. The impact of foreign banks on the SME sector is negligible.

The entrance of foreign banks has created the potential for competition with domestic banks but this potential has not yet been fully realized. Perhaps in recognition of the foreign banks' concentration on the multinational market, the President of NBP stated recently that the issuance of licenses for new banks wholly owned by foreign investors will be suspended. According to NBP it would be better for the banking system if foreign banks invested in existing Polish banks rather than competing with them. The President of NBP also recently announced that an ordinance would soon be issued requiring foreign banks to maintain their capital in zlotys rather than in the currency contributed. This regulation is intended to encourage strategic investors to participate in the privatization of state banks.

Cooperative Banks

Analyses of the financial and small business sectors tend to exclude Poland's 1,660 rural cooperative banks, taking the position that the co-op banks and the agriculture sector operate under a different set of economic rules. This ignores the fact that the banks have begun to include small business loans in their portfolios and to adopt the lending procedures of the commercial banking system. Because the difficulties encountered by SMEs in obtaining credit in the rural areas are significant, a brief discussion of the co-op banks' contribution to rural lending and the system under which they operate is included in this study.

The cooperative banking system has been active in Poland for more than 120 years. The Food Economy Bank (BGZ) was established in 1919 as the first State Agricultural Bank, merging in 1975 with the Central Association of the Savings and Lending Cooperatives. This merger provided BGZ with greater lending power, primarily because cooperatives are traditionally net saving organizations.

In mid-1990, BGZ discontinued its function as the central bank for cooperative banks and the cooperative banks entered into operational agreements allowing the co-ops to purchase shares in BGZ. By mid-1991, 1,576 of 1,664 cooperative banks had signed such an agreement with BGZ. Slightly more than 50 percent of BGZ capital is owned by the Treasury and the remainder is held by local cooperative banks. There is some question as to the financial stability of BGZ, casting some doubt on the value of the co-op banks' investment.

About one-third of the co-op banks have become affiliated with three new regional banks (in Poznan, Wroclaw, and Warsaw), which act as central banks for those participating. The $3.5 million capital requirement for establishing the regional banks was contributed by the cooperative affiliates. The latter retain their individual lending limit of 15 percent of their capital base, but can refer a larger loan to the regional bank in which they own shares.

Although co-op banks have historically been looked upon as providers of financial services to the agricultural sector, the loan portfolio mix has changed dramatically over the last year. In two banks interviewed, the agricultural business comprised only 16 percent and 10 percent of the total loan portfolios. Three years ago it was as high as 80 percent for one of the banks. To adjust to these new changes, the cooperative banks are adopting lending practices similar to the commercial banks. Loans are 12 months or less and require collateral at a 3:1 ratio. The difficulties involved in obtaining adequate financial information from its borrowers result in lending decisions based on management or character as well as collateral. The delinquency rate is reported to be approximately 10 percent.

To augment cooperative bank employees' knowledge, the USAID-funded Agricultural Cooperative Development International (ACDI) Project provides training for both regional and local banks in credit, human resources, planning, director roles and responsibilities, finance, and other topics. ACDI also helps strengthen the banks by providing technical assistance to the regional banks and to the National Union of Cooperative Banks. The U.S. training program will send 97 bank presidents to the United States for training. Follow-up will be provided to these bank presidents by Volunteers in Overseas Cooperative Assistance (VOCA) who will work with the presidents over a two-to-four-week period to implement management changes.

Although attempts are being made to stabilize the financial condition of the co-op banks, a substantial percentage remain in a precarious position. According to press reports 5 banks are bankrupt, 7 are waiting for their bankruptcy applications to be considered, and another 87 are eligible for either bankruptcy or liquidation.[1] Four banks are in receivership and rehabilitation programs are being implemented in 40 percent of all co-op banks. Only 30 banks meet the required 8 percent ratio of capital to risk assets while 15 percent report ratios of less than 2 percent.

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[1] "Banking: Fearing the Domino Effect," *Economic Review*, October 22, 1993.

Credit Unions

Credit union activity began in Gdańsk within the Solidarity movement and is supervised by the Foundation of Polish Credit Unions. The World Association of Credit Unions is providing technical assistance. As of October 1993, 51 credit unions have been registered, of which 26 are operational. Total assets are reported to be the equivalent of $4.5 million, with total savings of $3.2 million and total loans of $3.5 million. The credit unions provide members with consumer loans and, to a lesser degree, microenterprise loans.

Specialized Banks

Polish Development Bank

The Polish Development Bank (PDB), established by the Council of Ministers in 1990, is a refinancing apex bank. The State Treasury holds a 75 percent equity position, a 19 percent position is held by the Industrial Development Agency, and 6 percent by three foreign banks. A fourth foreign institution recently (December 1993) purchased shares of PDB, thus changing the State Treasury holding and the foreign bank holding percentages slightly. The long-term goal of PDB is to stimulate structural changes in the Polish economy through appropriate credit and investment policies. The bank's primary activities include financing and assisting the development of the private sector.

PDB relies not only on its own domestic currency resources but also acts as a wholesale lender via lines of credit granted by foreign banks and foreign assistance agencies including the European Investment Bank and the World Bank.

Zloty loans to finance industrial production are available to enterprises that have undergone, or are undergoing, commercialization or privatization, or are implementing restructuring investment projects. Zloty loans are also available to small- and medium-sized private businesses.

PDB loans funded by the European Investment Bank are denominated in ECUs or other hard currency and are provided for the same purposes as PDB's local currency loans. However, funds are also available for on-lending to joint ventures with priority given to partnerships with firms from European Economic Community (EC) countries. PDB is also involved in the EC-PHARE equity investment program that enables Polish private enterprises to use the European Investment Bank credit to strengthen their capital base. Such equity investment will have a maximum of 15 percent of the enterprise's existing equity, not to exceed ECU 200,000.

The World Bank has also provided funds to PDB for on-lending through intermediary banks to enterprises being commercialized, undergoing privatization, or implementing investment projects. A separate World Bank line of credit for the development of SMEs is also available.

Polish Investment Bank

In addition to the nine Treasury-owned banks previously under its control, NBP retained 49 secondary branches in provincial capitals, 4 foreign currency branches, and 2 branch offices. To complete the process of divesting itself of commercial banking activities, NBP created a new bank, the Polish Investment Bank (PIB). This bank, with 47 branches, has taken over the foreign currency and zloty accounts of NBP customers. The main purpose of the bank is to support Poland's economic reform. Because it will not have the burden of unpaid debt, which restricts the lending capabilities of Treasury-owned commercialized banks, PIB is expected to become an active source of medium- and long-term credit, access to which is now extremely limited in the commercial banking system. When PIB is fully operational, it expects to provide full service for individuals and corporations and to be involved in capital market activities. PIB opened in November 1993.

Bank for Socio Economic Initiatives (BISE)/ Foundation for Socio Economic Initiatives (FISE)

BISE was established in 1990 by the Ministry of Labor in collaboration with the French bank Caisse Centrale de Crédit Coopératif to support the development of SMEs as a job-creating initiative. To date, BISE has made approximately 1,000 loans. The average loan is $25,000 to $30,000. Initially, most of the loans were for commercial activity but, more recently, there has been a shift to small manufacturing. BISE has introduced several new initiatives such as the Society for Socio Economic Investments (TISE), which was established to offer equity capital to SMEs, and a mutual guarantee fund that was run on a mutual support line for participating borrowers. The guarantee fund was suspended in 1992. TISE has made three equity investments.

FISE was established concurrently with BISE and through a network of Agencies for Local Initiatives has provided counselling to small firms. Now almost half of BISE clients arrive after contact with FISE.

THE CAPITAL MARKET

Until Poland embarked on the transition to an open economy, there was no market-oriented financial system. Before late 1987, when a few state enterprises issued bonds, the concept of capital and money market activities did not exist.

In 1989, a true capital market began to emerge under the auspices of the Ministry of Finance. Because the primary and secondary market for selling and trading GOP securities was the only market of interest to the government, money market and credit instruments were left underdeveloped. During the same period, the spontaneous development of the stock exchange encouraged the growth of quasi-exchanges that traded not only securities, but almost anything tradeable. In April 1991, after a year and a half of unregulated development, the Act on Public Trading in Securities and Trust Funds eliminated quasi-exchanges and established the rules and regulations under which authorized traders and brokers were required to operate.

There are now only two categories of market participants who may trade directly in securities. These are independent broker-dealer firms and banks that maintain broker-dealer departments. The list of permissible activities includes securities offerings, buying and selling securities, portfolio management, and custodian services. Bank debt instruments do not exist although several banks are prepared to issue debt. Of the 20 registered securities houses, 16 are bank-operated, and those mostly by Treasury-owned banks. The only restriction on bank trading, stated in banking law, is to limit the value of a bank's securities portfolio to a maximum of 25 percent of capital and long-term deposits. Underwriting the issuance of new shares, usually of newly created banks, is the primary role of the banks in this segment of the market. A first-of-its-kind underwriting operation took place in mid-1993 when the Bydgoski Bank Komunalny underwrote the sale of municipal bonds issued by the city of

Plock. Banks are the primary participants in the capital market, particularly as investors in government securities.

According to literature circulated by the Polish Development Bank, it is prepared to play an active role in the emerging capital market. For joint stock companies, the bank will organize the issuance of commercial paper, buy the paper through primary subscription and create a secondary market for trading. PDB also issues and maintains a secondary market for certificates of deposit indexed on the basis of variations in the exchange rates between the zloty and the US dollar or the D-Mark. Forward foreign currency transactions and repurchase agreements are also included in PDB capital market activities.

PDB is the only significant initiator in the private sector money market and in most instances has created the instruments being traded. It operates on the secondary market for Treasury bills, and organizes primary and secondary markets for certificates of deposit and commercial paper issued by firms quoted on the stock exchange. It has recently added repurchase agreements and reverse repurchase agreements to its list of products offered on the money market. PDB trades with other banks with brokerage licenses, but, while the brokerage houses familiarize themselves with the mechanics of the instruments available, the volume is still low. PDB is also participating in the forward foreign exchange market although there is a very low volume of business because of a lack of basic client understanding of the product.

Money market instruments have not been subject to reserves in the past but, as the NBP reviews the mechanics and functions in the financial sector, it has designed a policy requiring these transactions to be included in reserve requirements.

In July 1992, a U.S.-based group established the Pioneer Trust Fund Company to test the Polish market for mutual funds. The Fund commenced full operations in April 1993, with capital of $2 million, and now has over 100,000 investors and assets of $280 million. Approximately 50 percent of assets are invested in government securities, 30 percent in the Warsaw stock exchange, 10 percent in overseas investments, and 10 percent in liquid instruments. Because of its success, the Pioneer group is planning to expand its operations with a second fund directed toward low-risk long-term investments.

THE INTERNATIONAL ASSISTANCE SECTOR

The international community has provided substantial assistance to help Poland reverse the damage done to the financial and business sectors by almost 50 years of socialist economic control. Financial support in the form of grants and long-term loans has been made available to both the public and private sectors. However, development of any one sector depends not only on financial contributions. The transfer of knowledge in the form of technical assistance and training programs must also be considered. To determine the positive impact and the shortcomings of foreign assistance initiatives, the GEMINI study team analyzed primary sources of support to measure the effect of this support on the development of the financial sector and SMEs.

Multinational assistance is provided by the International Monetary Fund (IMF), the World Bank, the European Economic Community, EBRD, and the United Nations Development Programme (UNDP). In addition, individual countries provide support to both the private and public sectors, the most significant of which comes from the United States through USAID. Great Britain, Germany, The

Netherlands, Switzerland, and France also have programs in place. And, finally, privately funded foundations direct financial and technical assistance to the private sector.

International Monetary Fund

Poland joined the IMF as a charter member when the fund was established at the end of World War II, but withdrew its membership on March 14, 1950. Reinstated in 1986, Pol.nd was granted a quota of 988.5 million Special Drawing Rights (SDR), approximately $1.36 billion. In late 1989, the Polish government proposed the first stand-by arrangement, which made $710 million available. However, Poland failed to meet performance requirements established by the IMF and eventually received a reduced amount of $473 million. A second agreement with the IMF was negotiated in April 1991 -- a three-year adjustment program called the Extended Fund Facility that gave Poland access to approximately $2.5 billion. Only $500 million of available funds have been used because the government exceeded the targeted budget deficit and banking system loans to the government. The government also failed to achieve the required level of foreign exchange reserves.

The IMF reviews the following economic and financial figures to determine whether Poland is an eligible borrower: the budget deficit, a specified level of foreign reserves, net domestic assets, government loans, and foreign loans granted or guaranteed by the government.

In March 1993, the November 1992 agreement for the $650 million, 14-month loan between Poland and the IMF was officially approved by the IMF's council after Parliament passed the budget law for 1993. These funds are to be disbursed in five installments. In August 1993, the loan covenants were monitored and all but one of the criteria were met (foreign currency reserves were somewhat lower than required). To rectify the situation, the government moved to devalue the zloty by 8 percent, which would in effect shift the movement of funds in the economy from foreign to domestic goods.

Meeting the terms of the IMF agreement is extremely important to Poland as a precondition for the second stage of debt reduction by the governments of creditor countries affiliated to the Paris Club. In Ap il 1994, further debt reduction is planned for about 20 percent ($6 billion) of Poland's debt.

Stabilization Fund

The stabilization fund was a multinational effort established in 1990 to protect Poland's foreign reserves position. As Poland's reserves increased, the agreement establishing the fund was allowed to lapse and, in 1992, funds were diverted to a bank recapitalization program.

The bank recapitalization program is structured so that the GOP issues securities to the remaining state-owned banks to cover the percentage reserves they have set aside for bad debt. When the bank is privatized, the securities are repaid with principle and interest by the stabilization fund. The government securities represent capital to the receiving banks. It is intended to bring the banks capital ratio (capital to assets) up to the BASEL standard of 8 percent. The Bank Przemyslowo-Handlowy, S.A. bank in Krakow has already received the GOP securities and is expected to be privatized by mid-1994, at which time the stabilization fund will step in and redeem the securities. The government has issued PLZ 11 trillion in securities to date and expect that they will have to issue a total of PLZ 21 trillion, about $1 billion.

According to information received from MOF, the following donor countries have provided funds to the stabilization fund:

Country	Type of Funds	Amount of funds (US$ 000's)
Great Britain	Grant	112,165
USA	Grant	200,000
Sweden	Grant	3,300
Austria	Grant	1,000
Ireland	Grant	17
Finland	Grant	518
Japan	Loan	146,000
France, Italy	Line of Credit	237,000
	Total Available	700,000

The funds are held at the Federal Reserve Bank in the United States.

World Bank

Loan Facilities

The World Bank's program for financial assistance provides one of the most significant sources of loan funds available to both the public and private sectors in Poland. As of October 1993, the Bank had approved 19 loans totalling $3.6 billion.

A $60 million line of credit for private enterprise development was obligated in July 1992 for small- and medium-sized (up to 500 employees) private enterprises. Of the total available, $58 million was to be channelled through the Polish Development Bank to qualifying intermediary commercial banks for on-lending to SMEs. Loans are denominated in U.S. dollars or Deutschmarks, for a maximum term of seven years. The loans are to range from a minimum of $200,000 to a maximum of $2 million for a single project, and a maximum of $4 million in aggregate to any one borrower.

To date PDB has been unable to establish a network of intermediary banks through which to channel the funds to SME borrowers. Banks cite too-high minimum loans, excessive paper work, and foreign exchange risk as the reasons for lack of participation.

In January 1993 negotiations were concluded for a $450 million loan, $350 million of which would be used for restructuring the industrial and banking sectors. The balance would be at the disposal of the government, including the option to buy Poland's external debt. There has been no utilization of this facility because the restructuring program is just getting under way.

Training and Technical Assistance

The World Bank has also acknowledged the need for technical assistance and training in Western banking practices, and to that end has undertaken a twinning program with 7 of the original 9 Polish state-owned commercial banks. These arrangements were proposed in 1991 and formalized by May 1992. The Polish banks have joined with experienced Western banks for the purpose of transferring skills over a three-year period in all areas of bank operations. Of the 2 banks that did not participate, 1 receives assistance from a USAID-funded financial advisor and the other has since been fully privatized. It is hoped that the technical assistance will develop into special business relationships including possible equity participation by the Western twinning partners.

The World Bank is involved in an incubator initiative set up to assist in the development of small businesses.[2] This program provides technical assistance, training, and lines of credit to 10 incubators in selected regions.

European Economic Community/European Investment Bank

The EC, through its PHARE program, has funded several programs targeted toward the development of the SME sector. The AgroLine program, similar to the SME concept, combines the development of cooperative rural banking with strengthening of advisory services and credit facilities. This program has a budget of ECU 30 million, of which ECU 27 million is for lending purposes.

In November 1992, the PHARE program was modified to make the majority of its funds available for lending to SMEs rather than for providing technical assistance. Also approved was the PHARE-STRUDER program in support of Polish regional policy. ECU 60 million was allocated for the program, which will provide loan facilities to SMEs, funds for financing or investing in new ventures, and a guarantee fund to facilitate SME access to credit. The Regional Development Agencies and the Polish Agency for Regional Development will implement the program, which was scheduled to begin operations by the end of 1993 and will be terminated by the end of 1995.

Loan Facilities

Through the Cooperation Fund, the SME Sector Import and Support Program was established to provide a credit line of ECU 19 million for on-lending by selected banks in the Lodz, Gdansk, and Wroclaw regions. The facility was suspended in August 1993 with unused funds transferred to the STRUDER program.

Utilization: 45 loans granted for approximately ECU 2.1 million (11 percent utilization).

The EC has also established a line of credit for ECU 75 million available to the Polish Development Bank for on-lending through the Export Development Bank and BISE. The loans, which may range from ECU 20,000 to 5 million, can finance up to 50 percent of capital investment projects of businesses involved in production, agriculture, tourism, environment, or energy. The minimum loan term is four years but the maturity date may not extend beyond year 2006.

Utilization: ECU 50 Million (66 percent) in loans have been granted. Loan applications for an additional ECU 16 million are under review.

[2] An incubator is a protected supervised area where special funds are injected to promote growth.

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Training and Technical Assistance

Through its EC-PHARE program, administered by the Cooperation Fund, the European Community has been providing technical assistance to both the financial and SME sectors. It has dedicated over 40 million ECUs for SME and financial sector reform. Resources amounting to ECU 6 million are currently allocated through this program for technical assistance in support of local organizations offering advisory and training services. A network of Business Support Centers has been established involving organizations such as the Chambers of Commerce and Regional Development Agencies, which offer counselling and information services. This service is scheduled to continue through the end of 1994.

European Investment Bank also offers a ECU 2 million equity line that can only be used in conjunction with the ECU 75 million loan. There has been no utilization to date because of a lack of qualified borrowers.

European Bank for Reconstruction and Development

EBRD is an international institution headquartered in London. Its membership includes 43 countries. The bank's mandate is to promote private entrepreneurial initiative by providing loans directly to the private sector, co-financing facilities to intermediary banks, and investing in other institutions active in development assistance. Over the last 18 months, EBRD has committed roughly $500 million equivalent in Poland, with the goal of lending 60 percent of its portfolio to the private sector.

The minimum amount for direct lending is $5 million, an amount too large for all but a few private sector businesses. In an attempt to reach the SME sector, EBRD has made co-financing arrangements with several banks and development institutions. However, for a number of reasons linked with lending policies of the intermediary banks, the difficult situation in the banking system, the frequently low quality of the demand for credit, and the strict lending policies and procedures of EBRD, the resources offered under these lines of credit have been underused or not used at all.

Loan Facilities

EBRD has established a $50 million line of credit for co-financing with Raiffeisen Centrobank (Austria). The loan amounts may range from $250,000 to $8 million. In cooperation with ING Bank, EBRD operates a joint credit line totalling $100 million for financing investments in the range of $100,000 to $10 million.

EBRD has granted Amerbank a subordinated loan of $5 million together with a credit line of $15 million that enables it to increase the size and number of its loans to Polish and foreign SMEs. Loans may range from $500,000 to $1.5 million. A similar facility has been granted to Kredyt Bank in the amount of US$ 10 million. Under the agreement EBRD will match a Kredyt Bank loan with up to the same amount. Loans will be considered up to US$ 2 million. EBRD will also provide a guarantee for 50 percent of the loan value.

Together with the Polish American Enterprise Fund, Creditanstalt Bankverein, and others, EBRD has made an investment in the Polish Private Equity Fund to co-finance development projects for US$ 500,000 to US$ 10 million. In selected cases the Fund can provide debt financing in addition to equity.

A $2.5 million investment in CARE Small Business Assistance Corporation (CARESBAC), Poland, has recently been finalized. An additional $2.5 million is also available in matching funds if another investor is identified.

Training and Technical Assistance

EBRD has funded the operations of the Polish Business Advisory Service (PBAS) in its effort to provide technical assistance to Polish entrepreneurs.

United Nations Development Programme

UNDP began operations in Poland in late 1990. Under the Fifth Country Program, developed jointly between UNDP and GOP, there are three priority areas for assistance, one of which is the Market Economy Institutions (MEI) Program. This program has been developed with the Ministry of Privatization as a two-year prototype program to assist the privatization of SMEs at the regional level (the program will focus on four voivodships: Lublin, Chelm, Biala Podlaska, and Zamosc). The program, with an initial budget of approximately $2 million (costs are shared among UNDP, GOP, and beneficiaries), has two primary focuses:

- To assist up to 65 enterprises in the region in preparation for entering a market economy as a private entity and preparation for privatization through provision of hands-on technical advisory services; and

- To help develop an enabling environment for business and SME development in the region, especially by enhancing management capabilities through training and strengthening public understanding and support for a market economy.

UNDP also supports other relevant initiatives that compliment the MEI program.

The Technology Business Incubators Program supports business incubator development in Poland. Business incubators offer support to start-up entrepreneurs with viable business plans ranging from low-cost office space, equipment and business support services, to training and consulting services in marketing, finance, and management. UNDP has been instrumental in establishment of a business innovation center in Poznan and supports the networking efforts through the Business Incubator Association.

The establishment of the Pilot Industrial Sub-contracting and Partnership Exchange (SPX) in Poland started its operations in 1991 to develop a network to promote industrial subcontracting in Poland. Subcontracting between large enterprises and SMEs is an essential feature of a market economy. It is a tool to develop more efficient use of national industrial capacities and resources and supports SMEs that are potential subcontractors. The pilot SPX was established in Gdansk. It is expected that two more SPXs will be established to create a national SPX network.

UNDP is also providing assistance to the credit union movement through the Foundation of Polish Credit Unions.

U.S. Agency for International Development

Financial Assistance

Polish Stabilization Fund. In 1990 the United States granted $200 million to the stabilization fund as a hard currency reserve to be drawn upon should Poland's foreign reserves fall below a specified amount. This reserve enabled GOP to implement the economic reforms of January 1990, including the establishment of the internal convertibility of the zloty. When Poland's foreign reserves increased as a result of the reforms, the stabilization fund reserves were no longer required. At the end of 1992 the fund was not extended and the decision was taken to divert this grant for the purpose of recapitalizing selected banks.

Utilization: none.

Polish American Enterprise Fund. PAEF was established as a nonprofit corporation funded from a 1989 U.S. Congress authorization of $240 million. Through its wholly owned and equity partners, PAEF is engaged in a broad range of programs for financing small, medium, and large businesses, and for investing in Polish companies and venture capital projects.

Utilization: It has been estimated that $180 million of the $240 million available to PAEF has been drawn down. $101 million represents loans and investments completed to date, $29 million has been committed for venture capital investment, and $50 million has been invested in the Polish Private Equity Fund.

In December 1990 the fund established the *Enterprise Credit Corporation* (PAECC) to administer the fund's loan program for SMEs. Funds are channelled through 10 Polish intermediary banks that accept and analyze loan applications for fund approval. Loans to a maximum of $500,000 are denominated in US dollars and bear a fixed interest rate of 11 percent (loans between $200,000-$500,000 can bear an interest rate between 11-16 percent) for a maximum term of three years. PAECC approves 80-100 loans a month and has $62 million in capital to lend. Loan requests exceeding $200,000, must be approved in the New York office. The average loan amount is $24,500 and the smallest loan is $400. PAECC now approves approximately 60 percent of loan applications as opposed to the 15 percent approved when they began operations.

Utilization: Approximately 2,600 credits have been approved for a total of $62 million.

In 1991 the *Enterprise Venture Capital Corporation* (EVCC) was funded with $10 million to serve the needs of medium-sized companies. Loans requested of $75,000 to $500,000 were financed through this corporation. In a recent restructuring, the activities of EVCC were transferred to another affiliated company but the corporation continues to manage remaining projects.

Under the new organizational structure for venture capital facilities, PAEF has established *Equity Enterprise Investors*. This group is responsible for the initial due diligence and analysis of potential investment opportunities. When a potential opportunity is identified and the deal is closed, the *Polish Private Equity Fund* (PPEF), established in 1992, takes over to manage and monitor the investment. PPEF, a closed-end venture capital investment fund, has start-up capital of $150 million. In addition to PAEF's investment of $50 million, EBRD contributed a like amount and Creditanstalt Bank, $7 million. U.S. corporation pension funds provided the balance of US$ 43 million. The purpose of the fund is to provide equity investment capital in Polish enterprises.

Utilization: To date the equity division has completed 27 investments, the smallest of which is $600,000 and the largest $15 million.

PAEF's participation in First Polish American Bank in Krakow is one of the Fund's most significant investments in a private Polish financial institution. PAEF invested in the bank to expand its capabilities in that region. Under the supervision of its new president, an American banker, management has introduced a new business strategy with new products, tighter credit standards, and more aggressive marketing. A new workout group has been successful in recovering several delinquent loans and otherwise returning nonperforming credits to a current basis.

Training and Technical Assistance

In technical assistance to the financial and SME sectors, USAID supports the GEMINI Small Business Development Program; IRIS Legal and Regulatory Reform Program; MBA Enterprise Corps; International Executive Service Corps; Bank Reform/Financial Advisory Services, U.S. Department of Treasury; and the Financial Services Volunteers Corps. All of these organizations place candidates in businesses, government offices or banks, to provide daily guidance and advice to improve, implement, and operate more effectively in a free market economy.

Although the Polish American Enterprise Fund's primary focus is to provide loan and equity capital to private sector entrepreneurs, a parallel effort has been undertaken to develop human resources. These programs are channeled through two organizations established by PAEF during the past 18 months: the Educational Enterprise Foundation is engaged in practical business education to the business community; the Enterprise Assistance Corporation provides training for accountants, management information specialists, bank lending officers, and executives.

Other USAID-funded organizations providing technical assistance specifically to SMEs include the Polish Business Advisory Service (PBAS), the Peace Corps Free Enterprise Transition Consortium, and the Small Business Advisory Center in Warsaw. All these business-consulting groups assist SMEs in their endeavors to operate a successful business, to learn standard Western business practices, and occasionally to obtain funding.

USAID is fully funding the Warsaw Banking School, which, in cooperation with the Union of Polish Bankers, is providing short-term courses and seminars for bankers. The program has dedicated a portion of its seminars to train bankers on SME lending and analysis. As a separate project, USAID provides assistance to credit unions through the Credit Union National Association Support Grant. This grant finances the training and start-up costs of credit unions throughout Poland. They expect 430 credit unions to be operating by the end of 1994 as a result of this assistance.

Overseas Development Administration (ODA)

Great Britain's ODA contributed $100 million to the stabilization fund of which $75 million is to be contributed to the Polish Bank Privatization Fund; $8 million is to be spent on assistance to debt workout units of the state-owned banks; and $17 million to state restructuring. $19 million of interest has accrued on the funds, which will be used to develop SMEs in the depressed regions of Bialystock and Lublin.

Utilization: Project in preparation, implementation expected in mid-1994.

The United Kingdom has a major presence via the Know-How Fund. This fund has been financing feasibility studies and a series of seminars for SME development. They are providing training in Western methodology through advisors and consultants to SMEs and banks. The British government has donated L50 million of which Poland has used about L35 million (70 percent). This fund has also supported the work of PBAS. British consultants have carried out quality management training for 20 companies under PBAS auspices. The Know-How Fund is also helping to build the capacity of FISE to run effective small business clinics.

Polish Swiss Regional Program

Under this program, 4 million Swiss Francs are available for capital expenditure loans. The program was started in Rabka (Nowy Sacz voivodship) and has recently been extended to Lukta (Olsztyn voivodship). In each district, committees have been established that recommend those undertakings with priority need for support.

GTZ (Gesellschaft für technische Zusammenarbeit)

Germany is offering technical assistance through its GTZ program. GTZ operates an advisory service for Polish enterprises, with an emphasis on five regions: Lodz-Warsaw, Katowice-Krakow, Bialystok-Suwalki, Wroclaw, and Poznan. It runs its operation as a coaching program, under which groups of 30 enterprises join in a series of seminars for key officials who then go back to their respective companies with the acquired management expertise. In the process the company can formulate a business plan and develop other activities. In addition, GTZ makes foreign experts available to help in solving specific problems on site.

Other Donor-Supported Agencies

CARESBAC-Polska S.A.

CARESBAC-Polska is a joint-stock company whose shares are held by CARE Small Business Assistance Corporation, EBRD, the Cooperation Fund, and the Foundation for the Development of Polish Agriculture. CARESBAC-Polska invests in Polish SMEs that demonstrate a high potential for success and are engaged in activities that contribute to the rebuilding of the Polish free market economy. Investment operations began in March 1992. Most investments are in either agribusiness or light manufacturing. The company also arranges expert business assistance for its investees through the many foreign assistance organizations operating in Poland, including VOCA, IESC, CDC, MBAEC, FDPA, and the Peace Corps.

Utilization: To date the company has 9 completed investments, 3 committed investments, and 2 approved investments that have not yet been funded. Committed funds total $2 million.

The Foundation for the Development of Polish Agriculture (FDPA)

FDPA was founded in 1988 as a private Polish foundation dedicated to Polish agriculture and the development of the rural economy. Initial funding was provided by U.S. philanthropic

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organizations; funding has been extended to include international institutions and governments. addition, FDPA engages in economic activities to help finance development objectives. The objectiv of the foundation are to assist in the development of private agriculture and the entire rural econon within the context of the restructuring of the Polish economy.

As a result of a strategic review of program activities, the foundation will concentrate i technical and financial resources in:

- Pilot agricultural projects essential to restructuring, including privatization;
- Establishment of a new specialist Rural Tourism Division;
- Expansion and promotion of activities related to sustainable agriculture and environmental issues;
- Expansion of the Rural Women's Enterprise Development program; and
- Development of a series of new training and educational activities.

Although significant funds for lending and technical assistance have been made available b foreign aid agencies, only a small percentage of total funds has reached the SME community in th form of credit. Opinions vary as to the reason for this situation; the general perception is th minimum loan limitations exclude the majority of small and medium entrepreneurs. (The PAE windows program holds a portfolio of $60 million with an average loan of $24,500 while most foreig assistance credits require a minimum loan in excess of $200,000.) Banks and potential borrower maintain that application procedures are too complicated and too much information is required of th borrower. Borrowers are also cautious with regard to the exchange risk in an economy whos currency is being devalued by approximately 1.5 percent per month. Although foreign donors cannc be faulted for being prudent, the fact remains that the SME sector is not participating, primaril because there are few foreign credit facilities for borrowers seeking loans for less than $100,000.

Guarantee Mechanisms

To improve SME access to credit, government ministries, NBP, and foreign assistance agencie have looked to guarantee programs to reduce the risk in lending to small business. Although referre to as guarantee funds, programs to date have been limited to government guarantees without the full capitalized institutional structure normally associated with a traditional fund.

In analyzing the feasibility of a guarantee fund, the study team assumed that such a fund shoul be a separate intermediary institution with a solid reputation in the financial community. It should b fully capitalized to demonstrate its ability to meet its guarantee commitments and to cover operatin expenses. A properly administered fund should be self-sustaining and maintain its capital through th life of the program. An exception could be made if GOP or a foreign assistance agency provide funds for social purposes, such as areas of chronic unemployment, with the knowledge that high-risk lending would probably decapitalize the fund.

For interview purposes the team made the assumption that a fund would be directed to thos enterprises whose loan proposals meet a bank's basic criteria but do not have sufficient assets to mee collateral requirements. Such a fund, if it were to remain financially viable, could not cover high-risk situations but would target its activities to borrowers falling just outside a bank's tolerance for risk.

The study team concluded that a guarantee fund could provide a limited benefit to the private sector during a period of economic difficulty. The added transaction costs and guarantee fees, however, may not appeal to either the borrower or the lending bank in much the same way that foreign lines of credit for the most part do not attract a response from the banks and the SME sector. These issues would have to be carefully analyzed by any institution considering a fund and a determination would have to be made as to whether the capital involved might better be applied to addressing other constraints to SME access to credit.

SMALL- AND MEDIUM-SIZED ENTERPRISES

A successful transition to a market-based economy is contingent upon the rapid growth and development of SMEs. Although many of the problems that impede the growth of SME development are beyond the direct control of the SME sector, others reflect the issues that small entrepreneurs must address to adjust successfully to open market conditions. One of the more evident issues is the difference between adjusting to the restrictions of central planning and aggressively meeting the demands of a market-oriented economy. Pretransition entrepreneurial skills were developed to serve a shortage economy in which effective business management, financial controls, and marketing techniques were not major concerns. In today's competitive market, largely free of government control, these issues have become increasingly important as private business replaces the state as the dominant contributor to the Polish economy.

To define a business as small or medium, most organizations use the number of employees as the standard of measure. Traditionally, SMEs in Poland were broken down by industry to include service firms with up to 50 employees, retail firms with up to 100 employees, wholesale firms with up to 200 employees, and industrial firms with up to 500 employees. This categorization has been modified to reflect today's expanding business sector. The Central Statistical Office has amended the official classification as follows: small companies: 1-5 employees; medium companies: 6-50 employees; and large companies: more than 50 employees. To categorize size more specifically, other organizations take into consideration whether a business is in the production or service subsectors.

Among foreign assistance agencies, eligibility guidelines vary. The World Bank has set an upper limit of 500 employees to define SMEs, while the EC-PHARE program will only consider loans to SMEs with less than 100 employees. EC also employs criteria such as financial independence and ownership mix to determine eligibility. PAEF defines the size of the company by the amount of the loan request. Western indicators such as sales, gross profits, sales per employee, and asset size are not normally considered.

Until 1989 the private sector existed to meet the needs of central planning. The government controlled the activities in which private entrepreneurs could operate and limited the number of workers a private sector enterprise could employ. With the removal of these regulations the number of private businesses expanded rapidly. Today there are 1.7 million municipally registered private sector companies. Statistics indicate that the number of private sector businesses increased by 15 percent over the 12-month period through mid-1993. The greatest change was in the service sector, which increased 40 percent in 1992. Growth during the first half of 1993 was almost 4 percent, an increase of 58,000 companies. Including court-registered businesses such as joint stock companies, limited liability companies, and general partnerships, the private sector accounts for 128,000 of the 198,000 economic registered firms operating in Poland (about 65 percent). This sector comprises 72,000 companies with Polish capital only, 18,000 with foreign capital, 20,000 cooperatives, and 18,000 miscellaneous companies.

The formal private sector, including natural persons, limited liability companies, joint stock companies, and agriculture, is now a major force in the development of the domestic economy, contributing 28 percent in 1989, 31 percent in 1990, 42 percent in 1991, and 47 percent in 1992. It is officially estimated that this contribution exceeded 50 percent at the end of 1993. When the figures from the gray market (unofficial and unregistered economic activity) are included, private sector participation in the GDP becomes even more significant.[3] According to an independent stud undertaken in 1993, the gray market may represent as much as 22 percent of GDP. Other estimate range from 15 percent to 30 percent of GDP. If accurate, these estimates reflect a much greate economic contribution by the private sector than is reflected in official statistics.

Most private sector firms are unincorporated proprietorships or partnerships because this wa the only legal form of ownership available to private entrepreneurs before 1986. Such enterprise include craftsmen, trade and service enterprises, and small manufacturing enterprises. However, th expanding market economy demanded more ownership flexibility. Legislative reform provided for th creation of joint stock and limited liability companies needed by larger private entrepreneurs to attrac outside equity investment.

Despite the rapid expansion of the SME sector over the four-year transition period, furthe development may well be limited by constraints that are largely beyond the sector's control. Thes external constraints are discussed later. There are, however, other issues within the SME sector itsel that can only be resolved with experience and the support of GOP and foreign assistance agencie experienced in free market business activity.[4]

INTERNAL CONSTRAINTS TO SME GROWTH

The Internal problems SMEs face, and underlying reasons for these problems, are detailec below. Many of these problems are the legacy of a planned economy.

Traditional Business Practices

Polish entrepreneurs have been compelled in the past to operate under circumstances dictated by foreign economic systems. To survive was to learn to function in an often-alien business environment and to maneuver around the restrictive laws and regulations that attempted to regulate economic activity. The ability to adjust to external constraints beyond their control carried successful entrepreneurs through almost 50 years of central economic planning. Although this trait ensured survival during a difficult period, it has become something of a handicap to many businesses in adapting to a demand-driven economy. Socialist central planning requires little knowledge of strategic planing, financial controls, and marketing practices. Entrepreneurs who became successful did so by adjusting to the external demands of central planning, ignoring the internal factors necessary to succeed under free market conditions. Although central control has diminished substantially, business advisors find that entrepreneurs remain preoccupied by issues they can do little about while neglecting basic management practices.

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[3] For further discussion of the shadow economy see the next section on constraints to SME development.

[4] The comments in this section reflect the perceptions of SME advisory service representatives working closely with small businesses to address these internal issues.

Lack of Management and Planning Experience

Prior to 1990 the average working person was excluded from the decision-making process. Management decisions and financial planning were the responsibility of central government policy makers. With the transition to an open market economy many entrepreneurs entered the private sector with sound concepts for providing goods and services to the consuming public. These sound concepts, however, did not always include the necessary expertise to actually operate a private sector business. Potential entrepreneurs also lacked familiarity with traditional capitalist banking systems and did not know how to gain access to that system for credit to start or expand a business.

The inability of many borrowers to prepare a business plan that establishes the need for financing and identifies the means of repayment continues to be a major stumbling block to borrowing. Although there is an increasing level of expertise, many entrepreneurs are unaware of bank requirements. As the banks are not notably helpful in assisting prospective borrowers, loan proposals are often incomplete, with inaccurate sales and income figures. Banks will counter with the comment that borrowers are frequently reluctant to provide accurate sales and profit figures in an effort to reduce or avoid tax liabilities. Bankers interviewed also tended to characterize inexperienced entrepreneurs as impatient and short-sighted, seeking quick profits in current trends instead of planning for long-term business growth.

Many companies have hired consultants to design long-term plans. These business plans are often missing the short-term tactical dimension that entrepreneurs are more accustomed to. Because long-range plans are not made for day-to-day operations, the entrepreneur does not understand their value. At the same time, because they are already familiar with short-term operations, they often feel that there is no need for a short-term business plan. The result is that a company will flounder because their short-term activities do not connect with long-term goals. Many entrepreneurs also state that it is impossible to project long-term goals because of the unstable economy, but few realize that the variables inherent in an unstable economy can be factored into a complete business plan.

Business advisors cite business planning as an issue that some entrepreneurs have not yet recognized as an essential component for success. But successful businesses have recognized the need to concentrate on strengthening or investing in internal operations and performance. By doing so these entrepreneurs are attaining a competitive advantage.

Cash Flow Problems

In addition to the need for start-up and expansion capital, SMEs are especially vulnerable to short-term cash flow shortages. Most firms operate on a strictly cash basis and must receive sufficient inputs from suppliers and timely payments from their customers. When companies have cash flow problems, banks seldom assist them in restructuring loan terms. Bankers take the position, however, that SMEs are undercapitalized and not prepared for cash flow problems. In general, SMEs will always have to address the issues of meeting cyclical demands and short-term capital needs. With this realization SMEs have begun to focus planning efforts on covering cash flow needs and now make this procedure a part of the company's overall market plan and strategic initiative.

Individualism

The reluctance of businesses to organize into private sector lobbying groups arises, in part, from historical avoidance and distrust of government. Entrepreneurs who operated successfully through the socialist period did so by quietly adjusting to, or working around, the system. This same attitude extended to their relationships with other entrepreneurs. Although businesses could have more influence if they organized into a unified group, they hesitate to unite because of distrust and individualism. The concept of lobbying to achieve mutual goals among entrepreneurs is not yet fully accepted. To organize is reminiscent of centrally dominated institutional structures. Pending legislation requiring all registered businesses to become members of a business organization reflects the reluctance of many entrepreneurs to independently promote the sector and the desires of some members of quasi-government business organizations to encourage centralized control of private sector business.

Links Between SOEs and the Private Sector

Private businesses require dependable suppliers and timely payments from customers. Because state-owned enterprises still dominate Poland's business activity, SMEs are frequently dependent on them as both suppliers and clients. Unprofitable SOEs are slow in meeting their payment commitments and unreliable as suppliers. As these SOEs are liquidated, many of these debts will likely remain outstanding to the financial detriment of SME providers of goods and services.

During the early years of transition the linkage between the public and private business sectors was of vital importance to SME profitability. However, privatization of state enterprises will transfer these companies and their producing assets to private investors, thus reducing the significance of this relationship.

Marketing Strategy

Prior to 1990 the private sector entrepreneur usually established a market niche that had little or no competition. Demand exceeded supply and the seller needed to do little more than wait for the customer to come to his place of business. The buyer considered himself fortunate to find a needed product or service and customer dissatisfaction was a minimal threat to a company's success. After four years, many firms continue to lose market share without researching the reason for the loss, concluding that increased competition rather than their own inefficiencies are to blame. Companies fail to understand that the cost of maintaining and retaining a current customer is a fraction of the cost of marketing to increase their customer base.

SMEs now realize that new marketing techniques must be developed but tend to concentrate on attracting new customers without realizing that these customers are quickly lost as a result of poor inventory planning or inferior product quality. Many small shop owners have not yet adjusted to the fact that supply has caught up with demand and simply having something on the shelf to sell will not automatically lead to success. They do not yet recognize fully that marketing must include such factors as location, inventory, display, presentation, and customer service.

Financial/Accounting Strategy

Business advisors continue to encounter companies that fail to realize that financial projections, careful cash-flow analysis, and detailed cost accounting information are essential to successful business operations. Without these systems entrepreneurs cannot determine actual production costs, forecast cash-flow requirements, or prepare realistic business plans that will support requests for bank credit.

Small manufacturers often cannot distinguish between the cost of defective products and salable goods because production costs are collectively reported. To establish a legitimate pricing strategy, cost accounting practice requires that the cost of defective goods be excluded from the pricing strategy and charged as a separate expense. If this cost is not specifically identified, the manufacturer will continue to raise prices thus affecting his competitive position.

Inventory Management

In today's evolving business environment, businesses can still be found whose owners fail to recognize the importance of inventory management. Clear records of inventory ordered, inventory on hand, work in process, finished goods, and defective inventory are essential for the proper coordination of marketing and production.

One business advisor cited as an example of this lack of inventory planning and coordination a medium-sized company whose marketing division forecast a significant increase in sales. The production department did not plan for the increase and failed to arrange for raw materials to meet increased demand. Marketing did not understand the long lead time needed to obtain the supplies from subcontractors and continued its sales crusade. The production department was unable to keep up with demand and found it necessary to turn to alternative, but unreliable, sources of supply. Production could not meet demand and the quality of the product was poor. Inventory management of this company was crisis-oriented, which cost the company valuable customers and diminished its competitive advantage.

EXTERNAL CONSTRAINTS TO SME DEVELOPMENT

Numerous external issues also affect the development and expansion of SMEs. These issues can be categorized as constraints within the public sector and the financial sector. However, an overriding issue and a major constraint to small business development is the lack of a comprehensive government policy in support of the SME sector. Such a policy is particularly critical to an economy that, after 40 years of central planning, has no institutionalized consciousness with which to guide the transition from public ownership to competitive private enterprise.

A well-defined SME policy would:

- Express government recognition that a well-developed SME sector is critical to building a strong national economy;

- Declare commitment of government to actively promote and support development of a vital SME sector;

- Mandate coordinated governmental action to remove existing constraints to SME development;

- Establish the goals and objectives against which individual and coordinated governmental initiatives affecting SMEs are measured; and

- Provide clear and consistent guidelines for decision making.

Without a comprehensive policy there can be no effective framework within which to address the other macroeconomic, financial, legal, and social constraints to SME development.

Financial Sector Constraints to SME Development

Lending Policy Issues

SMEs have traditionally financed their working capital and expansion needs with personal savings, family loans, and internally generated capital. These methods of financing are not uncommon globally. Historically, start-up companies throughout the world must provide their own capital until the company is a proven success and is thus able to approach the commercial banking sector for financial assistance.

According to a 1992 study of 300 entrepreneurs from the Gdansk region, four out of five existing businesses used internal financing for working capital. The study noted a declining role for loans from family and friends, and a marginal role for bank credit as a source of start-up capital for new firms. SMEs may find self-financing to be a short-term alternative to unavailable credit; however, the true difficulty becomes evident when a profitable business is unable to gain access to banks and capital markets to meet short-term working capital needs or to obtain investment funds to expand operations. With a lack of capital market mechanisms and the banking sector's high collateral demands and equally high interest rates, even successful small entrepreneurs are unable to have their credit needs fulfilled at a cost that will ensure continued profitability.

Until the late 1980s banks were limited to accepting deposits, granting centrally approved funds, and transferring funds as needed to state-owned enterprises. Lending to SOEs was a central government decision. Loan analysis and risk-taking were unknown. In 1990 the banks, largely free of government control, embarked upon a lending spree to newly established SMEs. Lack of well-defined lending policies and technical expertise resulted in substantial losses in lending activities to both the public and private sectors that still impede the performance of Treasury-owned and private banks.

This experience is largely responsible for bankers' aversion to lending to SMEs, which the bankers perceive as inexperienced and unreliable borrowers. In the current economic climate profit-oriented banks are understandably cautious and seek to ensure their own financial survival. Because of the added risk and higher transaction costs of smaller loans, many bankers decline lending to start-up enterprises, or offer only short-term credit with restrictions that most SMEs cannot meet.

Anecdotal Evidence. The obstacles encountered by new and unproved businesses are perhaps best described by the comments of executives from two foreign assistance institutions, PAECC and the Cooperation Fund, the implementing agency for the EC-PHARE program. In an article in the local press, a representative of PAECC stated that there are many clients with bright ideas of what and how to produce, but they don't know how to sell their products. Such loan applicants have no chance of obtaining funding. He also stated that the most serious problem for Polish entrepreneurs is lack of collateral. Frequently applicants lack even the funds required for their own investment in the project. Bankers who have advised businesses agree that Polish entrepreneurs want to do too much too quickly. Firms are immediately interested in big loans for large projects exceeding the company's current potential.[5]

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[5] "Foreign Credit Conference: Spelling it Out," *Warsaw Voice*, June 1993.

In an interview, a representative of the Cooperation Fund stated that the problem with lending to SMEs is three-fold. The first issue is that the borrower is new to the bank. Such companies have no history to demonstrate their ability to succeed. Entrepreneurs are usually specialists and lack management and financial experience. In the final analysis they are not sophisticated enough to demonstrate management and financial competence and often cannot offer collateral to strengthen their position. Second, in the new economy banks are required to make unaccustomed decisions. They are fearful and generally not open for project financing or risky endeavors. The SME sector has been ignored by banks because it is not a lucrative source of business. The banks have had poor lending experience from which they turn to government bonds as a profitable risk-free investment.

Credit Analysis Deficiencies. Through the period of economic transition, banks have been unable to properly assess acceptable levels of risk because of lack of training and experience with credit and commercial banking activities. As a result, they tend to protect their positions by seeking maximum security. To minimize risk, banks routinely require 150-200 percent security for principal plus interest. Today, the banks maintain that their high collateral demands are still appropriate in a rapidly changing economy where any business, no matter how successful, is subject to financial hazards beyond the banks' or the borrowers' control. Although there is some validity to this statement, too many banks use collateral as a substitute for credit analysis rather than as a last resort means of repayment.

Loan Monitoring Problems. Aside from deficiencies in credit analysis, banks admit to problems with loans caused by poor or insufficient loan monitoring. Follow-up procedures are often not established or maintained. As a result, many banks are unaware of problems until borrowers are already in serious financial difficulty.

Much of the banks' aversion to SME lending is a matter of perception. Banks have failed to realize that in a free market SMEs form the core of the business community. Having made the decision to avoid the sector, the banks have made little effort to introduce efficiencies in lending techniques that would reduce transaction costs and increase the profitability of their lending operations. They also do not realize that, although working closely with prospective borrowers may be costly in the short term, such efforts will develop into profitable relationships. Long-range planning would demonstrate that as the economy stabilizes and the financial position of the banks improves, alternative investments such as government securities will no longer be attractive and SME lending will begin to make a substantial contribution to bank profitability.

Interest Rates

Although interest rates are primarily a reflection of macroeconomic policy, they have a direct effect on the success of SMEs requiring bank credit. In an open market an entrepreneur who must factor interest costs of 40-50 percent into a business plan may run the risk of losing his market to better-financed competition, both domestic and foreign. Bankers are aware of the added risk of high interest rates but are reluctant to follow the downward trend of the NBP discount rate. They look upon maximum income as a hedge against existing and potential losses in their total loan portfolio. They appear to be inflexible in reducing the interest rate spread even though the discount rate has fallen from 40 to 29 percent. Banks maintain that they cannot make parallel adjustments because of NBP reserve requirements. Although the short-term attitude of the banks is understandable, a particular bank could take the position that by reducing rates it would attract a volume of good loans that would improve profitability.

Bankers also insist that they should be compensated for the opportunity cost of interest lost on reserves of 23 percent on current accounts and 10 percent on savings accounts. It is reasonable to expect at least nominal interest to be paid on deposit reserves, but NBP at this point cannot afford the expense.

In the first few years of the transition a considerable amount of short-term credit was extended to individuals and small businesses to finance rapid-turnover consumer goods. High interest rates were of no great concern when profits were high and loans were outstanding for short periods of time. As the private sector developed, however, the need for investment financing for productive activity expanded and the cost of borrowed money, particularly for term credit, became a significant factor for SME profitability. The alternative credits, at hard currency rates, available through foreign assistance agencies looked attractive. Little attention was paid to the dangers of devaluation and the potential need for an increasing zloty repayment requirement. Foreign currency borrowing is now perceived to have dangers of its own except for the export sector, whose sales generate the hard currency needed for debt repayment.

Financial Sector Liquidity

Although the issue of bank liquidity is not the primary constraint to SME access to credit, it is a significant factor in a financial market critically short of investment capital. There appears little doubt that the liquidity position of the banks would allow them to make a greater contribution to SME development if other problems, both perceived and real, were resolved. These problems relate in part to NBP policies and regulations that encourage bankers to seek alternative sources of income.

A basic issue concerns the limited capital with which many newly licensed private banks began operations in 1990. At that time, NBP had neither the experience nor the technical capacity to understand the implications of inexperienced bankers embarking on extensive loan programs. When NBP realized the danger and established new minimum capital requirements, many of the new banks were already in a precarious position. The need to attract new capital became a primary concern of these banks, requiring a search for new investors or mergers with other institutions.

Although the banks exhibited an average capital adequacy ratio of 12-13 percent at the end of 1990, the magnitude and speed of the portfolio deterioration experienced in 1991 led rapidly to serious solvency problems. Based on mid-1991 portfolio reviews, the seven commercial banks under review were estimated to be insolvent in the aggregate. The banks' financial condition has improved since then, as a result of increased interest income from very high spreads and, to some extent, a shift from risk assets to government securities. However, based on updated portfolio reviews and financial audits, the shortfall of the commercial banks' capital to their risk-weighted assets was still significant as of June 1992. During the first quarter of 1993, the liquidity ratio of the banks was as follows: 14 banks were below 0 percent; 3 banks were between 0-3 percent; 6 banks were between 3-6 percent; 4 banks were between 6-7.9 percent; and 59 banks were 8 percent and above. According to this report only 69 percent of banks maintained an adequate liquidity position.[6]

Banks with inadequate liquidity ratios are effectively prohibited from further lending until new capital is in place. These limitations are designed to protect the stability of the banks and ensure the safety of their customer deposits, but they also force the banks to cease lending and to look for other

[6] "Regulating Banks: The Players and the Game," *The Financial Voice*, May 1993.

sources of income. Bankers often choose instead to invest in short-term time or inter-bank deposits for greater risk-free returns.

The issue of the GOP deficit, and the need to borrow from the banks to cover that deficit, is a significant part of current negotiations with the IMF. Included in the GOP's recent Letter of Intent to the IMF are statements that, in accord with fiscal policy, the government will take the necessary steps to confine the budget deficit to PLZ 81 trillion, or 5 percent of GDP for all of 1993. Projections contained in monetary policy guidelines state that the increment in the banking sector's net assets for 1993 will be confined to PLZ 117 trillion. The government sector is projecting a need for PLZ 76.5 trillion in net financing.[7] It is difficult to assess the significance of the figures quoted above; however, the government's financing requirements will continue to be a considerable drain on the banking sector's funds position.

Bank Services

At its present stage of development, the banking system lacks many of the more sophisticated services available in most Western countries. Currently, credit services are limited primarily to short- and medium-term loans and guarantees to other banks. Export Letters of Credit (L/C) generally must be collateralized with cash except for the most creditworthy. Asset-based lending is basically unknown. Although most SMEs would not yet qualify for these services at this stage of their development, as the sector grows SMEs will require more up-to-date facilities.

Credit from a bank generally consists of a short- or medium-term loan for a maximum of 1.5 to 2 years with either a balloon repayment schedule or an amortizing principle schedule. These loans are offered at a spread above the cost of funds and are callable at any time. The spread above the cost of funds generally reflects the NBP discount rate although it varies from bank to bank.

A loan from one bank is often guaranteed by a second bank as a way for the latter bank to circumvent the credit ceilings currently applied by NBP and to generate fee income.

The use of export Letters of Credit is a routine service provided by Western banks to their exporting customers. This document guarantees the exporter that he will be paid for the product shipped abroad if the terms and conditions established by the credit are followed. L/Cs are generally opened for periods of 30-180 days depending, in part, on anticipated shipping time. From a funds flow point of view, the exporter, although guaranteed payment, must wait until the transaction is completed before he may expect to receive the funds. The second feature of a L/C allows for the creation of a banker's acceptance, a mechanism by which the bank issuing the L/C will discount the note that accompanies the document and pay the discounted proceeds to the exporter. The latter therefore receives immediate payment for a transaction that might otherwise be forthcoming only after 180 days.

In Poland, Letters of Credit as described above are available only to a bank's most creditworthy clients. A L/C is a guarantee by the bank that could conceivably cost them the amount of the credit should the transaction not be completed as agreed. Polish banks are seldom willing to take that risk for their SME clients and require the exporter to place a cash deposit with the bank until payment is ultimately received from the overseas importer. Under these circumstances the concept of discounting the document for immediate payment to the exporter is impossible.

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[7] *Economic Review*, Warsaw, December 15, 1992, pp. 3-4.

The use of the Letter of Credit service therefore represents a substantial cost for the Polish entrepreneur who has not yet reached the degree of creditworthiness required by his bank. His cash flow problems are increased by having to wait a significant period for payment from the foreign buyer, and he must also tie up an equal amount of cash to collateralize the L/C transaction.

As a constraint to SMEs' competitive position in the international market, inefficient financing mechanisms become a significant issue. Lack of internal capital and bank credit create cash flow deficiencies for exporting SMEs. To insure rapid settlement, Polish exporters are forced to offer lower prices thus reducing profit and ultimately resources for further development.

Bank Systems

The effectiveness of the bank regulatory framework depends ultimately on licensing, monitoring, and enforcement capabilities. Although significant progress has been made in the last year, these capabilities are still underdeveloped in Poland. An illustration of the impact of this situation is the large number of technical insolvencies in the private banking sector reportedly caused by fraudulent activities and insider lending. The management of NBP is unequivocally committed to developing off-site and on-site supervision. It has started to increase the staff of the Supervision Department and to improve its employee compensation in line with wage levels in the private banking sector. However, both new and many existing NBP personnel are still unfamiliar with modern banking supervision practices and principles, and a massive training effort will be required to develop a strong supervisory capacity.

According to the head of NBP supervision, "it is not unusual that a client's creditworthiness is not checked because, according to the bank, he offers excellent collateral. Aside from the fact that such actions violate the banking law, the banks should be aware that the quality of the collateral offered by customers under Poland's economic situation is fluid." With situations such as this in the banking sector today, it is difficult to maintain steady growth and development. From a slow start, NBP is now playing an effective role in monitoring the banking sector's operations and procedures.

Former state-owned banks are still under pressure from NBP to lend to SOEs, although many of these banks are already overexposed to a few large state firms. Although NBP provides banks with liquidity, banks carry their own credit risk. To avoid bank risk, the government will provide a guarantee that supports the SOE without directly affecting the state budget. Support of SOEs through the banking system tends to drain the system of funds that might otherwise be available to the private sector. Since many SOEs have their own capital adequacy problems, creditor banks may find themselves in serious financial jeopardy. Privatization of SOEs and restructuring of bad debts or recapitalization of Treasury-owned banks will improve the financial position of the banks and make them more likely lenders to the private sector.

Lack of automation and advanced systems has until recently created problems for bank clients in meeting their business obligations through the inter-bank payment system. Delays in this system not only produce cash flow difficulties for entrepreneurs, they also create an opportunity for fraud. Because of a lack of automation and information systems, a local company was able to make millions of zlotys in interest by depositing and withdrawing funds simultaneously through several banks, thereby earning multiple interest on a single deposit. After this technique was exposed, the SWIFT wire transfer system was introduced to selected banks. This development in management information systems has improved the efficiency and speed of the movement of funds, but, internally, many private banks are still doing all of their processing and reporting manually.

In January 1994, the introduction of Mobitex, a domestic wire transfer system, was expected to be implemented. This system, owned by Telbank, will allow banks and other business users to move funds more easily through the banking system.

Loan Security/Collateral

Banking sector policy regarding loan security is a major SME credit-access issue. Banks routinely require 150-200 percent coverage before they will consider a borrower's loan application. Security may take the form of a guarantee from another bank or individual known to the lender, or cash. None of these are readily available to most small entrepreneurs. The most common form of security is a mortgage or lien on fixed or moveable property.

Although collateral may be necessary to validate a credit proposal, it poses its own problems. In case of default, banks face difficulties in taking possession of collateral that they have been assigned in the form of real property. These difficulties include the lack of an efficiently run central registry where property ownership can be verified, difficulties in identifying prior mortgages outstanding, the cost of hiring an intermediary to present a collateral claim in court, the fee required by the court to register a claim, and the time and expense involved in court proceedings. In addition, there is no procedure for a bank to be granted a first lien on its collateral. In the event of multiple bank lenders, each will rank *pari passu* with all subsequent lenders.

In mid-1993 the treatment of private banks under banking law changed. The law previously stated that State Treasury banks had clear rights to execute a call on a loan and collect the collateral without court approval; now, all banks have this right. This law has reduced the time in which it takes to foreclose on a loan and liquidate collateral. In spite of this amendment to the law the complications and expense involved in relying on collateral as a means to collect on a nonperforming loan increases bankers' aversion to SME lending.[8]

Access to Foreign Assistance Funds

Interviews with bankers and private sector entrepreneurs indicate that, with few exceptions (primarily the PAECC), foreign assistance credit facilities are inaccessible to most of the SME sector. Banks cite this limited access to foreign currency lines of credit as due to complicated procedures, lack of information on availability, and restrictive borrowing criteria. Minimum loan requirements also tend to exclude many SMEs. Foreign assistance proposal requirements are too detailed and time-consuming for both the SME and the intermediary banks, and thus are not cost-effective. Some banks lack the expertise to go through the lengthy process of accessing foreign lines of credit, preferring to work with the few acceptable loan proposals received, or to invest in government instruments and interbank deposits.

The usual procedure for foreign assistance credits to reach the borrower is to establish an intermediary bank through which the funds are channelled to a network of disbursing banks. This system has proved effective for the Polish American Enterprise Fund but has been a stumbling block for the World Bank. The latter has approved a $60 million ($58 million for lending) loan for SMEs disbursed to designated lending institutions through the Polish Development Bank. PDB has been

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[8] The issue of collateral is a significant constraint to SME lending and is discussed at length under public sector legal constraints.

unable to identify intermediary banks that are both interested and qualified to participate. Although the facility has been available for one year (it took another year to finalize the loan agreement between PDB and the World Bank), it remains unused. In addition, PDB has indicated that the economies of scale for processing a SME loan discourage SME lending. EC-PHARE (Cooperation Fund) has offered a similar facility for two years. Utilization is reported to be 3-4 percent due, in part, to a lack of acceptable loan proposals. From the perspective of most SME borrowers, however, the criteria for borrowing are too restrictive. EBRD, whose minimum loan to SMEs is $200,000, has elected to take equity positions in other institutions to reach SME borrowers. These include the PAECC, which theoretically has no minimum loan requirement, and CARESBAC, Poland, the venture capital institution investing directly in SMEs.

The question of foreign currency risk meets with differing opinions. Representatives of foreign agencies tend to support the contention that because of the low rates for foreign currency loans (at least in the short term), the risk of devaluation of the zloty is minimal compared to the cost of zloty loans. Banks and potential borrowers appear generally unwilling to take that risk unless the borrower's business is generating foreign currency income.

Foreign assistance agencies, as prudent lenders, are safeguarding their investments in a high-risk lending climate by adopting Western loan standards and procedures. In doing so, however, they are unable to reach the small- and medium-sized entrepreneur.

Public Sector Constraints to SME Development

Legal

Numerous and varied laws and regulations guide today's economy in Poland. Here we concentrate on those legal and regulatory issues that have a direct impact on the financial and private sectors, impeding growth and development of SMEs.

Legal experts interviewed emphasized that changes in commercial, banking, civil, trade, and other laws that affect the private sector have lagged behind political developments. Of equal concern is that although some laws are in place and provide the necessary technical framework, there is little legal precedence to which the courts may refer for guidance. Therefore, there are opportunities for broad interpretation of existing law.

Collateral Law. The legal issues of primary interest to lenders and borrowers concern the assignment and, in the case of default, collection of assets held as collateral. The Law for Mortgage and mortgage records of 1982 and amendments of 1991 provide the legal framework for the regulation of real property pledged as loan collateral. The law regulates the registration of real estate and the indebtedness outstanding on it. The mortgage records are the official register from which the legal status of the property can be determined. This is designed to safeguard real estate business activity in determining ownership, perpetual usage, and, more recently, cooperative apartment ownership.

According to the law there is an obligation to establish and maintain registers for each piece of real estate. The register identifies the property and all matters related to it, identifies the owner or perpetual user, specifies the limited property rights that encumber the property, and registers mortgages that may encumber the property.

A mortgage on real property pledged as collateral gives the lender a privileged position. The lender can collect the debt from the encumbered property regardless of who its current owner may be, with priority over personal creditors of the property owner. One exception to this procedure concerns a claim by the state that need not be entered in the mortgage register. A state claim will affect a prospective buyer as it has priority over other mortgages. Thus, when a person purchases property or when a lender accepts a mortgage as collateral, there is no certainty that the property is free from a statutory claim.

A borrower may also allow a lien to be placed on movable property as collateral. The debtor must turn the property over to the creditor while the lien is outstanding and has no right to the use of the property. Therefore, machinery used in the production of goods cannot be used as loan collateral.

In addition to the assignment of a mortgage on real property as a form of collateral, the legal system provides for a personal guarantee backed by the property of the guarantor. The Civil Code governs the assignment of personal collateral. The guarantor is obligated to satisfy the claim in case of default by the debtor and is equally responsible with the debtor.

The discrepancies in the legal system as it relates to real property, mortgages, and the rights of the lending institutions to collect on such property pledged as collateral do not address the question of the cost in pursuing such action. There is a substantial fee that must be paid to the court to register a claim and such procedures must be carried out by a professional whose own fees are often substantial. The time factor in collecting on collateral and the valuation that is placed on the property also have cost implications.

Poland's current laws governing secured transactions create a lending regime that is unreliable, subject to fraud, expensive, and frequently time-consuming to execute. It is no wonder that the banks have been unwilling to lend in this unfavorable environment. Reform may be close at hand, however, if the Council of Ministers or the Polish Parliament adopts a version of the draft collateral law currently being reviewed by the various Polish commissions.[9] Enactment of the draft would expand the scope of property that could secure a bank loan and would clarify the law with respect to floating pledges. It would also provide for an effective method of registering pledges on movable property so that priority could be determined on a first-in-time, first-in-right basis. Finally, it would entitle certain banks to use an efficient and inexpensive method of execution on the collateral in the event of default. If adopted, this law would establish an effective system for asset-based loan transactions, thereby making it easier for developing businesses to secure adequate financing for growth and expansion.[10]

Bankruptcy Law. The issue of bankruptcy is a cause for concern to many bankers who are already averse to SME lending. According to Ministry of Justice statistics, approximately 85 percent of bankruptcies (there were 2,250 in the first half of 1993, a 300 percent increase over the same period a year earlier) are tactical maneuvers designed primarily to avoid repayment of bank debt. Neither the legal nor supervisory system is capable of coping with this situation because Polish law does not specify sanctions for bankruptcies. The previous Parliament was dissolved before it acted on a proposal for the protection of business dealings, which called for the introduction into the Penal Code of harsh penalties, including a three-to-five-year prison term for avoiding debt repayment.

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[9] Reform of collateral law is a major focus of the USAID-funded Iris-Poland Project, working with the Commission for Reform of the Civil Code and the Polish Ministry of Justice to draft a new collateral law.

[10] "Collateral Law Reform Project Making Progress," *IRIS-POLAND NEWSLETTER*, Summer 1993.

In addition to the existing court-led bankruptcy procedures, the state-owned banks will be given the right to conduct "conciliation" proceedings whereby minority creditors can be forced into a debt restructuring agreement with an enterprise willing to implement a credible restructuring plan. This right is intended to increase the ability of banks to recover some of their potential loan losses by declaring the company in default through a mutual agreement of the debtors. This allows the banks to monitor and control when they believe the investment is becoming too risky. The courts, however, retain the right to examine the regularity and fairness of any bank-led conciliation. Since this process is limited to state-owned commercialized banks, they are being given an unfair advantage over the private banks.

Regulatory Issues

Banking Regulation. Private sector entrepreneurs all criticized lending policies, but did not appear to be as familiar with regulatory matters affecting credit activities. There are, however, a number of regulatory issues now under review that limit the banks' capacity to serve the business community effectively.

The Banking Law includes several provisions that tend to favor the seven Treasury-owned banks. The obligations, including deposits, of these banks are presently guaranteed by the Treasury, while private banks established after 1989 do not provide deposit insurance. If such a system is allowed to continue, prudent depositors will place their funds in the Treasury-owned banks and thereby increase their competitive position.

These same banks have a specific privilege with respect to the collection of bad debts. Without going to court they may make use of a court officer to collect past due obligations. They may also take possession of a debtors real property even if the loan agreement did not require a mortgage.

The law of Financial Restructuring of Enterprises and Banks affords the financial sector an opportunity to expand its services as well as to increase the health of the banks in general. The law works in combination with the privatization of state-owned enterprises as well as with joint stock companies. Basically, the law allows a bank undergoing privatization to begin collection proceedings on its portfolio of bad or doubtful accounts. A bank holding greater than 10 percent of a company's total debt may initiate the proceedings and request that all other debtors participate in the collection or workout process. If a bank decides that it doesn't want to participate, then it must make its intent known within 30 days of the collection notification. If a creditor holds a lien or mortgage, they have the right to refuse to participate but must so notify the committee within 21 days. This creditor (with the mortgage or lien) will have rights to their collateral after the collection process is complete. Otherwise, all banks are ranked pari passu with regard to collateral collection in the proceedings.

The proceedings aren't necessarily undertaken to liquidate a company; they are used primarily to restructure the company and reorganize management. The creditor must give the company no less than 30 days to complete the management reorganization and show a debt repayment plan to the committee. However, if the bank and the company cannot come to an agreement within four months, the collection proceeding is canceled.

In addition to the loan workout situation, the law states that the bank may sell acquired debt in the public market via an auction. The bank's financial statements become public when it initiates this type of proceeding. The law also allows the banks that own a minimum of 30 percent of any one company's debt to organize a debt/equity swap with the company. To use this process, the company must also be involved in the privatization process.

A bank with more than 50 percent of its capital stock held by the State Treasury can use another method of increasing capital through the Ministry of Finance. MOF has the right to transfer treasury bonds and monetary resources to increase the bank's capital base. Only the banks with audited financial statements, reserves for doubtful accounts, or a loan workout department, or banks that have presented a loan workout plan to MOF, are eligible for this capital transfer option. When the bank participates in this capital transfer program it is not allowed to lend to businesses it has categorized as having doubtful accounts or bad loans.

The above opportunities to increase liquidity in the financial sector through capitalizing and loan workout are healthy options for banks. In addition, by allowing sales of debt and stock, the banks are stimulating the capital market sector as well.

Proponents of the law emphasize these procedures as key to financial sector recovery and the restructuring of state enterprises. An essential feature for the program's success is the emergence of a debt market with adequate liquidity. According to the law, the banks will participate in, and be responsible for, the implementation of this program. As part of this process, the stabilization fund, originally provided to GOP by a consortium of donor nations to protect Poland's foreign reserve position, has been diverted to the purpose of restructuring the Treasury-owned banks.

Tax Regulation. In a typical market economy business decisions are often tax-driven. There are certain tax benefits related to the structure of a business: where it is founded, where it operates, and what type of business it conducts. Government can encourage growth in the SME sector by providing certain types of tax benefits.

In Poland the use of tax policy and regulation as an instrument to encourage business development has been limited.[11] The Ministry of Finance plays a major role in developing tax policy with the basic purpose of maximizing income to meet government expenditures. In doing so it is obliged to meet short-term budgetary goals without considering the long-term benefits that might accrue from using tax policy to create an atmosphere in which business can expand, thereby increasing taxable income to the state treasury.

Entrepreneurs interviewed were not specifically opposed to the rate that must be paid as income tax but were concerned at the overall cost of doing business when customs duties, welfare benefit costs, and other fees were included. They also cited the technical complexity of the system and the practice of enacting retroactive tax legislation, thus making business plans and projections a meaningless procedure.

Continuing growth of the gray market is a clear indication that the tax system in Poland requires reform. The growth of this market is partly the result of liberalized regulations under which private businesses may function without adequate controls to ensure that entrepreneurs comply with tax and customs duty obligations. Tax loopholes, delays in legal regulations, and a lack of effective penalties create an atmosphere for systematic tax evasion. In addition to structural issues, evading taxes carries little social stigma. On the contrary, evasion is perceived in some circles as an example of entrepreneurial spirit.

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[11] In 1990 a Council of Minister's resolution provided a tax holiday to new businesses for up to two years. The resolution had a limit of two years and was allowed to lapse, in part for budgetary reasons. The holiday was used substantially by consumer goods importers and did not achieve the anticipated increase in production.

Gray Market Activity

The operation of unregistered businesses inhibits the growth of the official economy and prevents free market principles from functioning effectively. Of primary importance to SMEs are the market conditions in which registered businesses must compete with low-cost unregistered businesses. The official economy is subsidizing the unregistered business sector.

In addition to the competitive effect that gray market operations have on SME performance and development, the financial cost to the state budget is significant. As previously stated, the gray market may account for as much as 22 percent of GDP, which at the current time equals approximately 1 percent of the annual growth of GDP. This in turn reflects a substantial cost to the government in lost revenue. (Although the informal economy does not contribute income tax revenue, it does increase VAT income in purchasing goods, energy, and raw materials.)

Privatization

Although the process of privatizing the SOEs may not, in itself, have a direct impact on SME access to credit, it will have an effect on the financial markets. Continued support of unprofitable SOEs puts pressure on the central budget. Funding the deficit requires the sale of GOP treasury bills and bonds, with the Central Bank and the commercial banks the primary investors.[12] This procedure tends to drain the banking system of substantial funds that might otherwise be made available to private sector entrepreneurs. Without the possibility of alternative risk-free investments, the banks would presumably turn to lending activities as their primary source of income and profit.

In addition to fundamental issues, there is no question that the privatization process is a political distraction for GOP. Depending upon their personal political philosophy and the presumed interests of their constituents, opposition groups accuse the government of selling national assets to foreign investors at below-market prices, creating massive unemployment, and otherwise ignoring the interest of the workers. Rapid privatization (including programs to address the resulting social problems) would effectively deflect this issue and allow the government to turn its attention to other reforms conducive to the development of the economy.

Privatization also contains the potential for creating new SMEs through the sale of ancillary assets that investors in SOEs may not need. These new businesses can play a small role in alleviating the unemployment that might otherwise be created in the break-up of the enterprise. At the same time they will also create a greater demand for bank financing.

In spite of what is generally considered to be a critical element in the transition to a market economy, privatization is not without its detractors. Team interviews revealed differing opinions on the effect on private sector development of privatization of banks and state enterprises. Although most believed privatization to be necessary for transition to a market economy, there was disagreement on the appropriate time frame. An economist interviewed warned that if privatization is undertaken too quickly, many newly privatized firms may fail at a rapid pace. With decreased tax revenues, the budget deficit may quickly rise, causing increased inflation and further economic instability. Concerns were also expressed that SOEs undergoing privatization would face lack of investment capital, shortage

[12] In addition to a direct charge to the budget continued support to questionable SOE's is provided by Treasury-owned banks covered by government guarantees. This procedure also tends to absorb bank liquidity that might otherwise be available for lending to the private sector.

of experienced management, and an inability to compete in world markets. One person interviewed believed that privatized SOEs would be in danger of failure caused by poor worker motivation. If so, management would need to provide employee incentives to address this issue.

Although implementation of the privatization process has become a significant political issue, there is general agreement that the sale of nonessential SOEs is a key component of free market development. Accordingly, the privatization law was enacted on July 13, 1990, representing the primary legal vehicle for the transfer of ownership of state-owned enterprises. This law and other legislative acts allow for the following means of ownership transfer: outright sale to private investors, commercialization, and liquidation.

Outright Sale

The preferred procedure for the sale of SOEs is outright purchase from the government by domestic or foreign investors. In reality such sales result from protracted negotiations on asset value, settlement of debt, management and workers' rights, and numerous other issues.

Several problems with this technique were pointed out by interviewed parties. First, there are no clear procedural regulations that specify how, and by whom, the valuation of assets of SOEs should be conducted. Lack of specific valuation guidelines prevents the determination of the true market value of assets, leading to lengthy and unproductive negotiations among potential investors, unions, and government representatives.

The second obstacle to the smooth privatization of SOEs is the absence of adequate property laws establishing title to land, including real assets taken from private ownership by the communist government. Property rights are governed by the 1964 Civil Code, which is totally inadequate in today's economy. According to persons interviewed, this Code provides a satisfactory legal structure but is written in general terms and lacks legal precedence. As a result there is opportunity for wide discretion in interpreting the rules and procedures set forth in the Code. It should be noted also that lawyers as well as judges have little experience in open market business law because the legal system was supervised by the central government and offered little opportunity for interpretation.

Liquidation

Liquidation as an element of the privatization process includes two procedures. The first is based on the law about state-owned enterprises and refers to liquidation of an SOE due to financial failure. The second procedure is governed by the Privatization Law that allows liquidation of state-owned companies followed by transfer of ownership. Sale of assets of a given company is conducted by a liquidator appointed by the State Treasury. A liquidator is responsible for making an inventory of the company assets, evaluating the assets, establishing the terms and conditions regulating the sale of these assets, and, finally, supervising the sale. The sale of the assets to a potential investor can only be completed if the Employee Council, upon consulting with employees, supports liquidation.

If agreement is concluded on the behalf of the State Treasury, the amount charged for using assets is determined by the following formula: value of an enterprise divided by the number of years of the agreement. Annuity is set at the level of three quarters of the current interest rate.

Leasing is the most frequent form of transforming Treasury assets and takes one of three basic forms: leasing with purchase, leasing with purchase option, and ordinary leasing.

In theory, the liquidation process should be more efficient than outright sale because it does not require the supervision of the state through the entire process, and analysis requirements for liquidation are less demanding than those used in the capital method.

Commercialization

Commercialization is a means of converting state-owned enterprises into joint stock companies owned by the State Treasury. It may be the first step toward complete privatization although, in certain industries, enterprises will remain as Treasury-owned entities. The purpose of such transfer of ownership is to simplify the management and organizational structures of enterprises. Further, this method enables the establishment of a Supervisory Council and does away with the Employee Council.

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

- The primary conclusion to be drawn from the GEMINI study team analysis of the SME sector is that the government should adopt a comprehensive policy in support of small- and medium-sized business. Without such a policy no framework exists within which to establish initiatives needed to remove the constraints to further SME development.

- Foremost of these constraints is an underdeveloped financial sector, unable to meet the financing needs of private sector entrepreneurs. These constraints are the result of a lack of bank services and instruments appropriate to SMEs, inexperience, aversion to risk, the unstable financial condition of the banks, and a preoccupation with short-term profitability. The development of the capital market and the introduction of new financial instruments that will increase the flow of funds are critical to the viability of the financial sector. If these issues are not resolved, access to financial support will remained closed to all but the most creditworthy businesses.

- Government activity should be limited to removing the constraints subject to government control. The private sector must be persuaded to adopt management and business practices that will encourage private financial sector assistance without government subsidies and guarantees. GOP must be encouraged to take the necessary action to deal with the policy, legal, and economic constraints that impede private sector risk-taking and capital formation.

- Poland has neither the financial resources nor the experience to successfully implement and sustain a market driven economic restructuring process. Although a great deal has been accomplished with respect to knowledge transfer, it will be necessary to continue to seek the support of foreign assistance agencies. In addition to substantial foreign assistance for large-scale investment and economic stabilization, specific credit facilities have been made available for SME lending. For the most part, foreign assistance minimum loans far exceed the needs of small- and medium-sized entrepreneurs. Application procedures are beyond the capabilities of most SMEs and the banks do not find these credits to be cost-effective. Businesses must also consider the foreign exchange risk of foreign assistance credits. As a result the majority of these funds have not reached the groups targeted for assistance and the goals for which they were provided have not been achieved. In the absence of efforts to review and perhaps revise these programs, they will remain beyond the reach of most SMEs.

RECOMMENDATIONS

- To address these issues, the GEMINI study team recommends that GOP establish a new government institution in support of SME development. Such an advocacy unit will establish the necessary infrastructure to confront the constraints that impede SME development and create a proactive SME advocacy and promotion process in collaboration with SME organizations, governmental entities, and the foreign assistance community.

- Ongoing technical assistance should be provided to the new SME advocacy unit to transform policy guidelines and G-24 Task Force Report recommendations into action plans designed to remove the constraints to SME development referred to in this report.

- Specific priority should be given to addressing the financial constraints to SME development. A select task force of bankers, private sector entrepreneurs, and GOP representatives should be established in conjunction with the Bureau of Advocacy and G-24 Task Force to advocate implementation of financial recommendations of the Task Force Report and the Financial Sector Action Plan to be developed by GEMINI.

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Technical Notes:

Financial Assistance to Microenterprise Section:

*1. Series Notebook: Tools for Microenterprise Programs (a three-ring binder, 1 and 1/2 inches in diameter, for organizing technical notes and training materials) and "Methods for Managing Delinquency" by Katherine Stearns. April 1991. $7.50. Also available in Spanish and in French.

*2. "Interest Rates and Self-Sufficiency." Katherine Stearns. December 1991. $6.50. Also available in Spanish and in French.

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Other Publications of General Interest:

1. "Expansion with Quality: Building Capacity in American Microenterprise Programs." Elisabeth Rhyne. Development Alternatives, Inc. July 1993. $3.30

Copies of publications available for circulation can be obtained by sending a check or a draft drawn on a U.S. bank to the DAI/GEMINI Publications Series, Development Alternatives, Inc., 7250 Woodmont Avenue, Bethesda, MD 20814, U.S.A.
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Study of the Financial Sector and SME Development in Poland

Volume Two: Appendices

GEMINI Technical Report No. 68

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Study of The Financial Sector and SME Development in Poland

Volume Two: Appendices

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February 1994

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APPENDIX B

BANK LOANS AND DEPOSITS RESEARCH PRELIMINARY REPORT

Prepared by:
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Student Interns
GEMINI Project
Warsaw, Poland

JOLANTA KUPCZAK
4th-29th January

**BANK LOANS AN: DEPOSITS RESEARCH-
PRELIMINARY REPORT**

The objective of my bank loans and deposits research was:

* to create a list of main state, joint-stock and foreign banks operating in Poland;
* to establish deposit interest rates according to time periods offered by each bank;
* to classify loan rates according to time periods provided by each bank;
* to observe a trend in changes of loan rates during the past year and
* to compare loan and deposit rates in order to define the average percentage earned by each bank.

In my investigations I searched for information in "Gazeta Bankowa" and through a telephone survey. On the basis of the materials published by National Bank of Poland, I established a list of 20 banks and found data about their status, location and telephone numbers. Then, I worked on specific interest rates presented in "Gazeta Bankowa". I went to the newspaper editor's office where I got access to the tables of credit rates published systematically in 1992. I also made a few direct telephone calls to several banks to verify accuracy of the data published in the newspaper.
I found what follows:

- interest rates from "Gazeta Bankowa" are the average and general rates of bank loans including operating and investment loans as well as consumer's credits and loans for SMEs;
- each bank itself establishes the periods of credits and only general division into short-term loans (up to 1 year) and long-term loans (longer than 1 year) can be created;
- some banks have different loan rates for specific activities of SMEs (production, service, agriculture etc.) however, other banks do not distinguish their credit policies this way.

Calling to banks, I asked about current deposit rates loan policies provided by each of them. The deposit time periods differ from bank to bank, but most of them offer several short-term rates (from 1 week to 12 months) and long-term rates up to 36 months. The most popular among customers are short-term deposits (especially 3 and 6 months), because for longer periods interests paid by banks do not cover the cost of inflation.

To estimate the average deposit rates in short-term (up to 1 year) I took 3 rates: 3 months, 6 months and 12 months; in the case of long-term deposit rate I counted the average of 24 and 36 months periods. Deposit rates for time accounts are established very precisely in each bank, however, they change almost every month.

In the case of credit policy for economic entities, especially SMEs, each bank follows its own rules regarding the way of evaluating risk, appointing time periods, collateral and other loan requirements. This procedure is usually unique for every single firm and only general rates (rather wide ranges) can be presented. Majority of banks provide short-term loans for SMEs: operating and investment ones. Only few banks gave me accurate data, the rest of them could not present exact numbers or rates. Also only several banks have established precise long-term credit rates and specific time periods for long-term loans. This is why my comparison of loan rates in different banks is not complete.

In order to find out what average interests banks earn by lending and borrowing money I compared average deposit rates with average loan rates in both: short- and long-terms. However, as I mentioned above not all banks informed me about their long-term credit rates and my calculations are rather incomplete for this period .

On the basis of my investigation I gathered all data in the following tables:

- current deposit rates;
- current loan rates;
- comparison of average loan and deposit rates;

To see the changes better I also prepared a few charts showing these data.

To have better orientation in bank credit policy I established contacts with representatives of Polish Development Bank. I received from them full information about credit requirements for SMEs, application forms, conditions of credit financing. There are also information about amount of loans granted to SMEs by this bank in 1991, annual reports from its activities as well as interesting materials regarding banking system in Poland.

Attachement

CREDIT RATES: JANUARY, 1993

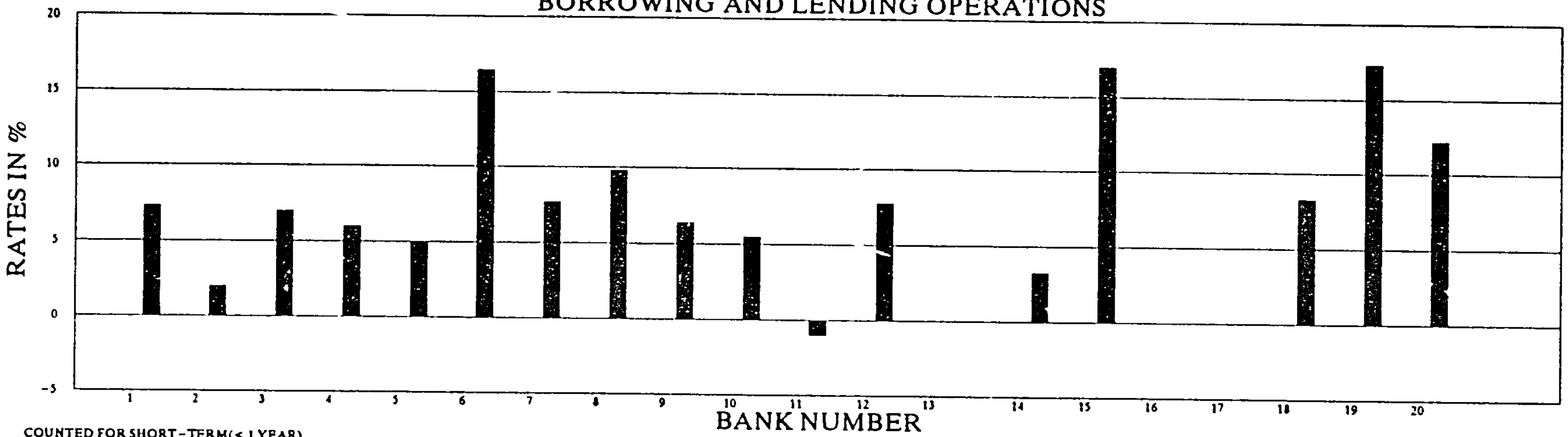
No.	NAME	LOCATION	ADDRESS	PHONE No.	FAX No.	STATUS	AVERAGE SHORT-TERM LOAN RATES (< 1 YEAR)	AVERAGE SHORT-TERM DEPOSIT RATES (< 1 YEAR)	% EARNED BY BANK	AVERAGE LONG-TERM LOAN RATES (> 1 YEAR)	AVERAGE LONG-TERM DEPOSIT RATES (> 1 YEAR)	% EARNED BY BANK
1	Bank Gdanski	Gdansk	Targ Drzewny 1 80-958	260-461 311-423	317-361	state bank	46	38.7	0 7.3 0 0	52.5	52.5	
2	Silesian Bank Bank Slaski	Katowice	ul.Warszawska 14 40-950	537-281/4 538-906	537-364 539-930	state bank	42	40	2 0 0		48	
3	Bank of Industry and Commerce Bank Przemyslowo-Handlowy	Cracow	ul.Sw.Tomasza 43 31-027	628-55-86 223-333	229-267	state bank	50	43	7 0 0		53.5	
4	Deposit and Credit bank Bank Depozytowo-Kredytowy	Lublin	ul.F.Chopina 6 20-928	217-12 203-04	240-65	state bank	46	40	6 0 0	54	48	8
5	Universal Economic Bank Powszechny Bank Gospodarczy	Lodz	ul.F.D.Roosevelta 15 90-950	362-231 329-440	365-044	state bank	44	39	5 0 0		49	
6	Wielkopolski Credit Bank Wielkopolski bank Kredytowy	Poznan	Pl Wolnosci 15 60-967	390-016 521-031	521-113	state bank	56.5	40	16.5 0 0		19	
7	The Pomerania Credit bank Pomorski Bank Kredytowy	Szczecin	Pl.Zolnierza Polsk. 16 70-952	533-114 400-261	533-114	state bank	48	40.3	7.7 0 0		55	
8	The State Credit Bank Panstwowy Bank Kredytowy	Warsaw	ul.Nowogrodzka 35/41 00-950	297-221 296-011/20	296-988	state bank	49.5	39.7	9.8 0 0	52	48	6
9	West Bank Bank Zachodni	Wroclaw	ul.Ofiar Oswiecim.41/43 50-950	354-928 445-621	349-17 441-982	state bank	46	39.6	8.4 0 0	54	48.6	5.4
10	Bank Handlowy S.A.	Warsaw	ul.T.Chalubinskiego 8 00-950	304-187 303-000	300-113	joint stock company	42	36.5	5.5 0 0	46		
11	Bank PEKAO S.A. Bank Polska Kasa Opieki	Warsaw	ul R. Traugutta 7/9 00-950	269-211	261-187	joint stock company	40	41	-1 0 0	60	49	11
12	Export Development Bank Bank Rozwoju Eksportu	Warsaw	Al Jerozolimskie 65/79 00-950	296-853 300-858	287-850 300-859	joint stock company	46	38.2	7.8 0 0		44	
13	Polish Development Bank Polski Bank Rozwoju	Warsaw	ul.Zurawia 47/49	628-72-01		joint stock company		29	0 0 0			
14	Upper Silesian Business Bank Gornoslaski Bank Gospodarczy	Katowice	ul.Warszawska 4 40-006	586-636 586-497	586-497	joint stock company	46	42.7	3.3 0 0		51.5	
15	Creditanstalt S.A.	Warsaw	ul. Nowy Swiat 6/12 00-920	267-070	265-110	foreign bank	52	35	17 0 0	51.5		
16	Citibank	Warsaw	ul.Senatorska 12 00-082	635-81-18 635-55-27	635-52-78	foreign bank	50		50 0 0			
17	ING	Warsaw	Centrum LIM 6th floor 02-697	625-00-40 625-73-52	630-72-67	foreign bank	42.5		42.5 0 0			
18	Credit Bank Kredyt Bank	Warsaw	ul.Kasprzaka 22 01-211	324-631	321-091	joint stock company	50	41.7	8.3 0 0	48.5	48	0.5
19	BIG S.A. Bank Inicjatyw Gosp.	Warsaw	Al. Jerozolimskie 44 00-950	268-454/9	270-013	joint stock company	58	40.7	17.3 0 0		49.5	
20	Amer Bank	Warsaw		248-505		joint stock company	50.5	38.3	12.2 0 0 0			

CREDIT RATES. JANUARY, 1993

No.	NAME	LOCATION	ADDRESS	PHONE No.	FAX No.	STATUS	LOANS RATES FOR SMEs: January'93 short-term < 1 YEAR % min.	% max.	long-term > 1 YEAR % min.	% max.	AVERAGE LOAN RATES IN 1993 %
1	Bank Gdanski	Gdansk	Targ Drzewny 1 80-958	260-461 311-423	317-361	state bank	46		51	54	50
2	Silesian Bank Bank Slaski	Katowice	ul.Warszawska 14 40-950	537-281/4 538-906	537-364 539-930	state bank	42				42
3	Bank of Industry and Commerce Bank Przemyslowo-Handlowy	Cracow	ul.Sw.Tomasza 43 31-027	628-55-86 223-333	229-287	state bank	50				50
4	Deposit and Credit bank Bank Depozytowo-Kredytowy	Lublin	ul.F.Chopina 6 20-928	217-12 203-04	240-85	state bank	40		50	58	50
5	Universal Economic Bank Powszechny Bank Gospodarczy	Lodz	ul.F.D.Roosevelta 15 90-950	382-231 329-440	365-044	state bank	44				45
6	Wielkopolski Credit Bank Wielkopolski bank Kredytowy	Poznan	Pl.Wolnosci 15 60-967	390-016 521-031	521-113	state bank	55	58			56
7	The Pomerania Credit bank Pomorski Bank Kredytowy	Szczecin	Pl.Zolnierza Polsk. 16 70-952	533-114 400-261	533-114	state bank					48
8	The State Credit Bank Panstwowy Bank Kredytowy	Warsaw	ul.Nowogrodzka 35/41 00-950	297-221 296-011/20	296-988	state bank	49	50	52		50
9	West Bank Bank Zach[illegible]	Wroclaw	ul.Ofiar Oswiecim.41/4 50-950	354-928 446-621	349-17 441-982	state bank	46		52	58	51
10	Bank Handlowy S.A.	Warsaw	ul T.Chalubinskiego 8 00-950	304-187 303-000	300-113	joint stock company	41	43	46		44
11	Bank PEKAO S.A. Bank Polska Kasa Opieki	Warsaw	ul.R. Traugutta 7/9 00-950	269-211	261-187	joint stock company	40			60	54
12	Export Development Bank Bank Rozwoju Eksportu	Warsaw	Al.Jerozolimskie 65/79 00-950	296-853 300-858	287-850 300-859	joint stock company					48
13	Polish Development Bank Polski Bank Rozwoju	Warsaw	ul.Zurawia 47/49	628-72-01		joint stock company			45	50	47.5
14	Upper Silesian Business Bank Gornoslaski Bank Gospodarczy	Katowice	ul.Warszawska 4 40-006	586-636 586-497	586-497	joint stock company					48
15	Creditanstalt S.A.	Warsaw	ul. Nowy Swiat 6/12 00-920	267-070	265-110	foreign bank	49	55	51	52	52
16	Citibank	Warsaw	ul.Senatorska 12 00-082	635-81-16 635-55-27	635-52-78	foreign bank	50				50
17	ING	Warsaw	Centrum LIM 6th floor 02-697	625-00-40 625-73-52	630-72-67	foreign bank	41	44			42
18	Credit Bank Kredyt Bank	Warsaw	ul.Kasprzaka 22 01-211	324-631	321-091	joint stock company	45	55	45	52	49
19	BIG S.A. Bank Inicjatyw Gosp.	Warsaw	Al. Jerozolimskie 44 00-950	266-454/9	270-013	joint stock company	57	59			56
20	Amer Bank	Warsaw		248-505		joint stock company	46	55			51

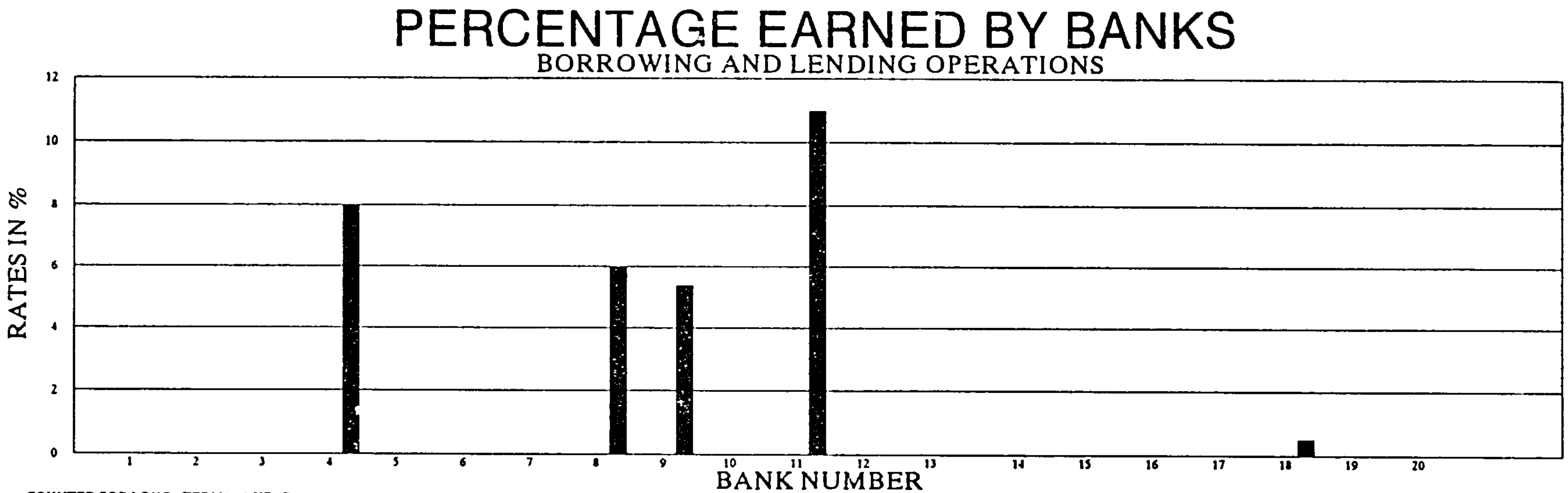
PERCENTAGE EARNED BY BANKS

BORROWING AND LENDING OPERATIONS



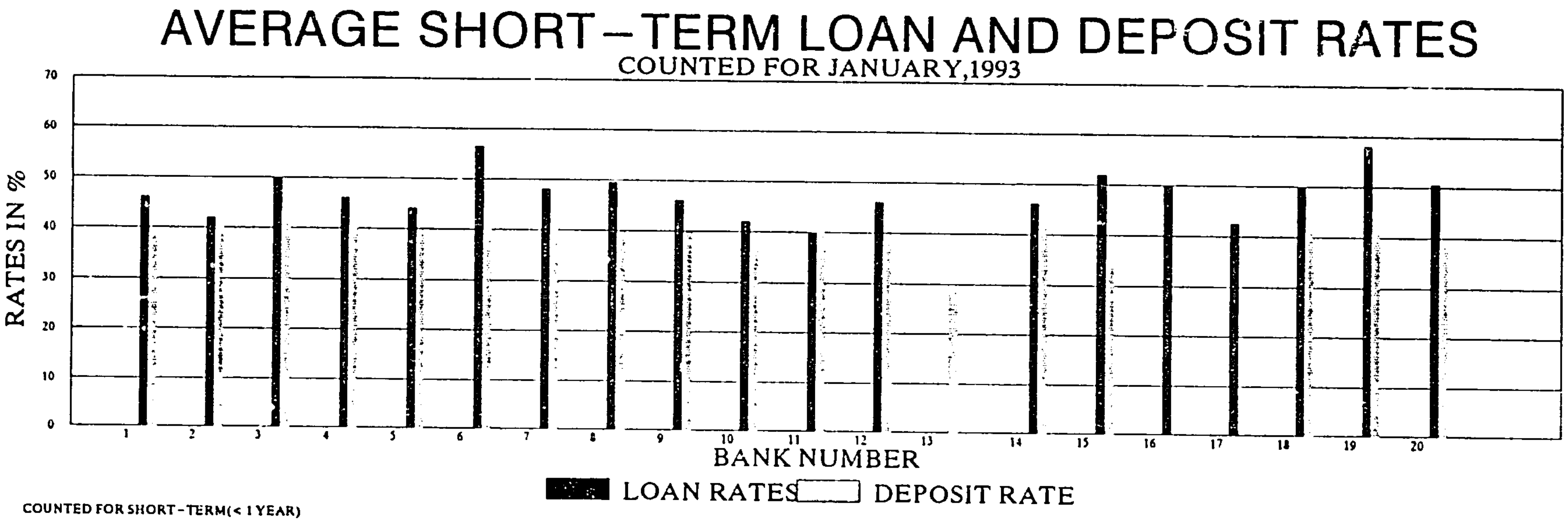
COUNTED FOR SHORT-TERM(< 1 YEAR)
JANUARY,1993

CREDIT RATES: JANUARY, 1993

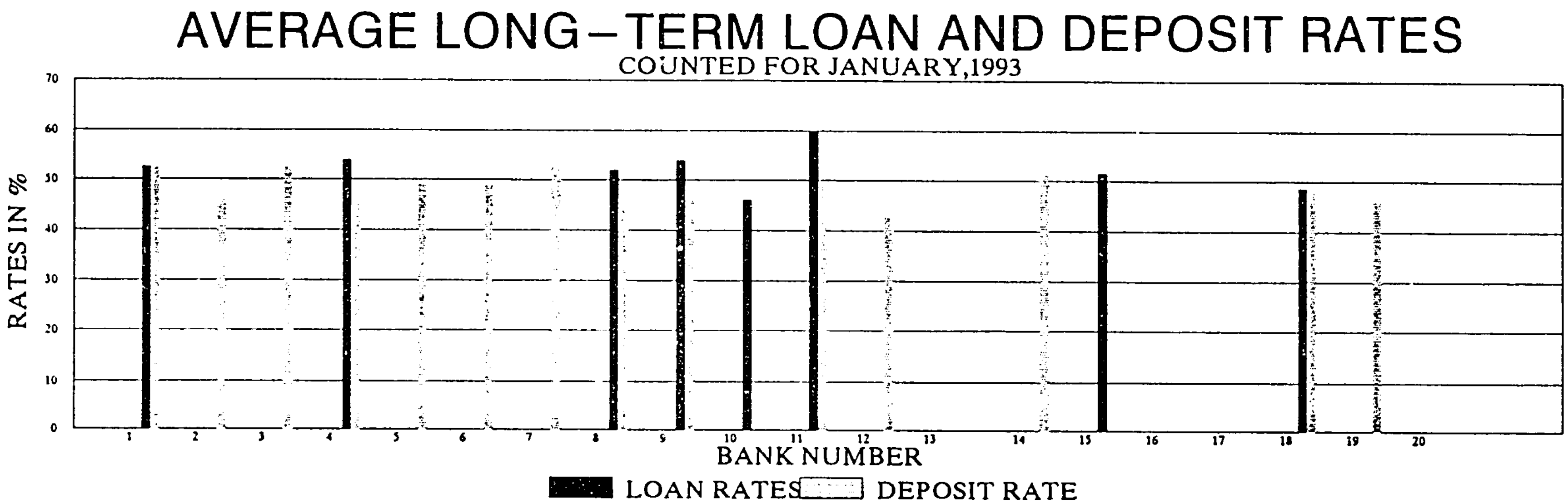


COUNTED FOR LONG-TERM(> 1 YEAR)
JANUARY,1993

CREDIT RATES: JANUARY, 1993



COUNTED FOR SHORT-TERM(< 1 YEAR)



COUNTED FOR LONO-TERM(> 1 YEAR)

DEPOSIT RATES: JANUARY, 1993

No.	NAME	LOCATION	ADDRESS	PHONE No.	FAX No.	STATUS	a vista	ROR	CURRENT 1 month	BANK 3 months	DEPOSITS 6 months	RATES: 12 months	JANUARY 24 months	1993 36 months
1	Bank Gdanski	Gdansk	Targ Drzewny 1 80-858	260-461 311-423	317-361	state bank	6.5	18		31	38.5	46.5	51	54
2	Silesian Bank Bank Slaski	Katowice	ul.Warszawska 14 40-950	537-281/4 538-906	537-364 539-930	state bank	6	16		36	40	44	48	
3	Bank of Industry and Commerce Bank Przemyslowo-Handlowy	Cracow	ul.Sw.Tomasza 43 31-027	828-55-86 223-333	229-267	state bank	5.5	19.95	19.95	35	42	52	53	54
4	Deposit and Credit bank Bank Depozytowo-Kredytowy	Lublin	ul.F.Chopina 6 20-928	217-12 203-04	240-85	state bank	6	18	20	35	41	44	46	
5	Universal Economic Bank Powszechny Bank Gospodarczy	Lodz	ul.F.D.Roosevelta 15 90-950	362-231 329-440	365-044	state bank	6	20		33	38	46	49	
6	Wielkopolski Credit Bank Wielkopolski bank Kredytowy	Poznan	Pl.Wolnosci 15 60-967	390-016 521-031	521-113	state bank	7	20	16	34	40	46	49	
7	The Pomerania Credit bank Pomorski Bank Kredytowy	Szczecin	Pl.Zolnierza Polsk. 16 70-952	533-114 400-261	533-114	state bank	6	20		34	39	48	55	
8	The State Credit Bank Panstwowy Bank Kredytowy	Warsaw	ul.Nowogrodzka 35/41 00-950	297-221 296-011/20	296-888	state bank	6	20		34	41	44	46	
9	West Bank Bank Zachodni	Wroclaw	ul Ofiar Oswiecim.41/43 50-950	354-928 446-621	349-17 441-982	state bank	6	14.4		34.8	39	45	47.4	49.8
10	Bank Handlowy S.A.	Warsaw	ul.T.Chalubinskiego 8 00-950	304-187 303-000	300-113	joint stock company	8		20	34.5	35	40		
11	Bank PEKAO S.A. Bank Polska Kasa Opieki	Warsaw	ul.R. Traugutta 7/9 00-950	269-211	281-187	joint stock company	9	16	22	37	42	44	48	50
12	Export Development Bank Bank Rozwoju Eksportu	Warsaw	Al.Jerozolimskie 65/79 00-950	298-853 300-856	287-850 300-859	joint stock company	10			35	38.5	41	44	
13	Polish Development Bank Polski Bank Rozwoju	Warsaw	ul.Zurawia 47/49	628-72-01		joint stock company			25	33				
14	Upper Silesian Business Bank Gornoslaski Bank Gospodarczy	Katowice	ul.Warszawska 4 40-008	586-636 586-497	588-497	joint stock company	6		18	18	42	50	51	52
15	Creditanstalt S.A.	Warsaw	ul. Nowy Swiat 6/12 00-920	287-070	265-110	foreign bank				33	35	37		
16	Citibank	Warsaw	ul.Senatorska 12 00-082	635-81-16 635-55-27	635-52-78	foreign bank								
17	ING	Warsaw	Centrum LIM 6th floor 02-697	625-00-40 625-73-52	630-72-67	foreign bank								
18	Credit Bank Kredyt Bank	Warsaw	ul.Kasprzaka 22 01-211	324-631	321-091	joint stock company	8		22	39	42	44	48	
19	BIG S.A. Bank Inicjatyw Gosp.	Warsaw	Al. Jerozolimskie 44 00-950	266-454/9	270-013	joint stock company	15		24	37	40	45	48	47
20	Amer Bank	Warsaw		248-505		joint stock company	10		20	35	40	40		

DEPOSIT RATES: JANUARY, 1993

No.	NAME	LOCATION	ADDRESS	PHONE No.	FAX No.	STATUS	a vista	ROR	CURRENT 1 month	BANK 3 months	DEPOSITS 6 months	RATES: 12 months	JANUARY 24 months	1993 36 months
1	Bank Gdanski	Gdansk	Targ Drzewny 1 80-956	280-461 311-423	317-381	state bank	8.5	18		31	38.5	46.5	51	54
2	Silesian Bank Bank Slaski	Katowice	ul.Warszawska 14 40-950	537-281/4 538-906	537-384 533-930	state bank	6	13		36	40	44	48	
3	Bank of Industry and Commerce Bank Przemyslowo-Handlowy	Cracow	ul.Sw.Tomasza 43 31-027	628-55-86 223-333	229-287	state bank	5.5	19.95	19.95	35	42	52	53	54
4	Deposit and Credit bank Bank Depozytowo-Kredytowy	Lublin	ul.F.Chopina 6 20-928	217-12 203-04	240-85	state bank	6	18	20	35	41	44	46	
5	Universal Economic Bank Powszechny Bank Gospodarczy	Lodz	ul.F.D.Roosevelta 15 90-950	362-231 329-440	365-044	state bank	6	20		33	38	46	49	
6	Wielkopolski Credit Bank Wielkopolski bank Kredytowy	Poznan	Pl.Wolnosci 15 60-967	390-016 521-031	521-113	state bank	7	20	18	34	40	46	49	
7	The Pomerania Credit bank Pomorski Bank Kredytowy	Szczecin	Pl.Zolnierza Polsk. 16 70-952	533-114 400-261	533-114	state bank	6	20		34	39	48	55	
8	The State Credit Bank Panstwowy Bank Kredytowy	Warsaw	ul.Nowogrodzka 35/41 00-950	297-221 296-011/20	296-888	state bank	6	20		34	41	44	48	
9	West Bank Bank Zachodni	Wroclaw	ul.Ofiar Oswiecim.41/43 50-950	354-928 446-621	349-17 441-982	state bank	6	14.4		34.8	39	45	47.4	49.8
10	Bank Handlowy S.A.	Warsaw	ul.T.Chalubinskiego 8 00-950	304-187 303-000	300-113	joint stock company	8		20	34.5	35	40		
11	Bank PEKAO S.A. Bank Polska Kasa Opieki	Warsaw	ul R. Traugutta 7/9 00-950	269-211	261-187	joint stock company	9	18	22	37	42	44	48	50
12	Export Development Bank Bank Rozwoju Eksportu	Warsaw	Al.Jerozolimskie 65/79 00-950	296-853 300-858	287-850 300-859	joint stock company	10			35	38.5	41	44	
13	Polish Development Bank Polski Bank Rozwoju	Warsaw	ul.Zurawia 47/49	628-72-01		joint stock company			25	33				
14	Upper Silesian Business Bank Gornoslaski Bank Gospodarczy	Katowice	ul.Warszawska 4 40-006	586-636 586-497	586-497	joint stock company	6		18	18	42	50	51	52
15	Creditanstalt S.A.	Warsaw	ul. Nowy Swiat 6/12 00-920	267-070	265-110	foreign bank				33	35	37		
16	Citibank	Warsaw	ul.Senatorska 12 00-082	635-81-18 635-55-27	635-52-78	foreign bank								
17	ING	Warsaw	Centrum LIM 6th floor 02-697	625-00-40 625-73-52	630-72-67	foreign bank								
18	Credit Bank Kredyt Bank	Warsaw	ul.Kasprzaka 22 01-211	324-631	321-091	joint stock company	8		22	39	42	44	48	
19	BIG S.A. Bank Inicjatyw Gosp.	Warsaw	Al. Jerozolimskie 44 00-950	286-454/9	270-013	joint stock company	15		24	37	40	45	46	47
20	Amer Bank	Warsaw		248-505		joint stock company	10		20	35	40	40		

APPENDIX C

VENTURE CAPITAL STUDY IN THE REPUBLIC OF POLAND

PHASE I

December 1992

Paper by FACET BV

Consultants for small and micro enterprises

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Study 'Venture Capital* for SME's in Poland' Phase I.

Summary of conclusions

Finance for the restructuring of the Polish economy is at present (autumn 1992) not sufficiently available. Savings circulate in the money markets more than anywhere else and are not invested into the economy.

Privatisation as part of a restructuring program, will necessarily destroy part of the existing capital base and can only succeed if new capital, management and technology is invested simultaneously.

Whether as spin-offs from the former state-owned companies or as greenfield investments, small and medium sized enterprises, SME's, will play a decisive role in innovating and expanding the Polish economy, as they have done in all other developed economies.

SME's cannot afford the high interest on bank loans and are faced with extreme collateral requirements when borrowing anyway. SME's therefore have restricted possibilities to innovate and grow.

For SME's to play their decisive role in establishing a new economical order, as they have done elsewhere, the right conditions have to exist or be created. A necessary condition is the availability of capital for investments.

Where bank lending to SME's is lagging behind in Poland, risk-bearing finance is the only practical source of new finance at the moment. Informal investments, for instance by family and friends, and retained profits are limited sources of risk-bearing capital. Venture capital* is the potentially most important source of new risk-bearing capital in Poland to be considered.

It takes a promotional effort to make SME's aware of venture capital as a source of finance, while at the same time taking away some of the misgivings and misunderstandings that are in existence about venture capital.

At present, very limited amounts of venture capital are available for SME's in Poland. At the same time, there is a high demand for venture capital with SME's. This would call for more venture capital, provided SME's do not only ask for new capital but are also able to absorb it in a productive way.

* *For a glossary of venture capital definitions and concepts, see appendix 1.*

The ability of SME's to absorb venture capital will first of all depend upon the quality of their internal business functions, such as finance & administration, marketing, production and management of human resources. Where this quality is generally low, as in the case in Poland, venture capitalists would have to hedge against future failure by offering not only new money, but also technical assistance.

Supplying scarce venture capital and technical assistance makes more sense when the SME's involved belong to the best prospects available among all SME's that can be identified as potential receivers. This puts high demands on the identification and intake coverage of venture capital operations.

The identification and intake of new ventures will require some form of regionalised network to cover a wider area and obtain informal information at 'grassroots' level, that makes up for the lack of reliable formalised business information about SME's applying for venture capital.

This kind of 'retail' networking would ideally lead to co-investing between partners, who share the risk between them. For a foreign venture capitalist, networking with a Polish counterpart will definitively diminish exposure to risk.

When a venture capital structure for SME's is established in the Polish economy, banks can and should in their own interest support venture capitalists, to whom they play a complementary role, e.g. by referring their clients to venture capitalists, by teaming up to combine loan and risk bearing capital for particular clients or even by co-funding venture capital operations.

A gouvernmental guarantee scheme for venture capital seems a useful instrument to stimulate the venture capital industry and through this Polish SME's.

Existing venture capital operations should be very seriously taken into account as potential partners of new Venture Capital Funds. The eventual creation of syndicates to spread risk and a mutual informal market to sell participations in are very interesting possibilities.

Sources of venture capital are to be found in Poland and abroad. There would have to be no shortage of venture capital, provided certain pre-conditions have been met.

Establishing and running a venture capital fund for SME's seems potentially a feasible operation with important positive effects for the innovation and growth of the Polish SME sector.

I. Actual situation with regard to the use of loans versus equity by Polish SME's

I.1. Historical background

Until the abandonment of State Communism Polish companies in general went to State banks, which were in reality acting as disbursement agents, for finance at relatively low interest rates. Looking for other sources of outside finance was irrelevant for corporations since these were neither wanted nor available. Financial skills were therefore not developed in a modern sense.

During the early days after the shedding of Communism this situation was continued as long as the banks did not introduce more severe lending conditions, which in the meantime they did. This helped to establish and maintain high levels of financial leverage with the state-owned companies, which are hampering the growth of the economy. As far as newly established private firms are concerned, these are staying away from short term bank lending as much as they can, because they cannot afford it. This fact also hampers growth.

During the central planning economy the focus was on production. Only manufacturing targets had to be met and goods manufactured today were fetched tomorrow by state sales organisations. Through this there was no need for commercial skills, which until today are lagging behind. The main problem here does not seem to be a lack of focus on sales so much as on marketing, which requires purchasing, manufacturing, packing, distributing, selling and supporting products in a systematic way, based on individualised planning.

Weak financial and marketing skills have caused a haphazard approach or complete neglect of essential business functions and have therefore also had a direct impact on the standard of business and feasibility plans, financial prognoses and cash flow calculations. Through this the Polish SME is in general not really an adequate prospect for a 'hands-off' venture capitalist who would not be willing or able to assist the SME in building up its business functions.

Equity capital for new SME ventures is mainly found with family and friends, because entrepreneurs take a dim view of sharing control of their companies with some outsider, who they do not know. Polish companies have no history of partnerships. It could be stated without much exaggeration that the attitude here seems to be one of keeping complete control, even when this would endanger the survival of the business.

This attitude seems to be confirmed by some of the few existing Polish venture capital operations who claim their clients initially do not want any equity financing and are looking for loans instead (from venture capitalists). It takes some explaining by venture capitalists to convince SME's that it is not the 'driving seat' the new investors are after. (See under V.1.)

A completely different bur more common source of equity funding is the relatively widespread custom of importing a foreign joint-venture partner's equipment and materials into Poland as a payment in kind for the shares the foreign partner gets in the Polish-foreign joint-venture.

This kind of equity investment can not be considered a venture capital deal in the strict sense, in that partners are 'insiders', involved 'hands-on', and in practical terms fully aware in advance of their mutual contribution to the commercial perspective and general viability of their new venture. Estimates are that the size of this equity financing in kind is considerable, compared with all the other sources.

Finally, it should be mentioned here that an eventual redistribution of state-owned assets would require a structure beyond the scope of venture capital organisations, but would certainly add to the capital structure of private companies and through this to the effectiveness of venture capital, which by origin is meant for the expansion of companies that have a trim capital base already, more than for their financial restructuring.

In the wake of any kind of privatisation operation, new SME's will emerge as direct successors to the state-owned enterprises and as spin-offs, taking on new activities. These SME's will be very aware of the significance of loans versus equity and how to structure their balance sheets by carefully balancing both sources of finance.

I.2. Loans versus equity ratios

A survey of financial structures, as shown by the balance sheets and new investment plans of Polish SME's, shows a very erratic pattern, which is to be expected in view of the short lives these SME's have led so far and the lack of reliable branch information.

Moreover, SME's attract new money wherever they can get it, which is not in many places. Because of this, using one source of capital (say equity provided by family and friends) does not mean there is an abundance of this type of capital, *quod non*, or that there is apparently no interest in other capital sources (say bank loans). Or, one step further, that even if there were no apparent interest in bank loans, changing/normalising the lending conditions would not lead to a vast demand for bank loans (which it most probably would).

A reflection of the aforegoing is found in the following debt/equity ratios, which were taken from the client-records of a Polish accountancy firm, working in the Polish market under 'western' supervision.

Branch	Equity/debt ratio
Clothing industry	14 : 1
Shoe and leather industry	1 : 1
Food processing	1 : 5
Construction	1 : 1
Services	1 : 3

We shall not draw any conclusions from the material presented here, other than that venture capitalists do not find any substance in financial statistics to base their preference for specific branches on.

II. The role of the banks as financeers of SME's

II.1. Present situation

Even though Poland has over 80 licensed banks and something like 1600 (small) cooperatives (unlicensed), which makes one inclined to believe Poland is to some degree 'overbanked', the banking sector is not at all competing to attract new SME customers.

Banks in Poland have a very near horizon and think in terms of 3 to 6 months rather than 5 to 8 years as venture capitalists do. This kind of short term finance, when not supplemented with adequate long term lending or equity, leads automatically to negative working capital, where fixed assets that revolve slowly are financed with short term borrowing. This in fact also helps to establish a short term view amongst entrepreneurs.

The technical obstruction to long term lending is the fact that deposits entrusted to the banks are also short term. The fact that interest on deposits is not taxed, helps to keep savings in the money-market instead of freeing them for investments. Another factor that reinforces this of course is the state-guarantee of deposits placed with state-owned banks.

It can further be noticed that banks, from a managerial point of view, do not know enough about their client's business to take a longer term view. Also, to take such a view they would have to be able to put more trust in their client's business plan, collateral and expected cash-flow. This could mean they would not readily finance long term capital needs, even if they had the funds for it.

The few international schemes for long term lending, like e.g. the EBRD long-term lending arrangement as operated by ING Bank, seem to bypass SME's, because the latter have relatively low project sizes. In the case of EBRD the required size is at between 1,000,000 and 10,000,000 USD (however note that the average investment is at approx. 2,000,000 USD), with a further requirement of 25% own capital. This 25% is not supplied by Polish banks, since Polish banks only lend short term.

Short term lending by Polish banks, in practice the only finance available, puts high demands on collateral, to be provided by investors:

- Machinery is not considered a collateral at all, mainly because the legal system is not waterproof in assigning a specific piece of machinery to a specific creditor who would have to claim 'his' collateral.
- Debtors are not considered a collateral at all, compared with more sophisticated economies where 60 - 70% of accounts receivable serve as loan-coverage. The same goes for stocks, with the exception of certain rigid stocks in accepted bonded warehouses, of which the keys are almost literally in the hands of the banks.
- Mortgages, when given (not by all banks) are given up to 50% of real estate value, although no bank we have spoken to seems to have any experience yet with executing for instance an occupied residential building, even though the law seems no longer to strictly prevent such action, as it did before.

Contrary to the excessive lending conditions, the lending criteria of Polish banks are not uncommon when compared with those in further developed economies and are in themselves rather healthy criteria, applied to the intake of lending prospects.

Banks ask for a business plan or feasibility-study, balance sheets/profit and loss accounts and realistic prognoses both in words and in numbers. Not many SME's however are able to supply such information because they do not have it or because they are unable to present it in an acceptable form.

The banks do not render any noticeable assistance in this matter. Also, the existing formalised methods and manuals for making and testing business plans (such as Unido's *Comfar*) seem to b too general, too abstract and too little user-friendly to be of great value.

So far the Polish banks and other financial institutions have not come up with solutions for the problems sketched above, which can be summarized as follows:

- no long term lending
- much emphasis on short term lending under severe conditions
- lending criteria that SME's in general can hardly meet
- no adequate assistance and co-thinking with SME clients

The outcome of this situation is that growth of the SME-sector is not stimulated by the financial sector.

II.2. Some positive developments

The negative implications in connection with the present situation in the Polish financial sector a generally recognised but not really considered to be quickly solvable. Some efforts are being m however. A mention has to be made of the World Bank's USD 60 million loan, borrowed an le on to Polish businesses through other banks. This loan is explicitly meant to support the creatio of new private business by

- providing finance for loans to private enterprise, particularly SME's
- overcoming deficiencies of business practices
- building support services for private enterprise development

This may well be the kind of structural approach the SME ector will be able to benefit from.

A positive development of a more qualitative nature seems to be the creation of Capital Market Centers by the big banks, such as Bank Handlowy and the Polish Development Bank, where t employees are trained to understand such new phenomena as:

- debt-to-equity swaps
- mergers and acquisitions
- longer term view development

III. Equity as an alternative to loans for financing the Polish SME

III.1. Insufficient loan capital

For a start, it must be observed that the commercial banks, state-owned or private, are very careful when lending to SME's, which leads them to stay away from overdraft and to restrict themselves to (heavily) secured loans.

It is vital to notice that Polish banks are offered and have widely embraced a much safer outlet for their investment capital than lending to SME's: interbank lending and state-guaranteed bonds and securities, that yield a profitable margin at virtually no risk. (The total size of this money market segment is at 20 billion USD, October 1992).

In cases where banks do lend to SME's, collateral in the form of guarantees, mortgages etc. has to be very high, which decreases the SME's capacity to borrow, to a higher degree than it would in fully developed capital markets. The excessive freezing of assets for the sake of bank security, blocks the way to use part of them as collateral in other directions or to divest them in exchange for liquidity or other much wanted assets.

Of course it is true that the applied lending rules are reducing excessive recourse to debt, which may be good from a financial policy point of view. For the real economy of goods and services however, excessively reducing the SME's disposition of assets that could play a role in furthering growth of investments, sales and profits, is bad. The effect is that SME's run dry with no loans at all or are stuck with expensive loans, whose interest decreases their capacity to retain profits as a source of finance and may even be the cause of losses and untimely bankruptcy. In both cases, the growth of the economy is negatively effected.

Even in an economy where banks thrive on corporate clients instead of the money market, the need for equity capital is clearly demonstrated by the enormous growth of the venture capital industry all around the industrialised world. (For Europe see appendix I).

Another negative effect is scored by the government budget deficits, causing high pressure on available capital and raising interest rates.

III.2. Venture capital instead of existing debt

In more sophisticated economies this kind of conversion in general has to be understood as an indirect conversion, meaning future venture capital instead of future debt financing. A direct one-on-one conversion of existing indebtedness by venture capital has no priority, because venture capital aims at capital gains through the financing of additional business activity and not at financi[al] restructuring by paying off the banks *per se*.

In cases where venture capital is consciously used to pay off banks, this is generally not done on one-on-one basis, but against an exchange rate which is unfavourable to the banks in situations where the latter have no option but to accept or lose all.

In the situation of Polish state-owned enterprises, conversion would have to be applied directly to existing debt as long as existing loan obligations are not waived by the banks or their eventual successors or at least depreciated in a substantial way. Restructuring the balance sheet by getting rid of suffocating bank loans through the input of new risk-bearing capital in that case would be the only way to restore sound financial conditions.

It could be imagined that the eventual further privatisation of the Polish economy, through the privatisation of selected large State enterprises and/or a mass privitisation programme to prepare a large number of smaller enterprises for private ownership (e.g. through management/employee-buy-outs), would popularise equity as a source of capital and indirectly work to the advantage of venture capital introduction. Also, the complementary roles of the banks, private owners and venture capital institutions would become more visible.
When privatisation is accompanied by foreign-debt-to-equity schemes, foreign venture capital institutions are offered another incentive to enter the market, because investment cost is made lower.

With or without any institutionalised legal backing of debt-to-equity swaps, venture capitalists would necessarily have to be able to discuss book values of the assets involved in relation to their replacement or expected future cashflow values. Deteriorated buildings and equipment would be abandoned, maybe rented but rarely bought without a considerable discount. Apart from the economic principle at stake, owning something that has or may have belonged to a predecessor seems to be an option that is still to be avoided in Poland.

In the case of private new ventures without a history of large employment numbers, indebtedness to banks and ownership disputes, there would clearly be much more manoeuvering space for venture capitalists to invest directly into unhampered innovation and growth.

III.3. Venture capital for innovation and growth of SME's

For some years to come profit regeneration to finance innovation and growth is not expected to be a sufficient source of new capital for Polish SME's. In the meantime, long term finance will have to come from outside SME's, venture capital being a natural source for investments that take a relatively long time to mature.

Venture capitalists are not investors in the stricter sense, in that they have more than a fractional interest in a company and wish to have the same information that the management has. It is especially this involvement that makes venture capital an interesting source of finance for SME's.

Innovation and growth rates of SME's are shown to have improved through the investment and involvement of venture capital. The main reason for this seems to be the fact that venture capitalists have indeed one focus when investing in a company: to make as big as possible a capital gain. To achieve this they monitor their investments closely with the eye of an entrepreneur rather than a financeer.

Venture capitalists may be expected to be the most business orientated financeers that the Polish economy can attract. They do not come in for a short period, but for 5 years or more, meaning they will be around for the whole period or growth phase that they have initialised by participating.

IV. Sources of venture capital and where to invest it

IV.1. Sources of venture capital

The original sources of corporate finance are:
- retained earnings
- bank credit (on collateral or as overdraft)

Venture capital became popular in the USA during the late 1970's, later to be followed by the UK and continental Europe. It is found in many sources, ranging from private individuals to the gouvernment. However, a pattern has emerged, that we will represent for Europe as a whole.

Sources of European venture capital in 1991

Corporate investors	5,1%
Private individuals	4,7%
Government agencies	1,6%
Banks	36,2%
Pension Funds	14,6%
Insurance companies	11,3%
Academic institutions	0,3%
Other sources	9,0%
Realised capital gains available for reinvestment	17,2%
Total new funds 1991	100,0%

There are reasons to assume that the sources mentioned above are in principle also available to the Polish economy and therefore the SME sector. Banks will not go into venture capital participations direct, but through venture capital funds in which they invest. Several banks have expressed interest in this. Realised capital gains, being the gains made on venture capital portfolio divestments on exit, is a source that will exist wherever venture capital exists, growing over time as portfolios mature.

Some Polish insurance companies are already into venture capital in a structured way (see under VII. 4.). However, insurance companies (19 licensed life and non-life) and pension funds (ZUS) in Poland still lack the substantial savings necessary to play a dominant role as institutional investors. Private individuals (type 'relatives and friends') and corporate investors are at the moment THE source for venture capital.

A comparison with the situation in Hungary, where a venture capital market has very recently been established, learns that in 1991 the following sources for new venture capital funding were tapped:

Sources of venture capital in Hungary in 1991

Corporate investors	53,9%
Private individuals	6,9%
Government agencies	13,1%
Banks	15,6%
Realised capital gains available for reinvestment	10,5%
Total new funds in Hungary in 1991	100,0%

IV.2. Identification of sectors eligible for participation by external investors

When the development phases of companies are taken into consideration, venture capital in Poland seems at the moment applicable to all but one development phases, i.e. to start-up, expansion, replacement and management buy-out phases, but **not to seed-finance phases**.

This one exception is a logical consequence of the fact that 'seed' financing refers to the development of an invention or idea that needs to be demonstrated as feasible before even a business plan is made, let alone a complete management-team exists. This is a very high-risk form of venture capital. In an economy which is relatively open to imports it is really only applicable to state-of-the-art innovations, which beat the competition by being more advanced and most of the times even protected by international patents. The present standing of the Polish economy does not indicate state-of-the-art levels in many sector of the economy where such high-risk investments are warranted.

During the study a number of promising sectors for venture capital were mentioned, such as:
- food industry, mainly agro-type
- bio-technology
- exporting light industry, such as
  . furniture and other wood products
  . footwear and leather
- construction
- energy and environmental protection
- transport and communication
- services, especially in the financial sector

When trying to find the most interesting sectors, it should be borne in mind that the Polish economy is, and will be for an uncertain amount of time to come, unstable. SME's come and go, or change their activities practically overnight. Company records are lacking or unreliable and the institutional registration functions are not fully in place. Therefore, much of the available statistical information on 'the' sectors of the economy is bound to be losing its factual basis upon or even before publication. This is the main reason why it is not the sectorial structure of the economy that venture capitalists should be focusing on.

Of course it is not implied here that the screening of any sound quantitative data is to be neglected. Venture capitalists should clearly be interested in as much data on management and company activities as they can obtain and trust. One just has to bear in mind that a desk-research approach is not a realistic option, when considering a 'due-diligence' process to verify the quality of any given prospect.

Our conclusion here would have to be that the identification of good investment prospects needs to be done at micro-level, that is at the level of individual SME's, more than at the level of sectors.

As has been the case in developed economies, specialisation of Venture Capital Funds as to sectors, market-niche's etc. will gradually develop later. In practice, this means that the managers of a Fund will divide the market between them and each specialise in specific sectors.

With a view to the necessity to invest scarce funds into the best available prospects, much attention will have to be given to selecting among the vast amount of SME's. Identification of ventures eligible for participation at micro-level will therefore require a well established network, covering enough of the Polish economy to come to the right SME participations.

V. Stimulating SME's to use venture capital

V.1. Promotion

To spread knowledge of venture capital among SME's, promotion campaigns are a 'must'. Methods to be used include:
- mailings
- advertisements
- road-shows
- brochures and leaflets
- public appearances, also on television and radio
- free publicity
- magazines, such as the brand new Financial Sector Magazine, published by Mediabank S.A.

SME's are not used to sharing ownership with investors. It is therefore wise to address and explain that situation at an early stage, to avoid the kind of misunderstanding and disappointment that would give venture capital a bad name.

The following questions need to be answered at a very early stage:
- Does the SME really need venture capital or are there any better alternatives? These may include leasing, merging with another SME, a joint-venture etc.
- How big should the participation be in terms of power transferred? If the participation tends to be too big for the SME's management to swallow, loans instead of share capital could be the solution. However, if the venture capitalist is a foreign operation, one has to take into account the fact that corporation tax is significantly lower if foreign shareholding exceeds the 30% range.
- What price is the venture capitalist willing to pay for his share in the SME? With this respect it is very important that the valuation methods applied are accepted by both sides.

A big point should be made of the fact that venture capital is for the longer term, say 5 - 10 years, and aims at structural improvement of the company-record. Too much reference to the 'upside' of the venture capitalist is to be avoided, although it is clear that a healthy profit must be in the cards to interest venture capitalists in the first place.

The intake-process should not take too much time or cost too much money. Lawyers making the contracts must do so at reasonable fees. Contract-standardisation, still allowing some flexibility, is cost-effective and should be applied. The use of consultants should not lead to disproportionate cost. Making use of existing volunteer-schemes offers some solution although real consultancy commitment stems from commercial involvement more than from any other form.

V.2. Technical assistance

Any institution, whether completely private, or financially backed by the Polish or any other state, that considers entering the market for venture capital on the supply-side, is confronted with clients that suffer from deficiencies in almost all aspects of business-knowledge and experience, even though they may be able to hide some or most of it.

Venture capitalists offering just money would certainly be forced to put severe demands on the client's financial standing and business track-records to avoid being drawn into ventures doomed to fail. This would mean that only low-risk prospects would be taken in and funded, a situation also existing on the supply-side of the market for loan capital.
A western-style due-diligence process at intake is off the mark, as it would put too much emphasis on finding problems that are there anyway and ask to be solved, not to serve as an eventual motive for withdrawal from the project.

There is a feeling in the financial world that venture capitalists will be looking at track-records too much. For management of SME's this will not create a fair chance. Also, it would automatically lead to neglecting greenfield investments, which are valuable in the present stage of development of the Polish economy.

Venture capitalists can only really add to the restructuring of the Polish economy by offering technical assistance. Such assistance could be restricted to functional support, e.g. in the field of administration and marketing, or could even include complete managerial take-over as in a management buy-in.

To gain the trust of SME's as potential users of the funds it is mandatory for venture capitalists to offer and apply constructive forms of assistance right from the beginning, when the business idea is translated into a feasible business-plan.

It would make sense for venture capitalists to invest some of their available investment funds in centralised technical training facilities, especially serving SME's and therefore also their own investees. This could be a profitable operation, taking into account the possibility to oblige investees to follow its programs as part of the investment contract.

V.3. Bank sector as linking pin

Business-plan creation is mentioned by the banks as the main technical issue facing the venture capital sector. Since banks are confronted with many unstable business plans and with many clients that need business partners before needing new money, the banks are bound to play an important role in linking up SME's with venture capitalists, both to enhance credibility and standing of venture capital and of the SME's involved. This goes to show that banks and venture capitalists can and will play complementary roles in the economy.

A problem still is the relative unawareness of the banks regarding SME practices and problems. Apart from the positive effects to be expected from the existing twinning-arrangements with foreign banks that exist for 7 of the 9 state-owned banks, continuous attention will have to be given to training the loan officers, directly or through training the trainers programs. A major issue seems to be the making and evaluating of a business-plan, including descriptions of at least the following areas:
- commercial side
- production
- finance & administration
- personnel
- external factors

(It is worth noticing however that a business plan has to remain the plan of the entrepreneur, who has to be fully committed to it).

V.4. Consultants

Already the emergence of a consultancy layer between SME's and the financial sector has become visible in Poland. Consultancy services are of utmost importance to SME's and to venture capitalists alike. Consultants may help SME's to understand the benefits of venture capital in relevant cases, apart from their function as developers of strategic and operational business functions inside SME's.

Venture capitalists will have to use consultants when taking in or upgrading their SME participations, for which they themselves are not sufficiently staffed. Training the consultancy sector, as for example PBAS/3P, a joint-venture of the International Finance Corporation and the European Bank for Reconstruction and Development, is doing is of utmost importance and has a direct positive impact on the venture capital sector.

V.5. Some practical cases

As part of the study individual meetings with several companies and institutions from the area were prepared by the Business Support Centre (Centrum Wspierania Biznesu) of Lodz, at the request of the Polish Cooperation Fund in Warsaw.

The meetings were seen as a way to get in touch with SME-practices, to be used as field-research material for the venture capital study. They also served to underline the need for technical assistance and consultancy as felt and expressed by the different participants in the discussion.

Company 1
This is a 100% private owned enterprise. Company 1. builds roads and bridges and needs a new machine to lay bitumen roads at high speed. They have guarantees from local government to lay several hundreds kilometers of new B-roads, now sandy roads. Turnover in '92 shall be DM 700.000, profits before tax 20%.

The machine they have in mind is a German machine, costing DM 400.000 and halving laying cost. There are however also other suitable machines, to be determined also by the eventual joint-venture partner. They have no bank loans, which are too expensive.

It is agreed that they need a strong business plan before they are able to approach a joint-venture partner or a venture capitalist. They expressed a need for assistance with making the business plan.

Company 2
This is a 100% private owned enterprise. It builds house-blocks, of which the parts are prefabed in their own plant. So far they have only been building for housing foundations, which pre-pay for the work as it progresses. Without this they would be in liquidity problems. They have no bank loans, which are thought to be far too expensive, except for so-called 'technology-loans' at 38%, which is the interbank lending-rate.

They now wish to tap the large market for private house-blocks, and work for their own account. This of course requires money and/or a partner. The risks in this market are higher but so are profits.

Company 2. is interested in talking about risk-bearing capital, as supplied by a venture capital fund or any other risk-bearing source. They need some assistance with the preparation of the business plan.

Company 3

Company 3. is a manufacturer of upholstery-fillings, which are made from coconuts out of Sri Lanka. They are 100% state-owned. Turnover is at DM 2.000.000.

Theirs is not a totally unique product, but since labour cost is at 25% of total cost in this particular manufacturing process, Polish low wages play a positive role in taking on foreign competition in their own markets (mainly Austria and Germany, total exports are at DM 600.000).

Company 3. wishes to find a partner who buys the company from the state and continues its operations. This could be a branche-companion, but also a more general furniture operation, or a venture capital fund. Asking price will probably equal book value (DM 4.000.000), but actual buying price can be lower. Also investments up to DM 3.000.000 are needed for mechanisation. After this the workforce could be reduced from 200 to 150.

They have had talks with a German manufacturer of seats for the car-industry, but these are not in a hurry. Company 3. therefore wishes to put pressure on them, while at the same time creating opportunities in other directions. It was agreed that the actual production of a solid business plan will take care of pressure meant, as the Germans clearly would understand and hopefully also fear its multi-applicability in the venture capital and take-over market.

Company 3. would need some, but not much, assistance when preparing the business plan, and some consultancy support with regard to doing the deal with the government.

Company 4

This is a privately owned policlinic, housed in a 2.000 sq. metre building with its own laboratory and pharmacy.

They need 100.000 USD to finish the existing operation, as it would allow them to make the following investments:

- *X-ray machine*	*20.000*
- *Peripheral Doppler*	*30.000*
- *Working Capital*	*40.000*
- *PR, advertising*	*10.000*

The working capital need is for buying drugs, which they will use themselves and resell to other hospitals, clinics etc.

The clinic was established on the basis of a 1.000.000 USD IDEA-loan, interest paid in advance, real disposition 700.000 USD. They now need to complete the outfit.

Management has at this moment much bigger plans, requiring several millions of dollars, but it was agreed to first show capability of finishing what was started.

Company 4. is now working on a business plan, that will enable it to get the necessary funds, preferably from some venture capital operation.

VI. Building the supply-side of venture capital

VI.1. Policy measures

As we have already stated, there are reasons to assume that adequate sources of venture capital are in principle available to the Polish economy and therefore the SME sector, provided the right pre-conditions exist.

One general pre-condition that would have to be fulfilled for venture capital to become a forceful factor in developing the Polish SME sector is the establishment and maintenance of political stability, as venture capitalists perceive it. The presence of Poland on the high-risk countries list of export credit insurance companies is a negative factor that has to be addressed by the Polish gouvernment.

Monetary policy should make clear how depreciation of the Zloty is being slowed down and eventually controlled. Grounding a strong exports sector on in part the depreciation-instrument, as has e.g. happened in South American countries, is to be avoided if one intends to integrate into a greater economical environment (say 'Europe') as a stable partner.

A negative fiscal policy factor will be the fact that, while interest on deposits is and will remain tax-exempt, capital gain on equity is going to be taxed in 1994. (In 1992 and 1993 it is tax-exempt). This would certainly not add to building the supply-side of venture capital.

The main policy factor influencing the supply-side of equity capital certainly is the privatisation process. The slowing down of this process would prevent more liquidity from flowing into the equity sector and also greatly hamper the development of the stock exchange, eventually one of the main exits out of venture capital participations.

Some other conditions under which to build the supply-side of venture capital are mentioned below.

VI.2. Retail networking

There is every reason to assume that recourse to equity has generally been blocked in Poland in at least two ways:
- co-ownership is distrusted by SME entrepreneurs, if not explained properly
- there is very little private or institutional risk capital available outside SME's

Both negative factors seem to put the initiative on the supply side. Even when this is so, the creation and functioning of a Polish market for equity capital requires more market transparency than is available now to enable assessment of the risks that are involved.

That is to say that even when SME's would embrace co-ownership and Venture Capital Funds would emerge in the market, the money might still not be invested because of insufficient or a negative insight into risks involved.

Some of the elements involved when assessing risk are:
- company track-record
- management track-record
- business-plan
- shareholders protection
- accounting standards
- taxation of profits and capital gains
- legal rights and liabilities
- stock-market and other exits

All these elements have to be clearly taken into account and understood by the investor before he commits himself.

Accounting standards for example have improved with the introduction of new requirements for company record-keeping and the production of financial statements. (1991, based on the EC's fourth directive). The accounting regulations however, deal with audit requirements for SME's (or any other companies) only in a limited sense, so more is expected to come from the Ministry of Finance. Especially the Polish practice that financial statements are used only to show that companies have observed legal and tax regulations has to be redressed so, that these statements in the future will serve also to give a fair and true view of the state of the companies' affairs. This latter application is the one venture capitalists are interested in before entering an investment, while monitoring it and wnen exiting from it.

Accounting standards have to allow for a clear evaluation of a prospect. Net asset value of a company (total value of assets minus liabilities) has to be based on 'true' value, which in practice requires revaluation of assets and liabilities. Discounted cash flow evaluation, based on expected future earnings, requires unambiguous monitoring standards (See under VIII).

Taxation is a factor already mentioned under VI.1. It can be added here that loss carry-forward is somewhat restricted, which is unfavourable in most venture capital situations where initial loss through growth/development-cost is consciously 'risked' with the expectation of full compensation with future profits. The absence of such full compensation might make initial losses too 'risky

Legal rights and liabilities have to be known in full, which requires a legal audit upon intake of new ventures. Especially property rights, such as usufruct, easements, pledge and mortgage are sometimes badly visible and also spread, which requires thorough and costly investigation.

As far as 'exits' are concerned, these will occur after 5-8 years, aiming at capital gains without any intermediate dividend payments. The stock-exchange is only one (and at the time not an ideal one) exit, others being the sale of the company to another corporate entity, the sale of the venture capital position to a (foreign) financial investor, a (re)purchase by a joint-venture partner who is in on a deal. Selling back to the Polish entrepreneur is also an option, but most of the times not realistic due to a high share-value if the venture has been successfull. The venture capitalist will have to assess his exit possibilities, especially if they are restricted.

So, even before a 'due-diligence' or verification process becomes relevant, there is the pre-screening or intake-period where the right SME's are identified and the wrong ones shed.

The identification of SME's, eligible for participation by external investors, will necessarily have to take place at ground level, where these SME's are operating. As we have seen earlier, their is neither much affinity with or knowledge of equity and venture capital with SME's, which indicates that SME's will as a rule not take the initiative and come to venture capitalists to discuss partnerships. Venture capitalists will therefore have to cast a rather wide net, that covers the country or parts thereof at 'retail' - level and approach SME's that way.

Retail venture capital networks require a strong regional or local component. Examples of such networks are:

Tise, disposing of a 15-office regional network, which makes it possible
- to identify and screen prospects at close range
- to supply not only the capital but also the support that may lead to the success of SME's involved. Consultants and technical assistance (SIDI, Peacecorps, etc.), are available on a no-cost *ad hoc* basis.

Business Support Centres, one out of the ten existing centres being part of the European Business & Innovation Centre Network. They are normally (but not always) connected to Chambers of Commerce and Industry, but do not take over their functions. They assist local business on all matters relevant to business development.

Regional Development Agencies, the Ministry of Industry and Trade/IDA and the Voivod (and sometimes also the Solidarity Economic Foundation) being the shareholders in the majority of cases. The RDA's stimulate regional development and do some investing of their own.

Cooperation of Venture Capital Funds with local and regional institutions like business support centres, chambers of commerce and regional development agencies enhances visibility and trust.

VI.3. Risk-sharing through co-investing

Venture capitalists will assess their risk as completely as possible. If they cannot estimate the extent of their exposure in a deal they will not do the deal, unless somebody else would bring the risk back to an acceptable level by co-assessing and sharing it.

Risk-sharing through co-investing is a normal practice for venture capital funds. Especially when a specific knowledge or experience is lacking, finding a partner can be the key to doing the deal or leaving it. As long as venture capital remains a little known phenomena in the Polish economy, it is to be expected that some outside expertise has initially to be involved in any case if and when new venture capital funds are to be established.

The specific knowledge lacking in such a case would be 'inside' knowledge of the Polish economy, its business climate, its business people and its ways to check on the formal and informal track-records of businesses and their management.

Co-investing with knowledgeable Polish partners helps to deal with this problem. It would also embody exactly what is needed in a developing economy: partnership-application of skills and experience during a period of transition.

VI.4. A venture capital guarantee scheme

Lending institutions like the World Bank, International Finance Corporation, European Bank for Reconstruction and Development, European Investment Bank, Phare, Cooperation Fund, Bank for Food Economy, whose available credit-lines are meant to be invested into companies, also SME's, experience rather slow disbursement into the economy and are looking for means to speed up the process, for instance through the eventual creation of a guarantee fund.

After the second world war most 'Western' gouvernments decided to stimulate their economies in various ways. State-guaranteed loan capital was one of the first instruments to induce new ventures. As long as the capital base of the economy remained high, no need was felt for the introduction of measures to create more risk-bearing capital.

During the 70's however companies started to show higher and higher leverage levels (ratio of loan capital to equity capital), mainly because higher added value led to disproportionately higher wages and lower profits, meaning less profits were available for investment.

In 1981 the Dutch gouvernment created a guarantee scheme to explicitly stimulate the creation and growth of SME's through additional risk-bearing capital. This was done indirectly by stimulating the creation of private Venture Capital Funds, that would invest into SME's. This scheme, that has undergone some changes over time, is basically still existing today.
Under the scheme, private Venture Capital Funds investing in SME's are offered a guarantee, stating that part of their losses incurred when investing in SME's shall be covered by the Dutch Gouvernment. In practice this meant that approximately 50% of losses on risk-bearing investments in SME's, made in accordance with certain rules and regulations, were paid back to the Fund by the State.

The guarantee scheme is generally thought to have had a profound influence on the establishment of a thriving and large venture capital market in The Netherlands, that has contributed considerably to the strength and variety of the Dutch private sector. In particular the readiness to invest in young and starting companies has increased.

An assessment of the effects of the guarantee scheme indicates that an extra Dfl. 40.000.000. in profit tax revenues is received by the Dutch State annually, whereas the total amount of annual loss-compensation payments under the scheme is much lower than that.

Also, every investment under the scheme has added 50% in employment during the investment period, totalling approximately 10.000. persons over 7 years. (One has to bear in mind however, that the Dutch economy is highly capital-intensive and that the employment effects will almost certainly be -much- higher in more labour-intensive economies, where labour is relatively cheap, as is the case in the Polish economy).

It has also been shown that the investment levels of Dutch SME's has on average more than doubled (from Dfl. 1,4 million to over Dfl. 3 million) during the involvement of venture capital funding, indicating that the company's innovative and growth potential had been strongly improved by this type of funding.

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A venture capital guarantee scheme for the Polish economy is certainly something worth considering, even at this early stage. Recourse to (semi-) gouvernmental regional development funds only, as seems to be the tendency, would certainly be valuable, provided no political criteria but strictly socio-economical criteria are applied. The emergence of private Venture Capital Funds would introduce a yardstick for measuring the gouvernmental investment sector and also create much needed possibilities to cooperate in co-investing schemes.

The creation of new jobs is clearly a policy issue for any government. As there are indications that the creation of a stable new job takes a financial input of between 5,000 (Enterprise Credit Corporation) and 7,500 USD (Bank Bise), venture capital could play an important role in re-employing people coming out of the privatisation process.
A governmental guarantee scheme, where the government shares the risk through carrying part of the losses incurred, provided these losses did not come about through negligence, would almost certainly have an impact on the introduction of venture capital. Experience in other countries, e.g. the Netherlands, has shown that the direct cost of such a scheme can be low and even negligible when compared with the indirect gains, such as less unemployment payments, more income and profit tax revenues.

VI.5. Information services

A requirement for a venture capital market to properly function would be the availability of information services that could be used to attract and verify information on companies, persons etc. that need to be screened before investing. At the moment, there are at least two noticeable initiatives

- Warta-TIM, who is working on a data-base, holding information on several hundreds of Polish companies, to which a considerable number is added every month. The information is at micro(company) level and serves to check credibility of companies and persons. Internationally Warta-TIM works together with Dun & Bradstreet.
- Centre for Privatisation, working with the so-called CePont database, that holds information at branch-level and follows 63 branches in the Polish economy.
- National Chamber of Commerce (KIG), offering some forms of verification services.

Size of the market

At this stage, only educated guesses can be made about the size of the venture capital market in Poland. From our discussions with several venture capital parties we gather that an amount of at least 100.000.000. ECU could be invested in venture capital deals within 3-5 years. When looking at the Hungarian market, where 23.000.000. ECU were invested during the first year of measured venture capital activities, this does not seem a wild guess at all.

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VII. A concise description of some venture capital organisations that are already active in the Polish market.

VII.1. Enterprise Venture Capital Corporation (EVCC) capital 10 million USD, 75.000 - 500.000 USD per project, committed 2.5 million USD in 15 projects

EVCC, in operation since May 1991, is a 100% daughter company of the Polish American Enterprise Fund and also run by them. Management uses a 'window-system' to reach out into the Polish economy. This system entails a cooperation with 9 banks, 8 of which are regionally spread, who operate 'windows' and 'sub-windows', staffed with trained screening officers to identify and assist viable business opportunities for investing. The training was based on the experience gained by the South Shore Bank of Chicago, when implementing a development scheme for the black community.

Companies, mainly private SME's, are getting help with filling out application forms (of 24 pages), preparation of the business plan etc. The 'window-system' also enables the rendering of technical assistance, for which very rarely outside consultancy is called in.

Up till now, 15 projects have been financed by the EVCC, all except one with loans however. At the same time the EVCC is expecting to do more equity deals in the future, since they feel they have now established their operation and gained enough experience to assess and take on risks involved with equity exposure. The main obstacles, according to EVCC, seem to be

- the lacking capability of the entrepreneur to make a solid business plan
- the unwillingness of the banks to follow the venture capitalist into an entrepreneurial approach of business activities
- the fact that entrepreneurs are not familiar with share-capital.

The market for venture capital is thought to be 'huge', which is why the EVCC thinks it will be doing more equity-based deals in the near future.

VII.2. Caresbac-Polska S.A. capital 5.2 million USD, 75.000 - 300.000 USD per project, committed 1.5 million USD in 5 projects, minority interest (25 - 49%)

Caresbac-Polska S.A., operational since 1991, is a joint-stock company, operating under Polish law, whose shares are held by Caresbac-USA (majority), the Cooperation Fund and the Foundation for the development of Polish Agriculture. The company's staff consists mainly of well trained and experienced finance and development experts with an international background.

The company's main purpose is to invest on strictly commercial terms in private SME's with between 15 and 100 employees, annual turnover of between USD 150.000 and USD 1.500.000. and current owner's equity of between USD 50.000 and USD 500.000. (read: Zloty-equivalents of these dollar amounts). Furthermore, they wish to supplement such investments with advice and support, mainly in the fields of finance, business administration and commercial activities. For this latter purpose Caresbac maintains relationships with support organisations, working with volunteers.

Investments are as a rule at between 25 and 49% of total paid-up share capital. Procedures followed include
- intake of prospects by Caresbac's regionalised network, including some of the chambers of commerce and the network of Tise in syndicated deals
- a quick screening of such prospects to check viability and agree on main issues
- development of the business plan

Caresbac-Polska claims it has identified some preferential sectors for investment, such as
- agro-food
- light industries for export
- businesses supporting the housing industry
- essential business services, like printshops and software services
- businesses helpful to the environment

Investments made to date, totalling 5, include
- a horticultural farm
- a poultry slaughter house
- a poultry farm equipment trader
- a software company for accounting/m.i.s. services
- a manufacturer of matresses.

Investment decisions in a final stage include a state farm privatisation project and a producer of apple concentrate.

Management feels the market for venture capital is very large, provided the right technical assistance can be offered. One of the main venture capital objectives would have to be strengthening the balance sheet by de-leveraging, i.e. roll over credits into equity.

VII.3. TISE, capital 7 billion zlotys, max. 500 million zlotys per project, SME's exclusively (approx. 10 - 50 employees), minority interest (below 50%)

Tise, or: Company for Socio-Economic Investments, was established in 1991. Tise is offering financial and other support to SME ventures from intake to exit, or from day one until on average 5 years after participation. The company shall soon be raising its capital basis to 7 billion zlotys.

Tise addresses solely SME's employing on average between 10 and 50 persons. Per enterprise a maximum of 500.000.000 zlotys is available. This means Tise is aiming at companies and projects that are considerably smaller than those in the target groups of EVCC and Caresbac-Polska.

For some valuable bigger projects however, syndication is established, for example with Caresbac-Polska. Also in some cases, cooperation is sought with commercial banks that supply loan capital. Participations amount to less than 50% of total share capital and are to last approx. 5 years. In some cases additional loan capital is made available. An important other activity is the leasing of machinery and tools. Over 1992 Tise is expected to commit 1 billion zlotys.

In order to qualify SME's must be able to show expected economic profitability and social value, like the creation of employment for lowly qualified people in socio-economical weak regions. Apart from offering money, Tise also organises technical assistance by Polish or foreign experts. It is important to notice that Tise is basically a non-profit organisation supported by the Ministry of Labour. Its performance is to be measured in terms of keeping the Fund intact in real terms (premiums on share-sales minus inflation minus investment losses) and of showing acceptable levels of capital spent per job created.

It is therefore that Tise, even though it is a non-profit organisation, stays away from higher-risk investments. SME track-records that show a history of earlier funding having gone the wrong way or that indicate personal problems within the local socio-cultural environment will prevent money from being invested.

Tise works closely together with its shareholders, Bise (Bank for Socio-Economic Initiatives), Fise (Foundation for Socio-Economic Initiatives) and Sidi (Société d'Investissement et de Développement International S.A.). Through this it is embedded in a network where knowledge of finance as a tool for economic development is available. What is more, a regionalised network of 15 agencies, under Fise, is available for intake, screening and monitoring of projects and training and supporting of SME-management.

The fact that the capital base of Tise is being raised in spite of selective/restrictive investment policies demonstrates that the market, also for the 'safer' projects, is considered to be not fully tapped. It seems likely that the further development of skills and experience within the Tise structure will eventually raise the level of acceptable risk, creating a wider range of action. An additional contribution to this is expected from local guarantee funds -now being discussed-, capitalised with money from local institutions.

Tise has no specific branches or sectors that it invests in, although there seems to be a preference for agro-related projects, also in connection with the geographical regions where the Tise network operates.

Some sectors where Tise is invested are:
- Dairy-industry
- Flour Mills
- Fruit juices
- Furniture
- Clothing
- Food processing

Some examples of recent investments by Tise are:
- a producer of fodder for rabbit farms
- a dairy project in public/private partnership
- a workshop for wood products
- a manufacturer of construction materials

VII.4. Warta-TIM, 20 operational people, shares held by Warta Insurance company and several Polish trading firms

Warta-TIM is an example of how financial and other strengths in the private sector (insurance companies and businesses corporations) are combined by a Fund manager and applied in a venture capital sense. Warta-TIM operates four lines of activity:

- assessing investment prospects for the shareholders (e.g. Swarzedzkie Fabryki Mebli)
- investing direct into companies (e.g. the furniture and the shoe industry)
- working as a business information service in cooperation with worldwide Dun & Bradstreet
- collecting debts

Investments are based on a positive assessment of business plans and feasibility studies presented. Warta-TIM has a preference for prospects that need money plus management support. Through management support they are upgrading companies, which they can then sell to industrial buyers (trade sales). Apart from the people from their own operation they can also involve specialists from their shareholders in the ongoing upgrading processes that require specialised expertise. Occasionally third party experts are hired.

At the moment they are in a consortium with foreign banks tendering for the 'Management of a national investment fund under the Polish mass privatisation programme.'

Participations shall not be smaller than 10% and always require a seat on the supervisory board. Apart from share capital also loans are offered to viable businesses.

It should noticed that most SME's will probably fall short of Warta-TIM's requirements, in that investments have to be rather short-term and rather large in money terms. At the same time it is clear that a venture capital fund would sometimes wish to syndicate bigger deals with this professional investment company that could render an 'inside' second opinion, or use it's management capacities. Since a venture capital fund needs profitable large deals to counterbalance management-intensive smaller SME-deals and protect overall profitability of the fund, Warta-TIM could indirectly play an instrumental role.

VII.5. Significance of existing venture capital operations in Poland

The existing venture capital-type operations in Poland, dealing with SME's, are of great value. They will assist in making venture capital a financial instrument that is both understood and accepted by Polish SME's and by investors, whose contributions will help to enlarge existing venture capital funds and create new ones.

A very interesting aspect in connection with the present forerunners is that the eventual exit from the SME's invested in would not only have to be sale of the shares to the management or other local interests, but also to venture capital operations established later, that can offer more capital and wider networks, for example reaching across border. In fact, this kind of informal market for participations is now being created between venture capital organisations in Western European countries as a way to enhance access and exit possibilities.

VII.6. Some further venture capital funds to come into the market:

- Avalon Ventures for bio-technology, 70 million USD
- Polish Private Equity Fund, 150 million USD in equity subscriptions; to invest in SME's
- Amsterdam Pacific Corporation, method: management buy-in, upgrading, reselling.

VIII. The significance of accounting and financial disclosure standards and practices.

VIII.1. General

In 1991 new regulations on accounting were issued by the Ministry of Finance. These regulations, based on the European Community's Fourth Directive, aim at significantly changing some of the requirements for company record-keeping and presenting financial statements.

However, the internationally accepted accounting and auditing standards and services are still under development in Poland. There is also the fear that over-regulation might stop the development of the Polish private economy dead in its tracks. The role for an independent auditing profession and its organisations in the whole process of verifying any new standards, will therefore be a limited one for the time being.

A special mention must be made of the fact that under the current (new) regime Polish companies are obliged to produce as financial statements only a balance sheet and profit and loss account, whereas venture capitalists will have to insist on cash flow projections also, meaning the future extension of the regime to include these projections would improve the climate for venture capital to grow in.

To bridge a time-gap here, we are referring to what we have already said earlier in this study (see under V.2.): that venture capitalists need to give technical assistance. Especially the training of financial management techniques would serve both sides of a venture capital deal.

The lack, at some specific points, of some financial information does not necessarily mean the exposure of venture capitalists in Poland would have to be unacceptably high when compared wi other, further developed countries. This is because even in a 'western' setting accounting standards, also when applied to the full, can never take away the necessity to look at other financial or non-financial data which are of special interest to venture capitalists, like information on directors, management and employees, premises, analyses of sales, markets and competitors analysis of contribution, production, suppliers, detailed description of the basis for valuation of fixed assets, inventory, debtors, cost of sales, labour costs and others.

The lack of financial information just means that venture capitalists will have to work out and apply some further standards and safeguards for themselves, which would then be imposed on and possibly paid for by the seekers of this finance who are actually receiving investment mon

It is very important that most of the information asked for in the first instance, is prepared by t management, under the assistance of the venture capitalist, rather than by the outside accounta as this will help to create a better mutual understanding of the business itself and its environm

It is very likely that the management will need both conceptual and technical assistance in preparing financial statements (balance sheets, profit and loss accounts and cash flow projections). Here is a task for venture capital institutions, who have to look at these figures anyway to answer the question of how much the business could afford to borrow and as a re how much equity will be required.

The information mentioned above is already on the checklists used by banks when investigating their credit clients. Because of the different levels of risk involved in 'debt' activity and venture capital activity, the accuracy and reliability of the information required by venture capitalists, who are not covered by collateral, will have to be -and as we have seen can be- higher.

VIII.2. Valuation with regard to venture capital risk-assessment

Review of balance sheet with respect to valuation at intake and/or exit

- **Fixed assets**	
. Building	Who owns it What value
. Land	Who owns it What are the environmental claims/liabilities
- **Current assets**	
. Inventory	What is value of finished goods
. Receivables	Who are debtors and how good are they
- **Provisions**	Any environmental claims
- **Long term debt**	Currency applicable to debt
- **Current liabilities**	Currency applicable to debt and payment-terms

During the study it became clear that presently most balance sheet figures presented to venture capitalists would include overvaluation of some kind, often to an intolerable degree. However, if one agrees upon the standards and the auditors to be used beforehand, this does not mean a venture capital deal would be 'wild'. It would just mean a venture capitalist would have to use the proper (network of) expert assistance when taking in prospects, making cost of doing so part of the deal.

Our conclusion has to be that the present status of accountancy application in Poland, although underdeveloped, is not a real threat to the development of a venture capital market. As with other business functions, such as general management and marketing, technical assistance should be rendered to bridge the gap between 'risk' and 'gamble', enabling hands-on corporate developme: approaches to prevail over the risk-avoiding detachment of bankers.

Appendices

1. Glossary of venture capital definitions, concepts, data, etc.
2. List of visits and discussions in connection with venture capital study

Definition of venture capital:

Venture capital is risk-bearing capital for companies or projects with a more than average risk-profile.
Specific characteristics of venture capital are:

- there is no collateral for the venture capitalist
  (Venture capital looks to future cash-flows more than to past balance sheet figures)
- there are no guarantees given to the venture capitalist
  (The only guarantee he has is his own expertise in assessing the risks involved)
- venture capital input is a substantial part of total equity, but not necessarily a majority
  (Venture capitalists are happy with co-owning but not with running the company)

Size of European venture capital market end of 1991

Total funds raised until end of 1991:	33,0 billion ECU
Total funds invested until end of 1991:	18,4 billion ECU

Sources of European venture capital in 1991

Corporate investors	5,1%
Private individuals	4,7%
Government agencies	1,6%
Banks	36,2%
Pension Funds	14,6%
Insurance companies	11,3%
Academic institutions	0,3%
Other sources	9,0%
Realised capital gains available for reinvestment	17,2%
Total new funds 1991	100,0%

Breakdown of sectors invested in 1991

Communications	1,6%
Computer related	5,6%
Other electronics related	3,3%
Biotechnology	1,9%
Medical/Health related	3,8%
Energy	1,7%
Consumer related	22,4%
Industrial products and services	12,9%
Chemicals and materials	3,7%
Industrial automation	0,6%
Transportation	5,1%
Financial services	2,6%
Other services	14,5%
Other manufacturing	9,3%
Agriculture	1,3%
Construction	3,3%
Other	6,4%
Total investment all sectors	100,0%

Development stages of European company-investees of venture capital 1991

% of total amount invested 1991

Development stage *	
Pre-start or seed finance stage	1,0%
Start-up stage	5,9%
Expansion stage	52,6%
Replacement capital stage	5,9%
Management buy-out	34,6%
Total	100,0%

*** Defining the development stages, as applicable to European venture capital:**

Pre-start or seed
- concept stage; no profits or losses, because there is no business yet
- backing an entrepreneur or a technology (invention)
- no management team in place yet
- no precise product or service definition yet
- no business plan available
- no track record established
- focus on technical viability + business plan development + management recruiting
- potential reward 60 - 80% rentability per year
- downside (risk): lose everything

Start-up stage
- well-conceived business plan available
- key members of management-team are in place
- some product development risk still there (more 'Development' than 'Research')
- no track record established yet
- focus on market and marketing strategy
- potential reward 40 - 60% rentability per year
- downside (risk): lose everything

Expansion stage
- scale-up stage; loss to break-even situation
- largest capital requirements for working capital more than to cover losses
- focus on market development and on manufacturing scale-up
- showing some track-record already
- potential reward 25 - 40% rentability per year
- downside: lose everything

Replacement capital stage
- existing shareholders wish to sell
- existing capital base too narrow
- restructuring and preparing for public share offering
- creating a capability to attract more banks loans
- focus on reinforcement of in-company business functions
- potential reward 20 - 35% rentability per year
- downside: (continuation of) losses

Management buy-out
- present ownership not 'best' long-term solution for company
- existing management wishes to control company through (co-)ownership
- venture capital needed to retain solvability
- focus on independent strategic position in market
- potential reward 15 - 30% rentability per year

Main forms of venture capital
- ordinary shares with voting rights, entitled to dividend only after all other company cost has been met
- preference shares without voting rights, but with priority rights regarding dividend and repayment
- sub-ordinated loans, often convertible into shares later

2 main positive opinions about venture capital
- venture capital enables growth where banks are not interested
- venture capital enables companies to survive in difficult periods

2 main negative opinions about venture capital
- a partial loss of independance for the entrepreneur
- some venture capitalists put excessive demands on companies

Modern characteristics of the venture capitalist:
- they are very professional
- they are taking no 'gambles' but only calculated risks
- they are able to give more than just money:
  . functional support in earlier stages (commercial, financial, technological expertise)
  . strategic support in later stages (positioning in market, clustering of activities)
  . networking all the time (contacts and introductions to important people and institutions)

How to approach the venture capitalist
- business plan
- strong management team

Contents of business plan
- history
- people
- products and markets
- production
- f & a
- external factors

Main subjects of evaluation at intake of new investments
- management
- market
- technology
- risk/reward

Main factors for success estimated at intake
- excellent management
- rapid market growth
- proprietary technology
- low capital intensity
- high involvement venture capitalist

Main factors for failure estimated at intake
- poor management
- undifferentiated product/service
- premature technology
- high capital intensity
- low involvement venture capitalist

Breakdown of good and bad managerial skills looked at by venture capitalist

good	bad
. high energy	. slave driver
. optimistic	. ignores risk
. team builder/leader	. poor manager
. visionary who is driven to succeed	. inflexible vision
. creative/unstructured	low interest in planning and control

Reasons for involvement with investment
- monitoring the investment
- realising capital gain in time

Forms of involvement with the investment
- supervisory board
- regular management information
- support and advice

Monitoring-procedure applied by venture capitalists
- regular information (m.i.s. has to be ok)
- management/shareholders contracts
- supervisory board

Exits out of investments
- trade sale (sale to another company)
- sale to other VC-funds
- flotation on the stock-exchange
- reselling to management

Trends in venture capital in Europe
- more and more later stage investments
- fewer but bigger transactions
- larger positions in portfolio companies, thus more influence
- start-up and early-stage only without dilutive financing by other capital investors

Appendix 2. List of visits and discussions in connection with venture capital study

Government

- Ministry of Finance
  mr. Andrew L. Kozlowski Esq., legal adviser to the minister

- Ministry of Industry and Trade
  mrs. Jolanta Tanas, director Department for the Promotion of Entrepreneurship

- Council of Ministers, office for the Minister of Enterpreneurship Promotion
  mr. Andrzej Gerhardt, director
  mrs. Aleksandra Duda, head international

- Cooperation Fund
  mrs. Krystyna Gurbiel, deputy director general
  mr. Charles L. De Smet, adviser
  mr. Mart Nugteren, adviser

International institutions

- Industrial Development Agency of the EC
  Dr. Lothar Nettekoven, senior adviser

- International Finance Corporation/3P
  mr. Gijs van de Mandele, managing director

- European Bank for Reconstruction and Development
  mr. Witold Radwanski, deputy resident representative

- The International Foundation for Capital Market Development and Ownership changes in Poland, Centre for Privatisation
  mr. Jerzy Krok, general director

- Dutch Embassy in Poland
  mr. Arjen Uijterlinde, trade secretary

- Development Alternatives inc. Gemini
  mr. Bruce Heatly, adviser

Banks

- National Bank of Poland
  mr. Jerzy Hylewski, director

- Polish Bank Association
  mr. Andrzej Wolski, assistant managing director

- Bank Handlowy
  mr. Edward Zbik, director

- ING Bank
  mr. Jos de Wit R.A., assistant general manager

- Amer Bank
  mr. Wlodzimierz Paszkowski, corporate banking associate

- Polish American Enterprise Fund
  mr. Piotr Kowalski, vice president

- Bise S.A.
  mrs. Nathalie Bolgert, senior account manager

- Wielkopolski Bank Kredytowy (in Poznan)
  dr. Hanna Gruchman, vice-president

- Bank Komercyjny 'Posnania' S.A. (in Poznan)
  mgr. Henryk Sobkowiak, vice-president

- Bank Market
  mr. M. Wojcichowski, president (in Poznan)

- Agricultural Credit Association (in Poznan)
  Dr. Marian Krol, president

- International Bank in Poland S.A.
  mr. Alfred de Serière, president

- PKO Bank
  mr. Krzysztof Ciosek, deputy manager

- Polish Credit Bank

Venture capital organisations

- Tise
  mr. Zbigniew Bondarczuk, managing director

- Caresbac-Polska S.A.
  mr. David A. Fisher, senior advisor
  mrs. Sarah M. Fisher, senior advisor

- Enterprise Venture Capital Organisation
  (see under Banks, Polish American Enterprise Fund)

- Warta-TIM S.A.
  dr. Andrzej Pielak, president
  mr. Stanislaw Bialecki, vice-president

Regional and local organisations

- Business Support Centre Lodz
  mr. Bartlomiej Walas, director

- Lodzka Agencja Rozwoju Regionalnego
  mgr. inz. Marek Skoczylas, vice-president

Companies and business clubs

- Small business club Warsaw
  mr. Wieslaw Witkowski, board member

- Company 1. Spolka z o.o. (in Lodz)
  mgr. inz. Janusz Opalek, vice-president

- Sekompo civil co. (in Lodz)
  mrs. Ewelina Zawadowska, M.Sc.C.E., president

- P.Z. Jaxa (in Lodz)
  mrs. Greta Wojcieszak, managing director

- Form Spolka z o.o. (in Lodz)
  mr. David Janer, president

- Company 3. (in Lodz)
  mgr. Henryk Kospin, director

- Medical Centre of Lodz Spolka z o.o.
  Dr. N. Med. Andrzej Berner

- Avny Industries Co.
  mr. Joseph Abernacio, president

- Johnson & Johnson Poland Spolka z o.o.
  mrs. Tanja Naastepad, division manager

- Zelmer ZZSD
  dr. ing. Boguslaw Madera, director

- BDO Binder z o.o.
  mr. Tomasz Zdziebkowski, office manager
  mr. Tomasz Adamczyk, consultant

APPENDIX D

PROJECT FOR CREATION AND OPERATION OF A CAPITAL FUND FOR THE POMORSKI REGION (GDAŃSK AREA)

Gdańsk, November 1992

Prepared by: Regional Development Agency

DESCRIPTION OF THE VENTURE

A/ General goal and the background

The currently existing methods of financing of SMEs in Poland are highly unsatisfactory and in general, are characterized by excessive share of the entrepreneur's own funds in the planned venture. This fact seriously limits the scope of feasible economic investments. In addition, the financing by the bank credits, especially of the new investment projects, includes the range which is too narrow. It is all connected with the lack of enough capital for financing so called "own contribution" and with the lack of appropriate collateral (mainly properties and guarantees). The important factor discouraging the investments by the way of bank credit is the excessive interest rate of local credits. There is lack of strong institutional investors, supporting investment projects. Out of the external sources (mostly bank credits) only **sure investments, where the risk is small** are financed and as a rule they are fully secured on properties. The banks are not willing to finance the projects where the risk level exceeds the limits they normally accept. This situation combined with total lack of the subjects interested in financing the ventures of middle or higher risk level on polish credit market, in practice makes impossible the implementation of vast part of the investment projects in the private sector, especially the new ones. Particularly the investments connected with introducing high-tech.

That is why there is a need to fill the gap existing on the market of investment project financing. It can be done by creating a capital fund specialized in financing and guarantying the **projects of middle and higher risk**.

B/ Specific goal

The specific goal is to create an enterprise - financial institution, bearing the proposed name **Pomorski Capital Fund - PCF** (Pomorski Fundusz Kapitałowy SA), operating for profit, in the field of financing investment projects of middle and higher risk level. The detailed description of the methods and techniques is presented in the further part of this report.

MARKET

A/ Demand

PCF is going to finance and guarantee:
* new and already operating private SMEs, mostly from Gdańsk region;

* investment projects of different level of engagement;
* strongly growth oriented enterprises with energetic management, which have enough potential market for their products or services, to be able to ensure for PCF an income which is appropriate to the level of the risk.

The Fund could guarantee the following:

- the middle and long term loans for SMEs and hand-craft establishments in the Gdańsk region;
- the temporary and minority shares in the capital of the SMEs of the region, lodged by the institutional investors or by capital risk companies.

According to the obtained information, only in the Gdańsk agglomeration there exists about 1300 private companies with relatively stabilized employment over five workers. Great part of those companies are strongly expansive and represent the potential customers of the PCF. The particular expansiveness is shown by the trading companies, and among these companies the particularly big percentage is represented by big companies. There is also a number of energetically growing enterprises owned by natural persons and a number of partnership companies. However, from the point of importance for the country economy, the PCF should chose companies involved in production or rendering services as its main partners.

B/ Supply

At the moment, practically, there is no supply of the financial means for investments of middle and higher level of risk in the polish financing market. There are some first tries to conduct the activities on equity financing basis done by some newly created financial institutions as for example Polish Development Corporation. However according to the obtained data, all these activities are either on the declarations or in a very preliminary stages. There is no activity based on near equity financing at all. There are no institutions dealing with generating of investments pools basing on their clients order. Big part of low interest rate credits out of euro-credit lines is not utilized due to lack of the guarantee or credit securing system. It makes impossible for the enterprises not having enough collateral to access those credit lines. Emerging possibility of complementary financing based on equity would expand the possibility of utilizing euro-credit lines.

INVESTMENT STRATEGY

The PCF should be a highly flexible investment partner, introducing different forms of financing depending on individual project:
* guarantees would be given for the loans obtained from institutions granting ordinary or extraordinary credits for SMEs and hand-craft establishments from the Gdańsk region, or for shares of the institutional investors or capital risk companies in the SMEs of the region, in order to create, or expand or enrich or change of the structure of those enterprises. The investments aimed at replacing or rescuing the deficit enterprises will be not allowed.
* The PCF would finance SMEs of middle and high growth ratio.
* The PCF financial engagement in the projects should be within the limits from 200 million to 10 billion zloty (depending on the possessed means) and will complement bank financing, especially the one from euro-credit lines.

* It can be assumed that the typical engagement of the PCF in a single project would be on the level of 2-4 billion zloty.
* The percentage of the shares of the PCF in the total value of the financed investment should be within 10-30%
* The PCF should be a patient investor preferring investments to be implemented within the period of two years and the repay period not longer than 5-7 years.
* The PCF would finance the economic ventures in the different stages of their development; to begin with a start up, through expanding the activities or restructuring, up to the ownership transfer.
* The PCF would be an easy accessible source of professional financial and managerial advice for its customers.
* Through involving its capital, time and its employees expertise, the PCF would contribute to expand the whole investment market.

FINANCING TECHNIQUES

The PCF will implement its investment strategy through:
a/ Investing into the capital of the enterprise - equity financing (for example purchase of the shares or bonds of the financed venture). It is assumed that this kind of action would involve 1 - 3 billion zloty.
b/ Investing through near equity financing. It is assumed that this kind of involvement should engage the financial means from 1,5 to 5 billion zloty. It can be foreseen that this kind of the financing will follow the below procedure:
* the agreement for financing a part of the project by the way of loan should be concluded;
* the agreement precisely defines the interest rate and term of repayment;
* the agreement defines certain moment in the future, when the creditor will be given an opportunity to change the loan into shares or bonds basing on the price agreed beforehand;
* during the time of the agreement the PCF enjoys the right to strictly control the finances of the enterprise concerned.

The example for the above is granting a loan with two years repayment waiting period, with the rate of interests higher by two points than the interests rate of euro-credit (for example LIBOR), providing that half of the loaned capital could be changed into shares or bonds of the financed project in the 4th - 6th from the start of the financing. The decision would be based on the financial results of the venture.

C/Complementary loan financing. It is assumed that this kind of financing could involve the means from 250 million zloty up to 2,5 billion for one venture. This form will be utilized exceptionally, only, when there is no possibility to obtain financing out bank credit line.

* **Loans for SMEs**
The loans will be granted for physical investments, excluding buildings, and for the following non physical investments: patents, licenses, research and development programs, expanding trade networks, software. The limitations imposed by this list can be subject to a change.

The guarantees will be given for the SMEs from the Gdańsk region which are operating in the field of the industry
(together with food processing) and services. The retailers will not be able to obtain the guarantees.

*** The loans for hand-craftsmen**
The loans will be granted for the necessary investments for founding, expanding or modernization of the hand-craft workshops in the Gdańsk region. The loans for purchase of buildings will not be guaranteed.

**d/Guarantees for the loans obtained from other source
(mainly banks)**

*** Guarantees for middle and long term loans**
The guarantee will be given basing on rational economic criteria, and it cannot be higher than a half of the loan value. The SMEs and hand-craft enterprises utilizing the guarantee should contribute annual fee amounting to 1% of the guaranteed sum remaining to be rapid.

*** The guarantees for purchase of shares or bonds**
The guarantees will be given to purchase shares or bonds in to become an owner or co-owner in order to secure the risk of lose connected with capital investments made by institutional investors or capital venture companies in SMEs or hand-craft establishments of the Gdańsk region. The above guarantees concern the same sectors as mentioned above for SMEs and hand-craft establishments. The minority shares and equity shares (up to 30%) aiming at obtaining profit within given time and constant growth of the net assets of the enterprises in which the share was purchased, are considered here in order to enable further physical and non physical investments. The guarantee will be given for defined risk level and for certain amount. The risk involved in the guarantee cannot exceed 50% of the sum spent for the share purchase, while the amount guaranteed cannot ne higher than defined limit (the indexation according to General Statistics Office - GUS retail prices is applied here).

The applications for loan will be studied basing on strict rational criteria of investment feasibility. The priority will be given for the investments connected with founding new enterprises. The recapitalization for the endangered enterprises will not be taken into consideration.

Each enterprise utilizing a guarantee will pay one time fee amounting 1% of the guaranteed sum for the first year of the guarantee, and 0,5% for every following year.

The guaranty period will be 10 years from the date of granting. The guarantee, within the first 7 years will cover all the risk percentage agreed upon in the guaranty agreement, this percentage then will subsequently decrease up to 3/4 in the 8th year, half in 9th and 1/4 in 10th year until it reaches 0 by the end of the 10th year.

The way of utilizing a guaranty will be analyzed in case:

* selling of the shares or withdrawal of the share from the investment or any form of resignation from participation in the project which is a subject of the guaranty
* voluntary or enforced liquidation of the enterprise of which the shares were purchased or dissolving the relationship of participation
* declaring bankruptcy and starting the bankruptcy procedures for the enterprise of which the share was purchased.

The above analysis will be done only in case when the facts mentioned above would occur not earlier than in two years after purchase of the share and termination of the guarantee. If whatever reason for bankruptcy would occur during the first two years of the guarantee, it will case its termination.

The guarantee gives the buyer of the share the right to compensation in case when the difference between final value (plus dividends and other profits) and the sum of purchase (revaluated according to the coefficient of prices changes, as calculated by GUS according to the coefficient of the month of issuing the guarantee) is negative. The analysis of the rationale of the guarantee utilization will be done if the negative difference exceeds 20% of the value of the amount invested multiplied by the coefficient of revaluation.

The value of the compensation paid from the Guarantee Fund will be equal to the percentage of risk guaranteed in the preliminary agreement and by no means can exceed the sum guaranteed initially, increased by the sum resulting from GUS coefficient.

The PCF will give the preference for equity, near equity financing and credit guarantees, treating regular loans as a supplement only. The typical practice of the PCF will be struggling to recover the invested sums by reselling the shares or bonds, **very frequently to the same company**, which was financed. The PCF will also identify investors to whom it could sell the shares by the way of public auction. It is assumed though, that this last possibility would be practiced very seldom.

GENERATING OF FINANCE POOL

1) In the first stage, the evaluation, selection and possible approval of the projects to be implemented will be done.
2) In the following stage, the rules of financing of the project will be fixed by the way of negotiations with a customer. Particularly the proportions of financing the project by the Fund, by the customer and by other external investors and by the banks will be settled. It is assumed that the PCF share in the financing of the project will reach from 10%to 30% of the project value (including 40% of the loan which is possibility to exchange it for the own capital or for own capital itself).

In order to increase the effectiveness of the investing, the PCF will suggest to the customer entering into capital arrangement with the external investor(s).

The choice of the external investor will be done as follows:

1/ First, the PCF will offer the shareholders of the Fund to join the investment pool,
2/ Next, the PCF will offer other big investors to join the pool,
3/ Finally the PCF will organize public auction of proposed project's shares.

This way of creating the investment pool will secure maximum profit for the share holders of the Fund and full access to information about investing possibilities.
The essential condition to arrange the effective operation will be to open 2 -3 euro-credit lines to finance the operation of the Fund and the projects.

With the anticipated share from an entrepreneur of 20% of the project value, about 10% share of an additional investor and 30% Fund's share - the remaining 40% could be obtained from the bank credit.

However, the limit of 30% of the Fund's share is not a final one and it can be anticipated that within the first period of 3 - 3 years this share could be increased up to 50%.

A Place on Investments Market

The strategy of investments of the PCF will tend to fulfill the existing gap on the investments market. This gap includes the part of the market between to crucial segments of the investments market i.e. between bank investments crediting and private investments.

The PCF will finance and guarantee mainly the investments of considerable and higher risk and income level. However, taking into consideration the lack of the venture capital institutions which are financing investments of the high risk level, it is possible that the PCF will apprehend a part of their functions.

The total value of the sums covered by the guarantees could never be higher than 6 times value of the Fund and at least one third of the guarantees has to connected with purchase of shares. If the above limit was ever surpassed as a result of a necessity to implement a definite guaranty, the above mentioned balance should be brought back as soon as technically possible.

Marketing Strategy

The place of the PCF in the market will determine its marketing strategy, and the success of the Fund depends on this strategy.

This strategy should be based on intensive activities including:

* **A direct marketing influence on the most promising potential clients.** The clients and their potential financial possibilities have to be identified. As a next step the

undertaking of actions aimed at making the clients realize possibilities of utilizing the forms of financing offered by the PCF as a form of investing and the profits out of it. The existing and newly created data banks (for example BIG of Solidarity Economic Foundation or planned Regional Center for Market Information within the frames of Agency of Development of the Gdańsk Region, or statistical data from Voivodship Statistic Office WUS and own researches) will be the basis for the action for identifying. The PCF will maintain close contacts with institutions and institutes working in the field of researching the investments market. Within the frames of the PCF the unit for market research will be created.

* **Creating of the effective investing network.** The PCF should utilize based on full trust relations with commercial banks, private investors and entrepreneurs. This requires presenting to all the interested parties the profits resulting from a cooperation with the PCF (increasing a number of clients by the banks, making easier the access to the capital for the entrepreneurs, providing attractive possibilities to deposit capital by private investors). The PCF should create effective information channels between entrepreneurs, banks and private investors.

A Project for the Company Agreement (Legal Structure)

The Fund should be created in a form of a joint stock company, the shareholders of the company should be : **commercial banks, big private companies, foreign financial institutions,** government agencies, funds and foundations lively interested in local investments. It can be assumed that the capital shares (bonds) should have high value and that is why it was assumed the value of the single share should be 1 billion zloty. This should ensure that only serious shareholders of good financial standing would join the PCF. It will be allowed to purchase one share by a few investors who should appoint their representative.
The company agreement should be concluded for an unlimited period. It is assumed that every shareholder of the PCF will be represented in the Supervisory Board of the PCF proportionally to the number of shares.
The intention of the PCF promoters is creating a solid capital structure providing a chance to expand the activities of the PCF over the limits of this business plan.
The intention of the PCF promoters is also to gain such shareholders who could play a role of active investors for the projects financed by the PCF.

Capital Structure

One of the key conditions for proper sharpening of the PCF is gaining 1 - 2 foreign companies specialized in the field of venture capital financing, what, besides utilizing their experience, would ensure more profitable fiscal treatment.

The basis of the idea of financing by the PCF is an assumption that about one third of the capital necessary for financing will be out of the stock capital and the remaining two thirds from bank credit lines. This means that the share of the PCF in financing in a venture should be at least like 1:2.

It can be assumed that the capitalization will take place in two following stages:

1) **Initial stage** - preparation. A goal of this stage is to get the PCF organized and especially:

a) to select shareholders,
b) to sign notary act for foundation of the PCF
c) to chose the company authorities and recruitment of personnel
d) gathering the stock capital for the first stage of capitalization amounting to 30 billion zloty
e) beginning of choosing the projects and implementation analyzes
f) signing an agreement for opening credit lines
This stage could last from 0,5 to 1 year.

2) **Start up stage** aiming at:

a) practical implementation of financing of the projects
b) widespread search for new projects, market research, investment analyses
c) opening 1 - 2 new credit lines
d) within 3 years, a successive final capitalization of the Fund with the capital up to 60 billion zloty ; the payments would be done successively upon request of the Fund, along with starting the financing of new projects.
It is assumed that this stage will last 3 years.

3) **Operation stage** - form the 4th year.

System of Administration

In the initial stage, the PCF will be managed by an operation manager and two operational investments analysts subordinated to him. The contracting of vendors to execute certain works (especially expert analyzes) is foreseen.

At the final stage it is foreseen that the board of the Fund will be enlarged by following oparation mamager (deputy) and employment of one additional investment analyst.

The employees should enjoy good knowledge of banking (crediting) and they should be sent for short but intensive (one month) training courses in other fiendly foreign funds.

For the operation directors and investment analysts the salaries according to Western standards should be ensured i.e. the directors shoud earn 5 times average country sal;ary and the analysts 3,5.

The mamagement of the PCF will be supervised by the Supervisory Board consisting of the shareholders or their representatives.

The Role of the Agency for the Development of Gdańsk Region (ADGR)

The scope of work of the ADGR is:

a) promotion and spreading of information about the Fund among the final receivers of financial means, crediting and investing institutions, and capital risk companies operating on regional and national levels. The appropriate information will be also passed through regional and national professional associations.

b) administrative service and book-keeping of the Fund.

C) analysis and decision making for the giving the guarantees basing on appropriate information obtained from the institutions applying for guarantees.During the process of decision making the Agency could use an assistance of specially created comitee. The comitee of about five members of the Agency and people of high knowledge of industrial and problems of the region.

d) permanent control of the condition of the final users of guarantees.

The financial management of the cash of the Fund will be entrusted to regular credit bank, having its seat, branch or department in the Gdańsk region. The bank will be sellected in the bidding process. In the terms for the bid the minimum and maximum limits of income to be obtained from capital and capital operations and the limits of commission for the services will de determinated. All the net income obtained from the free capital turnover will be destined for increasing of the guarantee fund. In exchange for the above mentioned services the ADGR could obtain yearly remuneration paid directly from the cash reserves of the Fund. The remuneration will be calculated on a basis of real justified costs but it cannot increase certain sum.

Financing of PCF

(comments for the pro-forma balance and the pro-forma calculation of costs and income)

The initial financial plan of the venture was prepared in the form of balance and costs and income calculation pro-forma, taking as an example a similar plan prepared for one of american funds.

1) The balance and costs and income calculation would comprise the period of ten years including 4 years of obtaining capitalization and seven years of obtaining planneg capitalization out of credit lines.

2) In the prepered plans the following simplifications and assumptions were applied:

a) The own capital will be gathered successively, 30 billion in the first two years and following 15 billion in the furth year.

b) The credit lines will be opened gradually starting from 5 billions in the first year until 124 billion in the eighth year i.e. so called leverage factor will grow from 1,17 up to about 3,07

c) It was assumed that the average loan or guarantee will be about 1 billion zloty and it will be granted for 5 years with 3% rate of interests over prime rate; the total number of financed ventures will grow from 16 up to 26; it means engagement in about 130 projects from the 7th year what will cause (in case of successive repayments) the current engagement of means of 52 billion zloty.
It is assumed that the loans will be granted in the complementary way compared with with a possibility to change it for own capital. The number of projects can vary depending on profitability and needs.

d) For the sake of simplicity, it was assumed in the financial plan that the Fund will conduct guarantying and near equity activities, so the equity investments were skipped.

e) For the sake of simplicity, it was assumed that the Fund would use the option of changing a loan into capital mainly, to sell it. It will allow to recover the loaned borrowed capital and will increase rate of money flow. It was assumed that an average additional profit will be about 1 billion (when financing is about 3 billion). This figure was established taking pesimistic assumption that the obtained income will be one third lower that in similar american ventures.

f) The average financing on the basis of near equity capital was assumed on the level of 3 billion zloty. The loans would be granted for 7 years, with excuse period in the first years. The number of financed ventures would grow from 7 to 11 as a final number what willcause that finally the Fund will be involved in 55 projects for total amount 132 billion. That means that final involvment of the Fund will reach 52 billion in regular loans and 132 billion for option loans.

g) The option of changingloann for the capital would be used in the 5th or 6th year. This kind of loans would have 2% interest rete over the prime rate.

h) The pro - forma balabcc was prepared with the assumptions that the income of the Fund is paid to the shareholders in full (not reinvested). Assuming the rule of reinvestment in the first few years would increase the profitability and future expansivity of the PCF.

i) For the sake of simplicity , it was assumed taht the primne rate is 10% and the credit lines opened for the Fund will have 0,5% over prime rate, the Fund will grant regular loans 3% over prime rate and option loans 2% over prime rate.

j) It is planned that the net income obtained from the own capital will be 30% starting from the 8th year onwards. It will be resulted by the increase of the leverage factor up to over 3.07 and abtaining additional income out of utilizing option loans (from the 6th year).

k) The financial plans were made with the assumption of constant rate of the exchange of zloty against the currency of the credit lines (or few currencies). It is assumed that the settlement of all the loans

APPENDIX E

THE DEVELOPMENT OF THE CAPITAL MARKET IN THE PROCESS OF TRANSFORMATION OF POLAND'S ECONOMY INTO A MARKET SYSTEM

THE GNAŃSK INSTITUTE FOR MARKET ECONOMICS

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Edmund Pietrzak

The Development of the Capital Market in the Process of Transformation of Poland's Economy into a Market System.

The period of 1989-1992 (June)

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I. THE CAPITAL MARKET AS AN ELEMENT IN THE TRANSITION OF POLAND'S ECONOMY INTO A MARKET SYSTEM.

At the time of the establishment of the first non-communist government (August - September 1989) since the Second World war, Poland's economy was governed by the command system, and only a few, residual elements of the market economy were in place. There was no market-oriented financial system in Poland at that time. Nor did any of the four parts (money market, capital market, credit market and off-balance sheet financial instruments market) of a real financial market exist. In a sense, the credit market operated at that time, although its scope and the way it worked were far different from the credit market of a market economy.

It is worth noting, however, that an embryonic foreign exchange market was in operation in Poland in the late 80's. Formally it appeared in 1982 following the governament's decision to modify partially the central distribution of foreign exchange by introducing the right to foreign exchange retention accounts. In reality this market started to operate only in 1987 after the foreign exchange retention rights' accounts became proprietary and foreign retention rights auctions were initiated.

We should stress that this minor and specific currency market which existed in Poland in the period of 1987 - 1989 was the only foreign exchange market in Central and Eastern European countries at that time.

The key elements in the transition from a command-type economy to the market system are: ownership changes; building markets and market institutions. Among the markets the most important are: goods and services markets, financial market, foreign exchange market and labor market.

These three key areas of the transformation are mutually interdependent.

At the beginning of 1992 i. e. more than two years after the first non-communist government was formed in post-War Poland, the transformation process has made little progress, although the progress made in Poland had certainly been greater than in any other country of the region. Privatization had progressed slowly and at the same time its concepts had changed a few times. Advancement in building up markets and market institutions was modest, although the development of the individual markets proved highly uneven.

At present the most advanced is the goods and services market which has gained the features of similar markets existing in developed economies. The financial market as a whole is under-developed, although specific segments are at different stages of development. In terms of size and scope of operation the credit market is certainly far ahead of the other financial markets, although it is much smaller and less mature than the least developed credit markets in Western Europe. The capital market is at an early stage of development; its trading volume is very low and it does not play any of the functions of a mature capital market yet. Paradoxically, the capital market is the most precisely regulated by law and it operates within a more detailed legal framework than any other market in Poland. Of all segments of the financial markets, the least advanced is the money market which has not yet left its embryonic stage. The off-balance sheet financial instruments market does not exist at all.

In practical terms, there is still neither a labor market. Nor a currency market. The latter statement may come as a surprise since - as mentioned earlier - a minor, untypical currency market operated in Poland in the late 80's. It was, however, eliminated as a result of the launch of the economic stabilization program and the amendments to the currency law at the beginning of 1990.

More than two years after the transformation process began, it seems clear that the transition to the market economy has not been backed by any comprehensive vision. In fact, it must be stressed that the market economy has grown spontaneously, while some of its elements have not been implemented at all. The impression is that the transformation effort has focused on attempts - which proved successful - to build up the goods and services market and to maintain this market in equilibrium. Instead, the other elements of the transformation activity have been designed separately and incompletely while some have been neglacted. In other words, the natural and mutual relations among the various elements of the market economy have been overlooked and a workable timetable for implementing them has not been effected. There are numerous examples which confirm the above:

1) the privatization law (passed in July 1990) is not fully compatible with the securities law (passed in March 1991),

2) the privatization law came into force before finding a settlement for reprivatization claims (which still need to be settled),

3) the development of the capital market precedes the establishment of the money and currency markets. The process should have gone the other way round,

4) the state-owned banks which are the core of Poland's banking system have not yet been privatized. In result, the development of the money market has advanced little, while the more developed credit and capital markets are partially distorted since state-owned banks operating basically in a non-market way are major participants in the both markets. This especially refers to the credit market which has been much more accessible to large state-owned and politically strong enterprises than to small and medium-size private firms which operate exclusively according to market forces.

5) the embryonic currency market operating in the period of 1987 - 1989 ceased to exist at the beginning of 1990 as a result of the tightening of the foreign exchange law. Foreign exchange retention rights were replaced by a compulsory sale of export earnings.

II. THE KEY FEATURES OF THE DEVELOPMENT OF THE CAPITAL MARKET IN THE PERIOD OF 1989 - 1992. (June)

There are two ways in which a capital market can be built up in a country attempting to transform its economy from a command system to a market economy. Firstly, the capital market may develop spontaneously without any state control or interference. Such a development of the market is generated by the entrepreneurship of private entities and based on commercial and civil laws. Secondly, it may be a state-generated and state-controlled development of the market where state regulation may take the form of either the direct or indirect supervision of the capital market by state institutions.

As international experience indicates, only the oldest, most mature and developed capital markets emerged and progressed in a spontaneous way, while state supervision of these markets appeared much later. This form of development was followed by the capital markets of the U.K., the U.S.A., Canada, Australia and Switzerland. It is worth adding that until recently, there was no state supervision of capital markets-in the form of separate laws to regulate them or separate state or governmental institutions to control trading in securities-in some of the countries with the oldest capital markets. For instance, such state supervision appeared in the U.K. only in 1986 and in Switzerland only in 1990.

On the other hand, in most of the countries whose market economies developed later, the establishment of capital markets was shaped and controlled by the state from the very beginning.

Although in theory there is no room for the spontaneous development of a capital market in any country in the very late XX century, and that the only option is to leave the state with the task of shaping the market - in practice this may be not so. The point is that the spontaneous development of a capital market allows for its rules of operation to be better fitted to the individual conditions of a given country, such as the society's mentality, existing trading habits and traditions, society's risk preference and ability to be entrepreneurial Should this spontaneous market development concept be abandoned, it is necessary to make an extremely careful examination of other countries' experiences relating to the development of their capital markets. This is the best use which may be made of foreign experience when preparing a new capital market and adopting it to local conditions.

It is true that there are many ways of organizing and operating the capital markets which exist in different countries. All these systems can be, however, grouped in two basic models of the capital market, if the two key features of these markets are defined as, the method and scope of state supervision over the capital market, and secondly the type of legal framework according to which the market operates. These two models are: Anglo-American and Continental European.

Under the Anglo-American model of the securities market, the state indirectly oversees the market participants and market operation, leaving much room for self-regulation. Moreover, the stock exchanges - the major institutions of the secondary market - are private institutions.

Under the Continental European model of the securities market, the state directly oversees the market participants and market operation, leaving very little or no room for self-regulation of the market. The securities exchanges are mostly state institutions.

Poland has choosen to develop its capital market in a non-spontaneous way. That choice was reflected not by any governmental resolution or declaration but by a decision to set up a working group at the Ministry of Finance in early autumn 1989 whose task was to elaborate a conception of the development of the capital market in Poland. The rules for selecting the members of this group have never been publicly released. Astonishingly enough, the securities market was the only one out of 5 financial markets which drew the government's attention. The remaining four financial markets (money market, credit market, currency market and off-balance sheet financial instruments market) were neglected.

Moreover, the financial market as a whole has been neglected by the government, too. There was no governmental working group to deal with the financial market. I take the view that the government should have set up a working group whose primary aim would be to design a plan for the building up of the financial market. The group's work could have prevented the financial market from chaos, financial scandals and distortions and, at the same time, could have helped to build up the financial market in an orderly way.

Despite the fact that the governmental working group on the development of the securities market was set up in early autumn 1989, the securities market had been spontaneously developing for about a year and a half. This was possible because there was no state regulation or other restrictions on securities trading before April 25, 1991 when the Act on Public Trading in Securities and Trust Funds came into force after having been passed by the Sejm on March 22, 1991. The draft securities law was drafted by the afore-mentioned governmental working group and finally approved by the Sejm despite the strong criticism it aroused from traders operating on the spontaneous securities market which existed prior to April 25,1991.

April 25, 1991 is a formal date which seperates two phases of the development of the Polish capital market since September 1989. In its first phase, the development of the market was - as mentioned - spontaneous, whereas since April 25, 1991 the capital market has come firmly under the authority of the government. What were the major features of the spontaneous development of the capital market?

The most important feature of development of the Polish capital market in the period September 1989 and April 1991 was its spontaneity. The market participants had to comply only with the general provisions of the commercial law (The Commercial Code of 1934), the civil law (The Civil Code of 1964 which was based mostly on the Napoleonic Civil Code) and the Act on Bonds of 1988. There was no specific legislation to regulate the capital or financial markets. The market praticipants who were thus not restricted by any specific provisions of the law and whose knowledge of the organization and operation of capital markets of the market economy was very limited, shaped the Polish emerging capital market in a way different from that known in the market economies. For instance, the Polish spontaneous market participants did not have distinct primary and secondary securities markets. Although trading in securities usually took place on the organized markets which were called securities exchanges, in reality they had - with very few exceptions - nothing to do with real stock exchanges, but were small brokrage firms or broker-dealer firms which traded according to the rules of the OTC market, not to exchange-like rules. In almost all cases those quasi-exchanges were not non-for-profit organizations, but profit-oriented economic entities.

A specific feature of the spontaneous development of the capital market was that the quasi-securities exchanges traded not only in securities but also in products typical of commodities exchanges (like sugar, coffee, grains, oil etc.) and in non-exchange products (like cars, clothes, TV sets, videos etc.). The spontaneousness of the market was also reflected in the many cases of violation of the old principle "my word is my bond" and in the fact that the professional and ethical performance of many traders was poor.

The autonomous capital market became very popular in the emerging private sector and among people who had excess funds. Nevertheless, the real reason for that popularity was not businessmen's hopes of issuing their firms' securities to borrow money for development, but their belief that the capital maket will enable them to earn a great deal quickly.

The third important feature of the capital market which existed from September 1989 till March 1991 was its very small size and shallowness. Although shares of joint-stock companies were the most numerous financial instruments on that market, state bonds accounted for the bulk of trading (in terms of volume).

The small size and shallowness of the capital market in the period of September 1989 - March 1991 was obviously caused by the low number of securities issues, their size and the limited extent of trade in them. It is enough to say that only 19 economic entities (of which 6 were banks) publicly issued their shares prior to March 31, 1991. In most cases the size of the issue was in the range 10,000 - 20,000 shares. What is also worth noticing is that not all of the 19 issues were fully sold on the primary market and that some of the issues sold on this market had no involvement with secondary markets.

The number of bond issues, including the first issue (July 1989) and second issue (December 1989) of Treasury bonds, was not much smaller than the number of share issues, totalling 11. It is worth considering the circumstances of these issues. The point is that the majority of the 11 bond issues took place in the second half of the 80's, that is under conditions of a centrally planned economy, market shortages and growing inflation. The state interprises which issued most of the bonds did not attempt to attract a possible investor-lender through interest payments (which was wretchedly low in comparison to the inflation rate), but rather by offering privileged access to the goods and services they produced. The price liberalization effected in early 1990 and the dramatic decline in real incomes which followed put the goods and services market into equilibrium. In result, the humiliating queues and market shortages disappeared, and individual enterprise bonds became unattractive for lenders.

Since the later issues of enterprise bonds (issued after January 1990) were also unattractive to investors, and the first issue of Treasury bonds (July 1989) was small and transitory, the whole bond market in the phase of the spontaneous development of Poland's capital market was practically reduced to the Treasury bonds of the second issue (December 1989).

For about two years, these second-issue Treasury bonds represented the greatest similarity between the Polish financial instruments and their Western counterparts. The nominal value of the whole second issue to be launched between December 1989 and November 30, 1994 was to total zl 5,000 billion, that is about US $ 5 bn at the December 1989 US $/zloty exchange rate or more that US$ 0.5 bn at the January 1990 US$/zloty exchange rate. Thus it is the largest issue of "one-name" securities in Poland since 1945.

The Treasury bonds of the second issue were launched in 4 denominations: zl 200,000: zl 400,000: zl 1 million and zl 5 million. According to the January 1990 US$/zl exchange rate the nominal dollar value of the bonds were respectively: about 21, about 43, about 105 and about 526 US dollars.

These bonds are unusual. They are convertible, giving their holders the right not only to receive interest but also to convert bonds into shares. In case of Treasury bonds of the second issue their holders were (and are) eligible to convert bonds into the shares of those state interprises which are privatized thorough public offers of shares.

Treasury bonds of the second issue are attractive to the holders not only because they can be converted into shares but also because they offer a 20% discount when used to buy privatized state enterprises' shares. Apart from that, Treasury bonds (of the second issue) attract investors by offering anti-inflation protection. The idea is that the interest rate on Treasury bonds is variable and equals the inflation rate, calculated by Central Statistics Office. This means that a bond nominal value is increased every month by the previous month's inflation rate.

The Treasury bonds have two further untypical features. Number one, they may be bought only by private individuals, not by legal entities. Number two, they are attractive to state enterprises' management since they can be used by state enterprises to avoid the excessive salaries tax. When paying salaries (or their part) in the form of bonds rather than cash, state enterprises are exempt from excessive salaries tax.

The sale of Treasury bonds (of the second issue) on the primary market did not continue till the planned deadline (Nov. 30,1994) but was stopped by the government in early May 1991. The total sale of these bonds amounted to zl 500 billion in that period, that is about 10% of the target figure.

The sale of Treasury bonds on the primary market was uneven. The nominal value of the bonds which were sold during the first nine months of the issue amounted only to zl [illegible] billion. The sales of bonds radically accelerated in the four last months of 1990 and in the first four months of 1991 as the sale of privatized state enterprises' shares on the secondary market began.

A similar tendency could also be seen on the Treasury bonds secondary market. This market was not too active in the first nine months since the launching of the bonds issue. The trading volme of the bonds secondary market began to increase significantly in early autumn 1990 and boomed in early May 1991 after the issue was suspended.

The fourth and very important feature of the spontaneous phase of the development of Poland's capital market was the initiative displayed by its participants, particularly by broker-dealer firms. The most visible manifestation of that entrepreneurial spirit was the unusually large number of quasi-exchanges established in the two-year period that followed the formation of the first non-communist government in September 1989. As mentioned, those exchanges traded not only in securities but in almost anything tradeable. An extreme example of this entrepreneurship, as well as being evidence of the market participants' ignorance, was the fact that shares of one of those quasi-exchanges were sold on that exchange !

Poland proved to be the only post-communist country wich experienced such a strong eruption of entrepreneurship on the capital market and in the exchange trading. A similar phenomenon appeared only in Russia, the Ukraine and Belorussia in the last months of 1991.

Now, let's examine the second of the key issues raised earlier, namely the major characteristics of the government's plans to shape the market administratively. Before discussing this issue it should be remembered that there is a fundamental difference between the process of shaping the capital market by the government in a post-communist country like Poland, which has only started to build up a market economy, and a country with a market economy already in place but without a capital market. The examples of the latter are Indonesia, Thailand or Malaysia. What makes the difference is that creating a capital market in an already extant market economy consists largely of providing the relevant legislation and - to some extent-capital market institutions, whereas in post-communist countries it must include not only prividing the legislation and all capital market institutions but also undertaking activities aimed at creating a supply of financial products for the capital market.

To accomplish the last, the state can act either ditectly or indirectly. Acting directly the state initiates and monitors the privatization of state enterprises. It also issues debt instruments (mostly bonds). Acting indirectly, the state pursues a macroeconomic policy to extend development oppotrunities in the private sector, and at the same time encourage investment funds-hungry economic entities to step into the capital market. That means that even those governmental economic policies which do not relate directly to the capital market can have a strong impact (positive or negative) on this market. For instance, the tax policy of 1990 and 1991 which exempted the interest on bank deposits from taxation and did not extend that privilege to dividend income, was undoubtedly an important obstacle to capital market development. Obviously, under such a tax policy, investors would always be much more willing to make deposits with banks than to buy shares on the capital market.

Another example of how macroeconomic policy can negative influence capital market's activity is a high nominal interest rates policy, and in particular - positive real interest rates policy. If real interest rates are positive, investors would rather go to banks than to the capital market.

The major purpose of this section of the report is not to provide a detailed analysis of the establishment of a legal and institutional infrastructure for the Polish capital market by the state. Nor is to provide a detailed examination of the government's activities (direct and indirect) aimed at increasing the supply of financial instruments for the capital market and increasing its trading volume. This section of the report aims at reviewing only the key characteristics of the process of the shaping of the capital market by the state. However, a detailed assessment of this issue is to be developed in the final section of this report.

The Act on Public Trading in Securities and Trust Funds, which was passed by the Sejm on March 22, 1991 and came into force on April 25, 1991 will prove to be crucial in the government's influence of capital market development. Generally speaking, this securities law is principally based on the Continental European model of the capital market with only a few ideas adapted from the Anglo-American system.

The final shape of the securities law was - to a limited extent - a compromise between the governmental concept of the capital market development (as mentioned, the concept elaborated by the governmental working group) and the vastly different concept offered by the businessmen who had established numerous quasi-exchanges.

As a matter of fact the governmental working group did not have a clear concept for a long time, hesitating whether to restore the model of the capital market which had operated in Poland in the inter-war period or to adopt the solutions presently used in Continental Europe. Nevertheless, the governmental group also considered specific solutions which had nothing to do with the Continental European model of the securities markets. For instance, the group considered preventing banks from being important players on the Polish capital market and ensuring that private stock exchanges rather than state-owned ones, should constitute a secondary market.

Finally, the governmental concept departed completely from the solutions used in Poland in the inter-war period. It proved to be, however, a very restrictive version of the Continental European model of the securities markets.

The community of the quasi-exchanges was mostly in favor of the Anglo-American model of the securities markets, being against any state regulation of the market at all.

The particularity of the compromise between the two concepts was that although the final shape of the securities law included only very few suggestions coming from the community of the quasi-exchanges and expressed mostly the governmental group's ideas; nonetheless it accepted the key demand of this community, that the on-exchange trading in securities be geographically decentralized.

The government's view that Poland should have only one stock exchange (in Warsaw) was rejected. This point needs additional explanation. It is likely that Poland will have no more than one stock exchange in the future. However the community of the quasi-exchanges took the view that market forces rather than the government should have a decisive say regarding the number of stock exchanges in Poland and their geographical location. The legislators accepted this view. In result, the securities law brought the Warsaw Stock Exchange into being on the one hand, and opened the way for setting up stock exchanges in other major cities in Poland. Although the Warsaw Stock Exchange is an almost 100% state-owned, it will be privatized. (In practice, it will take many years to get the WSE privatized). The other stock exchanges to be set up can be either state-owned or private since only the State Treasury, banks and broker-dealer firms are eligible for exchange membership. By the end of June 1992, there was still only one stock exchange in Poland.

There is no doubt that the most important characteristics of building up the Polish capital market within the legal framework of the Act on Public Trading in Securities and Trust Funds is the decisive role played by the state and, at the same time, the direct and extremely rigoros control the state has over this process. As a result, since the securities law came into force, the development of the capital market has involved no self-regulation.

The institution of permits is the most basic tool by which the state exerts control over the capital market. Practically anything that happens on the market must have a permit. The

Polish capital market does not employ such innovations as licences or registration which have similar meanings to permits, but which allow for more flexibility in practice.

The Securities Commission brought into being by the securities law exercises institutional control and supervision over the market. Unlike the U.S. Securities and Exchange Commission, it is not an independent state body, but it is directly run by the government administration. In this respect and in terms of the scope of its powers, the Polish Securities Commission is more reminiscent of the French Commission des Operations de Bourse, prior to the radical changes of the French securities legislation which took place in 1988.

Although the Securities Commission exercises many powers, three are of key importance. Firstly, the Securities Commission is empowered to enforce the rules of fair trading and competition applying to public trading in secrrities. Secondly, the Securities Commission is responsible for initiating, organizing and undertaking activities aimed at securing an orderly stock market and investors' protection. Thirdly, which probably constitutes the greatest power of the Securities Commission, it is empowered to undertake any action provided for by the securities law.

The Securities Commission is the only institution empowered to admit securities to public trading. It exercises this power by issuing permits. No securities may be publicly issued and traded without a prior Securities Commission's permission. However, this rule does not refer to securities with a maturity of less than one year. Nor does it refer to securities issued or guaranteed by the State Treasury and National Bank of Poland. The securities law does not refer to checks or drafts, either.

The securities to be admitted to public trading must comply with very high requirements set by the Securities Commission, similar to those applied in developed market economies.

There are only two categories of market participants who may directly make deals in securities either for their customers or on their own account. These are broker-dealer firms and the broker-dealer bureaus of banks. Both broker-dealer firms and banks' broker-dealer bureaus may only be involved in activities relating to securities market. The list of permissible activities includes: offering securities for public trading; buying and selling securities for clients and on firms and bureaus' own account; managing client's portfolio of securities, serving as advisors on securities trading and offering custodian services in securities.

Broker-dealer firms or banks' broker-dealer bureaus may operate on the capital market only after being admitted by the Securities Commision. To receive the Securities Commission permit, a broker-dealer firm or bank's broker-dealer bureau must meet a number of requirements, set by the securities law. In case of a broker-dealer firm they refer to the size of a firm's own capital, its office space and technical and telecommunications equipment, as well as to a ratio between the firm's own and borrowed funds, and between the firm's own capital and its trading volume. In addition, a firm must employ a sufficient number of persons who have a Securities Commission permit to act as broker-dealer.

It is worth stresing that the October 9, 1991 amendment to the Act on Public Trading in Securities and Trust Funds imposed an important restriction on setting up broker-dealer firms. Before the amendment was made, a broker-dealer firm might be operated by a private individual, legal person or an entity without personality at-law. The amendment excluded private individuals from those entities entitled to operate as broker-dealer firms.

Broker-dealer activity on the Polish capital market may be conducted not only by residents (in terms of the currency law) but also by non-residents. The latter may - like the former - operate broker-dealer firms or banks' broker-dealer bureaus. Non-residents also must apply for a Securities Commission permit to conduct broker-dealer activity and must meet the same requirements. The only difference is that non-residents must comply not only with the provisions of the Act on Public in Securities and Trust Funds, but also with other acts which govern the conduct of economic activity by foreign parties in Poland, and economic activity with the participation of such parties.

The Securities Commission is also empowered to issue permits for private individuals wishing to obtain the broker-dealer rights without which no natural person may conduct broker-dealer operations.

A natural person may obtain broker-dealer rights provided that he:

a) has full capacity to perform legal actions;

b) enjoys full public rights;

c) has not been sentenced for crimes in respect of documents, economic offences, forgery of money, securities or official stamps, or fiscal offences;

d) has passed an official examination for securities broker-dealers.

Should all these requirements be met, a private individual may be entered into the register of broker-dealers which is kept by the Securities Commission. However, even if the private individual has been entered into register, it does not entitle him to undertake broker-dealer operations. This is permitted only after such a person has been employed by the broker-dealer firm or bank's broker-dealer bureau.

The Securities Commission also exercises its extensive powers to oversee the activity of trust fund corporations which manage trust funds. A trust fund corporation may be established exclusively in the form of a joint-stock company. The Securities Commission is authorized to approve the charter of the trust fund corporation, the by-law of trust fund and selection of the trustee bank. The Securities Commission is also empowered to approwe any change in charter of the trust fund corporation, the by-law of the trust fund and the selection of the trustee bank. In addition, the Securities Commission has a right to approve the decisions of the general meeting of the trust fund corporation concerning the composition of its board of directors. Finally, the Securities Commission is authorized to request the dissolution of the trust fund corporation, should it fail to observe the provisions of the securities law.

The Securities Commission's powers to oversee the Broker-Dealers Self-Government Organization (brought into being by the securities law) are even greater than those to oversee trust fund corporations. The Securities Commission exercises (using the language of the Act) **superior supervision** over the Broker-Dealers Self-Government Organization, while having the right to suspend the resolutions of the Broker-Dealers Self-Government Organization's bodies. The charter of this Self-Government Organization is subject to the Securities Commission's approval. As a result, the Broker-Dealers Self-Government Organization is only notionally a self-governed organization since it has been effectively incapacitated by the provisions of the securities law.

The rigid state control over the capital market is reflected not only in the extensive power of the Securities Commission but also in the fact that the state interferes administrativel in the organization and operation of the secondary securities market. The point is that securities law prefers on-exchange trading to off-exchange trading (the OTC market) sinc one of the law's provisions says that secondary public trading in securities takes place o stock exchanges. Although off-exchange trading in securities is not banned, it is subject a Council of Minister's permit. Moreover, only the Council of Ministers is authorized define the forms of off-exchange trading in securities, although this job should be left to the spontaneous activity of broker-dealer firms which have been admitted to the public trading.

A very specific and, at the same time, most modern characteristic of the Polish capital market is the concept of "dematerialization" of the securities trading. The essence of this is that it is not physical securities themselves that are traded, but their ownership which is exchanged through electronic media. It practically means that neither buyers nor sellers have physical securities at their disposal. What they do have, are securities accounts entries. The only document that confirms that somebody holds securities is a Certificate of Securities Deposit which, in itself, is not a security.

The "dematerialization" of securities trading has been enforced at the level of the Securities Law. The law obliges any issuer to deposit his securities with the National Deposit of Securities.

While it must be admitted that the Polish capital market is one of the smallest in the world, it is at the same time one of the most advanced in terms of the "dematerialization" of securities trading. Even the oldest and most developed capital markets like markets in the USA and UK, have a long way to go to accomplish the full "dematerialization" of securities trading.

I take the view that the "dematerialization" of securities trading cetrainly has a number of advantages. However, I do not regard this concept as appropriate to present conditions of Poland. It is premature for the Polish capital market, and thus wrong. I shall refer to this issue in more detail in the final section of this report.

The Warsaw Stock Exchange, which was brought into being directly by the Act on Public Trading in Securities and Trust Funds, is a very important ingredient of the institutional and legal infrastructure of the Polish capital market. As mentioned, it is a state-owned institution. The WSE is very likely to play a dominant role on the secondary securities market for some years to come. There are two major reasons for this. Firstly, on-exchange trading in securities is preferred - at the expense of the off-exchange trading - by the law.Secondly, the WSE was the only stock exchange operating in Poland in 1991 and the exchange is very likely to remain the only one in 1992 and, maybe, longer. Since the trading volume of the Polish capital market has been very low over the last year, and is unlikely to grow significantly in the near future, even one stock exchange may not earn enough (in the form of transaction fees and other fees) to cover the total cost of its activity. A state-owned stock exchange may survive running a deficit since it is financed by the state. A possible private stock exchange (or stock exchanges) might not.

A particular characteristic of the stock exchange in Warsaw is its trading and price determination system, which is not dependent on a continuous trading system. Nor is it any combination of the open outcry system with continuous trading. The trading and price determination method used at the only stock exchange in Poland is modelled on the French version of the fixing system which was in operation in France before 1988. This system is called in France "par-casier".

Although there is a trading floor at the Warsaw Stock Exchange, and there are broker-dealers on it during trading sessions, transactions in securities are not concluded on the trading floor nor are securities' prices determined by broker-dealers. This is because the Warsaw Stock Exchange uses a computerized fixing system which sets automatically the price of the day for each security and determines the number of transactions concluded at this price.

From the opening on April 16, 1991 through to the end of 1991, trading sessions at the Warsaw Stock Exchange were held once a week (on Tuesdays). Since the beginning of 1992 they have been held twice a week (on Tuesdays and Thursdays).

Privatization is a primary direct activity of the state aimed at securing a supply of good quality financial products for the capital market. Although the privatization legislation includes a lot of legal acts, the most important is the Act on the Privatization of State Enterprises of July 13, 1990. The Act provides for a number of different methods of privatization, of which nearly all could directly or indirectly increase the supply of the financial products for the Polish capital market.

"Capital" privatization, based on public offers of shares is the method of privatization most likely to increase the supply of financial products. Under the capital privatization method only large and relatively successful state enterprises have been privatized.

The commercialization of state enterprises is the initial stage of its privatization. Commercialization takes place when a state enterprise is transformed into a joint-stock company owned by the State Treasury. The essential stage of capital privatization - the public offer of shares - begins with the public sale of the shares of the State Treasury's companies to third parties. The State Treasury may offer for public sale only a part of its holding, keeping the rest for itself. Should this happen, the State Treasury's company becomes a mixed private-state enterprise or the State Treasury will offer the rest of shares it hols to selected investors through individual negatiations.

It should be noted that the principle of the general access to shares through their public offering is to some extent limited by two factors; the employees of a privatized state enterprise are eligible to buy 20 % of its shares on preferential terms, and, non-residents may buy shares of the privatized state enterprises at the same terms as residents.

Other methods of capital privatization than the public offering of shares of the State Treasury's company are much less effective in generating a supply of financial products for the capital market. They are, however, of importance in the process of ownership transformation now occurring in Poland. These methods include: the sale of shares by tender or negotiations initiated by a public invitation to tender or negotiate; management buy-out and employee buy-out.

Public offers of shares of State companies proved not only the most important form of the capital privatization but also a decisive privatization method in general during the period of July 1990 (the date when the privatization law came into being) to the end of June 1992. Nevertheless, the speed of privatization under this method was slow, its scope was limited and the supply of financial products it provided was very modest.

In this period (that is July 1990 - June 1992) 13 state enterprises were privatized through public offers of their shares. That means that the shares of the 13 joint-stock companies, which appeared following the transformation of 13 state enterprises, were admitted to the public trading and were offered for sale on the primary stock market before the end of June 1992. However, only the shares of 9 out of those 13 companies were traded on the secondary stock market by the end of 1991. The shares of 13 out of these 13 companies were traded on the secondary stock market at the end of June 1992. It should be added that the secondary stock market means practically the Warsaw Stock Exchange in the case of these companies.

The equity capital of the first 12 state enterprises which were privatized through public offers of their shares, was distributed into about 22.5 million shares whose nominal prices ranged from zl 20,000 (more than 2 US $ at January 1, 1991 US dollar/zloty exchange rate) to zl 50,000 (more than 5 US $) with one exception where a nominal price stood at zl 100,000 level (more than 10 US $). The average public offering price of shares was twice their average nominal price. However, with respect to the supply of financial products on the capital market it is not the total number of shares, offerd for sale on the primary stock market that matters. What matters most is the size of the public offer of shares. 50 % or more of the total issue was accounted for by the public offer of shares in the cases of 9 out of the 12 privatized state enterprises. The public offering of shares of these 12 amounted to about 12.6 million which accounted for about 55.5 % of all the 12 issues combined.

If the most important source of the supply of financial products for the capital market, i.e. capital privatization based on the public offering of shares, is very modest, the other methods of capital privatization and the other methods of privatization played a minimal role. It is enough to say that shares of only 3 joint-stock companies other than those of the State Treasury, were submitted for public trading before the end of 1991. This number did not change over the next 6 months. This figure is certainly astonishingly low since a lot of fast-growing and capital-hungry private companies (including private banks) have been set up over the last two and a half years. There are many reasons why these companies do not choose the method of public issue of their securities to meet their capital needs. They are discussed in more detail in the final section of this report.

However, it is necessary to stress at this stage that one of the most important barriers to private companies entering the capital market is the rigidity of the legislation that governs the Polish capital market.

The point is that altough the securities law rightly sets high requirements for companies wishing to increase their capital through the public issue of securities, it does not consider the important differences existing among potential issuers. In other words, the legal requirements for securities to be admitted to public trading were principally designed for only one category of economic entity, namely large, long-standing and healthy state enterprises, subject to the capital privatization based on the public offer of shares. Thus, the securities law ignores an obvious outcome of the newly emerging Polish market economy, namely that quite new private companies would be formed. Some of these have grown rapidly and dynamically and are performing very well. At the same time, they are not well known and do not have established names.

The securities law also ignores the existence of smaller and less well-known enterprises than the first 13 state enterprises privatized through capital privatization based on the public offer of shares.

Both categories of economic entities (i.e. "pure" private companies and smaller and less known state enterprises) do not have a serious chance of being admitted to the capital market as issuers of securities, at least in the short run. At the same time, most of them, and maybe all of them, are currently facing capital shortages.

Moreover, it is likely that public issues of the securities of new private companies and privatized medium-sized state enterprises would be more popular in the regions of their operation than the securities of large privatized state enterprises operating in other parts of the country.

A simple way, which is not provided for by the securities law, to dismantle this barrier to the development of the private sector of the economy and the capital market would be to set different requirements for different categories of potential issuers. This is not to say that issuing requirements be lowered. This is to suggest that a more flexible approach to issuing requirements, which would be differentiated in line with different categories of issuers, should be applied. Judging by the examples of other countries among of which the UK's securities market is particulary appealing, such a flexible solution would secure acces to the primary securities market for many more issuers than has been the case.

In addition, a segmentation of the secondary securities market should be implemented. Naturally, it would have to be in line with differentiated issuing requirements for different categories of issuers. For instance, the secondary market could be segmented into two parts: senior and junior markets. Only securities subject to the most rigoros issuing requirements could be admitted to the senior market, whereas the other securities could be traded on the junior market. Presently, the stock exchange in Warsaw (and possible stock exchanges to be set up) could serve as the senior market, whereas the OTC market could become the junior market. The secondary securities market could also be segmented in such a way that both the stock exchange and OTC market are divided into the senior and junior markets.

A very important feature of the process of the administrative shaping of the Polish capital market is its being subordinated to the efforts aimed at ownership transformation in the economy. Moreover, the capital market has been shaped in such a way as to be closely in line with only one privatization method, namely the capital privatization based on the public offer of shares. This privatization method - modelled on the British privatizations of the 80's - was seen by the first non-communist government (August 1989 - November 1990) as the fundamental path of ownership transformation in Poland. Of course, it must have had its impact on the way the government saw a future capital market and securities law. Although the second government (December 1990 - December 1991) showed more flexibility and less one-sidedness in its approach to methods of privatization, it has had little influence on the final shape of the securities law.

It is logical to link the building up of the capital market with privatization under the conditions of a post-communist country. Otherwise it is hardly possible to see a capital market operating in an economy with state ownership predominant. On the other hand, it could be of little use to think about establishing a capital market for its own sake, with the conviction that a capital market must exist in a market economy.

It is not productive, however, to subordinate the formation of the capital market to privatization in general, and to one method in particular. As a result, the Polish capital market has been developing very slowly, slower than it could have been, and at the same time, has become one of the barriers (although not the most important) impeding the ownership transformation in the economy.

The government's concept of the transformation of the capital market in Poland has unfortunately ignored other countries' experience which showed that a decisive role in this particular phase of capital market development should be played not by ownership instruments (mostly shares) but by debt instruments (mostly bonds) issued by the state. Had the state begun forming the Polish capital market with the state bonds market rather than with time and effort-consuming public issues of shares of State companies, the capital market would have grown much faster and be much bigger.

This thesis can be justified by the practice of the Polish capital market over the last two years. The paradox is that the state bonds (of the second issue) were the most actively traded individual security on the capital market in the period of 1989-1991. Moreover, a total weekly trading volume of the state bonds was higher - with the exception of 2 weeks - than the combined weekly trading volume of shares at the Warsaw Stock Exchange in 1991. The essence of this paradox is that the second issue of state bonds was conducted without reference to the planned establishment of the capital market, and was stopped in May 1991. It is worth adding that the objectives and character of the second issue of state bonds were very closely related to the goverment's macroeconomic policy. To sum up above, the largest segment of the Polish capital market in the period 1990-1991 was the one almost completely ignored by the authors of the final concept of the formation of the capital market.

III. THE ASSESSMENT OF THE OPERATION ON THE CAPITAL MARKET IN THE PERIOD 1989 - 1992 (JUNE).

Poland is the third post-communist country after Hungary and Yugoslawia to have established a capital market. The origins of the Poland's capital market go back to the second half of 1987 when a few state enterprises issued their bonds. However, conditions for the development of a real capital market appeared only two years later with the dismantling of the centrally planned economy which took place in August 1989.

The process of the development of Poland's capital market in the period 1989 (August) - 1992 (June) can be divided into two phases, separated by the date of April 25, 1991 when the Act on Public Trading in Securities and Trust Funds came into force. In the first phase, the capital market was growing spontaneously within the general framework of the commercial and civil laws, and without any state regulation or supervision. However, in the second phase, the process of the formation of a capital market has been regulated and strictly controlled by the state, and at the same time deprived of any spontaneity. In addition, the official final concept of the administrative shaping of the capital market by the state ignored all the practical solutions and experience of the earlier autonomous development of the capital market. It is true that the autonomous development brought about a number of negative occurrences on the capital market. It is equally true, however, that some of these practical solutions and experiences are worth applying.

The most visible achievement of capital market development has been creation of the elementary institutional infrastructure of this market. It is composed primarily of the Securities Commission, The Warsaw Stock Exchange (other stock exchanges may be set up), bank's broker-dealer bureaus, broker-dealer firms, the National Deposit of Securities and Broker Dealers' Self-Government. Equally important, all these institutions have been slowly, but systematically entering the social consciousness. Further good news is that the legal infrastructure of the capital market has been elaborated and brought into being although my strong feeling is that the securities law, which is the core of this infrastructure, is inappropriate for Polish conditions. In this context it is worth stressing that the capital market is the only one out of 5 markets (the remaining markets are: money market, credit market, off-balance sheet financial instruments market and foreign exchange market) constituting the financial and currency system whose development has been based on a prepared plan and thus, has not been a chance result of the government's economic policy and transformation efforts (unlike the four remaining markets).

At the same time it must not be overlooked that even allowing for its being at the initial stage of development, the scope of the operation of the capital market is narrower only than that of the credit market. The capital market is very small and shallow. Its trading volume is also very modest. It is hard to assess whether the market trading volume would have significantly been higher if the capital market had continued to develop in a spontaneous way (without the state regulation and supervision). However, it can be assumed that the continuation of the spontaneous development of the capital market would have brought more financial products into being than was the case.

The small size of the capital market has already been illustrated by selected figures. To supplement it, the following facts should be added. At the end of 1991, the shares of 12 State Treasury companies (which came into being as a result of the transformation of 12 state enterprises) were in public trading. So were the shares of 3 purely private joint stock companies. (The former figure increased to thirteen, while the latter did not change over the next 6 months). Apart from these ownership instruments, the state bonds of the second issue were also in public trading at the end of 1991. Unlike the shares of the companies, the state bonds were not subject to the admission procedures executed by the Securities Commission.

Public trading in securities included also shares and bonds of about 10 enterprises and companies, which had issued those instruments a few years before the Act on Public Trading in Securities and Trust Funds came into force, and which did not make any effort to adjust their former issues of securities to the issuing requirements set by the securities law. Trading in these securities has been illegal, and its voulme has been residual. Out of 16 securities which were legally in public trading at the end of 1991, 9 were listed on the Warsaw Stock Exchange. As at the end of June 1992, the respective figures were 18 and 14.

The capital market trading volume must be recognized as very modest, in both the phase of spontaneous and regulated development of the market. This refers to both primary and secondary markets.

The primary market trading volume is determined by the size of the issues of specific securities. The secondary market trading volume is determined by the total number of on-exchange and off-exchange transactions.

It is hard to calculate precisely the secondary market trading volume. While it involves no difficulties in case of the Warsaw Stock Exchange, such a calculation is hardly feasible when it comes to the OTC (secondary) market.

According to the statistics, more than 1,730,000 shares changed hands in the course of 36 trading sessions held at the Warsaw Stock Exchange in 1991. Thus an average weekly trading volume was about 48,000 shares. Total market value of all transactions concluded at the Warsaw Stock Exchange amounted to about zl 292 billion (i.e. about US$ 26 million at the December 1991 US$/zl exchange rate). Accordingly, the average weekly value of the trading volume was about zl 8.1 billion (about US$ 736 thousand). A trading volume record was set at the 34th session held on December 10, 1991, when 182,000 shares worth zl 45 billion (US$ 4.1 million) changed hands.

What is certain about the OTC securities market is only the fact that its key ingredient in all respects are state bonds of the second issue. It is practically infeasible, however, to assess precisely the trading volume in state bonds and its value since a portion of these transactions in state bonds has evaded any statistics. The point is that some of the transactions in state bonds took place (and to a lesser extent are still taking place) on the grey and black securities markets, i.e. off-authorized broker-dealer firms and bank's broker-dealer bureaus. In addition, some of the transactions in state bonds concluded by the broker-dealer firms were not recorded (the latter referring only to that period of time - that is up to July 25, 1991 when the three-month long legislation vacation relating to the securities law was over -during which broker-dealer firms could still trade in securities without the Securities Commission's permit).

Since only the recorded trading volume in state bonds was higher than the Warsaw Stock Exchange total trading volume, and an unrecorded trading volume in state bonds may have accounted for up to 25 % of the recorded figure, we again arrive at the conclusion that state bonds (of the second ussue) proved unexpectedly a primary financial instrument of the Polish capital market in the period of 1989-1991. So the bond market appeared to be the largest segment of the capital market. As we already know, those developments were far away from the intentions of the authors of the official concept of the formation of the Polish capital market, who were strongly in favor of the share market.

The Polish capital market is not unified in organizational and technical terms. Until the Warsaw Stock Exchange commenced its trading (April 16, 1991), only physical securities were traded on the Polish capital market. It became a two-tier market after that moment since the on-exchange trading is "dematerialized", whereas OTC deals involve physical securities.

In addition to being very small and shallow, price movements on the Polish capital market are extremely volatile and unpredictable. Market volatility and unpredictability stem not only from the narrowness and shallowness of the market, but also from other factors. These include: political instability in Poland, the failure of the shock therapy implemented in early 1990, growing economic troubles, short term speculation in securities by some of their holders and the fact that the capital market is hermetic. However, I take the view that the major explantation for the market volatility is something else, namely that the capital market is - in a sense - artificial. The artificiality of the capital market consists mostly in its not being integrated with the real economic process occurring in Poland's economy. In other words, the capital market in Poland does not play yet any of the basic roles of a true capital market. The most visible manifestation of the lack of the correlation between securities prices and real economic process has been the movement of the Warsaw Stock Exchange share prices which has had very little to do with the economic performance and development prospects of the various companies.

One of the most important aspects of the operation of the capital market in its regulated development phase has been its hermeticism. Access for potential users is extremely difficult. In my view this low accessibility may be primarly blamed for its artificiality, small size and lack of dynamism.

The hermeticism of the market can be seen in all areas of its operation. Let's begin with the promotion of the capital market - an issue whose importance in bringing the idea of this market to the public's attention seems quite obvious in a country whose economy was centrally planned for about 50 years. The promotion of the capital market has been very limited, and some of the very few promotion activities do more harm than good. A well-known example of such an unsuccessful measure was the TV campaign which accompanied preparations to the public issue of shares of the first five privatized state enterprises (the last two months of 1990). The campaign slogan was: "Learn the power of your money", which was usually presented together with the interior of the most luxurious hotel in Warsaw. Bearing in mind that national income per capita in Poland was 20 % lower in late 1990 than a year before, one must conclude that the authors of this campaign demonstrated their isolation from the economic reality of the country in which they intended to build up the capital market.

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A very important element of the market hermeticism is also the "dematerialization" factor. Realizing that the man in the street knows almost nothing about the capital market and perceives it as something strange, it is no wonder that a "dematerialized" product traded on this market makes it even more remote from public perception.

Under Polish conditions, the "dematerialized" capital market can not be a mass market. It can only be an exclusive market which is not able to meet appropriately the functions of the capital market. The Polish capital market is hermetic also because the scope of the operation of broker-dealer firms has been narrowed by the securities law. This limits the number of broker-dealer firms operating on the capital market while ensuring that banks dominate, at least in the short run as it occurred in Ponand in 1991 and in the first six months of 1992. Most (16) of the 20 broker-dealer securities houses which operated in Poland at the end of 1991 were bank's broker-dealer bureaus of which the most numerous were state banks' broker-dealer bureaus. It should be added that the state banks play a dominant role both on the primary and secondary securities markets.

Other countries' experience shows that banks can and - in some nations - do have a leading role on the securities market. Germany is the best example of a country whose capital market is dominated by banks.

In a number of developed economies, however, commercial banks not only do not operate on the securities market but are not eligible to enter this market. The major institutions engaged in securities trading on such securities markets are broker-dealer firms. I am strongly in favor of the view suggesting that only broker-dealer firms, not banks, should have been the primary players on the capital market under Poland's conditions. There are many causes to justify this thesis.

Firstly, the Polish banking system is still dominated by the state banks, and this is not likely to change in the near future. As a result, state entities (that is state banks' broker-dealer bureaus) will continue to hold a dominant position on the Polish securities market for at least, the next few coming years. Thus the market will continue to operate without the necessary vigor which would be naturally brought into the securities market by pirvate broker-dealer firms. The developments occurring on the securities market in 1991 and the first six months of 1992 fully confirmed these fears.

Secondly, the well konwn weaknesses of the Polish banking system should be noted. They include - among other things - banks' inability to perform banking services like the banks of developed economies and their poor technical equipment.

Finally, it does not seem to be a good idea to charge the same institutions (that is banks) with a double task of underwriting securities issues on the primary market and being primary traders on the secondary market. Such a situation may give rise to confilicts of intrest and corrupt practices.

It is true that the dominant position of the state banks in the first year of the regulated development of the securities market was - to great extent - caused by the official concept of forming the capital market. Had a less cautious and bureaucratic and more flexible concept of building up the capital market been chosen, the state banks would not have had to play a leading role both on the primary and secondary securities markets. In case of the latter - banks might have been replaced by selected private foreign exchange bureaus or the best of the broker-dealer firms that had operated before the Act on Public Trading in Securities and Trust Funds came into force.

However, even under the terms of the official concept of building up the capital market, it is feasible to weaken the monopolistic position of the banks on this market. In order to do this, the admissible scope of the broker-dealer firms' operation would have to be extended. Accordingly, the securities law would have to be slighly amended. In this context, it should be stressed that the watchdog of the Polish securities market, that is the Securities Commission, seemed to have neglected this issue in 1991.

The Polish capital market has been sealed against almost all of the economic entities which might attempt to raise funds on the capital market. This is so - leaving aside the reasons relating to the macroeconomic policy - because the rules of operation of the capital market were almost exclusively fitted to share issues by State companies. No wonder that the number of other companies whose shares were admitted to public trading was minimal at the end of 1991 (this number being the same six months later).

It was even worse in case of bonds. There was no public issue of bonds in 1991, apart from the continuation of the issue of state bonds (of the second issue) till early May of that year. It is worth emphasising that municipalities are an important group of potential bond issuers who do not yet have access to the bond market for legal reasons. The point is that the Securities Commission has not yet determined a list of requirements for a bond issuer's issuing prospectus.

I take the view that the most important characteristic of the Polish capital market is that it doesn't perform any of the essential functions of the true capital market. Since the phase of the natural development of the Polish capital market is over and was short-lived, the following remarks are restricted to the phase of regulated development in the capital market.

What evidence can we give to justify this assertion that the Polish capital market is artificial and does not serve its purpose?

Number one, the capital market still does not provide a mechanism for channelling funds within the economy from those who have money reserves to those who need investment capital. Only residual funds were transferred through the capital market in 1991.

Number two, the capital market does not yet constitute an investment valuation mechanism. This is a simple consequence of the capital market's not being a mechanism for transferring funds and the fact that the securities prices on the secondary market have very little to do with the performance of respective companies.

Number three, since the capital market neither transfers funds in the economy nor values their investment uses in defferent sectors of the economy, it does not serve as a resources allocation mechanism, either.

The performance of the capital market should not come as a great surprise despite the fact that a number of government officials expected it to do better. Firstly, because of the time factor. Too little time has passed for the capital market to integrate with real economic process. Secondly,the capital market has been built up under the specific conditions of the financial system as the whole. The essence of the problem is that the Polish financial system is still not market-oriented, and that the development of the capital market has been taking place while a comprehansive concept of a market financial system has yet to be worked out. Moreover, the capital market has been built up without the assistance of the money market and foreign exchange market which effectively do not yet exist. As other countries' experience indicates, a capital market can not serve its functions without a money market. Nor can it deveolp appropriately unless it is linked with foreign capital markets through the currency market. Finally, the capital market has been developing under strong and effective competition from the state banks-dominated and warped credit market.

Thirdly, a good deal of blame for the poor performance of the capital market should be put on its hermeticism and super-restrictiveness. Had its rules of operation been more liberal, the capital market would have been more integrated with the real economic processes.

Fourthly and finally, the macroeconomic policy implemented in early 1990 has not supported at all the development of the capital market. Contrary to that, this policy can be seen as an important obscale to capital market growth. As is widely known, macroeconomic policy has resulted in a dramatic decline in Poland's national income and industrial production over the last two and a half years. By definition, deep economic recession does not support any capital market, and particulary such a new and untried market.

In addition, an important element of Poland's macroeconomic policy, namely the positive real interest policy, has obviously favoured investments in the form of bank deposits at the expense of securities purchases. This has been compounded by the overvalued real exchange rate policy which has made zloty bank depisits even more attractive for investors.

A negative impact of the macroeconomic policy on the capital market has also resulted from one of the faulty assumptions on which this policy was based. This assumption was that state enterprises would be forced to undertake adjustment and restructuring efforts under the conditions of tight monetary and fiscal policies implemented in early 1990 and - as later became clear - without new technology injection from abroad. This has proved to be a completely wrong expectation. Most of the enterprises chose a survival approach, not a development option. Thus they have not attempted to raise funds on the demanding and shallow capital market, but turned to the credit market. The more so because the existing connections between state banks and state enterprises made it easier for the latter to seek bank credits. The political power enjoyed by large state enterprises made their borrowning on the credit market even easier.

Apart from the above, the general character of macroeconomic policy combined with the political instability negatively influenced the behavior of most economic entities, making them uninterested in long term strategies. Instead, they tried to accomplish either short-term or very short-term objectives. In result, they do not need the capital market, but prefer to borrow on the credit market. Finally, the tax policy should be mentioned in that sense that it has stimulated depositing money with banks rather than investing in securities.

Naturally, it would not have been too difficult to design such a macroeconomic policy for Poland over the last two and a half years which would have had a positive impact on the development of the capital market. No matter whether Poland's economic performance over the last two and a half years is assessed positively or negatively, should it not be accused of having being subordinated to the considerations for the formation of the capital market. Surprisingly enough, such a subordination is demanded by one of the authors of the official concept of the capital market development who is disappointed with the poor performance of the capital market. This is putting the cart before the horse. He complains[1] about the maintenance of positive real interest rates and financing state budget deficit through issues of the Treasury bonds and bills. According to him, both factors have impeded the development of the shares section of the capital market. He is right. Nevertheless, it is not enough to demand that changes of the macroeconomic policy be made on this ground. Such a reasoning indicates that the functions of the macroeconomic policy and capital market in the economy are not understood, and that natural interrelations between the two have been overlooked. It confirms once more that the designers of the official concept of the formation of the capital market neglected opportunities to initiate building up the capital market as a bond market, particularly the State Treasury bonds market. It also gives on evidence that at least one of those designers is still far away from recognizing the harm that has been done to the capital market by banning the spontaneous market and by the bad legal construction of the existing market.

All the above is not to say that the macroeconomic policy could have not included - at least to a limited extent - considerations for capital market development. That was certainly feasible, and, practically speaking, some modifications of the macroeconimic policy, which would stimulate investing in securities, should have been implemented: for instance such modifications of tax policy that would have encouraged investing in securities.

A very important characteristic of the development of the Polish capital market is its mutual interrelation with privatization. In the long term, it is just the scope and speed of privatization that will determine the size and depth of the Polish capital market. At the same time, it is obvious that privatization would face vast difficulties or would stop if it were not accompanied by an effective capital market.

That mutual linkage between privatization activity and the capital market has not worked well since their inception. The privatization program has produced fewer issues of securities than was originally hoped for. On the other hand, the capital market which suited to only one privatization method (capital privatization based on the public offering of shares), has hardly been accessible for any economic entities, except those state enterprises which have been privatized under this method. The capital market has not assisted privatization efforts also because of its being hermetic.

Despite its having operated for more than a year, the regulated capital market is still far away from being a funds channelling mechanism in the economy. At present only the credit market constitutes such a mechanism in Poland.

This is an abnormal situation even the two additional factors are taken into account: the youth of the Polish capital market and the fact that the credit market is the only external source of funds for most small and medium size firms in market economies.

The final and most important conclusion of the report is that the development of the capital market in Poland up till now has mostly had a symbolic rather than real meaning for the performance of Poland's economy and its transition to the market system.

In order to stimulate the capital market and integrate it with real economic processes, it is necessary to undertake the steps and measures which have been indicated above[2].

The primary measure should be to fully integrate the capital market formation into a program of transforming the whole financial system. The program needs to include primarily the following items:

1. privatization of state banks,
2. interest rate liberalization,
3. exchange rate liberalization,
4. setting up a money market,
5. setting up a currency market.

It is also essential to modify significantly the securities law in order to reduce the hermeticism of the capital market and make it popular and democratic.[3]

FOOTNOTES

[1] See Jedrzejczyk G. Dlaczego nie działa rynek kapitałowy? Lepiej do banku niż na giełdę (Why does capital market not operate? Better bank than stock exchange), "RZECZYPOSPOLITA", no 193, August 20, 1991.

[2] See also Pietrzak E., Rynek kapitałowy po roku (The capital market after one year), "FIRMA", no 3, March 1992.

[3] A need to revise the securities law was also recognized by the chairman of the Polish Securities Commission, see "RZECZPOSPOLITA", no 229, October 1, 1991.

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APPENDIX F

INVESTING IN THE FUTURE

REPORT OF THE TASK FORCE FOR SMALL AND MEDIUM ENTERPRISES

POLAND

May 1993

Investing in the Future

Report of

the Task Force for Small and Medium Enterprise

Poland

May 1993

Secretariat of the Task Force:

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with the kind assistance of
the Cabinet of the Minister for Entrepreneurship Promotion
and the GEMINI Small Business Project

This report presents the views of the members of the Task Force in their individual capacity and cannot bind the institutions which they represent.

The recommendations have been based on three months of investigations which by their nature have been incomplete. Since the background is constantly changing, in some cases recommendations have been overtaken by events and work has already started. More detailed information should be found for each individual recommendation when a detailed work plan is produced.

Costs presented in the report are purely indicative and should not be interpreted as commitments from either foreign donors or the Polish government.

Preface

Investing in the future - this means in the Polish context mainly investment by hundreds of thousands of entrepreneurs in their small and medium-sized businesses, with the aim of creating income and employment. As we all know, these enterprises are playing a key part in the transition of Poland towards a modern, market oriented economy. Poland will have to find its place within an enlarged European Community. Therefore, promotion of small and medium-sized enterprises means facilitating Poland's access to the European Community.

A lot has been achieved in this transitional process. The private sector is growing steadily and strongly. The Government is striving to create the favourable framework required to bring this process to full fruition. Poland's international friends and partners have pledged important amounts to assist this transition process.

The buik of the work, however, is still ahead. The business environment needs continuous improvement, the enterprises need better access to capital and advisory services, and donors need to make their assistance more effective. Being aware of all these constraints, the Polish Government, the private business sector and the donor community organised in the "Group of 24" have undertaken to combine their efforts aimed at developing the small and medium-sized business world in Poland by establishing this SME Task Force.

The present report is the result of three months of concentrated work of the Task Force. It contains a set of priority recommendations which all aim at actions to be taken in the shortest possible time, involving the Government, the financial sector, the donors, but most importantly, also the target group itself, the entrepreneurs and their organisations.

The intention is to maintain the Task Force beyond this first phase, as an instrument for effective implementation of these and other actions still to be developed. It has been a unique exercise in Poland so far, and we do have reasons to believe that it can produce results which will go far beyond of what has been achieved already.

We therefore encourage the Task Force members to continue their fruitful work also in the next phase which should see substantial progress in the implementation of the actions recommended in this report. We would also like to thank the Task Force secretariat for their intelligent and tireless efforts in compiling this report.

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Executive Summary

Background

The private sector has emerged at an impressive speed in Poland. The liberalisation of the economy has led to many new entrepreneurs establishing their own firms, while those already in business now have better prospects for expansion.

About 1.7 million private enterprises are currently registered and more than 5 million people work in the private sector (more than 9 million including agriculture). These figures indicate that the private sector is a sector of very small or micro enterprises. The share of the private sector in the total GDP is about 42%, being only 28% in 1989.

Sustaining this growth of the private sector is important for a number of reasons. The private sector, and in particular small and medium-sized enterprise (SMEs), will form the backbone of a market economy and in the future will, as in most other countries, give the majority of employment. In addition, support for small enterprise can help in demonopolisation as part of the process of transformation as well as in social stability through the creation of a middle class.

Since the sector is new and does not have a powerful political lobby or clear and comprehensive institutional support, and given that the size of firms is typically very small, it is important that at this stage further support is given to the development of the sector in general. Many foreign donors have recognised this factor and made SME development one of their priorities in giving aid to Poland. Equally, the Government of Poland has recognised the importance of this sector by appointing a Minister without portfolio with specific responsibility for Entrepreneurship Promotion.

To try to harmonise these various actions, and to create better coordination, a Task Force has been set up consisting of representatives of the Government of Poland, the G-24 donor community, the Polish banking sector and the private sector, to produce a recommended list of actions for the development of small and medium enterprise. The Task Force met six times during February, March and April 1993 to discuss the constraints affecting the sector, and possible actions to overcome them.

Constraints to SME Development

The constraints for SMEs identified by the Task Force on the basis of documents, reports and interviews are numerous and diverse and affecting practically all aspects of business. Constraints were initially grouped into nine major fields: general environment; enabling environment; entrepreneurship promotion; financing; information and counselling; technology; privatisation; trade, export, import; and foreign assistance. After discussion, it was felt that it was not possible to deal with all these areas in the initial phase of the Task Force's work and therefore work should concentrate on three fields, namely:

- enabling environment
- financing
- information and counselling

This prioritisation does not mean that the other areas should be ignored - for example, the macroeconomic environment, including the rate of inflation, has a major effect on, for example, the ability of the banking sector to deliver finance to SMEs at an acceptable interest rate. In addition, these areas cannot be treated wholly in isolation: development of policy towards the SME sector must interact with any general macro-economic policies, whilst any actions which require foreign funding must take account of the limitations under which foreign donor programmes operate.

As a result of discussion of the constraints in the three areas against the background of existing and proposed initiatives, some 37 recommendations for action were proposed by the Task Force. All of these actions are feasible and should be carried out in due course. Nonetheless, it was felt useful to agree which were the crucial actions to be carried out immediately and as a result 9 actions were highlighted for particular attention by Task Force members. It is expected that the Task Force will continue its work and that over time new priorities will take over, including actions which are not a priority in the first phase.

Priority Actions

As an absolute priority, Task Force members emphasised the need to support the ***reform of civil and commercial law.*** This is a precondition to the effective functioning of the banking system, where lack of adequate collateral law and a central collateral register hamper credit assessment and consequently access to finance by SMEs. After this reform, the major financing instrument emphasised by Task Force members was to support ***pilot guarantee schemes,*** both mutual and loan guarantee schemes. Guarantee schemes operate in a number of other countries where they are used to extend the collateral to which SMEs have access. In the period of transition it is felt best to have closely monitored pilot projects to discover whether this instrument can also be effective in Poland.

The government should also take action to develop an ***umbrella policy*** towards the SME sector and to place this in ***an SME Act*** stating the government's intentions towards the sector.

Not all actions should be taken at a national level, however. In addition to national actions, donors should try to fund ***regionally-based projects.*** A number of different suggestions for action were given, including an approach of "coaching" regional business promotion agencies.

Donors can also help by developing instruments using examples from abroad. This is important for careful preparation of detailed proposals in complex but important areas. A particular suggestion was for *analysis of the tax system* and fiscal measures in order to develop effective proposals to stimulate SME investment. There should be a parallel *review of the capital market* which also has considerable importance in generating finance, in order to develop proposals to accelerate development of this sector. This process should be complemented by a *regulatory review* which should be repeated at regular intervals in order to ensure that regulations which adversely affect SME development are identified and modified.

Although much of the discussion around financing related to financing instruments, continued *training of bank personnel* was also seen to be of considerable importance in developing the banking sector and consequently their services to SMEs.

Finally, in order to address the need for information of both donors and intermediaries serving the SME sector in the field of information and counselling, it was proposed to set up an *SME Information Centre* to coordinate the flow of information.

Other Actions

Other actions can be most easily presented in the context of the three fields identified above.

In the field of the enabling environment, general SME policy should be addressed. As well as the *umbrella policy*, the Minister for Entrepreneurship Promotion should take a number of actions to improve coordination and communication among government departments and with the private sector. Such actions include the creation of a *Coordinating Committee* with other Ministries, the creation of a *Council for Entrepreneurship* including representatives of the private sector, and addressing the needs of the regions by *regional representatives or liaison people*, and *regional meetings*. The Minister should also have a clear *role of advocacy* and a right to intervene in the legislative process where this affects SMEs. In order develop policy on the basis of appropriate information, a *Research and Analysis Unit* should be established. Finally, there should be an *awareness campaign* to ensure that policy makers and legislators are aware of the particular problems of the SME sector.

Laws and regulations are also important parts of the enabling environment. As well as the *SME Act*, a *regulatory review*, and *support for civil and commercial law reform*, actions should be taken to *stabilise the regulatory framework*, and to give the Minister for Entrepreneurship Promotion the right of *obligatory assessment of new regulations*. Finally, two further specific areas were highlighted as needing particular attention, namely *public procurement*, and *accounting regulations*. These areas can have a particular effect on SMEs and therefore changing regulations should take the sector into account.

Tax policy can also be used to help SMEs. It is proposed that a study is carried out on *tax measures to stimulate investment by SMEs*. Also, particular areas for attention would include: *equal treatment of income from dividends and interest, a* *study on tax incentives for investment in SMEs*, and *support to the tax control service* in order to make the tax system fairer.

In the field of finance a number of recommendations for financial instruments were made in addition to pilot projects on *guarantee schemes*. Consideration should be given to the idea of a *grant scheme with commercial loans* on the basis of monitoring the current STRUDER initiative and its success or failure, and *credit lines with preferential terms* since both these initiatives would help reduce the cost of capital to SMEs. As well as *support for the development of the capital market*, support should be given in developing a national *clearing chamber* to help improve banking services and *a credit rating service* to assist in risk assessment. Finally, as before, the importance of *bank personnel training* should not be forgotten.

As far as actions to support information and counselling activities, apart from the *SME Information Centre*, actions should take place at a regional level. Regional actions can include, as well as *coaching of business promotion agencies, funding of other specific regional projects, training for voievodship offices, establishment of telephone help lines*, and making a *study on regional development*. All these actions should assist in the better delivery of services to SMEs at a local level.

The special needs of *medium-sized enterprises* should not be forgotten, since they often have greater needs for sectoral consultancy and management training services. Institutions assisting this sector should therefore be supported.

Finally, support for *organisations of entrepreneurs* can help in all of the above actions by enabling the private sector to help itself. As part of the debate on business registration and whether there should be compulsory membership of business organisations, it is proposed that there should be a *study on business registration systems* to see how this could most effectively be performed using existing institutions.

Final Remarks

Although there are many recommendations listed, many of them are ongoing or can be performed by existing institutions. Wherever possible it is clearly better that an existing institution active in the field carries out an action rather than that a new body is created - this applies, for example, to the establishment of the Research and Analysis Unit and the SME Information Centre.

Nonetheless, much of the work of initiating these actions will fall on the Cabinet of the Minister for Entrepreneurship Promotion which has only limited size. If the recommendations are to succeed, strengthening of the Cabinet will be essential.

Finally, it should be noted that this is only the first step in the process of jointly developing measures to support the SME sector in Poland. It is to be hoped that the Task Force will continue its activity with regular meetings and that over time the other fields and constraints can be addressed.

List of Recommended Actions

Time scale indications: I - ongoing, II - as soon as possible, III - within a year
Underlined actions are priorities

Ref.	Action	Initiator	Major Actors	Time
GENERAL SME POLICY				
3.2.2	Umbrella policy	MoEP	other Ministers	I
3.2.3	Coordinating Committee	MoEP	other Ministers	II
3.2.3	MoEP standing for advocacy	MoEP, Council of Ministers	Prime Minister	III
3.2.3	Council for Entrepreneurship	MoEP, business organisations	Prime Minister	II
3.2.3	MoEP Regional Representatives	MoEP	regional business organisations and authorities	I
3.2.3	Regional meetings of MoEP	MoEP	Regional Representatives	II
3.2.4	Research and Analysis Unit	MoEP	donors, Bureau for Foreign Assistance	II
3.2.5	Awareness campaign	all Task Force members, business organisations etc.		II
LAWS/REGULATIONS				
4.2.2	SME Act	MoEP	Council of Ministers	III
4.2.3	Stabilising regulatory framework	MoEP	Min. of Justice, Council of Ministers	III
4.2.4	Regulatory Review	MoEP	Min. of Justice	III
4.2.5	Obligatory Assessment of proposed new regulations	MoEP	other Ministries	III
4.2.6	Support for Civil Law reform	MoEP	Min. of Justice, donors	II

4.2.6	Public Procurement Act	MoEP	business organisations	II
4.2.6	Accounting System	Accounting organisations	Min. of Finance	I
TAXES				
5.2.2	Study on tax measures to stimulate investment by SMEs	MoEP	donors, Bureau for Foreign Assistance, Min. of Finance	III
5.2.3	Equal tax treatment of income from dividends	MoEP	Min. of Finance, Council of Ministers	II
5.2.4	Study on tax incentive for investment in SMEs	MoEP	donors, Bureau for Foreign Assistance, Min. of Finance	II
5.2.5	Support to tax control service	Min. of Finance	donors, MoEP, Min. of Finance	III
FINANCE				
6.2.2	Support for Clearing Chamber	Union of Polish Banks, NBP, MoEP donors, National Clearing Chamber, Telebank		II
6.2.3	Bank personnel training	Phare PIU, Foundation for Development of Financial Sector, Task Force for Training, Bureau for Foreign Assistance		I
6.2.4	Improvement of the Capital Market	NBP, SEC, Stock Exchange, Min. of Finance, Union of Polish Banks		I
6.2.5	Credit Rating Service	Union of Polish Banks, donors		I
6.2.6	Mutual Guarantee Scheme (pilot project)	MoEP, Bureau for Foreign Assistance., NBP, local initiatives		II
6.2.6	Loan Guarantee Scheme (pilot project)	MoEP, Bureau for Foreign Assistance., NBP, donors		II
6.2.7	Grant Scheme based on commercial loans	MoEP, Bureau for Foreign Assistance., NBP, donors		II
6.2.8	Credit Line with preferential terms	MoEP donors, Bureau for Foreign Assistance, Ministry of Labour		III

INFORMATION and COUNSELLING

7.2.2	SME Information Centre	MoEP	donors	III
7.2.2	Donor-funded regional initiatives	MoEP	donors, Bureau for Foreign Assistance	I
7.2.2	Funding for specific projects at grass roots level	MoEP	donors, Bureau for Foreign Assistance	III
7.2.2	Training for Voievodship Offices	MoEP	donors, Voievodship offices	III
7.2.2	Telephone help-lines	MoEP	donors, regional authorities	III
7.2.2	Study on Regional Development	MoEP	CUP, donors	III
7.2.2	Coaching Regional Business Promotion	MoEP	donors, Bureau for Foreign Assistance	III
7.2.3	Support of the medium-sized sector	MoEP	donors, Bureau for Foreign Assistance	I
7.2.4	Support for Organisations of Entrepreneurs	Council for Entrepreneurship, MoEP, donors		I
7.2.4	Study for business registration system	Chambers	MoEP, donors,	III

MoEP = the Minister for Entrepreneurship Promotion
NBP = National Bank of Poland
SEC = Securities and Exchange Commission
CUP = Central Planning Office

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1. Introduction

1.1 Background

Increased investments by small and medium enterprises (SMEs) in profitable projects is seen as a key to economic recovery and development in Poland. In spite of many measures undertaken by the Government of Poland and the Donor Community in respect of the SME sector, currently SMEs face major obstacles in their development.

Measures taken so far have proved to be insufficient in the face of the problems. A large and growing number of potential and existing SMEs are unable to overcome the obstacles to profitable investment. On the other hand, large amounts of foreign loans have remained unspent.

Against this background, the Polish government and the G-24 donor community established a Task Force in February 1993 with the objective of recommending measures aimed at a sustainable increase of profitable investments by SMEs. Terms of Reference are presented in Annex A. Members of the Task Force have been representatives of Ministers (for Entrepreneurship Promotion, European Integration and Aid Coordination, Finance), of Polish banks (National Bank of Poland, Union of Polish Banks), of the Polish private business world, as well as representatives of the G-24 donor community (World Bank, Commission of the European Communities, European Bank for Reconstruction and Development, USAID, and the Federal Republic of Germany). Several other Ministries, organisations, foreign donors and individuals participated actively in the work of the Task Force, during the public sessions as well as through interviews and written contributions. A list of Task Force members is enclosed in Annex B whilst Annex F lists persons interviewed by the secretariat.

This report presents the recommendations worked out by the Task Force between February and April 1993. The report was compiled by the Task Force secretariat, a group of four experts funded by the Commission of the European Communities under the PHARE programme.

1.2 Policy Objectives

Small and medium sized enterprises are expected to contribute to the economic welfare of Poland, in particular to economic growth and job creation. As experienced in many other countries, SMEs are already contributing to competition in markets for goods and services and guaranteeing a permanent process of creativeness and innovation, essential elements of economic development. In Poland this rôle of SMEs has been recognised and the Polish government has defined the tasks of the Minister of Entrepreneurship Promotion accordingly.

In Resolution No 139/92 of the Council of Ministers (see Annex C) it is stated that the Minister of Entrepreneurship Promotion undertakes activities in the field of shaping economic, legal, social and organisational conditions for the promotion of entrepreneurship and the development of small and medium enterprises.

It is in this frame that the Task Force for Small and Medium Enterprises has worked out the major strategy for reaching this objective. In particular it has considered actions to reach a sustainable development of the SME sector.

Some basic principles have to be addressed in the design of an adequate SME policy and these are explored below.

1.3 Basic Principles

1.3.1 SME Target Group

Since the Polish economy is in transition, various categories of private firms exist with different legal forms. Firms originate from a variety of sources including: new start-ups; continuation of the former private sector; and privatisation of State Owned Enterprises. Most of these are very small firms, although a certain category of firms have already reached a certain scale which guarantees survival better. Moreover, SMEs have emerged in all sectors of economic life but in particular in trade.

Taking into consideration these aspects the SME sector should be seen as quite heterogeneous in legal status, size and sector.

To define policy instruments, these aspects should be taken into consideration, which means that the target group of SMEs should be defined more precisely when these measures are elaborated in more detail. This will favour more effectiveness of policy initiatives than considering every measure or instrument applicable for all SMEs.

In particular it should be considered which economic activity or sector of SMEs should be addressed.

It should be emphasised that strengthening the competitiveness of the Polish economy and thus creating economic growth and more employment can be more directly reached by stimulating the manufacturing sector or other balance of payment oriented sectors like transport, wholesaling and tourism. On the other hand, stimulating the SMEs in general or in other sectors is providing the Polish economy with an entrepreneurial class that guarantees creative entrepreneurship in the long run.

1.3.2 *Regional Approach*

SMEs need an approach on the national level especially as far as it concerns macro-economic conditions and the enabling environment, in particular related to the legislative and regulatory framework. However, the action-radius of SMEs is rather limited as they are operating quite strongly on the local and regional level. That is why initiatives should be developed or stimulated at the local and regional levels as well. In order to harmonise, to avoid overlapping and to facilitate certain actions, both national support and cooperation with local and regional actors should be envisaged.

1.3.3 *Non-discriminatory Policy for SMEs*

In the Polish transitional economy it should be stressed that the private sector and in particular SMEs are facing a rather discriminatory position. As a result, rather than looking for preferences, the first stage should be that they are not discriminated against. It should be stressed that if SMEs are expected to be the backbone of the Polish economy in the future, as it is in all market economies, then special attention is required to eliminate at least this discriminatory position. Developing specific instruments to support and to stimulate SME development in particular in this phase of the transition period can be considered as investing in the future prosperity of Poland.

1.3.4 *Policy Organisation*

The problems of SMEs are very diverse and concern the policy areas or fields of almost all ministries. As a result, many of the policy instruments necessary to reach the SMEs belong to the field of other ministries. That is why it should be recommended that there is good cooperation between the Minister for Entrepreneurship Promotion and the other ministries and a commitment of all ministries to the SME sector.

As the Minister for Entrepreneurship Promotion has not his own ministry but is operating from his Cabinet in the Office of the Council of Ministers, activities for SMEs can to a certain extent only be initiating, stimulating or consulting. Implementation is to a great extent dependent on staff and capacities of other ministries and/or extra governmental organisations.

1.3.5 *Financial Constraints.*

The feasibility of the implementation of the actions depends on the financial possibilities in Poland. Being faced with serious budget deficits the Polish government will have to look for financial means for strengthening the SME sector at present. It is important to look for budget-neutral solutions favouring the SME sector on one hand: on the other hand concerted actions by bi/multilateral donors and organisations should be sought in order to strengthen the financial capabilities of the Polish government and to develop a genuinely large scale programme for developing SMEs.

1.4 Methodology and Structure of the Report

The methodology followed in the process of reaching the actions recommended in this report is based on the concept of the policy cycle. Taking into consideration the above mentioned objectives of an SME policy, first an investigation of the problems and constraints has been carried out. Based on the results of this information-gathering phase the Task Force selected three major policy fields out of nine possible ones and these were:

- Enabling Environment (general SME policy, legislation, and taxes),
- Finance, and
- Information and Counselling.

For each policy field an inventory of possible actions has been made. The Task Force selected the most feasible ones which were recommended for implementation. In the following chapters this process is presented.

In Chapter 2 a short analysis of the position of the SME sector is provided. The support systems geared to the SMEs are presented together with a list of the constraints in the different policy fields.

In Chapters 3 - 7 the selected policy fields are discussed and concrete actions are recommended. In each of these chapters first a short analysis of the obstacles in the policy fields is given. These analyses emerge in appropriate actions or packages of actions that are recommended by the Task Force. In particular, attention is paid to the implementation phase: which steps are needed, who should be initiator or actors involved, and what are the institutional and financial aspects of the actions. Very rough estimates of the costs involved in carrying out the tasks are also presented. In general these costs represent the annual costs of running the various projects.

Finally, in Chapter 8 specific points which emerged from designing the programme or packages of actions in the previous chapters are discussed together with a general review of the recommendations.

2. State of the Art

2.1 Introduction

In this chapter, the state of the SME sector is analysed to show which constraints most urgently need to be addressed. First a brief overview is presented on facts and figures of the private sector. An overview of the activities which already exist to support SMEs as well as donor-funded projects and financing instruments of the banks is given. Thereafter, the constraints registered in literature, reports and mentioned by many experts on SMEs are listed. In the concluding paragraph the major constraints to which SME policy should be oriented are discussed.

2.2 Statistical Information

From the late seventies onward private firms in Poland were gradually released from central planning. Unincorporated firms received opportunities for development earlier than the incorporated, which were enabled to boom after the adoption of the Law on Economic Activity in 1988.

At the end of 1992 there were about 1.7 million private enterprises (excluding agriculture) producing approximately 471 billion złoty[1]. That means that about 42% of the total GDP in Poland comes from the private sector. Including the agricultural sector the share of the private sector in the total GDP rose from 28% in 1989 to about 48% in 1992.

Since 1989, the growth of the private sector in comparison to the state owned sector has been impressive. Growth figures of the GDP in real terms for the private sector were estimated to be 7.1 % in 1990, 33.3% in 1991 and for 1992 the estimates go up to 12%. The outlook of the Polish economy for this year is optimistic: there are certain indications that Poland is emerging from the recession. Exports are doing well and the private sector is strongly contributing to this economic recovery.

The dynamism in the private sector is illustrated by the investment figures as well. Of the total gross domestic investment in 1989 35% was in the private sector. This figure increased to 41 % in 1990 and it is estimated that in 1991 this figure has been slightly higher.

The share of the investment of private enterprises in manufacturing are lagging behind, while those in construction and trade are much higher. In the manufacturing sector approximately 15% of the total investment was carried out in the private sector in 1990.

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[1]Note: all figures relating to 1992 GDP in this section are preliminary estimates calculated by the Main Statistical Office (GUS).

This production boom in the private sector is in balance with the development of employment: the share of the private sector can easily be estimated to exceed already 55% (including agriculture), the share at the end of 1991. At the end of 1992 more than 5 million people worked in the private sector. Including private agriculture this figure was more than 9 million.

A part of the increase in private production is due to reclassification of former public entities (notably cooperatives) and changes in ownership (privatisation). Interesting is that the growth rate of the "old"-reclassified private sector was exceeding the growth rate of the private sector as a whole, both in 1990 and 1991.

As concerns the different categories of legal forms the unincorporated firms (1.63 million) showed a growth figure of number of enterprises of 14.8% in 1992, a bit less than in 1991 (25%). The strongest relative growth could be registered with incorporated firms (legal units), of which those that are completely domestic owned showed growth figures of 33% and 23.7% in 1991 and 1992 respectively. The incorporated firms set up with participation of foreigners rose considerably from less than 5000 in 1991 to more than 10000 in 1992: a doubling.

Incorporated firms are of a larger size than the unincorporated. Incorporated have an average employment of 14.7 when they are completely domestically owned. Incorporated firms with foreign participation show an average employment of 23.1, while the unincorporated have an average of 1.6 per firm including entrepreneurs.

At the end of 1992 the largest number of private enterprises owned by legal persons were in the trade sector (38%), while in manufacturing 21% were active. Measured in employees the share of the manufacturing sector is highest (36%), while that in trade is only 30%, indicating that the average size of the manufacturing enterprise exceeds considerably that of the trade sector.

If the unincorporated firms are considered in 1991 approx. 880,000 out of a total number of approx. 1.42 million enterprises belonged to the category of very small or micro firms (< 5 employees), which is about 62%: it should be considered however that these figures include the entrepreneur but do not take into consideration those employees that are working on short term contracts.

If only the private enterprises in manufacturing with more than 5 employees are considered then the following size-class distribution of employment can be shown:

small firms	18.5%
medium sized	52.0%
large firms	29.5%

The small firms in the manufacturing sector as well as in the construction sector are defined as firms between 6-50 employees and medium sized firms between 51 and 500 employees.

From this it can be seen that in the manufacturing sector the number of jobs in the medium-sized firms is considerably higher than in the small or large firms.

In conclusion, it can be stated that the private sector is experiencing substantial growth and can contribute to the recovery of the economy. It should be realised, however, that at least outside the manufacturing sector the firms are generally small and vulnerable.

2.3 Existing Support Institutions and Donor Funded Projects in the SME Sector

There are a wide variety of different initiatives on the ground in Poland: private, public, and funded by foreign aid. Since the network of support organisations has grown organically with little overall coordination, these initiatives in some cases complement each other and in other cases act almost in competition. Equally, whilst in some areas there are many activities in support of the development of private enterprise, in other areas the level of activity is very low, and this does not relate to the actual needs of the area.

On the Polish side there are a number of different networks of business support institutions, mostly giving basic advice, information, and training to very small enterprises and entrepreneurs who wish to start in business. Such networks include those set up by the Economic Foundation of NSZZ Solidarność, Regional Development Agencies (mostly supported by the Industrial Development Agency), local Chambers of Commerce and of Craftsmen, a number of Management and Business schools and a variety of independent local initiatives such as incubator projects. A number of national initiatives complement this, including the Foundation for Socio-Economic Initiatives, FISE, (supported by the Ministry of Labour) which operates through regionally based Agencies for Local Initiatives.

Foreign donors have supported some of these initiatives, including FISE and certain local chambers, as well as setting up new institutions, such as Business Support Centres (supported by PHARE through the Cooperation Fund) and hosted mostly by Chambers of Commerce, and Regional Management Centres established through the British Know How Fund which offer advice and counselling to the private sector as well as management training. As well as initiatives aimed at small enterprise, the International Finance Corporation, in association with the European Bank for Reconstruction and Development and USAID has set up Polish Business Advisory Services, a consultancy and training organisation based on commercial terms and aimed at management training and sectoral consultancy for medium sized private enterprises as well as the training of Polish consultants to form an indigenous consultancy sector. The German government has funded a parallel initiative, coaching medium sized enterprises using foreign expertise.

Current initiatives suffer from lack of overall coordination and in general the institutions are weak and lacking in resources (other than those provided by foreign aid).

A more comprehensive list of projects is presented in annex D.

2.4 Banks and Other Financial Institutions relevant to SMEs

Although a new banking structure has been established, it is still in the process of development and does not always serve the SME sector very well. This is partly due to lack of experience of the banks themselves, but also due to lack of an adequate environment. For example, inadequacy of collateral law and the lack of a collateral register makes assessment of the value of collateral very difficult.

The situation of the banks makes them particularly risk averse owing to the problems of risk assessment, the high rate of failures, and the lack of adequate collateral law. In addition, the regulations of the National Bank of Poland related to the necessary ratios for private banks have caused them to increase their own capital rather than give more credit to SMEs. This tendency has meant that SMEs have inadequate sources of credit, particularly long term credit. A more detailed description of the constraints hampering the financing of SMEs is presented in chapter 6.

There have been a wide variety of different foreign funded initiatives aimed at disbursing credit to the private sector. A large number of foreign credit lines are largely unspent and a major reason for this has been the difficulty of using the existing banking system and the fact that simply adding a credit line does not remove the reasons for risk aversion indicated above. This is most clearly illustrated by the fact that the most successful foreign initiative is the Polish American Enterprise Fund which has done credit appraisal itself and used the Polish banks only as 'windows'.

There are a number of initiatives related to other financial instruments, such as guarantees and equity schemes but as yet none of these has reached a sufficient stage of development or size to have any real impact on the SME sector. The STRUDER programme will have pilot regional projects for both types of actions, but they are only at the formation stage at this moment.

Other financial services are largely undeveloped. Such services include leasing, factoring, and relevant insurance services. Equally, the services which support the banks, including a national clearing chamber and appropriate credit rating agencies are only now being put in place. Nonetheless, there are a number of donor-funded initiatives to develop additional services, for example the PHARE financial sector development programme which provides support to the accounting, insurance, and tax administration sectors as well as banking training.

A more comprehensive presentation of the financial sector is presented in Annex D.

2.5 Overview of the Major Constraints

The constraints for SME development, and in particular in investing in SMEs, that could be identified in the Polish economy are numerous and very diverse. In the following list, which was developed from a variety of sources and presented to the Task Force, the constraints are listed in nine policy fields without giving a specific ranking, either for the policy fields or for the constraints.

2.5.1 *General Environment*

Macro-Economic
- high inflation
- recession (national and international)
- large government budget deficit
- high interest rates
- high taxes

Underdeveloped Infrastructure
- telecommunication
- market information system
- transportation system
- distribution systems
- business space availability

Business Climate
- suspicion and negative attitude towards successful entrepreneurs
- weak business ethics (trade practices, long payments)
- limited entrepreneurial tradition
- lack of favourable government policy

Informal Sector
- unfair competition (bribes, etc.)
- tax evasion
- massive illegal imports

2.5.2 *Enabling Environment*

Policy, Legal and Regulatory Framework
- no formal government policy or action plan for the private sector
- insufficient quantitative and qualitative policy related information on SMEs
- unsatisfactory and inadequate influence of private business on the policy making process

- legal and regulatory framework is often not clear and transparent, changes too often and leaves wide discretion for arbitrary civil administration and court decisions
- government administration and juridical system is not compatible with the creation of a private sector market driven economy
- legislators, administrators and courts lack experience and guidance in fostering the free market economy
- insufficient communication and coordination between various government institutions and ministries
- serious gaps and imperfections in laws (see other fields for example collateral law under financing)
- public procurement practices unfavourable to SMEs

Fiscal Policy

- inadequate tax enforcement and collection capabilities which lead to an excessive administrative burden on private business
- business perceive taxes as too high
- tax legislation is changing too often (even retrospective)
- no tax incentive for investment
- unequal tax treatment of dividend and interest on personal income
- high custom duties on imported equipment and raw materials

2.5.3 *Entrepreneurship Promotion/Assistance to Start-ups*

External

- difficulties with start-up finance/insufficient equity investment
- growing necessary minimum initial capital
- insufficient information, technical assistance and training for start-ups
- limited entrepreneurship promotion

Internal

- lack of knowledge and experience on running business in a competitive market
- limited entrepreneurial tradition
- limited personal assets and savings

2.5.4 *Financing*

a. *Equity Capital*

External

- unavailability of domestic capital
    - lack of venture capital institutions and instruments
    - unequal tax treatment of dividend and interest on personal income
    - underdeveloped security and capital markets
- no tax incentive for business investment

- limited flow of foreign investment

Internal

- too much reliance on debt financing to capitalise business
- low profitability of many businesses
- businessmen are reluctant to put their own capital in fixed assets (focus on short term business activity)
- entrepreneurs are reluctant to jointly invest in and "share" control of business

b. Credit

External

- high collateral and or guarantee requirements
    - banks meet problems in taking possession of the collateral
        - no asset/collateral registry
        - loop holes in the land and housing registry
        - lack of adequate property law
        - no collateral law
        - poor bankruptcy law
    - lack of standard procedure and market price information to guide valuation of assets/collateral
- high interest rates (nominal and real), due to inflation and bank margins
- banking services underdeveloped and time-consuming
    - underdeveloped clearing system
    - overdraft hardly available
- low risk investment alternatives (government bills and bonds)
- difficult access to long term financing
- actual or formal minimum loan size requirements are too high for most SMEs
- risk aversion by banks
    - banks have less experience in assessing private sector creditworthiness and risk evaluation
    - banks need other institutions to share the risks (for example credit guarantee institutions)
    - no incentives/strong disincentives to take risk by state owned bank management
    - the high rate of bad loans make banks more cautious on risk taking
    - undercapitalisation of banks
    - major taxes levied on banks when writing off bad loans
    - required credit documents are too detailed and time-consuming for SMEs
- banks avoid giving small loans (operational costs, etc.)
- lack of flexibility by banks to restructure debts

Internal

- problems with preparation of application forms and other credit documents including a business plan
- focus on "low costs" foreign exchange loans and without understanding of foreign exchange risk

Other

- inter enterprise credit *zatory*
- underdeveloped legal framework and institutions for leasing, factoring and insurance

2.5.5 *Information and Counselling*

External

- insufficient development of a business assistance support network
- limited availability of information necessary for good business decisions, especially information on:
    - markets
    - financing
    - technology
    - management
    - SME-support organisations
    - legislation and regulations
- private advisory and consulting firms are too expensive for SMEs
- big differences in the quality of information and advisory services available

Internal

- insufficient awareness of the importance of information and advice sharing among entrepreneurs
- lack of knowledge among entrepreneurs how to collect and use information for their own benefits.
- limited knowledge and lack of experience in free market business, in particular:
    - marketing
    - finance/accounting
    - management
    - customer services
    - quality control

2.5.6 *Technology*

External

- undeveloped institutions and mechanisms for technology commercialisation and transfer
- unavailable financing for R&D and technology upgrading
- brain flight

- intellectual property protection

Internal

- adaptation to international market norms and standards
- technological backwardness of SMEs affects quality and limits flexible reaction to market signals
- insufficient awareness of the necessity of technological and quality improvement, product design and production processes
- lack of knowledge on technological developments
- unawareness of the importance of R&D
- lack of financial means for R&D and modernisation of the production processes
- high custom duties on modern equipment

2.5.7 *Privatisation, SMEs and SOEs*

- no policy or programme which integrate SME development with SOE privatisation
- limited SME access to assets of SOEs being privatised
- problems of SOE affect SMEs
- insufficient information on privatisation process
- monopoly situation of some public sector enterprises, especially in regional markets

2.5.8 *Trade, Export, Import*

- difficulties in adaptation to world norms and standards
- lack of market information on foreign markets
- lack of information on foreign regulations
- relatively high costs for SMEs to access foreign markets
- high custom duties on import equipment and raw materials
- foreign import quotas on various products
  - actual preferences for SOEs
- unfair competition due to illegal import
- developing/transforming industries are threatened by competitive import

2.5.9 *Foreign Assistance*

- insufficient coordination
- insufficient information on foreign assistance
- assistance perceived as not based on the priority needs of the private sector and tend to be inflexible
- private business and the government have little or no influence . foreign assistance for private business

- business unsatisfied with significant part of foreign assistance spent on foreign consultancies and privatisation
- limited implementation of the results of foreign studies
- inadequate monitoring of implementation of foreign assistance
- no coordination and linkage between financial and technical assistance
- foreign credits (credit lines) do not reach SMEs

2.6 Conclusion and Selection of Major Policy Fields

In the preceding paragraphs it was indicated that the private sector and the smaller firms in particular have been emerging strongly in the last few years. In spite of the actions undertaken to support SMEs directly, either by strengthening the banking sector - an essential actor - or through economic development, this has not resulted in a smooth development of the SME sector. Many obstacles have been identified that are obstructing the private sector from prospering and exploiting its full potential.

The Task Force has discussed at length the numerous constraints and has selected out of the nine policy fields indicated, three major fields to which the SME policy making should be orientated, being :

1. The enabling environment: attention should be paid to the general policy aspects related to SMEs, as well as to legislation, regulations, and taxes.

2. Finance: in particular the clearing system, training of bank personnel, credit facilities.

3. Information and counselling; in particular integration with regional policy.

The obstacles in the other six policy fields which were not discussed in detail are nonetheless considered important for the further development of the SME sector. Alongside the priorities indicated in this document, it is important to recognise the need to address the other constraints, in particular those related to the macro-economic environment, which have a large effect on the effectiveness of the actions in the report. For example, nominal interest rates are closely related to the level of inflation, and therefore high inflation means reduced demand for investment credits.

Equally, it is important that actions taken to support SMEs fit in with actions of the government in other sectors and therefore, for example, SME policy should not contradict the general macro-economic policy of the government.

Finally, in seeking funding for the actions recommended, the limitations of donor funding caused by the different procedures used by different donors and the difficulty of effective coordination and cofinancing should also be taken into consideration. Grant and loan aid need to be more effectively interlinked and the government should strengthen its coordination mechanisms in this respect

3. General SME Policy

3.1 Elaboration of Constraints

Lack of a coherent SME government policy or an action plan is a major constraint causing other constraints for the development of the sector. It lacks first of all an umbrella policy which would confirm the recognition of the importance of SMEs for economic growth and general welfare, commit the government to foster SME development and provide a basis for specific SME policies by all the ministries in a coordinated manner.

The following reasons for the lack of a policy have been identified:

- Among other important questions that the government had to address, formulation of policy favourable to SME and the private sector in general has not been a priority. Some policy makers found policy for the public sector, then covering almost all the economy, more important. Others believed that the private sector would take care of itself. In particular, departments responsible for SME and entrepreneurship promotion were located in the Ministry of Industry which, being overwhelmed with the problems of SOEs and heavy industry, could not give priority to SME development.

- It seems that overall strategic objectives of government SME policy have not been developed. One has to answer the questions: *why do we want to support the SMEs? What are the long term objectives?* Without clear strategic guidelines defining specific policies is difficult.

- In 1989-92 attempts to formulate a comprehensive government policy towards the SME sector failed. Changes in cabinets and officials responsible for SMEs and entrepreneurship promotion caused delays and eventually no binding decisions were made. For example a document "Assumptions for the Government Commissioner for Entrepreneurship Promotion" prepared in the Ministry of Industry was revised several times and never approved. "Assumptions" defined certain objectives, and a set of short and long term actions (including established of a government Commissioner at the minister level, development of information and counselling system, measures for promotion of entrepreneurship, etc.)

- Institutions responsible for SME and entrepreneurship promotion were too weak to foster the formulation of such a policy. Their institutional weakness and inadequate resources limited their actions. In particular they could not implement any significant advocacy function.

- Since several ministries, agencies and institutions were involved in SME and entrepreneurship promotion, difficulties arose in coordination and elaboration of a common policy.

- The government has lacked policy-related information on SMEs and the constraints SMEs face. To formulate such a policy one needs reliable information and adequate communication between the policy makers and the business community. It lacked monitoring procedures and instruments.

- The business community has been politically too weak, inadequately organised and has not developed lobbying instruments to influence policy-making effectively. It has not clearly articulated its demands. Business people were often reluctant to collaborate with the policy makers. Since the business community is not sufficiently integrated, none of the chambers or associations can act as the single representative of the SME sector.

- There has been a lack of adequate efforts and recommendations on the part of donors in stimulating the government in SME policy issues.

3.2 Recommendations

3.2.1 Introduction

Some of the barriers to the formulation of an SME policy have become lower. In particular, observers have noticed growing (but still unsatisfactory) awareness among policy-makers of the importance of the development of the SME sector (and the private sector in general). Appointment of the Minister for Entrepreneurship Promotion is a sign of this and increases the opportunities for formulation and adoption of a coherent government policy towards the private sector and SMEs in particular. However, several other barriers still limit the possibility for formulation, adoption and implementation of such a policy.

To overcome these barriers and to develop a coherent SME policy as well as for current and future effective policy-making the following actions are recommended.

a. Initiate systematic policy process for coherent SME policy through adoption of an SME umbrella policy.

b. Improve the communication and coordination
    - between the ministries and government agencies dealing with SMEs;
    - between the government and the business community and business support institutions.

c. Support trends to integrate the business community at the regional and national level and assist efforts to develop lobbying instruments.

d. Provide the government with sufficient SME policy related information.

e. Initiate a campaign to increase the awareness of importance of SMEs for economic growth and general welfare.

These actions are described in the following paragraphs.

3.2.2 *Umbrella Policy*

Action:

- ❑ To proceed with the ***umbrella policy*** the Minister for Entrepreneurship Promotion, who is mandated to prepare drafts of governments programmes for private entrepreneurship support, should prepare a Policy Statement to be adopted by the Council of Ministers.

Function:

- The Statement will confirm the recognition of the importance of SMEs for economic growth and prosperity through increases in competitiveness and employment generation. SMEs have proved their essential role in this in many countries, in particular in the period of economic transformation. The small business contribution to the welfare of the Polish people, in the long run, will occur through competition between SMEs which will produce lower prices, better quality of output, and innovative goods and services.

- It will confirm that the government recognises the necessity to produce a policy regime which is supportive of competitive small businesses. The government should focus on establishing conditions in which SMEs can function effectively: produce or distribute goods and services, make profits, invest and, some of them, fail.

- It will define long and medium term objectives of government policy towards SME sector. This may be the basis for target group selection (see chapter 1).

- The statement will provide an umbrella over specific policies towards the SME sector by all the ministries in a coordinated manner, in particular for appropriate legislative steps and fiscal policy (SME Act, regulatory review, instruments stabilising regulations, obligatory assessment of new regulations, investment incentives, etc.). It will be a political frame accepted by the whole government for the advocacy role of the Minister.

Steps:

- The Minister for Entrepreneurship Promotion initiates the action drafting the statement.

- The statement will be made more precise during consultations with other Ministers, with comments coming from business community representatives and experienced business support institutions, and

- finally approved by the Council of Ministers.

The statement should be based on:

- the social and economic policy objectives defined in the Government Programme, the Assumptions for Social and Economic Policy, etc.;
- the Council of Ministers resolution regarding the scope of work of the Minister for Entrepreneurship Promotion;
- the Task Force report;
- proposals from business organisations.

The umbrella policy will not replace specific policies, it can only make a base for them.

3.2.3 *Improving Communication and Coordination*

To adopt a coherent SME policy as well as for current and future effective policy-making, ***government has to improve internal communication and coordination*** as well as SME advocacy in the government. The following actions are recommended to be undertaken as soon as possible:

- ❑ Establish a special *Coordinating Committee* consisting of officials in charge of SME development (from Ministry of Industry and Trade, Ministry of Labour, Bureau for Foreign Assistance, Ministry of Finance, Ministry of Justice, etc.).
  - The Committee should be set up by the Prime Minister at the initiative of the Minister for Entrepreneurship Promotion;
  - It should be chaired by the Minister for Entrepreneurship Promotion;
  - It should meet periodically to discuss specific policies in relation to overall SME policy, current and programmatic issues, coordinate SME related activities of various ministries, and improve collaboration between the ministries.
  - The Cabinet of the Minister for Entrepreneurship Promotion will serve as the Committee secretariat.

  Estimated cost: $10,000

- ❑ To fulfil his ***role of the advocate of the SME sector*** in government and the member of the government mandated to formulate and foster government SME policy, the Minister for Entrepreneurship Promotion should be given appropriate standing required to allow him to intervene in legislative development and regulatory proceedings, e.g.
  - the Minister should assign and if necessary hire several persons to advocacy staff and procurement staff;
  - a Research and Analysis Unit be created at arm's length from the Minister (see 3.5);

- more substantial funds be assigned for these tasks from the government and donor sources.

Estimated cost: $100,000

To improve the communication between the government and the business community, channels for communication at national and regional level need also to be created, in particular:

❑ Create an advisory body - the ***Council for Entrepreneurship*** - to the Prime Minister or the Minister for Entrepreneurship Promotion (who is mandated to represent the government in contacts with entrepreneurs).

Function:
provide the government with first hand opinion of business community leaders on relevant issues, increase their influence on policy-making process, develop the advocacy role of the Minister for Entrepreneurship Promotion.

- The Council should consist of delegates of major business associations. The business organisations should be appointed following defined rules of admission (to encourage self-organisation and integration of the business community) such as membership, geographic or sectoral coverage, etc.

- The Council should be mandated to consult on all SME-related draft legislative acts prepared by the government as well as those draft economic programmes and regulations which the minister presents to the Council.

- The Cabinet of the Minister for Entrepreneurship Promotion will provide logistic support to the Council.

Steps:
- provision for a Council for Entrepreneurship is included into the umbrella policy statement;
- the Minister for Entrepreneurship Promotion drafts the Council's charter to be approved by the Prime Minister;
- the Prime Minister appoints the business organisations as members and they appoint delegates.

Cost: besides some operational costs and certain member's costs, the Council should be enabled to contract out certain research and analysis projects. These projects could be funded by foreign assistance. The estimated cost would be $50,000.

❑ Appoint *representatives/liaison people of the Minister for Entrepreneurship Promotion at the regional/voievodship level.* This is a temporary solution to improve communication between the local business communities, the Minister for Entrepreneurship Promotion and regional/local authorities as well as to stimulate establishment of autonomous regional Councils of Entrepreneurs. This action has already been initiated.

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Function:

- Representatives will be the Minister's voice in the regions and the voice of the regional business community to the Minister.

- They will initiate and facilitate contacts between the business and local administration and have advocacy role at the regional level.

- They will initiate and facilitate research and analysis efforts to provide the Minister with policy-related information on SMEs in their region.

- They will stimulate the establishment of regional Councils of Entrepreneurs which will take on the functions assigned temporarily to the representatives.

Steps:

- The Minister defines terms of reference for the representatives.

- The Minister consults with regional business organisations and local authorities regarding candidates for representatives.

- Appointed representatives develop their channels for communication with local business community, local authorities and business support institutions.

Cost: because representatives are usually Voievodship office economic development department employees they should be given a small budget for tasks which exceed their present duties and to cover additional research cost when requested. Donor's assistance should be made available to support their training and efforts. Estimated cost: $5,000 per representative.

❑ Convene periodic ***meetings of the Minister with regional business community*** leaders, local authorities and business support institutions.

Steps:

- The Minister for Entrepreneurship Promotion prepares and makes public a Calendar of meetings in different regions.

- Minister's representatives organise the meetings in their regions in cooperation with local business community leaders.

Function: as for the advisory body.

Costs: pm

In addition to these actions, it is important to encourage trends toward integration and development of business associations. Additional measures are presented in section 7.

3.2.4 *Research and Analysis Unit*

To make proper decisions the government needs reliable SME policy-related information. Availability of essential data and information is also critical for effective advocacy. Without the factual base, arguments made by the SMEs or by the Minister will be looked on as special interest pleading. Effective information can highlight the real nature of the problem and can clarify why the desired policy is important not only to SMEs but also to the general welfare.

The Cabinet of the Minister for Entrepreneurship Promotion should sponsor or conduct research on the role of SMEs in the Polish economy, including studies of the manner in which SMEs and entrepreneurship affect the economy, and studies of the manner in which the economy, regulations and policies affect SMEs. This may be obtained through the ***creation of a Research and Analysis Unit*** (RAU) which will provide the government with the necessary SME-related information.

Function:

- The Unit will gather and analyse quantitative and qualitative information on existing SMEs, analyse trends in the sector, needs, opportunities and threats for SME development and other information collected for specific questions. The Unit should also report annually on the state of the sector.

- The Unit will either carry out itself or contract out monitoring and assessment of effects of specific government policies as well as projects for SME support and entrepreneurship promotion.

- A data collection function should be defined depending on lack of SME related data in main data collection agencies.

- The Unit should organise a "think tank" to deepen analysis of major issues.

- Analysis of draft laws and regulations as a part of obligatory assessment procedure may also be assigned to the Unit.

- The Unit should work at arm's length from the Minister for Entrepreneurship Promotion.

The above research and analysis activities have been done to some degree by several research institutes and assistance projects. The unit should use the information and expertise accumulated in major business support institutions. Their knowledge may be useful to: identify specific needs and opportunities of SMEs especially at the regional level; provide concepts and instruments for business support positively tested by one institution which may be applied elsewhere; define appropriate procedures for selection, financing, monitoring and evaluation of assistance projects.

Steps:

- Responsibility for the implementation of the new Unit should be given to a member of the Cabinet of the Minister for Entrepreneurship Promotion who should be given the task to produce a plan within one month detailing the costs, responsibilities and funding opportunities for the Unit. Production of this plan will involve discussions with donors and interested organisations working in Poland. Clearly, opportunities for funding, particularly from the donor side, may have an influence on the exact nature of the new Unit.

- On the basis of the study scope of work and specific functions are defined.

- These research and analysis tasks may be contracted to an independent institution (existing or newly created), selected on a competitive basis. This model has proven effective in other countries. A close working relationship between the unit and the Cabinet of the Minister for Entrepreneurship Promotion should be developed.

- The Unit should be obliged to use at least 50% of funds it has available to contract out with non-governmental or private institutions for research, analysis or information collection.

A foreign assistance project should be set up to support these efforts in funds, expertise and information.

Costs: assuming 10-15 staff and a foreign advisor gradually withdrawing, for the basic research and analysis with little data collection:
year 1: $350,000; year 2: $300,000; year 3 and later: $250,000.

3.2.5 Awareness Campaign

Whilst observers have noticed growing awareness of the importance of the development of the SME sector (and the private sector in general) the level is not yet satisfactory, even among policy makers, legislators, etc. An ***awareness campaign*** - concerted efforts of the Minister, business associations, entrepreneurship promotion institutions, donors, etc. is therefore recommended to all Task Force members. For example:

- the Task Force Report should be exploited for this purpose. The Report or its summary should be distributed among policy makers, legislators, media, etc.

- public statements or press releases at other occasions highlighting the importance of entrepreneurship and SMEs;

- awards for journalists, newspapers, tv/radio programmes, promoting actively entrepreneurship and positive thinking on SMEs.

Costs: $50,000

4. Law/Regulations

4.1 Elaboration of the Constraints

Entrepreneurs, bankers, business support providers state that various laws and regulations are inadequate for a modern market driven economy, in particular in the regulatory framework for financial institutions serving SMEs. Frequent and sudden changes of regulations make impossible any serious business planning and may affect even a well prepared enterprise. The problems of SMEs are not sufficiently considered in the legislative process. Legislators, administrators and courts lack experience in fostering a free market economy.

4.2 Recommendations

4.2.1 *Introduction*

It is the basic duty of the government to create and foster the legal and regulatory framework, institutions and mechanisms needed to keep the market working smoothly - to facilitate exchange between private individuals and private companies. The SMEs cannot themselves set the official rules by which markets effectively operate. The long term goal of the government policy towards SMEs should be to accomplish this structural activity.

Specific legislative steps should reflect the objectives of the umbrella policy and address major constraints identified in the legal and regulatory framework. The following measures are recommended:

a. SME Act;
b. Stabilisation of the Regulatory Framework;
c. Regulatory Review;
d. Obligatory Assessment of proposed new regulations;
e. Specific issues: speeding up the Civil Law reform and the Public Procurement Act.

4.2.2 *An SME Act*

The main expression of the adoption of an SME umbrella policy may be ***an SME Act***. Its function is to:

- strengthen the recognition of the importance of SMEs and the government's commitment to foster SMEs and entrepreneurship;
- provide a legal basis for various policy measures;
- create more confidence in the government among entrepreneurs.

In such an act it should be:

- emphasised that SMEs are important for economic growth, prosperity, competitiveness and labour generation;
- stipulated that comprehensive measures will be taken in the fields influencing the SME sector;
- acknowledged that the government is to take legislative steps required to implement appropriate measures;
- defined which firms belong to the SME sector;
- stipulated that SME policy formulation and implementation is a joint effort of the Government and the SME sector, in which both carry responsibility, respecting each others positions.

Specific measures may be presented depending on policy objectives adopted. In particular, the Act should include provisions for:

- relative stability of regulations influencing the environment of business;
- regulatory review;
- obligatory assessment of all legislation/regulations that may affect SMEs;
- creation of an advisory body to the government - Council for Entrepreneurship.

Steps:

- provision for the Act should be included in the Policy Statement. During consultations on the Policy Statement the Minister for Entrepreneurship should discuss the issue bilaterally with other Ministers and the Prime Minister;

- the umbrella policy having been adopted by the government, the Minister for Entrepreneurship Promotion should draft the Act on this basis. Use of foreign assistance to provide western experience of SME legislation is recommended.

- the draft is submitted to the Council for Entrepreneurship and for interministerial consultation;

- when approved it will be sent to the Parliament. SME organisations and Chambers increase their lobbying efforts to ensure support for the Act in the Parliament.

Costs: steps are a part of duties of the Minister. Some foreign assistance to present and advise on western experiences. Estimated costs: $25,000.

4.2.3 *Stabilising the Regulatory Framework*

Poland is undergoing deep transformation and changes in laws and regulations are inevitable. However, for the economy certain balance of change and stability is necessary. The government should make ***special efforts to avoid sudden and frequent shifts*** which will increase business people's confidence in stability of regulatory framework and ability to plan, such as:

- Guarantees of a minimum length of time between an act being adopted and coming into force, except where special circumstances require otherwise. This should apply especially to acts that require some adaptation efforts in enterprises. The relative burden for SMEs must be taken into consideration.

- Wherever possible strategic programmes of legal and regulatory reforms and directions for changes in regulations should be published. It may take form of "Calendars of Proposed Regulations" published by the ministries. The programme of adaptation to the EC norms and standards may serve as a framework.

- Advocacy staff of the Minister for Entrepreneurship Promotion should be obliged to raise the issue explicitly and loudly when too frequent change occurs.

Steps:

- specific legal conditions to introduction of these instruments and possible adverse effects should be investigated by the Minister for Entrepreneurship Promotion staff with outside legal experts and possibly Ministry of Justice. Experience of similar instruments and their results in other countries can be provided under a foreign assistance project.

- provision for such measures to be included in the Policy Statement;

- the Minister for Entrepreneurship Promotion staff draft the documents with assistance from outside Polish and foreign experts;

- provision for such stabilising mechanisms can be included in the SME Act or adopted in other appropriate form to be defined during the process.

Costs: pm

4.2.4 *Regulatory Review*

To identify and examine specific constraints in present legal and regulatory framework, a ***regulatory review*** should be undertaken.

Steps:

- Provision for such a Review is to be included into the umbrella policy.

- A Review Commission should be established by the Minister for Entrepreneurship Promotion, consisting of lawyers, business practitioners, consultants, etc. (5-10 persons).

- Several partial lists of legal and regulatory constraints have already been prepared (for example, by Union of Polish Crafts, and GEMINI) and may be used as a basis. Chambers and Associations should be invited to submit their recommendations to the commission.

- Identified constraints should be prioritised by the Minister in consultation with the Council for Entrepreneurship. The priority constraints will be elaborated and options for amendment or removal investigated.

- Action to address the elaborated constraints will be initiated and supported by the Minister. The Minister should bring them in attention of other relevant ministries, the Ministry of Justice and Ministry of Finance in particular.

Provision for such a regulatory review can be included in the SME Act.

Foreign assistance should support the Commission efforts. The Review may be repeated annually, but of course on a much smaller scale.

Costs: Main review costs are estimated at $100,000; annual review costs at $25,000

4.2.5 *Obligatory Assessment of Laws and Regulations*

To limit the possibility of introduction of new laws and regulations adverse to SMEs, all proposed laws and regulations that may influence the SME environment should be sent to the Minister for Entrepreneurship Promotion for examination.

Steps:

- Provision for such an obligatory assessment to be included into the umbrella policy.

- The Minister assigns analysis of drafts to a selected staff or to a specific committee as necessary. This may also be a function of the Research and Analysis Unit. Transparency, simplicity and relative costs for SME should be given particular consideration.

- Analysis should be presented to the Council for Entrepreneurship.

- Assessments should be presented to relevant bodies: other ministries, Governmental Committees (KERM, KSERM), Parliamentary Commissions.

- the Minister for Entrepreneurship and his advocacy staff should endeavour to convince relevant bodies regarding the problems of SMEs.

Provision for such an obligatory assessment should be included in the SME Act. If not, such a Review should be made obligatory by strengthening the Resolution of the Council of Ministers of November 20, 1992, par. 3.2.1.

Time: the analysis should start as soon as possible. For example the Public Procurement Act analysis may serve to develop procedures for analysis and consultation. Regular obligatory assessment will start when the umbrella policy is approved.

Costs: pm. depends on volume of new regulations, but can be approximately $100,000.

4.2.6 *Specific Issues*

There are a number of regulatory problems identified and already being considered. In particular:

Civil Law Reform

The Ministry of Justice Commission for the Reform of Civil Law has worked on several acts essential for the banking sector. To speed up and improve the process of the reform the Commission should be supported in these efforts. It is recommended that at the initiative of the Minister for Entrepreneurship the following steps are undertaken:

- Priorities are set among the laws needing reform. *Collateral Law, Acts on Commercial and Collateral Register,* will all necessarily be priorities due to their importance in financing of SMEs.

- Appropriate funds are allocated to the Commission (for experts, operational costs, etc). A Foundation for Polish Civil Law Reform is now being created which donors (both foreign and Polish) should use to channel the funds. An international board of directors led by Polish jurists will be able to direct money to needed reform projects. Progress of work will depend on funds available.

- A reasonable schedule for prioritised tasks should be set with the Ministry of Justice and the Commission.

- The Union of Polish Banks should continue to organise meetings with the members of the Commission to discuss questions which bankers face in practice. The Minister for Entrepreneurship Promotion should support such contacts.

- When a draft law is ready, the Minister for Entrepreneurship Promotion and other interested parties (banks, business representatives) should convince the government to use the fast legislative track or extended (decree) powers (if granted).

Costs: pm

Public Procurement

The public procurement system is of high importance for SMEs. Until now procurement practices have been unfavourable to SMEs. A draft Public Procurement Act is being prepared in the Central Planning Office and will soon be sent for interministerial consultation. The following steps are recommended:

- The Minister for Entrepreneurship Promotion Cabinet analyses the draft. Possible effects of the new public procurement system for SMEs should be carefully examined.

- Measures to compensate SMEs for their relative disadvantages (caused by smaller size, lack of collateral etc.) should be planned in advance. Study of relevant policies in other countries be undertaken in the Cabinet. Foreign assistance will be helpful to find appropriate concepts.

- The Minister for Entrepreneurship Promotion should ensure that the Act includes provisions allowing for introduction of measures to decrease barriers that SMEs face in access to public procurement. SME organisations should similarly lobby in the Parliament for SME favourable provisions in the Act.

- When voted for, the government and business organisations should publicise the rules defined in the Procurement Act, and sponsor the training to be carried out by the Bureau for Public Procurement on how to deal with SMEs.

- Facilitating SME access to public procurement will be a major task for the Minister for Entrepreneurship Promotion staff. They should develop close working relationship with the Bureau for Public Procurement.

Costs: pm

The Accounting System

Accounting is an essential device to measure and evaluate the enterprise. The present accounting system is not appropriate to a modern market driven economy and does not provide businesses with useful information. Reforming the principles and regulations ruling the accounting system would

- help companies better understand and resolve their own problems;
- help banks in assessing prospective borrowers;
- help the tax authorities, etc.

For these reasons it is recommended that the Association of Accountants in Poland should initiate a joint action with the Ministry of Finance to review the existing regulations and principles of accounting in Poland and to study possibilities of

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improvement. Although accountancy regulations are primarily the responsibility of the accountancy profession, the current state of transition and the effects on, for example, tax matters, means that the government should be involved in any proposals for change.

For this task a group of experts should be contracted. Foreign assistance project(s) should support these efforts.

5. Taxes

5.1 Introduction

SMEs do not have enough financial means to invest. This problem can partly be solved by giving them certain tax preferences. Poland has a serious budget deficit problem and room for tax incentives is limited. Nonetheless it is possible to adopt a number of policy measures which would not necessarily have negative budgetary effect. Incentives for SME investment and employment generation can pay themselves back by increased revenue from a larger private sector.

There is a need for equity capital, particularly for SMEs (also see chapter 6, Financing) and there are private persons willing to invest in SMEs but the existing tax system does not stimulate investment in private businesses. There are no tax incentives to stimulate equity financing. The existing regulations even discourage equity financing since as regards income tax interest from savings and government bonds are considered as tax free and dividends not. Risk-free government bonds used to finance budget deficit are an attractive alternative for investment in business.

The third constraint related to taxes is the current situation whereby taxes are perceived as very high by entrepreneurs but control is rather limited. Consequently much private economic activity goes on in the informal sector. It therefore creates no revenue for the state through taxes and enlarges unfair competition to entrepreneurs paying taxes.

5.2 Recommendations

5.2.1 Introduction

If adopted, the umbrella policy/SME Act will provide a basis for a more active tax policy towards the SMEs or targeted groups among the SMEs, depending on the policy objectives.

To stimulate investments by SMEs tax measures should be developed. This action is described in 5.2.2.

To stimulate private persons to invest in the equity of SMEs
the following tax measures must be implemented:

- income from dividends should be treated equ...
  savings in terms of tax
- a certain percentage of investment in equity by private persons should be tax deductible.

These actions are described in 5.2.3, respectively 5.2.4

In the final paragraph an action is described to improve the tax collecting system.

5.2.2 *Tax Measures to stimulate Investment by SMEs*

Functioning

As described there are limited tax measures to stimulate investments by SMEs. Examples of possible tax measures could be:

- extending the application of regulations which allow for tax deductions for job generating investment in equipment in high unemployment regions. Their effects should be monitored and, if possible, application of this incentive extended to other regions, sectors, etc.
- extending the income tax deduction (for both legal and natural persons) for investment in SOEs under privatisation.
- other incentives which proved to be good instruments in other countries should be considered, for example: a general profit apportionment scheme under which companies with sharp profit fluctuations spread profit/losses over a certain numbers of years backwards as well as forwards; an allowance for self-employment; tax deductions for investment related to objectives of the SME-policy, such as investment in new technologies or Research and Development, etc.
- complementary measures on tariffs, for example reducing the tariffs on raw materials and means of production should also be investigated.

Advantages/Disadvantages

Advantages:

- the tax measures will improve the possibilities for SME to invest.
- tax measures will reach all the firms

Disadvantages:

- without any restructuring of the government budget, tax incentives will in the short run lead to an increase of the government budget deficit. In the longer run, however, an increase of the tax revenues can be expected from the increased profits of the firms.

Implementation steps

To develop these measures a project must be started consisting of the following steps:

1. make a comprehensive expert review of current tax legislation, in close cooperation with the Ministry of Finance, in order to develop detailed revenue-neutral measures to improve the way the tax system affects the SME sector
2. make an inventory of possible tax measures which can be implemented in Poland on the basis of the existing tax system and on the basis of information abroad.
3. analyse the effects of the selected measures on:
   - behaviour of companies and on
   - the tax revenues of the government.

4. study the possibilities for changes in the tax system such that this measure has no negative consequences for the government budget (budget neutral).
5. introducing measures with limited scope and monitoring the results.

Actors
The Cabinet of the Minister of Entrepreneurship Promotion, the Ministry of Finance, and the Bureau for Foreign Assistance should approach foreign donors for assistance of this project.

Time schedule
This action can be started immediately.

Financing
Steps 1 to 3 should be financed in the framework of Technical and Financial Assistance programmes of foreign donors.

Costs
Steps 1 to 3 involve ad hoc costs.
Estimated costs $ 100,000

5.2.3 *Income of Dividends versus Interest*

Functioning
The tax system must be changed so that income from dividends is treated in the same way as income from interest.

Advantages/Disadvantages
Advantages:
- due to this measure there will be more equity investment available for SMEs
- investment by private persons will decrease the debt/equity ratio.
- most SMEs are sole traders and most of them raise their capital from private persons including relatives and friends. Therefore these tax measures can have a real, if marginal, effect on a larger number of SMEs than venture capital institutions can.

Disadvantages:
- in the case that tax on dividends is decreased without any restructuring of the government budget, the measures will in the short run lead to an increase of the government budget deficit. In the longer run however an increase of the tax revenues can be expected due to the fact that the firms invested in will become legal and due to their increased profits.

Implementation steps and actors
The Cabinet of the Minister for Entrepreneurship Promotion should submit to the Council of Ministers an appropriate draft to amend the existing regulations.

Time-schedule
This process should be started in the short term.

Costs

With the activities of the Cabinet of the Minister of Entrepreneurship Promotion no extra costs are involved, because they these activities to their normal tasks.

5.2.4 *Tax Incentive for Private Persons investing in SME*

Functioning

As described there is a need for equity capital, particularly for SMEs and there are private persons willing to invest in SMEs. To stimulate private persons to invest in the equity of SMEs a certain percentage of this investment should become tax deductible.

Advantages/disadvantages

Advantages:

- due to this measures there will be more equity investment available for SMEs
- investment by private persons will decrease the debt/equity ratio.
- most SMEs are sole traders and most of them raise their capital from private persons including relatives and friends. Therefore these tax measures can have a real, if marginal, effect on a larger number of SMEs than venture capital institutions can.

Disadvantages:

- Tax measures, without any restructuring of the government budget, will in the short run lead to an increase of the government budget deficit. In the longer run however (and maybe even in the short run) an increase of the tax revenues can be expected due to the fact that this provision will be an incentive for firms to regularise their tax status. Over time, the profitability of firms with adequate capital can be expected to show solid growth.

Implementation steps

To develop this measure a project must be set up in which the following activities are carried out:

1. Information must be collected on the effects of similar kind of measures existing abroad.
2. On the basis of this information a simulation must be carried out to measure the effects of the measure in the short and long run in Poland
3. Possibilities for changes in the tax system must be studied in order that this measure has no negative consequences for the government budget (budget neutral).

Actors

The Cabinet of the Minister of Entrepreneurship Promotion should approach the Bureau for Foreign Assistance and foreign donors for assistance for the project. Actions should be carried out in cooperation with, or even under the management of, the Ministry of Finance.

Time schedule
This process can be started at short notice.

Financing
The additional costs of foreign experts, cooperating in the project can be financed in the frame of Technical and Financial Assistance Programmes of foreign donors. As far as extra work force is necessary it must be discussed with the donor involved.

Costs
The costs involved are all ad hoc costs. These costs comprise only the costs of the expert(s).
The activities of the other parties involved belong to their normal tasks so no additional costs are involved. However it may be necessary that these parties need extra work force. Estimated ad hoc costs of experts: $25,000

5.2.5 Tax Collection

Functioning
Much of the economic activity in the SME sector is conducted in the informal sector. The Ministry of Finance should be assisted in its efforts to improve tax collection.

Advantages/Disadvantages
Advantages:
- the tax revenues for the government will raise
- unfair competition between SMEs will be reduced
- SMEs will be obliged to improve their book-keeping

Disadvantages:
- For the SMEs, which are not paying the tax they are obliged to, the income and consequently their ability to develop the firm, will decrease.

Implementation steps
1. Consultation with the appropriate department of the Ministry of Finance regarding the progress of their activities and their needs.
2. If necessary provide the tax control department of the Ministry of Finance with expertise and assistance.

Actors
The Ministry of Finance and the Bureau for Foreign Assistance should approach foreign donors for assistance.

Time schedule
This action can be started in the short term.

Financing
This action should be supported in the frame of Technical and Financial Assistance programmes of foreign donors. As far as extra work force is necessary it must be discussed with the donor involved.

Costs

The costs of the identification mission are ad hoc costs. These costs comprise only the costs of the expert(s). Estimated costs: $ 25,000

The activities of the other parties involved belong to their normal tasks so no additional costs are involved. However it may be that these parties need extra work force.

6. Financing

6.1 Elaboration of Constraints

6.1.1 Payments

Underdeveloped regular banking services
Banks operate under very difficult conditions and like many aspects linked with transferring the Polish economy into a market economy, the regular banking services are still underdeveloped. Especially for private businesses, routine payments mean an extensive administrative burden and are very time consuming, time and energy which can better be used for making more well-considered decisions. One of the causes of the underdeveloped services is the underdeveloped clearing system between banks in Poland.

6.1.2 Credit

Banks do not finance private business adequately
Several reasons are mentioned why banks are not financing private business adequately in terms of overdrafts and term credit.

The first reason is that banks are undercapitalised and are therefore not able or not allowed to give loans.

Secondly, banks consider the operational costs of giving loans to SME too high in relation to the size of the loan.

A third reason mentioned is that banks have possibilities to invest their money into state bonds and bills or inter bank deposits which are less risky than private business. In criticising this attitude first it has to be stressed that it is one of the main obligations of banks not to put their money in risky business because they are lending not their own money but the money of those who deposited it at the bank. However to earn some profits, normal banking practice means that banks have to take risks. The basic problem is how to assess the risk of financial transactions.

Risk aversion
In dealing with this problem one has to bear in mind several reasons mentioned why Polish banks are even more risk-averse than average banks.

- Polish banks have become more risk-averse due to the high rate of bad loans.
- Polish banks have less experience in assessing private sector creditworthiness and risk.
- There is inadequate collateral law and in particular an ineffective collateral register which means that banks have no guarantee that the collateral is not already pledged.
- The existing bankruptcy law reduces the possibility that banks get some repayment when firms go bankrupt.

- Banks meet problems in getting sound information on businesses which want credit. At this moment banks have limited possibilities to check whether firms really exist and to gather reliable business information on business. When firms are registered they are registered at different courts depending on their legal form and in different regions. In any case these registers give insufficient information on the business activities of the firms. However, a new act on commercial registers is already in preparation.

Documentation, reports and interviews suggest that banks will give more credit to private business if there are other institutions to share the risks with.

Regarding the state owned banks there is another problem hampering the provision of loans to private business. There are no incentives but even disincentives to take risk by these banks. Due to the fact that there is no well defined definition of risk, managers of state owned banks can be prosecuted if the bank makes losses.

High interest rates
If loans are provided to private business many of them consider the interest rates (nominal and real) as too high. The high interest rates are caused by the high inflation rate and the bank margins charged by banks. The level of interest rates is determined by:

- the high saving rates banks must pay to attract current and time deposits
- the fact that banks must account for loan loss reserves.

The high rates banks have to pay on deposits is among others linked with the alternatives persons have in investing their savings, for instance in government bonds.

Regarding the attraction of deposits by banks it must be mentioned that the regulatory/legal framework regarding banks leads to unfair competition between banks. For example the fact that savings in state banks are guaranteed by the state and those of private banks not.

It can be expected that margins banks have to charge for overcoming loan loss reserves will diminish in the course of time as banks work more efficiently and restructure their portfolios.

The interest rate is linked to the rate of inflation and psychologically this seems very high. In any case the real inflation rate for different sectors of the economy varies and therefore the real interest rate for a loan varies with it.

Additionally the current depressed state of the economy means that many SMEs cannot make profits high enough even to cover normal bank margins.

Size requirements are too high
Most private business complain that the actual or formal minimum loan size requirements are too high. On the other hand banks stated that the operational costs of handling small loans is too high in relation to the revenues.

Loan monitoring
Private business which had bank loans complain that the banks are not flexible enough regarding rescheduling the repayment of loans. Banks keep too strictly to the rules and have a lack of experience in judging the development of business.

In addition, banks insufficiently monitor the loans provided to private business. Consequently banks are not aware of the development of the firms and are not able to assist the firms in time.

Application requirements
Private business approaching banks for loans complain that the required credit documents are too detailed and time-consuming to complete. Banks seem to be unable or even unwilling to assist private business, which can be assumed as one of the tasks of banks if they want to develop themselves in the future.

Hiring consultancy for completing the application forms by SME for this purpose can prove to be very expensive. One of the interviewees stated that the costs could be as high as 10% of the loan needed.

Another aspect regarding the application of loans is that private business are not willing or able to show banks their true financial position which makes it even more difficult for banks to make a sound judgement of the application.

Foreign exchange loans
There seems to be a tendency that the preference of private business for foreign currency loans rather than złoty loans because of much lower interest rates is decreasing. This may be partly because private business now seems to recognise the foreign exchange risk.

6.1.3 *Equity*

Unavailability of equity capital
One of the reasons of the lack of equity is the lack of domestic or foreign venture capital institutions at this moment. This lack is partly caused by a lack of bankable demand for venture capital. Due to the high operational costs and the high risk of venture capital participation this participation is only profitable if it concerns relatively large amounts of capital invested. In other words venture capital operations in smaller firms are in general not very profitable. In any case, especially in smaller firms, entrepreneurs are reluctant to jointly invest in and "share" control of their businesses. At this moment there are a lot of small firms and many large firms but only a relatively small number of medium-sized business in which it is profitable to invest venture capital.

A second reason which hampers the availability of equity capital is that there is not a developed security market where securities can be dealt in.

The existing tax system does not stimulate investment in private businesses. There are no tax incentives to stimulate equity financing. The existing regulations even discourage equity financing since as regards income tax interest from savings and government bonds are considered as tax free and dividends not.

6.1.4 *Other Financial Institutions*

There is a lack of financial institutions other than banks which can assist SMEs in their development. Institutions for, for example, leasing, factoring and insurance. Reasons can be found in the undeveloped legal framework for these institutions to carry out their activities properly. In addition, institutions which support the banking sector, for example in credit rating are poorly developed.

6.2 Recommendations

6.2.1 *Introduction*

In paragraph 6.1 an elaboration is given of the constraints which are hampering financing of SMEs. On the basis of interviews, documents and reports the Secretariat has selected possible actions to cover these constraints. In annex E these possible further actions are described.

These possible actions were discussed in the Task Force meeting and with individual interviews with the Task Force members. The final actions recommended by the Task Force are elaborated in this paragraph. In addition to these actions, a number of actions in other sections of the report have a bearing on the functioning of the banking system and financial instruments. Such actions include the development of collateral law and a collateral register; establishment of a commercial register; tax measures; and business support activities.

To improve the banking services two actions are recommended, namely:
- support for the establishment of a National Clearing Chamber
- support and coordination of training initiatives for bank personnel

These actions are elaborated in paragraph 6.2.2 paragraph and 6.2.3 respectively.

Two actions are presented to improve the environment for financial institutions. In section 6.2.4 actions to improve the capital market are elaborated and in section 6.2.5 actions to establish a credit rating service.

Lack of collateral by SMEs and the unwillingness of banks to take risks are mentioned as major constraints for bank financing of SMEs. To overcome these constraints a Guarantee facility should be set up. A distinction can be made between Mutual Guarantee Schemes and a Loan Guarantee Schemes. Due to the fact that there are already initiatives to set up both kind of schemes and due to the fact that both have advantages and disadvantages it is recommended that actions are taken to set up pilot projects for both kinds of scheme. Paragraph 6.2.6 describes action to establish pilot projects for both Mutual Guarantee Scheme(s) and a Loan guarantee Scheme.

As mentioned before one of the reasons that banks are not willing to take risk is the lack of information on their clients. In chapter 7 (Information and Counselling) an action is described to develop a proper system of business registration.

Finally, two actions are elaborated to overcome the high costs of loans for SMEs. Paragraph 6.2.7 outlines the implementation of a Grant scheme based on Commercial Loans and in 6.2.8 attention is paid to Credit Line with preferential terms.

To improve the supply of equity to SMEs, a tax allowance for investments by private persons in SMEs is suggested. In addition, income from dividends should be treated similar as income from interest. Both measures are described in chapter 5 (Taxes).

6.2.2 *National Clearing Chamber*

Functioning
A National Clearing Chamber (KIR) has recently been set up with the task to introduce a national clearing system. In addition a company called Telbank is established. This company is building up a computerised inter-bank communication network. Both companies are owned by The National Bank of Poland, some individual banks and the Union of Polish banks. These initiatives should be supported.

Advantages/Disadvantages
A clearing system is a tool to improve the regular banking services. Especially for private businesses, routine payments mean an extensive administrative burden and are very time consuming, time and energy which can better be used for making more well-considered decisions.

Implementation steps
1. Consultation with the National Clearing Chamber and Telbank to identify the progress of their activities and their needs.
2. If necessary provide the National Clearing Chamber and Telbank with assistance such as, for example, the training of personnel in working with a computerised system.

Actors
The Union of Polish Banks in cooperation with a representative of the National Clearing Chamber and of Telbank should approach foreign donors for support. Negotiations with foreign donors should take place through the Bureau for Foreign Assistance.

Expert(s) in clearing systems in cooperation with a selected number of individual banks, the Union of Polish Banks, and the National Bank of Poland should identify the project and the necessary financial support for the project.

Time schedule
This action can and should be started immediately because the National Clearing Chamber and Telbank are already working on it and the sooner it works the better.

Financing
This action should be supported in the frame of Technical and Financial Assistance programmes of foreign donors. As far as extra work force is necessary it must be discussed with the donor involved.

Costs
The costs of the identification mission are ad hoc costs. These costs comprise only the costs of the expert(s). Estimated costs: $20,000

The activities of the other parties involved belong to their normal tasks so no additional costs are involved. However it may be necessary that these parties need extra work force.

The costs of implementing the assistance needed, are to be presented by the identification mission. Some of the costs may be ad hoc such as those linked to activities aimed at getting the system computerised (buying computers etc..).
The costs of other activities such as training will depend on aspects such as:
- is a course already developed
- the size of the course
- the number of persons who need to be trained, etc..

6.2.3 Training of Bank Personnel

Function
Currently there are a number of projects consisting of training bank personnel. It is recommended that the existing projects aimed at informing, advising and training banks should be supported and coordinated in fields such as:
- normal payments, overdrafts, letters of credit, etc..
- customer friendly activities such as informing clients on the services of the bank
- assessing creditworthiness and risk evaluation
- loan monitoring
- restructuring of loans like rescheduling the repayment of loans
- procedure on valuing assets/collateral, etc.

Advantages/Disadvantages

This training will improve the ability of banking personnel to work with SMEs and to provide them with all the banking services they need to run their business properly and efficiently.

Implementation steps

The existing initiatives being undertaken by the PHARE Programme Implementation Unit in the Ministry of Finance and the Foundation for the Development of the Financial Sector should be supported. The PHARE PIU is already creating an inventory of donor-funded initiatives.

Between these two bodies the following tasks need to be undertaken:

1. making an inventory on all existing activities taken in this field;
2. creating criteria (a national curriculum) on which the existing initiatives can be judged to improve the quality if necessary;
3. collection of information on the training which is missing. Courses on subjects which are not yet covered could then be initiated;
4. designing of a support scheme providing subsidies for costs of courses on subjects linked with financing of SMEs.

Actors

As well as the two bodies identified above, coordination with foreign donors should be done through the Bureau for Foreign Assistance. Training activities should be done in cooperation with the Task Force for Training and Human Resources in the Cooperation Fund which has been assigned responsibility for all training matters by the Polish government.

Time schedule

This action is already ongoing

Financing

The activities of the PHARE project at the Ministry of Finance, of the Task Force for Training and Human Resources, and of the Foundation for the Development of the Financial Sector cover what is required for this recommendation. Any further finance required could come from other foreign donors.

Costs

The recurring costs of actual training should be paid by the banks themselves on a commercial basis, at least in the long run.

6.2.4 *Improvement of the Capital Market*

Functioning

To speed up the evolution of a normal capital market, as well as better banks, a wide variety of instruments and institutions should be developed, including:

- broker arranged private placement of shares, to provide funds beyond those available from internal generation, and from relatives and friends;

- development of markets for unlisted securities of all kinds;
- formation and development of equity investment funds, pension funds, life insurance companies, mutual funds (unit trusts), and investment banking services.

This process is much further along than widely known. For example amendments to the Securities Act permitting many of these activities are currently under consideration by the government.

Advantagcs/Disadvantages

By improvement of the capital market as described above a considerable amount of money will be generated, particularly for small and medium- sized enterprises.

Steps

A working group should be established which should:

1. make an inventory of all the initiatives already going on and the support needed by these initiatives
2. examine further initiatives needed to develop the capital market.

Actors

This working group should be established by the National Bank of Poland, the Securities and Exchange Commission, the Warsaw Stock Exchange, the Ministry of Finance, the Union of Polish Banks and other experts.

Time schedule

This action can be started immediately

Financing

This action should be supported in the frame of the Technical and Financial Assistance programmes of foreign donors.

Costs

The costs can be considered as ad hoc costs. The activities of most of the parties involved belong to their normal tasks so no additional costs are involved. However it may be necessary that these parties need extra work force.

6.2.5 *Credit Rating Service*

Functioning

A credit rate service provides information on the business behaviour of firms. In other countries these services are normally private initiatives. The Polish banks have already set up an information system on their clients for internal use only. A credit rating service gives broader information such as how are firms dealing with their subcontractors, etc..

Advantages
This service could serve the banking sector and other business with information on their clients.

Steps
It must be studied to what extent these services are already developed in Poland and to what extent these initiatives can be stimulated. It should be noted that EBRD is already active in this field.

Actors
Banks and private companies should be encouraged to form such a system. Indeed, such a system is being initiated by the Union of Polish Banks. Donors should consider ways of supporting actions initiated by Polish organisations.

Costs
Estimated costs of this study: $ 10,000

Time schedule
This action can be started immediately

Financing
This action should be supported in the frame of Technical and Financial Assistance programmes of foreign donors.

6.2.6 *Guarantee Schemes*

a. *Description of Mutual Guarantee Schemes and Loan Guarantee Schemes*

Two constraints hampering bank financing of SME are the lack of collateral and the unwillingness of banks to take the risk of SME-financing alone. Abroad, guarantee facilities have proved to be effective instruments in assisting SMEs unable to get financing due to the lack of collateral. Nonetheless, in Poland the experience with guarantee facilities is still very limited. Due to the problems of an economy in transition including an underdeveloped banking system, it is not clear whether a guarantee facility will be a success.

At this moment there are several initiatives regarding the establishment of Loan and Mutual Guarantee Schemes. However, none of these schemes is already so far developed that it can be implemented immediately: funding is not available, the functions of the Guarantee Institution are not well defined, etc..

It is recommended that action must be taken aimed at establishing a Mutual Guarantee Scheme and/or a Loan Guarantee scheme as pilot projects.

Mutual Guarantee Scheme
Mutual Guarantee Schemes ("MGS") can be defined as follows: "Systems of Mutual Guarantees consisting of joint actions of a number of independent enterprises in

order to provide each other with the necessary securities, in the form of guarantees to raise capital from commercial sources. These enterprises form a Mutual Guarantee Company which administers a Fund." Mutual Guarantee Schemes are mostly set up on a regional basis. Equally, it is possible to set up a Mutual Guarantee Scheme between main and sub-contractors in the distribution sector.

Under a Mutual Guarantee Scheme the firm approaches the Mutual Guarantee Company for a guarantee. The Mutual Guarantee Company than assesses the viability of the project taking into account the qualifications and characteristics of the entrepreneur. If approved the Company approaches the bank and negotiates the conditions of the loan.

Loan Guarantee Schemes
Under a Loan Guarantee Scheme banks can ask for a guarantee for loans which they provide to small and medium-sized business. The guarantee is given by a special Institution which administers a Guarantee Fund from which the losses are paid. In this case the Entrepreneur approaches the bank directly.

Funding
In the case of a Mutual Guarantee Scheme the Guarantee Fund is financed by firms becoming a member in order to get a guarantee. In existing schemes abroad two ways can be distinguished in which the SME pays for a guarantee, namely:

- a fee which will usually include an annual charge, in most of the systems a percentage of the sum guaranteed. Additionally a initial fee is charged to cover the appraisal and administrative costs.
- a participating interest in the risk fund or equity capital of the scheme. This participation is paid back to the firm when the loan is repaid.

In addition the Fund can be financed besides individual firms by national, local and regional government, business organisations, banks and other organisations interested.

The capital for the Guarantee Fund under the Loan Guarantee Scheme comes mainly from the government. SMEs getting a guaranteed loan should pay to the Institution a provision for administrative costs of the Guarantee Institution, as a certain percentage of the money guaranteed.

In both kinds of schemes the size of the Guarantee Fund must be above a certain minimum because the investment revenues and the extra fees must cover operational costs of the Institution and the losses. It is necessary that the capital of the Fund will be invested in risk free investments. Guarantee Institutions should not be obliged to pay any tax since they constitute a mean of facilitating financing for SME.

Eligibility criteria
Under a Loan Guarantee Scheme the government, as the main initiator and financier, should develop eligibility criteria for SMEs benefiting from the scheme

and the banks applying for the guarantees. The eligibility criteria for SMEs can vary depending on the objectives of the government. Criteria could be:

- linked with the activities of the firm, for instance SME in the manufacturing or export sector
- linked with the size of the firm such as firms with less than 100 employees, etc..

The banks applying for the loans should also meet certain criteria, for example:

- have enough regional cover
- meet certain solvency criteria
- give a certain percentage of their loans to SMEs to show that they are able and have enough experience to work with SME
- be willing to train their personnel to serve SMEs, etc..

Under a Mutual Guarantee Scheme the members themselves decide on the eligibility criteria.

Functions of the guarantee institutions

The Mutual Guarantee Company has the following functions:

- Commercial Function; attracting partners and researching and analysing their transactions
- Assessment function: All the applications are assessed by the Company.
- Control and Monitoring Function: in order to ensure that bad debts are kept to a minimum the Mutual Guarantee Company has to check that all partners fulfil their obligations. If non-fulfilment occurs an agreement must be made between the interested parties to minimise as much as possible the losses.
- Management of delayed payments: After the Company has paid to the defaulting party, the Legal Department will take the necessary steps to recover the portion already paid on the loan guarantee.
- Administrative functions: this will cover all tasks relating to payments, accounting, data processing, personnel matters, etc..
- Management functions: The Company will need a general manager who will be in charge of overseeing and coordination all other functions involved as well establishing and maintaining contacts with financial institutions and other entities.

The Institution responsible for the Loan Guarantee Scheme will have the following functions:

- Administrative function: this will cover all tasks relating to processing applications, contact with banks, payments, accounting, data processing, etc..
- Management function: the Institution will need a general manager who will be in charge of overseeing and coordination all other functions involved

The other functions depend heavily on the tasks of the Institution decided upon. In most existing guarantee schemes abroad the banks select the firms which need a guaranteed loan and the banks applying for a guarantee. This system is only possible under a well developed banking system. At the beginning of chapter 6 constraints were mentioned regarding the fact that SMEs cannot obtain or are not willing to use bank loans. One of the constraints mentioned was that banks are not able to evaluate projects and to assess the risk. This problem must be solved in order to establish a viable guarantee scheme. Measures to be taken include:

- training the banks, but it will take some time before the banks have the necessary experience for judging good projects (see 6.2.3)
- giving the Guarantee Institution the task of assessing the projects brought forward by the banks. In this case the Institution must have experts who carry out this task. This can be seen as a double check. Although this double check will increase the administrative burden linked with the guarantee and make the whole procedure longer, it can be considered as necessary to reduce the losses of the scheme. In the long run when the banking structure will be improved this function can be abolished or at least reduced.

Special advantages of a Mutual Guarantee Scheme

Due to the fact that firms are guaranteeing each other a default of one company has consequences for all members. Because the Companies are set up regionally the members are known by each other. Due to this "social control" firms will do their best to repay the loan and in case of default repay the Company.

Role of the government in of both schemes:

Guarantee Schemes will only function if the government carries out the following activities:

- Supervision: the activities of the Guarantee institutions must be supervised so that the Fund is administered properly. In addition it has to be checked how the Fund is administered and in what way the capital of the Fund is invested
- The government may provide a re-guarantee so that the banks will see the Guarantee Institution as a reliable partner. In this case there must be clear rules and agreements.
- In both schemes government support is needed. Under the Loan Guarantee Scheme the government is the main financier of the Guarantee Fund. Abroad many governments also support Mutual Guarantee Schemes by the provision of part of the capital needed to start the scheme and of subsidies to reduce the costs of guarantees for SME. At the moment the government of Poland has a large budget deficit which hampers financing the re-guarantee fund and providing financial support to the Mutual Guarantee Company. Allowing an increase of the budget deficit seems to be out of the question so financial support for a Guarantee Scheme needs a restructuring of the government expenditures. Nonetheless, a certain willingness of foreign donors have been registered to finance guarantee schemes. In the STRUDER programme a budget is available for a guarantee fund. Due to the fact that this guarantee facility is not developed yet, the possibility should be examined whether it may be possible to use this budget for the establishment of a re-guarantee fund and for financial support of Mutual Guarantee Schemes in one or more of the four selected regions.

Extra role of the government for Mutual Guarantee Schemes

- The government must create the conditions to enable MGS to be established and to stimulate a positive attitude towards MGS among banks and SMEs.

Extra role of the government for Loan Guarantee Schemes

- The government must take the initiative to start the scheme.

Other conditions for both schemes:

- Banks must be able to provide loans to SME.
- Banks in the scheme must be ones willing to provide loans to SME.
- Banks must be willing to provide small loans although they consider the operational costs of giving a loan to SME as too high in relation of the size of the loan.
- Banks must be willing to take risk.
- Banks must be trained in assessing risk, evaluation of projects, valuing of collateral, etc..

Advantages to banks under both schemes:

- Banks get experience in giving loans to SME
- Reduction of risk

Additional advantages to banks under Mutual Guarantee Schemes:

- Reduction of operational costs such as marketing costs and research and operational costs, because the projects are assessed and monitored by the Mutual Guarantee Company.

Advantages to SME of both schemes:

- A Guarantee scheme improves the opportunities for SMEs to obtain financing even when they have a lack of collateral.

Additional advantages/disadvantages to SMEs under Mutual Guarantee Schemes:

- Mutual Guarantee Schemes improve the opportunities for SMEs to obtain financing and to improve the quality of the information on which banks have to decide.
- When an SME has paid its fee and is considered as a member of the Mutual Guarantee Company this means that it has to share in the losses of the Company and consequently it is not clear how much it gets back from the financial contribution.
- A Mutual Guarantee Company can provide SME expert advice on running a business such as marketing, management, production and accounting. If the transactions of the Company are increasing they are in a position to negotiate loans with more favourable conditions such as a lower interest rate or longer maturity periods.

b. *Action to set up a pilot project for a Mutual Guarantee Scheme*

Implementation steps

A programme must be started in which the following activities are carried out:

1. Review of the regulations to ensure that there are no legal barriers hampering the functioning of Mutual Guarantee Scheme.
2. Studying the feasibility of a re-guarantee facility and the feasibility of public financial support for Mutual Guarantee Schemes, including the feasibility to introduce a system of Mutual Guarantee Schemes in STRUDER.
3. Selecting one or more initiative(s) by a tender procedure.
4. Providing the selected Mutual Guarantee Scheme(s) with the necessary technical and financial support.
5. Development of a system (criteria) for monitoring the activities of the selected Mutual Guarantee Scheme(s) .
6. Monitoring the functioning of the selected Mutual Guarantee Scheme(s).

Time schedule

Step 1 and 2 of this programme can be started immediately (after agreement with a donor), especially when discussion with STRUDER shows a certain feasibility. On the basis of the results must be decided whether it is feasible to proceed with step 3, 4, 5 and 6. Step 4, the provision of technical and financial assistance, and 6, monitoring of the functioning, will last for a longer period.

Actors

The Cabinet of the Minister of Entrepreneurship Promotion should discuss with the Bureau for Foreign Assistance and foreign donors the possibility of financing the activities described under the different steps. The programme must be carried out by a team of Polish and foreign experts in consultation with the Ministry of Finance and other Ministries involved, the National bank of Poland, the Union of Polish banks and other parties interested in Mutual Guarantee Schemes (such as authorities, Chambers of Commerce, business organisations and individual banks).

Financing

All the activities mentioned under the different steps can be financed in the frame of Technical and Financial Assistance programmes of the foreign donors.

Costs

The costs of all the steps are ad hoc costs, except for the financial support of government of the fund if needed.

Estimated ad hoc costs of $ 75,000

The costs of the financial support can not be estimated, they depend on the size of the scheme, the functioning of the scheme etc..

c. ***Action to set up a pilot project for a Loan Guarantee Scheme***

Implementation steps

For the establishment of Loan Guarantee Scheme a programme should be started consisting of the following activities:

1. Select one of the existing initiatives on the basis of:
    - All existing constraints hampering bank financing of Polish SMEs

- Relevant information in Poland such as the experience of the National Bank of Poland, the preparatory work of the Cabinet of the Minister of Entrepreneurship Promotion, the feasibility study of Gemini, the preparatory work of the Ministry of Finance Department of Financial Policy and Analysis, etc..
- Experiences abroad with Loan Guarantee Schemes
- Consultation with possible financiers and their conditions, etc..

2. Further develop the selected initiative so that it becomes operative.
3. Implementation of the Loan Guarantee Scheme. If financing is not available the selected initiative can operate as a pilot project in the four selected regions in the STRUDER project.
4. Technical assistance for the Guarantee Fund.
5. If the scheme is set up as a pilot project, criteria must be developed to monitor the scheme.

Time schedule
Step 1 and 2 can be started immediately especially when the scheme should be introduced in the STRUDER project. The results of step 1 and 2 will show the feasibility of starting the implementation of a Loan Guarantee Scheme.

Actors
The Cabinet of the Minister of Entrepreneurship Promotion should discuss with the Office for Foreign Coordination and foreign donors the possibility of financing the activities described under the different steps. The programme must be carried out by a team of Polish and foreign experts in consultation with the Ministry of Finance and other Ministries involved, the National bank of Poland, the Union of Polish Banks and other parties interested in Loan Guarantee Schemes.

Financing
The activities of the programme can be financed in the frame of Technical and Financial Assistance programmes of foreign donors.

Costs
The costs of all the steps are ad hoc costs, except the costs of financial support of the Guarantee Fund which will be recurring.
Estimated ad hoc costs of step 1, 2: $ 40,000.
The costs of step 3 and 4 depend on the results of step 1 and 2 and can not be estimated at this moment.

6.2.7 Grant Scheme based on Commercial Loans

Entrepreneurs state that the interest rates charges on loans are too high and that therefore it is not economic to take credit.

Two type of actions can be taken to lower the costs of credits:
- a Grant Scheme based on Commercial Loans
- a Credit Line with Preferential Terms

In this paragraph the Grant Scheme based on Commercial Loans is described. The next paragraph discusses the establishment of a Credit Line with Preferential Terms.

Under the "Grant Scheme based on commercial loans" SME can get a grant on the basis of loans which are granted by banks on the basis that the projects are viable and that the loans are given on normal banking terms.

It is however impossible that all SMEs can get this grant. On the basis of business activities of SME which have to be stimulated to improve the economic development of Poland a selection must be on target groups which can apply for the grant. Examples of target sectors could be:

- Manufacturing companies or companies investing in fixed assets
- Medium-sized expanding firms
- SMEs in relatively disadvantaged regions
- SMEs in potential growth regions
- Start up companies
- Companies which create additional employment
- Commercialisation of technology
- Export orientated companies.

The grant should come from a well-defined separate fund of money, controlled by a specific institution and with clear and public eligibility criteria. This institution needs to have effective double check systems for appraisal of the projects to avoid the obvious tendencies towards corruption caused by public subsidy.

Advantages/disadvantages

Advantages:

- If the grant is used for investment in equity the debt/equity ratio will decrease which makes firms less vulnerable to reverses in fortune.

Disadvantages

- If the level of the grant is connected with the size of the loan, the amount of subsidy obtained by an entrepreneur is dependent on the size of the loan rather than actual needs or merit of the project. Other grant schemes could be developed based on other factors.
- Loans will increase the debt/equity ratio of SMEs. This ratio is already relatively high, which make the SMEs more vulnerable for reverses. A grant scheme based on commercial loans could encourage SMEs to take unnecessary loans and consequently a higher increase of the debt/equity ratio than necessary.
- Due to limited resources on the Polish side an appeal should be done on donors to have such a support schemes established.
- Given the shortage of resources in Poland, the funds should be used to put in place the desperately needed enabling environment. Unless and until that work is fully funded, money should not be diverted to grants or subsidies to individual firms.
- There is an overwhelming experience that the recipients of such grants or subsidies tend to be firms with entrepreneurial expertise in getting grants

and subsidies, instead of in the business of business. The dream of something for nothing tends to distract entrepreneurs from their real business.

Implementation steps

In practice, the grant scheme proposed in the STRUDER project is an example of this type of scheme.

1. the results of this pilot programme should be closely monitored and evaluated on the effect on SMEs. To do this efficiently, criteria for monitoring and evaluating the effects must be developed before the start of the Programme so that is it is clear which data have to recorded. In this way information on the development is available at any point of time. In STRUDER there is already a budget for monitoring activities.
2. On the basis of the results it should be decided to which extent a scheme can be used to stimulate other business activities.

Time schedule

STRUDER is planned to start in Summer 1993. As described the activities under step 1 must be carried out before the start of STRUDER. Due to possible start up problems, unawareness of SME on the grant etc. a reliable assessment of the scheme can take place after 12 months.

Actors

The Cabinet of the Minister of Entrepreneurship Promotion must consult the Bureau for Foreign Assistance and the European Community on the criteria for monitoring and assessment developed under STRUDER. If necessary foreign donors should be consulted on getting technical assistance for the activities mentioned under Step 1.

Financing

The activities described under step 1 can be carried out in the frame of the Technical and Financial Assistance Programmes of foreign donors.

Costs

The costs of step 1 are ad hoc costs.
Estimated costs of step 1: $10,000

6.2.8 *Credit Line with Preferential Terms*

Functioning

As described above, entrepreneurs state that the terms of commercial loans mean that it is not economic to take credit. It is possible to address this problem by giving credit with preferential terms. Such terms may mean, for example, a lower interest rate, or a long grace period. The preferential terms do not necessarily mean that the credit should have a negative real interest rate and, indeed, many of the sources of credit (such as foreign donors) oppose the idea of negative real interest rates because of the fact that they distort the market.

Clearly, any scheme which gives terms better than normal commercial conditions presupposes that the refinancing agency has access to subsidy.

It is however impossible that all SMEs can get this subsidy. On the basis of business activities of SMEs which have to be stimulated to improve the economic development of Poland a selection must be on target groups which can apply for the subsidy. Examples of target sectors could be:

- Manufacturing companies or companies investing in fixed assets
- Medium-sized expanding firms
- SMEs in relatively disadvantaged regions
- SMEs in potential growth regions
- Start up companies
- Companies which create additional employment
- Technical commercialisation
- Export orientated companies.

The subsidy should come from a well-defined separate fund of money, controlled by a specific institution and with clear and public eligibility criteria. The institution controlling the subsidy part of the scheme needs to have effective double check systems for appraisal of the projects to avoid the obvious tendencies towards corruption caused by public subsidy.

At the moment the Ministry of Labour operates a subsidised credit scheme for the unemployed and for small firms which increase employment. Additionally, Germany is setting up such a credit line with a subsidised interest rate through her Kreditanstalt für Wiederaufbau in cooperation with the Polish Development Bank.

Advantages/Disadvantages

Advantages

- Such loans will reduce costs to the SMEs.

Disadvantages

- Even when there is a positive real interest rate, it may be difficult to make the resource renew itself since it is refinanced on less than commercial terms.
- Given the shortage of resources in Poland, the funds should be used to put in place the desperately needed enabling environment. Unless and until that work is fully funded, money should not be diverted to grants or subsidies to individual firms.
- There is an overwhelming experience that the recipients of subsidies tend to be firms with entrepreneurial expertise in getting subsidies, instead of in the business of business. The dream of something for nothing tends to distract entrepreneurs from their real business.
- The fund may locally influence the demand for commercial credits which local banks may not be able to meet.

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Implementation steps

1. Analyse the effects of the scheme of the Ministry of Labour to determine the effects of this scheme as well as analysing the problems related to other existing credit lines.
2. Perform a feasibility study on the establishment of the scheme, including conditions and target groups.
3. Approach foreign donors for financing such a scheme.

Actors

The Cabinet of the Minister for Entrepreneurship Promotion and the Bureau for Foreign Assistance should approach foreign donors to finance the activities under 1. and 2.

Time schedule

This action should be started within one year.

Costs

Step 1. and 2. have ad hoc costs estimated at $75,000.
In step 3 no extra costs are involved since these are normal activities of the actors.

7. Information and Counselling

7.1 Elaboration of the Constraints

The constraints in this area can be divided as follows:

7.1.1 *Lack of Business Advice/Counselling/Consultancy*

The business support network is currently insufficiently developed in Poland. For entrepreneurs there are too few places to go for advice and the quality of advice they receive can be very variable. The private sector (commercial consultancy) does not fill the gap since most entrepreneurs cannot afford to pay for such consultancy and the sector is not well enough developed for the market to sort out quality. Currently, organisations which coordinate entrepreneurs (such as Chambers of Commerce and business associations) are weak and therefore the small enterprise sector is not very effective at sharing advice between its members.

7.1.2 *Lack of Information*

Corresponding to the lack of advice, there is a lack of information in selected areas. This includes basic areas of information necessary for good business decisions (markets, financing, technology, SME support organisations, legislation) and also lack of skills amongst entrepreneurs in collecting information and in actual knowledge in key areas (marketing, finance/accounting, management, customer services, quality control). Entrepreneurs additionally complain about lack of information on activities where actions and information tend to be centralised, such as privatisation and foreign trade connections as well as information on foreign assistance schemes. The organisations dealing with such information claim to send the information to regional networks, but clearly communication is still not sufficiently effective. It should be noted that for the entrepreneur, the problem is not just the lack of information - since much information exists somewhere - but the ability to process it into something useful for his business.

7.1.3 *Differing Needs of Different Types of SMEs*

Although the SME sector consists mainly of very small enterprises whose needs for advice and information tend to be very general, we should not ignore the needs of medium sized enterprises, formed either through the growth of small enterprises or as a result of spin-offs from the privatisation process. Such medium-sized enterprises require strategic management training and probably sectoral consultancy services. As a result, the types of institutions which need to be developed for this sector have different characteristics from those developed for start ups or very small enterprises.

7.1.4 *Existing Initiatives*

There are a wide variety of initiatives, both Polish and donor initiated, which act to give advice and information to entrepreneurs and seek to cover the problems outlined above. A list of these initiatives is presented in annex D. Analysis of these initiatives would suggest the following problems:

- Coordination and cooperation between the various networks created by both Polish organisations and by donors is poor.

- Given that SMEs, local authorities, and the various organisations which support business support networks all have few resources, the rate at which the various networks can grow and develop their services is very limited without support from external sources (either the Polish government or through foreign aid). Indeed, without continuing subsidy from some external source, many of these initiatives will cease to exist.

- Most activities are targeted at start-ups and very small enterprises and there is less provision for the needs of medium-sized enterprises.

- Despite a wide geographical spread, there is a large concentration of initiatives in the larger cities and in most cases there are no offices outside the main city of each Voievodship.

7.2 Recommendations

7.2.1 *Introduction*

A number of possible actions to address these constraints are listed in Annex E.

After discussion in the Task Force and in a smaller working group, these actions were prioritised and regrouped. During discussion it was suggested that the following issues should be addressed by any actions to be taken:

- coordination and cooperation between different business support institutions and networks;
- transparency in the allocation of resources, particularly funding, to business support institutions;
- development of effective regional policy;
- availability of future sources of funding for business support;
- development of institutions to address the special needs of medium sized enterprises;
- development of autonomous organisations of businesses and entrepreneurs.

Taking these issues into account, actions are grouped into three areas:

- Actions to improve coordination, cooperation, and the flow of information, both centrally and at a regional level;
- Actions in support of the medium-sized sector;
- Actions in support of autonomous organisations of entrepreneurs.

7.2.2 *Actions to improve Coordination, Cooperation and the Flow of Information*

Such actions need to happen both on a central and a regional level since a large amount of the activity is at the grass roots and emphasises a local aspect, whilst any effective coordination, particularly with foreign donors, needs to have a nationwide element.

a. *Actions at a Central Level: Establishment of an SME Information Centre*

Functioning

A number of the actions which have to be coordinated centrally relate to what should be done in terms of regional policy. Regional policy covers much wider issues than that of SME support, but any allocation of resources to SME support organisations should be done in the context of priority regions and needs. Current indications are that concentration will be made on the most depressed regions which are quite probably not those where there is the greatest potential for SME development. In the absence of any effective governmental regional policy, it is important that there remains some coordination of information between the various business support networks which currently exist and that will be developed in the future.

To address this need, it is proposed that a small SME Information Centre is established with the following specific tasks:

- *Collection and dissemination of information relevant to SMEs* as a core activity including information found within governmental departments such as opportunities resulting from privatisation, information on standards and changes in standards, information on legislation and changes in legislation, information on foreign trade and foreign investment opportunities. Such information should be available to all interested intermediaries dealing with SMEs.

- *Provision of information to foreign donors on projects* which they can fund and, conversely, *information to projects on the availability of foreign assistance*. This activity is ***not*** one of coordination of donors and donor aid. Instead, the centre will ensure that business support institutions are aware of new initiatives and sources of funding and that the bodies which make decisions on foreign aid are appropriately informed.

- *Support in the elaboration of individual local initiatives* which have relevance across the whole country, for example in promotion of subcontracting of private SMEs to the state owned sector as part of the restructuring process.

In performing such a function, in the medium term the tasks of the centre can be extended to cover the responsibility for:

- *Establishment of centres of excellence in training,* both of business counsellors and of entrepreneurs themselves. Such centres could be established by better coordination of foreign assistance and some form of competition between the many business schools and management training institutes which already exist. Such centres could ensure the maintenance of standards as well as the effective use of strategies related to training trainers. This is important if the knowledge of people trained at high expense by foreign sources is to be retained when they leave the organisations they are trained to work in.

- *Monitoring and evaluation* of individual projects. To start this process it will be necessary to do a comprehensive institutional audit of the existing business support networks.

Within the tasks identified above, the interaction with foreign assistance should be done in close cooperation with the Cabinet of the Minister for Entrepreneurship Promotion and the Bureau for Foreign Assistance, since negotiations on such matters should be done through governmental channels.

Future development of such an centre depends heavily on the development of governmental regional policy, since the centre will have to interact with it. Along with such a policy which would give priorities to regions and a strategy for resource allocation between the regions, the centre could enhance transparency for the projects and better inform policy-makers of the needs of SMEs in individual regions and the needs of business support organisations for support.

Advantages and Disadvantages

This scheme addresses the identified needs for information by intermediaries and the problems of coordination and transparency in the allocation of resources as well as providing the possibility of more efficient use of resources and better information for policy makers.

However, it undoubtedly cannot solve all the problems. Lack of any regional structure and regional policy will limit its effectiveness, whilst its effect on entrepreneurs depends on the effectiveness of individual initiatives at a local level in reaching the true grass roots.

It is possible that some of the functions of the centre could also be performed by better cooperation and coordination between the existing institutions and organisations. As a result, it may prove that no additional quasi-governmental agency at the central level would be of sufficient benefit to justify its high set up and operational costs.

Implementation Steps

Responsibility for the implementation of the new centre should be given to a member of the Cabinet of the Minister for Entrepreneurship Promotion who should be given the task to produce a plan within a short period detailing the costs, responsibilities and funding opportunities for the centre. Production of this plan will involve discussions with donor and interested organisations working in Poland. Clearly, opportunities for funding, particularly from the donor side, may have an influence on the exact nature of the new centre.

When funding is identified and a business plan is produced, establishment of the new centre can be relatively fast, particularly if it is in an institution which already deals with information.

The individual responsible for the project, together with any relevant donor, will then organise a tender between the different organisations which are interested in the project to decide which of the existing organisations should be the host. Criteria for selection should include the experience of the organisation in this field, the possibility to raise funding from other sources, and the degree to which the host organisation already has an information network.

Practical results will only appear in the medium term, since the new centre will have a job of several months after establishment in gathering basic information, identifying and assessing business support institutions across the country, and starting its operation. This task should not be underestimated since there will be a need to create and maintain relationships with a large number of diverse organisations including both individual initiatives and national bodies.

The financial consequences of this action are somewhat difficult to calculate. A rough estimate of the costs for such a centre with real foreign technical assistance come to $650,000 working at full capacity which may be diminished if foreign input is limited.

b. Actions at a Regional Level

Functioning

Although national coordination is poor, at a local level cooperation between different support institutions is growing and this needs to be fostered.

There is general consensus that it is not practical at this time to create a unified network of regional agencies across the country to stimulate this cooperation. Reasons for this include:

- The lack of a clear definition of a "region". Generally the identity of the population and the infrastructure is not congruent with any specific administrative unit.

- The lack of any realistic candidates for this function. The Regional Development Agencies, for example, are a heterogeneous set of organisations with differently defined roles.

- The need to select initiatives on the basis of quality. In the circumstances where many new initiatives have been created, it is important to support those which are actually successful and not just those with the right name.

There are already some initiatives being taken to coordinate regional development, in particular the planned establishment of the Polish Agency for Regional Development which will coordinate the STRUDER programme as its initial task. In addition, the creation of the SME information centre will help in regional cooperation by informing both donors and projects of the current situation and opportunities, as well as experience elsewhere in the country.

Nonetheless, the following additional actions can be taken to promote regional cooperation and grass roots initiatives:

❑ *Continued support of donor-funded regional initiatives* and close monitoring of the results. If regional development is to be effective it requires cooperation between different institutions, whilst a source of funding at a regional level will force decisions on which projects should survive where activities overlap.

❑ A *funding allocation for innovative projects at a grass roots level.* Such funding could come from both government and donors and should be disbursed in a transparent and competitive way. Such projects will have to show that they can raise some part of the costs of the project from their own sources.

❑ Similarly, a funding allocation for *projects which enhance regional cooperation* between different initiatives.

These two actions should be coordinated by the Cabinet of the Minister for Entrepreneurship Promotion and run on the basis of a widely advertised open competition between projects. Projects which fail to get assistance can therefore also be identified as candidates for foreign donor assistance and are at least visible for the information centre elaborated above. Assessment of projects should be done by a panel consisting of representatives of several

Ministries as well as the private sector to ensure that the system is seen to be transparent.

- *Support for Voievodship Offices* (and other local authorities) from central government in how to deal with entrepreneurs and how to stimulate cooperation between local initiatives. This would take the form of intensive training of individual officers. This training should also include training of the regional representatives of the Minister for Entrepreneurship Promotion and be performed in cooperation with the Regional Council for Entrepreneurship where this exists.

- *Establishment of a network of telephone help-lines*, both local and national, to advise entrepreneurs on sources of assistance locally and nationally. Local help lines are important if such an initiative is to be effective.

- A *Study on Regional Development* to identify regions where there is the greatest potential for growth in the SME sector and the regions where there are the greatest problems. The study should also identify existing business support institutions and gaps in the institutional network. This could be used as background information for all the above actions in the absence of a regional policy.

- *Support for Coaching of Regional Business Promotion.* A comprehensive concept of regional business promotion which can be implemented successively in all the regions in Poland within five years has been developed. For this purpose Poland is split up in 28 units. A unit consists of approximately 30 towns. The Coaching Programme 'Regional Business Promotion' would consist of three divisions, namely:
  - coaching of Polish companies
  - coaching of Polish consultants
  - coaching of Polish regional business promoters.

  The first two divisions are already implemented in some regions and have shown the first positive, measurable results. The strategy of the coaching approach consists of accompanying the regional business promoters, companies and consultants to success by training, advising and controlling. The tools to reach the success are seminars, practical training on the job assistance by Polish and foreign experts and an efficient controlling system. Business promoters in the third division can include regional development agencies, chambers, business associations, regional banks, etc.. These regional business promoters should deliver various kinds of products such as business contacts, meeting/information days, seminars/workshops, business incubators, development of commercial and industrial areas, etc.. The main customers should be private companies, state owned companies, governmental/ municipal offices and foreign investors and trade customers.

Advantages and Disadvantages

Although these actions can help to improve the environment, it is impossible to force different initiatives to cooperate and to share their experience. In the short term, while much money comes from central sources which are not orientated towards regional coordination, there is a certain incentive for local initiatives to compete with each other for funding. The major factor which will improve the situation will be growth of business support services and recognition of the need for cooperation for practical reasons - as is already beginning to happen in some regions.

Implementation Steps

The steps outlined above are part of an ongoing process and therefore it is difficult to make a clear time schedule for action. It should be noted, as above, that practical results will take a long time, perhaps several years, to appear.

In order to ensure that action is taken, a member of the Cabinet of the Minister for Entrepreneurship Promotion should be given the responsibility for producing an action plan for regional development, including accurate costings, for the above actions. Such a plan should be produced within three months. In terms of specific steps, the following can be noted:

Continued support of donor-funded initiatives
A member of the Cabinet of the Minister for Entrepreneurship Promotion should be given the task of coordination with foreign donors and liaison with the Bureau for Foreign Assistance. It is important that this individual collects information on individual projects from the sources identified by other actions and makes recommendations in the framework of the study on regional development.

In itself this action is within the existing budget of the Minister for Entrepreneurship Promotion.

Funding Allocations for specific types of projects
To allocate funding to projects, a proper assessment Board and procedure should be elaborated by the member of the Cabinet of the Minister for Entrepreneurship Promotion responsible for regional policy. Clearly, the exact criteria depend very heavily on the opportunities for funding this type of activity. It should be noted that a scheme which is very similar in structure is described in the project description of the World Bank's Private Enterprise Development Project and therefore after appropriate negotiation, there is a source of funding which could be available. In trying to establish a fund for the activity a minimum level of activity would require funding for, say, at least 10 projects every year at an average cost of $100,000 making the minimum viable amount $1 million. The Polish government should make a budget allocation for this amount of money in the medium term.

Support for the Voievodship Offices

Before establishing a very large training scheme, a short training needs analysis study of these offices needs to be performed (costing less than $50,000). This could easily be funded by foreign donors. As far as actual training is concerned, it would cost of the order of $200,000 to give two people in each Voievodship a one week training course organised by foreign trainers. Such could be funded by foreign donors.

Establishment of Telephone Help-Lines

This action should be sponsored by the Cabinet of the Minister for Entrepreneurship Promotion but probably the network should be managed by the SME Information Centre outlined above. $100,000 for this project would cover both an initial study and actual implementation in at least a number of regions. An initial study has to be commissioned to determine the best location for such help-lines in the regions and the accurate costs of running such a scheme nationwide.

Study on Regional Development

The study on regional development can be commissioned immediately. Since this is a study that can easily be funded by foreign donors, the individual responsible for the action plan should first approach donors to discover if there is any interest. The cost for such a study should be of the order of $200,000 and should recommend ways of keeping the study updated as well as concrete actions to be taken. The survey should be done as soon as possible in order that it can be used as background information for all of the actions detailed above.

Support for Coaching of Regional Business Promotion

The coaching programme could start in October 1993. Poland would be divided into 28 units. The estimated costs for one unit would be:

capital $ 60,000

annual fixed costs $ 180,000

variable costs $ 660,000

19% overhead costs

The cost of the whole programme of 28 units over 5 years would therefore be more than $20 million. It would be possible to have a reduced programme of a lesser number of units and the costs would be reduced accordingly.

7.2.3 *Actions in Support of the Medium-Sized Sector*

Functioning

It is clear that support for medium-sized enterprises requires different institutions and skills from that for micro-enterprises and entrepreneurs starting new enterprises. In particular, larger enterprises typically require strategic management training and sectoral consultancy as well as professional accounting services.

Although many of the existing initiatives aimed generally at advice to SMEs (such as the Business Support Centres supported by the Cooperation Fund) help medium sized companies, the main initiative which focuses on this field at present is Polish Business Advisory Services (PBAS). PBAS is supported by many of the major foreign donors and also has Polish government support. PBAS has now established itself both as a service supporting the medium-sized sector and as an agent for the development of an indigenous consultancy sector. It has developed a good reputation, although it still needs to expand its services as the sector which it serves expands.

It is clear that PBAS requires continued support, particularly since in the economic situation and stage of development of the private sector, even medium-sized enterprises cannot afford to pay an economic rate for its services.

Additionally, there are a number of other projects in this area, primarily promoted by foreign donors, such as the "coaching" scheme presented to the Task Force by GTZ. If the GTZ scheme obtains foreign donor support of an adequate nature it could complement regional initiatives such as STRUDER. Any new initiatives should not be set up in competition with the existing ones and there should be agreement, for example, on levels of fees charged to client companies.

In order to make such initiatives more effective, they should have clear access to the information described in the first section, in particular that which is most relevant to the medium sized sector (for example, on technology, technical standards, and foreign trade opportunities).

- It is important for the sector to continue to develop institutions to support medium-sized enterprises, but since foreign aid is likely to be temporary it is recommended that the Polish government develops a strategy to take over funding where this is necessary. Such funding can be at a lower level than at present if the existing initiatives succeed in training a team of Polish consultants to take over from external Western expertise.

Advantages/Disadvantages

Although there is a need for support for the medium-sized sector, in the longer term this should come from the private consultancy sector and there is a danger that subsidised schemes can inhibit the growth of this sector meaning that the Polish government will have to subsidise the existing schemes into the future.

The success or failure of the schemes in this sector depend heavily on the environment and therefore reforms of regulations and availability of finance need to be improved at the same time.

Implementation Steps

The government needs to have some strategy for taking over funding of the various schemes in the future - perhaps in 1-2 years' time. In the current turbulent environment it is difficult to estimate the realistic costs of this, but it could be of the

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order of several million dollars a year. In order to help to create such a strategy, which is also true for organisations supporting smaller enterprises, an individual in the Cabinet of the Minister for Entrepreneurship Promotion should be allocated the task of creating a clear plan for funding of business support for the future which can be put forward for incorporation in the budget in future years. This task should be coordinated with the centre outlined above, when this is established.

7.2.4 *Actions in Support of Autonomous Organisations of Entrepreneurs*

Functioning

To develop effective sharing of information between entrepreneurs, a systematic scheme to help develop autonomous structures such as Chambers of Commerce and business and trade associations needs to be developed.

Foreign donors have already given a number of small amounts of technical assistance either to the National Chamber of Commerce or to local Chambers, but this could be made more effective through exchange of information. A natural place for such coordination would be the information centre outlined above. It is important to note that foreign aid has concentrated on the official Chambers and has neglected the development of associations of entrepreneurs and trade associations. This tendency should be rectified if possible.

Most business organisations are weak in the ability to represent and lobby for the interests of their members. Whilst some of this ability can only come by organic growth and political experience, other measures which can be taken to quicken this process include:

- the inclusion of representatives of the business sector in the various bodies connected with policy making, their inclusion being conditional on their effectiveness in representing the sector (encouraging integration of different organisations);

- foreign assistance in making connections with foreign small business associations and learning from their experience.

- foreign assistance in training in the field of lobbying instruments and procedures.

In order to strengthen the Chambers of Commerce and Chambers of Craftsmen themselves, a number of people have suggested that compulsory membership would be useful. Owing to the problems of a strong reaction against this caused by memories of forced membership of communist organisations in the past, it would be necessary to ennance the services given by Chambers of Commerce at the same time, for example by giving them the role of registering businesses and therefore the opportunity to give information. Opinions are divided on this subject and the final result will be determined as part of the political process.

- To help to inform the process of developing the systems of Chambers, it is recommended that a study of the feasibility of using the existing Chamber system for registering business is commissioned.

Advantages/Disadvantages

Although the actions outlined above can have some effect, it is important to realise that truly representative organisations can only grow organically. Even in countries where, for example, Chambers of Commerce have compulsory membership, they have earned this privilege by being truly representative of the sector and offering services to their members. Such a situation will probably take years to achieve.

Implementation Steps

The action to include business representatives in policy making bodies is already discussed above in chapter 3.

Connection with foreign business associations is a matter which foreign donors can effectively facilitate without high costs. A number of such actions are already in progress and should continue. It may be possible for wider overall coordination to be added to this - for example PHARE's assistance to the National Chamber of Commerce or support to Eurochambres (the European Association of National Chambers of Commerce) in training members of Chambers of Commerce. As stated above, such assistance should be enlarged to include associations of entrepreneurs and the establishment of trade associations. The Council for Entrepreneurship should be given responsibility for producing a coordinated plan for using foreign aid in this way which can be submitted to foreign donors.

As a specific action to help the Chambers of Commerce and Craftsmen in the current situation, a survey using foreign expertise and experience should be commissioned to determine the feasibility of using the existing system of Chambers for the purpose of registering businesses and the consequences of this in terms of both financial and other resources. Such a study would cost around $50,000 and could be financed by foreign donors.

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With regard to the financial sector, specific measures include:

- the creation of some new institutions (PDB, bise, private sector banks, RDAs);
- TA to the banking sector (both for training and direct management assistance) through PHARE, the IFC twinning programme and others);
- the allocation of lines of credit for SMEs generally intermediated through Polish banks (except for the Polish-American Enterprise Fund).

These measures have proved inadequate in the face of the problems. A large and growing number potential and actual SMEs is unable to overcome the obstacles to profitable investments. On the other hand, huge amounts of foreign grants (mainly for technical assistance) and loans (for channelling finance to SMEs) have remained unspent.

In recognition of these problems, the Government and the donor community have agreed to establish a short-term SME task force.

Task Force General Objective (Mission Statement)

The mission of the task force is to recommend measures aimed at sustainable increase of profitable investments by SMEs.

Task Force Specific Objectives

The task force will analyze all of the above and possible other obstacles to SME investments and recommend appropriate measures.

Specific, but not exclusive, attention will be given to the bottlenecks in the banking system. In this area, the task force will:

- examine the current and future demand on and the capacity of the banking system to channel funds of all kinds to SMEs;
- define the gaps between demand and capacity and make proposals on how to fill these gaps, possibly with the help of technical assistance.

Also with regard to other obstacles, the task force will assess the global needs and delivery capacities of the existing structures and develop recommendations.

Annex 1

DRAFT CONTENTS OF STUDY REPORT

Executive Summary

1. Policy objectives for the SME sector.

2. Picture of the existing situation in the SME sector:

   - trends of SME development since 1990, general, sectoral and regional (appendix: available statistics on SME);

   - existing support institutions and donor funded projects in the SME sector (appendix: list of institutions and projects);

   - banks and other financial institutions relevant for SMEs, donor funded projects in this area (appendix: list of institutions, projects);

   - assessment: results in achieving past and present policy objectives.

3. Main bottlenecks identified for further SME development:

   - legal, regulatory and administrative framework;
   - entrepreneurial and managerial capability;
   - access to modern technology;
   - network of support institutions;
   - finance (interest rates, types of finance available, collaterals, structure of banking system, other financial institutions, etc.). Finance related bottlenecks will be given particular attention in the report.
   - any other relevant bottlenecks.

4. Recommendations on how to overcome the main bottlenecks and major priorities to be addressed by:

   - the Polish Government and the G-24 donor community
   - other donors
   - the financial sectors
   - other support institutions
   - SME sector organizations

   This chapter should also include comments on some recent proposals with regard to existing bottlenecks, such as the "G-24 TA Restructuring Fund".

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Output of the Task Force

The task force will report on the above to the Government of Poland and the G-24 in early 1993. The core of the report will be written by independent consultants (see below: "Task Force Secretariat") and will be discussed and accepted by the task force, in its capacity as a steering committee. A draft outline of the report is enclosed as annex 1.

Composition of the Task Force

The task force will be composed of members representing the Polish Government, banking system and SME sector, as well as of some G-24 representatives.

The Polish representatives (6) will come from:

- Ministry for SME (co-chairman of the task force)
- Ministry of Finance
- Ministry for Foreign Assistance and European Integration
- National Bank of Poland
- Union of Polish Banks
- Entrepreneurs

The G-24 representatives (4) will come from:

- EC Delegation (co-chairman)
- World Bank
- United States of America
- Federal Republic of Germany

G-24 representatives will participate in the task force in their own rights, without committing their governments\headquarters or the G-24 as a whole. Any G-24 member not represented in the task force but wishing to make contributions to the work of the latter

Annex A - Terms of Reference of the Task Force and the Task Force Secretariat

Task Force Secretariat

The secretariat will carry out the study and write the report along the outline enclosed in annex 1. In doing so, it will extensively interview the task force members, any other institutions and donors active in SME development and finance in Poland, as well as a sample of SMEs. During its work, the secretariat will report fortnightly to the task force, in steering committee meetings. These meetings are open to attendance by interested Polish SME sector representatives and G-24 members.

The secretariat will be managed by the Cabinet of the Minister for Small Business Promotion, assisted by the GEMINI Project, in collaboration with qualified Business Advisory Experts contracted by the EC PHARE programme.

Funding of the Task Force

No remuneration or cost reimbursement will be granted to the members of the task force. Contributions to the secretariat will be made as follows:

- Minister for Small Business Promotion: logistical support such as offices, secretarial services and local transport;
- EC PHARE programme: fees, per diems and international transport for experts.

Time Schedule

10 Feb 93	constitution of the task force
15 Feb 93	steering committee meeting, start of work of the secretariat
1 Mar 93	steering committee meeting
15 Mar 93	steering committee meeting
29 Mar 93	steering committee meeting
9 Apr 93	submission of draft report
14 Apr 93	steering committee meeting (discussion of draft report)
26 Apr 93	submission of final report
30 Apr 93	acceptance of final report by the task force and submission to the Government and the donor community

After discussion of the report with the Government, the task force could either be dissolved or maintained, with the aim to assist the Government in the implementation of the retained recommendations.

KS/TW 03.02.93

DRAFT TERMS OF REFERENCE

3 February 1993

Secretariat of

Task Force for SME Investment

1. Background

The Polish Government and the G-24 donor community have established a task force, with the objective of recommending measures aimed at a sustainable increase of profitable investments by SMEs. Specific objectives and other details of the work of the task force have been laid down in the terms of reference for the task force (draft version of 17.12.92). Those terms of reference also give an outline for the work of the secretariat.

2. Objectives

Accordingly, the secretariat will write the report to be submitted, with the approval of the task force, to the Polish Government and the G-24 donor community.

3. Working procedures

In the course of carrying out the study and writing the report, the secretariat will extensively interview the task force members, any other institutions and donors active in SME development and finance in Poland, as well as SME organizations. It will furthermore exploit the existing literature on SME development and finance in Poland.

Based on this analysis, the secretariat will develop draft recommendations aimed at a sustainable increase of profitable investments by SMEs. These recommendations will be submitted to the task force for discussion. The secretariat will consider any comments and changes made to the recommendations by the task force. Possible reservations expressed by individual task force members to recommendations accepted by the task force will be reported in footnotes or annexes to the main report, if this is especially so wished.

The secretariat will report to and seek comments from the task force as a group, in steering committee meetings called fortnightly by the chairmen of the latter.

5. Actions to be taken

In the event that the study report proposes institutional changes and\or the creation of new institutions in the financial sector, it should give terms of reference covering such issues as:

- objectives and scope of work (regional, sectoral)
- ownership\capital structure
- staffing (including recruitment and training)
- operational guidelines.

6. Proposals on monitoring the implementation of the recommendations, the activities of existing and newly planned institutions and the flow of investments into SMEs.

KS\TW 03.02.93

A draft outline of the study report is given in Annex 1. The main text of the report should not exceed 50 pages. Ample space will be given to the chapters "recommendations" and "actions to be taken". Theoretical deliberations, descriptions of the past and present situation as well as of the bottlenecks identified and any further background information should be dealt with chiefly in annexes; in the main text, these should appear only to the extent necessary to justify the recommendations. The main text will be preceded by an executive summary of no more than 5 pages.

4. Time schedule (provisional)

10 Feb 93	constitution of the task force
15 Feb 93	steering committee meeting, start of work of the secretariat
1 Mar 93	steering committee meeting
15 Mar 93	steering committee meeting
29 Mar 93	steering committee meeting
9 Apr 93	submission of draft report
15 Apr 93	steering committee meeting (discussion of draft report)
26 Apr 93	submission of final report
30 Apr 93	acceptance of final report by the task force and submission to the Government and the donor community

5. Composition and organization of the secretariat

The secretariat will be managed by the Cabinet of the Minister for Small Business Promotion, assisted by the GEMINI Project, in collaboration with qualified Business Advisory Experts contracted by the EC PHARE Programme (Prof. J. Vianen and an assistant, together about 12 person/weeks, Mr. S. Thompson, about 4 person/weeks and a Polish member, nominated by the Cabinet Office of Minister Eysmont, Mr. Dariusz Stola, for about 8 person/weeks). The Cabinet Office, of Minister Eysmont, with assistance from the GEMINI Project, will provide professional and logistical support such as office space, secretarial services, communication facilities and transport.

Fees, per diems and international transport will be funded by the PHARE Programme, under the Small Technical Assistance Facility.

KS/TW 03.02.93

Annex B - List of Task Force Members

Polish Side Members	*Representatives*
1. POLISH GOVERNMENT	
Mr. ZBIGNIEW EYSMONT (Co-chairman) Minister - Member of the Council of Ministers	Mr. Tomasz Wąsowicz
Mr. JAN KRZYSZTOF BIELECKI Minister - Member of the Council of Ministers	Mr. Marek Kozak
Mr. JERZY OSIATYŃSKI Minister of Finance	Ms. Helena Góralska
2. POLISH BANKING SECTOR	
Ms. HANNA GRONKIEWICZ-WALTZ President of Polish National Bank	Ms. Janina Kraszewska
Mr. MARIAN KRZAK Union of Polish Banks	Mr. Andrzej Wolski
3. POLISH PRIVATE SECTOR	
Ms. DANUTA PIONTEK Convention of Entrepreneurs, Traders and Agriculture Producers	
Mr. BOGUSŁAW WÓJCIK National Chamber of Commerce Crafts Chamber of Small and Medium Enterprises	
Mr. ZBIGNIEW NIEMCZYCKI Polish Business Round Table	Mr. Jerzy Schön
Mr. MAREK GOLISZEWSKI Business Centre Club	Mr. Witold Michałek
Mr. TADEUSZ MAĆKOWIAK Christian Entrepreneurs' Club	
Ms. ANNA [illegible] Union of Polish Crafts	

Annex C - Resolution of the Council of Ministers regarding the scope of work of the Minister for Entrepreneurship Promotion

G-24 Members		*Representatives*
1.	Mr. ALEXANDER DIJCKMEESTER (Co-chairman) Commission of the European Communities.	Mr. Klaus Schmidt
2.	Mr IAN HUME World Bank	Mr. Mario Reyes-Vidal
3.	Mr. WILLIAM R. JOSLIN USAID	
4.	Mr. BERND SCHLEGEL The Government of the Federal Republic of Germany	
5.	Mr. JOHN HASTINGS European Bank for Reconstruction and Development	

(DAI/GEMINI English Translation of Polish Original)

Resolution No. 139/92

of the COUNCIL OF MINISTERS

dated November 20, 1992

regarding the scope of work of the Minister, Member of Council of Ministers, Zbigniew Eysmont.

The Council of Ministers decides as follows:

§ 1.

The Minister - Member of the Council of Ministers undertakes activities in the field of shaping economic, legal, social and organizational conditions for the promotion of entrepreneurship and the development of small and medium enterprises; supporting inter-departmental activities and the creation of policy in this area.

§ 2.

The duties of the Minister, Member of the Council of Ministers, Zbigniew Eysmont include, specifically:

1) preparing, in cooperation with the appropriate state administration agencies and non-governmental organizations, of a draft of a government program for promotion and support for the development of private entrepreneurship;

2) representing the Government in cooperation and contacts with entrepreneurs and their organizations;

3) informing the appropriate state administration agencies of the opinions, conclusions and expectations of the private entrepreneurs; in order for these to be taken into consideration in the implementation of the social and economic policy of the state;

4) initiating and organizing research concerning the conditions, tendencies and barriers in the development of entrepreneurship; and making evaluations of the current economic and legal system from the standpoint of its influence on economic activity;

5) initiating and preparing, in cooperation with the interested agencies and institutions, projects for programs and legal acts supporting the development of private entrepreneurship;

6) initiating and supporting the activities of the appropriate agencies, institutions and organizations for the development of infrastructure supporting the development of private entrepreneurship and its promotion;

7) cooperating with international organizations and other appropriate institutions in activities supporting the development of private entrepreneurship and its promotion;

8) cooperating with the appropriate state administration agencies and with the Government's Plenipotentiary for European Integration and Foreign Assistance, in order to obtain financial and material resources, both domestic and foreign, designated for the development of private sector, as well as participation in the disposition of these resources;

9) cooperating in the acquisition of foreign technical and financial assistance for the promotion of private entrepreneurship.

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§ 3.

1. In the course of performing the tasks defined in art.1 and 2, the Minister, Member of the Council of Ministers, Zbigniew Eysmont shall cooperate with the interested state administration agencies and governmental organizations.

2. The Minister - Member of the Council of Ministers:

   1) comments and consults (makes recommendations) on programs and legislative acts which can have influence on the development of private entrepreneurship;

   2) comments and consults (makes recommndations) activities pertaining to the acquisition of financial and material resources, both domestic and foreign, which serve the promotion and support of private entrepreneurship;

   3) evaluates and consults (makes recommendations) on proposals for allocation and conditions of using domestic and foreign resources designated for the promotion of entrepreneurship and development of private sector;

   4) comments (makes recommendations) on directions and programs of activities relating to the transformation of the economy and its promotion abroad; acquisition of new technologies and the creation of capital and cooperative relations concerning small and medium enterprises.

§ 4.

The state administration agencies and authorities are obliged to cooperate with the Minister, Member of the Council of Ministers, Zbigniew Eysmont in the scope of implementing the duties described in article 2 and 3.

§ 5.

The activities of the Minister - Member of the Council of Ministers Zbigniew Eysmont are supported by the Cabinet of the Minister, which is an organizational unit of the Office of the Council of Ministers.

§ 6.

The resolution becomes effective on the day it is approved.

(original signed on November 20, 1992)
Prime Minister
Hanna Suchocka

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Annex D - Existing Projects and Institutions Supporting SMEs

We acknowledge considerable help from Polish Business Advisory Services in collecting information used in this section.

1. Types of Support

Support from foreign donors does not come without strings attached. Each donor has its own rules of procedure and eligibility. The following general comments apply:

- The majority of bilateral aid is disbursed on a project by project basis, often including very small projects. As a result, the number of such ongoing projects in this list is relatively small. This does not mean, however, that there are no opportunities for assistance.

- Most bilateral aid is tied to using technical assistance from the donor country. In many cases this means that it is difficult to fund revenue costs relating to Polish employees of a project through foreign assistance.

- In the case of PHARE, although the actual use of the money is not too tightly tied and the funds come as a grant to the Polish government, disbursement is tied to general programmes determined on an annual basis and specific items identified within these programmes are put out to competitive tender where appropriate. PHARE programmes are therefore relatively inflexible when it comes to funding new specific projects. The World Bank operates in a similar way, but the funds come by way of a loan.

The different rules and procedures of different donors can mean that coordination and cofinancing of projects is difficult to achieve.

2. Existing Support Institutions and Donor Funded Projects

Business Support Institutions

There are a wide variety of initiatives, both Polish and donor initiated, which act to give advice and information to entrepreneurs.

a. Polish Initiatives

There are a number of different networks which have been established to give advice and information to entrepreneurs, including:

- Regional Development Agencies. RDAs are autonomous bodies charged with activities connected with regional development, including development of

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the private sector. Most are relatively new and are still defining their exact activities. There are RDAs in almost half the Voievodships and they are now trying to establish a national association.

- Economic Foundation of NSZZ "Solidarność". The Foundation has organised a variety of different actions in support of small enterprises including training, advice, and an information bank. The Foundation has 23 regional offices.

- Fundacja Inicjatyw Społeczno-Ekonomicznych (FISE). FISE was set up as an initiative of the Ministry of Labour and Social Affairs and operates through 16 Agencies for Local Initiatives giving basic advice and information. The Agencies have been set up in areas of greatest economic and social need. FISE is closely connected with the bank BISE.

- Chambers of Commerce and of Craftsmen. Chambers exist across the country (although there is a big concentration in the larger towns, particularly Warsaw). Most Chambers are small and weak and in some cases are dominated by State Owned Enterprises.

- Economic Societies. Economic Societies exist across the country promoting economic development. Although they were significant at the point of transition, newer organisations such as local Chambers of Commerce have in many cases taken over their role as far as support of SMEs is concerned.

- Activities within Voievodship Offices. All Voievodship offices have departments dealing with business promotion and information/ consulting points.

- There are a number of other independent initiatives such as the establishment of local incubator projects.

b. *Donor-led Initiatives.*

It should be noted that a number of the initiatives above, for example FISE, have received foreign aid.

Specific initiatives include:

- Business Support Centres. 16 BSCs have been created through the Cooperation Fund using PHARE assistance. The BSCs give basic advice information and training and are hosted by existing institutions, mostly Chambers of Commerce. The Cooperation Fund also has a number of other initiatives, including the establishment of a national Euro Info Centre Correspondence Centre, giving information on standards and contacts with the European Community, and assistance to the National Chamber of Commerce.

- Polish Business Advisory Services (PBAS). This is an initiative to provide consultancy and support to medium-sized enterprises. The initiative has been set up by the International Finance Corporation and EBRD in association with and with support from a number of other foreign donors and the Polish government. This initiative works on the basis that the recipient enterprises contribute towards the costs. The German organisation GTZ proposes to introduce a similar initiative but without payment by the recipient.

- Regional Management Centres. The UK Know How Fund has established four Regional Management Centres (in Lublin, Łódź, Poznań and Gdańsk) which as well as providing management training also provide advice services to SMEs in their areas.

- STRUDER. This regional development initiative funded by PHARE will include provision for advice and information to the private sector when implementation starts during 1993. In order to support STRUDER, the Polish Agency for Regional Development is being established. This body will have responsibility for coordination of the STRUDER actions.

- USAID has established three Polish-American Small Business Advisory Centres in Warsaw, Gdańsk, and Łódź.

- The Ministry of Labour has a project funded by the World Bank in support of micro-enterprises which includes provision for the establishment of a number of incubator projects across the country.

Schemes for Low Cost Consultancy

There are a variety of schemes to use retired executives or MBAs to help specific enterprises at low cost. These include: USAID (International Executive Service Corps, MBA Enterprise Corps), Canada (Canadian Executive Service Organisation).

Management Training

There are a variety of initiatives to promote management training, since this is an area to which many foreign assistance programmes are ideally suited. Specific initiatives include:

- Management and Business Schools. There are at least 38 such schools in Poland giving a variety of different courses, some relevant to entrepreneurs.

- Regional Management Centres. The UK Know How Fund has established four Regional Management Centres (in Lublin, Łódź, Poznań and Gdańsk) which as well as providing management training also provide advice services to SMEs in their areas.

- Small Business Training Institutes funded by USAID in Białystok, Poznań, and Rzeszów

Many bilateral donors have some form of training exchange programme, typically for targeted sectors and for managers and not necessarily relevant to SMEs. Courses are normally run in the donor country. Countries operating such schemes include: Britain, Sweden, Netherlands, and Denmark.

Policy Advice

USAID has funded the long term *GEMINI* project which provides SME policy advisors attached to the office of the Minister for Entrepreneurship Promotion. To assist legislative reform, USAID has funded the IRIS project (an independent body looking at institutional reform and the informal sector), and RITE (removal of impediments to trade) initiatives, the Rule of Law and Commercial Law projects.

EC-PHARE has allocated funds to policy advice activities, originally scheduled to be with the Ministry of Industry, but the actual use of these funds is still under discussion.

Sectoral Projects

Projects which are related to other sectors also have an impact on SME development. Such sectors include particularly: agriculture, tourism, employment initiatives, technological development.

This applies not only to foreign assistance but also to Polish governmental initiatives. In particular, the Ministry of Labour has a number of schemes related to employment creation and the retraining of the unemployed. These schemes give very small grants or loans to unemployed people who wish to set up their own businesses.

Short Term Assistance from Foreign Donors

As stated above, there are many examples of foreign donors giving short term technical assistance to small projects (for example Swiss government support to SMEs in two specific gminas). There are too many projects to mention individually, but it should be noted that this is a real opportunity for the future.

3. Banks and Other Financial Institutions relevant to SMEs

Banks and Institutions Supporting SMEs

The Polish banking system is structured in the following way:

- National Bank of Poland - the Central Bank
- State-owned banks

Private banks

At the moment there are more than 90 private banks active including several with foreign capital. In addition there are extensive number of cooperative banks. The majority of these banks are affiliated in the Food Economy Bank.

Special Institutions

A number of specific institutions have been set up specifically to help the banks help the private sector. These include:

- The Polish American Enterprise Fund (PAEF), set up as a separate fund using the banks only as windows for dealing with clients rather than for credit appraisal. PAEF has also set up a number of other initiatives including an equity fund set up in association with EBRD.
- The Bank for Socio-Economic Initiatives (BISE) set up by the Ministry of Labour with assistance and funding from France and operating in close cooperation with FISE (see above).
- Caresbac Polska. Caresbac Polska is operational since 1991. It is a joint stock company whose shares are held by Caresbac-USA, the Cooperation Fund and the Foundation for development of Polish Agriculture. The aim of the company is to invest in firms with between 15 and 100 employees. In addition to the investment Caresbac provides the firms invested in, with information and advice on all business related subjects. The minimum level of the investment is $ 75,000.
- The Polish Development Bank, set up as an apex bank and responsible for credit lines from the World Bank, the European Investment Bank (EIB) and a number of foreign donors. The PDB also gives loans itself although these are not orientated towards SMEs.

Bank Training

Bank Training is clearly of importance in developing the banking sector. Foreign assistance has been given in various different forms from, for example, EC-PHARE, and the British Know-How Fund. The initiatives listed above have required a substantial amount of bank training to be effective, for example from France in the establishment of BISE.

Sources of Credit

As well as normal bank credit, there are the following schemes of assistance to SMEs:

- Specialist institutions as listed above.

- A credit line denominated in ECUs funded by EC-PHARE managed by the Cooperation Fund

- Loans from EIB and EBRD for larger enterprises. The EIB loans are managed by the Polish Development Bank. The EBRD loans are through a variety of foreign owned banks.

- World Bank loans through the Polish Development Bank. The World Bank also proposes to set up small funds alongside the incubator projects being set up in the programme managed by the Ministry of Labour.

- Small loans to the unemployed who start up businesses funded by the Ministry of Labour through Local Labour Offices.

Sources of Equity

Equity finance is at present an underdeveloped sector, but there are institutions which deal with equity including the Polish American Enterprise Fund, Caresbac Polska, and TISE (associated with BISE). Inevitably these initiatives presently concentrate on larger SMEs and have yet little experience.

The STRUDER programme includes provision for the establishment of regional investment funds.

Western-funded Credit Lines

There are a number of schemes which finance exports from the West to Poland. Such schemes include ones financed by Austria, Denmark, France, Finland, Spain, Norway, Germany, and Switzerland. Such finance is not necessarily very useful to SMEs unless they can avoid the exchange risk by exporting from Poland. Schemes have been agreed but not implemented with a number of other countries, including South Korea.

Nonetheless, there are a number of credit lines which are available for enterprises, typically orientated for a particular sector. Most of the credit lines have not been disbursed very quickly, owing to the conditions and problems in the banking sector. A separate review of these credit lines has been undertaken by a banking task force and its report should be available in due course.

Other Initiatives

Although there has been much speculation about the establishment of guarantee schemes, there is no large scale scheme functioning at present. Under the NBP scheme, 212 guarantees were issued for some 130 billion złoty in 1990-92. Since the guaranteed part of the loan was decreased in mid-1992, no new guarantees were given. The STRUDER programme includes funding for a new guarantee fund.

There are few sources of direct grants outside the STRUDER scheme which will give grants to enterprises receiving loans from accredited banks in specified areas of the country.

There are a number of additional initiatives to support institutions relevant to the financial sector. In particular:

- ❑ EC PHARE has a financial sector development programme which, as well as improving the capabilities of the banks through training, seeks to develop the insurance sector, the accounting and auditing sector, and the tax and fiscal administration sector.
- ❑ EBRD has initiated a project using a private company to set up a credit rating service.

Annex E - List of Possible Actions

1. Financing

Banking Services

To improve the banking services implies a good infrastructure of payments between banks and this means action to develop banking information technology and the establishment of a clearing house.

In addition, banks have to be informed, advised and trained in working with this new technology. Also personnel of banks have to be trained, for example to be more customer friendly.

Finally, services for foreign transactions, such as provision of letters of credit, are underdeveloped and further action needs to be taken to develop these services.

Credit

The establishment of a central business register could assist banks in gathering information on their clients. Businesses could also use this register to get information on their business partners. There are already a number of concepts developed for the establishment of such a register.

According to normal banking practice, banks ask for collateral when providing loans to private business to diminish their risk. The existing relevant legislation in Poland hampers this process. Regarding legislation it is necessary to:

- speed up of the reform of collateral law including the establishment of an asset/collateral register
- reform the bankruptcy law
- reform the property law

To judge the value of collateral it would be helpful if standard procedures for the valuation of assets/collateral were to be developed whilst in addition a kind of information system on the value of assets and collateral should be set up.

Apart from legislation/regulation and information on collateral also the lack of collateral by SME is mentioned as one of the constraints in lending to private banks. Documentation, reports and interviews suggest that banks will give more credit to private business if there are other institutions to share the risk with. To overcome this problem a guarantee facility can be set up.
Two kind of guarantee facilities can be distinguished, namely:

- a Mutual Guarantee Scheme
- a Loan Guarantee Scheme

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At this moment there are several initiatives developed to set up Mutual Guarantee Schemes and Loan a Guarantee Scheme. It would be reasonable to decide that one of the initiatives aimed at setting up a Mutual Guarantee Scheme and one aimed at setting up a Loan Guarantee Scheme will be carried out as pilot projects.

High interest rates form an important constraint for firms for getting loans and consequently for investment. To stimulate investment soft loans could be provided by banks or by specific institutions. The criteria for eligibility of these loans depends on the strategic objectives developed as part of SME policy and could include:

- manufacturing SMEs
- investment in fixed assets
- SMEs in relatively disadvantaged regions
- SMEs in growth potential regions
- start ups

To improve banks in dealing with loans to private business it is necessary that bank personnel are advised and trained on aspects such as:

- assessing creditworthiness and risk evaluation
- loan monitoring
- restructuring loans

Although there are a number of initiatives of donors in this field, the coordination and scope of these initiatives should be improved.

Equity

As described above there is a lack of equity capital. The provision of equity financing by private persons can be stimulated by special tax measures such as:

- tax incentives for private persons investing in private business
- similar treatment of dividends and interest on savings

The number of venture capital institutions is still very limited in Poland. Due to high operational costs and the high risk venture capital firms are not eager to participate in small business. Via schemes participation by venture capital institutions can be improved. Such schemes might include

- tax incentives for venture capital firms investing in SMEs
- guarantee scheme for venture capital firms

A further way of introducing equity is through joint ventures with foreign companies. Such ventures have the added advantage that they introduce management skills and technology to the Polish business. There needs to be further promotion of opportunities for joint ventures.

Other financial institutions

The establishment of leasing, factoring and insurance institutions requires a change in the legislative and regulatory frame work linked with the activities of such institutions.

Other support schemes

Apart from the above mentioned actions which are mainly aimed at the institutions providing financing it also necessary that SME will be informed, advised and trained on different aspects of financing: accounting, filling in application forms and in preparing other required documents, consequences of foreign exchange credits, etc.. In the chapter "Information and counselling" more information is given on the ways in which this can be realised.

The transition to a market economy will inevitably lead to increasing international competition. New technological developments are leading to new and better products and services, to more efficient means of production and to an increasing productivity. To assist SMEs in improving their competitive position, schemes can be developed to assist them in financing activities needed such as:

- soft loans/grants for the financing of technical commercialisation
- soft loans/grants to finance modernisation of the production process

At this moment the economic situation of the domestic market does not leave much room for SME-development, particularly in depressed regions. To grow SMEs, producing goods and services which can be exported, need to export as quickly as possible. In the field of export financing the following actions can be developed:

- soft loans/grants for the financing of export activities
- an institution can be set up for insurance and financing of export activities
- financial support to promote the formation of export consortia consisting of small firms. Support is given for joint export promotion or marketing activities, because in particular these activities are relatively costly for SME to finance on their own. In addition cooperation between firms can improve the exchange of experiences between SME

2. *Information and Counselling*

To address these constraints in the context of existing experience, the following actions have been suggested:

a. To increase the number of local initiatives, some form of central government subsidy scheme open to all local initiatives supporting small enterprise. Such subsidy would be subject to clear criteria of eligibility, for example: a specified maximum amount; at least matching funds from the initiative itself; preference to be given to the establishment of initiatives in relatively disadvantaged areas; no funding for salaries or purchase of property; business plan showing how the initiative can become self-financing. In order for such a scheme to be effective in the longer term, attention must be given to evaluation of existing projects as well as selection of new ones.

b. To develop standards and knowledge among business counsellors operating in business support organisations, central government coordination of training of such personnel using both Polish and foreign resources. Such coordination could lead to the creation of some form of centre of excellence for such training, ensuring that standards are kept and that training of trainers is effective. There should also be corresponding coordination of training for relevant public agencies, for example the people working in the information points in Voievodship offices.

c. To develop opportunities for relevant training and education for entrepreneurs, similar coordination of training activities in Management and Business Schools (together with any training provided by business support organisations).

d. To increase the quality of private consultants acting for the private sector, some form of national accreditation scheme for such consultants which could be used by other agencies in referring entrepreneurs to private consultants. Possibly a national directory of consultants could be published.

e. To stimulate businesses to use private consultants, the creation or a grant scheme directed at subsidising consultancy costs.

f. To ensure that small businesses can locate sources of assistance, a central government help-line (perhaps with additional regional help-lines) to give information on assistance and to direct entrepreneurs to appropriate institutions. This initiative could include the publication of a directory of sources of foreign assistance.

g. To ensure that information on specific subjects reaches entrepreneurs, coordination of national sources of information so that they use all the local networks of business support institutions identified above. This would require national action in the provision of general business information together with specific information in the fields of technology, export and foreign trade, privatisation issues, regional action on these issues, and also, for example, opportunities for subcontracting. Although this will not necessarily solve the communication problem, it could nonetheless improve the current situation. Any provision of information needs to be coordinated with training of personnel in business support organisations and Voievodship offices in how to deal with queries and how to market information to entrepreneurs.

h. To ensure that the information available centrally is relevant and presented in an appropriate way, a study of the information needs of the SME sector. It should be noted that the Cooperation Fund has already initiated such a study under the PHARE programme.

i. To develop effective sharing of information between entrepreneurs, a systematic scheme to help develop autonomous structures such as Chambers of Commerce. Foreign donors have already given a number of small amounts of technical assistance either to the National Chamber of Commerce or to local Chambers, but this could be made more effective through coordination.

j. To support the medium-sized enterprise sector, continued support from the Polish government and foreign donors to organisations assisting medium-sized enterprises through consultancy and dissemination of information on, for example, technical standards, sources of finance, and other assistance available.

k. To develop the existing networks of business support agencies, continued support from foreign donors (Business Support Centres, STRUDER, etc). Foreign assistance should pay attention to mechanisms to ensure that over time an indigenous Polish consulting and advice sector will develop itself as a complement to these networks.

Annex F - List of Persons Interviewed by the Task Forc Secretariat

Ms. Eve W. Anderson
USAID

Mr. Krystyn Bernatowicz
Ministry of Labor

Minister Jan Krzysztof Bielecki
Minister for European Integration and Foreign Assistance

Ms. Nathalie Bolgert
BISE - Bank of Social and Economic Initiatives

Mr. Radosław Czapski
EC Delegation

Mr. Michael Davenport
British Government Know How Fund

Mr. Ronald A. Dwight
IRIS - Poland Project

Minister Zbigniew Eysmont
Minister for Entrepreneurship Promotion

Mr. David A. Fisher
CARESBAC-Polska S.A.

Mr. Yves Fortin
European Bank for Reconstruction and Development

Mr. Adam Gałczyński
Cabinet of the Minister for Entrepreneurship Promotion

Mr. Andrzej Gerhardt
Cabinet of the Minister for Entrepreneurship Promotion

Ms. Krystyna Gurbiel
Cooperation Fund

Mr. Jerzy Gutkowski
Ministry of Finance

Mr. Krzysztof Herbst
FISE - Foundation for Social and Economic Initiatives

Mr. Konrad Hryciuk
DAI/GEMINI

Mr. Jacek Jettmar
SAKK

Mr. Tomasz Jeziorański
BISE - Bank of Social and Economic Initiatives

Mr. William R. Joslin
USAID - U.S. Agency for International Development

Mr. Wojciech Kostrzewa
Polish Development Bank

Mr. Marek Kozak
Office for Undersecretary of State for European Integration and Foreign Assistance

Ms. Janina Kraszewska
National Bank of Poland

Mr. Jan Król
Member of the Parliament

Mr. Waldemar Kuczyński
Unia Demokratyczna

Mr. Marek Kulczycki
Polish-American Enterprise Fund
The Enterprise Credit Corporation

Mr. Andrzej Lewiński
Ministry of Industry and Trade

Mr. Wojciech Lipka
Union of Polish Banks

Mr. Jerzy Loch
Cabinet of the Minister for Entrepreneurship Promotion

Mr. Charles van der Mandele
Polish Business Advisory Service

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ANNEX G

BOTTLENECKS TO PRIVATE SME DEVELOPMENT IN POLAND

Paper prepared by:
David Hartford.
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Bottlenecks to Private SME Development in Poland

Introduction

As 3P/PBAS surveys its experiences over the past year, there are some generalizations it can put together about the factors it has encountered which impact its chosen market segment: private, Polish SME's. These factors are important, 3P/PBAS believes, because if the SME's do not develop, Poland's economy is likely to be fractured into extremely large companies, state-owned and foreign, and a proliferation of very small enterprises which aren't able to grow to their true potential. If it is presumed that employment growth is most likely to come from a vibrant private SME sector, this situation would lead to significant unemployment and underemployment.

The first perception is that there is a very active private sector: many people starting businesses, particularly trade, and retail of consumer products. There is no question about there being a very active entrepreneurial spirit in Poland. The government statistics about the private sector producing near 50% of GDP is a clear indication of this.

However, there are a number of factors which are inhibiting the development of private SME's, particularly the medium-sized businesses. This brief is intended to set forth some of these factors as the basis for further discussions, and perhaps research. Therefore, no attempt has been made to weigh, or even validate, the factors. This paper is as exhaustive as possible in trying to identify inhibitors, leaving the determination of their relative importance open to a future discussion.

Many of these factors are not limited in their impact to SME's. However, it is believed that their impact on the overall business environment has a fairly clear effect on SME development, because it is assumed that even the profitability and growth, or lack thereof, of larger enterprises, state or private, whether Polish, foreign or joint ventures, will impact the SME sector directly, because of the larger enterprises being potential customers for SME's (suppliers and subcontractors) as well as employing people who are potential customers for SME's (consumer products and services). What 3P/PBAS has tried to do in this memo, therefore, is to break the identified factors into sections, from the most general to the more specific: 1. factors influencing business development generally; 2. factors influencing the private sector generally; and 3. factors specific to SME's.

Also, many of the issues raised in this paper are based on personal observations and can not be proven by any hard statistics. In fact, combined, they present an almost contrarian view of what is currently happening in the area of new business development, where economic statistics suggest a gradual improving of the economy, on which there also appears to be some consensus among the experts. It may be, as suggested by some, that the improvements in the economy are taking place in the state sector, in which case the observations by 3P/PBAS would remain generally valid. However, some of the observations by 3P/PBAS, e.g., the lack of information for a manager to base his decisions on or the absence of marketing skills within the enterprise, would seem to be equally valid for the state enterprise sector as well. The recent successes of some enterprises may well be the result of a temporary opening of the foreign markets, of luck, or of not yet observed deficits elsewhere (e.g., state-owned enterprises not paying their bills, not servicing their debt or paying their taxes. They will have gained time for the economy to seriously start working on lifting some of the inhibitors enumerated below.

FACTORS INFLUENCING BUSINESS DEVELOPMENT GENERALLY

1. Economic Environment

a. internal and external recession; and
b. loss of traditional markets due to economic and political changes in them.

2. General Psychological Outlook

mistrust of others, particularly outsiders (foreigners) This is not entirely unjustified: the first wave of foreign partners, and consultants, included a lot of carpetbaggers.

3. Governmental Action and Inaction

a. lack of comprehensive industrial policy that could serve as a framework for appropriate legislation. This is the result of moving to the other side of the pendulum, i.e. away from even a semblance of state-planning and - interference;
b. agreements with foreign governments which limit the ability of Polish companies to protect themselves against imports, while restricting their access to foreign markets;
c. foreign export development programs, particularly those which include financing at preferential rates, which induce both government and business in Poland to buy foreign ; and
d. particular uncertainty about ownership of land and other assets, and therefore inability to sell, lease or otherwise contract.

4. Infrastructure

a. while major projects are underway to alleviate this problem, poor telecommunications remain an important impediment (even when it works, it's time consuming);
b. transportation system (roads, railway, air) inefficient, internal and external equally remain a bottle-neck to rapid change;
c. after the collapse or retrenching of the formerly state-owned domestic trade organisations, there is a lack of distribution networks that can support the individual enterprise that is now forced to establish its own network from scratch (even where the know-how is available, this entails major costs);
d. service industries are in infancy (e.g., lawyers, accountants, consultants, insurance); and
e. financial services, especially the banking system, are not yet capable of serving a growing, de-centralized economy. Its management and staff are relatively inexperienced (and relatively low paid). There is a lack of an efficient clearing system, which makes cash transactions more attractive. Finally the banks still offer an only limited financial product range.

5. Miscellaneous Factors

lack of access to technology -- being retarded by perceived lack of legal protection of intellectual property?

6. Company Management - General

a. inexperienced in dealing with all the realities of a market economy;
b. lack of knowledge of financial planning, cost accounting, marketing and sales;
c. particular inability to understand the necessity of including financing costs, especially related to accounts receivable, in prices;
d. disinclination to plan (a reaction to old central planning ?); and
e. few international language capabilities.

7. Labor

a. immobility because of lack of housing in areas where employment is possible;
b. transportation system not geared to long-distance commuting, further reducing labor mobility;
c. psychological difficulties in changing from we pretend to work and they pretend to pay us ;
d. perception that they were the ones who forced the change from the old system, but are the ones who are bearing the major costs of the change; and

e. educational institutions without resources and capabilities to train for the free market environment.

FACTORS INFLUENCING THE PRIVATE SECTOR GENERALLY

8. General Psychological Outlook

a. business ethics (Caveat Emptor) that are a prerequisite in a modern, market-based economy, still have to take root;
b. unwillingness to share information or to trust others, making it difficult to form joint ventures. For the same reason, many entrepreneurs are refusing to incorporate their businesses, making them less attractive to the banks;
c. carryover of psychology that no one should get ahead of others;
d. tendency to want to slow or drag down anyone who might make money , naturally presumed to be at the expense of others ;
e. tendency to not want to stand out and be visible in success (however, there are a lot of Mercedes automobiles around);
f. risk aversion (good performance previously not rewarded, while mistakes severely penalized); and
g. risk addiction (reaction to prior restrictions being removed?).

Note: the last two items may appear to be contradictory, but 3P/PBAS sees more of the stereo-types at the two ends of the spectrum than in the middle.

9. Information Availability

a. one of the basic underpinnings of a private free market economy is accurate and up-to-date information on both macro and micro levels - this is quite deficient in Poland;
b. potential suppliers (and banks) do not know who is reliable and who is not;
c. financial sources do not know who is already active in a market, or who may have plans to enter a market e.g., there has been a proliferation of mineral-water and soft-drink bottling plants; and
d. this makes any business or investment decision risky, and as a result, worthy companies that want to form customer relationships and borrow money are subject to extremely long delays, when information is being verified, at a time when time is particularly of the essence.

10 Legal and Tax System

a. inexperience of legislators and regulators with free market and not understanding the economic ramifications of laws and policies;
b. some residual antipathy among legislators and regulators toward the free market system and private companies, resulting in delays in the promulgation of new rules or even introduction of rules that adversely affect the outcome of private enterprise;
c. low pay in government sector making people ripe for facilitation fees , directly or through so-called business consultants (in fact, lobbyists);
d. many carryovers from the socialist legal system;
e. in order to make appropriate business decisions, certainty in the legal environment is a critical factor - it's better for business for law to be certain more than to be right ;
f. laws sometimes come into effect, and companies are in violation, for a long time before anyone even knows what the laws are;
g. lack of clear real property recording system;
h. even with the continuation of the Popiawek, there remains a continuing bias in the tax laws against private business; and
i. labor laws strongly favor full time employees (and concomitant additional costs), reducing ability of companies to employ part-time or short-term employees, or alternatively encouraging them to break the law by under the table payments in order to avoid high ZUS.

11. Condition of companies

a. almost universally over-leveraged (carryover from earlier days of easy credit);
b. many apparently successful private companies are, in fact, mini-conglomerates with a number of businesses which are marginal, not linked by any strategic focus or synergies, but financially interdependent. The whole structure is therefore vulnerable to a downturn in any one of the constituent companies - a carryover from the old system, where small, strategically unrelated enterprises were safer and synergies were principally financial. Many conglomerates are essentially a method to remain invisible to tax authorities;
c. financial information within the companies is often totally lacking or irrelevant:

   i. information required by the government is useless for decision making;
   ii. systems not in place for collecting and analyzing appropriate information
   iii. companies do not know how to value what they are selling
   iv. cash flow is often equated to net income or profitability without regard to future working capital or asset replacement requirements;

d. quality control is not valued and production management not adequately understood;
e. capable management, particularly middle managers, is at a premium; and
f. lack of marketing skills, which becomes even more of a bottle-neck in the face of the disintegrating distribution system.

12. Capital Availability to and Receptivity by Private Polish Companies

Credits

a. banks generally are still focused on security as opposed to a cash-flow orientation;
b. the banks' horizon is very short. They are not willing to take long-term risks in project finance, particularly not when they can earn the same spread on short-term revolving credits or an only marginally lower spread on lower-risk Treasury bonds. This explains, in part, the banks' disinclination to offer loans through World Bank, IFC, EBRD and other credit lines;
c. for prospective borrowers of Polish Zlotys, interest rates on available loans, when available, are crippling: at a real interest rate of sometimes as high as 16%, few Polish company can hope to remain competitive. Manufacturing companies can rarely afford even 10%;
d. in view of the high cost of local currency loans, Polish companies have tended to go for low cost foreign credits, without an understanding of the risks they are taking on exchange rate changes, which tend to raise the overall cost of foreign borrowings to close to the level for Zloty loans;
e. even where a borrower's production is sold for hard currency and the risk of exchange rate fluctuations is reduced, restrictions reportedly exist imposed by the National Bank of Poland, e.g., in the case of exporters wishing to borrow foreign exchange for (local currency) working capital items (capital rationing?);
f. the relative shortage of loan capital and its high cost will have a serious impact on, e.g., trading companies which would otherwise be able to do backward integration into production;
g. misunderstanding by Polish companies of the role of banks, and the types of risks that are appropriate for banks to take, i.e., financial, not market or technical;

Equity

h. equity (both local and foreign) is in short supply and often not appreciated: there is only a very short history in Poland of building personal fortune legitimately;

i. perception by foreign investors of lack of receptivity of Polish government, partly generated by investor perception that Polish government is concerned about being accused of selling assets too cheaply, real or imagined;

j. impact of this perception can be the potential long-term impact of loss of strategic investments being made in Central Europe, which may as a result go to, e.g., the Czech Republic or Hungary, where the investment climate is viewed to be more positive; and

k. finally, even when equity is available from a Polish or a foreign source, Polish entrepreneurs often are not enthusiastic about the prospect of sharing information, control or upside potential.

13. Company Management - Private

a. trading mentality and focus on the short-term:

   i. this may also reflect a somewhat rational response to a particularly uncertain environment

   ii. those who have been successful so far have generally been traders, taking advantage of temporary dislocations (i.e., few appropriate role models);

b. extreme focus on ownership of assets, instead of on the dynamics of the business: and

c. usual difficulties in making transition from entrepreneur to manager.

14. Privatization - Pace and Impact

a. slow pace of privatization leaves a number of state companies which are inefficient and unlikely to survive, but while they live, they can act irrationally in pricing (e.g., not basing on true costs, and riding an asset down in value), which can be extremely harmful to the private sector company trying to price rationally;

b. a great many state companies remain vertically integrated, limiting efficient allocation of resources;

c. in more developed economies, specialization occurs. As long as the state companies are not purchasers of products, those market segments are likely to remain inefficient due to lack of economies of scale;

d. rules regarding privatization get changed in midstream ;

e. this discourages bona fide entrepreneurs from participating in the process and making productive use of the assets;

f. secondary impact may be to encourage the establishment of private companies which will be put at risk when state companies in the same segment are rationalized, resulting in inappropriate investment decisions;
g. assets retained by state companies are not available to the private sector;
h. inefficient use being made of real property assets because of ownership uncertainty (high costs of small proportion of safe real estate); and
i. the Mass Privatization Program - where does it fit, and what impact will it have?

BROAD FACTORS INFLUENCING SME DEVELOPMENT

15. Old Private Companies

It appears that many of the private production companies which were started prior to the changes in 1989 have had major difficulties in making the transition to a free market economy. This may be due to their reliance in the past on sales, often through personal relationships, to state-owned companies which are now either not buying, or not paying for what they buy (which is undoubtedly worse). In other instances, because prior to the market opening, anything that could be made could be sold, regardless of quality, there was no real understanding of how to market and sell. Many of the managers of these companies have personally had an extremely difficult time making the transition, perhaps because they had spent so much effort in adapting to the old way (or getting around the old way) that it is difficult for them to unlearn this behavior, and to learn the new ways.

16. New Private Companies

3P/PBAS has encountered few entrepreneurs who are looking to develop a company in a step by step, controlled growth fashion. They seem more to be on two ends of the spectrum - wanting either to build the biggest of something (thus emulating the old state enterprises) or creating a business which has extremely limited horizons (akin to mom and pop enterprises), which may be a carryover from the old days, where private enterprise could only survive if they weren't visible to the authorities. Such zero and micro enterprises are significant in providing employment, e.g., they had about 27% of employment in the EC in 1986. These latter may, however, be extremely vulnerable when someone actually does develop more rational approaches to these market segments.

17. Time for SME Sector to Develop

Because the economic changes are so new, and because of the inhibiting factors enumerated above, there has been a limited time for SME's to develop to their potential. This has two effects: first, it retards the growth of SME's that are started, and secondly, because of the lack of successful role models, it limits the number of SME's that actually get started.

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