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## Restructuring and Competition Strategies of Privatised Enterprises in East Germany: What Lessons for Russia?

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# Deutsches Institut für Wirtschaftsforschung

Discussion Paper No. 157

## **Restructuring and Competition Strategies of Privatised Enterprises in East Germany. What Lessons for Russia?**

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## I. Introduction

As in all transition countries the east German economy has been going through a deep crisis from the beginning. When, on 1 July 1990, the German Economic, Monetary and Social Union (GEMSU) came into force, it was already apparent that the industrial sector of the German Democratic Republic would be unable to withstand the competitive pressure from the West for long. The big conglomerates, controlled by the government, hierarchially structured and bureaucratic, started into the market system with low competitiveness due to an obsolete capital stock and overmanning, insufficient product quality, distorted specialization and orientation towards the former COMECON, as well as deficient management capacities and, as a result, low productivity. Overnight, the „transformation shock“ laid bare the economic inefficiencies of the old socialist system (DIW, IfW, IWH 1995). In the second half of 1990 gross value added was only half the level recorded during the first half of the year. Initially, however, only a small number of plants were closed. The majority remained in operation for the time being, although in most cases at a greatly reduced rate of capacity utilisation. Frequently, their continued use was only possible due to massive financial support by the government. The Treuhandanstalt, the institution which took care of the former state-owned plants, covered east German companies' liquidity requirements generously. In addition, substantial government support bolstered exports to Eastern Europe.

Taking the general conditions into account, the east German way of transition is not typical for the process in other transition countries in central and eastern Europe.

- On the one hand, the adjustment process of firms were heavily hampered by the politically motivated revaluation of the Mark against the Deutschmark, as well as the sharp wage increase. At the currency rate at parity and at labour unit costs as twice as high as in west Germany, there was no chance for a gradual adjustment process for the old companies.
- On the other hand, the conditions for investments were improved very fast by massive government support. Subsidies reached, on average, about one third of the investment. Beside that, attractive privatization conditions were a strong in-

centive for western investors. In addition, government investment in rebuilding infrastructure (telecommunication, traffic etc.) improved the overall conditions for investment, too.

Up to now, the reconstruction of the East German economy has made substantial progress. Production has been expanding and productivity has tripled within the first four years since unification. Nevertheless and despite massive government support there is still a long way to go in attaining western standards of efficiency and competitiveness. East Germany contributes less than 10 percent to the overall German GDP - compared to the share of 20 percent in total population. Export activities are still very low reaching 12 percent of total sales of manufacturing (1995), 32 percent in west German manufacturing. The main markets are local and domestic markets, respectively. 57 percent of total sales by eastern companies were non-tradables, in west Germany only 37 percent were non-tradables (Naujoks 1994). The level of productivity still makes the half of that in West Germany and unit labour costs by one third exceed the West German standards (DIW, IfW, IWH 1995). In addition, the pace of catching-up has slowed down during the last year. In 1997, the east German economy growth rate was 2 percent, in west Germany 2,5 percent. Manufacturing industry is still expanding, but, as in the years before, from a very low level (DIW, IfW, IWH 1998). All in all, this cannot be interpreted as a great success.

Whereas the description of the poor performance of the East German economy is quite clear, the diagnosis of the reasons lying behind has been discussed controversially. Most experts argue that the level and the rise of labour unit costs are the main reason for the low competitiveness. Other experts take into account the low productivity which results from an insufficient capital stock of enterprises. Finally, some experts put an emphasis on the low level of sales and the insufficient integration into the national as well as the international markets.

Whatever the reasons for the dragging of the catching-up process are, obviously something is going wrong with the restructuring process in East Germany. After unification, were the expectations concerning the market power of companies too optimistic? To give an answer to the question of a low competitive power we have to focus on the strategy and behavior of East German companies. What has happened

to companies having been privatised? What are the newcomers alike? And: Which role play investors from the West? To find answers on these questions is not only substantial for policy-makers in Germany. It is also of significant relevance for other economies in transformation: What can be learnt from the east German experience?

The following paper consists of two parts. Part I provides some evidence on the actual situation and examines the adjustment and reconstruction process in the East German manufacturing industry. Part II discusses some options which can be learnt for other transformation economies with special reference to the Russian situation.

## **II The East German Experience**

### **II.a Restructuring and Competition Strategies: Some Considerations**

Economic restructuring concerns the way companies try to get competitive advantage. Attaining competitiveness simply means that firms are able to convince the customers that they can sell their products. There are several preconditions for that: Companies should be able to realise market opportunities, to develop products according to the market needs, to produce them at favourable costs and, last but not least, to establish an efficient sales and distribution system for keeping their up-to-date customers and attract new ones. Principally, competitive advantage may be reached either by product specialisation and differentiation (for example, on new and high quality products) or cost-leadership (for example, for already existing products by innovative low-cost production and distribution systems). Clearly, product specialisation and cost-leadership can be attained at the same time. Another important variable for competition is „competitive scope“ (Porter 1990) concerning the question of choosing the range of products, the type of buyers, the geographic areas etc.

The reconstruction process in the East German manufacturing industry is characterised by a fast and enormous change-over in the number and the ownership structure of the companies' stock. On the one hand, former state-owned companies were privatised or closed down, on the other hand, new firms were founded. The investors came from east Germany, itself, from west Germany or from abroad. Not only big

international companies are involved in east Germany, but also the so-called "Mittelstand" (medium-sized companies) as well as individuals who may have started a company for the first time in their life. In addition, there are still some companies in the hands of the successor institutions of the Treuhandanstalt.

It is quite clear that the examination of the competitiveness of the East German manufacturing industry has to take into account its heterogenous structure. It can be assumed that competitiveness differs very significantly for different types of firms. In general, it is assumed that privatised firms can provide much better than government-owned companies what is urgently needed for catching-up, as market know-how, investment capital or management skills. However, privatisation is not a precondition for restructuring per se, it also depends on the specific implementation of privatisation and on the competitive „competence“ of the investor (Carlin, van Reenen, Wolfe 1994). Therefore, closer investigation of the post-privatisation process is needed. It is hypothesised that the owners with the market experience would be an advantage for the East German plants as they may offer access to national and international markets. Thus, specific interest is to be put on East German plants which are owned by West German or foreign companies.

## **II.b Data Base**

The questions raised require an appropriate data base. It is obvious that there should be information available which corresponds to the sectors of manufacturing industry described above. However, the official data sources compiled by the German Central Statistical Office provide only limited information on the complex adjustment process in the East German manufacturing industry. They collect data on production, turnover, exports, employment, wages and investment on a firm level but due to the strict data protection legislation, information is aggregated and available only on a sectoral or a firm-size level. This allows only for an analysis on the basis of average figures, whereas the individual adjustment processes and problems of expanding and shrinking companies cannot be analysed. In order to close this information gap, the DIW established its own data base on East German firms.



The DIW started at an early stage, commissioned by the Federal Ministry of Economics and with the collaboration of the Kiel Institute of World Economics (IfW) and the Institute for Economic Research Halle (IWH). So far, five surveys have been conducted, in summer 1991 (DIW, IfW 1991), summer 1992 (DIW, IfW 1992), winter 1993/94 (DIW, IfW, IWH 1994), spring 1995 (DIW, IfW, IWH 1995) and autumn 1996 (Brenke, Eickelpasch 1997). About 1 700 industrial firms employing more than 1 million workers participated in the summer 1991 survey; almost 2 000 industrial firms with about half a million employees responded in summer 1992, almost 2 500 firms with more than 200 000 employees were the respondents of the survey in winter 1993/94, 2 800 firms with 180 000 workers were inquired in spring 1995 and more than 3 800 firms with 250 000 employees - in autumn 1996.

Comparisons with official data are very difficult, as the official survey programme differs from that chosen in the DIW surveys in various ways. In particular, the DIW surveys also cover small-scale industry. This sector of the manufacturing industry is much more developed in East Germany than in West Germany. Official data only take companies with 20 and more employees into account. However, it can be assumed that the sample gives a representative picture of the situation in the East German manufacturing industry.

The information was collected by a questionnaire sent out by mail. The questionnaire consists of different parts. Some questions deal with the actual situation evaluated by an individual firm, others cover such hard aspects as turnover, market areas, employment, investment as well as ownership status. These questions were repeated in all surveys. Thus, investigations over a period of time were possible. In addition, some questions were substituted from one survey to the next. The questions covered different issues. For example, in autumn 1996, information on the evaluation of subsidies was collected and, in spring 1995, information on market access of East German firms.

Due to the design of the surveys, there are different ways of using the data. First, as a cross-sectional approach, data on firms can be analysed for each survey separately. Comparison of results provides information on the adjustment process at an aggregate level. Second, the surveys can be considered as a panel of those firms

which contributed to all five inquiries or some of them and, thus, will allow a longitudinal analysis on adjustment processes of individual firms. However, due to the fact that since unification, entries and exits have been very high, a relatively small number of firms can be observed on a longitudinal approach.

The findings presented in this paper will focus on some general questions. These are the following. First, the changes in ownership are discussed and hence, the overall situation of East German companies and obstacles for gaining competitiveness. second, as one major issue for evaluating market performance, the access and integration into national and international markets; and third, the investment strategies of companies.

## **II.c Selected Findings**

### *Ownership Change*

At the beginning of the GEMSU, the manufacturing industry in the German Democratic Republic was nearly completely state-owned and consisted of very few and very large unities with a lot of plants. The whole manufacturing was concentrated in 221 so-called „Kombinate“, e.g. horizontally or vertically integrated conglomerates of plants (Staatliche Zentralverwaltung für Statistik 1989). 126 „Kombinate“ were directly controlled by the ministry which was responsible for the corresponding industrial branch. They consisted of 40 to 60 plants and employed on the average 10 000 to 20 000 workers, some up to 60 000 workers. The remaining 95 „Kombinate“ were controlled by local authorities and they were smaller, about 5 000 employees on the average.

After reunification, the ownership change took place in two different ways, on the one hand by privatizing the former state-owned companies, on the other hand by founding new firms.

The Treuhandanstalt had the task to privatise the companies rapidly which it had taken the charge of. Firms were sold in a „normal“ sales-process to domestic and foreign purchasers, and were not given away via voucher privatization as it was done

in the Czech Republic, the Slovak Republic or other eastern European countries. At the beginning, for most of the companies the Treuhandanstalt could not find an investor, as most companies to be sold were too large, their production programme was too diversified, or the capital stock was worn-out. Thus, the Treuhandanstalt pursued the strategy of splitting up the former „Kombinate“ into smaller units (Schmidt 1993). The Treuhand-strategy of „decomposing“ taken together with the massive quasi subsidizing via mostly favourable prices for the investors (Brücker 1995) led to fast substantial change in ownership. Until the end of 1994 the Treuhandanstalt sold most of its firms and the Treuhandanstalt was closed. In addition to this „top-down“-privatisation, new companies started their business. As „bottom-up“-privatization, they formed the second part of ownership transformation.

In 1991, 92 percent of those employed by the firms which were surveyed, worked in the firms owned by the Treuhandanstalt. Over time, the ownership structure changed rapidly. In 1996, there was just a handful of former industrial combines that are still administered by one of the institutions-successors of the Treuhandanstalt (table 1). Privatised firms now account for 57 percent of the workforce, reprivatised for 10 percent and newly founded businesses for a fifth. Three quarters of the firms surveyed can be considered as industrial "Mittelstand", i.e. independent small- and medium-sized firms. On the other hand, West German and foreign-owned subsidiaries account for a half of the industrial jobs.

### *Overall Performance*

The comparison of the five sets of annual results shows that the firms initially perceived themselves to be facing massive problems, but that the pressure to adjust to these problems since then has been steadily declining. In summer 1991, more than four fifths of the firms reported that they were experiencing great difficulties in holding their own on the market. In summer 1992, the figure was more than two thirds and in spring 1995, it only slightly exceeded one half. But since then, the situation did not improve further, the share of companies with massive competitive problems remained relatively stable (table 2).

Table 1

**East German Manufacturing Firms**  
**According to Ownership Status (percent) 1991 to 1996**  
as a % of all firms and employees resp.

	Summer 1991		Summer 1992		Winter 1993/94		Spring 1995		Autumn 1996	
	Firms	Em- ployees	Firms	Em- ployees	Firms	Em- ployees	Firms	Em- ployees	Firms	Em- ployees
Private firms	14	8	66	41	94	76	99	95	99	95
of which:										
Independent firms	9	1	49	19	80	42	77	50	77	51
Firms owned by west German or foreign firms	5	7	17	23	14	34	22	45	22	44
of which:										
Privatized Treuhand-firms	X <sup>1)</sup>	X <sup>1)</sup>	48 <sup>2)</sup>	36 <sup>2)</sup>	41	55	34	60	33	57
Reprivatized Treuhand-firms	X <sup>1)</sup>	X <sup>1)</sup>	.	.	20	8	17	13	13	10
Private firms before 1990	X <sup>1)</sup>	X <sup>1)</sup>	5	2	7	5	5	2	8	6
Firms founded after 1989	X <sup>1)</sup>	X <sup>1)</sup>	13	3	26	7	43	20	44	22
Firms owned by the Treuhand or its successor organizations	86	92	34	59	6	24	1	5	1	5
<b>All firms</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

<sup>1)</sup> Too few to mention. - <sup>2)</sup> Including reprivatized firms.  
Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.

Table 2

**East German Manufacturing Firms Facing  
Problems on the Market 1991 to 1996**  
as a % of firms surveyed

	Summer 1991	Summer 1992	Winter 1993/94	Spring 1995	Autumn 1996
Private firms	62	57	55	52	55
of which:					
Independent firms	73	59	55	55	56
Firms owned by west German or foreign companies	56	52	56	45	50
of which:					
Privatized Treuhand-firms	X <sup>1)</sup>	62 <sup>2)</sup>	60	55	61
Reprivatized Treuhand-firms	X <sup>1)</sup>	.	64	65	61
Private firms before 1990	X <sup>1)</sup>	58	51	48	51
Firms founded after 1989	X <sup>1)</sup>	41	45	46	50
Firms owned by the Treuhandan- stalt or its successor organizations	88	84	82	53	89
<b>All firms</b>	<b>85</b>	<b>66</b>	<b>57</b>	<b>52</b>	<b>55</b>
<sup>1)</sup> Too few cases to mention. - <sup>2)</sup> Including reprivatized firms. Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.					

The gravity of the competitiveness problems varies for different enterprise categories:

- It is particularly acute for the firms owned by the Treuhandanstalt or its successor institutions. In 1991, almost all Treuhand firms, according to their own evaluation faced massive problems. The relative share of these problematic firms has declined sharply over the past five years, as Treuhand firms have been privatised or closed down. During the last year the situation for those firms have become more serious again. It seems that, the longer the companies are been taken care of the more they become unable to solve their problems.
- Among privatised and reprivatised firms, too, the proportion of companies facing major problems was considerable, although they are better off than Treuhand-companies. However, it seems that the adjustment process which made progress in the first years after unification has come to an end as the share of companies facing major problems in 1996 has grown, compared to 1995.

- According to the survey findings, new businesses are definitely experiencing fewer difficulties in withstanding competitive pressure. Clearly, the firms started without the burden of the socialist economy. Nevertheless, also for those companies the situation has not improved in the course of time. In 1996, the half of companies were complaining the competition pressure. In 1992 they accounted for only two fifths of the surveyed firms.
- As far as ownership forms are concerned, it is evident that independent firms are more likely to face problems than those owned by West German and foreign companies. However, the difference between the two categories is not as high as expected and has become smaller in the last two years. This may be due to the fact that the Treuhandanstalt sold also those companies to western investors which were operating in „sensitive“ branches, most of them suffering from world-wide overcapacities.

Some problems have proved particularly thorny throughout the entire period: rising competition pressure, financing problems and rapid wage growth as well as the level of labour costs (table 3). It seems that it is becoming increasingly difficult to find skilled labour. On the other hand, the proportion of firms operating with outdated plant and those reporting problems on the sales/distribution side has declined. Overall, these trends suggest that the problems of adjusting to the market economy have largely been overcome, whereas those typical of the consolidation and market penetration phase are becoming more relevant.

### *Longitudinal Evaluation*

In order to determine whether firms have been able to solve their problems, or whether they are now facing new difficulties, it is not sufficient merely to compare a number of unrelated cross-sectional analyses. What is required is a longitudinal analysis of individual firms. To this end, the 1 200 firms that participated in both of the last two DIW surveys were selected. These firms account for around two fifths of the firms surveyed in spring 1995 and for one third of those having participated in the autumn 1996 survey.

Table 3

**Selected Problems Perceived by Manufacturing Firms  
in East Germany 1991 to 1996**

	...% of firms saw ...as a problem				
	Summer 1991	Summer 1992	Winter 1993/94	Spring 1995	Autumn 1996
Social security contribution growth too rapid	-	-	-	-	62
Wage costs too high	-	-	-	-	60
Delays in recouping debts	-	-	-	59	56
Inadequate equity capital	-	-	-	52	51
Increasing competitive pressure	-	-	-	50	56
Liquidity constraint	-	-	-	49	47
Wage and salary growth too rapid	31	44	41	43	39
Lack of finance for investment	53	49	39	43	39
Difficulty in obtaining skilled labour	6	17	20	27	27
Suppliers of comparable products cheaper	-	22	26	26	32
Local administration clumsy	-	28	25	26	32
Plant/buildings outdated	38	38	28	23	18
Sales/distribution inadequate	46	39	18	22	22
Local infrastructure inadequate	15	28	18	17	20
Shortage of commercial sites and premises	-	13	14	16	12
Skill level of workforce inadequate	14	13	10	9	-
After sales service inadequate	-	13	10	6	9
Product quality inadequate	7	7	4	2	-
Plant/equipment too large	16	16	10	-	-
Key staff have left the firm	6	7	3	-	-

Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94, spring 1995 and autumn 1996.

The results of this longitudinal evaluation of the data confirm the picture already given: in 1995 just a half of the firms believed that they could withstand competitive pressure without great difficulty, while the remainder were clearly facing major problems (table 4). This distribution has changed slightly over time. In 1996, 59 percent of the firms evaluated their situation as critical. More detailed analysis reveals more strongly differentiated trends, however.

Table 4

**Manufacturing firms in East Germany Facing Problems on the Market or not, 1995 and 1996  
as a % of firms**

	Firms experiencing problems on the market in 1995			Firms <i>not</i> experiencing problems on the market in 1995			Memo item: firms facing problems on the market	
	total	of which: firms that in 1996...		total	of which: firms that in 1996...		1995	1996
		still had problems on the market	no longer had problems on the market		still did not have problems on the market	had problems on the market		
Privat firms	100	78	22	100	63	37	51	59
of which:								
privatised Treuhand firms	100	82	18	100	60	40	53	62
reprivatised Treuhand firms	100	79	21	100	64	36	61	63
firms privately owned before 1990	100	82	18	100	50	50	47	65
firms founded after 1989	100	72	28	100	67	33	45	51
of which:								
independent firms	100	78	22	100	64	36	54	59
firms owned by west German or foreign companies	100	82	18	100	61	39	41	56
Firms with ... employees								
1 to 9	100	77	23	100	62	38	59	60
10 to 19	100	75	25	100	54	46	47	60
20 to 49	100	79	21	100	69	31	52	57
50 to 99	100	78	22	100	67	33	55	58
100 to 199	100	91	9	100	60	40	45	63
200 to 499	100	72	28	100	60	40	41	54
500 or more	100	81	19	100	50	50	59	70
<b>All firms</b>	<b>100</b>	<b>79</b>	<b>21</b>	<b>100</b>	<b>63</b>	<b>37</b>	<b>51</b>	<b>59</b>
1) Firms that took part in both surveys. Source: DIW surveys conducted in spring 1995 and autumn 1996.								



- Only a fifth of the firms experiencing significant competitiveness problems in spring 1995 since then have managed to overcome these initial difficulties. To put it another way, 79 percent of the firms experiencing problems at that time have not made decisive progress since.
- For as many as 37 percent of the firms which, by and large, were operating without serious problems in 1995, the situation has changed: they are now suffering serious competitiveness problems.

The adjustment process in the period between spring 1995 and autumn 1996 has been slightly sluggish among privatised firms and companies that were privately owned prior to unification. Compared to the average of manufacturing, many of the firms founded after 1989, on the other hand, have mastered their problems. At the same time, the share of privatised firms whose problems have worsened between 1995 and 1996 is also slightly disproportionately high and significantly high concerning those firms privately owned before 1990. On the other hand, relatively few newly founded businesses report a deterioration in their situation.

The situation of many independent firms has grown more acute in recent years. Fewer of them have proved able to overcome the initial problems. It seems that the firms owned by the West German or foreign companies were better in coping with the adjustment process, though the difference is slight. The longitudinal analysis confirms that there are several problem areas facing East German firms: rising competition, difficulties in obtaining finance and wage trends (table 5). Only about one fifth to one third of the firms surveyed has mastered these problems. In addition, about one quarter of the firms who had not had that problems in 1995, are now facing the above described situation.

### *Profit Situation*

Regarding the profit situation of the firms surveyed, it is quite clear that most of the companies have not reached their break-even point yet; turnover is still too low compared to their costs to cover. One third of the firms had significant losses in 1996 and another third just reached a balanced result (table 6). But the differences

Table 5

**Selected Problems for Manufacturing Firms in East Germany, 1995 and 1996**  
as a % of all firms

	Firms experiencing the problem in 1995				Firms <i>not</i> experiencing the problem in 1995				Memo item: firms that had the problem in 1996 as a % of all firms
	total	of which: firms that in 1996 ...		Memo item: firms as a % of all firms	total	of which: firms that in 1996...		Memo item: firms as a % of all firms	
		still had that problem	no longer had that problem			still did not have the problem	had the problem		
Competition rising	100	76	24	51	100	62	38	49	58
Customer in arrear	100	75	25	57	100	71	29	43	55
Lack of own Capital Stock	100	78	22	51	100	76	24	49	52
Liquidity Shortage	100	70	30	48	100	72	28	52	48
Wages and salaries growth too rapid	100	62	38	47	100	67	33	53	40
Lack of finance for investment	100	61	39	41	100	77	23	59	38
Plant/buildings outdated	100	49	51	23	100	90	10	77	19
Sales/distribution inadequate	100	46	54	21	100	88	12	79	19
Suppliers of comparable products cheaper	100	58	42	27	100	78	22	73	32
Local administration clumsy	100	58	42	22	100	84	16	78	25
Difficulty in obtaining skilled labour	100	49	51	28	100	88	12	72	23
Local infrastructure inadequate	100	50	50	17	100	88	12	83	18
Shortage of commercial sites and premises	100	32	68	15	100	93	7	85	10
After sales service inadequate	100	35	65	5	100	94	6	95	7
Work Flow Management in Plant not yet optimal	100	38	62	16	100	62	38	84	15

1) Firms that took part in both surveys.  
Source: DIW surveys conducted in spring 1995 and autumn 1996.

Table 6

## Profit Situation Perceived by East German Manufacturing Firms 1995 and 1996

	... % of firms achieved in 1995 ...				Profit situation not be estimated	... % of firms achieved in 1996 ...				Profit situation not be estimated
	acceptable profit	low profit	balanced result	significant losses		acceptable profit	low profit	balanced result	significant losses	
Private firms	16	24	27	30	3	13	26	35	21	5
of which:										
Independent firms	15	26	27	28	4	13	27	35	19	6
firms owned by west German or foreign firms	17	18	27	35	3	14	23	32	27	4
of which:										
Privatized Treuhand-firms	13	20	27	39	1	10	23	37	26	4
Reprivatized Treuhand-firms	12	22	26	38	1	10	20	38	27	5
Private firms before 1990	23	34	19	22	2	17	26	34	15	8
Firms founded after 1989	18	26	29	21	6	16	30	32	16	6
Firms owned by the Treuhand	0	4	11	85	0	0	4	27	65	4
<b>All firms</b>	<b>16</b>	<b>24</b>	<b>27</b>	<b>30</b>	<b>3</b>	<b>13</b>	<b>26</b>	<b>35</b>	<b>21</b>	<b>5</b>

Source: DIW survey conducted in autumn 1996.

between the categories of companies mentioned are very significant. First and not very surprisingly, almost all firms still owned by the Treuhand-successors are producing substantial losses. On the private side, there are differences as well. More than other firms, privatised and reprivatised companies suffer from their burden. On the other hand, companies which already existed before unification seem to be best off, about half of them achieved profits. Besides, also newly founded companies obviously are quite successful. Surprisingly, that does not correspond to the ownership structure. Western or foreign ownership does not always seem to be an advantage for East German firms. In this group, a fewer proportion of firms achieved reasonable or at least low profit.

Certainly, the fact that a company does not make profit must not lead to the conclusion that a firm is facing substantial problems. A number of firms invested a lot in the past years and this may be a reason for high depreciation and hence, for low profit. This is true especially for companies owned by foreigners.

#### *Capacity Utilisation, Order Situation and Market Access*

Around 70 percent of the firms surveyed reported that their capacity utilisation was "rather good" or "satisfactory". About 80 percent of firms expressed the same view of the state of their order books (table 7). Even so, there remains a significant number of firms in which capacity utilisation and the state of order books are unsatisfactory. Such firms are to be found in large numbers in every branch and every size category, in independent firms and in West German and foreign-owned subsidiaries, among the former Treuhand firms and among companies set up after monetary union. In a nutshell, firms experiencing difficulties in maintaining their market position are to be found throughout East German industry. At the same time, there are branches in which such firms are particularly usual, indicating that the problems are to be sought not only at the enterprise, but also at the branch level.

The most important sales market for East German industry remain the new federal states themselves. Almost 44 percent of total turnover was realised there in 1996, 15 percent of it - with customers in the immediate vicinity (table 8). West Germany

Table 7

**Capacity Utilisation and Incoming Orders in East German  
Manufactury Firms in Autumn 1996**

	... % of firms evaluating capacity utilization as ...			... % of firms evaluating incoming orders as ...		
	rather good	satis- factory	rather bad	rather good	satis- factory	rather bad
Private firms	22	47	31	23	51	26
of which:						
Independent firms	22	48	30	23	51	26
Firms owned by western German or foreign firms	23	45	32	24	49	27
of which:						
Privatized Treuhand-firms	23	53	24	28	51	21
Reprivatized Treuhand-firms	15	46	39	18	50	32
Private firms before 1990	21	46	33	20	51	29
Firms founded after 1989	24	49	27	27	50	23
Firms owned by the Treuhand	16	40	44	0	61	99
<b>All firms</b>	<b>22</b>	<b>47</b>	<b>31</b>	<b>23</b>	<b>51</b>	<b>26</b>
<i>Source: DIW survey conducted in autumn 1996.</i>						

Table 8

**Distribution of Turnover of East German Manufacturing Firms in 1996**

	... % of total turnover falls to markets ...					Total
	immediate vicinity <sup>1)</sup>	somewhere else in east Germany	somewhere else in west Germany	in Eastern Europe	somewhere else abroa	
Private firms	16	28	35	5	16	100
of which:						
Independent firms	18	31	34	4	13	100
Firms owned by west German or foreign firms	15	26	35	6	19	100
of which:						
Privatized Treuhand-firms	12	27	36	6	19	100
Reprivatized Treuhand-firms	18	28	32	6	17	100
Private firms before 1990	30	29	30	2	10	100
Firms founded after 1989	25	32	33	2	9	100
Firms owned by the Treuhand	2	41	47	1	10	100
<b>All firms</b>	<b>15</b>	<b>29</b>	<b>36</b>	<b>5</b>	<b>16</b>	<b>100</b>
<i>Note:</i> 1995	16	30	35	5	14	100
<sup>1)</sup> Radius of about 30 km.						
<i>Source: DIW survey conducted in autumn 1996.</i>						

accounts for a third of sales. At 5 percent, Eastern Europe now only plays a subordinate role as a sales market, and sales to western countries make up a similarly small proportion of turnover. Since 1995, there has been a quite stable situation so far in regional sales structure in favour of the West German market.

At the first sight, there is not much evidence for the hypothesis that western-owned companies have better access to western markets than independent firms have. For both categories of firms the market share for the immediate vicinity and the rest of East Germany is a bit less than a half of the turnover. Nevertheless, the export quota of those firms is on the average significantly higher than the quota of independent firms. There is one main reason for the unexpected high local orientation of western firms: some companies from the West or abroad mainly came to East Germany to serve mostly local markets, such as the markets for construction supply or food and beverages. Privatised firms seem to be more successful on western markets, quite independently of the ownership structure. On the other hand, start-ups are more oriented to local markets.

In 1997, the East German industry is expected to increase turnover by around 8 percent compared to the previous year. This is a higher rate of growth than that achieved between 1995 and 1996. Expectations are particularly optimistic with respect to foreign markets: foreign sales growth of around one fifth is considered possible. Sales to West Germany are also supposed to expand perceptibly (12 percent). Independent firms are very optimistic to expand in terms of overall performance as well as on the different market areas.

### *Investment Strategies*

In 1992 investment activities in East Germany increased very rapidly. Existing plants were modernised and new plants have been established. As there is no satisfactory information as of the scale the East German capital stock has been renewed, questions on investment activity and size and modernity of capital stock have been included in the survey.

According to the results of the survey, investment activity remains high. Almost 90percent of industrial firms undertook investment in 1996, which is as much as in 1995. On the other hand, the 1996 investment volume decreased by a tenth compared to the previous year. Obviously, the peak of the investment cycle was reached in 1995. Investment levels were highest in quarrying, the chemical, the food and the plastic product industries. The investment dynamics were somewhat less pronounced in the investment goods sectors: mechanical and electrical engineering, steel and light metal construction and rail vehicles. Altogether, the branches mentioned accounted for almost two thirds of total industrial investment in 1996.

The investment volume per employee amounted to nearly DM 25 000 in 1996, although this average figure conceals major differences in the level of investment and in trends over time (table 9). Independent East German companies invested around DM 19 000 per employee in 1996, which amounts to merely two thirds of the sum committed on average by West German and foreign investors (30 000 DM). Compared to 1995, investment activity by the West German and foreign investors in the survey sample has declined, whereas there has been virtually no change among

Table 9

**Investment per Employee in East German Manufacturing Industry**

DM

	1995	1996	1997
Private firms	25 500	24 100	23 200
of which:			
Independent firms	19 300	18 800	17 900
Firms owned by western German or foreign firms	32 800	29 800	28 500
of which:			
Privatized Treuhand-firms	26 300	25 900	26 200
Reprivatized Treuhand-firms	18 500	14 700	17 000
Private firms before 1990	28 500	19 300	19 800
Firms founded after 1989	25 700	24 900	18 000
Firms owned by the Treuhand	44 800	43 900	37 500
<b>All firms</b>	<b>26 400</b>	<b>24 800</b>	<b>23 800</b>
<i>Source: DIW survey conducted in autumn 1996.</i>			

independent companies. Those companies that are being kept afloat by the successor institutions to the Treuhandanstalt invested significantly more per employee than privately owned firms, although this is due to the fact that a small number of large investment projects exert a strong influence on the average figure.

Concerning the quality of the capital stock, a difference should be made between machinery and buildings. According to the survey, one quarter of the firms are producing with totally or partly obsolete machinery, while three quarters of the firms evaluated their equipment as sufficiently modern or almost up-to-date. Concerning buildings the situation has improved, too: more than a half of the firms reported their buildings as being at a sufficient level. Quite clearly, the result of the high investment intensity of West German or foreign companies is documented in the figures: All in all, in 31 percent of these plants equipment has a higher technical standard than in independent firms (19 percent). About the same relation can be found for buildings.

Companies not only invested for reasons of modernization or replacement but also for expansion. Western-owned companies mostly have reached their plant-size already, four quarters of them reported that there was no need for further new machinery. On the other hand, among independent firms the share of such firms is also very high (70 percent); nevertheless, one quarter of them are producing with insufficient equipment.

Any estimation of investment activity is subject to great uncertainty, not least because at the time the survey was conducted a significant part of firms - four of each ten - were unable to commit themselves as to how much they would invest during 1997 (table 10). Also concerning leasing, companies are very irresolute. Those firms that have already taken a decision in this regard, plan to cut their investment volume by almost 10 percent compared to 1996. This figure is due primarily to the decline in investment by firms still under the control of one of the institutions that have succeeded the Treuhandanstalt. Also, privately owned companies, irrespective of their independent or subsidiary status, intend to invest less in 1997 than they did in 1996.



Table 10

**Plans for Investment and Leasing of East German Manufacturing Firms for 1997**

	... % of firms ...					
	did not plan investments	planned investments	investments not yet decided	did not plan leasing	planned leasing	leasing not yet decided
Private firms	9	52	39	50	15	35
of which:						
Independent firms	9	49	42	47	15	38
Firms owned by west german or foreign firms	7	63	30	58	14	28
of which:						
Privatized Treuhand-firms	6	63	31	49	18	33
Reprivatized Treuhand-firms	8	54	38	52	14	34
Private firms before 1990	14	41	45	49	13	38
Firms founded after 1989	10	47	43	50	13	37
Firms owned by the Treuhand	7	57	36	33	30	37
<b>All firms</b>	<b>9</b>	<b>52</b>	<b>39</b>	<b>50</b>	<b>15</b>	<b>35</b>
Note:						
1996	13	82	5	64	30	6
1995	15	85	-	68	32	-

Source: DIW survey conducted in autumn 1996.

However, the number of firms investing in order to expand capacity has fallen sharply. For large firms, in particular, the expansionary phase has, for the moment, been completed. According to the investment plans of the firms, in 1997 24 000 DM per employee will be invested. Here also, the western companies rank higher than independent firms. All in all, the results of the survey suggest that the existing stock of companies cannot be expected to achieve a further rise in investment during the current year.

### III. What Lessons for Russia?

While initial problems of East German and Russian enterprises at the beginning of transformation had much in common, macroeconomic conditions underlying the process of enterprise restructuring in these countries are hardly comparable. After a very strong initial shock, East German enterprises have been transforming in much more favourable macroeconomic environment. They were at once included into a stable industrialised market economy, their restructuring began with the large-scale government programme of rapid privatisation and was supported by massive state investment subsidies over a long period of time. To further advantages count central geographical location and free access to the European market.

Comparative analysis of macroeconomic conditions of enterprise transformation in East Germany and Russia is not the subject of this paper. To illustrate the gap, we just give one figure. According to the ifo Institute for Economic Research, total investments into East German economy in 1991-1995 made up 745,9 bill. DM, of which 622,2 bill. DM were invested in the enterprise sector. In Russia with a population (not speaking of the territory) nine times exceeding East German, total investment at the same period is estimated at 220-230 bill. DM. By this, since the beginning of transformation investments in the real sector of Russian economy has been permanently reducing.

The latest DIW survey showed that in 1996, 74 percent of East German enterprises estimated their equipment as very modern or sufficiently modern; at the same time, 72 percent of enterprises considered their capital stock (equipment) to be sufficiently large. These responses give evidence of a significant progress in enterprise development and modernisation of capital assets.

Nevertheless, recent performance of East Germany faces decreasing growth rates, the process of economic convergence with West Germany slows down and almost 60 percent of manufacturing enterprises feel not competitive enough. It is recognised that expectations regarding results and the time horizon of enterprise adjustment proved to have been too optimistic.

Given the unique East German path of transition to the market, three possible ways of useful interpretation of its experience for Russia and other transforming countries may be regarded. The first one is to consider (with some limitations) the German model as an "extreme case" of favourable macroeconomic prerequisites for transition. In this case, the results may be treated as "the best possible outcome" within the given period and thus contribute to the dismantling of illusions and preventing from unrealistic policies. The second way may consist in regarding the performance in the post-privatisation period and discussing the applicability of German approaches to the Russian case. The third way could consist in considering experience East German enterprises in a broader context of global integration and national and international competition strategies.

In the paper, these approaches, together with some considerations concerning possible lessons for Russia, are offered for the first discussion. To draw conclusions, further in-depth analysis is required.

### **III.a General lessons from the “extreme case”**

The first reality to be accepted is that even in conditions of high macroeconomic stability in the broadest sense, attraction of private investment for modernisation of a backward economy requires strong efforts on the side of the state. As stated by B. Breuel, the president of the Treuhandanstalt (the government body which was responsible for privatisation), the strategy of privatisation was “not selling enterprises but buying investors”. As a rule, private investors were restrained in investing their capital in East Germany, except in few industries where quick profits were expected (real estate, retail trade). Their discretion was explained by systemic factors, such as underdeveloped traffic and communication infrastructure, by organisational and administrative difficulties as well as by a special East German problem of restitution claims. To provide necessary incentives for investment, the state had to heavily subsidise private investors.

The second general lesson from the East German experience is that “money can not buy everything” (Gerling, Schmidt 1997), that is, even enormous investment cannot secure too rapid progress and significantly shorten the time necessary for gaining experience and integration into the markets. After six years of unprecedented transfers and great organisational efforts, East German enterprises have not succeeded to get sufficient access to the foreign markets. In 1996, almost the half of overall sales of East German manufacturing companies were realised in the local and regional markets of East Germany, which can provide only a limited growth potential. One third of industrial production was sold in West Germany, about 20 percent in the foreign markets. Of a special interest is decrease in the share of East Europe to 5 percent. The average export quotas of East German enterprises made less than a half of the West German level. Their contribution to total German exports were less than 3 percent, while the share in population equalled to about 20 percent.

In view of the above said and taking into account the enormous potential of the Russian market, a question of priorities in market specialisation of Russian enterprises arises. In spite of all the complexity of internal problems, generally, orientation of enterprises on the domestic market seems to be a more realistic policy, though priorities can essentially differ depending on sector, product mix, and size of enterprises. In contrast to East Germany, Russian market is not fully open to foreign (or quasi-foreign) competitors, and the pressure on Russian producers from abroad can be regulated by appropriate state measures. "Keeping domestic markets" seems to be the first task, at least at the medium run.

### **III.b Which enterprises are doing better?**

As of the autumn of 1996, 99 percent of East German manufacturing enterprises employing 95 percent of manpower were private. Of all enterprises, 22 percent belonged to West German or foreign owners; they accounted for 43 percent of all employees. 49 percent of private companies (absorbing 28 percent of employees) were founded after 1989. Relative performance of companies depending on their ownership status and enterprise size is described in detail in the first part. Summarising one can state that, in spite of significant variations, some better than average performance in terms of competitiveness demonstrate two types of private enterprises: (1) independent firms established after 1989, which as a rule are involved into small-scale production and have succeeded to find a profitable niche on the market; (2) large enterprises which are owned by West German or foreign firms and have access to the western know-how and management experience.

The worst situation face enterprises which remain in the hands of the Treuhand successor. They make about 1 percent of the total number of enterprises and employ approximately 5 percent of the manpower. Mostly, these are the former large GDR „combinates“ having poor chances to be privatised and effectively restructured. Very small private companies (up to 10 employees) are usually lacking resources and therefore, also have stronger difficulties in establishing their products in the market. Interestingly, the smaller enterprises generally have a lower level of capacity utilisation, thus facing additional problem of growing product unit costs.

In general, there is a clear positive correlation of the enterprise size and the share of sales on the foreign markets. In this relation, East German enterprises have not yet reached an optimal size structure and, in spite of significant progress with modernisation, are not strong enough to successfully compete on the international markets<sup>1</sup>. In a concrete case, sectoral specialisation is of a great importance and often can matter more than the enterprise size.

In Russia, about 65 percent of the formerly state-owned enterprises have been privatised since 1992. In 1996, private sector produced about 70 percent of the GDP. However, if speaking of the privatisation problems and results in Russia, this is only the peak of iceberg. A very complicated and very special character of the ownership structure of Russian privatised enterprises is being widely discussed in the literature (for example Boiko, Shleifer, Vishny 1995, Bim 1996, Gurkov 1996). Here, we only mention two aspects.

In contrast to East Germany, privatisation in Russia has not been initially oriented at the attraction of investors. It began under the slogan of "fair distribution of the state ownership". For the overwhelming majority of enterprises the problem of finding investor remains crucial. In fact, ownership has been concentrating in the hands of the Russian top managers whose real control over enterprises by far exceeds their formal ownership share. Only about 2 percent of companies belong to foreign owners. There is no mass-scale greenfield investment in manufacturing. Thus, the ownership patterns bringing about relatively better enterprise performance in East Germany are only minor presented in Russia. Economic performance of Russian enterprises is strongly complicated by a dramatic lack of capital investment and is extremely dependant of the motivation, managerial qualifications and creativity of general directors. According to some estimates, the large (if not the major) part of managers due to different reasons exercise "destructive" strategies, which are aimed at a quickest extraction of income and capital from the enterprise to their own benefit (see Bim 1996). Obviously, there is little sense to speak about long-term competition strategies in such cases. Therefore, further considerations apply to the healthy part of

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<sup>1</sup> In the course of privatisation the large GDR enterprises have been dramatically "decomposed" or "compressed" in size: many of them were sold by parts while the other saw a radical (sometimes ten-fold) decrease in personnel.

enterprises, where the top executives identify their own future success with the long-term adjustment and recovery of their enterprises.

As far as the size of Russian industrial enterprises and its influence on the competitiveness is concerned, this aspect cannot be regarded separately from enterprise restructuring and modernisation. In Russia, the share of large enterprises in industrial production and employment is essentially higher, than in East Germany. Even if compared to the West German enterprise sector, the structure of Russian industrial enterprises by size appears to be shifted in favour of large enterprises (table 11).

Table 11

Manufacturing enterprises by the size groups of employment, 1995

Number of employees	Russia			West Germany
	Number of enterprises	Production share	Share of employed	Share of employed
1-200	88,0%	10,0%	15,0%	32,2%
201-500	6,5%	12,0%	13,0%	19,2%
over 500	5,5%	78,0%	72,0%	48,5%

Note: West German data include manufacturing and mining enterprises.

Source: Statistisches Bundesamt; Kari Liuhto.

However, if taking into consideration that the major part of large Russian enterprises has not been restructured and re-equipped, their present situation seems to be in line with that of the former GDR „combinates“ remaining with the Treuhand successor, i.e., with enterprises having the strongest competition problems. In any case, the consequences of enterprise „decomposition“ in the course of privatisation and restructuring for the future competitiveness should be realised and accounted for.

### III.c Access to foreign markets: special and common problems

The main problems, leading to insufficient competitive position of East German enterprises on the markets were pictured in part I. In the international dimension, they are even more sharpened.

The factors hampering penetration into international markets can be divided into special for East Germany and common for transforming economies. To special problems, above all, count high labour and overhead costs. In some cases, favourable investment conditions in East Germany resulted in overinvestment (for example, in construction industry) and underutilisation of capacities, which brings about competitive disadvantages in terms of excessive product unit costs. These peculiarities strongly restrict opportunities of price competition. East German products offered on the foreign markets often have inappropriate price-quality parameters, that is, for a given quality they are too expensive.

Table 12 illustrates relative importance of other factors as revealed by the survey of the Institute of German Economy, Cologne (February 1997; 71 German chambers of commerce and trade delegations abroad were questioned).

Table 12

Export Disadvantages of East German Enterprises

<b>Problems</b>	<b>mentioned in % of questionnaires</b>
Marketing	72
Financing problems	67
Brand image	60
Knowledge of markets	64
Knowledge of foreign languages	57
Development of foreign contacts	54
Service	36

Source: Institut der Deutschen Wirtschaft.

Except for high labour and overhead costs, the list of problems can be easily applied to Russia. At this, the Russian scale of problems is much more impressive. For Russian producers, one of the most critical is information problem, which includes many aspects, like knowledge of quality and product design requirements, international market regulations, leasing and credit conditions, etc. Especially this applies to the Russian province. Typical is incapability to carry out market studies, to estimate own chances and possible market niches; marketing is on the rudimentary level.

Even those companies actively operating in the foreign markets, in fact, have no sufficient information as of the strategies of their main competitors, their price policies, methods of competition, etc. Their "market success" is often based on the occasional information and dumping prices.

To discuss the chances of Russian enterprises on the foreign markets, let us first regard the table 13. The table gives an idea of competitive advantages which can promote success of a firm on the established markets. It presents the results of survey performed by the STRATOS group, the international network of European researchers. The sample included 1135 firms in three industries (food, clothing and electronics) from eight West European countries.

Looking at the table, one can state that in the medium term, only few instruments are available to Russian enterprises if speaking of the attempt to improve their independent performance on the foreign markets. Above all, these are instruments of price competition, eventual technological advance in some selected sectors and "creativity". This impression is confirmed by the results of the DIW survey among Berlin enterprises (1993), which displayed that their purchases of manufacturing products in transition countries in more than 90 percent of cases were motivated by a favourable price-quality relation and only in about 10 percent of cases - by technological lead and conformance quality (Eickelpasch, Pfeiffer 1995).

In the longer perspective, two different approaches could be simultaneously developed in Russia: strengthening of independent market positions and/or integration into international production chains. Each of them has its own advantages and problems.

No doubt, that independent performance on the international markets is generally more attractive in terms of the profit margins and long-term success. The East German experience shows however, that this is an extremely challenging task and that the way to go is very long and expensive. It is hardly possible to expect "the Russian economic wonder" in this sense. Along with numerous widely discussed aspects of achieving general stabilisation and favourable macroeconomic climate for



Table 13

Factors Used by Firms in Getting Comparative Advantages<sup>2</sup>

Rank	Factor	Importance Mean	Standard Deviation
1	Product quality	4.53	0.68
2	Reliability of delivery	4.41	0.76
3	Reputation of the firm	4.30	0.74
4	Workers' skills	4.22	0.88
5	Flexibility of the firm	4.14	0.83
6	Quality of management	4.09	0.89
7	Good local image and personal contacts	4.02	0.97
8	Financial capability	3.96	0.89
9	Purchasing	3.85	1.06
10	Social climate	3.85	1.03
11	Low cost position	3.81	0.98
12	Creativity	3.80	1.12
13	Brand image	3.74	1.22
14	Personal selling	3.73	1.20
15	Payment conditions	3.67	1.08
16	Pricing policy	3.64	1.08
17	Advanced production technology	3.57	1.14
18	Market share	3.52	1.12
19	Product design	3.51	1.34
20	Engineering capacity	3.45	1.33
21	Distribution channels	3.43	1.18
22	Service and delivery	3.42	1.44
23	Variety within product groups	3.31	1.10
24	Advertising/sales promotion	3.16	1.19
25	Technical assistance before delivery	2.82	1.40
26	Size of sales force	2.73	1.19

Source: STRATOS Group, 1994.

investment, the state efforts should be concentrated at promotion of a favourable informational environment and creation of the new managerial elite. For Russia, in-

<sup>2</sup> The authors give the following explanation of these results. Low cost position and pricing policy as well as marketing activities are ranked here relatively low. However, the variance of low-ranking factors is high, which reveals large differences between and within industries. Thus, advanced technology and engineering are very important in electronics, while in clothing, product quality depends on skills rather than on technology.

vesting in human capital seems to be not less (if not more) important than investing in productive assets. Financial resources should be found and the state policies developed, directed towards promotion of the best opportunities for promising young people to acquire the modern managerial qualifications. Importantly, a critical mass of competent Russian managers with practical experience in international companies is to be achieved and attractive conditions of their employment at home be promoted.

Another approach consists in development of different forms of integration into international production networks, such as licensing, franchising, minority joint ventures, production sharing contracts and strategic alliances. In East Germany, such forms are developing in the process of merging with the West German economy. Therefore, experience of Central European countries seems to be more relevant in this case.

One of examples is the Outward Processing Traffic regime (OPT) introduced between the European Union the CEEC at the beginning of the nineties. This arrangement favours sub-contracting activities of the EU firms by a specific trade regime. It enables the firms to relocate part of their production activities in CEEC under preferential conditions: an EU company can deliver material to be processed in one of the CEE countries and re-import it back, at this benefiting from reduced or suspended customs tariffs. In practise, OPT is mainly applied in the textile and clothing industries, but also in electrical and mechanical engineering, furniture and plastics production and some other sectors. In certain sectors, OPT has become one of the major forms of production co-operation between the CEEC and EU and accounts for significant shares of the CEEC foreign trade. The forms of sub-contracting can differ, in practise, however, the simple forms are predominant. In the simplest case, contracted semiproducts are produced from material and on the basis of documentation and technology supplied by the foreign contractor and are delivered exclusively to him. The higher levels of integration imply supplying the foreign contractor with semiproducts of own design.

The experience of OPT is contradictory. On the one hand, it promotes timely deliveries of inputs and guarantees the output sales, thus helping enterprises to survive in

unstable economic environment. On the other hand, this is a rather asymmetric form which, in fact, does not provide independent access to the international distribution channels, hampers development of own R&D facilities and own brand image and brings little in terms of profit margins. At the same time, there are several examples of successful employment of OPT as a springboard to international experience and own independent market performance (for more details, see, for instance, J. Pellegrin; J. Sereghyova; G. Papanek, B. Lakatos). In Russia, where a disinclination of enterprises for losing own identity is very strong, such forms should be carefully analysed and first of all, applied as a transitional form of gaining experience and moving to own independence.

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