

## Industrial Restructuring in the Baltic Countries: Large-scale Privatisation, New Enterprise Networks and Growing Diversity of Corporate Governance

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CHRISTIAN VON HIRSCHHAUSEN & WAN-SZE HUI

Lithuania, Latvia and Estonia—generally referred to as the Baltic countries—are attracting increasing interest in the international economic and research community. As the first countries of the former Soviet Union to leave the ruble zone, they all rapidly reestablished links with the Western world, while trying to maintain close economic integration with Russia, Belarus, Ukraine and other CIS countries. The macroeconomic 'success story' of the Baltic countries, and in particular of Estonia, has been widely documented recently (Barnett, 1993; Lainela, 1993; Sutela & Lainela, 1994; Kukk, 1995). Yet this is only half the story. The other half is to understand how these countries have approached industrial restructuring and the perspectives of the micro-underpinnings of the reform process. The analysis of statistical data on privatisation is insufficient to provide a clear picture of the results of industry reform. Now that the macroeconomic patterns have been identified, the industrial economics perspective can provide new insight into the complex reform process in the Baltic countries, and in post-socialist economies as a whole.

In this article<sup>1</sup> we analyse the strategies of industry restructuring that each of the Baltic countries has adopted, and identify achievements and obstacles. The originality of the approach is threefold: first, we do not assume the existence of an 'optimal' reform path that the countries more or less follow; instead, we put emphasis on the positive analysis of the *process* of reform. Second, we adopt an industrial economics approach to analyse the meso-level of reform, in between the macroeconomic and business administration levels. Third, we base our analysis on an extensive series of case-studies, carried out within the industrial sites, those former 'forbidden cities' of socialism; this hands-on approach is necessary to link theory to real-life developments in industry.

The plan of this article is as follows: first, we propose a conceptual framework of analysis. The starting point of industrial reform is the former socialist industrial units, whose activities were coordinated in the form of networks. We consider that these socialist networks of production disappear irreversibly with the end of socialism, and that there is no way to restructure them gradually. Instead, entirely new enterprises and enterprise networks emerge which work under budgetary constraints and whose exchange relations are predominantly monetarised. The issue of industry reform, then, is not only corporatisation and privatisation, but also the creation of an

Dr Christian von Hirschhausen, c/o DIW German Institute for Economic Research, CEE & NIS Department, Königin-Luise Str. 5, D-14195 Berlin, Germany; Wan-Sze Hui, Associate Researcher, CERNA - Centre for Industrial Economics, Paris School of Mines, 60 bd. Saint-Michel, F-75272 Paris cedex 06, France.

institutional framework conducive to accelerating the emergence of new enterprise structures. We then examine the patterns of industry restructuring in Lithuania, Latvia and Estonia. Lithuania carried out the most rapid mass privatisation programme in Eastern Europe; this programme has brought about the creation of a unique institution, the 'post-socialist industrial holding company', that might become a major actor in the post-privatisation phase.

The case of the Lithuanian electronics industry provides an example of the functioning of such holding companies, which emerge primarily in countries that have applied mass privatisation. In Latvia, a broad range of institutions were developed to deal with restructuring, among them a complicated voucher-compensation scheme, two state property departments and a short-lived Ministry of Economic Reform; yet the fundamental problem of efficient corporate governance in newly created state enterprises was not resolved until early 1994. Since then, an attempt has been made to 'privatise the privatisation', in order to accelerate restructuring. The case of the large minibus factory, once supplier of the entire Soviet Union, shows the difficulty they have in establishing new industrial networks after the breakdown of the socialist ones. Estonia certainly adopted the most drastic approach to restructuring; the Estonian Privatisation Agency became the major administrator of privatisation, whereas restructuring was the responsibility of private owners. Today, domestic financial institutions are the driving force behind new enterprise creation. The case of the largest wood and furniture combine shows the speed that has been imposed on industrial restructuring by the Estonian shock therapy.

### **From Socialist Industrial Networks to New Enterprise Networks**

#### *The Disappearance of Socialist Networks and the Emergence of New Enterprise Networks*

The productive system of any industrialised country is made up of a large number of production sites that are connected with each other in the form of networks. In the socialist countries these networks worked in a very particular manner, as socialism was an attempt to coordinate production without any reference to monetary values, under the sole direction and control of the party-state (Boinsiel & Rouvez, 1995; von Hirschhausen, 1994, 1995). First, socialist industrial units did not work under any budgetary constraint, even a soft one; they were entirely subordinated to the rules of the party-state. Thus they obeyed different requirements, production of goods not necessarily having priority over, say, the social services provided (housing, hospitals, kindergartens, nurseries, schools) or the tight political and civic control over individuals (exercised through the party administration, the trade union, socialist youth and cultural organisations, in some cases even prisons). Second, not only did production on local industrial sites escape rational planning, but the same was even more the case for the spatial coordination of productive activities among different socialist industrial units, organised in the form of non-monetary networks of production. The knots of the networks were the industrial combines, between which products, energy and information circulated without any corresponding monetary flow.<sup>2</sup> The Communist Party was the sole organiser of the networks. In designing them, monetary, geographical and even technical factors were subordinated to the political goal: a forced coherence among the industrial units within each country, and also across countries, according to the 'socialist international division of labour'.

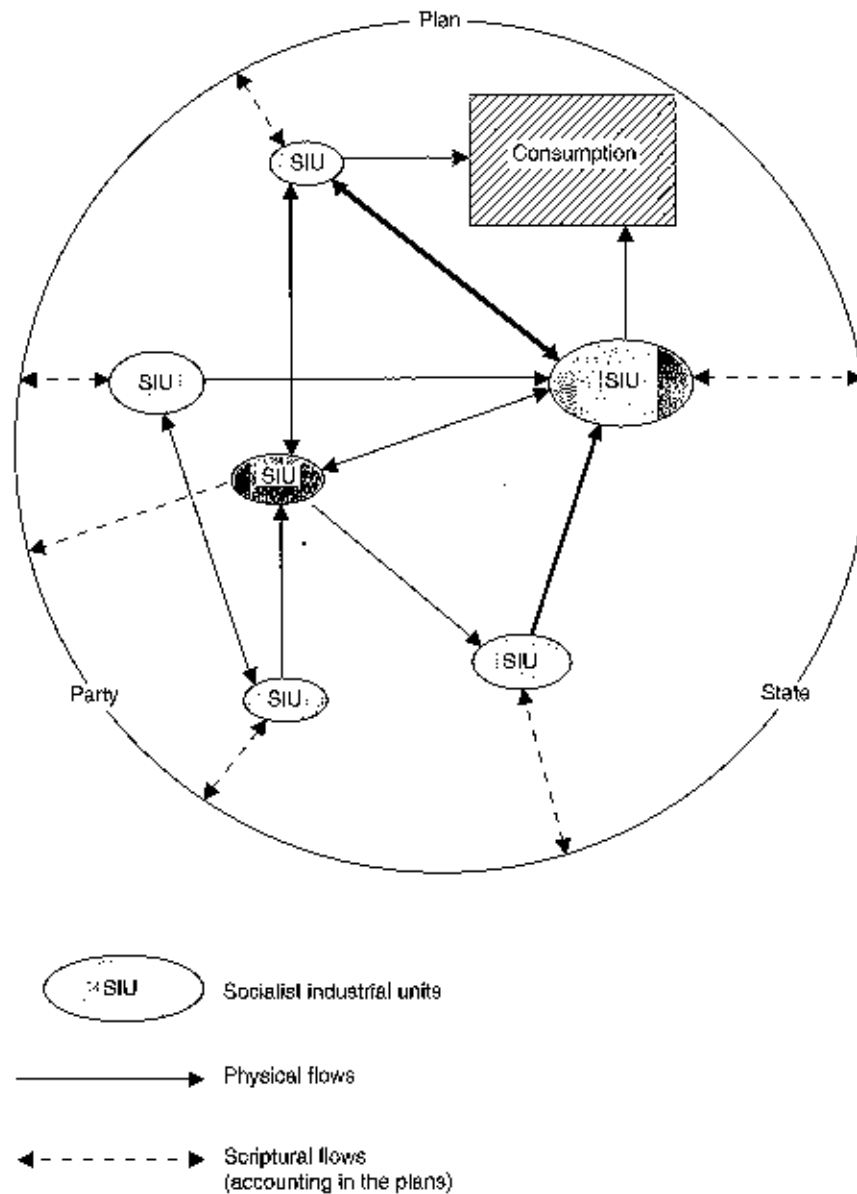


Figure 1. Network of Socialist Industrial Units Governed by the Party-State.

From Siberia to Pomerania, the socialist networks spanned the entire universe of the CMEA. Figure 1 provides a representation of the structure of socialist industrial networks. Three points are central: first, the links between the industrial units are non-monetary: the physical flows between the industrial units are accounted for in scriptural 'money' only, which is nothing but an accounting unit for balancing the plans. Second, obtaining raw materials is an exogenous factor for each industrial site, over which it has no control. Third, the link between production and consumption is also non-monetary; the network structure is extremely inflexible to changes in demand.

The representation of socialist industry provides a clear-cut characterisation of the link between socialism and post-socialism. The end of socialism corresponds to the end of the non-monetary coordination of productive activities by the party-state. In other words, socialism and the functioning of socialist industry end abruptly and irreversibly with the introduction of money as a universal equivalent and a certain price liberalisation, a step that we call monetarisation. Monetarisation introduces the possibility of attaching monetary values to goods and factors of production, including labour; thus, the fundamental pillar of socialism, the non-monetary reign of the party-state over production, ends.<sup>3</sup> With monetarisation, prices that were absent under socialism appear; transport, stocks, energy, social services, labour—all inputs become real costs. Thus, monetarisation causes the immediate implosion of the socialist networks; where production was formerly non-monetary, questions of liquidity and cash flow now dominate the management of production. We contend that after the breakdown of socialism, there can be no gradual restructuring of individual industrial units or networks. Industrial production now has to finance inputs and provide a profit margin from the proceeds of selling goods to solvent demand. Though the physical structure of the industrial networks (buildings, machines, people) remains identical, the very nature of the relations is radically transformed. Therefore, the problem of industrial restructuring is not just to change ownership of any given object; nor is 'unbundling' the over-integrated structures a sufficient response (Aghion *et al.*, 1993). Indeed, the very *raison d'être* of each production unit has to be redefined.

In this context, privatisation is a necessary but not sufficient instrument for setting up new, competitive enterprises. No capitalist entrepreneur will ever be interested in taking over a former multifunctional combine, an industrial 'ruin', as such. The identification of new ownership rights is a first, unavoidable step. Corporatisation—i.e. creating ownership—has been carried out rapidly throughout the countries (Frydman, Rapaczynski & Earle, 1993), but privatisation—i.e. creating new private entrepreneurs—has been an immediate success in small-scale operations only. There are no established ways to reform, adapt or restructure former socialist combines into new viable enterprises. We therefore propose to change the angle of attack; instead of looking only at the aspect of ownership right transfers, we shall analyse the process by which new enterprises emerge in the post-socialist context. Destruction of the old structures is one process; construction, from scratch, of new capitalist enterprises the other. The central issue of post-socialist industry restructuring is the creation of new viable enterprises, from the ruins of the socialist industry; this we shall call the process of enterprisation (Bomse & Rouvez, 1995). The debate on how to conceive industrial policies to favour enterprisation and the question of the appropriate governance structures have emerged as important issues of post-socialist industrial reform.

#### *The End of Socialist Industrial Networks in Lithuania, Latvia and Estonia*

Until 1991 the industries of Lithuania, Latvia and Estonia were integrated—by their historical fate as Soviet Republics—into the Soviet socialist networks of production. As an integral part of the ruble zone, the Baltic countries also depended on the socialist monetary and pricing policies controlled by the central authorities in Moscow. Repeated attempts at 'reform' had already been made since the late 1980s; in particular, the parliaments of Lithuania, Latvia and Estonia passed laws on ownership reform in 1990 (Frydman, Rapaczynski & Earle, 1993). Yet these reforms

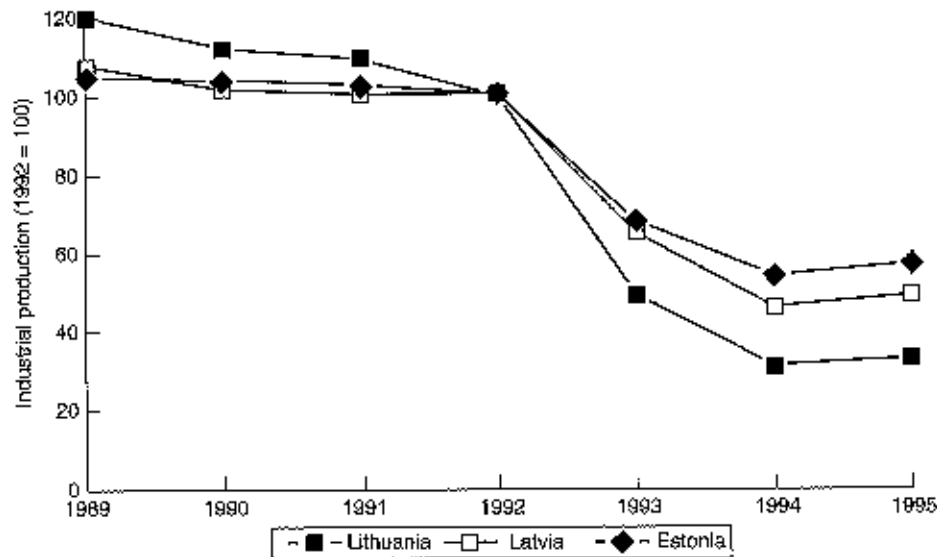


Figure 2. The Shock of Monetisation on Industrial Production in the Baltic Countries. Sources: EBRD; National statistics.

could only aim at improving the existing socialist system gradually, not abandoning it. The end of socialism in the Baltic countries corresponds to the end of socialism in the former Soviet Union—2 January 1992, the date when the dominant part of price controls was abandoned, internal convertibility of the ruble was introduced, and thus money (the ruble) became a real unit of value. This is what we have called monetisation.

Monetisation led to the immediate collapse of the Soviet industrial networks. The appearance of prices, in particular for energy and transport, made the integration of Baltic industrial sites into other former Soviet republics obsolete. However, alternative networks could not be created from one day to the next. Though several factors were at play, the collapse of the socialist industrial networks is the decisive factor behind the sharp drop in output observed in 1992. We show this by analysing the behaviour of output in the Baltic countries between 1989 and 1994 (Figure 2): it can be seen that during the last years of socialism (1989–91), output reductions had already been observed, but that these were only gradual. The radical slump appears immediately after the introduction of money and monetary constraints, following January 1992. The decline continued in 1993, though much more gently. From 1994 one observes the upward slope of a classic J-curve.

Much has been said on the macroeconomic reforms that have followed the end of socialism. Monetary and macroeconomic stabilisation has succeeded rapidly in all three Baltic countries (Lainela, 1993; Sutela & Lainela, 1994; Kukk, 1995; Lugus & Hachey, 1995). In Table 1 we simply summarise the main parameters of this stabilisation, which places the Baltic countries among the macroeconomic success stories of Central and Eastern Europe (CEE). The trajectories of macroeconomic reform in the Baltic countries are consistent with patterns observed in other CEE countries (EBRD, 1994). Significant differences between the three countries appear on the micro-level when we analyse the patterns of industry restructuring.

**Table 1. Indicators of Macroeconomic Stabilisation in Lithuania, Latvia and Estonia**

|           | PPP-based GNP<br>(US\$ per capita)<br>1992 | GNP (change %) |      |      | Inflation (%)     |      |      | Official<br>unemployment (%)<br>1994 |      |
|-----------|--|----------------|------|------|-------------------|------|------|--------------------------------------|------|
|           |  | 1992           | 1993 | 1994 | 1993 <sup>a</sup> | 1992 | 1993 |                                      | 1994 |
| Lithuania | 3710                                       | -38            | -16  | 2    | 3                 | 1175 | 188  | 40                                   | 3.8  |
| Latvia    | 4690                                       | -34            | -12  | 1    | 2                 | 958  | 35   | 25                                   | 7.8  |
| Estonia   | 5250                                       | -26            | -8   | 3    | 6                 | 954  | 36   | 42                                   | 3.9  |

Sources: EBRD, 1994; national statistics, IML.

Note: PPP-based GNP figures are taken from World Bank, *World Development Report*, as cited in EBRD (1994). In the computation of this estimate the country's nominal GNP per capita is divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as \$1 would buy in the United States.

<sup>a</sup>Estimates.

**Lithuania: Emergence of a New Institution of Enterprisation: The Post-socialist Industrial Holding Company**

*The Most Rapid CEE Privatisation Programme and the Emergence of Post-socialist Industrial Holding Companies*

Lithuania was the first CEE country to carry out a very ambitious programme of privatisation. It saw mass privatisation—distribution of vouchers to employees and the population as a whole—as an ‘efficient and fair’ way to get rid of the socialist system of ownership. As early as October 1990, Sajudis (the political ‘movement for restructuring’) prepared a privatisation programme that became the December 1990 ‘Law on the Accumulation of Private Capital of Employees in State Enterprises’; this law became the basis of the July 1991 ‘Initial Privatisation Programme’. While the Polish government was failing to implement its Sectoral Privatisation and Mass Privatisation in 1990–92, and while Czechoslovakia was still giving the first thoughts to mass privatisation, Lithuania went ahead with a complete programme as early as 1991 (Frydman *et al.*, 1993; Samonis, 1994; Maldeikis *et al.*, 1995). Table 2 provides some quantitative evidence on the achievements of the Lithuanian mass privatisation programme.

Curiously, it may be precisely that early haste that has forced the new Lithuanian state to play a long-lasting, active role in restructuring. Its determination to push through privatisation as quickly as possible has prevented the government from controlling the process properly. Several decisions show an inconsistency of approach: thus, having refused to define an initial regulatory framework for mass privatisation, the government spent the following three years trying to establish this framework *ex-post*, always one step behind developments. Having refused to define the criteria it sought to apply to the restructuring of former combines—either state-owned or mass-privatised—it was forced to bail out all 260 bankrupt combines in 1994. Having refused to define the end of the voucher programme precisely, it is now facing a situation in which 30% of the vouchers are still in the hands of individuals; thus, instead of simply closing the voucher programme in late 1994, the government must search for alternative solutions.<sup>4</sup>

All this does not imply that the mass privatisation has not triggered off a unique process of setting up new enterprises; on the contrary, the distribution of vouchers and the absence of a bankruptcy procedure have brought about the creation of a particularly striking institution of enterprisation: post-socialist industrial holding companies. While 95% of the newly created investment funds may be characterised as small or medium-sized, about eight of them—holding 52% of the invested vouchers—today dominate the programme. The structure of these funds stretches way beyond what was initially expected: thus, each of them generally controls a commercial bank, one or more insurance companies, distribution networks and trade organisations. Generally, the post-socialist industrial holding companies have specialised in the sector of origin of the owners or managers of the company. Table 3 gives a list of major post-socialist industrial holding companies in Lithuania, the share of vouchers they have received and their major field of activity. The specific feature of this kind of holding company is that, with the smallest possible amount of capital, a small investment fund can become the majority owner of a large network of enterprises. Similar cases are observed in other countries that have initiated mass privatisation, most notably in Russia.

The absence of clear-cut regulation of mass privatisation has largely favoured the dominant position of the holding companies. Indeed, Lithuania had not initially

**Table 2.** Results of Mass Privatisation in Lithuania (January 1995)

| Sector                 | Number of privatised enterprises | % of all enterprises | Authorised capital of privatised enterprises (million LTL) | % of total capital of privatised enterprises |
|------------------------|----------------------------------|----------------------|--|--|
| Industry               | 681                              | 76                   | 2367   | 35   |
| Transport              | 143                              | 76                   | 136  | 25   |
| Construction           | 554                              | 85                   | 440  | 87   |
| Trade and catering     | 1629                             | 76                   | 276  | 65   |
| Utilities              | 282                              | 70                   | 51   | 72   |
| Services               | 964                              | 89                   | 60   | 85   |
| Total/weighted average | 4253                             | 80                   | 3330   | 45   |

| Methods of privatisation                    | Number of units to be privatised | Of which privatisation achieved | Relative weight of privatisation methods (%) |
|---|----------------------------------|---------------------------------|--|
| Auction                                     | 2973                             | 2607                            | 51   |
| Tender (core investors)                     | n.a.                             | 10                              | 0.2  |
| Sold for convertible currency               | n.a.                             | 40                              | 1  |
| Public subscription (mass privatisation)    | n.a.                             | 2470                            | 48   |
| Other                                       | n.a.                             | n.a.                            | n.a.   |
| Total (large and small-scale privatisation) | 8388                             | 5127                            | 100  |

Share of private sector in GDP: c. 50% (rough EBRD estimate)

Source: Lithuanian Ministry of Economy, as cited in Maldeikis *et al.*, 1995.

planned that investment funds should become an instrument of mass privatisation, and they did not figure on the agenda for privatisation. However, in order to speed up the process, the December 1991 'Amendment to the Initial Privatisation Law' opened the way for the creation of 'investment stock corporations'. The first investment funds were set up in February 1992; by November 1992, only nine months later, 325 of them existed, a number that grew only marginally afterwards (Maldeikis *et al.*, 1995). The regulatory framework was practically non-existent: no limits were defined on the composition of assets, or on the creation of multiple funds by the same people. Neither the Central Privatisation Commission, the Securities Exchange Commission, nor the State Price and Competition Office had significant insight or control of what exactly happened during these nine months of 'unleashed capitalism', that laid the foundations of the Lithuanian economy for years to come.

**Table 3.** The Dominant Post-socialist Industrial Holding Companies in Lithuania, 1995

| Name                                      | Share of vouchers (%) | Main industrial activities   |
|---|-----------------------|------------------------------|
| East-Baltic State West EBSW <sup>a</sup>  | 12                    | Electronics                  |
| Jobustas <sup>a</sup>                     | 10                    | Construction                 |
| Hermis                                    | 9                     | Banking, construction        |
| Invalda <sup>a</sup>                      | 8                     | Furniture, light industry    |
| Concern Agroinvest                        | 6                     | Agriculture, food processing |
| Western Corporation Klaipeda <sup>a</sup> | 3                     | Wood processing              |
| Corporation Lietvarislas                  | 3                     | Wood processing              |
| Sabina                                    | 2                     | Trading, warehouses          |
| Total                                     | 52                    |                              |

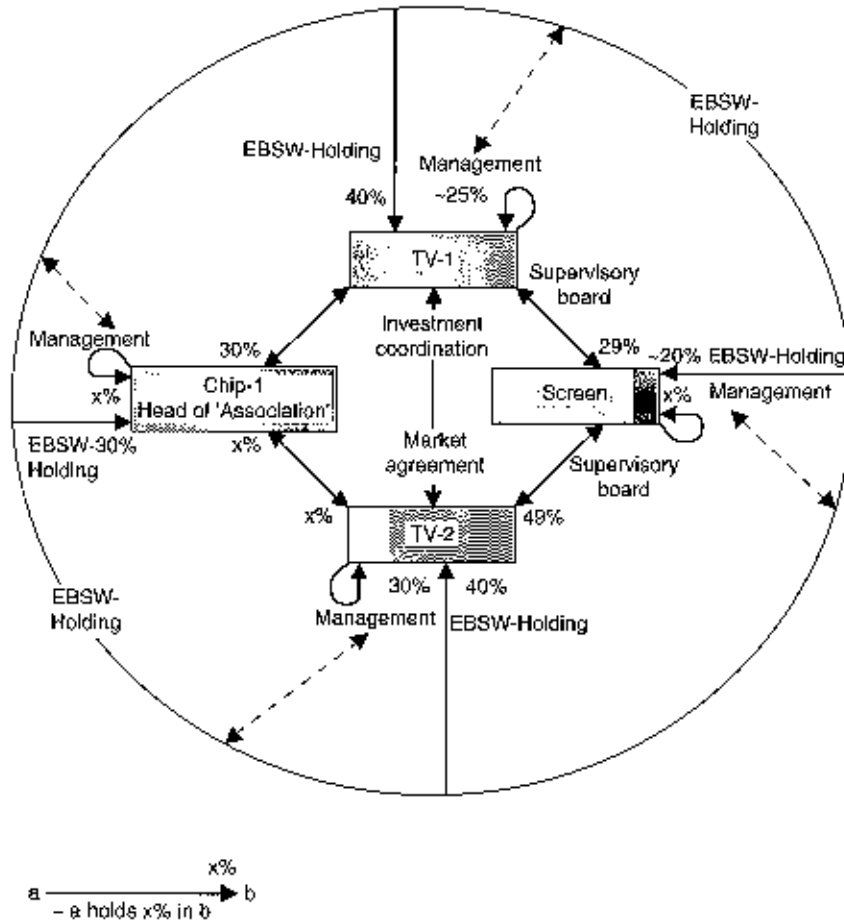
<sup>a</sup>Listed on the stock exchange.

Source: Moldejikis et al., 1995.

#### *Case-Study: A Post-socialist Industrial Holding Company in the Lithuanian Electronics Industry*

The Lithuanian electronics industry, and in particular TV-set production, is a striking example of the immediate destruction of a former socialist industrial network and the emergence of a dominant post-socialist industrial holding company resulting from mass privatisation.<sup>5</sup> The Lithuanian electronics producers were entirely integrated into the Soviet networks; thus the production of TV-sets and other electronic goods depended 70–80% on deliveries from the Soviet Union. In the late 1980s Lithuania had two large producers of TV-sets, called TV-1 and TV-2, with a combined production of over 500 000 sets per year.<sup>6</sup> Among their domestic suppliers were the following combines: SCREEN (screens, tubes, plastic frames), TUBE (special parts for cathode tubes), CHIP-1 (microchips, plates), CHIP-2 (microchips), SCHEME (definition of micro schemes, R&D), BROAD (broadcasting equipment), and RES-DEV (microchip R&D, special applications). They employed 50 000; 80–90% of their production was shipped to Soviet producers and consumers.

Monetarisation of the economy in early 1992 and the breakdown of the Soviet production network meant a radical cut in demand for the output of all Lithuanian electronic producers. TV producers from abroad (South-East Asia, China, Western Europe) started to flood the former Soviet Union. The sales of the largest Lithuanian producer, TV-2, fell by 65% in three years. The situation of the others was no better; having lost their main customers, in Lithuania and in Russia, their production and sales shrank by 50–80%. In 1994 the electronics industry combines practically all made losses and they had to be integrated into the government's 'rescue 260 programme'. In the meantime, all the former combines had participated in the programme of mass privatisation through public subscription, and the shares of most of them had been distributed. Benefiting from the lack of regulation in 1992, one investment fund, EBSW, pursued a very straightforward policy to obtain control of the entire branch. EBSW was in fact largely owned by the managers of the electronics industry itself. The fund immediately bought 40% of the shares of TV-2, 30% of the shares of TV-1, and equally important stakes in the other enterprises. The managers also acquired personal shares in their own enterprises: in the case of TV-1, managers rapidly owned 30% of the shares directly, in the case of TV-2 it was 25%, etc. In other words, the managers of the former combines, who held ownership rights



**Figure 3.** Structure of the Post-socialist Industrial Holding Company in the Lithuanian Electronics Industry.

indirectly through EBSW, and directly through their personal shares, now controlled dominant stakes across the entire branch. A typical post-socialist industrial holding company had been created. Once established as the dominant actor in the electronics industry, EBSW intensified the development of the new network, this time among domestic enterprises only.<sup>7</sup> The cross-participation that started in early 1992 was well established by 1994. The Lithuanian combines, having lost their former supply networks, had created their own national network (see Figure 3).

In 1994 the holding company started to implement a joint commercial and investment strategy for its subsidiaries. TV-1 and TV-2 agreed to reorganise the market shares they still held in the small and large-diameter TV-set market. As Russia undoubtedly represents the market of the future, the Association of the Electronics Industry is trying to push the government to conclude commercial agreements with the CIS, in order to reestablish old production and trade connections. The setting-up of EBSW also allows the definition of a long-term investment strategy. The production activities of the former combines will gradually be concentrated: TV-production (between TV-1 and TV-2), broadcasting equipment (between TV-2 and BROAD), microchips (CHIP-1, CHIP-2, SCHEME, RESEARCH) and

fundamental research will each be limited to a single site. A common strategy for attracting foreign investment is being prepared.

*What Role for the Post-socialist Industrial Holding Companies?*

After the rapid completion of mass privatisation and the success of macroeconomic adjustment, Lithuania now has to define what should happen to those former socialist units that have not yet been restructured, are facing financial difficulties or for which investment has not been found; about 150–200 of them fall into the latter category. A general moratorium or cancellation of debts would be as inefficient a measure as continued debt forgiveness for all enterprises alike. A topic that is gaining particular relevance is privatisation through liquidation. An increasing number of holding companies are trying to 'solve' the bad debt issue by privatising the greatest possible number of subsidiaries. The debts of the former unit then belong entirely to the holding company, which can then be liquidated, while the subsidiaries are cleared of debts. It is not certain whether this method is sufficient to reestablish the new enterprises on a sound basis, or whether it is a pure accounting manoeuvre.

Another question concerns the future regulation of the investment funds. If the funds, and in particular the eight to ten post-socialist industrial holding companies remain closed-ended—with very limited control over entry and exit to and from the fund or over its activities—their investment in any one enterprise will be severely restricted, and thus the role they might play in the restructuring of their enterprises. The open-ended option, transforming the investment funds into open stock companies controlled by the Securities Commission, might allow them to play an important role in the setting-up of new, independent enterprises. The central question will then become: who controls the holding companies that control industry? Given the openness of markets in Lithuania, it is much less price control than controls on financial and investment flows within the post-socialist industrial holding companies that industry needs.

**Latvia: Institutional Diversity with Little Control on State Enterprises**

*Hesitation between Centralisation and Decentralisation*

In Latvia the legacy of Soviet industrial development is the heaviest: Latvia, the most industrialised of the Baltic countries, suffered particularly from the collapse of socialist networks. While some branches have switched their trade flows to the West, most industrial enterprises are stuck in former supplier–client relations that are only gradually being monetarised. This situation makes the Latvian case particularly relevant to other post-socialist republics of the former Soviet Union. It was only in 1994 that attempts to streamline government control over restructuring led to a more promising approach.

Initially, the government envisaged an ambitious programme of reform, expressed in the Privatisation law of June 1992; it foresaw the classical two steps: corporatisation, i.e. transformation into state-owned enterprises, and then privatisation. But whereas macroeconomic reforms progressed systematically, structural reforms were complicated by an increasingly complex institutional setting. Political instability and the absence of established legislation on crucial issues such as land ownership and restitution blocked the structural reforms between 1992 and 1994 (Gulans & Praude, 1995). Among the unresolved issues were the role of the voucher

programme, compensation and restitution, the evaluation of certain former producers as 'strategic', and the control mechanisms imposed upon corporatised state enterprises. Consequently, restructuring of former combines was a rather hesitant, insider-dominated process, the results of which have obstructed rather than favoured enterprisation. The hesitation between a centralised and a decentralised approach was another factor hampering economic reform and increasing institutional uncertainty. Though the legal framework of privatisation was established as quickly as in other countries, the government's capacity to control the process remained limited. Three government changes caused as many profound reorganisations of the administrative body in charge of corporatisation and restructuring.<sup>8</sup>

The issue of voucher privatisation illustrates the permanent conflict between efficiency and 'political justice' with which the government had to cope. Right from the beginning of reform, the use of vouchers was considered a 'just' way to undo the injustice of the socialist past. The 20 March 1991 Supreme Council decree stated that vouchers would be used as a means of privatising flats and dwellings, as well as small and large enterprises (Frydman *et al.*, 1993). Vouchers were supposed to represent approximately half the value of objects to be privatised. However, a real process of voucher privatisation has still not taken off. First, because the complex process of distributing vouchers has caused long delays.<sup>9</sup> Secondly, once distributed, it turned out that people were mainly interested in purchasing their flats; no demand developed for the industrial objects on sale. Hence, the trading value of the voucher fell continuously.

One major result of the incoherent governance structures was the virtual absence of large privatisation. Between 1992 and early 1995 only some 47 large enterprises were entirely privatised. The remaining combines (c. 200) were all corporatised, i.e. transformed into state enterprises, so-called 'closed joint-stock companies'; yet the state was often unable to exercise real control over their activities or, alternatively, to close them down. In the absence of clear-cut privatisation, mixed ownership forms emerged. 'Leasing' has been the major technique in the restructuring process: private individuals—most often managers—can agree long-term lease contracts with the state. The financial obligations were often negligible: leasers can use vouchers and obtain favourable payment conditions for cash transactions. For the time being, this peculiar way of creating new enterprises has been the most efficient: 78% of all privatisations have been carried out through long-term lease. Table 4 provides some statistical data on large-scale privatisation in Latvia.

#### *Case-Study: From a Socialist Network to a Monetarised Network in the Motor Industry*

The case of the large minibus combine RAF in Jelgava (50 km south of Riga) shows that the disappearance of socialist networks of production completely alters the competitive positioning of an industrial unit. Until 1991 RAF was the only producer of 12-seat passenger and ambulance vans in the Soviet Union, and was therefore at the centre of a large socialist network to which about 10 major and 100 minor suppliers of components and materials belonged. Only 10% of supplies came from Latvian producers, whereas 80% came from other Soviet republics, often several thousand kilometres away. The most strategic supplies came from Russian factories: powertrain, axles and steering units from the Gorky Automobile Company (GAZ), and flat rolled steel for car bodies from the Novolipetsk steel plant; 93% of RAF output went to customers in the Soviet Union.

Table 4. Results of Large-scale Privatisation in Latvia (January 1995)

| Methods of privatisation   | Number of units to be privatised | Of which privatisation achieved | Relative weight of privatisation methods (%) | of which         |          |              |
|--|----------------------------------|---------------------------------|--|------------------|----------|--------------|
|  |                                  |                                 |  | Trade & services | Industry | Construction |
|  |                                  |                                 |  | Transport        |          |              |
| Leasing with purchase option                                     | 253                              | 230                             | 78   | 39               | 130      | 37           |
| Core investors   | 293                              | 47                              | 16   | 12               | 27       | 24           |
| Sale for hard currency   | 24                               | 15                              | 5  |                  |          | 5            |
| Auction  | 4                                | 3                               | 1  |                  |          |              |
| Special methods, incl. voucher                                   | 151                              | n.a.                            | n.a.   |                  |          |              |
| Other  | 9                                | n.a.                            | n.a.   |                  |          |              |
| Total entities stated for large-scale privatisation              | 734                              | 295                             | 100  |                  |          |              |
| Share of the private sector in GDP: c. 55% (rough EBRD estimate) |                                  |                                 |  |                  |          |              |

Source: Golans & Prauda, 1995; *Monthly Bulletin of Latvian Statistics*.

Monetisation in 1992 meant the immediate break-up of the network. Transport and coordination costs complicated the relation between RAF and most of its suppliers; the latter now demanded advance payment that RAF could not always guarantee. The demand for the 17 000 minibuses a year produced in socialist times disappeared; in 1994 only a few thousand were sold. Last but not least, competition became a central issue. Although RAF production costs are two to three times lower than the world average, Western car makers started to investigate the markets in the Baltic countries and the CIS. Also, the former suppliers of RAF decided to start minibus production themselves; at least three potential producers are investing heavily in R&D and are preparing to bring new models to the market in 1996 or 1997 (GAZ, Bratsk, Uliyanov).

One strength of RAF was its R&D capacity, which allowed it gradually to adapt the existing model to new uses (commercial vans, pick-ups). Yet the investment required for developing and assembling a new model was estimated at \$500 million, a sum that neither RAF nor its owner, the Latvian state, were capable of raising. Thus RAF realised that its short-term survival depended on the utilisation of existing capacities. In order to ensure input supply RAF decided to intensify relations with its strategic supplier, GAZ. After intense debates, the Latvian government agreed in February 1995 to offer GAZ a 30% share in RAF capital, in exchange for the regular supply of power trains. Thus, RAF has hooked up to a new industrial network. Figure 4 shows the new supplier-customer network of the minibus industry in the former Soviet Union; formerly centred around RAF, the network is now centred around GAZ and its large market outlets.

#### *Towards 'Privatisation of the Privatisation'?*

All parties concerned agreed that during the first two years of post-socialism Latvian industry was not able to benefit from liberalisation. With the arrival of the Birkans administration in late 1993, a reorientation of industrial policy was decided on, with a view to separating the tasks of restructuring from those of privatisation. Two new, largely independent organisations were set up, with a view to replacing the former institutional diversity: the Latvian Privatisation Agency (LPA) was put in charge of implementing a 'core investor' privatisation, similar to the model applied by the Estonian Privatisation Agency since 1993. On the other hand, the Latvian Development Agency (LDA) was supposed to identify these core investors and to accompany the restructuring process actively. The particular status of the two new agencies indicates the change of philosophy the government has adopted: the LDA is a privately owned, independent organisation that has strong incentives to develop the largest possible number of new enterprises. Employing industry experts on a turnover basis, the LDA is able to develop tailor-made solutions, something that none of the former administrations had been capable of doing. The LPA works similarly: as a para-public organisation, its staff depends on the number and the volume of transactions it has actually carried out.

Two issues may determine the success of the new Latvian model of profit-oriented restructuring. One concerns the continuity of government support that the LPA and LDA need to apply their concepts consistently. One year of successful restructuring has made the Latvian Development Agency an object of high prestige, but also a playing field for political conflicts. In order to continue its work efficiently, the LDA should be strengthened rather than curtailed. Another issue is whether the decentralised approach to controlling industrial restructuring can be maintained,

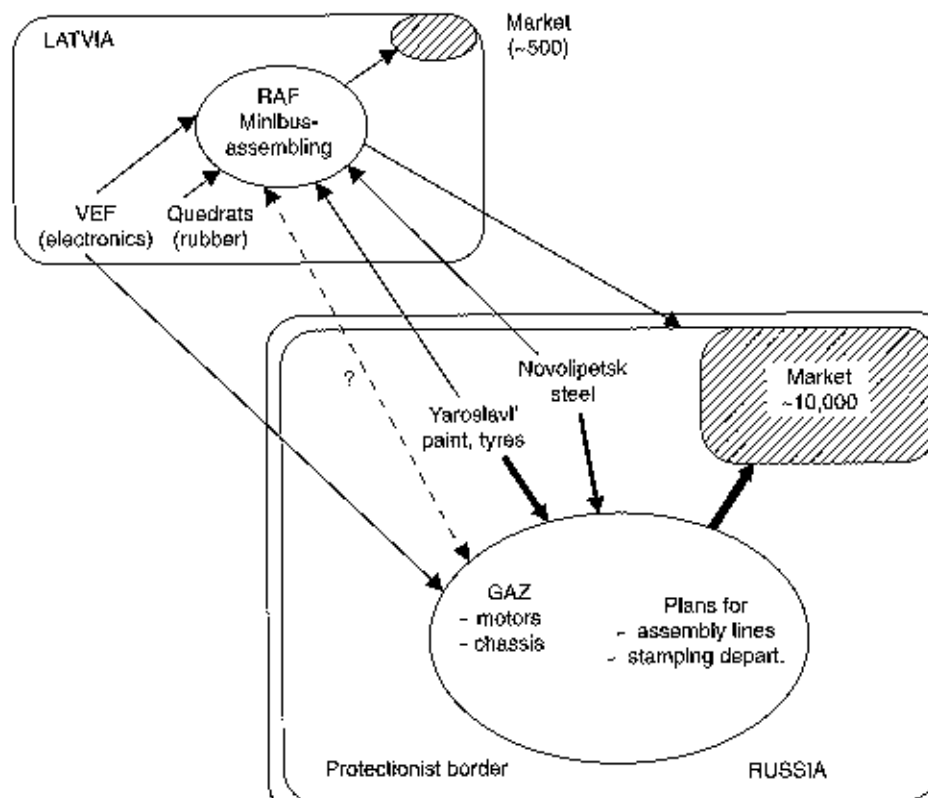


Figure 4. The Emerging Minibus Industrial Network in the Former Soviet Union.

amid increasing industry lobbying for public investment programmes and protection. For the time being, and after three years of bickering between advocates of centralisation and decentralisation, Latvia's new approach is promising. More concrete results will become visible in 1996, when the privatisations undertaken in 1995 are completed. The effects will be most visible in the small and medium enterprise sectors, where the LDA has already identified about 100 new projects. It is still too early to determine whether this original form of 'privatising the privatisation' is also a feasible strategy for large-scale restructuring.

#### **Estonia: Accelerated Splitting-up of Industrial Sites and Creation of New Small and Large Enterprises**

##### *A Radical Approach and an Aborted Strategy to Emulate the German Treuhandanstalt Model*

Estonia has certainly chosen the most radical strategy of structural adjustment of all post-socialist countries in Central and Eastern Europe and the former Soviet Union. Between 1992 and 1995 the country carried out a vast programme of liberalisation and macro-stabilisation, going way beyond the Polish or the Czech programme

of economic reform. From 1992 to 1994 price liberalisation covered all products except some municipal services and housing. International trade was completely liberalised—including such sensitive items as agriculture, textiles and wood products (Sutela & Lainela, 1994; ACE, 1995). Thus Estonia emerged—according to the Ministry of Economics—as the ‘most liberal and open economy in the world’. This strategy had to have a profound impact on the process of industrial restructuring. At the same time, the government gave practically no attention to the obstacles to industry restructuring on the combine level. Both tendencies—liberalisation and neglect of restructuring issues—may be brought into balance as the ‘window of opportunity’ that has allowed the shock therapy seems to have been closing since the March 1995 elections.

The Estonian approach to privatisation has been compared—not least by its own founders—to that of the Treuhandanstalt in Eastern Germany (Sutela, 1994). However, it is today widely understood that the Treuhandanstalt was anything but a privatisation agency; on the contrary, the strategy applied in Eastern Germany was decentralised, active restructuring on the combine level (von Hirschhausen, 1995). The conditions necessary for such a strategy did not exist in Estonia; as a consequence, the initial ‘Treuhandanstalt strategy’ pursued by Estonia was gradually aborted, and replaced by elements specific to the Estonian context. Initially, the Estonian Privatisation Enterprise (EPE), set up in August 1992, was supposed to become the centre-piece of industrial reform. However, EPE had largely underestimated the effects of the June 1992 monetary reform on industry, that imposed an immediate liquidity squeeze on the former combines. A radical re-orientation of sales towards solvent customers took place in those sectors that were relatively close to some kind of final demand and whose capital needs were limited (e.g. furniture, clothing, transport). Other branches, characterised by the production of intermediate goods and/or high capital intensity, simply collapsed, as was the case with the pulp and paper, chemical, engineering and metal industries, as well as agriculture. During the three years 1992–94 only those former industrial units that immediately hooked up to a new industrial network, mainly in Western Europe, were able to continue production. The process of restructuring of industrial combines was thus dominated by actors downstream (traders, distributors) who also accounted for a major share of the 2.6 billion EEK (\$200 million) of privatisation proceeds.<sup>19</sup>

Given its limited financial and human resources, it quickly became evident that the EPE would not be capable of fulfilling the role of organiser of industry restructuring. Privatisation proceeded rather slowly between August 1992 and June 1993 (Kein, 1995). Realising the incompatibility between the initial concept and the slow pace of privatisation, the government decided on two important reversals in 1993: first, it abandoned the idea of the *independent* EPE as the organiser of large privatisation and merged the EPE and the Department of State Property (DSP) into one large body: the Estonian Privatisation Agency (EPA). Second, privatisation was taken out of the hands of the Ministry of Economics and subordinated to the Ministry of Finance. The EPA continued to play an administrative role in organising tenders, but it was henceforth the Ministry of Finance that decided on the criteria for the final selection of investment proposals. Privatisation accelerated considerably in 1994. Henceforth, two types of privatisation dominated: foreign investment privatisation, and management buy-outs. Also, rapid decisions were taken to close down those producers whose restructuring seemed hopeless. Table 5 provides some quantitative data on large-scale privatisation in Estonia.

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Table 5. Results of Large-scale Privatisation in Estonia (January 1995)

| Methods of privatisation   | Number of units to be privatised | Privatisation achieved | Relative weight of privatisation methods (%) |
|--|----------------------------------|------------------------|--|
| Tender (core investors)  | 260                              | 126                    | 17   |
| Auction  | 321                              | 297                    | 40   |
| Pilot privatisation  | 7                                | 7                      | 1  |
| Voucher privatisation  | n.a.                             | 5                      | 0.7  |
| Leasing  | n.a.                             | 300                    | 41   |
| Wild privatisation   | n.a.                             | n.a.                   | n.a.   |
| Total  |                                  | 735                    | 100  |
| Total investment guaranteed (EEK million) <sup>a</sup>           |                                  | 753                    |  |
| Total employment guaranteed <sup>a</sup>                         |                                  | 23 160                 |  |
| Share of the private sector in GDP: c. 55% (rough EBRD estimate) |                                  |                        |  |

<sup>a</sup>For investment by tender only.

Sources: Keim, 1995; Estonian Ministry of Economics.

#### *Case-Study: Immediate Diversification and Rapid Restructuring in the Woodworking and Furniture Industry*

The case of the Estonian woodworking and furniture industry, and in particular its largest enterprise, Tarmeko, is an example of the almost instantaneous reorganisation of production structures and networks in an industry close to final demand. In socialist times the production of furniture was organised in a few combines that were fully integrated and highly specialised in mass production of a limited number of products. Thus, Tarmeko mainly mass-produced five different sizes or components of one single product: chipboard desks, for Soviet Union customers. The rupture for Tarmeko and for the Estonian woodworking and furniture industry as a whole came in 1992, when the introduction of real money—and thus the appearance of costs and financial constraints—destroyed the former non-monetary networks. Upstream, the supply of wood and other inputs (paint, glue, coatings, mechanical pieces, rubber) from Soviet sources was largely cut off and had to be replaced with hard currency purchases; downstream, the entire distribution system collapsed: within a couple of months, the demand for the chipboard desks shrank from 500 a day to a couple of dozen.

Under these conditions, one survival strategy for Tarmeko was to diversify production, develop new products, and hook up to existing distribution and sales networks, primarily in the West. Tarmeko rapidly commenced production of a vast range of new products that international distributors were demanding, from very simple products (wooden chairs, lacquered products) to very sophisticated products (leather sofas, bent and veneered spare parts). From five, the number of products rocketed to 150 in 1994. The quantity of mass-produced products had decreased by 66% (Hui, 1995); the small quantities of each product sold implied high capital costs for stocks. But it was thanks to this strategy that Tarmeko achieved a spectacular

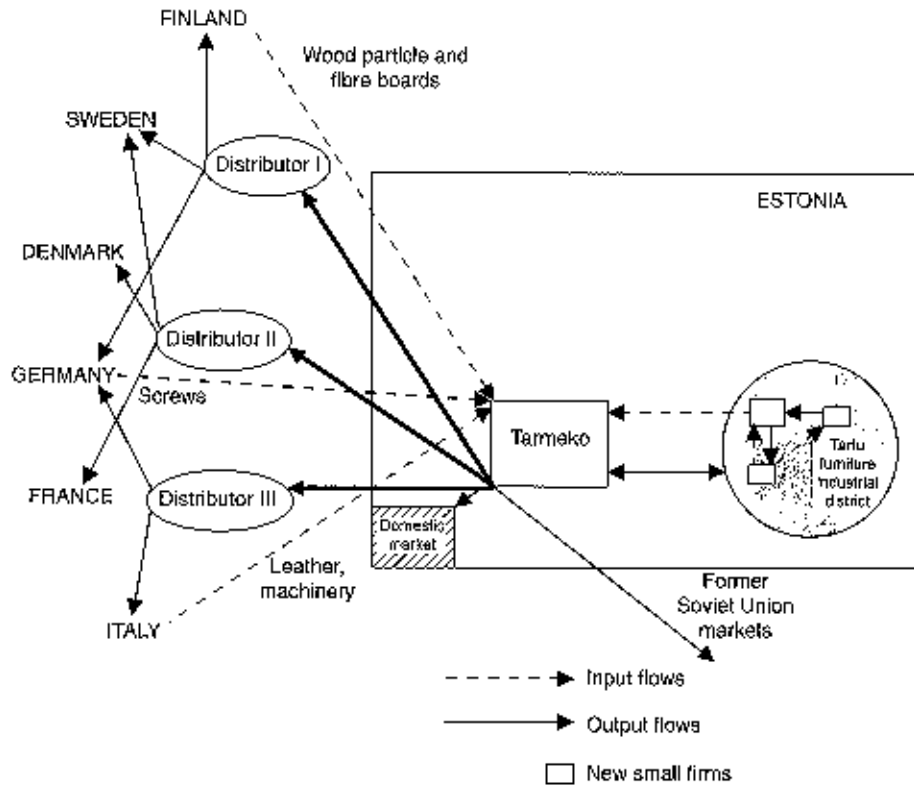


Figure 5. The Integration of an Estonian Furniture Enterprise into International Networks.

reorientation of sales; whereas in 1991 96% of its products had been shipped to the Soviet Union, in 1993 Tarmeko sold 88% of its products to hard currency countries, mainly in Western Europe.

All this has not necessarily meant that Tarmeko was able to accumulate sufficient funds for the investments necessary to re-specialise its product range. Whereas some barter trade (products against machinery) has helped to modernise equipment, no investor—foreign or domestic—has shown any interest in taking over the former combine in its present state. The official owner of Tarmeko, the Estonian Privatisation Agency, had refused to provide financial means. In accordance with its overall strategy of rapid privatisation, the EPA then decided to give away Tarmeko through a management buy-out. In December 1994 six directors of the enterprise took over two-thirds of the property. For the time being, the EPA holds the remaining third, in order to ensure that Tarmeko respects the pledged volume of new investment and job guarantees. Figure 5 shows the emerging network structures around Tarmeko.

#### *Towards Finance-dominated Restructuring*

Four years after the end of socialism, and first monetary reforms, Estonia is approaching the end of a period characterised by an ambitious and consistently

Table 6. Approaches to Privatisation and Emerging Patterns of Corporate Governance in Lithuania, Latvia and Estonia

|           | Privatisation approach  | Main actors and institutions  | Emerging structures of corporate governance  | Prospects   |
|-----------|---|---|--|---|
| Lithuania | Mass privatisation<br>Little regulative   | Accumulation of vouchers, mainly by insiders<br>Decentralised auctions, favouring insiders (tender for best business plan)<br>Foreign investors largely absent<br>State institutions rather passive (Central Privatisation Commission, Securities Exchange Commission, State Prices and Competition Office) | 8-10 post-socialist industrial holding companies dominating industrial sectors<br>Private/public conglomerates, insider-controlled<br>Increasing role of insiders through management buy-outs<br>350 small investment funds for individual subjects<br>Loose handling of the debt issue (260 enterprises saved from bankruptcy)<br>Little control on corporatised state enterprises (Closed Joint-Stock Companies)<br>Long-term lease as the major way of ownership transfer<br>Since early 1994: attempt to separate privatisation from restructuring;<br>Increasing role for Latvian Privatisation Agency (LPA) and Latvian Development Agency (LDA) | Opening-up of capital of holding companies; increasing role of capital markets<br>Privatisation through liquidation |
| Latvia    | Mixed approach: voucher privatisation, auctions, individual sales, long-term lease<br>Important role of restitution and compensation  | Unstable institutional environment (Ministry of Ownership Reform, Council for Economic Reform, State Enterprise Department, State Property Fund, etc.)<br>Foreign investment largely absent<br>Voucher scheme not applied to large-scale privatisation  | Little control on corporatised state enterprises (Closed Joint-Stock Companies)<br>Long-term lease as the major way of ownership transfer<br>Since early 1994: attempt to separate privatisation from restructuring;<br>Increasing role for Latvian Privatisation Agency (LPA) and Latvian Development Agency (LDA)  | *Privatisation of privatisation?<br>Extended public ownership for 'non-privatisable' enterprises?                   |
| Estonia   | Ambitious approach to privatisation/restructuring, spurred by macroeconomic shock therapy<br>Attempt to emulate a Treuhänderstalt approach of active restructuring<br>Centralised, administrative privatisation | Ministry of Finance as the decisive control organisation<br>Estonian Privatisation Agency (EPA) as the executive of privatisation<br>Relatively important role of foreign investors   | Increasing role of financial institutions in restructuring (commercial banks, investment funds, Compensation Fund)<br>Insiders: Management Buy-Out under favourable conditions<br>Rapid closure of hopeless cases  | Finance-dominated industry restructuring<br>State involvement in a few exceptional cases only                       |

pursued shock therapy, the results of which have emerged rapidly. The real industrial policy issue now is what to do with the stock of about 100 former combines that are today run as 'state enterprises' by local management, but in reality controlled by nobody. The government will have to decide who will be responsible for the restructuring of these units into viable enterprises, and what criteria should be used to split up the industrial structures that are, in most cases, no longer adequate. The range of instruments is wide: the transfer of ownership to the current management—management buy-out (MBO)—is the easiest solution, but it is not certain that the managers always pursue a long-term strategy of industrial development. Mass privatisation—either through internal or open distribution of shares or vouchers—might be considered a 'fair' solution, but it hardly resolves the questions of the necessary splitting-up or of investment. Another solution—extended public ownership—seems politically difficult at present but might be the least difficult solution in the short term.<sup>11</sup>

Given the experience of neighbouring Russia and Lithuania with mass privatisation, Estonia seems to be too far advanced in the restructuring process for mass privatisation to play an important role. Instead, the Ministry of Finance favours the conversion of the vouchers already distributed into government bonds or shares of investment funds, thus transferring larger responsibility for restructuring to financial markets, in particular the already existing investment funds (like EEIF, BBI, Scandia SICAV-Hansabank, etc.) or new ones. The EPA, as the organiser of privatisation, could thus be rapidly replaced by an institutional setting where banks control the restructuring of industry. As a result of the shake-up of the banking system in 1993 and the strict regulation of financial activities, the Estonian banking system has reached a state of maturity unmatched by other post-socialist countries. Together, the state-run Compensation Fund, private investment funds and predominantly private commercial banks are emerging as the core institutions of the Estonian model of finance-dominated restructuring.

### Conclusion

As in other post-socialist countries, industrial restructuring in Lithuania, Latvia and Estonia is a complex process that has not always evolved as expected in the initial reform programmes. Whereas macroeconomic stability was achieved rapidly, the pace of industry restructuring lagged somewhat behind. The transformation process from industrial networks to networks of capitalist enterprises—the process that we have called enterprisation—also depended on the institutional framework in which it was taking place. Different structures of corporate governance also had an impact on the nature of industrial restructuring. Rather than one standard model, one can observe an increasing variety of reform processes on the micro-level.

We have analysed this variety for the Baltic countries; although Lithuania achieved the most rapid privatisation programme of all CEE countries, it has not yet defined clear-cut criteria governing the restructuring and closure of enterprises. The Lithuanian case is a case in which impressive results of privatisation do not automatically imply an efficient restructuring process. Latvia hesitated for a long time between various institutions of enterprisation, without exercising significant control over its state enterprises. Its attempt to privatise the privatisation since early 1994 will accelerate restructuring, though it might not be sufficient to overcome all remaining obstacles. Estonia pursued a consistent strategy of monetary and structural adjustment, without paying much attention to the different steps of restructuring on

the combine level. Restructuring is now more and more controlled by the rapidly developing financial institutions. Table 6 summarises the link between privatisation approaches and emerging governance structures in the Baltic countries. Post-socialism is not a pre-defined series of reforms but an open process, the results of which cannot be known in advance; the three cases of Lithuania, Latvia and Estonia are appropriate to illustrate the diversity of post-socialist industrial restructuring.

### Notes

1. This article is a result of the ACE-PHARE Research project on 'Industrial Restructuring in the Baltic States', financed by the EU Commission, GD-II, and carried out mutually by the Economic Research Centre (Vilnius, Lithuania), the Institute of Economics (Riga, Latvia), the Institute of Economics (Tallinn, Estonia), the Science Policy Research Unit (SPRU) (Sussex, Great Britain) and the Centre for Industrial Economics, CERNA (Paris) (ACE, 1995). We are grateful to the participants of the CEPRUBALT research group for scientific cooperation, furthermore to Rutger Wissels and Antonio Torres-Lacasa at the EU-Commission and to Pierre-Noël Giraud and Olivier Bomsel at CERNA for comments. The article was written while von Hirschhausen was researcher at CERNA. The usual disclaimer applies.
2. We use the term 'socialist industrial units', to designate the smallest administrative unit with an individual accounting and production plan; this corresponds to the *predpriyatie* in the former Soviet Union and the *VEB* in the GDR.
3. For most CEE countries the date of monetarisation can be easily identified, as it coincides with the beginning of macroeconomic reforms: Poland (January 1990), Eastern Germany (July 1990), Czechoslovakia (January 1991), Russia, Lithuania, Estonia (January 1992). In other cases, it is more difficult to identify a precise date, but the year of qualitative change can be given: Hungary: 1990, or Romania: 1991.
4. Since June 1992 the vouchers have been tradable at the Central Privatisation Commission; their price—nominally 4 Litas—has continually diminished; in late 1994 it was between 0.07 and 0 Litas.
5. The background material of the three case studies in this article was prepared by the Economic Research Centre (Lithuania), the Institute of Economics (Latvia) and the Institute of Economics (Estonia), respectively, who also participated with the authors in the field work. We thank the enterprises visited for intense and open discussions.
6. In this case the names of the enterprises have been modified.
7. For example, TV-1 took a 29% share in SCREEN, which, in turn, installed one of its managers on the supervisory board of TV-1. TV-2 sold 49% of its shares to SCREEN, in return receiving a long-term guarantee for the supply of screens and tubes. CHIP-2 was represented on the supervisory board of TV-2 and served as the head of the newly created Association of the Electronics Industry, the main task of which is to lobby Vilnius government offices.
8. A Ministry of Ownership Reform was created in 1991 and closed in 1993. A Council of Ministers for Economic Reform was set up in 1993, without concrete results. Within the Ministry of Finance, the State Enterprise Department and State Property Funds competed for power.
9. Among the factors entering into the calculation of voucher rights were years of residence, Latvian citizenship, years of office in the Communist Party, years spent in political exile, etc.
10. Approximately 1–1.5 billion EEK (c. \$100–120 million) of foreign investment was channelled to Estonia through joint ventures, making Estonia the post-socialist country with the third highest foreign investment per capita (behind Hungary and the Czech Republic).
11. Cases in which the tough line of the Ministry of Finance has been softened are rare, but

they do exist, such as the Kreenholm textile combine in Narva, or the Social Bank rescue. The pulp and paper industry might become a test case: once a flagship of Estonian industry, integrated physically upstream in the timber industry, pulp and paper is today about to disappear, as a result of the introduction of energy prices and environmental standards. The government has signalled its willingness to become a minority owner of one of the mills and to guarantee investment loans from international banks, in order to favour the chances of a new network being developed in this branch.

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