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**OF THE**  
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**AND FINANCE**

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## **FROM THE EDITING COMMITTEE**

We are glad to present the sixty three volume of “Studies and Works of the Collegium of Management and Finance” of Warsaw School of Economics. The volume has been prepared in English.

The articles presented in this issue are a result of scientific work conducted by the staff of the Collegium as a part of own research as well as of doctoral and assistant professorial dissertations. All the articles were positively reviewed.

The presented publication reaches not only all the economic libraries and central institutions in Poland, but also the scientific centres all over Europe cooperating with the Collegium of Management and Finance of Warsaw School of Economics.



**PART ONE**

**ARTICLES ON FINANCE  
AND BANKING**





## The Wealth Channel of Monetary Policy

### 1. Factors Preceding Price Changes of Stock Exchange Assets

The capital market is an important source of capital for companies. Issuing shares and bonds constitutes growing competition for bank credit, as far as financing development is concerned. In highly developed economies the capital market has become the key place for supplying firms with sources of financing, since it is less costly than bank credits. Also, for different reasons, certain companies may experience difficulties in access to bank loans. For those firms issuing securities (either shares or bonds) becomes a necessity. The development of the capital market, including the financial stock exchange, is a necessary condition for effective re-distribution of national savings.

The level of activity of the capital market is an indicator of financial condition of stock exchange companies, and reflects the macro-economic trends. Companies are willing to use extra sources of financing, when the forecasts for level of production sold and increase of income are optimistic. Therefore it is the objective of economic policy, including the monetary policy of the central bank, to create stable conditions for development of the capital market, including the financial stock exchange.

Fluctuations of stock exchange indexes express changes in economic situation of companies. Therefore, they are a synthetic measurement of investors' expectations regarding future income and perspectives for development. Rising indexes reflect optimistic expectations regarding future incomes of companies, and their expansion. Falling indexes express lack of faith of investors in a possibility of improvement, and even in the possibility of maintaining the existing profitability of companies.

Increasing stock exchange prices can derive from two sources:

- 1) they can result from improved efficiency of the economy and improved profitability of companies;
- 2) they can result from excessive expectations regarding the increase of the market value of companies.

Price increase of share securities resulting from a company's improved efficiency is perfectly justified, and takes place over a prolonged period of time.

Price increase resulting from the latter factor causes excessive demand for shares, and consequently their overpricing. Excessive expectations constitute a kind of self-fulfilling prophecy causing speculation. A stock exchange boom transforms into a speculative bubble, which can be burst by a single pessimistic information causing a rapid loss of investors' confidence. A rapid reduction of share prices can in turn destabilise the financial market and hold back capital-raising transactions at the stock exchange. In extreme circumstances a stock exchange crisis can lead to actual economic recession, i.e. to falling production and employment.

Therefore, a speculative increase of share prices resulting from excessive investors' expectations ought to be corrected early in the development stage of a speculative bubble. The task of stabilising share prices and creating climate of confidence in the financial stock exchange ought to belong to, among others, the monetary policy. It is a new function of a modern central bank, deriving from an increasing role of the capital market as a source of financing for companies.

A rise of share prices is usually preceded by expansive monetary policy. A higher than normal increase of supply of money and credits in the economy creates extra income, which exceeds the value created in the processes of production and exchange of goods and services. An expansive issuing policy is accompanied by a low level of effective interest rates. Unjustified optimism of the stock exchange is particularly strongly influenced by credits granted for purchase of shares. Thus created capital has no source in accumulation of savings, but is created as a result of excessive, unjustified issue of money. Therefore, it is a process of creating capital, which has no backing in actual resources within the society. The increase of money supply and credit not justified by the effective GNP growth creates extra demand for stock exchange securities. However, the rising prices do not result from improved effectiveness and development of companies. They are an effect of speculation aimed at short-term earnings in expectation of further increase of prices of the securities. Obviously, this excessive optimism of investors comes from monetary expansion.

Increase of share prices can be the result of credit expansion and premature issuing of money.

On the other hand, fluctuations of share prices are considered as an important factor explaining trends at the stock exchange, and the size of banks' credit activity. Property is the basic collateral for bank credits. An increase of prices of land and buildings facilitates the development of banks' credit action. Banks are more willing to grant credits, when market value of collaterals for those credits increases. Rising property prices downright indicate the development of credit action. They constitute one of the initial symptoms of stock exchange

speculation. Nevertheless, as has been shown above, the interdependence can take place in the opposite direction – the credit expansion can trigger the rise of property prices. And the increase of the latter can in turn lead to a secondary expansion of credits.

The danger of destabilisation of the equity market arises at the moment, when share prices begin to fall, due to an automatic reduction of value of collaterals for credit receivables. In the situation of intensified credit risk and falling value of collaterals, the share of bad debts in banks' asset portfolios rises. Consequently, the banks are forced to limit their credit activity.

The chain of financial consequences described above is now reversed. Pessimism begins to prevail at the stock exchange. Reduced credit action decreases demand for stock exchange equity. Not only do the prices not grow, but they even get reduced. Some investors face the necessity to pay off credits incurred for purchasing shares. The speculative bubble bursts, and the equity market is dominated by a slump. The fall of share prices is the higher, the more they were overpriced during the boom. And just as a stock exchange boom is usually accompanied by macro-economic recovery, a fall at the financial market is followed by less dynamic economic operation within the entire economy. Falling share prices discourage investment and development of production capacity. Decreasing household incomes further reduce the scale of production. It is worth mentioning, that in the modern times the scale of fluctuations of the volume of production is fairly narrow. Therefore, the fluctuations at the financial markets are far higher, than those observed in real economy, to the extent, that a situation may occur, when the changing stock exchange situation does not result in any changes in the level of production. Obviously, this does not signify, that a depression at the financial market is not dangerous. In extreme cases it can even lead to a stock exchange panic and a financial crisis.

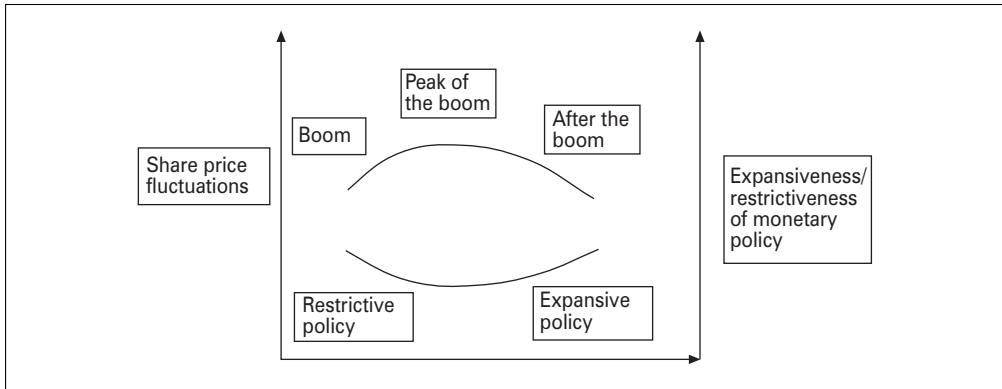
In the countries where the financial markets are most developed, the inflation is stabilised at a low level. Central banks effectively implement the policy of direct inflation targeting. In modern times, there is no correlation between changing prices of assets at the financial markets and the level of inflation. The inflation is similar both in times directly before a boom, during its peak, and when it is over. Therefore, a price level does not limit the freedom of engagement of central monetary institution. Then what attitude ought to be assumed by the central bank? Should it assume an active approach, or rather adjust to the prevailing situation? An important question is: in which phase of the stock market cycle should the central monetary institution take action in order to stabilise the financial market?

The central bank can introduce though measures at the moment of rapid share price increase, in order to cool down the over-optimistic expectations

concerning further growth. However, such attitude of the central bank does not guarantee success, due to postponed transmission of monetary impulses. A certain transition period needs to take place between the action aimed at limiting the global demand, and the curbing of prices of financial assets. Effectively, the cooling down of the stock exchange may arrive too late, when the speculative bubble has already burst. In such case, adverse effects can be doubled, and price fall can be geometrical, since it will be caused not only by the investors' pessimism, but also by falling income of households, resulting from restrictive monetary policy.

Preventive action undertaken during an early phase of share-price rise proves more effective. There is a hope, that due to delays of transmission, the effects of restrictive monetary policy will bring effect during the peak of the stock exchange boom. Preventive actions of the central bank reduce the scale of re-evaluation of share prices, and the boom itself is milder. The difficulty lies in correct identification of the beginning and the peak of the boom. On the other hand, when the boom is already underway, the central bank ought to relax the monetary policy, in order to soften the inevitable fall of share-prices. In other words, the central bank has to think about the "after the boom" period while the boom lasts, in order to mitigate the fall of share-prices. Such action limits the scale of a stock exchange boom.

Fluctuations of asset prices can take place with different intensity. There are strong and mild booms. The former are characterised by a very high price rise, and a following deep fall. The fluctuations are accompanied by dynamic growths and rapid reductions of production. In case of the latter, the above symptoms occur as well, but at a far smaller scale. Economic costs of strong booms are higher than the losses incurred by mild booms. However, it is very difficult to make early predictions about the strength of individual booms, which are crucial for the choice of means to counteract asset price fluctuations. In practice it is only possible to determine power of a cycle, and its economic costs, in its final phase, i.e. too late to properly react to adverse tendencies. Hence, the distinction between strong and mild booms has cognitive value, but little practical use. Nevertheless, it seems that analysing changes of money and credit supply in early phases of asset price rises can provide a certain degree of insight into intensity of the upcoming rises and falls of stock exchange prices. It can be expected, that a higher than normal increase of supply of money and credits in the economy precedes a strong growth of asset prices, and their following deep reduction. Mild increases of money and credit supply in turn, precede a moderate course of the stock exchange cycle.

**Figure 1. Monetary policy and fluctuations of share prices**

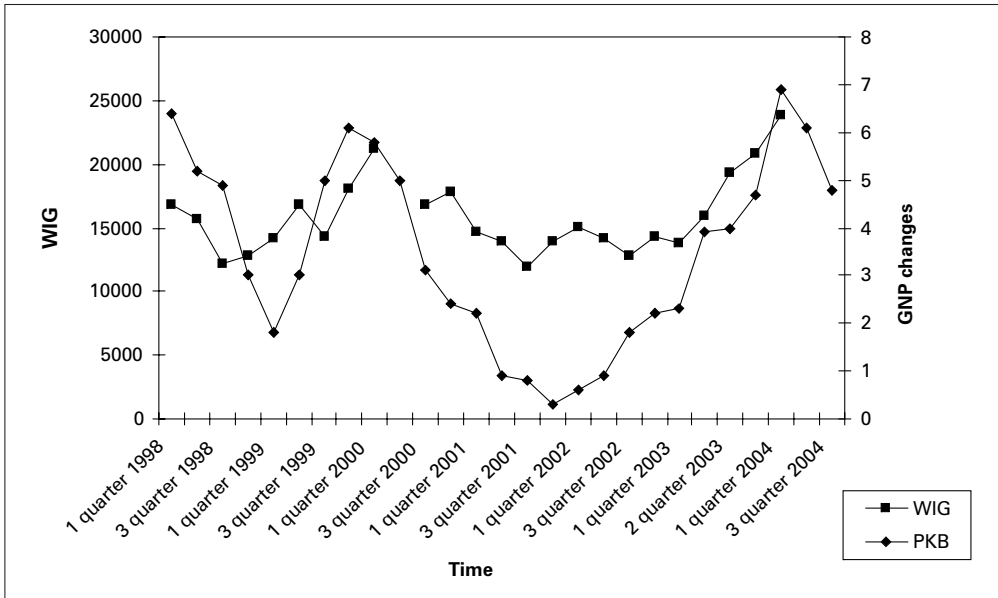
Source: own presentation.

It is the central bank's task to counteract share price changes. The objective of monetary policy is to reduce their rises, and mitigate their falls. Prices of financial assets ought to fluctuate solely as a result of the changing market positions of companies, and not under influence of speculative factors. The central bank can implement this policy by preventive changes of money supply, of basic interest rates, and the value of credits in the economy. Stabilisation of conditions in which capital market operates allows for correct supply of capital to companies.

## 2. The Direction of Monetary Policy in Poland, and the Changes of Market Prices of Shares

When analysing the operation of stock exchange channel in Poland, it is important to explain the character of fluctuations of stock exchange indexes first. It is up to assessment, whether the fluctuations of stock exchange equity prices have been caused by actual changes of economic operation, or whether they have been triggered by volatility if investors' attitudes and speculative factors. In order to assess that, we shall compare fluctuations of the effective GDP and the WIG (Warsaw Stock Exchange Index) level during the years 1998–2004. The divergence between changes of those two indicators may signify influence of speculative factors upon the share prices. On the other hand, the convergence, and similar intensity between the changes of GDP and WIG suggests the significance of actual factors influencing the situation of stock exchange companies.

**Figure 2. Changes of the effective GNP and the WIG during the years 1988–2004**



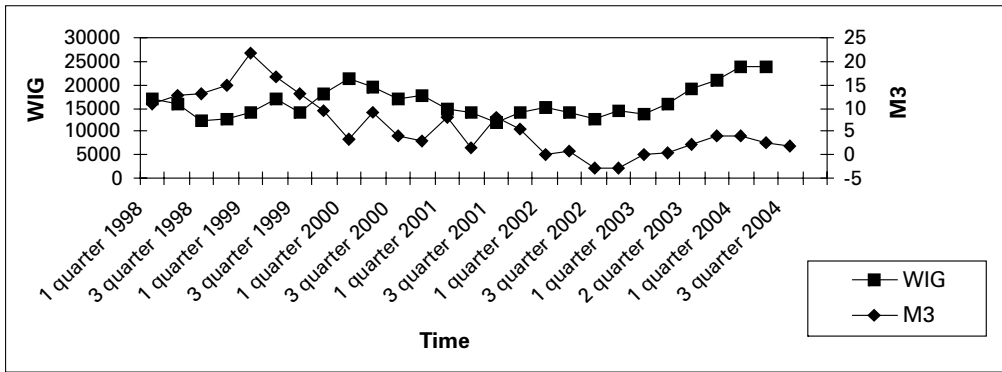
Source: The National Bank of Poland.

The effective changes of the WIG and the GDP are illustrated by similarly shaped lines. Nevertheless, although the direction of changes was the same, the scale of fluctuations was different. The GNP changes during the researched period were far larger than the changes of the stock exchange index. The WIG reduction in the initial period of the first quarter of 1998 – the third quarter of 1998 was far smaller, than the fall of the gross national product. The situation was analogical between the first quarter of 2000 and the third quarter of 2001. In 2004 the WIG changes had the direction opposite to the changes of GDP. Only between the first quarter of 2003 and the first quarter of 2004 the two quantities had a very similar shape. Therefore, it can be said that the share price fluctuations were influenced not only by the state of the economy, but also by the speculative factor.

The question arises, whether the monetary policy of the central bank could have influenced expectations of investors and speculation at the equity market? Changes of money supply did influence income of households. In order to establish the possible connection we shall present the changes of money supply in Poland (M3), and the fluctuations of the Warsaw Stock Exchange Index (WIG), during the years 1998–2004. A possible faster growth of money supply, and a consequent increase of household income, could facilitate an increase of share prices. And vice-versa: a falling dynamics of money supply increase

could lead to reduced dynamics of purchasing power, which could consequently lead to falling share prices. The WIG fluctuations have been illustrated since 1998. An analysis of this indicator during the earlier period seems immaterial – the initial years of transformation brought solely the increasing values of the index, due to a dynamic growth of the newly emerged market, and one-sidedly positive attitude of investors.

**Figure 3. The level of WIG, and the effective of M3 during the years 1998–2004**



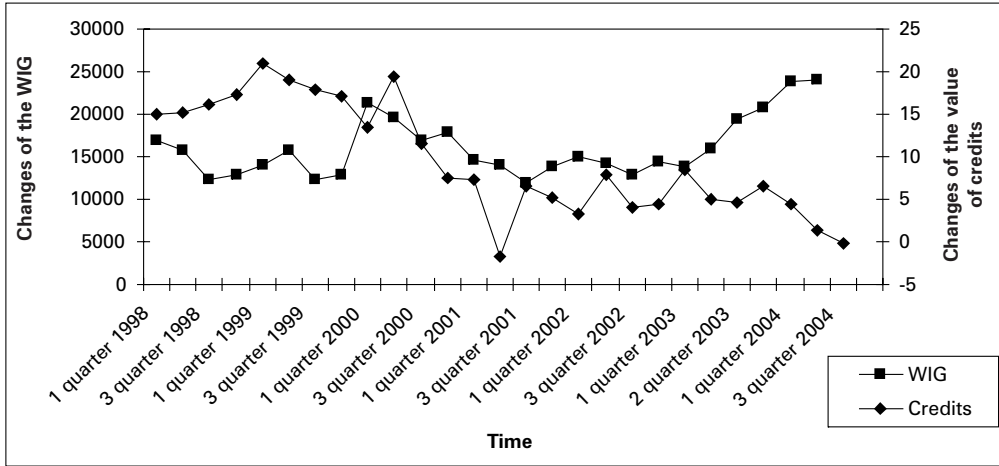
Source: The National Bank of Poland.

The shape of lines representing changes of WIG and M3 indicate a certain convergence between the two during a part of the analysed period. The convergence is quite apparent during the years 1998–2001. After the increase of money supply between the first quarter of 1998 and the first quarter of 1999, there was a somewhat delayed increase of the WIG. And vice-versa – the reduction of money supply between the first quarter of 1999 and the second quarter of 2001 resulted in a slightly delayed reduction of asset prices at the stock exchange. Then, until the fourth quarter of 2002, both lines run in opposite directions, and after that they resumed convergence in the direction of change. However, this time there was no delay, which had been so characteristic of the initial period of the analysis. This calls for cautious formulation of a thesis connecting the changes of money supply with the changes of investors' activity at the stock exchange. It would be unreasonable to expect immediate changes of prices of stock exchange assets, directly after changes of money supply. Nevertheless, they cannot be ruled out. And either way, for a large part of the analysed period, the above hypothesis seems to be correct.

The question of connection between changes in purchasing power of the society, and the level of activity of the stock exchange, can be examined in a different

way – by substituting money supply with changes of credit action of the banking system. Figure 4 illustrates this approach.

**Figure 4. Changes of the WIG and the effective changes of credit supply during the years 1998–2004**



Source: The National Bank of Poland.

The lines illustrating changes of the WIG and real changes of supply of commercial credits during the analysed period usually run in different directions. Usually the rising credit action of banks was not accompanied by changing share prices. The above was particularly apparent from the first to the third quarter of 1998, and during the years 2003–2004. The former period was characterised by falling WIG, whilst credits were increasing, and the latter by the opposite situation: the stock exchange index was going steeply up, in spite of decreasing credit action of banks.

However, the problem looks different if one is to take into account the delays in realisation of possible interrelations. Changes of the society’s purchasing capacity resulting from development of credit action are unlikely to result in an immediate change of attitudes among investors, but they occur after a certain period of time. Consequently, the increased supply of credits in the period between the first quarter of 1998 and the first quarter of 1999 could result in rising WIG no sooner, than between the fourth quarter of 1998 and the first quarter of 2000. The credits’ falling between the second quarter of 2000 and the second quarter of 2001 could contribute to weakening of the stock exchange index later, between the fourth quarter of 2000 and the third quarter of 2001. On the other hand, the dynamic growth of the WIG since the year 2003 could prove to be a result of the

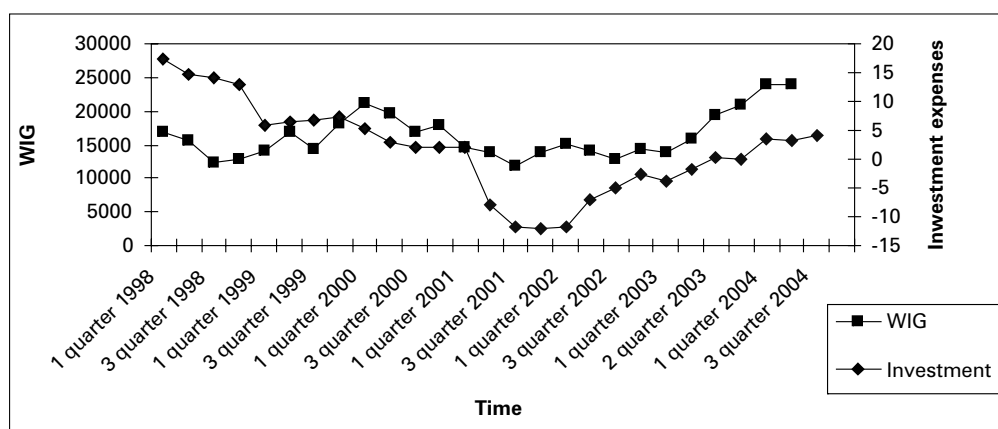


earlier expansion of banks' credit action between the second quarter of 2001 and the first quarter of 2003. The analysed inter-relation is not unequivocally obvious. Nevertheless there is a high probability, that it does exist. Therefore, it is possible to risk a statement, that the extent of expansion or restrictiveness of monetary policy does indeed influence market prices of shares at the Polish stock exchange.

### 3. Changes of Market Share Prices vs. Corporal Investment in Poland

The literature emphasises the significance of the stock exchange channel for the development of investment activity of companies. Rising share prices usually facilitate investment optimism of entrepreneurs<sup>1</sup>. In order to cover costs of investment projects, companies are more willing to issue shares during a stock exchange boom, than when share prices are falling. It is preferred to conduct the smallest possible issue necessary in order to preserve the prevailing ownership structure. Also, the rising market share prices indicate rising financial income in the future. Hence, the rising market value of company's equity capital encourages development of production capacity. Did the above phenomenon indeed occur in Poland? In order to establish this we shall analyse the direction of changes of the value of the WIG stock exchange index, and of the changes of expenses on investment in the country during the years 1998–2004. Figure 5 illustrates the values.

**Figure 5. Changes of the WIG and the dynamics of changes of investment expenses in Poland during the years 1998–2004**



Source: The National Bank of Poland.

<sup>1</sup> F. S. Mishkin, *The Economics of Money, Banking and Financial Markets*, Addison Wesley Longman, 2000, p. 653.

The direction of changes of the WIG and of real investment within the economy indicates an apparent connection between the two indicators since 2000. Also in this case certain delays could be observed, due to the fact, that the changes of the stock exchange index could not result in rising real investment expenses until later periods. Nevertheless, the co-relation between the stock exchange activity and the real investment activity is quite apparent. At first the rising WIG was accompanied by falling investment expenses. Then, since 2002, the rising share prices have been accompanied, after some delay, by rising expenses on fixed assets within the economy. The above inter-relation could be observed during the first three quarters of 1998, but nine months is too short a time to take it into account in the analysis.

The existing co-relation between the changes of market share prices and the changes of real investment indicates operation of wealth channel of monetary policy in Poland. Its existence creates new possibilities for the central bank to influence the economy. By changing interest rates and the supply of money, the central bank is able to stabilise prices at stock exchange. Counter-acting the speculative rises and falls of share prices can prevent financial crises. In the long term, such policy facilitates rational allocation of capital and dynamic growth of the economy.

#### **4. Summary**

The capital market becomes an important source of financing corporate assets. Stabilising the conditions of its functioning is a necessary condition for prevention of financial crises. Speculative fluctuations of share prices adversely affect the process of correct capital raising for firms. Therefore, the policy of preventing occurrence of speculative bubbles is an important element of rational allocation of capital within the economy.

In Poland, changes of market equity prices influence real investment activity of companies. The stock exchange operation influences the actual economic operation. Furthermore, the changes of direction of monetary policy have a certain effect upon the changes of the level of the WIG. The wealth channel of monetary policy in Poland works. Its existence justifies the need to apply monetary policy in stabilising capital market functioning. The possible financial instruments include the changes of basic interest rates, and changes of money supply. A new function of the central bank has emerged – stabilisation of conditions of operation of the capital market. Its implementation may facilitate correct capital raising for companies and improve the level of investment within the economy.

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## **Development of the Euro Zone and Problems of the Russian Economy**

While analysing Europe of the beginning of the 21<sup>st</sup> century as “Europe of changes”, and at the same time regarding the dynamic changes going on in the whole world, it is necessary, in our opinion, to evaluate the trend in the European development, which influences and will keep influencing the general character and prospects for economic and political relations in Europe (and the world as a whole) – the introduction and development of the euro zone. In this case, the introduction, functioning and development of the euro zone act as a component part of a more general process of the EU expansion (yet having definite autonomy).

The European Union expansion has deep and objective foundations, and in the long run, in one way or another, will lead to the formation of the All-European economic space. The development along this line should, undoubtedly, have been accelerated due to the passing in October 2004 of the Constitution of the European Union. But the consequent events (and primarily the negative results of the referendums on the EU Constitution in France and Holland in June 2005), even if they do not question the perspectives for not only economic but also political European integration, still demonstrate to the full extent the complicated, controversial and ambiguous character of the process. The ideas of realization of a rather ambitious plan to form “Big Europe”, when international economic integration in Europe ceases to be a West European issue, and becomes an All European one after Central and East European countries’ joining of the EU, those ideas do not turn out to be as simple and clear as it seemed for some “new” EU members. Contradictions between the “old” and the “new” EU members, a part of whom try to pursue an openly Russophobic policy, prove to be sharper than it was anticipated while considering the issues of the EU expansion in 2004.

Yet in the general context of the European integration development, the promotion and expansion of the euro zone constitutes “expansion in expansion”, as in reality there is an “overlap” of expansion and development processes between the euro zone and the European Union as a whole.

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Russia may, on the whole, treat these expansion processes positively because it is the EU that Russia is related to through long-term foreign economic, investment, scientific and research, and cultural co-operation, as well as co-operation in the field of education, which is becoming more active after Russia's joining the Bologna process. The Russian positive stance found its reflection in April 2004, during the session of the Russia-EU Cooperation Council, at which a protocol and a joint statement on the EU expansion were signed, lifting the last obstacle on the part of Russia to ten new members joining the EU. (As a kind of "payment" for the support to the EU expansion process, the Russian party received 16 guarantees of the EU in the sphere of Russian export regulation, which in its turn was a manifestation of the moderation of the EU's attitude to Russia's joining the WTO). Finally, meeting the wish of the EU, Russia ratified, in October 2004, the Kyoto Protocol (which the USA still refuse to sign).

At the same time, proceeding with the tasks of activation of the European co-operation in mind, and, naturally, of their own national interests, the Russian side has approached the expansion as a complex of positive, ambiguous and evidently negative consequences. One of the possible essentially negative consequences of the EU expansion is connected with the threat of emergence in Europe of new demarcation lines. Striving to overcome unresolved problems in co-operation with the EU in the previous years, as well as the new problems appearing due to its expansion, the Russian party welcomes the dialogue on the above issues. Meanwhile, it is very important for both parties of the dialogue to be able to listen and to hear each other and to regard to the full the interests of the EU and Russia. In this area a lot depends not only on the stand point of the EU, but also on efficiency of this country's economy, and on adequacy of its entire complex of foreign economic policy.

After ten new countries jointed the EU in May 2004, the possibilities to expand co-operation between Russia and the EU have broadened. If earlier up to 40% of the Russian foreign trade fell on the EU, then now under new conditions this index grew nearly up to 50%. If in 2003 as much as 60% of all the accumulated and 45% of all direct investments into Russia came from 15 EU countries, then with the EU expansion the investment co-operation should become more sizable. Of considerable interest are the issues related to joint co-operation not only in the economic, but also in the scientific and technical spheres, as well as the issues connected with the enhancement of international mobility in culture and education, etc.

At the same time, the EU expansion poses new problems and tasks before Russia, pertinent to the fact that while having generally favourable relations with the "old" EU countries in the past years (first of all with Germany, France

and Italy), the relations of Russia with some of the “new” EU countries remain rather complicated (for example, with Latvia due to the infringements upon the rights of the Russian-speaking part of the population, with Estonia due to borderline controversy). Up till now, the problems related to Russia’s joining the WTO have not been fully solved (though in April 2004 the session of the Council on Co-operation between Russia and the EU solved a part of these problems). It is necessary to try and find more effective and acceptable for all the interested parties ways to solve the problems of the Kaliningrad region.

It should be noted that by now we have failed to realize to the full those lines of economic cooperation, which were fixed in the 1997 Agreement on Partnership and Co-operation between Russia and the EU. It is evident that the EU expansion gives rise to new questions in the above field. All these aspects should be taken into account while assessing new possibilities, and on the other hand – the problems which Russia may face in the course of the introduction, expansion and development of the euro zone (of the Economic and Currency Union – EEU).

In the 1990s, the share of the European currencies in servicing payment and settlement relations of Russia was relatively small (as compared to the shares of these countries in the foreign trade turnover). The completion stage of the euro zone establishment process is changing the situation, and is leading to considerable strengthening of the position of the new European currency in Russia and in other CIS countries.

Yet the “completion stage” of the euro zone formation process is relative, as in time it will undergo expansion at the expense of new members. The reason being that according to the Copenhagen criteria, the newly joined EU member states should adopt the responsibility to become members in the Economic and Monetary Union. It means that the provision about the right of free participation in the Economic and Monetary Union doesn’t extend to the mentioned states (contrary to, for example, Denmark or Great Britain, which are EU member states but are not members of the Economic and Monetary Union (euro zone)). Thus, as the participation in the Economic and Monetary Union for the new EU member states becomes an integral part of their membership in the EU, these countries have to immediately join the Economic and Monetary Union and the European System of Central Banks. Yet, the membership of a particular country in the Economic and Currency Union, and in the ESCB does not automatically mean its membership in the euro zone because for this the country should, during at least two years, demonstrate its compliance with the Maastricht standards as well as meet some other requirements to confirm the sustainability of its economic development. After 2–3 years from the new countries’ joining the EU, their central

banks may become members of the ESCB. In line with the 1997 Amsterdam Agreement, which was passed in the development of the Maastricht Agreement, a country-candidate, after joining the EU, becomes a euro-zone member with “limited rights” or “with exceptions”. Thus, incorporating all the mentioned specifics, the new EU member states will really become full-fledged participants in the Economic and Monetary Union not earlier than in 2007.

Slovenia, Estonia, Lithuania and Latvia are among the countries, which can really transit to euro quicker than others. The first three countries of the above candidates started to use, as early as May 2004, the mechanism of currency exchange rates regulation, the essence of which is binding the national currency to euro. Nevertheless, even for these countries the date of joining the euro zone is 2007.

On the whole, the Economic and Monetary Union in its present form commands a considerable economic potential to allow euro claim the role of a leading world currency. Yet, it is worthwhile mentioning a relatively weak point of euro – the insufficiently developed financial market, which cannot be compared to the USA market (which is, in fact, of a global character). In the EU, it is the financial market of Great Britain that is most developed, but in 2005 this country was not in the euro zone. Regarding the mentioned circumstances, a lot will depend on how, and how dynamically the financial market of the euro zone develops. The negative results of voting on the EU Constitution in France and in the Netherlands (by June 2005) will undoubtedly manifest themselves not only in politics, but in the economy too. In fact, if the ideas of the single economic space begin to be doubted, then the single currency may turn from an instrument of economic development into an obstacle.

The facts stating a better economic situation in the EU countries outside the euro zone as compared to the countries in the zone are often brought about as an argument against involvement in the euro zone. Thus, in 2005 growth rates in Great Britain and Sweden were anticipated at the level of 2,4–2,8% while in the euro zone only at the level of 1,1%. The unemployment level in Great Britain amounts to 4,7%, in Sweden – 5,5% while in the euro zone – 8,9% (to add here that in the key euro zone economies – in Germany, France and Spain – the unemployment exceeded 10%)<sup>2</sup>.

In the future, the correlation between the economic development dynamics not only in the euro zone itself and the USA, but also between the countries oriented to the US dollar (one group of countries) and to euro (another group of countries) will be of essential importance. In this case, it is also too early to

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<sup>2</sup> “Expert”, 2005, No 21, 6–12 June, p. 18.

forecast enhancement of the euro zone. In particular, numerous analysts mark a comparatively faster growth of production and international trade in those Asian countries' currencies, which stand closer to the US dollar. At the same time, it is possible to note the activated US policy towards interrelationship with the countries of the Asian Pacific Economic Cooperation (APEC) and the US attempts to transform NAFTA into a Pan American free trade area.

Besides, the attitude towards euro in the world markets will depend, to a considerable degree, on how efficiently the EU countries cope with the problem of guidance from the common centre for the single financial and economic policy, and also on the extent of the countries' political consolidation process and their setting up and improving of supra national managerial structures, thus, in fact, turning the present day EU into a confederate structure. The problems with ratification of the EU Constitution by the EU countries serve as a proof to how difficult it is.

After the euro zone formation is over, Russia (as any third country – non-member of this zone) will get a broad field to manoeuvre in its foreign economic and monetary policies. Lately, the share of the euro in the RF monetary reserves has been invariably growing while the share of the US dollar has been reducing. Besides, the Russian Government takes into account the growing role of the euro while solving problems of currency structure of foreign borrowings and foreign trade (in which, as it was noted above, the participation of the EU countries is rather profound).

It is evident that countries – members of the euro zone (in a broader sense – the EU countries) are interested in the euro strengthening its position in Russia and other CIS countries. It is true that in order to acquire the status of a full-fledged international currency, the euro should first of all strengthen its position and role of an all-European currency. Gradual transition of Russia from the US dollar to the euro could be very beneficial for the European Union from the point of view of enhancement of its position in the world, and the balance of forces in the EU-USA dialogue.

In the above context, the striving of the EU leadership to promote in every possible way the movement of the euro to the Russian market is quite understandable. As early as May 2001, during the EU-Russia Summit, the European party turned to RF President V.V. Putin with a proposal to carry out commercial and economic relations between Russia and the EU countries in euro.

In practice, the problem lies in the fact that there are not many regions in the world where euro could hope for a broad circulation in the future. Firstly, there is the European Union itself (where there still are countries – non euro zone members, at the expense of which the mentioned zone can expand). Then



the Central European and East European countries – the new EU members. Finally, the Mediterranean and North African countries (historically they were for a long time oriented to the leading West European countries). That is why Russia and the CIS countries are a region opening a tremendous perspective for the euro.

Though at present the US dollar maintains on the whole its priority position in Russia and other CIS countries, the rise of euro may take place due to the following factors:

- the history of “dollarisation” of the economy in Russia is comparatively short, and, just as the Russian citizens learnt how to operate with dollars, they can learn very quickly how to use the euro (the main reason being not the habits, but the economic expediency);
- the bulk of the RF economy is concentrated in its European part, which historically counts many years of economic relations with the European countries; at the same time, Russia doesn't have similar close and long-term economic contacts with the USA (though the USA would like to have them, for example expanding purchase of fuel and raw materials from Russia).

Due to the above facts, Russia too is interested in the euro being a stable and reliable currency. But a gradual transition from dollar to euro (even to a limited degree) is a complicated and time-consuming process. Strategically it is more useful for Russia to diversify the monetary structure of its official reserves, bank assets and foreign economic operations (similarly to the diversification of its foreign trade in terms of types of commodities and geography).

Therefore, supporting the promotion of the all-European economic space, and on the whole treating positively the expansion of the euro zone, while still prioritising its own political and economic interests, Russia as a Euro-Asian state should objectively pursue a multi-vector foreign economic policy, including the monetary sphere as well. Co-operation with the EU is one of the priorities in this field. That is why Russia should not “get fixed” only on the European line in its foreign economic policy, but should also actively promote foreign economic cooperation (including monetary relations) with China, Japan and other countries in the Asian Pacific Region, India etc. Another important trend in the international monetary, credit and financial co-operation, which still has a perspective, is Russia's co-operation with other CIS countries (though the situation in this field is becoming more and more complicated, and the CIS perspectives – less and less concrete).

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## **Availability of Public Aid, and its Significance for Small and Medium Enterprises, According to Survey Research**

### **1. Introduction**

Stimulation of development of small and medium enterprises (SME's) is facilitated mainly by providing access to capital, a shortage of which – including access to credit – can hinder development or make it impossible. New products, new technologies require involvement of significant funds. Introduction of innovation demands extra capital support.

In this context two problems are apparent: the question of choosing the right forms of supporting small and medium enterprises, and the problem of effectiveness of those forms as far as development and building a competitive advantage of those businesses are concerned. The objective of assistance is to shift different kinds of barriers, such as: legal and administrative, financial, information, as well as limitations connected with managerial skills and innovativeness. All of those barriers hinder the development of the sector of small and medium enterprises – the key sector of Polish economy. Effectiveness of assistance is connected with creation of conditions necessary for achievement of company goals.

Effective support is closely connected with the global view of organisation's operation, and the necessity to adjust it to the changing environment.

The sector of small and medium enterprises plays an important role in the economy; nevertheless it is necessary to strengthen the position of small and medium businesses both in relation to large Polish companies and to foreign competition.

Actions aimed at strengthening the position of small and medium enterprises in Poland were significantly intensified in the 1990s. They were supplemented by various EU programmes focusing on supporting the sector. One of the conditions for effective implementation of assistance programmes for small and medium enterprises is the identification of problems (barriers) facing those businesses.

Problems of small and medium enterprises concentrate in areas such as lack of access to capital for founding companies and financing research and development; poor access to information; increasing competition and changing laws. The most important dangers for SME's, according to entrepreneurs, are:

instability and complication of legal regulations, high taxes, high labour costs, competition<sup>1</sup>.

The policy towards small and medium enterprises is implemented via legal, financial, organisational instruments, as well as through information and training.

This article presents, on the basis of empirical research, the national public aid for small and medium enterprises. Such aid is one of the financial instruments of the national policy towards SME's. The article focuses on assessing the accessibility and determining the significance of horizontal aid for the development of small and medium enterprises, which find it more and more difficult to compete with rivals who have larger capital at their disposal.

The survey was conducted in December 2003 on the sample of 413 businesses. The respondents had used public assistance granted by the Polish Agency for Enterprise Development (PAED) during the years 2001–2003<sup>2</sup>.

The sample consisted of micro-businesses (up to 9 employees) – in 26,2%, small enterprises (10–49 employees) in 34,6%, and medium companies (50–249 employees) in 39,2%. The structure of the research sample significantly differs from the structure of the SME sector, which is dominated by micro-businesses (95%). The sample was composed according to the principle that the shares of businesses of each type ought to be more or less equal.

The sample was dominated by limited companies (58,6% of medium firms, 53,1% small businesses and 23,1% micro-companies), and individuals (50% of micro-businesses, 25,5% small businesses and 11,1% medium firms).

Services dominated in the sample as far as type of operation was concerned – 35,1% micro-businesses; 30,8% small businesses and 34,1% medium companies.

The researched firms presented mainly national or regional scope of operation. Most of the businesses had operated for from 6 to 15 years, therefore it can be assumed, that they were experienced in operating within the market economy and growing competition.

## 2. Availability of Public Aid to SME's

The necessity to urgently prepare Polish firms to compete at the European markets, the growing influence of small and medium enterprises upon the state

<sup>1</sup> Report on the condition of the sector of small and medium enterprises in the years 2002–2003, PAED, Warsaw 2004, p. 202.

<sup>2</sup> The article was based on the research project number KBN 2H 02C 088 23: The influence of public aid upon the conditions of operation of small and medium enterprises. Joint work, IRWiK, Warsaw 2004.

of the economy, and especially their job-generating role, persuaded the government to act in support of SME's. This attitude was expressed by the creation of the Polish Agency for Enterprise Development, and defining it as a state unit responsible for facilitating development of SME's<sup>3</sup>.

The government's aid programme provides different forms of support for small and medium enterprises. Some of those are various forms of government grants, namely:

- for training,
- for obtaining certificates,
- for preparation of entry into the capital market,
- for increasing capital of loan funds or guarantee funds,
- for initiatives supporting development of entrepreneurship.

The basic condition for obtaining public aid is belonging to a certain group identified according to the criterion of economic operation. Therefore, in order to apply for assistance for SME's, an entrepreneur has to prove his or her status (by presenting the required documents) to the appropriate authority. The possibility of granting public aid depends on several other conditions, which must be fulfilled simultaneously, i.e.<sup>4</sup>:

- the subsidy must be socially beneficial,
- its volume must be adequate to the importance of the problem it is to address,
- it must supplement other resources invested by entrepreneurs.

Availability of public aid to small and medium companies is a very important problem. The importance results from the objective of public aid itself – supporting entrepreneurs to help them cope with competition. The criterion of selectivity is very important.

The survey indicates, that small and medium companies have used public aid on average 1,3 times. Accordingly, the following questions arise:

- what was the reason for such state of affairs?
- what hindered or limited the possibility to use public assistance?
- or possibly – was there no demand on the part of small and medium companies?

The respondents reckoned, that the situation was mainly a result of difficult access to public aid (78% of answers). Difficult access to public resources concerned

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<sup>3</sup> The Decree of the Minister of Economy, of 21.05.2001, on the conditions and procedures of granting subsidies by the Polish Agency for Enterprise Development (Dz.U. of 2000, No. 57, position 598 with amendments).

<sup>4</sup> The Act of 27.07.2002 on the conditions of acceptability, and supervision over public assistance for entrepreneurs (Dz.U. No. 144, position 1177).

mostly co-operatives (90,0%), trade companies (81,5%), companies operating locally (84%), or for a period shorter than 5 years (86,4%).

Table 1 presents the assessment of availability of public aid according to the criterion of the number of employees.

**Table 1. Availability of public aid according to the number of employees (% of answers)**

Company size	Access to public funding	
	difficult	easy
Up to 9 employees	81	19
10–49 employees	79	21
50–249 employees	75	25
Total	78	22

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

As we can see, a vast majority of entrepreneurs found access to public funding difficult, indicating the following reasons:

- procedures, formalities, requirements – 41% of indications,
- lack of sufficient information – 38% of indications,
- bureaucracy – 25% of indications,
- limited resources – 12% of indications.

Table 2 presents difficulties in accessing public aid, according to the chosen criterion of categorising the researched firms.

**Table 2. Types of difficulties in accessing public aid according to the number of employees (% of indications)**

Company size	Types of difficulties in accessing public funding				
	Procedures, formalities, requirements	Lack of sufficient information	Bureaucracy	Limited resources	Other
Up to 9 employees	38,6	45,5	26,1	11,4	1,1
10–49 employees	32,7	38,9	24,8	14,2	5,3
50–249 employees	51,2	30,6	24,0	9,9	2,5
Total	41,3	37,6	24,8	11,8	3,1

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

It seems, that the above indications concerning the reasons for difficult access to public assistance constitute a very important signal for the authorities granting the assistance, and for the centres propagating knowledge among entrepreneurs.

If one of the reasons for limited usage of public assistance is lack of sufficient information, then the sources of such information ought to come into focus. The respondents quoted mainly: the media (55% of indications) and the Internet (42% of indications).

The similar tendency can be observed in examined sections. Micro-companies gathered more information about public aid from corporations, societies, agencies and foundations (15% of indications), than from state authorities (10%), which can be considered normal. Information about public aid ought to be available from and provided by institutions and organisations closest to the entrepreneurs.

As has been mentioned, the basic sources of information on public aid for small and medium enterprises during the researched period were the media and the Internet. In individual groups of companies the percentage of indications was as follows:

- 54% and 38% of indications – up to 9 employees,
- 54% and 42% of indications – 10–49 employees,
- 57% and 46% of indications – 50–249 employees.

The survey researched the criteria, which, according to the respondents, ought to decide about granting public aid to SME's. The purpose proved to be the most accepted criterion (75% of indications). The second most quoted criterion was the amount of assistance applied for by a company (37% of indications). The respondents indicated other criteria as well (10%), but did not specify them.

The criterion – purpose of aid – was indicated predominantly by small entrepreneurs, while the amount was important for micro-companies. Such situation results from different significance of public aid for individual types of enterprises, and different possibilities to access the assistance. More difficult access to public funding (which has been confirmed by the research), and a very competitive market situation mean, that for micro-firms the amount of aid is more important, since it can lead to a favourable market position. The aid can be treated as a decisive factor for survival.

Another researched problem was: which companies have most chance of achieving aid from public funds?

Almost one in three entrepreneurs reckoned, that all companies had equal chances of accessing public funding. However, considering the number of employees, the following companies had more chance during the years 2001–2003:

- medium firms (50–249 employees) – 28% of the total number of respondents,
- large firms (250 and more employees) – 22% of the total number of respondents,

- small firms (10–49 employees) – 16% of the total number of respondents,
- micro-companies (up to 9 employees) – 3% of the total number of respondents.

The micro-entrepreneurs were least optimistic as far as access to public funding was concerned. Only 27% of them considered the chances of all applicants to be equal. Representatives of micro-businesses were very pessimistic about chances of their group to gain public assistance; they saw more opportunities for large firms – 30% of answers.

There was more optimism among small businesses (38% of the total number of respondents in this group). One in five representatives of small businesses saw a chance of raising public funding, nevertheless more respondents indicated medium firms (22% of small-business respondents), and at the same time saw no opportunities for micro-companies (1% of the total number of small-businesses). The medium-business respondents admitted, that they saw their own chances of accessing public assistance to be the best (30% of the total medium-business respondents), and gave least chance to micro-businesses (1% of the total number of medium-sized respondents).

Therefore, the research indicates, that in practice micro-businesses had no or little chance of accessing public aid, and were aware of this limitation.

### **3. Forms of Public Aid for SME's**

SME's can use various forms of assistance included in the state programme of public aid. The survey concerned the forms of public assistance used during the years 2001–2003.

The main form of support for SME's were subsidies.

The number of answers involving ISO subsidies deserves particular attention. This form of public assistance reached mostly medium-sized companies (15% of responses), co-operatives (27% of responses), firms operating in the service sector (14% of responses), at the nationwide market (16% of answers), for longer than 15 years (17% of answers). Table 3 presents forms of public assistance used by small and medium enterprises during the years 2001–2003.

Comparing the three years of operation of small and medium companies with the entire period of their existence, the respondents noted a diminishing tendency as far as the following forms were concerned: state agencies and funds, subsidies for company development, local and national government subsidies. A growing tendency was observed in the field of subsidies and refunds for job creation, and ISO grants.

**Table 3. Forms of public assistance used by SME's according to the number of employees (% of answers)**

Company size	Forms of public aid						
	Government agencies and funds	Subsidies for development	Subsidies from the national and local government	Refunds and subsidies connected with job creation	ISO subsidies	Other	Not used
Up to 9 employees	29,6	21,3	21,3	13,9	7,4	1,9	4,6
10–49 employees	42,0	19,6	6,3	17,5	11,2	0,7	2,8
50–249 employees	24,7	24,1	21,0	13,6	14,8	–	1,9
Total	32,0	21,8	16,0	15,0	11,6	0,7	2,9

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

The public aid for the researched small and medium enterprises derived mostly from the Polish Agency for Enterprise Development (79% of indications). The indicator is hardly surprising, since the sample involved companies, which had used assistance provided by this institution. Other sources of aid were far less frequent, and included:

- job centres – 11% of indications,
- local communal authorities – 9% of indications,
- tax offices – 6% of indications,
- the Ministry of Finance – 5% of indications.

It seems, that considering the above, the assistance from local authorities was far too modest. Perhaps the situation was due to insufficient activity of communal governments in the field of public assistance for small and medium enterprises, or maybe their capabilities were too small compared to needs. It is worth remembering, that local communities ought to be most interested in development of small and medium enterprises, and in creation of conditions facilitating such development. There is a strict connection between development of small and medium businesses and development of local communities.

Recapitulating, public assistance reached mainly the businesses which operated on a broad scale, possessed experience and a stable market position, as well as the companies which appreciated the necessity to develop and adjust to demands of foreign markets, and therefore orientated towards product quality and staff creativity.



#### 4. Significance of Public Aid for SME's

Public assistance supports both day-to-day operation, and all types of ventures (such as obtaining certificates, advisory services, fairs, training, etc.).

The research shows, that most of the public aid was put towards day-to-day operation (35% of indications). Other important purposes included:

- training – 25% of indications,
- ISO – 25% of indications,
- new jobs – 18% of indications,
- fairs – 5% of indications.

The importance of individual purposes indicated by utilisation of public aid in small and medium enterprises is similar in companies of all categories – Table 4.

**Table 4. Purposes of utilisation of public assistance by SME's according to the number of employees (% of indications)**

Company size	Purposes of utilisation of public aid						
	Day-to-day operation	Training	ISO	Jobs	Fairs	Other	Refusal to answer
Up to 9 employees	30,6	36,1	21,3	11,1	3,7	0	15,7
10–49 employees	36,4	17,5	25,9	20,3	4,2	1,4	14,7
50–249 employees	35,8	24,1	25,9	21,6	6,2	2,5	13,6
Total	34,6	24,9	24,7	18,4	4,8	1,5	14,5

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

Micro-businesses spent more resources on training (36% of indications), than on day-to-day operation (31% of indications).

The situation looked similar in small and medium co-operative enterprises (training – 27%; day-to-day operation – 9%), partnerships (training – 32%; day-to-day operation – 23%), and companies operating for less than 5 years (training – 33%; day-to-day operation – 27%), as well as services (training – 32%; day-to-day operation – 28%). Also, those types of businesses attributed a lot of importance to obtaining ISO certificates, e.g. co-operatives – 36% of indications.

The smallest proportion of resources from public aid spent on training was shown by small and medium unlimited partnerships (9% of indications). Those firms financed mainly the creation of new jobs (35% of indications).

Job creation is a particularly important issue. The survey indicates, that a vast majority of respondents did not allocate subsidies towards creation of new jobs (64% of indications). The “yes” answer was given by just 17% of respondents. Apart from that:

- 16% indicated allocating funds towards maintaining the existing jobs,
- 5% indicated employing persons experiencing difficulties in finding jobs.

A similar tendency concerning job creation from public aid resources could be observed in small and medium enterprises analysed according to the number of employees – Table 5.

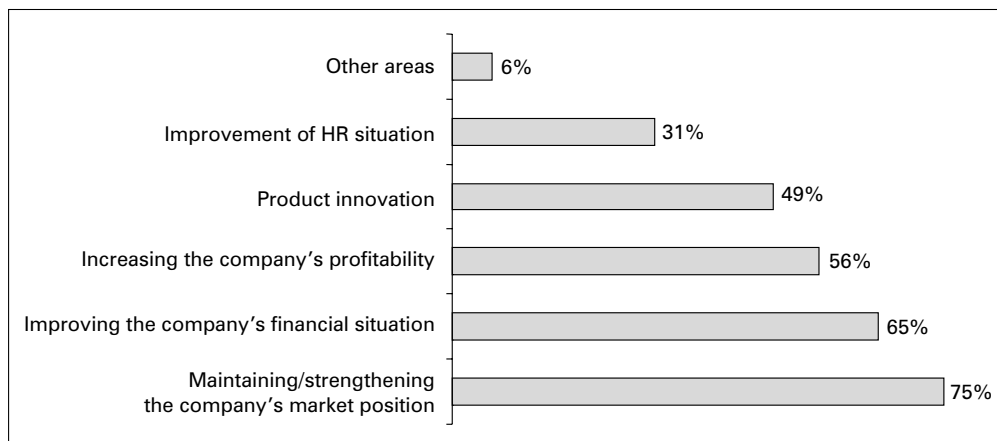
It ought to be mentioned, that small and medium enterprises were not indifferent to the problem of unemployment. Firstly, to a certain degree they did create jobs; secondly, they concentrated on maintaining the existing jobs (which can be as important as creating new ones); thirdly, they helped people experiencing difficulties in finding jobs. Hence, it can be said, that small and medium companies conduct their own employment policy, which to some extent is aimed at supporting business development and creating its positive market image.

**Table 5. SME’s utilisation of public assistance resources for job creation, according to the number of employees (% of indications)**

Company size	Have new jobs been created from the public aid resources?			
	No	Yes	No, but the resources were used to maintain the existing jobs	Persons experiencing difficulties in finding work (e.g. unemployed, disabled) were employed
Up to 9 employees	74,1	8,3	14,8	3,7
10–49 employees	55,9	21,0	20,3	5,6
50–249 employees	63,6	20,4	13,6	6,2
Total	63,7	17,4	16,2	5,3

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

The significance of public aid for operation and development of small and medium enterprises is another important issue. According to the respondents, such assistance is most important from the point of view of maintaining and strengthening a firm’s market position (75% of indications). The importance of this goal in a market economy is beyond discussion. The basis for operation and development of any company is the possession of a long-term competitive advantage. Other quoted elements may contribute to achieving this goal, and have often been mentioned – Figure 1.

**Figure 1. Influence of public aid upon chosen elements of operation of SME's**

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

The small and medium enterprises survey analysed according to the respondents' number of employees revealed a similar order of benefits from public assistance – Table 6. Small and medium enterprises registered as individuals, presented similar assessment of both their firm's position, and the improvement of its financial situation (71% of indications). A stronger influence of public assistance upon a company's financial situation was indicated by small and medium shared-stock companies (which seems to be closely connected with maintaining the company's market position) – 71%; and by local operators – 77% of indications.

**Table 6. Influence of public aid upon chosen elements of SME's operation, according to the number of employees (% of indications)**

Company size	Influence of public aid upon chosen elements of operation					
	Maintaining/ strengthening of market position	Improvement of financial situation	Improvement of profitability	Product innovation	Improvement of HR situation	Other areas
Up to 9 employees	76,9	65,8	55,6	45,4	33,3	4,6
10–49 employees	76,9	62,2	57,3	48,3	26,6	8,4
50–249 employees	71,6	64,8	54,3	51,9	32,7	4,3
Total	74,8	64,9	55,7	48,9	30,8	5,8

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

Considering the above, it can be said, that the surveyed entrepreneurs are aware of the significance of public assistance. Certainly, extra financial resources

from public aid improve their financial situation with regard to particular ventures. Benefits from implementation of those ventures (e.g. obtaining certificates) can, to a certain extent, help maintain or improve the firm's market position. It is worth remembering, that public aid provides support for businesses, the purpose of which is to create financial benefits. Therefore, it is up to companies themselves to ensure their development and achievement of long-term advantage at a competitive market.

Small and medium enterprises appreciate public assistance, and intend to use it in the future. 62% of the respondents showed positive attitudes towards using public funding, and declared their willingness to raise such funding again in the future. Only 10% of respondents answered "no", but as many as 28% could not tell whether they would use public aid again.

Of all the researched businesses, the micro-businesses were least willing to re-apply for funding (52%), and they most often avoided giving decisive answers (difficult to say – 36% of the total number of the researched micro-businesses) – Table 7.

**Table 7. Willingness of respondents to re-apply for public assistance, according to the number of employees (% of answers)**

Company size	Are you going to re-apply for public assistance in the future?		
	Yes	No	Difficult to say
Up to 9 employees	51,9	12,0	36,1
10–49 employees	66,4	8,4	25,2
50–249 employees	65,4	10,5	24,1
Total	62,2	10,2	27,6

Source: original research on the basis of the survey conducted as a part of research project number KBN 2H 02C 088 23.

In the context of the above results, it seems that far too many entrepreneurs avoided answering the question. Were they not fully aware of the benefits brought by using public aid? Or was it down to over-complicated procedures and formalities discouraging people from re-applying for public aid resources, which makes them hesitant about their future plans?

## 5. Conclusions

The conditions of operation of small and medium enterprises depend mainly upon external conditions (including legal and economic ones) as well as internal conditions (knowledge, experience, skills and dedication of entrepreneurs).

The development of the sector of small and medium enterprises in Poland during the years 2001–2003 was determined predominantly by external legal factors. Therefore, emphasis needs to be put on the necessity to stabilise, clarify, and simplify legal regulations, and to provide small and medium enterprises with an appropriate period to adjust to new or changed regulations. Fulfilling those proposals ought to reduce operating costs of small and medium enterprises, and effectively contribute to their rising financial balance. Furthermore, Poland's joining the EU will not automatically stimulate the development of small and medium enterprises. Such stimulation depends on their capability to face competition (which is very low in case of most SME's), and possibilities of obtaining EU grants (which are limited too, because one of the basic conditions for obtaining grants is possessing an appropriate own financial input). Public aid in itself will not dramatically improve the conditions in which small and medium enterprises operate.

Public assistance granted to entrepreneurs ought to bring certain effects, demonstrating themselves both in a day-to day operation of a company, and in long-term benefits connected with a particular venture.

## Derivative Transactions in Corporate Foreign Exchange Risk Management

### 1. Currency Risk in Corporate Operation

Forecasting constitutes a vital element of corporate operation. A risk of making a mistake is inherent in every element and in every phase of corporate economic operation. It is important to recognise this risk<sup>1</sup>. Constant changes in the operating environment are the main problem companies are exposed to. Uncertainty regarding future developments is the source of risk in economic activity.

On one hand, globalisation in the world economy facilitates international exchange of goods, services and capital; on the other, it causes new risks. The risk connected with exchange rates of foreign currencies is of particular importance to companies. Exporters, importers and entities indebted in foreign currencies run FX risk. FX risk results from portfolio investments in foreign markets as well. A change of FX rate means a change in conditions of corporate economic operation. Not only may FX fluctuations impact the net result, but also they may determine if the company survives on the market or not.

Foreign exchange risk may be defined as a possibility of deterioration of a company's financial profile due to an unforeseen change of an exchange rate<sup>2</sup> or a possibility of suffering a loss following an unfavourable exchange rate fluctuation.

FX risk results from the impossibility to foresee exchange rate parity of two currencies, which consequently means the impossibility to determine the rate of return from such assets as foreign currencies, domestic currency, substitutes of those currencies and liabilities denominated in foreign currencies<sup>3</sup>.

FX risk affects not only operation of a company, but also its financial and investment activity. Foreign exchange risk can be subdivided into three types, depending on results of an open FX position: transaction risk, re-calculation risk and economic risk<sup>4</sup>.

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<sup>1</sup> A. Janc, Pomiar i kontrolowanie ryzyka kursu walutowego, in: Zabezpieczenie przedsiębiorstw przed ryzykiem kursu walutowego, ed. I. Wiślak, p. 14.

<sup>2</sup> T. Krayenbuehl, Cross-Border Exposures and Country Risk, Woodhead, New York 2001, pp. 36–37, in: P. Misztal, Zabezpieczenie przed ryzykiem zmiany kursu walutowego, Difin, Warsaw 2004, p. 37.

<sup>3</sup> N. Kaldor, Capital Accumulation of Economic Growth, St. Martin's Press, New York 1987, p. 210.

<sup>4</sup> P. Wojtyło, Ryzyko walutowe w przedsiębiorstwie, "Finansista", 12.2002–01.2003, p. 66.

**Transaction risk** appears in a situation when changes of an exchange rate impact the net result or cash flow of an exporter or an importer of goods or services<sup>5</sup>. Transaction risk affects enterprises exporting or importing goods or services, incurring debt denominated in foreign currencies, or making direct or indirect foreign investments<sup>6</sup>. Exchange rate fluctuations impact both the net result and liquidity of a company via the amounts of trade liabilities and debt service costs. Changes of an exchange rate induce FX risk by creating a possibility that liabilities or receivables might not be repaid as a result of those changes.

**Re-calculation risk**, also called conversion or balance sheet risk, can be defined as a situation when exchange rate changes impact the value of company's assets, which results in losses. Re-calculation risk affects mainly multinational companies. The risk can be detected at the moment of calculation and consolidation of a balance sheet of a multi-national company holding subsidiaries or branches abroad. A difference between exchange rates at the beginning and at the end of the financial year may burden the balance sheet of the controlling entity<sup>7</sup>.

**Economic risk**, known as a strategic, operational or competitive risk, results from an unfavourable development of an exchange rate which may negatively impact a company's competitive position on the market, and its market value, via the amount of income, the level of costs or correctness of hedging measures.

## 2. Foreign Exchange Risk in Poland

On 11 April 2000, the Polish government and the National Bank of Poland introduced floating exchange rate for the Polish zloty, i.e. gave up the parity rate, crawling devaluation and fluctuation band of +/- 15%. The National Bank of Poland exposed the zloty to the market influence and accepted its fluctuations against other currencies<sup>8</sup>. The exchange rate of the zloty was subjected to the game of supply and demand. Such development introduced great uncertainty into the operation of Polish enterprises. The abolition of the fluctuation band resulted in a situation where it was more and more difficult to estimate profitability of transactions with foreign entities, financial costs and value of foreign investments. Consequently, the floating exchange rate of the Polish zloty led to

<sup>5</sup> P. Wojtyła, Rzyko walutowe w przedsiębiorstwie, "Finansista", 12.2002–01.2003, p. 67.

<sup>6</sup> M. Dębniwska, A. Wyszynski, Zastosowanie kontraktu terminowego do zabezpieczania ekspozycji na ryzyko walutowe w przedsiębiorstwie, "Rynki Terminowe", No. 3/2002, p. 36.

<sup>7</sup> *Ibidem*, p. 39.

<sup>8</sup> R. Karkowska, Zjawisko umacniania się złotego na rynku walutowym w Polsce, "Bank i Kredyt", No. 9/2003, p. 24.

destabilisation of financial results of Polish companies, and managements faced the dilemma of finding adequate FX risk reduction tools.

### 3. Methods of Reducing Foreign Exchange Risk

There is a whole set of hedging methods protecting companies from exchange rate risk. The commonly used methods can be subdivided into internal and external ones<sup>9</sup>. The basic internal methods, i.e. those where hedging is conducted by the hedging party itself, are the following ones: selection of the domestic currency in transactions with a foreign counterpart, valorisation clauses, leading and lagging, netting and matching.

The basic external hedging methods i.e. those where risk is transferred to another entity in return for a charge, are as follows: discount of bills of exchange, reinsurance, financial hedging, purchase of debt instruments denominated in foreign currencies, and derivative transactions. This article is going to focus on derivatives.

### 4. The Definition and Characteristics of Derivative Transactions

The word “derivative” expresses well the nature of the instrument in question – it means a thing derived from another. Dictionary of Finance and Investment Terms defines a derivative in the following way: “Derivative or derivative instrument is a contract deriving its value from the market value of other underlying assets, index or other investment”<sup>10</sup>. According to the definition presented by A. Fierla, a derivative instrument is a forward instrument, the current and future value and cash flow of which depend on other underlying asset or assets<sup>11</sup>.

Derivatives are contracts between two or more parties, allowing those parties to agree the price of a transaction that will take place in the future. The term “derivative“ simply means that the value of an instrument is based or derives from the value of something, which is to be bought or sold in the future.

Underlying assets may be an object of trade at the capital market (equities, bonds etc.), at the currency market (e.g. Treasury bonds), or at a foreign exchange market (foreign currencies).

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<sup>9</sup> Classification by P. Misztal, *Zabezpieczenie przed ryzykiem zmiany kursu walutowego*, Difin, Warsaw 2004, p. 67.

<sup>10</sup> Dictionary of Finance and Investment Terms, Barron’s Educational Series 1998, Inc., Fifth Edition.

<sup>11</sup> A. Fierla, *Opcje Akcji. Nowy Instrument Polskiego Rynku Kapitałowego*, “Monografie i Opracowania”, 422, SGH, Warsaw 1996, p. 6.



Derivative instruments are of a great importance to risk management of companies, as they allow for recognising different types of risk and bringing them under control. Effective use of derivatives can contribute to limitation of risks in companies' operating activity. Since derivative instruments allow for transferring risks to other entities, they may be compared to an insurance policy<sup>12</sup>. Nowadays, derivatives are used in the following fields:

- hedging,
- speculation,
- arbitrage.

## **5. The Role of Derivative Instruments in Corporate Foreign Exchange Risk Management**

A currency derivative is a so-called external method of foreign exchange risk management. The nature of external methods of risk management boils down to transferring risk to other entities in return for a charge<sup>13</sup>. Derivative transactions, unlike operations in currency markets, have an off-balance nature i.e. they are not reflected in the result sheet of firms. The main currency derivatives are: currency forwards, currency futures, currency options and currency swaps. It must be mentioned that currency derivatives create much more efficient possibilities of hedging than natural hedging.

## **6. How is Hedging Conducted in Poland?**

The derivatives market is relatively young in Poland. It dates back to the first half of the 1990s. Although the use of currency derivatives by Polish companies appears to be much more frequent, many companies still suffer losses due to unfavourable exchange rate fluctuations.

According to a market survey carried out by the Rzeszow School of Information Technology and Management<sup>14</sup> in 2003, currency forwards are the form of hedging most popular with Polish companies (55% of the sample). A half of companies use natural hedging (50% of the sample). A significant group of

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<sup>12</sup> Reuters, *Instrumenty pochodne – wprowadzenie*, transl. Marcin Ferlak, Dom Wydawniczy ABC, Cracow 2001, p. 20.

<sup>13</sup> P. Misztal, *Zabezpieczenie przed ryzykiem zmian kursu walutowego*, Difin, Warsaw, 2004, p. 77.

<sup>14</sup> P. Perz, P. Znamirowski, *Zarządzanie ryzykiem walutowym w przedsiębiorstwach – research on the basis of “500 Biggest Companies in Poland”*, a special supplement, published by the daily “Rzeczpospolita”, 2002, Instytut Gospodarki Wyższej Szkoły Informatyki i Zarządzania w Rzeszowie, Rzeszow 2003.

Polish companies declares that they use currency option strategies (42%). Swaps are used by 26% of the surveyed companies. Futures do not appear to be very popular with Polish companies (8% of the sample). It should be noted that a considerable group of companies declared that they had not so far tried to reduce foreign exchange risk at all.

## 7. A Currency Forward and its Advantages for Companies

A currency forward contract is an agreement between two parties to buy or sell an agreed amount of currency at an agreed price at a value/settlement date later than spot. The definition is a general one, which can be applied to currencies, interest rates, equities etc. All forward contracts operate in a similar way. The contract is bilateral; no cash is exchanged at the time of the agreement. Postponement of delivery results in a situation, where the agreed amount of currency may change its value. The settlement is usually done by a physical delivery or by settling the difference between the spot rate and the agreed forward rate for the currency pair at the maturity of the forward (in the case of Non Delivery Forwards – NDF).

The initial value of the contract is zero. The price of the contract depends on the spot exchange rate and the interest rates for both currencies. Theoretically, the spot rate and the forward rate may be the same, however in practice they differ due to a difference in interest rates for both currencies. A forward rate reflects the difference in interest rates for both currencies. Calculation of forward rates is done in a strictly analytical way, without any element of forecasting. Forwards are Over the Counter products (OTC) i.e. conditions of the contract, such as notional value or time of delivery, are agreed by two parties on an individual basis, as the product is not standardised. Occasionally, one party may require an initial deposit from the other, to be kept throughout the contract, due to credit considerations.

Adequate use of currency forwards reduces a company's currency exposure and allows for precise projection of the financial result.

**A currency forward is the most popular currency risk reduction measure used by Polish companies.** The main advantage of a currency forward over other currency derivatives is its relatively low cost. A certain difficulty is the necessity to place a margin deposit by companies without a credit limit for derivative transactions. Placing a margin deposit may pose a problem in case of transactions with high notionals, or in case of several overlapping transactions. However, it should be emphasised that the necessity to place a deposit constitutes

an indicator of the scale of market risk resulting from the transaction. A deposit covers potential FX exposure from an executed transaction. Placing a deposit confirms, that a company is ready to cover potential loss from the transaction. Thus, the barrier should be considered as a safety measure. In addition, banks pay interest on margin deposits. Sometimes Polish banks offer overdrafts to cover the margin deposit. Such measure results in an increase of financial costs for companies.

It is worth mentioning that high margins are the main disadvantage of the forwards offered by Polish banks. Banks are ready to negotiate margins in case of notionals exceeding TEUR 20, which discourages or practically eliminates small enterprises from hedging.

**Table 1. Structure of revenues at the currency market in April 2004, according to type of participant (average daily revenues in USD million)**

	<b>Resident</b>	<b>Non-resident</b>	<b>Total</b>
<b>Spot market</b>	<b>614</b>	<b>1306</b>	<b>1930</b>
financial entities	314	1300	1614
non-financial entities	310	6	316
<b>FX swaps</b>	<b>450</b>	<b>3645</b>	<b>4095</b>
financial entities	411	3645	4056
non-financial entities	39	0	39
<b>Outright-Forward</b>	<b>300</b>	<b>29</b>	<b>329</b>
financial entities	12	25	37
non-financial entities	288	4	292
<b>Currency markets</b>	<b>1364</b>	<b>4980</b>	<b>6354</b>
financial entities	737	4970	5707
non-financial entities	637	10	647

Source: Department of the Financial System at the National Bank of Poland, Warsaw, 28 September 2004.

## **8. Currency Futures in Corporate Foreign Exchange Risk Management**

Both a currency forward and a currency future are agreements between two parties to buy or sell an agreed amount of currency at an agreed price for a value/settlement date later than spot. The main difference lies in the way a transaction is settled, and in the fact that futures are exchange traded standardised instruments, unlike forwards, which are OTC transactions. A future contract is not a mutual obligation of both counterparts, as in the case of forwards. In this case, counterparts have obligations towards a clearing house. The clearing house is not concerned who the contractors are or what their motivations for

the transaction are. All it is interested in is whether the parties can meet their obligations in case of an adverse price movement. This is achieved by using a system of margin accounts where market participants deposit a certain amount of cash with the clearing house. The cash is used to protect the clearing house against default. In a forward transaction, both counterparts run credit risk mutually. The clearing house requires an initial margin and a variation margin. All future positions are marked-to-market or re-valued after the end of each trading session to reflect the day's net gains or losses respectively on the underlying futures positions. This way, market participants receive their returns over the life of their position, and value of the contract amounts to zero throughout its validity. Whilst managing the margin account is one of the biggest disadvantages of using the futures market, at the same time it allows for efficient market functioning. A future transaction can be settled by a physical delivery, but usually it is settled via offsetting trade. Future transactions are strictly standardised in terms of currencies, notionals, expiry dates, collateralization and settlement, unlike forwards, which are adaptable to individual needs of a company.

Corporate hedging against currency appreciation boils down to taking a long position in this currency in the futures market. Taking a short position in a given currency in the futures market protects a company from depreciation of this currency.

A situation when a company is in a position to match a future contract with its open position is described as perfect hedge. In practice, it is difficult to match contracts with real open positions, and companies open new transactions immediately after the expiry of previous ones. Such strategy is described as rolling the hedge forward. In case the relevant currency is not traded in the futures market, it is possible to buy or sell a contract for a currency which is most co-related with the currency for which hedging is needed. Such strategy is called cross hedge<sup>15</sup>.

**In Poland** futures are traded at the Warsaw Stock Exchange and Warsaw Commodities Exchange. They are not very popular with Polish companies. Futures market in Poland is not very liquid. Growing bank product offer, and intensifying competition among banks operating in the Polish market result in growing popularity of forward contracts, which can match corporate requirements much more precisely than futures. High level of standardisation makes it difficult to match contracts with requirements of companies. An additional difficulty in trading futures is the necessity to place an interest free deposit, which effectively increases

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<sup>15</sup> See: P. Kalwejt, Zabezpieczenie przed ryzykiem walutowym za pomocą transakcji futures, in: Hedging i nowoczesne usługi finansowe, eds. M. Biegański, A. Janc, AE w Poznaniu, Poznan 2001, p. 47.

the cost of transaction. Banks usually offer interest on margin deposits in case of forward transactions. In addition, creditworthy counterparts are often granted credit limits to accommodate the risk of derivative transactions, meaning that no cash needs to be frozen in case of a forward transaction.

## 9. Currency Options

A currency option gives the holder the right, but not the obligation, to buy or sell a certain amount of currency as the underlying instrument, at a pre-determined price on a specified date or during a specified period. An owner of an option is called a Buyer or a Holder, while a party accepting risk is known as a Grantor, a Seller or a Writer. A Call Option gives the holder the right to buy the underlying currency, while a put option gives the holder the right to sell the underlying currency.

The pre-determined price is known as a Strike Price and Exercise Price and the specified date or period is known as the Expiry Date or Exercise Date.

There are two types of options, European and American. A European style option can only be exercised on the expiry date, whereas an American style option can be exercised on any business day up to – and including – the expiry date.

A Premium is the cost paid by the buyer of an option for the rights specified in the option. The Premium is paid up-front and compensates the seller for the risk they take guaranteeing the buyer. An option premium can be looked at in a similar way as an insurance premium is.

An option is said to be **In-The-Money** if, in case of a call option, the current exchange rate is higher than the strike price, and **Out-Of-The-Money**, if the current exchange rate is lower than the strike price. The opposite applies to a put option. Both call and put options are said to be **At-The Money** if the current market price is the same as the strike price. The difference between the strike price of an option and the current market price is referred to as the **intrinsic value**. The intrinsic value is positive when the option is In-The-Money and nil when the option is ATM or OTM.

The price of an option, being a premium, is derived mainly from spot rates of currencies, interest rates for those currencies, the strike price, volatility and the period till the expiry.

Options may be exchanged or OTC-traded. OTC options can be more efficiently adapted to individual needs of companies. The advantage from the company's point of view is the fact that it gives the owner a perspective of unlimited return, and the cost is limited to just the premium. The classic strategies

of hedging against appreciation of a currency are: a call option, a bull spread using a call option and a bear spread using a put option. Strategies against currency depreciation are: a put option, a bull spread using a put option and a bear spread using a call option<sup>16</sup>.

**In Poland** options are offered on the inter-bank market and on the dealer-to-client market. None of the Polish exchanges offer currency options. Options for currency futures offered by the Warsaw Commodity Exchange constitute an exception, however these instruments have not so far enjoyed a great popularity with investors.

Options are not as popular with managements of the Polish companies as forwards are. The main reason is their price. In Polish conditions, prices for currency options are very high due to high volatility of the Polish zloty. For that reason, in practice it does not make sense to buy a plain vanilla option. What does make sense, is to follow zero-cost currency option strategies. However, in order to use zero-cost strategies Polish companies need special know-how, which still appears to be missing in many cases.

**Table 2. Average daily revenues of derivative products in the domestic market in April 2004 (USD million)**

	PLN	Total
<b>Currency derivatives</b>	<b>141</b>	<b>180</b>
CIRS	1	3
Currency Options	140	177
<b>Interest rate derivatives</b>	<b>848</b>	<b>958</b>
FRA	635	691
IRS	213	267
Interest rate option	0	0
<b>Derivative market total</b>	<b>989</b>	<b>1138</b>

Source: Department of the Financial System at the National Bank of Poland, Warsaw, 28.09.2004.

## 10. A Currency Swap and its Advantages to a Company

An FX swap is an agreement between two counterparties to exchange two specified amounts of currencies for an agreed period of time. The principal amounts will be exchanged at the beginning and at the end. The cash flow at the end should include the possible interest rate differential between the two currencies. In other words, a foreign exchange swap is a pair of transactions executed today between two counterparties, in which one currency is sold spot against another

<sup>16</sup> P. Misztal, Zabezpieczenie przed ryzykiem zmian kursu walutowego, Difin, Warsaw, 2004, p. 107.

currency and bought back at a future agreed date. The only difference between the two rates is the interest rate differential between the two currencies.

The main reason to use an FX swap is a cash flow mismatch. When a company is long in one currency and needs to cover a temporary shortfall in another currency, it could borrow the missing currency for the required period of time, and against this lend the surplus currency it currently owns to the same counterparty. Doing this a company does not need to buy the missing currency, which would create a foreign exchange exposure. The FX swap can be considered as some kind of collateralised borrowing where the collateral is the currency it currently holds. FX swaps are OTC products.

**In Poland** FX Swaps are traded primarily on the inter-bank market. An average notional of FX swaps ranges between PLN 1–100 million, and the market offer appears to be orientated towards banks rather than companies. High minimal notionals are one of the main obstacles for companies.

## 11. Summary

Currency derivatives are one of the youngest and one of the most effective methods of foreign currency risk management methods. Skilful and effective use of derivatives can contribute to reduction of corporate exposure to transactions, conversion and economic risk.

Growing offer of derivatives in the Polish market and growing competition make those instruments more and more available, also to medium-and small sized companies.

In spite of that, Polish companies still use currency derivatives rather rarely. The following factors constitute the main barrier:

- 1) high costs of running derivative strategies result in a situation, where only companies recording high revenues decide to follow derivative strategies in order to protect themselves from foreign exchange exposure. Foreign exchange risk is usually hedged by enterprises with high revenues, multinationals holding subsidiaries in Poland and subsidiaries of foreign companies<sup>17</sup>. According to surveys, a significant proportion of Polish companies declare that the costs connected with hedging exceed the advantages of hedging<sup>18</sup>. Banks operating in the Polish market often

<sup>17</sup> See: G. Brycki, Hedging opłaca się sporym firmom, Pieniądze Firm, Transakcje Zabezpieczające, "Rzeczpospolita", 22.01.2002.

<sup>18</sup> See: P. Perz, P. Znamirowski, Zarządzanie ryzykiem walutowym w przedsiębiorstwach; The question "Did the advantages of hedging exceed the cost of hedging?" was answered as follows: 17% of the surveyed companies said "rather not", 13% - "definitely not".

act as intermediaries between a Polish company and its parent bank based abroad, which is reflected in transaction costs. Additionally, due to lack of expertise of local banks, transacting derivatives is often transferred to London, which not every corporate can afford;

- 2) lack of knowledge of derivative products is still the case as far as Polish companies are concerned. The market of derivatives in Poland is young, and knowledge of products is not widespread among Polish managers;
- 3) lack of understanding of the scale of currency risk is still an issue among Polish companies. Formalised policy regarding foreign exposure is still a rarity. Managements show their interest in hedging currency risk during market unrest i.e. when it is too late, as hedging becomes expensive during such periods.

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## **The Polish Derivatives Market in 2004 – Regulatory Changes, New Instruments, and Perspectives for Development**

2004 was an important year in the development of the market of derivative instruments in Poland, due to the following events:

- regulatory changes connected, among others, with Poland's joining the European Union,
- introduction of new types of instruments,
- intensification of turnover at the exchange and the off-exchange markets.

### **1. Regulatory Changes**

The most important new acts concerning derivative instruments are:

- the Act of 21.08.1997 on the change of the Law on public securities turnover<sup>1</sup>,
- the Act of 27.05.2004 on investment funds<sup>2</sup>.

In 2004, a significant novella was introduced to the Law on public securities turnover, under the name of the Act of 12.03.2004 on the change of the Law on public securities turnover and on amendments to other acts. The novella, connected with Poland's joining the European Union introduced serious changes into the terminology concerning the definition of a security. Until the introduction of the said act, only the derivatives (property laws) the price of which depended directly or indirectly upon prices of other securities (specified in the article 3. point 1 and 2 of the Act), i.e. shares, bonds, and transferable rights resulting from shares and bonds, were described as securities. The novella broadened the category of securities to property laws approved for public turnover, under the condition, that they are to be registered in the securities repository. Therefore, in practice, the artificial division of stock exchange derivatives has been removed – some of those used to have no status of securities (e.g. currency derivative instruments).

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<sup>1</sup> Dz.U. of 1997 No. 118 position 754 with subsequent changes.

<sup>2</sup> Dz.U. of 2004 No. 146 position 1546.

According to the article 3a and 3b of the amended Law on public securities turnover<sup>3</sup>, as well as the derivative rights, the following non-securities can be traded at the regulated market:

- futures financial contracts,
- forward contracts concerning interest rates,
- share swaps,
- interest rate swaps,
- currency swaps,
- call options and put options,
- other instruments approved for the market, or subject to application for approval.

The above derivatives can become securities, providing they are registered at the securities depository (article 3, point 4). Hence, financial instruments constitute a broader category than securities – they include all derivatives subject to stock-exchange turnover, as well as derivatives not subject to it (e.g. forward contracts)<sup>4</sup>.

The Act of 27.05.2004 on investment funds is an important document determining scope of operation of investment funds at the derivatives market. The act defines a separate framework for using derivatives by open-end investment funds and open-end specialist investment funds (the quoted types of funds are treated identically), as well as limits for closed-end funds. Open-end funds and open-end specialist funds are allowed to use derivative instruments both in order to secure ongoing and planned investment into cash instruments, and in order to secure efficient management of the investment portfolio, providing that the fund's statute specifies the types of derivatives approved for investment, the criteria of their choice, and the conditions of their use (the speculative motive). It is a novelty that open-end investment funds are now allowed to use derivatives for speculative purposes.

Since it was the legislator's intention to define a framework for investment policy of open-end and open-end specialist investment funds in such a manner, that it carried less risk than the policy appropriate for closed-end investment funds, three groups of limitations were introduced:

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<sup>3</sup> Those articles were introduced on the basis of the Act of 12.03.2004 on the amendment to the Law on public securities turnover and amendments to other acts (Dz.U. of 2004, No. 64, position 594).

<sup>4</sup> The lack of consistent definition of different types of derivatives, and lack of precision in defining their characteristics and functions (derivative rights, property rights, financial instruments, securities) are confirmed by different definitions of the term "financial instrument" in the Law on public securities turnover and the Act of 29.09.1994 on accounting (Dz.U. of 1994, No. 121, position 591).

- nominal value of securities (instruments of the money market) constituting a basis for derivatives is to be added to the value of securities (instruments of the money market), and the total value is subject to the limits concerning (in percentage terms) the net total assets of the fund,
- if a security, or an instrument of the money market contains an in-built derivative instrument, the value of the instrument is considered while calculating investment limits,
- while analysing the limit of investment in a particular subject, the value of contractor's risk resulting from transactions involving non-standardised derivatives is taken into account (the value of contractor's risk, from the fund's point of view, is a positive evaluation of futures transactions concluded with that contractor).

The principles of using derivatives by open-end funds are more precisely presented in the Directive of the Minister of Finance of 26.08.2004<sup>5</sup>. The Directive specifies, that a fund is obliged to maintain a part of its assets at a level securing clearing futures transactions (for complex instruments those are their underlying instruments, and for non-complex instruments – monetary means). The Directive defines conditions to be fulfilled by transactions involving non-standardised derivatives and contractors (such as liquidity, possibility of MTM evaluation).

Other matters regulated by the Directive include:

- the principles of compensating payments and liabilities resulting from futures transactions with a particular contractor,
- the manner of considering collaterals submitted by a contractors in futures transactions. For complex derivatives this requirement concerns underlying assets, and for cash-settled derivatives – monetary means or the most liquid securities,
- the limits based on, among others, the value of contractor's risk (e.g. value of a particular contractor's risk must not exceed 5% of a fund's net assets).

In the case of close-end funds, limitations concerning three areas were introduced:

- information – if a close-end fund intends to get involved in non-standardised derivatives or property rights the prices of which are dependent upon asset prices, the statute must specify conditions to be fulfilled by those derivatives, parties with whom such transactions may be concluded, principles of assuming positions in the quoted derivatives, the manner of

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<sup>5</sup> The Directive of the Minister of Finance of 26.08.2004 on signing contracts concerning derivatives, including non-standardised derivatives, by open-end investment funds (Dz.U. of 2004, No. 197, position 2021).

appointing and the maximum level of contractor's risk, the manner of determining the fund's maximum financial involvement in derivatives, and the types of risk connected with derivatives. Furthermore, the fund is obliged to design and introduce principles of investment decision-taking, risk measurement, and influence of derivatives upon the fund's portfolio,

- liquidity (derivatives must be negotiable),
- concentration (underlying instruments for derivatives, and derivatives in-built into securities, or instruments of the money-market are included in the limits of concentration presented in Table 1).

**Table 1. Derivatives-related limitations of investments of close-end funds**

Limitation	Limit (as a proportion of fund's assets)
Securities or instruments of the money market issued by a single party, receivables towards this party, and shares in this party.	Up to 20%*
Mortgage bonds issued by a particular mortgage bank	Up to 25%
Foreign currency of a single country or EURO	Up to 20%

The limit does not concern securities issued or guaranteed by the State Treasury, the National Bank of Poland, OECD member states or international financial institutions of which the Republic of Poland or at least one of OECD member countries is a member. Furthermore, according to Article 154 paragraph 2, the limit does not include derivatives based on recognised indexes.

Source: original research on the basis of the Act of 27.05.2004 on investment funds.

## 2. New Derivatives on the Polish Market

In the Resolution No. 20/1038/200 of 17.03.2004, changed by the Resolution No. 26/1044/2004 of 21.04.2004, the Council of the Stock Exchange determined the standard for the programme of futures contracts for active treasury bonds issued by the Minister of Finance, for which total value of an issue is no less than PLN 5 million, and time of redemption is between 2 years and nine months, and five years and six months, calculated for the date of contract execution. The key principles of turnover<sup>6</sup>:

<sup>6</sup> "Warunki obrotu dla programu kontraktów terminowych na obligacje skarbowe o oprocentowaniu stałym, emitowane przez ministra finansów o wartości emisji nie mniejszej niż 5 mld zł i terminie wykupu nie krótszym niż 2 lata i dziewięć miesięcy i nie dłuższym niż 5 lat i sześć miesięcy, licząc od dnia wykonania kontraktu" – the document available at [gpw.com.pl](http://gpw.com.pl) on 25.02.2005 and Ziębiec J., Kontrakty terminowe na obligacje skarbowe na Gieldzie w Warszawie, "Rynek Terminowy", No. 26.04.04, pp. 6–13, and Goncaryk M., Rozliczanie kontraktów terminowych na obligacje, "Rynek Terminowy", No. 26.04.04, pp. 14–16.

- contracts of nominal value of PLN 100 000 are quoted at the basic market as fixed quotations;
- contracts amount to hypothetical treasury bonds. After expiry of a contract delivery can be made in bonds fulfilling the following conditions:
  - they were issued by the Ministry of Finance
  - their nominal values and interest are denominated and paid in PLN,
  - they are fixed interest bonds (active bonds), with interest paid out annually,
  - time to redemption of the issue of bonds, calculated from the date of contract execution, is not shorter than 2 years and 9 months, and not longer than 5 years and 6 months,
  - the total value of the issue of bonds is not less than PLN 5 million;
- a slightly different session schedule, than in the case of other derivatives, i.e.:
  - a longer session (closing at 16.30, rather than at 16.20 as in the case of other stock-exchange derivatives),
  - no post-auction trading,
  - shorter time for placing orders before and after the auction.

Initially, the turnover would involve contracts expiring in March and June 2005. After the expiry of the March issue, the September issue would be introduced into the market. For each issue, the term of contract expiry is 6 months from the expiry of the previous issue.

The introduction of futures contracts for bonds seems to bring the following benefits<sup>7</sup>:

- lack of credit risk, thank to the system of clearance guarantees provided by the Institute of Accounting and Taxation (IRIP),
- security of turnover and its expected high liquidity,
- possibility of co-operation between banks and brokerage houses within a single platform,
- low transaction costs – no transaction fees were charged until the end of June 2005,
- a single contract securing several underlying instruments (bonds),
- a possibility of securing the component of value risk of interest rate,
- new members of the stock exchange (i.e. banks which do not conduct brokerage) emerge with the introduction of contracts for bonds. Those banks operate as direct members signing transactions in their own name

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<sup>7</sup> Ziębiec J., Kontrakty terminowe na obligacje skarbowe – dlaczego na giełdzie?, April 2004, presentation available on 25.02.2005 at [gpw.com.pl](http://gpw.com.pl), pp. 7–9.

and on their own account (this concerns all futures contracts and bonds, depending on the type of KDPW (National Depository for Securities, Poland) membership<sup>8</sup>).

The instruments, which proved popular at the off-exchange market, were:

- DCD (Dual Currency Deposit) transactions and DCC (Dual Currency Credit) – products offered by ING BSK SA,
- ARF (Average Rate Forward),
- Call and put credit options,
- Forwards for futures contracts involving different underlying instruments, including those quoted at foreign markets, except for shares and indexes – products offered by BRE Bank SA,
- Forward Limited Outlook, Forward Plus, Super Forward (products of Pekao SA Bank).

### 3. The Off-Exchange and the Exchange Turnover

The off-exchange market of derivatives in Poland is dominated by currency and interest rate derivatives. The OTC market consists of two main segments: the inter-bank market and dealer-to-client market (transactions between banks and corporate clients).

Derivative transactions at the off-exchange currency market include operations, for which the pair of currencies includes two foreign currencies, or a foreign currency and the zloty.

In the case of the former, the volume of transactions decreased in 2004 by PLN 95 billion (4,5%) of the total nominal value of operations. A particularly sharp reduction could be observed in the area of contracts with residents (almost 70%), although it has to be said, that contracts with residents constitute a mere 0,5% of all dual currency transactions based on two foreign currencies. In 2004 (as in 2003), the inter-bank currency market connected with transactions involving mutual exchange rates of foreign currencies was dominated by swaps, although the nominal value of those instruments fell in comparison with the year before by 4%.

In the case of derivatives based on a zloty to a foreign currency rate, the increase of the volume of transactions concerned solely the swaps with non-residents. In 2004, those transactions constituted about 78% of all inter-bank

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<sup>8</sup> Banks participating in KDPW may be involved in all derivatives quoted at GPW. Banks not participating in KDPW may be involved only in contracts for treasury bonds and debt securities issued by NBP.

dual currency transactions involving the zloty. The increased by 10% in relation to the year before value of swaps with residents determined the increase of the market of inter-bank derivatives involving the zloty in dual currency transactions by 5,3%, in spite of the scale of operations with residents decreasing by 8,2%.

The inter-bank market of currency derivatives, including all pairs of currencies, in 2004 underwent a 3% growth of the nominal value of transactions, facilitated mainly by the intensification of transactions with non-residents (5,8% growth), which in turn resulted from the development of currency swaps with the zloty in a currency pair. Furthermore, in 2004 an increase of turnover with non-residents could be observed – this area experiences increasing concentration of the market – in 2003 transactions with non-residents constituted 81,6% of all transactions at the inter-bank currency market; in 2004 – 83,8%.

The dealer-to-client market is about 20 times smaller than the inter-bank segment. It is dominated by transactions with residents, which constitute about 98% of all currency futures operations between banks and their corporate clients. The size of the dealer-to-client market increased in 2004 by about 60%, to the level of PLN 438 million.

The following characteristics of the Polish off-exchange market of currency instruments are particularly interesting:

- the increase of the nominal value of transactions to PLN 9 740 billion, determined by the growing value of inter-bank currency swaps issued for zlotys in relation to a foreign currency,
- the reduction of share of transactions with residents from 20,8% to 19,9%.

The detailed data concerning transactions at the non-stock exchange currency derivatives market is presented in Tables 2–4.

**Table 2. Inter-bank off-exchange market of currency derivatives in Poland during the years 2003–2004**

	2004	2003	Change
Resident	1 505 815	1 661 677	-9,4%
Non-resident	7 796 263	7 366 638	5,8%
Total	9 302 078	9 028 315	3,0%
Share: resident	16,2%	18,4%	
Share: non-resident	83,8%	81,6%	

Source: original research on the basis of periodic reports prepared by the Department of Inland Operations, the Section of Monitoring and Control of Securities Turnover of the National Bank of Poland on the basis of data received from 19 banks, reports analysed on the basis of the Decree of the Minister of Finance of 5.11.2001 on the reporting duties concerning securities turnover, issued by the Treasury of State, as well as the data from the KDPW.



**Table 3. Dealer-to-client off-exchange market of currency derivatives in Poland during the years 2003–2004**

	2004	2003	Change
Resident	429 351	270 626	59%
Non-resident	8 601	2 405	258%
Total	437 952	273 031	60%
Share: resident	98,0%	99,1%	
Share: non-resident	2,0%	0,9%	

Source: original research on the basis of periodic reports prepared by the Department of Inland Operations, the Section of Monitoring and Control of Securities Turnover of the National Bank of Poland on the basis of data received from 19 banks, reports analysed on the basis of the Decree of the Minister of Finance of 5.11.2001 on the reporting duties concerning securities turnover, issued by the Treasury of State, as well as the data from the KDPW.

**Table 4. Off-exchange market of currency derivatives in Poland during the years 2003–2004**

Total Currency OTC Market			
	2004	2003	Change
Resident	1 935 166	1 932 304	0,1%
Non-resident	7 804 864	7 369 043	5,9%
Total	9 740 029	9 301 346	4,7%
Share: resident	19,9%	20,8%	
Share: non-resident	80,1%	79,2%	

Source: original research on the basis of periodic reports prepared by the Department of Inland Operations, the Section of Monitoring and Control of Securities Turnover of the National Bank of Poland on the basis of data received from 19 banks, reports analysed on the basis of the Decree of the Minister of Finance of 5.11.2001 on the reporting duties concerning securities turnover, issued by the Treasury of State, as well as the data from the KDPW.

The following tendencies could be observed at the off-exchange interest rate derivatives market:

- the expected reduction of short-term interest rates resulted in reduction of involvement into long positions in FRA transactions (long position guarantees a fixed interest rate for a debtor, securing them from rising market interest rates), as well as in the increased value of short positions (in total by 10,99%),
- the expectations concerning future profitability were mixed – the value of short and long positions rose in both cases practically equally (over two times),
- in the case of interest rate swaps, the significance of transactions with residence increased decisively. In 2004 those transactions constituted about a half of all transactions (compared to less than 30% in 2003),

- the market continues to be dominated by short-term transactions with a single clearance (FRA-Forward Rate Agreement), although the share of swaps rises consistently.

The detailed data on off-exchange interest rate derivatives is presented in Table 5.

**Table 5. The off-exchange market of interest rate derivatives in Poland during the years 2003–2004**

<b>Interest Rate Swap</b>			
<b>Long position</b>			
	<b>2004</b>	<b>2003</b>	<b>Change</b>
Resident	80 619	40 305	100,02%
Non-resident	82 368	98 275	-16,19%
Total	162 987	138 580	17,61%
Share: resident	49,5%	29,1%	
Share: non-resident	50,5%	70,9%	
<b>Short position</b>			
	<b>2004</b>	<b>2003</b>	<b>Change</b>
Resident	77 524	37 220	108,29%
Non-resident	72 207	93 754	-22,98%
Total	149 731	130 974	14,32%
Share: Resident	51,8%	28,4%	
Share: Non-resident	48,2%	71,6%	
<b>Forward Rate Agreement</b>			
<b>Long position</b>			
	<b>2004</b>	<b>2003</b>	<b>Change</b>
Resident	283 074	325 913	-13,14%
Non-resident	257 754	282 352	-8,71%
Total	522 206	562 437	-7,15%
Share: Resident	54,2%	57,9%	
Share: Non-resident	49,4%	50,2%	
<b>Short position</b>			
	<b>2004</b>	<b>2003</b>	<b>Change</b>
Resident	299 356	296 726	0,89%
Non-resident	302 355	245 424	23,20%
Total	601 711	542 150	10,99%
Share: Resident	49,8%	54,7%	
Share: Non-resident	50,2%	45,3%	

Source: original research on the basis of periodic reports prepared by the Department of Inland Operations, the Section of Monitoring and Control of Securities Turnover of the National Bank of Poland on the basis of data received from 19 banks, reports analysed on the basis of the Decree of the Minister of Finance of 5.11.2001 on the reporting duties concerning securities turnover, issued by the Treasury of State, as well as the data from the KDPW.

The stock-exchange market of derivatives in Poland includes the turnover at the Warsaw Stock Exchange (GPW) and at WGT (Warszawska Giełda Towarowa

SA). Compared to the GPW, the importance of WGT is negligible (in 2004 the WGT registered 29 140 contracts, that is about 2,5% of GPW's)<sup>9</sup>, therefore the analysis below concerns only the GPW turnover.

The most popular of derivatives quoted at the Warsaw Stock Exchange are the futures contracts for the WIG 20 index. In 2004, the total value of turnover of those contracts amounted to PLN 122,2 billion, which signifies an 8% increase compared to 2003. However, this increase in value was not accompanied by a rising number of transactions. The average number of transactions per session decreased by 17%, in spite of the rise of the number of positions opened by as many as 36%. The above situation resulted from investors maintaining their positions for a longer time (which can be explained by stability of trends), and by the higher level of the underlying index<sup>10</sup>. Similar conclusions can be drawn from analysing futures contracts for shares (an increased value of turnover accompanied by a reduced number of transactions). In the case of contracts for TechWIG and MidWOG indexes, the value of turnover in 2004 increased (respectively, 2 and 4 times) with the number of transactions increasing as well.

2004 brought a reduction of value of futures contracts turnover for the EUR/PLN and USD/PLN exchange rates. The volume of contracts for the EUR/PLN rate turnover decreased by 69%. For the USD/PLN rate, it increased by 13%. The higher investors' interest in the upheavals of the USD/PLN exchange rate is proven by the doubling of the number of positions opened in futures contracts for the quoted pair of currencies.

In general, the futures market in Poland in 2004 experienced a rise in the value of turnover by 8%, to the level of PLN 125,5 billion, with a simultaneous reduction of the average volume per session by 16%. The reason for this state of affairs is identical with the reasons for changes at the futures market for the WIG 20 index, because the value of turnover of those instruments constituted over 97% of the total value of derivatives turnover at the Warsaw Stock Exchange in 2004.

The basic information about the volume and the value of derivatives turnover at the GPW during the years 2003–2004 is presented in Tables 6–7.

<sup>9</sup> Statystyka 2004–2005. pdf – the file provided by WGT.

<sup>10</sup> Between the end of 2003 and the end of 2004 the index rose from 1 574,04 points to 1 960,57 points, i.e. by 24,6%.

**Table 6. Derivatives at GPW in 2004**

	IV 2004	III 2004	II 2004	I 2004
Forward contracts (PLN million)	29 896	24 628	29 797	41 174
Index units (PLN million)	2	2	5	6
Options (PLN million))	16	10	12	12
Total forward market (PLN million)	29 913	24 640	29 814	41 192

Source: original research on the basis of statistics available on 24.02.2005 at [www.gpw.com.pl](http://www.gpw.com.pl)

**Table 7. Futures contracts at GPW during the years 2003–2004**

	2003	2004	Dynamics
Number of transactions per session	5 049	4 529	-10%
Total value of turnover (PLN million)	116 201	125 493	8%
Average turnover per session (PLN thousand)	462 951	492 134	6%
Average volume per session	16 860	14 153	-16%
Number of positions open	22 535	30 270	34%
The number of sessions (at the end of the year)	49	51	4%

Source: original research on the basis of statistics available on 24.02.2005 at [www.gpw.com.pl](http://www.gpw.com.pl)

## 4. Recapitulation

2004, the year of Poland's joining the European Union, brought significant changes at the derivatives market. Those include:

- changes in the area of defining securities and financial instruments,
- increased investment opportunities for investment funds; more precise definition of the influence of derivatives upon the limits of involvement of those institutions,
- expanding the market by new constructions, especially the stock-exchange contracts for bonds,
- intensification of turnover, both at the stock exchange, and the off-exchange market.

At the same time, while attempting to determine the perspectives for derivatives markets in 2005 and the following years, the following indications can be made:

- increasing availability of derivatives to individual clients,
- increased interest in currency derivatives in connection with Poland's intention to join the EURO at the soonest possible time, and to implement the Balassy-Samuelson effect, i.e. a faster increase of work efficiency in sectors of exchangeable goods in Poland than in its trade partners, resulting in gradual appreciation of the zloty<sup>11</sup>,

<sup>11</sup> Rosati D., Interwencje i rynek, czyli co powinien zrobić NBP, "Rzeczpospolita", 14.06.2002.

- substituting the currency and interest-rate stock exchange derivatives with their off-exchange equivalents,
- banks paying more attention to operational and credit risk connected with derivatives (in particular with off-exchange derivatives),
- an intention to broaden the range of derivatives on offer, in particular with regard to such underlying instruments as treasury bills, inter-bank interest rates and corporate credits and bonds (credit derivatives),
- increasing importance of medium- and long-term derivatives.

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# **Influence of Introduction of Maximum Limits for Interest Rates on Credits upon the Conditions of Operation of Polish Banks and their Clients in the Context of European Experiences**

## **1. Introduction**

Poland did not pioneer maximum limits of interest on credits. Considering the need and possibility of introducing regulations of this type, the following issues ought to be analysed in the first place:

- the degree of banking services penetration within the society, with a particular consideration for indebtedness and its formative factors,
- other countries' experiences related to introduction of maximum limits for credit interest,
- consequences of introduction of maximum limits for credit interest in the country in question.

The analysis of the above issues constitutes the subject of this paper. The subject is up-to date, and important, because as of the beginning of 2006, regulations concerning maximum interest rates on credits and credit fees/charges are going to be in force in Poland.

## **2. Banking Services Penetration within the Polish Society, and its Formative Factors**

The level of banking services penetration within the Polish society increases, nevertheless in comparison with other EU countries it remains relatively low. Between January 2004 and January 2005, 39% of the Poles did not use any banking services, nor other financial products or services<sup>1</sup>. The published opinion polls indicate, that on average one in two adult Polish citizens use banking services<sup>2</sup>. Only 55% of Poles over 15 years of age have a current bank account,

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<sup>1</sup> P. Jabłoński, S. Karpiński, Giełda coraz modniejsza, "Rzeczpospolita" 31.01.2005, after: E. Ślązak, Bankowość detaliczna w Polsce, addition to "Bank i Kredyt", No. 2/2005.

<sup>2</sup> Sytuacja finansowa banków w 2004 roku. Synteza, National Bank of Poland, Warszawa, May 2005, p. 10.

while in the Czech republic the figure is 80%, in the UK – 85%<sup>3</sup>, and in the EU countries on average 90%. Also in terms of the value of per capita non-cash turnover, Poland lacks behind not only the old EU members, but many countries of Central and Eastern Europe as well (e.g. the Czech Republic, Hungary, Slovenia)<sup>4</sup>.

Household indebtedness rises in Poland; nevertheless, it remains relatively low in comparison with the EU average. In most European countries average debt of a household amounts to over 100% of its annual disposable income; for example in the UK the analysed indicator amounts to 138%<sup>5</sup>, and in Denmark as much as 200%. Another country where indebtedness is high is Holland. It is low in Italy, France and Poland. The level of indebtedness in relation to annual income in Poland amounts to about 20%<sup>6</sup>.

The credit market in Poland is dominated by relatively low-value credits, i.e. almost 60% of respondents indicated, that their debt did not exceed PLN 2 500. 35% reported, that their monthly repayment did not exceed PLN 100<sup>7</sup>.

About 45% of respondents indicated, that they never borrowed money, 18% borrowed only from family and friends, and 32% borrowed only in case of sudden need. In March 2005 over 60% of Polish respondents did not have any credits or loans, and 22% used only one. Only 17% of Poles declared borrowing only from financial institutions<sup>8</sup>.

The above results indicate, that only a low proportion of Poles use banking sources of financing in spite of their broad availability (only 4% of respondents indicated lack of opportunities to raise sources of financing<sup>9</sup>). Therefore, it is worth considering, whether in this context the introduction of regulations concerning maximum interest rates on credits in Poland makes sense, since such regulations hinder development of certain segments of the credit market.

<sup>3</sup> Efekty kontroli odsetek w innych krajach, Policis, August 2004, p. 26.

<sup>4</sup> E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 13.

<sup>5</sup> The OECD Report “Economic Outlook”, No. 76 after: E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 8.

<sup>6</sup> Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005, p. 9.

<sup>7</sup> Raport z badania na temat korzystania z produktów finansowych przez Polaków, prepared by PBS Spółka z o.o., ordered by Konferencja Przedsiębiorstw Finansowych, Sopot, April 2005, p. 14.

<sup>8</sup> Raport z badania na temat korzystania z produktów finansowych przez Polaków, prepared by PBS Spółka z o.o., ordered by Konferencja Przedsiębiorstw Finansowych, Sopot, April 2005, p. 8–9.

<sup>9</sup> Raport z badania na temat korzystania z produktów finansowych przez Polaków, prepared by PBS Spółka z o.o., ordered by Konferencja Przedsiębiorstw Finansowych, Sopot, April 2005, p. 8–9.

It is worth emphasising, that the structure of bank indebtedness of households in the highly developed EU countries is different than it is in Poland. In Poland, housing credits constitute about 40% of household debt, while in Holland and Finland – over 90%, in the UK and Germany – about 75%, and in France and Austria – 60%. About 26% of respondents in Poland spent their credit on purchasing housing<sup>10</sup>. The remaining part of debt is constituted by consumer credits, mainly hire purchase and overdrafts on current accounts. In the highly developed countries, the share of consumer credits in the total amount of debt rarely exceeds 20%. The highest value of consumer credits can be observed in Germany and the UK, and the lowest of all the countries of the “old” EU 15 – in Portugal. Still, in Poland the value of consumer credits is several times lower than in Portugal<sup>11</sup>. In Poland about 30% of consumer credits are granted to individuals via indirect channels of distribution, i.e. by credit brokers<sup>12</sup>.

The structure of credits described above (the domination of consumer credits) and a relatively high participation of credit brokers in the channels of distribution of credit products in Poland may enhance the effect the introduction of maximum levels of interest rates on credits will have upon the business environment. It ought to be said, that maximum limits of fees/charges concern solely the consumer credits, and credits offered by brokers usually have high interest rates. The effects of introduction of maximum limits for credit interest rates are discussed in detail in further parts of this paper.

Recapitulating, it has to be emphasised, that the level of banking penetration in the Polish society is low. The following main reasons of lower banking activity of the Polish society have been quoted: high unemployment (fear of job loss), and consequently lack of financial resources (80% of indications), lack of a developed awareness of financial needs in the society (64%), and only in the third place the relatively high costs of banking services (37%)<sup>13</sup>. According to the opinion poll conducted by OBOP, an average credit-taker chooses a form of external financing on the basis of accessibility of financial resources, and pays little attention to costs of credits and loans. In turn for easy access to credit, almost a half of

<sup>10</sup> Raport z badania na temat korzystania z produktów finansowych przez Polaków, prepared by PBS Spółka z o.o., ordered by Konferencja Przedsiębiorstw Finansowych, Sopot, April 2005, p. 10.

<sup>11</sup> Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005, pp. 8, 10 and 23.

<sup>12</sup> E. Ślęzak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 7.

<sup>13</sup> Audyt bankowości detalicznej 2000–2003, Instytut Pentor, after: E. Ślęzak, Bankowość detaliczna w Polsce, addition to “Bank i Kredyt”, No. 2/2005.



CBOS respondents were ready to pay PLN 15 more per month during their re-payment period<sup>14</sup>.

One of the basic reasons for introduction of regulations concerning maximum limits of interest rates is curbing credit prices. The cost of winning a new source of financing in Poland is higher than in developed financial markets, for which there are several reasons. Firstly, due to over three times higher cost of loan capital at the inter-bank market (WIBOR 3M is three times higher than LIBOR 3M for euro). Secondly, due to relatively low creditworthiness of clients, the risk premium connected with granting credits is far higher in Poland than it is in highly developed countries. Thirdly, there is relatively little competition at the Polish credit market, which is indicated by high difference between credit interest rates for individuals and the rates for companies (such high difference does not occur at highly developed financial markets)<sup>15</sup>. Fourthly, the relatively high interest on credit in Poland is influenced by attractiveness of treasury securities.

### 3. European (French and German) Experiences from Introduction of Maximum Limits for Interest on Credits

Experiences concerning maximum limits of interest rates on credits vary according to individual countries. For example, such limits do not exist in the UK, but are in power in countries such as France and Germany. The regulations concerning maximum limits of interest rates on credits can be characterised as follows:

- limits are set in relation to the rates determined by the central bank,
- limits concern obligatory charges, while extra fees (e.g. charges for correspondence with the bank or membership charges) are not regulated,
- sanctions against debtors for not meeting their obligations are severe (e.g. in Germany, in case of 14% of low-income debtors who had problems re-paying their debt, creditors executed the repayment from debtors' accounts, and in the case of further 9%, the execution was performed from debtors' wages – in Germany, in case of delay in re-payment longer than 3 months, a creditor is automatically granted the right to execute the re-payment from wages and social benefits)<sup>16</sup>.

<sup>14</sup> E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 11.

<sup>15</sup> Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005 p. 67.

<sup>16</sup> Original research on the basis of: Efekty kontroli odsetek w innych krajach, Policis, August 2004.

The experiences of the quoted countries indicate, that introducing maximum limits for interest rates on credits causes following effects:

- a lower dynamics of development and smaller range of credit products and services (in particular in the case of the consumer credit market – short-term credits, hire purchase and credit cards – dominated by low value credits of relatively high interest rates, which can be contributed to high risk they generate),
- withdrawal of crediting institutions to countries, where no regulations concerning maximum limits of interest rates on credits prevail, which does not pose any serious problems considering the openness of EU financial markets and the free flow of capital,
- toughening of credit granting procedures in order to eliminate high-risk clients – among the surveyed Germans, 19% mentioned a refusal to be granted credit<sup>17</sup> (e.g. minimal values of credit are set at a much higher level than the one attractive to the lowest-paid customers; only 9% of consumer credits granted by German savings banks (*Sparkassen*) are granted to consumers earning less than euro 700 per month<sup>18</sup>),
- increased scale of illegal financial transactions (e.g. in France, 7% of the low-income population admits to having used illegal services; in Germany – 8%<sup>19</sup>), resulting from limited possibility of drawing credits or loans in banks and other financial institutions; from social exclusion of the part of the population without a steady income; and from regulations interfering with the mechanism of market competition<sup>20</sup>,
- falling share of interest in the total price of credit, compensated by increasing role of fees/commissions, aimed at circumvention of the law, resulting in lower “clarity” of credit costs (difficulties in clients’ understanding the conditions of a credit contract),
- increased number of debtors’ bankruptcies (in France 25% of the population who have problems servicing their debt declare bankruptcy, and 6% in Germany, although 16% of the German population provided their creditors

<sup>17</sup> E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 12.

<sup>18</sup> The effect of interest rate controls in other countries, The Department of Trade and Industry, London, August 2004, p. 16 ([http://www.dti.gov.uk/ccp/topics1/consumer\\_finance.htm](http://www.dti.gov.uk/ccp/topics1/consumer_finance.htm)), after: Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005, p. 66.

<sup>19</sup> Efekty kontroli odsetek w innych krajach, Policis, April 2004, p. 50.

<sup>20</sup> Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005, p. 50.

with a so-called declaration of insolvency – *Eidesstattliche Versicherung* – which is a form of bankruptcy procedure<sup>21)</sup><sup>22)</sup>.

The above facts indicate that the experiences of the analysed countries ought to be taken into account both during discussions on the need and the form of introduction of maximum limits of interest rates on credits, and during the creation of the act on consumer bankruptcy in Poland.

#### **4. Polish Solutions Regarding Maximum Limits for Interest Rates on Credits, and Possible Consequences of their Introduction**

In Poland, the Act of 7.07.2005 on the amendment to the civil code and on amendments to certain other acts<sup>23</sup> introduced two important solutions regarding maximum prices of credits, loans and other sources of financing. Firstly, the maximum level of per annum interest rate resulting from a legal transaction must not exceed four times the level of the national bank's Lombard credit rate. It ought to be emphasised, that the above regulation concerns not only the maximum level interest rates on credits and loans, but on other sources of financing as well, e.g. open accounts. Secondly, the total amount of all charges, commissions and other costs connected with a consumer credit contract, except for documented costs and costs resulting from other legal regulations concerning establishment, change or expiry of collaterals and insurances, must not exceed 5% of the total amount of the consumer credit itself. It is worth emphasising, once again, that the regulation concerning maximum charges/commissions (the object of which is not precisely defined) pertains to only consumer credits, i.e. the limit has not been set for other sources of financing. Effectively, the limit of interest (four times the NBP Lombard credit rate) can be circumvented in case of instruments other than consumer credit, by introducing unrestricted charges/commissions. It can be presumed that in order to circumvent the regulations banks and other financial institutions will create and offer more credit products, which will not fulfil the definition of a consumer credit. It is worth mentioning, that the Polish legislator stipulated, that the above regulations include institutions operating in Poland on the basis of foreign law.

The introduction of maximum limits for interest rates on credits in Poland violates the principles of market economy, and the freedom of contract signing. It could result in:

<sup>21</sup> Efekty kontroli odsetek w innych krajach, Policis, August 2004, p. 48.

<sup>22</sup> Original research on the basis of: Efekty kontroli odsetek w innych krajach, Policis, August 2004.

<sup>23</sup> The Act changes the following acts: the Act of 29.06.1995 on bonds, the Act of 20.07.2001 on consumer credit, and the Act of 28.10.2002 on responsibility of collective bodies for punishable acts.

- lowering of credit action (by PLN 5 billion in 2009 compared to the base scenario in case of consumer credits<sup>24</sup>) due to toughening of credit policy and excluding from crediting the segment of the highest risk customers, which would influence the entire economy – the macro-economic indicators (the lowered credit action may concern mainly credit cards and credits granted via brokers, which could result in job losses in those institutions and the necessity to build other channels of distribution for banking products and services),
- exclusion of a part of the society, in particular the poor, from a possibility to access sources of financing, because the interest plus charges/commissions would not compensate for the risk and cost of servicing – for example, in case of a PLN 500 credit, a PLN 25 commission, i.e. 5% of the credit's value in most cases would be unable to compensate for costs (if banks decide to finance infeasible transactions aimed at the poorest members of the society, those transactions would have to be paid for by banks' rich customers),
- development of illegal loan market for the part of the population excluded from the legal financial market (of the Polish respondents, 2% would definitely be willing, and 5% rather willing, to use services of professional lenders, who would not be representatives of financial institutions<sup>25</sup>),
- development of the offer of currency loans, in particular cash currency loans, which are cheaper than the zloty ones due to lower cost of fundraising, while credit-takers would accept a part of currency risk,
- increased weight of extra commissions/charges in the total price of credit, in order to circumvent the regulations, e.g. introduction of high fees for running a bank account, which would be obligatory for clients wishing to draw credit in the particular bank<sup>26</sup>.

<sup>24</sup> E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005, p. 16.

<sup>25</sup> Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005 p. 50.

<sup>26</sup> Original research based on:

- E. Ślązak, Prognoza rynku kredytów i pożyczek konsumpcyjnych w okresie 2006–2009 z uwzględnieniem wpływu odsetek maksymalnych, in: Wpływ wprowadzenia przepisów o maksymalnym oprocentowaniu kredytów na rozwój rynku kredytowego i gospodarkę w Polsce, Instytut Badań nad Gospodarką Rynkową, Gdańsk, June 2005,
- Zadłużenie konsumentów w bankach i instytucjach finansowych, Instytut Badań nad Gospodarką Rynkową, Gdańsk, April 2005,
- P. Pietkun, Falszywy klejnot, "Gazeta Bankowa", No. 29 (873) of 18–24.07.2005.

## 5. Recapitulation

Introduction of maximum limits of interest rates on credits adversely affects economic development, conditions of operation at the financial market, and limits accessibility of certain types of credit, which, considering low level of banking penetration in the Polish society, raises doubts. Introduction of regulations concerning maximum limits of interest rates on credits has more effect upon the operation of co-operative banks than of joint-stock companies due to their lesser capacity to shape prices of low-value credits and their servicing less affluent customers than in the case of joint-stock banks. At the same time, the influence of the maximum limits of interest rates on credits upon the conditions of operation will, in practice, concern solely the market of consumer credits and credit cards.

The issue of the level of interest rates, commissions and charges ought not be regulated by legal acts, but should be sorted by market mechanisms. The inevitable increase of competition at the banking market will naturally force a tendency for lowering cost of credit products and services. From the day of Poland's joining the European Union until August 2005, 91 credit institutions registered their operation<sup>27</sup>, which indicates an increase of the number of financial institutions operating in Poland, and implementation of the principle of a single banking passport.

Recapitulating, it ought to be the increased competition rather than introduction of imprecise regulations on maximum limits of interest rates on credits, that should determine prices of credit (this has been confirmed by research conducted by the US National Commission on Consumer Finance<sup>28</sup>). However, the following actions aimed at development of the credit market in Poland would be welcome:

- educating the society on skilful use of financial products and services, including credits,
- further development of economic/credit information offices,
- creation of consistent, materially correct legislation concerning regulation of operation of institutions at the financial (credit) market, as well as the rights and duties of consumers (e.g. a possibility to declare bankruptcy).

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<sup>27</sup> The communiqué of the Commission for Banking Supervision on the session of 7.09.2005, [www.nbp.pl](http://www.nbp.pl), 2.10.2005.

<sup>28</sup> Efekty kontroli odsetek w innych krajach, Policis, August 2004, p. 25.



**PART TWO**

**ARTICLES ON ECONOMY  
AND MANAGEMENT**





## Controlling in Modern Company Management

### 1. Functions and Objectives of Controlling in a Modern Company

Aggressive competition, expansion of new technologies, choppy situation at the world markets, unstable fiscal and economic policy of governments, tendency for growing complication of processes taking place within companies and excessive corporate growth are just some of the areas faced by management staff of a modern company. Efficient company management is becoming more of “tough business”, and less of “intuitive art”.

Controlling is the tool for solving the quoted external and internal problems in a company’s operation. It constitutes a universal management mechanism ensuring informative and advisory support, and plays a coordinative and supervisory role towards the entire economic organisation. Controlling is a super-functional management system involving result-oriented guidance processes implemented via planning, control and reporting<sup>1</sup>. The term “controlling” may express different aspects of operation connected with this management system, resulting from the scope of application of controlling tools in a particular company. In order to ensure effectiveness of controlling solutions, those actions ought to be directed at key elements of the organisation, so that the controlling system can actually support the management in decision-making, and even constitute a modern managerial tool. Those elements include: company goals, influence of present actions upon the future situation, the market, the client, and bottlenecks<sup>2</sup>.

A company within a controlling framework ought to be goal-oriented, which is tightly connected with strategic company management. Setting goals helps stick to the chosen way, and thus achieve the goals faster. The first area of interest of controlling are the formal goals (concerning value aspects of planning, e.g. financial liquidity, effectiveness) – values, indicators. Analysing material goals (defining the objective of company operation) takes place after the numerical data have been processed. Goals ought to be clearly formulated and described in

<sup>1</sup> More on the subject in: Vollmuth H., *Controlling. Planowanie, kontrola, zarządzanie*, Placet, Warsaw 2002.

<sup>2</sup> A. Skowronek-Mielczarek, *Wykorzystanie kontrolingu w polskich przedsiębiorstwach*, in: *Doskonalenie procesów zarządzania w przedsiębiorstwach a świadomość menedżerska*, edited by M. Strużycki, SGH, Warsaw 2001, p. 176.

numerical terms, which helps avoid misunderstandings, and analyse results more easily. Setting goals facilitates relating every operation within a company to its future situation.

Concentrating on the **future** brings dynamics into corporate operation. In a modern management system, a company's board focuses on opportunities created by the environment, and the potential of the company itself, which can be utilised in the future. The future constitutes a platform for introduction of changes and development. The increasing competition, changing company models (e.g. globalisation), pressure to lower operating costs, generate persisting challenges for the traditional model of past-oriented accounting. Ex-post analysis does not suffice in controlling; ex-ante analyses are a necessity.

A company can be successful, if its operation is **market-oriented**. The ever-changing environment must be reflected in cost and profitability accounting. In order to put market-orientation into practice, it is necessary to precisely define connections between customer needs on one hand, and sales and marketing on the other. Thank to direct market confrontation, firms have the opportunity to consistently examine and improve competitiveness of their processes. The companies able to recognise development tendencies of the market can better adjust to the signals received from the environment, thus becoming more competitive. The firms' focusing on costs and financial results must not lead to ignoring the needs of clients. A company operating in a market economy can exist only when it can provide something of use to consumers. Orientation towards customers means, that the company's objective is maximising customer satisfaction. A controller ought to provide information necessary for consumer research (e.g. analysis of groups of customers, customer satisfaction research). Customer-oriented attitude has a positive effect upon quality of the offer, servicing times and cost of service.

**"Bottleneck"** orientation means, that controlling should focus on those areas of a company, where resources are insufficient in relation to needs. This prevents losing concentration and dispersing resources, and allows for full concentration on the problems most significant from the company's point of view.

Determining the key elements of concentration of controlling facilitates defining the main types of action, which ought to be undertaken to implement them. Those actions constitute sub-systems of controlling systems. They include:

- a sub-system of planning, involving mostly coordinative functions,
- a sub-system of control and analysis, involving identification and analysis of e.g. actual values of results achieved by trade companies, variations within the planning-execution system, reasons for variations defining the problem areas within the company, or indicating the phenomena of a particularly harmful character,

- a sub-system of reporting, i.e. the internal system of information backup for the management,
- a sub-system of regulation, which identifies variations and their reasons, and on that basis defines the tools for alleviating variations and preventing them in the future,
- a sub-system of guidance, which involves anticipating possible sources of threats and proposes modifications and improvements.

It is worth emphasising, that the above groups of actions are of a logical, rather than chronological nature. This means, that they do not occur in the presented order, where the commencement of a following task would depend on completion of the previous one. All the presented actions can overlap and intertwine.

## 2. Types of Controlling

Of all the types of controlling, two classifications deserve particular attention: the ones based on functional criteria and on the level of management. The following categories of controlling can be identified according to the functional criteria: controlling related to logistics, production, marketing, personnel management, and costs and finance. The criterion of management level produces the categories of **operating** and **strategic** controlling. Different levels of management, to which the above types of controlling relate, generate different perception of their goals, orientation, character and objectives, as well as time scale. The elements typical for both types of controlling are presented in Table 1.

**Table 1. Characteristics of strategic and operating controlling**

Characteristics	Strategic Controlling	Operating Controlling
Goals	Securing long-term development of a company	Current profitability, liquidity and effectiveness
Orientation	Company environment (particularly in the context of adjustment to its changes)	Internal (particularly in the context of co-ordination of internal processes)
Character of tasks	Mainly qualitative (low structuralisation)	Mainly quantitative (measurable goals)
Tasks	Assessing chances and threats generated by the environment vs. identification of weak and strong spots of the company	Identification and verification of quantities within the following configurations: <ul style="list-style-type: none"> <li>• Costs-revenues,</li> <li>• Expenses-income,</li> <li>• Earnings-expenditures</li> </ul>
Time scale	Long-term	Short- and medium-term

Source: original research.

**Strategic controlling** focuses on helping managers implement long-term objectives. The instrument is used to support managers by co-ordinating the operation of individual strategic management sub-systems in order to create conditions for actions consistent with long-term development objectives. The main tasks of strategic controlling can be summarised as follows:

- initiating and supporting the management in seeking and optimal application of future strategic potentials of the company,
- creating a database containing data on the environment, the company, and the scope of use of individual instruments,
- supervising the processes of strategic control, analysing and working out counter-actions against adverse effects of the environment,
- designing a system of strategic reporting, securing and supervising the implementation of the strategy (particularly in the area of feedback and coordination with operating controlling).

**Operating controlling** is oriented towards regulation of internal processes in order to guide company's results in a short-term. It involves specification and verification of concepts designed at the strategic level. The basic tasks of operating controlling boil down to coordination and co-operation in the processes of strategy implementation, including support and advise by providing appropriate analyses and calculations, and to providing strategic controlling with information on the stages of strategy implementation. Those tasks assume the following form within the analytical perspective:

- coordinating and supporting participation in setting the key and the specific goals (on the basis of the pre-defined strategies),
- co-operation in designing plans of actions aimed at achieving the set goals,
- transformation of action plans into budgets,
- defining measurements of the level of implementation of action plans and budgets,
- day-to-day coordination and support for actions involved in implementation of plans,
- day-to-day control, analysis and regulation of the process of implementation of the appointed action plans and budgets (including providing information to the managerial staff of the medium and top levels),
- determining the level of implementation of strategic objectives and indicating the possible improvements (feed-forward).

### 3. Tools of Strategic Controlling Applied in Corporate Management

The tools of strategic controlling considered important and applied in companies include the balanced scorecard, benchmarking and responsibility centres.

On one hand the **balanced scorecard** reaches far beyond the instruments of traditional controlling, on the other it can be treated as a reference standard for future instruments, since it is characterised by high levels of communication and integration. It integrates measurement and evaluation of the key factors of corporate success, i.e. costs, time, quality, innovation and permanent improvement – the holistic analysis of the value chain, as well as the internal and external orientation of the company. Hence, it is used for management at the strategic level, and examining the level of implementation of the long-term organisation's goals in a shorter term<sup>3</sup>. In the concept of the balanced scorecard, the traditional systems of financial indicators are appropriately supplemented with the indicators introducing the customer perspective, the perspective of internal processes, and the perspective of learning and growth of the organisation.

When creating a balanced scorecard, a firm specifies strategic goals and determines key success factors deciding about their implementation. The responsibility for fulfilling the goals specified in the balanced scorecard lies on the entire management team, which means, that it constitutes a common basis for many processes taking place within the company. Also, it is a source of consensus and co-operation between all the members of top management, regardless of their earlier experiences and knowledge. The balanced scorecard helps explain the strategy to top managers and company's board, and involve them in strategy implementation. It encourages dialogue between individual organisational units and the top management, concerning not only short-term financial indicators, but also formulating and implementation of the strategy, which is aimed at success in the long run. The next stage of construction of a balanced scorecard is defining the measurements, which are to be used for monitoring the effectiveness of actions implemented within the areas determined by key success factors. The target values of measurements reflect the requirements defining the expected results of those actions. Presenting the strategy as a set of measurements facilitates communicating it within the firm. It is a simple and logical way for the management to communicate to the staff what actions need to be taken, and what the effects of those actions are to be in order for the firm to fulfil the vision and the mission of its development.

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<sup>3</sup> More on the subject in: Friedag F., Schmidt W., *Moja Strategiczna Karta Wyników*, C.H. Beck, Warsaw 2003.

Recapitulating, the four perspectives of the balanced scorecard create an image of the company, which communicates how the company intends to implement its strategy, and what the effects of this strategy are to be, i.e. what resources are required (*Learning and Growth Perspective*), and how to allocate them (*the Business Process Perspective*), in order to satisfy the expectations of customers (*the Customer Perspective*) and shareholders (*the Financial Perspective*).

**Benchmarking** signifies seeking and setting the desired standard to which a particular company is to aspire<sup>4</sup>. Benchmarking includes a systematic definition of the results of best practice in a particular discipline, as well as examining, comparing and evaluating in this context of products and internal processes in order to estimate one's position against the leaders and indicate ways of matching them. This activity allows for determining the strong and weak points of the company against the leaders. Assuming the best practical achievements as the standard creates an opportunity to utilise experiences and successes of others. Such knowledge may contribute to improving effectiveness and efficiency, on the basis of methods employed by others. Implementation of benchmarking contributes to rising quality both in terms of processes and within the customer perspective, which results in integration of both those perspectives, and contributes to development of e.g. Total Quality Management. Another important issue is the fact, that applying benchmarking in a company requires a strategic analysis of the company's potential, as well as of the potential of the chosen exemplary firm.

Benchmarking usually involves the following stages:

- planning, including: determining objects of research (products, processes, functions, tasks), which are to be improved; determining the company's success factors, determining the bottlenecks – problem areas, choosing the company exemplary for the particular branch, function, products;
- analysis, including: collecting information about the exemplary firm, determining the reasons for its competitive advantage, identifying the differences between the solutions applied in the exemplary firm and the examined one;
- conclusions, including: identifying and choosing the desired level of operating indicators of the researched company, considering the actual possibilities to use particular methods and solutions, determining the possibilities of transferring the exemplary solutions to the researched company;
- implementation, including: setting targets for the proposed improvements, preparation of procedures for implementation, their introduction and control.

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<sup>4</sup> See more in: T. Bendell, L. Boulter, *Benchmarking*, Wydawnictwo Profesjonalnej Szkoły Biznesu, Cracow 2000.

If benchmarking is conducted systematically, i.e. if after the last stage the process returns to stage 1, then the process of continuous improvement of the company has been initiated. It has to be emphasised, permanent improvement has, for many companies, become an element of competitive capacity and survival on the market.

**Responsibility centres** are treated as particular tools of strategic controlling, since they enforce long-term organisational changes within companies, and facilitate consolidation of management from the point of view of economic and financial indicators. A responsibility centre can be a branch, a department or another organisational unit within the company structure, responsible for specified administrative activity within the organisation. In other words, it is every unit within an organisation, which executes control over cost generation or creation of incomes<sup>5</sup>.

The benefits from introduction of responsibility centres in companies can be summarised as the following advantages: creation of an improved system of information, stronger motivation to generate profits among the employees, managerial attitudes oriented towards profit-generating activity, better awareness of sources of costs, faster reaction to occurring weaknesses of the company, more motivation to achieve profit, faster decision-making, shorter circulation of information, profit-based system of remuneration, clearer evidence of effectiveness.

The creation of responsibility centres within a firm is the first, and the basic step in creating a system of planning and control based on controlling. In practice, it is very difficult to separate individual responsibility centres<sup>6</sup>. Nevertheless, it is important to aim at an efficient system of planning and control. It is worth remembering, too, that separating responsibility centres contributes to delegating prerogatives to line managers, and therefore to de-centralisation of management. In a de-centralised organisation, managers possess wide autonomy in their decision taking within their area of responsibility. The broader the autonomy of particular responsibility centres, the more they resemble separate and autonomous institutions within the company.

#### 4. Operating Controlling Tools Used in Corporate Management

Implementation of controlling functions and tasks is possible thank to the use of a wide collection of tools. It is worth mentioning that most of the tools used

<sup>5</sup> Zarządzanie przedsiębiorstwem, ed. M. Strużycki, Difin, Warsaw 2004, p. 435.

<sup>6</sup> There are four basic types of responsibility centres. Those are: *cost centres* – managers are responsible solely for costs; *profit centres* – managers are responsible for both costs and revenues; *investment centres* – the management is responsible for costs, revenues and resources; *revenue centres* – managers are responsible only for revenues.

within a system of controlling were not created purposefully for it, but were a result of individual modifications of existing tools. The tools used in operating controlling are not new, but they are interconnected in a new way, and new is the organisational centralisation.

**The system of economic indicators** is used in controlling as an important instrument illustrating a company's situation. The results of using this tool can be useful in the process of planning, control, and day-to-day guidance. The basic group of indicators includes the financial indicators. Basically, they can be divided into four categories relating to the condition of a company in the areas of: financial liquidity, debt, economic activity and profitability<sup>7</sup>. The quoted groups of indicators are highly aggregated. They serve mainly for global evaluation of operation and the condition of the company as a whole. Obviously, the presented groups of indicators do not represent all the possible approaches. The system of indicators may, and should be modified and adjusted to conditions and particular characteristics of each company. Nevertheless, certain general rules connected with designing and re-designing of the system ought to be remembered:

- the number of indicators ought not be too high, since it adversely affects the clarity of the situation,
- the informative contents must fit the needs of the user (determined mainly by his or her position within the organisational structure and the role they play),
- the indicators should not be perceived individually, their inter-relation is important, and so is granting their groups a truly systemic character.

A significant increase of competition on one hand, and a rapid increase of the share of fixed costs, resulted in the creation and development of the system of **marginal costing**. The system of marginal costing has a special feature – an in-built relation between variable costs, volume of sales and gross margin. By dividing costs into the variable and the fixed element, and comparing revenues with costs on two levels, i.e. revenues minus variable costs – in order to calculate the surplus in the shape of the gross margin, from which after covering fixed costs (i.e. on the second level) the second level of the result is calculated: the operating profit. Therefore, the system of marginal costing provides information necessary for breakeven analysis. Also, it provides data for optimising the programme of sales, feasibility studies for individual products, etc. It constitutes a starting point for development of multi-level systems of costs and profitability accounting. The benefits from using the system of marginal costing can be presented as follows:

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<sup>7</sup> Z. Leszczyński, A. Skowronek-Mielczarek, *Analiza ekonomiczno-finansowa spółki*, PWE, Warsaw 2004, p. 125.



- it facilitates assessment of profitability of products or product lines since it is not distorted by conventional grouping and clearing of indirect costs,
- it facilitates application of the breakeven analysis,
- it facilitates price setting and diversifying its level depending on the market conditions,
- it helps in assessment of future cash-flows, which is useful for establishing the point of liquidity, and facilitates a number of operational decisions,
- it is useful in conditions where the resources are limited, because the gross margin of the key resource is known at the point of sales programming,
- the generated information is significant for short-term decision making.

On the other hand, the system is not without its flaws. Its disadvantages include:

- separating too large groups of fixed costs,
- difficulties in categorising costs into fixed and variable,
- the necessity to apply a dual cost and profitability accounting, or several calculations in order to fulfil the standards of financial reporting.

In the situation of growing fixed costs, the earlier, traditional types of margin costing have been criticised. This criticism stemmed into multi-level profit-and-loss accounts<sup>8</sup>.

**The short-term profit and loss account** is seen as a powerful guidance instrument used both by company management, and by the controller. A short-term profit-and-loss account constitutes a tool for determining and analysis of company's profits and losses along with the elements they consist of. In this way, it provides a basis for the proper course of the decision-making process. The obtained information allows for easy recognition of company's strong and weak points, and consequently for prompt undertaking of remedial measures in order to alleviate the problems found, and to improve the company's profitability. A short-term profit-and-loss account can be prepared in accordance with the total cost method or with the turnover cost estimation method (the cost of distribution). At the same time, the account can be run on the basis of full costs or variable costs. However, to use all the benefits connected with the concept of controlling, the preparation of a short-term profit-and-loss account is proposed to involve the method of turnover cost estimation (this helps to direct the analysis towards the market, since the account presents all the income from sales during a particular period of time against the costs of distribution). Furthermore, in order to realise the results, it is important and recommendable to base the analysis on the variable costs account.

<sup>8</sup> Rachunkowość zarządcza, ed. G. Świdorska, Poltext, Warsaw 1999, p. 74.

An important way of decision coordinating in a company is the preparation of detailed action plans for the future (years, months), expressed in quantitative and value terms, which are known as **budgets**. A budget is a quantitative expression of a plan of action, used for implementation and co-ordination of plans. The experiences of companies operating in the countries of a developed market economy indicate, that budgeting is particularly useful in managing and control over large and medium companies. Budgeting is an integral element of controlling. Budgeting guidance is a basic way of influencing costs within companies, and their optimisation. Budgeting may provide several measurable and qualitative benefits to the company, which uses it. Those benefits are connected to particular functions of budgeting, which include:

- 1) facilitating quantification of descriptive plans and goals,
- 2) mobilisation for periodic planning,
- 3) providing basis for control and monitoring of achievements,
- 4) reinforcing coordination, co-operation and communication,
- 5) providing data for the design of motivation systems within the company,
- 6) raising awareness, particularly concerning the operating costs,
- 7) fulfilment of legal requirements and obligations resulting from contracts<sup>9</sup>.

Budgeting as a process can be divided into three stages:

- preparation of a budget,
- its introduction
- and budgeting guidance.

The preparatory stage of budgeting begins with determining objectives of a particular unit. It involves defining objectives by applying accounting and finance measurements for measuring the desired financial results, i.e. profit per share, rate of profit, value of sales, rate of profitability of sales etc. Those quantities constitute quantitative criteria, with which future actual values (determined within the accounting system) will be compared. Therefore, budgets constitute standards, against which the actual values are compared, and variations from which are calculated. Such comparison and calculation of variations are conducted during the third stage of budgeting, i.e. the budgeting guidance, as an internal report on budget implementation.

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<sup>9</sup> Komorowski J., Budżetowanie jako metoda zarządzania przedsiębiorstwem, PWN, Warsaw 1999, p. 25.

## 5. Conditions Connected with Introduction of Controlling into Corporate Management

Introduction of controlling solutions in a company, and their mutual connection in order to create a consistent system, is a very time-consuming process, requiring a serious input of energy and resources. The basic difficulty faced by introductory teams, is the complexity of actions, which need to be taken in order to spread the controlling network over all the areas within the company.

The commencement of implementation works requires fulfilling many conditions concerning the following areas:

- introduction of organisational and structural changes,
- introduction of the style of management complying with new principles,
- assumption of new solutions regarding cost account,
- transformation of the system of planning and control,
- construction of an internal system of information and reporting,
- re-construction of the motivation system,
- modification of company's organisational culture (behaviour, systems of values, and staff awareness).

The fundamental condition is winning the managers' approval and support for the idea of controlling. It is necessary not only when the decision to commence the introductory procedure is taken, but during the implementation of subsequent stages and the day-to-day operation.

**The organisational and structural transformation** in a company ought to commence with targeting the weak points of the organisational structure and principles of organisation, the identification of which is the objective of the initial organisational analysis. The principal objective of such analysis is the clear demarcation of responsibility of individual organisational units and employees, as well as determining the principles of co-operation, which will ensure mutual exchange of information and consultations on the subjects concerning more than one department.

The sense of controlling as an instrument of management requires, that the **style of management** complies with the requirements of the market. As much as in a seller's market authoritarian style would be in place, in a buyer's market it has to rely on initiative and authentic participation of lower rank managers and professionally active employees. Another form of delegation of prerogatives contributing to taking the strain off the management is the introduction of team systems of management.

If a system of controlling is to operate efficiently, it must rely on appropriately processed data. Since the economic and financial results occupy a central position

in controlling, the form of presenting and analysing all data connected with costs, receipts, income and expenses, profits and losses, becomes particularly important. Such attitude facilitating obtaining reliable information is provided by management accounting. Introduction of controlling system requires, among others, the assumption of **solutions concerning the cost and productivity account** originating from the standards of management accounting.

The coordinative function of controlling involves, among others, **designing and implementation of the system of planning and control**. The operation concentrates on identifying individual sub-systems of the system of planning and control, and establishing the type and character of connections within and between those sub-systems.

Construction of the **system of information and reporting** ought to ensure the inflow of information with such frequency, and in such moments, that they can be used in the decision-making. The effectiveness of operation depends on this system to a great extent, since it ensures access to the appropriate source data, facilitates day-to-day communication and provides permanent information about the company's condition. Furthermore, it is worth remembering that satisfactory results in the field of promptness and efficiency of data collecting and processing, as well as passing reports, is to a great extent conditioned by applying the right techniques of data processing. The controlling solutions require the use of integrated computer systems of recording and reporting and a network electronic mail.

Furthermore, it is necessary to **modify the existing system of motivation**. The introduction of controlling methods and tools in itself does not guarantee the efficient operation of the entire system. It is necessary to simultaneously influence the staff to mobilise and activate them as much as possible within the framework of the assumed solutions. It is necessary to harmonise individual objectives of managers with the goals of the company as a whole, via an adequate system of remuneration.

**The re-construction of elements of organisational culture** leads to changes in behaviour of employees, which ought to be consistent with the form of management unique for the particular company. Introduction of a controlling system requires not only appointing the adequate structures and procedures of operation, but also the simultaneous modification of behaviour of individual employees, their systems of values, convictions, attitudes and the character of their mutual relations. Modification of the organisational culture is a particularly difficult and painstaking phenomenon. In order to adjust it to the new reality of controlling, apart from the described above motivation systems, it is important to provide training and information explaining the principles and character of the theoretical concept of controlling in relation to the practice.

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## Franchising Networks – Origins and Development

### 1. Introduction

The essence of franchising is an unique successful idea, and the concept of granting paid access to the entire know-how constituting the uniqueness of a certain product or service, formalised as a number of rules and procedures, the success of which has been confirmed by economic practice of a vast majority of businesses that adopted it.

Franchising is a dynamically developing form of economic co-operation. There are over 17,5 thousand systems operating worldwide, and they involve almost 2 million receivers<sup>1</sup>. For years, franchising has been considered one of the best methods of winning new markets, and expanding business both globally and locally.

Popularity of franchising grows in Poland, as it does worldwide, to the extent, that the situation is often described as franchising network “boom”. In countries where franchising has strong position, such as the USA and the West European countries, a stable increase of share of franchising companies in the business population can be observed.

In Poland, franchising keeps winning new grounds, which is evident both from the point of view of the number of franchising networks (or franchisers), and of franchisees. At the moment there are 210 franchising systems operating in Poland. In 2004 the highest ever growth of the franchising market took place, 39 new networks were created<sup>2</sup> (compared to 26 in 2002 and 27 in 2003). There were more systems created in retail (23), than in services (16). In 2004, the number of franchisees increased by 14,4%. At the moment there are over 13,6 thousand outlets operating as franchising receivers.

Since franchising becomes an increasingly popular form of economic operation, it is important to learn about its origins and history of its development.

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<sup>1</sup> Data by International Franchise Association, [www.franchise.org](http://www.franchise.org)

<sup>2</sup> Raport o franchisingu w Polsce 2004/2005, Profit System Sp. z o.o., Warsaw 2004.

## 2. Origins of Franchising

Franchising as a method of economic co-operation originates from the United States of America, while the concept comes from the French Romanesque culture.

Three main stages of development can be distinguished in the history of franchising. The first one is the feudal period, when the first symptoms of economic co-operation similar to franchising could be observed. The second stage, lasting from the second half of the nineteenth century until the early 1950s, was a period of gradual formation of franchising networks. The last period, which commenced in the 1950s and has been lasting until the present, has been a time of dynamic development of franchising systems.

### 2.1. Archetypal Forms of Franchising

Early forms of franchising resulted from the feudal structure of West European societies in the tenth to thirteenth centuries. The meaning of the term “franchising” indicates its feudal origins. In medieval French the word “franc” meant “free”, and the verb “franchir” (or “affranchir” in modern version) – “to free”. Initially, “la franchise” meant exemption from different public contributions: tributes, taxes and duties. It constituted one of the main foundations of feudalism, and in time assumed a broader meaning. In feudal times, the term meant a privilege or a particular right granted by the sovereign to his individual subjects – merchants or craftsmen – to perform a particular trade or service, after paying a certain charge<sup>3</sup>. One of such privileges concerned organising markets and fairs.

Researching the etymology further, one can find the term “franc-archer”, signifying a member of the archer society (founded by Charles VII), who was exempted from taxes due to his military merits to the kingdom.

The feudal system was in some ways similar to the modern-day franchising. As early as in the eighth century, in the Frank Monarchy, a liegeman had an agreement with his lord, which obliged him to full obedience and loyalty towards the liege. In practice, this meant fighting in the lord’s name and under his flag, as well as wearing the master’s colours and code of arms. A liegeman could choose from two forms of gratification: a fixed pay along with keep (living costs of the liegeman and maintaining his arms), or land (from which rent was to be paid), in which case the liegeman had to look after himself. And so, the lord

<sup>3</sup> See: P. Hall, R. Dixon, *Franchising*, Pitman Publishing, Great Britain, 1988; B. Fusch, *Umowy franchisingowe*, Kantor Wydawniczy Zakamycze, Warsaw 1998; B. Pokorska, *Franchising w Polsce: stan i kierunki rozwoju*, IRWiK, Warsaw 2000.

could pay the liegeman a fixed amount of money, or he could let his vassal be the master of his own fate, with certain limitations specified in the agreement<sup>4</sup>.

Franchising was formally applied for the first time by the church and secular rulers of France in the twelfth century, as the so-called “charters de franchise”, which meant the right to use forest land in turn for providing services or a certain sum of money<sup>5</sup>.

Another example can be the Guilds, which functioned in London in the eleventh century, and introduced principles of acquiring membership similar to modern-day franchising. The membership could be acquired after completion of training, and gave the right to independent economic operation in London. Members of the Guilds enjoyed prestige and reputation connected with membership, in turn for which they had to pay fees. There are elements of franchising in this archaic structure. Firstly, members acquired the right to operate under the Guild’s name, and to apply the methods of operation made available to them by way of training, in turn for which they were obliged to pay fees<sup>6</sup>.

Forms similar to modern-day franchising appeared in the fifteenth-century Spain as well. Queen Isabella granted a “franchise” to Christopher Columbus in 1492, to develop trade, and travel to the “New World”<sup>7</sup>.

According to B. Pokorska<sup>8</sup>, the first contracts, which could constitute a prototype for modern franchising agreements, were signed in the 15–16<sup>th</sup> century between church dignitaries and the king. They included elements of modern-day franchising, and could be responsible for introducing the term “franchising” for this type of economic co-operation. The agreements provided, that landowners and church dignitaries were to pay the king a certain amount of money and were obliged to support him in turn for the right (the so-called “franchiso”) to collect taxes and administer justice in their land. This early form of franchising lasted until 1562, i.e. until verification and reform of the prevailing taxation procedures. In British legal literature, we can still find the name of courts operating in this area – franchise courts<sup>9</sup>.

The next stage of this phase of development of franchising in the 18<sup>th</sup> century Britain took shape of agreements, which significantly influenced the formation of modern-day franchising. They are called tied house contracts (functioning to this day), and provide, that the king, or another governing body,

<sup>4</sup> S. Price, *The Franchising Paradox*, Cassell, London 1997, pp. 63–65.

<sup>5</sup> *Ibidem*.

<sup>6</sup> A. Krawczyk, *Franchising w Wielkiej Brytanii*, “Franchising”, No. 1/3, Warsaw, February 2000, p. 16.  
<sup>7</sup> Data from College of Business Administration, Louisiana State University, [www.bus.lsu.edu](http://www.bus.lsu.edu)

<sup>8</sup> B. Pokorska, *Franchising...*, *op. cit.*, p. 8.

<sup>9</sup> R. Justis, R. Judd, *Master Franchising: A new look*, *Journal of Small Business Management*, July 1986, pp. 16–21.



grants a long-term monopoly in a certain discipline of trade or industry, in return for specified fees and services. The development of those contracts was sparked off by the introduction of regulations concerning sales of alcohol, which required concessions to sell alcoholic beverages in public houses. The number of concessions was limited, which meant, that outlets possessing them became far more valuable. Several potential purchasers lost a chance to run a business. Producers of alcohol, and particularly brewers, took advantage of the situation, and begun to buy-out public houses with concessions, in order to let them afterwards. Later, tied house contracts were signed between breweries and pubs, providing, that the latter were obliged to sell alcohol produced by the former. Independent pub and restaurant owners were offered modernisation of their outlets in turn for obligation to sell solely the alcohol produced by a particular producer<sup>10</sup>.

Similar solutions were applied in what is now modern-day Germany, in the 1840s. A brewer granted certain outlets exclusive right to sell their beer. At the same period in France terms appeared, such as “franchise douaniere” (customs duty exemption), “franchise d’impot” (tax exemption), “franchise de poste” (postal exemption), or “franchise diplomatique” (exemption from diplomatic service)<sup>11</sup>.

## 2.2. The Development of the Concept of Franchising from the 1850s Until the 1950s

Modern franchising originated in the 19<sup>th</sup> century, and its beginnings can be traced back to the American territory before the foundation of the United States. The term “franchise” described a state concession given to people to colonise the land, in turn for their subsequent right to use state property. One example of such solutions, known as “public utility franchise”, is the American **Railway Company**, which had the exclusive right to build railways, stations and rolling stock infrastructure. The company then re-sold its rights to other, independent companies, which contributed to a faster development of railway across the country. Authorities of individual towns in the 1880s begun to grant exclusivity over a certain territory to companies providing water, gas, and – later – electricity<sup>12</sup>.

The pioneers of modern franchising are such companies as: Singer, General Motors, Coca-Cola, Pepsi Co or Rexall. Development of franchising took place at the turn of the 19<sup>th</sup> and the 20<sup>th</sup> century, when companies felt the need to develop their distribution channels, but did not have sufficient funds to build

<sup>10</sup> P. Hal, R. Dixon, *Franchising*, Pitman Publishing, Great Britain, 1988, p. 4.

<sup>11</sup> B. Pokorska, *Franchising...*, *op. cit.*, p. 8.

<sup>12</sup> See: B. Pokorska, *Leksykon franczyzy*, Difin, Warsaw 2002, p. 38; M. Dudzik, *Franchising*, Centrum Kreowania Liderów, Międzybórz 1992, p. 5.

a network of distribution. The solution was to offer franchising agreements to individual entrepreneurs possessing appropriate capital. In return for co-financing development of channels of distribution, those entrepreneurs were granted sole distribution rights at their particular territory<sup>13</sup>.

In 1855, the first of franchisers, **Singer Sewing Machine Company**, introduced a concept of distribution of goods based on territorial expansion, and soon after the civil war created the first network of independent distributors selling sewing machines produced by Singer. The sewing machine industry had only just begun its development. Singer did not possess sufficient capital to build an effective dealer and servicing network, so they signed sole distribution contracts with independent representatives, controlled their retail prices and supported their credit applications, as well as organised joint, uniform advertising campaigns. Distributors demonstrated, sold, and serviced sewing machines. Although in the 1860s Singer changed their development strategy and commenced sales only through their own outlets, their initial dealer network became the archetype of franchising.

At the beginning of the 20<sup>th</sup> century, franchising became a common technique. Once again, dynamically developing companies felt the need to broaden their channels of distribution, but did not possess sufficient capital. Selling “franchise” to individual entrepreneurs with capital to finance the operation was the right solution. In return for financing the development of the channels of distribution, they gained sole distribution rights over their particular territory. Producers of cars, and later of other goods as well, appreciated the advantages of franchising over own distribution networks. Those advantages included smaller financial input into network construction – most expenses were carried out by distributors; no fluctuations of retail prices – wholesale prices were more stable than retail ones; transferring costs of complaints and repairs to dealers<sup>14</sup>. In 1898, the first company to employ the franchising method of distribution in car sales was Olds Motor Vehicle Company, the oldest division of the created in 1908 General Motors Corporation. Franchising agreements between car producers and distributors can be regarded an example of modern brand franchising.

The form of car distribution based on franchising included a territorial sole distribution clause, which allowed producers to ensure dealers, that they would be protected from competition from other distributors, and to guarantee high sales. In return, producers required their brand to be the only one distributed by dealers. Distributors were obliged to invest in their outlets, stock of vehicles,

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<sup>13</sup> G. Kotlarski, *Franchising*, Cim, Warsaw 1992, p. 10.

<sup>14</sup> P. Hall, R. Dixon, *op. cit.*, p. 5.

infrastructure necessary to provide post-sale service, and ensure service standards required by the producer. The concept of dealer networks fully developed by 1910. At the moment, it is estimated, that 95% of new passenger vehicles are sold via franchising outlets<sup>15</sup>.

Oil industry was another area important for development of modern franchising. In the early 1930s in the United States, during the so-called oil price “wars”, independent fuel stations proved their advantage over outlets belonging to fuel producers. They were more flexible as far as setting prices at levels competitive at local markets was concerned. Producer’s stations had the disadvantage of central management, which did not allow for regulating prices in individual regions of the country. This contributed to falling feasibility of producer’s own fuel stations, and to the producers’ decision to apply franchising in distribution of their products nationwide. Franchising allowed for flexible pricing policy considering local competitive conditions, helped avoid price fluctuations while maintaining consistent look of fuel stations. In this case, too, franchising proved to be the best solution, contributing to rising sales and profits<sup>16</sup>. In 1930, the first company to resort to franchising was **Standard Oil of Indiana**. They had their stations managed by paid managers, which significantly reduced costs, and allowed for flexible adjustment to the market’s requirements.

Another branch contributing to popularisation of franchising as a form of economic co-operation was the soft-drink industry. Large volume of products, and the resulting feasibility problems with transporting products to large distances, as well as a limited area where returnable bottles could be used, constituted a barrier for territorial development of networks. The best way to overcome territorial barriers was development of a network of bottling plants. The producer – franchiser – was responsible for delivery of concentrate to bottling plants, where it was subsequently diluted and bottled. Franchisees, i.e. bottling plants, sold drinks under the producer’s name and brand. Such solution was favourable to soft drink producers, since most operating costs were borne by owners of bottling plants. The pioneer in this area was a pharmacist, John S. Pemberton. Heavily wounded in the civil war, during his treatment became addicted to morphine and cocaine. In 1886, in his laboratory in Atlanta he designed a recipe for a soothing mixture based on coca leaves and cola nuts. He later sold it as a refreshing drink from a saturator. Pemberton’s partner came up with a name, and created a logo, which today is one of the most recognisable in the world. The recipe, without the narcotic ingredient, is a carefully protected secret, known

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<sup>15</sup> *Ibidem*.

<sup>16</sup> *Ibidem*, p. 6.

only to a few chosen employees of the company. Its formula is deposited in a safe in Sun Trust Company in Atlanta. In 1899, the drink's inventor started to grant bottling plants concessions for distribution. In the same year, the first franchising distribution chain for Coca-Cola soft drinks was created, which was soon followed by a similar network created in 1905 by Pepsi Co. Until this day, the world's largest soft drink producers have distributed their products in the same way.

In the early 1920s, first retail outlets based on franchising co-operation were created. Those were the outdoor stands selling chilled A&W root ale. In 1919, an entrepreneur Roy Allen bought from a pharmacist a formula for production of root ale, and in 1922, together with his partner Frank Wright formally named their product **A&W Root Beer**. The drink became very popular, so its producers began to sign franchising agreements with partners, to whom they sold concentrate of the beverage. In 1933, there were already 170 outlets selling it in the West of the United States. Along with the development of the automobile era, the network became a prototype for fast-food restaurants, and drive-in systems.

Every year there were new franchising systems appearing in the United States. One of those was the **Rexall** chemist network. Lewis Liggett considered to be one of the pioneers of modern franchising, begun to develop it in 1902.

The development of franchising systems in those days was facilitated not only by the economic factors, but also by legal reasons. The United States introduced anti-monopoly regulations, which contributed to flourishing of the franchising form of organisation of channels of distribution<sup>17</sup>.

During the same period, franchising chains began to develop at the European continent. One of them was **Bata**, a Czech firm founded in 1894 by Tomas Bata, who created an international franchising network of production and sale of footwear<sup>18</sup>. In 1917, first shops operating with a franchising licence were opened, mainly in Italy.

Philippe Bourguignon can be considered a pioneer of modern franchising in France. He created the first franchising network of distribution for the spinning-mill belonging to Jean Prevoust. The network was based on the principle of territorial sole distribution<sup>19</sup>.

Dynamic development of franchising networks was halted by the economic crisis of the early 1930s, and by the outbreak of World War II.

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<sup>17</sup> Handel na świecie, edited by C. Kalińska, Zakład Wydawnictw Naukowych, IHWiU, Warsaw 1979, p. 20.

<sup>18</sup> *Ibidem*, p. 20.

<sup>19</sup> B. Pokorska, Franchising..., *op. cit.*, p. 11.

The quoted forms of using franchising to finance and develop channels of distribution, and at the same time to expand territorially, became known as franchising of the first generation – the traditional one.

### 2.3. Franchising Boom After World War II

After the Second World War in the United States of America, a certain boom of operation based on franchising of the second generation – “business format franchising” – took place. The form was initiated in the 1950’s, and lasts to this day. Instead of merely granting rights to distribute products, franchisers began to sell rights to implement an entire concept of running a business – from a logo, through standardisation of visual design of outlets, standard of service, right down to a method of accounting. Franchising networks started to expand to subsequent branches of the economy: electronics, retail, or fast food restaurants. It happened thank to the easiness of creating and operating franchising networks, and to the prevailing economic and organisational conditions. On one hand, producers of goods and services embraced franchising as a way to expand nationwide, on the other, small businesses with limited capital gained an opportunity to run their companies under the name and brand well known all over the country.

The most dynamic development of franchising networks took place in the fast-food restaurant business. Its pioneer was the Dairy Queen chain. In 1944, Harry Axene discovered an ice-cream outlet in the United States, where father and son McCullough created a unique formula by using a new technology of ice-cream production – the freezing machine allowed for achieving a homogenous mass instead of frozen chunks. The new ice-cream formula was christened “Diary Queen”. The ice-cream producers, along with Harry Axene, employed the unique formula for ice-cream production, and a modern concept of distributing it. Together, they found 26 potential investors, who purchased the licence for sole distribution for an initial fee, plus the cost of ingredients for ice-cream production they would buy<sup>20</sup>.

Another well-known, and still existing fast-food network, founded in 1952 by Pete Harmon – an owner of a fast-food restaurant in Salt lake City, and Harlan Sanders – an owner of a motel and a restaurant in Corlin, is **Kentucky Fried Chicken**, developed thank to application of franchising methods to organisational structures. Harmon looked for a new recipe to diversify the menu, and by accident, during a dinner at his friend’s in Corlin (Kentucky), he discovered a unique formula for roasted chicken coated in a mixture of 11 herbs and spices. Harmon and Sanders

<sup>20</sup> See: [www.dairyqueen.com](http://www.dairyqueen.com), and [www.entrepreneur.com](http://www.entrepreneur.com)

introduced the recipe to the menu of their restaurants, and displayed a Kentucky Fried Chicken sign. The restaurants soon built a regular clientele. Then, the recipe was introduced to the national market, by selling the licence to restaurant owners and collecting the fee of 5 cents for every chicken sold<sup>21</sup>.

Of all the fast-food chains of the era, the network created by the McDonald brothers and Ray Kroc is probably the most prominent. The success of expansion of McDonald's fast food restaurants, initially in the US, and later worldwide, can be contributed to sub-franchising.

Ray Kroc, a Multimixer salesman selling multi-function food processors, noticed, that in San Bernardino (California) brothers Dick and Maurice McDonald, who run a hamburger bar, had bought a tenth food processor, while other restaurants owned no more than two. He soon found, that the sources of the McDonald's success were: fast service, efficiency, and cleanliness. Kroc reckoned, that the McDonald's success depended on each individual franchisee. Therefore, he designed a complete operation scheme for the new chain of fast-food restaurants. He created a whole new concept. Traditional franchisers, while selling rights to use their ideas, did not provide a package, which they could offer to the receivers in a standardised form. They were orientated mostly towards quick profit from selling their concept, and not towards long-term success connected with a necessity to continuously invest and supervise. This meant high initial payments, and many businesses resorted to sub-franchising, as a way to recover the invested money. In many cases, sole distribution rights were granted over very large areas, often the size of entire states. Such solution brought franchisers large, although one-time profits, but they subsequently lost control over their network, which often led to loss of reputation of the system.

Kroc's idea was to build a network outstanding in its homogeneity, and quality of its products and services. He came to a conclusion, that the only way to maintain control over the network was to grant franchising licences to open a single restaurant. A franchisee received sole distribution free of charge, but had to comply with specific standards in order to receive a licence to open subsequent restaurants at their territory. If the franchisee did not fulfil the agreement, and quality of service did not comply with the standards required by the franchiser, the franchisee did not obtain permission to develop. As soon as the contract expired, the restaurant returned to its parent company. The actions of Kroc led to dynamic growth of the network, keeping up of its standards, and strengthening of its brand.

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<sup>21</sup> E. Banachowicz, J. Nowak, M. Starkowski, *Franchising czyli klucz do przyszłości*, Businessman Book, Warsaw 1994, pp. 9–11.

In 1955, Ray Kroc convinced the owners, who owned two restaurants, that he could develop their operation nationwide, and signed a sub-franchising contract with them. The contract provided, that all restaurants would look the same, and would provide services of identical standard. In the same year, the system was inaugurated, and the first showroom McDonald's restaurant was opened in Des Plaines, at the outskirts of Chicago (Illinois). The restaurant is now a museum of the chain. The principles of McDonald's system are: continuous supervision and support for franchisees, and permanent advertising. Kroc organised subsequent outlets, each of which brought \$ 950 of initial fee, and almost 2% of total income, of which 0,5% went to Kroc, and the rest to the McDonald brothers. 164 McDonald's restaurants were opened by 1959. Further expansion of the chain has been taking place up to the present day; in 1969 there were a thousand, in 1980 – 5 thousand, and in 2000 – 20 thousand franchising units<sup>22</sup>.

Until the McDonald's concept, franchisers did not offer a complete franchising package to their franchisees. They were orientated mainly towards fast profits without a necessity to invest. They did not maintain sufficient supervision over franchising outlets, and franchisees took advantage of the situation, removing the name of their parent company and substituting it with their own, in order to save money on payments to franchisers. They often benefited seriously from getting released from the network, because many of franchisers in those days counted on fast profit, and did not provide franchisees with appropriate support<sup>23</sup>.

The scientists studying franchising networks<sup>24</sup> emphasise, that the source of McDonald's success is the uniform quality standard, concerning both the product, and the service. When the first restaurants were being created, the only way to maintain control over quality was to grant franchisees the right to run only one restaurant. In time, as they achieved good results and fulfilled the rigorous standards, they were allowed to open subsequent restaurants. This was the only way to motivate franchisees to obey the rules imposed by the franchiser.

When studying the origins of franchising, one cannot miss one more of its kinds, which appeared in the 1970s. Its essence was, that the already existing independent outlets, or small chains, joined a franchiser's network by adapting its concept of operating a business. The pioneer of this solution was Anthony Ynigues, who used the above method to develop his real estate system **Red Carpet Realty**. He offered other agencies operation under joint name, and with a centralised advertising fund. This type of franchising proved effective with

<sup>22</sup> See: G. Kotlarski, *Franchising...*, *op. cit.*, p. 13.

<sup>23</sup> E. Banachowicz etc., *Franchising...*, *op. cit.*, p. 14.

<sup>24</sup> B. Pokorska, *Franchising...*, *op. cit.*, p. 10.

regard to real-estate agencies, and building companies, mainly due to minimum interference with the way individual outlets looked and operated<sup>25</sup>.

The new attitude towards franchising appeared after the Second World War. Franchisers seized to treat their systems merely as one of the channels of distribution for their products (**product distribution franchising**), and created complete business running schemes (**business format franchising**), which included elements from logo, through standardisation of outlet décor and outfits for personnel, to detailed technological procedures, sales techniques and promotion. This, currently dominant, form of franchising contributed to the creation of the most famous global franchising systems, such as Kentucky Fried Chicken, Pizza Hut, Holiday Inn, InterContinental.

The idea of franchising begun to expand to other continents, most dynamically in countries of a strong market economy. Its advantages soon begun to be put to the test in Western Europe, both by American networks, which started to create franchising units, and by local entrepreneurs. Franchising networks caught on best in such countries as the United Kingdom, Italy, Germany, Denmark and the Netherlands.

The first modern franchising system in Britain was **Wimpy** – one of the world’s largest gastronomic systems selling hamburgers. The inspiration for its name came from J. Wellington Wimpy, a character from E.C. Segar’s Popeye cartoon. It all begun with Eddie Gold, who in the 1930s Chicago operated 12 restaurants under the name “Wimpy”. In 1954, the ownership of the Wimpy chain was purchased by J. Lyons Co. from Great Britain, which was a hotel and restaurant potentate interested in developing fast food bars in the United Kingdom, and hence purchased the brand licence. The first Wimpy bar was opened in London in 1954. The concept was widely appreciated, and very popular with consumers. Initially it successfully coped with competition from the potentate in its field – McDonald’s. In the early 1970s, there were 1000 restaurants operating in 23 countries around the world, of which almost a half in Great Britain. In 1977 the chain and brand were purchased by United Biscuits, some of the restaurants were closed down, other were transformed into self-service outlets capable of coping with competition from McDonald’s, which begun its expansion in Britain in 1974. The Wimpy network changed several owners, and in 2002 was subject to the last management buy-out, but still remains the largest independent franchising network of restaurants in the UK, with 300 outlets<sup>26</sup>.

<sup>25</sup> G. Kotlarski, Franchising, Ministerstwo Przemysłu i Handlu Departament Promocji Przedsiębiorczości, Centrum Informacji Menedżera, Warsaw 1992, pp. 5–11.

<sup>26</sup> See: [www.kzwp.com](http://www.kzwp.com), [www.wimpyburgers.co.uk](http://www.wimpyburgers.co.uk)



Of all the Asian countries, where franchising develops as well, it is most dynamic in Japan.

The dynamic development of franchising in the 1950's and 1960's in the United States and in other countries, was influenced by several different factors, such as:

- increasing competition between dealers and producers, which forced businesses to defend their market position,
- the economic recession of 1957–1958,
- aiming at increased control over the market,
- sales based on commission initiated by certain companies,
- dynamic urbanisation of the society,
- growing participation of women in the job market,
- development of the youth culture,
- poorly developed traditional cuisine,
- advancing speed of lifestyle,
- increasing proportion of car owners (hence the development of drive-in and drive-through restaurants),
- development of inter-state highways<sup>27</sup>.

The above factors illustrate the economic and social processes taking place in the developing capitalism of the countries of Western Europe and the United States, which largely contributed to the development of franchising that at the time constituted an effective way of business expansion, since competition from other franchising chains was still low.

In the post-war times, gastronomy developed so dynamically, that in the years 1960–1969 over 60% of outlets serving sandwiches operated within franchising systems.

This form of economic co-operation was slowed-down in the 1970's, due to the economic recession connected with the OPEC rising fuel prices. Nevertheless, in the consecutive years, franchising regained its dynamics.

The next stage of development of franchising networks was facilitated by processes of concentration and integration of channels of distribution. Growing supply of consumer goods and number of supermarkets forced small businesses to concentrate around stronger market players, by joining franchising systems.

The following years further enhanced the dynamic development of franchising worldwide. Lifestyles changed, which was expressed by growing numbers of working women, and increasing significance of the time spent outside

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<sup>27</sup> S. Price, *The franchising...*, *op. cit.*, p. 56.

the home. This meant growing interest in such services as fast food restaurants, car services, cleaners, and hairdressers<sup>28</sup>.

An important part in the development of franchising was played by the new social attitude towards self-employment and opening own businesses, particularly apparent in highly developed countries.

### 3. Beginnings of Franchising in Poland

In the times before 1989, there were a few systems in Poland operating according to the described method of economic activity, nevertheless the term “franchising” was not used. International hotel networks, such as **InterContinental** and **Novotel** operated in this way, after some of Orbis hotels joined foreign systems based on franchising in the 1970s. In the same period, there were other systems similar to franchising networks, such as agency contracts binding operators of **Hortex** ice-cream bars and cafés.

Three stages can be identified in the development of franchising in Poland after 1989<sup>29</sup>. The first of those was connected with foreign investors entering the Polish market, first Polish franchising systems being organised, and positive attitudes of the Polish society towards entrepreneurship. Thank to the social and economic changes after 1989, franchising networks appeared on a broader scale, when foreign concerns chose franchising as their method to enter the market and develop. The first shop operating on the principles of franchising opened in Poland in 1990. It belonged to a French cosmetics network – **Yves Rocher**, which opened on Warsaw’s Chmielna Street, and has been successfully operating ever since. The next year global systems **McDonalds** and **Adidas** opened their franchising outlets.

In Poland, foreign capital found a large market, unsaturated with goods, and market niches ready to be taken over. Polish firms, and private entrepreneurs organised their franchising systems as well. In 1992 first Polish franchising networks – **Požegnanie z Afryką** and **A. Blikle** were organised. Cafés /shops **Požegnanie z Afryką** created by the Drohomierscy family continue to develop within a franchising system. **A. Blikle** confectioneries started to develop their distribution channels in the same way.

Franchising companies were created as a result of ownership transformation of state-owned companies. Newly independent units were re-integrated on the

<sup>28</sup> P. Hall, R. Dixon, *Franchising...*, *op. cit.*, p. 8.

<sup>29</sup> B. Pokorska, Pierwsza dekada XXI wieku szczególnym wyzwaniem dla sieci franchisingowych, in: *Badania Instytutu Rynku Wewnętrznego i Konsumpcji wobec nowych wyzwań. Konsument-Przedsiębiorstwo-Rynek*, F. Misiąg, ed., IRWiK, Warsaw 2003, p. 171.

basis of a franchising agreement. The ownership transformation of Hortex and Orbis were based on franchising co-operation.

The next stage of franchising development in Poland took place during the years 1996–1999. This was a period of growing competition, and a vast majority of franchising systems were foreign, equally those developed directly, and those developed by master-franchisees<sup>30</sup>.

The following years (2000–2001) were the time of developing Polish systems, which competed with foreign networks by creation of diverse forms of integration, and creation of templates for franchising agreements. Most of those involved links, which could be described as quasi-franchising, nevertheless are regarded by market researchers as franchising companies. This dynamic development of Polish systems resulted mainly from signing of numerous contracts over a short period of time, in order to significantly develop networks, and due to liberal requirements towards franchisees. Many systems did not require any initial licence fee; often details concerning standards (product range, service quality) were not specified.

2001 was the first year, when Polish systems outnumbered foreign ones – they constituted 56% of all systems. Further “polonisation” of franchising took place in the following years. In 2003, Polish networks constituted 74% of the total number of franchising systems<sup>31</sup>.

The recent years have been the time, when the existing systems have been improving quality of their operation by development of logistics centres, have been developing trade brands, introducing new services, and improving the existing procedures.

#### 4. Recapitulation

The presented origins of franchising indicate its growing significance for the economy of several countries. Over the ages, the meaning of the term evolved, and so did the basic principles of franchising systems. Co-operation based on franchising networks, or similar, evolved from the traditional form, applying nothing but sole distribution as the advantage of such co-operation, to a far more complex model, involving a complete scheme of running a franchising system.

Dynamic development of franchising took place in the second half of the 19<sup>th</sup> century, as a result of evolution of distribution systems. The main incentive for development of franchising was the tendency to increase integration and

<sup>30</sup> B. Pokorska, *Pierwsza dekada...*, *op. cit.*, p. 172.

<sup>31</sup> See: Raport o franchisingu w Polsce 2002/2003, Raport o franchisingu w Polsce 2004/2005, Profit System Sp. z o.o., Warsaw.

economic co-operation between independent businesses. Those links, as other forms of integration and co-operation, constituted one of the main forms of preventing fast processes of concentration taking place in industry and trade. Traditional organisation of channels of distribution was gradually substituted by systems based on vertical co-ordination, including franchising.

At the moment in Poland, as everywhere else in the world, the described form of co-operation develops dynamically, and proves its suitability for a growing number of branches of trade, as well as services. Franchising is present in a multitude of areas, from fast food restaurants, cleaners, to retail and distribution of all kinds of products. The recent years saw intensification of expansion of new systems developing operation in market niches, i.e. executive services, exclusive wine shops, dating and matrimonial agencies, vegetarian bars, shoe cleaning services, and even private healthcare facilities. Based on the advantages of franchising, this form of co-operation is used for development of small and medium businesses around the world. It is so, because it constitutes one of the safest strategies of business development, allowing for significant broadening of distribution channels and territorial expansion.

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## **Are the Poles Increasingly Well off?**

### **1. Introduction**

Social stratification of the Polish society was one effect of introducing market economy in Poland. The diagnoses of social changes initially concentrated upon the problems of poverty, as the most painful results of economic changes. Over the last few years, research begun to include social groups of high income, described, perhaps not very accurately, as the economic elites<sup>1</sup>.

The issue of economic elites, attractive for the media and useful for marketing strategies of several firms, is a methodologically complicated object of research. There is a simple answer to the question “why?”: nobody likes to discuss his or her income or wealth. Hence the issue of consumption and life-styles of high-income households is not well documented, mostly due to problems with conducting reliable empirical research. The number of rejections is too high, to consider the research representative. Therefore, the criteria of including a certain household to the economic elite are usually arbitrary, and the level of income considered by the researcher to be the limit of good material situation is appointed subjectively. High-income groups are generally found among samples drawn for other research, and the characteristics of consumer behaviour in such groups are determined on the basis on additional questions.

The description of Polish high-income households presented below, is a result of secondary research based on public statistics provided by GUS (the Central Statistical Office), and of the survey conducted by the Department of Consumption and Living Standard at the Warsaw School of Economics in 2004. Due to scarce sources concerning the subject, the results can be considered one of the first attempts to provide a detailed assessment of the level and structure of consumption of the Polish economic elites, characterised by expenses. The research was undertaken in order to verify the hypothesis, that economic elites (high-income households) create a modern model of consumption pattern similar to structures of consumption in highly developed economies. In order to do this, additional

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<sup>1</sup> In this article the terms “high income households” and “the economic elite” are interchangeably.

comparative analysis of the situation in chosen countries of the European Union, considered “rich” according to certain criteria, was undertaken.

## 2. The Criterion for Definition of Economic Elites

The elite is usually described as a group of people distinguished from other groups by possession of certain characteristics or goods (e.g. high official status or income).

For the purpose of the analysed empirical research, the *economic elite* has been defined as the group of households where the *equivalent per capita monthly income during the researched period exceeded PLN 5 000*<sup>2</sup>. This simple criterion of determining who is distinguished from the general public according to their income fits the meaning of the term “elite”. Choosing this very level of income was based on the fact, that the GUS research of household budgets indicated, that during the years 2000–2004 households where income was decisively high, e.g. PLN 10 000 per person, were scarce, whilst the group where per capita income was higher than PLN 5 000 was already statistically significant as far as analysing structures and co-relations was concerned.

High income is one of the factors determining wealth of people and households; property is the other. Nevertheless, a research based on both those factors is methodologically a very difficult task, since it requires expert assessment of material and utility value of collected objects. Owning objects in itself does not signify wealth – it is necessary to determine age, current price, and proportion in which the objects belong to different members of the household. Furthermore, the criterion of “wealth” includes credit balance, value of repayments, savings in previous years, state of ongoing investments etc., which for different reasons are practically impossible to estimate.

Considering the above, and realising, that the criterion of income is not the sole factor determining participation in the group described as the economic elite, due to complication of the definition of “wealth”<sup>3</sup>, income has been appointed as the only criterion.

One of recent studies concerning predicted consumption of households contains the following statement: “quality of household equipment is not taken

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<sup>2</sup> According to the survey by CBOS “Wealth and wealthy people” almost 30% of respondents regard as “rich” the people, who earn at least PLN 2001 per capita per month.

<sup>3</sup> Certain indexes aggregating information about standard of living and considering state of possessions are proposed, but raise serious controversy. On the other hand, a chance of even preliminary numerical estimation of such indexes exists only in research institutions such as CBOS, which possess access to data from different sources. See: K. Zagórski, *Life Cycle, Objective and Living Standards and Life Satisfaction. New indexes building and applications, Poland 1992–2004*. ESOMAR, *Technical issues in social research – New ways of thinking*, p. 247, 2004.

into account (this concerns matters such as type of product, year of purchase, price, value of wear)<sup>4</sup>. This constitutes an important argument for the view, that it is extremely difficult to examine wealth according to ownership of goods (such as household equipment).

Furthermore, it needs to be said, that the economic elite is not identical with business elites (financial circles), which remain outside the scope of traditional statistical research. Interviews conducted among a dozen acquainted people broadly considered to be very rich, does not constitute a basis for any general remarks on the Polish economic elite<sup>5</sup>.

In conclusion, the income criterion for including households into the economic elite has been established as the basic factor. Also the fact that current income is the main factor conditioning consumer behaviour has been taken into account.

### 3. Sources of Empirical Data

The source of statistical data is constituted by the research on household budgets conducted by the Central Statistical Office (GUS). The above is the main source of public statistics, based on annual, and by definition representative examination of incomes and spendings, and there is a monthly rotation of sample<sup>6</sup>. Representative samples of households chosen for examination of distribution of incomes and consumer spendings during each of the periods between 2000 and 2003 were large, and, for example in the year 2003, included 32452 households.

The analysis regarding high-income households was limited to national data, since regional diversification was not justified, due to a small number of such households. Only small numbers of households fell into the defined income range: 67 in 2000; 69 in 2001; 101 in 2002; 108 in 2003. In comparison with the year 2000, the number of high-income households grew by over 60%<sup>7</sup>. In classification according to type, in all the researched years the group was dominated by households located in the mazowieckie province (particularly in Warsaw). Countryside households were quite numerous as well. As far as source of income was concerned, the most were employee households, with one or two members; also childless marriages.

<sup>4</sup> See: J. Podgórski, *Dochody a wyposażenie gospodarstw domowych*, Unpublished materials from research concerning consumer demand, ordered by the Department of Macro-Economic and Structural Analyses of the Polish National Bank, Warsaw, January 2005.

<sup>5</sup> K. Jasiołkowski, *Elita biznesu w Polsce. Drugie narodziny kapitalizmu*, IF i S PAN, Warsaw 2002.

<sup>6</sup> The problem of rejecting research by the randomly chosen households (in 2002 the rejection index amounted to 47,4%) is to some extent levelled by appropriate procedures during data processing. See: *Budżety gospodarstw domowych w 2002 roku*, GUS, Warsaw, p. XVII.

<sup>7</sup> The growth was far larger (400%) in comparison with 1998.

The social and demographic, as well as the territorial stratification within the economic elite group has changed little. Their number systematically grows, but the dominating types of households with income exceeding PLN 5 000 do not significantly change.

The known measures of structure, positioning, diversification and asymmetry of individual equivalent distribution of incomes and consumer spending were applied for statistical analysis<sup>8</sup>. Double-weight (by number of household members and by household weight) formulas for descriptive statistics were used, i.e. the GUS weights<sup>9</sup> were applied in order to approximate the sample distributions to the actual ones, as well as the OECD scale of equivalence was employed.

The main object of analysis was distribution of expenses on individual groups of goods and services, as well as other consumer spending. Identical approach was applied in the GUS research of household budgets<sup>10</sup>. Fourteen groups of consumer spendings were identified:

- 1) food and non-alcoholic drinks,
- 2) alcoholic drinks and tobacco,
- 3) clothes and footwear,
- 4) accommodation and energy,
- 5) household equipment, furniture and running costs,
- 6) health,
- 7) transport,
- 8) telecommunications,
- 9) recreation and culture,
- 10) education,
- 11) restaurants and hotels,
- 12) other goods and services (except pocket money),
- 13) pocket money,
- 14) other expenses: gifts donated by the household, taxes and non-current payments.

An empirical survey was conducted in 2004, on a purposefully selected sample of 150 households in 13 provinces (the podkarpackie and świętokrzyskie regions were excluded), using the PLN 5 000 per capita/per month criterion for random selection. The questionnaire included 32 questions aimed at obtaining information concerning opinions about life values and expectations from life, level of contentment, as well as ways in which high-income household members pass their leisure.

<sup>8</sup> See: Luszniwicz A., Słaby T., *Statystyka. Teoria i zastosowania*, Wyd. C.H. Beck, Warsaw, II edition, 2003, p. 24 and following.

<sup>9</sup> *Metodyka i organizacja badań budżetów gospodarstw domowych*, GUS, Warsaw, 1999, p. 21–22.

<sup>10</sup> *Ibidem*, p. 85.



#### 4. Changes in Income Situation vs. Consumer Spending by Polish Economic Elites

Changes of consumption in high-income households will be presented against nationwide differentiation of money management in households. Numerical values of descriptive measures are presented in Table 1.

**Table 1. Descriptive statistics of distribution of incomes and expenses in the years 2000–2003**

Specification	Descriptive measurements			
	Average (PLN per person per month)	Mean (PLN per person per month)	Variability ratio (%)	Diagonality ratio
<b>Poland in total</b>				
<b>Income</b>				
2000	791,18	681,40	90,5	28,34 <sup>*)</sup>
2003	877,66	742,17	76,3	6,25
2003/2000 (in %)	110,93	108,92	84,3	– <sup>**)</sup>
<b>Spending</b>				
2000	755,11	624,16	75,7	6,13
2003	827,82	670,78	79,0	5,67
2003/2000 (in %)	109,62	107,47	104,0	–
<b>High-income households</b>				
<b>Income</b>				
2000	8335,63	6700,00	45,4	1,20
2003	7762,46	6245,80	46,9	2,16
2003/2000 (in %)	87,85	93,22	103,3	–
<b>Spending</b>				
2000	3881,07	3658,23	75,4	2,02
2003	3939,89	3665,75	68,1	1,74
2003/2000 (in %)	101,52	100,21	90,3	–
<b>Share of spendings in income (%)</b>				
<b>Poland in total</b>				
2000	95,4			
2003	94,3			
2003/2000 (in %)	98,8			
<b>High-income households</b>				
2000	46,6			
2003	50,7			
2003/2000 (in %)	108,8			

<sup>\*)</sup> The extremely high level of the indicator is a result of the presence in the distribution of untypical households with extremely high income. This is responsible for a very strong positive asymmetry and overvaluation of the asymmetrical average.

<sup>\*\*) Irrelevant.</sup>

Source: original analysis based on the data by GUS from the research of household budgets during the years 2000–2003.

According to the data presented in Table 1, the diversification of distribution of consumer spendings in the population of the economic elite households (as of 2003) during the years 1998–2003 was similar as on the nationwide scale, nevertheless they became more homogenous, which is indicated by the almost 10% reduction of the variability ratio in the said year in comparison to the year 2000. The average income of a high-income household fell by over 12%, but the reduction was not reflected in the level of expenses, which – however slightly – grew. The dynamics of consumer spendings on the listed 14 items was far lower within the economic elite, than nationwide (increase by over 9%). It can be assumed, that high-income households used to assign large sums of money towards non-consumer purposes, such as investment, purchases at the capital market, re-payment of credits, or savings. The data concerning average share of consumer spendings in income confirm this assumption. In high-income households in 2003 this proportion amounted to 50,7% (with a growing trend). An average Polish household assigned merely about 6% of their income towards non-consumer expenses, and the share decreased in comparison with the year 2000. *Hence the relation between consumer expenses and income was far more favourable in the case of the economic elite households, which can signify a large potential for development, increased possibilities for expenses on non-consumer purposes, and the structure of consumption shifting towards more luxury goods.*

Considering the diversification of households, in 2003 the highest “surplus” was displayed by farmers, and farm-owning employees. The opposite situation could be observed among households situated in cities between 200 000 and 500 000 inhabitants. In their case cost of living significantly increased consumer expenses even in high-income households. Also childless marriages and retired people displayed high share of consumer spending.

It is obvious that consumption measured by consumer expenses depends on several factors, including the level of inflation. Therefore, it can be assumed, that rising level of expenses actually signifies higher consumption.

Comparative assessment of changes of per capita expenses per month in high-income households according to purpose indicates, that in 2003, in comparison with the year 2000, increased spending concerned the following categories: food, accommodation and energy, education, recreation and culture, restaurants and hotels, other goods and pocket money. Reduced spending concerned: alcoholic drinks and tobacco, clothing and footwear, household equipment and furniture, transport and telecommunications. The relatively highest change concerned accommodation and energy (increase by, on average, PLN 170 per person per month) and equipment, furniture & running of the household (reduction by, on average, PLN 316 per person per month). In addition, a rather surprising situation

regarding the economic elite was observed – in relatively many households there were no expenses made at all towards categories other than food (expenses equalling 0), e.g. towards health, education, recreation and culture.

It could be expected, that in high-income households as well, social and demographic characteristics of households (represented by their heads) strongly determine consumer spending. The assessment concerned the joined influence of the following characteristics (determinants): income, place of habitation, size of household, its composition, source of income, age and level of education of the head of the household<sup>11</sup>. The quoted determinants of diversification of consumption were used for estimating a linear function of multiple regression. The determination index of the model amounted to 25% for the 2000 data, and 33% for 2003, which suggests a relatively insignificant *combined influence of the characteristics upon the total consumer spending*, but the low value of the measurement seems to have resulted from a low sample size of high-income households. It ought to be mentioned, that increasing income only insignificantly influenced further increase of consumer spending.

**Table 2. Statistically significant numerical measurements of the linear multiple co-relation index according to purpose for Polish high-income households; the years 2000 and 2003**

Purpose of expense	Linear co-relation index	
	2000	2003
Food	*)	0,36
Alcohol and tobacco	0,50	0,37
Clothing and footwear	0,48	0,39
Cost of accommodation and energy	*)	0,44
Household equipment and furniture	*)	0,34
Health	*)	0,42
Telecommunications	*)	0,43
Transport	0,69	0,49
Recreation and culture	0,55	0,49
Education	0,57	*)
Restaurants and hotels	0,62	*)
Other goods and services	0,57	0,39

\*) None of the defined characteristics had a statistically significant influence upon the differentiation of expenses.

Source: original research.

<sup>11</sup> Two determinants, i.e. the level of education and the age of the head of the household were statistically insignificant as far as influence upon spending was concerned, and therefore they were not considered in the final assessment of the aggregated influence upon total spending, nor on spending on individual purposes.

Table 2 contains numerical measurements of influence of the identified characteristics of households upon *individual consumer expenses*. The analysis of its contents suggests, that compared to the year 2000, in 2003 the combined influence of those characteristics was significantly lower. Therefore, it can be assumed, that in households belonging to the economic elite, the customary determinants (household characteristics) have a small (and decreasing in time) influence upon decisions concerning the level of consumer spending on individual purposes.

## 5. Opinions About Status and Operation of Polish High-Income Households

Although the level of income was made the basic criterion for identifying households belonging to the economic elites, the survey included a question directed to those households, about characteristics (attributes), which determine assignment to the economic elite. In 2004 high-income households chose the following attributes while describing themselves as belonging to a certain social minority (Table 3).

**Table 3. Attributes of belonging to the economic elite (% of indications)**

Attributes	Money	Professional position	Education	Luxury car	Acquaintances, contacts	Material possessions	Positive personality features	Property	Own company
Respondents in total	39,3	28,0	24,7	18,0	16,7	16,7	16,0	14,7	12,0

Source: original research on the basis of the empirical research "Consumption patterns among Polish economic elites", conducted in 2004 by the Department of Consumption and Living Standard, Warsaw School of Economics, 2004.

The characteristics most associated with belonging to the economic elite are (in decreasing order): money, professional position and the level of education. A relatively low percentage of indications towards owning a company signifies, that the general opinion about the necessity of self-employment does not determine high income. The choice of money as the main indicator confirms accuracy of choosing high income as the criterion for identifying the economic elites.

The assessment of changes in managing a rather high income may reflect changing needs, aspirations, or expectations of households, influencing changes in the structure of purpose of expenses.

**Table 4. Changes of budget structure in high-income households during the last three years (% of indications\*)**

Specification	Yes, we spend more on food	Yes, we spend more on goods other than food	Yes, we spend more on services	Yes, we save more	No changes
<b>Respondents in total</b>	41,3	32,7	24,0	10,7	33,3

\* Respondents could indicate more than one option.

Source: as in the Table 3.

According to the data in Table 4. Over 30% of high-income households have not changed their level of expenses during the last three years (i.e. during the years 2001–2004), and only over 10% saves more. Obviously, such situation can result from various reasons, e.g. a change in family relations, or external conditions. Those factors could increase expenses on food, whilst increased spending on services and goods other than food can be connected with a changing structure of expenses following growth of income.

According to the national data, the share of consumer spending in income of high-income households only slightly exceeds 50%, which signifies higher money surplus. Table 5 presents different manners of utilising this surplus, e.g. at the capital market. By far the most respondents invest in bank deposits. There is a relatively high interest in investment funds, followed by purchasing property, bonds and shares.

**Table 5. Forms of locating financial surplus by households of the economic elites (% of indications)**

Ways of investing financial surplus	% of respondents
Bank deposits	62,0
Investment funds	30,0
Property	18,0
Government bonds	17,3
Shares	14,7
Works of art	3,3
Other forms of saving	3,3
No savings	4,7
Refusal to respond	6,0

Source: as in Table 3.

One of the questions concerned manners in which high-income households secure their, and their children's future. It was rather surprising, that almost 70% do not apply any form of securing children's future. It is possible that changes at the education services market meant higher expenses on children's education,

which their parents consider to be a form of securing the future. As far as their own future was concerned, over 78% of households chose life insurance policies.

There were no changes observed in high-income households during the years 2000–2003, as far as food purchasing was concerned. Against expectations, only a small percentage of households, due to high income and diffusion of foreign patterns, often choose to eat out. Only a small number of households use catering services a few times a month. This could be a result of the need to display wealth in a discrete manner, or the temporary character of the fashion to spend free time with friends or family in restaurants. Nevertheless, if they choose this manner of satisfying their needs, they choose renowned outlets serving European regional cuisine.

Furniture and equipment in Polish high-income households, although varying, maintains high standard. A certain classic set (multi-media, digital cameras, a computer, a car) is commonly present, although only 2% of households possess two cars or more. Households are very often loyal to favourite brands. Only fitness equipment is rarely owned – by a mere 12% of households. Households pay less attention to the price of equipment, and more to its quality and modern technological solutions.

The analysis of the structure of consumption of households of the economic elite focused on the level of expenses on services, which indicates how modern is the running of the household, and whether it increases the amount of free time. Polish high-income households regard their needs to be well satisfied by services, especially as far as building services are concerned, legal services, healthcare & fitness, and culture. However, increasing usage of cultural and recreation services does not mean, that members of the economic elite households, who work long hours, will soon change their style of spending free time. This is still dominated by passive, “media” behaviour (e.g. watching TV). If they ever go outdoors, it is usually to large shopping centres, where they use an opportunity to do their weekly shopping.

Their self-assessment concerning material situation is important, since positive assessment creates consumer demand. Over 80% of respondents from those households consider their material status to be satisfactory. This particularly concerns young households with a-level or academic education, living in cities. However, those households are aware of a possibility of job loss (over 40% of respondents), but are less concerned about the influence of external factors, such as repercussions of wars and world terrorism. They list happy life and securing a good start for their children as their crucial values. Therefore, high-income households can be included into the “post-materialistic” groups of the society, aiming at a higher quality and comfort of living.

## 6. Comparison Between the Structure of Consumption in Polish High-Income Households and Similar Households in Chosen Countries of the European Union

It is difficult to fully compare structure and dynamics of consumer expenses in the years 2000–2004 between Polish and EU households, due to several reasons. Mostly, there is no detailed data on distribution and expenses in the EU countries, and in particular there is no access to data concerning the richest households, whilst the data published by Eurostat are erratic. There are relatively full data concerning 2001, and this year was singled out for comparisons, based on the assumption that in rich EU countries changes in level and structure of consumption are never rapid.

The choice of the richest countries was made on the basis of two indicators of irregularity of distribution of income, namely the S80/S20 indicator (the indicator compares the group of 20% households of the highest equivalent income, with the group of 20% of the lowest income), and the measure of irregularity in income distribution known as the Gini ratio. Low levels of those ratios indicate, that there are no large inequalities regarding income, so households can behave similarly towards consumer spending (assuming that consumption is conditioned only by the level of income). And so, in 2001, in 15 EU countries the S80/S20 indicator amounted to 4,6, which means that the 20% households of the highest income received 4,6 times higher income than the 20% of the lowest. In 2001 the lowest distribution of income could be observed in Denmark, and amounted to 3,0; the highest could be observed in Portugal, and amounted to 6,5.

The chosen two indicators characterise situation of households as far as the level of income is concerned. This allowed for identification of the least unequal countries, considered rich, and **approximately** the same treatment of data on consumer spending in those countries, as relatively “closest” to the situation observed in Polish high-income households.

**Table 6. Income inequality indicator S80/S20 and the Gini ratio, 2001**

Countries	S80/S20 indicator	Gini ratio
<b>UE 15</b>	<b>4,6</b>	<b>30</b>
Belgium	4,0	28
Denmark	3,0	22
Germany	4,0	27
France	3,9	27
Luxembourg	3,8	27
Austria	3,5	24
Finland	3,7	27
Sweden	3,4	24

Source: original research on the basis of:

<http://europa.eu.int/comm/eurostat/newcronos/suite/retrieve/en/theme3/ilc/ilc-mi/ilc-1>

The share of consumer spending in high-income Polish households was calculated in the national scale (see Table 1), and in 2003 amounted to 50,7%. This signified, that almost a half of all income could be assigned to purposes other than consumption, such as investment or savings. In the chosen EU countries the share was as in Table 7.

**Table 7. The share of consumer spending in income, 1999\***

Countries	Share (%)
EU15	74
Belgium	67
Denmark	73
France	67
Luxembourg	75
Austria	69
Finland	54

\* ) Concerns the comparison between average equivalent expenses and income per person There is no data available for later years, and some of the countries.

Source: as in Table 6.

In most of the EU countries considered “wealthy”, the share of consumer spending in income (nationwide, on average) was higher than in Poland. Highly satisfied needs probably changed the structure of consumer expenses. Possibly, this situation will concern Polish economic elites in the future. However, it needs to be emphasised, that in 2003 the share of those expenses in Polish high-income employees’ households has already begun to shift. In households located in cities of 200–500 thousand inhabitants it amounted to 67,7%, among childless marriages to 64,3%, and among retired people 60,1%, which allows for stating a certain similarity with the situation in the chosen EU countries.

As far as the structure of expenses on specified purposes in the chosen “rich” EU countries and in Polish high-income households<sup>12</sup>, the following data was obtained for 2001 (see Table 8).

<sup>12</sup> The relation was measured on between expenses towards individual purposes and the total expenses (average values).



**Table 8. Percentage share of average monthly consumer expenses in the chosen EU countries and in Polish economic elite households, 2001**

Purpose of expenses	Chosen EU countries*)							The Polish economic elite**)
	Belgium	Denmark	Germany	France	Austria	Finland	Sweden	
Food & non-alcoholic drinks	12,91	12,81	12,15	14,45	12,25	12,89	12,43	12,88
Alcohol, tobacco	3,65	4,56	3,86	3,42	5,90	5,90	4,05	3,96
Clothing	5,50	5,08	6,29	4,81	6,51	4,67	5,50	6,67
Accommodation	23,28	28,56	24,60	23,52	19,52	25,30	28,86	9,79
Household equipment & furniture	5,78	5,87	7,02	6,25	8,53	4,95	4,95	6,49
Health	4,27	2,66	4,07	3,54	2,23	3,89	2,49	2,00
Transport	14,84	11,45	14,26	15,12	12,62	12,34	13,29	14,04
Telecommunications	2,14	2,02	2,76	2,28	3,41	3,38	3,27	4,63
Recreation & culture	9,53	10,62	9,55	8,87	11,78	11,35	12,20	9,82
Education	0,58	0,77	0,69	0,60	0,64	0,47	0,22	3,20
Restaurants & hotels	5,52	5,51	4,84	7,54	9,37	6,75	5,08	4,39
Other expenses	12,00	10,08	9,91	9,59	7,24	8,11	7,65	11,74

\*) No data for Luxembourg.

\*\*\*) In the Polish classification there were two more purposes (pocket money and other, e.g. gifts), hence the results do not sum up to 100%.

Source: original research on the basis of the data as in Table 6.

In order to facilitate interpretation of differences in shares spent on the listed purposes in total income between the chosen EU “rich” countries and Polish high-income households, additional calculations were made. Their results are presented in Table 9.

The minimum differences illustrate the relatively smallest distance between the share of consumer spending in the total expenses in Polish economic elite households, and the analogical expenses in the EU countries regarded “rich”. In the case of four items: alcohol & tobacco, transport, recreation & culture and restaurants & hotels, the smallest gap could be observed between Poland and Germany. With regard to food and non-alcoholic drinks the distance was smallest with Finland. The largest difference concerned expenses on accommodation in Sweden. In the remaining groups of expenses, the maximum differences are not particularly high.

Recapitulating, it ought to be emphasised, that the share of consumer expenses in Polish economic elite households is relatively close to consumption in the chosen EU countries. Therefore, there is a strong similarity between Polish high-income households and the EU.

**Table 9. The highest and the lowest differences of share (in %) between Polish households and a chosen EU country in 2001**

Purpose of expenses	Average level in the chosen EU countries	Differences	
		Minimum	Maximum
Food & non-alcoholic drinks	12,84	0,01 Finland	1,57 France
Alcohol, tobacco	4,47	0,1 Germany	1,94 Austria; Finland
Clothing	5,48	0,16 Austria	2,00 Finland
Accommodation	24,81	9,55 Austria	19,07 Sweden
Household equipment & furniture	6,19	0,24 France	2,04 Austria
Health	3,31	0,23 Austria	2,27 Belgium
Transport	13,42	0,22 Germany	2,59 Denmark
Telecommunications	2,75	1,22 Austria	2,61 Denmark
Recreation & culture	10,56	0,27 Germany	2,38 Sweden
Education	0,57	2,43 Denmark	2,98 Sweden
Restaurants & hotels	6,66	0,45 Germany	7,02 Austria
Other expenses	9,22	0,28 Belgium	4,98 Austria

Source: original research based on the data in Table 8.

## 7. Conclusions

The assessment of various aspects of operation of the Polish elites is a methodologically complex research task. Even identification of this new social group is in itself problematic. However, the group is noticeably growing in numbers. Therefore, a statement that the Poles become wealthier is justified, which is proven by the analysis of distribution of income and consumer spending. Apart from the areas of evident poverty, there are symptoms of creation of the middle class, one of the attributes of which is a particular material status. This can also signify, that Polish economic growth slowly begins to translate into the increasing wealth of the society. The most important information originating from the public statistics is, that as soon as the basic consumer needs are satisfied, almost a half of income in well-off households is available for non-consumer purposes. This is good news for firms in the property and the capital markets, as well as for producers of luxury goods.

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## **Consumer Rights and Consumer Awareness in Poland**

### **1. Consumer Rights**

Studies of consumer policy in several developed market economies, such as the countries of the European Union, clearly prove, that harmonious operation of the entire economy, including households, requires a properly developed system of consumer protection and education.

The changes taking place in the conditions of operation of Polish households, as well as of the market, more or less radically influence the changes of consumers' purchasing behaviour, and their requirements concerning information about consumer rights, protection of their economic interest, as well as education regarding this area.

In the market environment Polish consumers gained their rightful sovereignty, which means they can now enjoy a relatively large freedom to choose goods and services on the market according to their financial capacity and preferences. International flow of goods and services broadens opportunities for seeking more feasible and innovative offers. On one hand the market full of goods and services provides the consumer with a chance to better satisfy his or her needs, but on the other, which may seem paradoxical, creates certain threats infringing on consumer rights.

It is obvious, that companies possess a far stronger economic market position than consumers and their households. This market advantage of companies over consumers is enhanced by marketing strategies implemented by companies on ever broader scale, and ever more perfectly. Firms stimulate consumers' senses (smell, taste, touch, hearing and sight), skilfully choosing compositions of tastes, smells, colours, properly shaping the packaging, thus influencing consumers' purchasing decisions. The situation is similar as far as product positioning (a well-designed marketing strategy will convince any client, that only this particular product is necessary and able to satisfy his or her needs), pricing (e.g. price reductions, psychological pricing), promotions (discounts, coupons for free samples, aggressive advertising) are concerned – all those limit consumers' sovereignty.

The awareness of consumers' inferior position against companies and their market and marketing actions resulted in creation of numerous institutions and organisations aimed at protection and education of consumers.

The beginnings of organised activity concentrating on protection of consumer rights reach the mid-nineteenth century; the particularly intensive development of the consumer protection movement took place at the beginning of the 1960's. The authors reckon, that another stage of consumerism development could be observed in the 1990's, and later, in connection with ongoing globalisation and the process of European unification and the creation of the homogenous common market<sup>1</sup>.

Regardless of solutions adopted by individual countries, the forms of operation of the world's consumerism are similar. Of those, the following deserve particular attention:

- legislation, i.e. creation of conditions facilitating satisfaction of consumer needs by introducing laws, acts, directives and regulations protecting interests of consumers;
- education, i.e. creating a basis for conscious and rational consumer behaviour, by supplying the consumer with the necessary information about goods, conditions of their purchase, effects of rational and improper consumption or use of goods.

Legislative action is a prerogative of government bodies. However, education, identified with consumer protection, can be conducted practically by all institutions and organisations. The level of application of both those forms is an indicator of the level of consumerism and consumer policy of the government in a particular country.

The problem of consumer protection was closely related to the developing, especially after the Second World War, ideas of human rights. The problem was globally expressed in the famous address by the president of the United States, J. F. Kennedy, on 15.03.1962, in which the president stated, that: "...[consumers] are the only important group in the economy who are not effectively organized, whose views are often not heard. (...) If consumers are offered inferior products, if prices are exorbitant, if drugs are unsafe or worthless, if the consumer is unable to choose on an informed basis, then his dollar is wasted, his health and safety may be threatened, and the national interest suffers." The speech formulated four basic consumer rights: the right to safety, the right to reliable information, the right to choose, and the right to be heard.

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<sup>1</sup> More on the subject: A. Dąbrowska, M. Janoś-Kresło, I. Ozimek, *Ochrona i edukacja konsumentów we współczesnej gospodarce rynkowej*, PWE, Warsaw 2005.

Those rights were supplemented by the resolution of the European Communities Council of 14.04.1975, concerning the initial programme of policy of consumer protection and information, and in the following years approved and expanded by Consumers International (CI).

In 1985 the UN General Assembly approved “Directives on Consumer Protection”<sup>2</sup>. They specified consumer rights, which contained guidelines for further legislation on the matter.

In connection with integration and creation of the common market, an increased interest in consumers, their protection and education could be observed in Europe. “Every citizen is a consumer and the European Union takes great care to protect their health, safety and economic well-being. It promotes their rights to information and education, takes steps to help them safeguard their interests, and encourages them to set up and run self-help consumer associations”<sup>3</sup>.

Supporting consumer rights, ensuring their well-being and satisfaction are key values of the European Union, which is reflected in the regulations of its legislation. The basic principles on the ways in which the EU law protects consumers, regardless of their country of residence, are as follows<sup>4</sup>:

- 1) consumers are entitled to purchasing goods according to their own decision, and in the place of their choice,
- 2) consumers have the right to return faulty goods,
- 3) consumers are protected by high safety standards concerning food and other consumer goods,
- 4) consumers have the right to know what they eat,
- 5) consumers have the right to fair conditions of contracts,
- 6) consumers have the right to change their mind,
- 7) consumers are to be assisted in comparing prices,
- 8) consumers must not be misled,
- 9) consumers are to be protected during their holidays,
- 10) consumers are to be helped with effective solutions of trans-border disputes.

Detailed solutions vary in individual countries, depending on the way each of them introduced the EU principles into their national legislation.

Consumer rights constitute an area of operation for the EU (including Poland’s) consumer policy. They are consistently filled with new contents, in accordance with the changing market situation and consumer environment.

<sup>2</sup> Since 1983 the 15<sup>th</sup> of March is celebrated as the World Consumer Rights Day.

<sup>3</sup> Activities of the European Union, Consumers, <http://europa.eu.int/pol>, 29.06.2004.

<sup>4</sup> Consumer Protection in the European Union: Ten Basic Principles, European Commission, Health and Consumer Protection Directorate-General, 20.07.2004.

Consumer rights can be presented as the following catalogue:

- **the right to satisfaction of basic needs** – those needs include clean air, water, proper food, shelter, healthcare and hygiene, education. The right concerns the basic goods and services, which provide a sense of security;
- **the right to safety** – the right to protection from products and services dangerous to health of life. This means that goods and services offered to consumers must not pose any threat to their life and health;
- **the right to be informed** – this fundamental right protects economic interests of consumers. The statement that a customer should not be lied to is obvious, however the question what is, or can be considered a fraud, becomes increasingly controversial and inconsistent. Good, thorough information allows customers to make rational choices in accordance with their individual wishes and needs. The right to thorough information signifies, too, the right to protection from dishonest and misleading advertising and information on products;
- **the right to choose** – the right concerns maximising consumers' economic benefits. A consumer deciding about a purchase aims at achieving satisfaction depending on the product's utility value matching its price. Such possibility is created by competition between many products and services of varying quality;
- **the right to be heard** – requires creating special institutions ensuring ability to formulate postulates, express them in public, and have them considered in the economic and social policy of the government;
- **the right to redress** – signifies the necessity to assist consumers as they claim their rights. This requires legal and administrative measures ensuring that customers have access to formal and informal procedures leading to satisfaction of their claims;
- **the right to consumer education** – consumers must know their rights and duties, and should be aware of procedures for claiming their rights and for redressing, should quality of goods or services prove insufficient;
- **the right to a healthy environment** – a consumer has the right to live in a healthy natural environment, guaranteeing their life and health.

## 2. Consumer Awareness in Poland

The level of consumer awareness in Poland has for years been an object of the authors' research and interest<sup>5</sup>. A particular emphasis has been put on the following research areas:

- knowledge of institutions and organisations dealing with protection and education of consumers,
- knowledge of conditions of sales of goods and services,
- attitude towards reading contracts and information on packaging about goods and services,
- attitude towards consumer education.

### 2.1. Knowledge of Institutions and Organisations Dealing with Protection and Education of Consumers

According to the catalogue of rights, a consumer has the right to representation and organisation. This means, that consumers ought to have a possibility to get organised, and present their stance on all the matters, which concern them. The institutional infrastructure has been significantly strengthened during the system transformation. Actions aimed at protecting consumer interests are undertaken by different institutions and organisations. Institutional consumer protection in Poland is at present provided by: the Office for Competition and Consumer Protection (until 1996 Anti-Monopoly Office), Trade Inspection, and local consumer ombudspersons (since 1999). The national organisations, which have consumer protection as their statutory objectives are: Polish Consumer Federation and Association of Polish Consumers (since 1995). Banking Arbitrage (since 2001) and the Insurance Ombudsman (since 1995) provide assistance for consumers as well.

According to the research conducted by the authors, the awareness among consumers about the above institutions is low (Table 1). For years, the most quoted organisation has been the Office for Competition and Consumer Protection, which is a body of government administration obliged by law to implement consumer protection. Among consumer organisations, the most quoted has been the Polish Consumer Federation, independent, and the largest of NGO's, aiming mainly to protect individual consumers.

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<sup>5</sup> The authors conducted research in the years 2001, 2002, 2003 and 2005. The results of the research during the years 2001–2003 were presented in: A. Dąbrowska, M. Janoś-Kresło, I. Ozimek, *Ochrona...*, *op. cit.*

**Table 1. Spontaneous knowledge of institutions and organisations protecting interests of consumers**

Specification	Year 2001 (N = 1000)*	Year 2002 students (N = 290)	Year 2003 students (N = 393)	Year 2005 (N = 1000)*
Office for Competition and Consumer Protection	16,0	8,3	23,3	16,0
Polish Consumer Federation	11,0	7,6	8,6	11,0
Trade Inspection	17,0	9,0	9,1	10,0
A local consumer ombudsperson	1,0	7,6	7,5	2,0
Association of Polish Consumers	5,0	1,7	1,1	3,0

\* Original research conducted in co-operation with GfK Polonia.

Source: original research.

The knowledge of consumer institutions and organisations increases with level of education, and size of the place of residence.

## 2.2. Knowledge of Conditions of Sales of Goods and Services

Consumers have the right to reliable information about goods and services. This rule provides, that a consumer ought to have a possibility to learn about basic characteristics of goods and services on offer, to make an informed choice from competitive offers, to use products and services safely to her or his satisfaction, and to seek compensation for damages resulting from using products and using services.

One of the research areas was the knowledge of the law regulating sales of goods and services, and the willingness of Polish citizens to read information on packaging and products before purchasing them, as well as to read contracts before signing them.

The act on particular conditions of consumer sales came into effect on 1.01.2003<sup>6</sup>. The act introduced significant changes in the following areas: duties and responsibilities of a seller, rights and obligations of a buyer, deadlines and procedure of claim vindications, warranties, responsibility of advertisers.

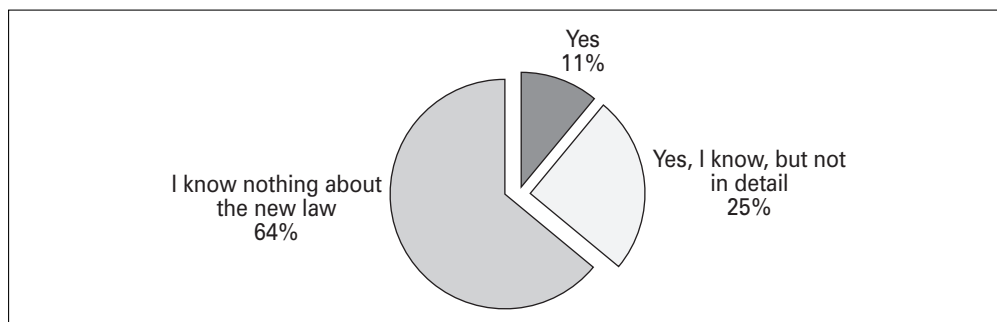
After two years since their introduction, the knowledge of the regulations concerning the conditions of sales of products and services is rather modest. Merely 11% of respondents know the law, and only 25% of the Poles are aware of its existence (Figure 1). Interestingly, in spite of low knowledge of the regulations

<sup>6</sup> Ustawa z dnia 27 lipca 2002 roku o szczególnych warunkach sprzedaży konsumenckiej oraz o zmianie kodeksu cywilnego (Dz.U., No 141, position 1176 with subsequent changes).



concerning conditions of sales, as many as 81% of respondents stated, that they would know what to do in case they purchase a faulty product<sup>7</sup>.

**Figure 1. The knowledge of the new regulations concerning conditions of sales of goods and services**



Source: original research, 2005.

Higher level of knowledge is declared by people aged between 20 and 59 years, with at least a-level education, inhabitants of large cities and Warsaw.

Low level of knowledge of this subject was confirmed by the results of the research conducted in October 2003 among students<sup>8</sup>. Only 4,9% of respondents knew about the change of law concerning conditions of sales of goods and services, and declared knowing the new regulations; 41,2% knew about the law, but did not know its details; 53,9% were unaware of the law's existence.

Consumers are strongly aware of the term "warranty", due to the presence of this term in earlier regulations. Since 1.10.1992, warranties in Poland have been voluntary. The authors' original research indicates, that 52% of the Poles know the regulations concerning warranties. Socio-demographic characteristics did not differentiate the level of knowledge about this subject. However, the research ordered by the Office for Competition and Consumer Protection indicates a much higher consumer awareness of the regulations in question – 84% of consumers indicated, that they knew the right to warranty, and 51% were aware, that they can choose from several options of vindicating claims (demanding repair on the basis of guarantees in the warranty card from a service indicated in that card, exchanging the product, demanding a price reduction from the seller, refund of expenses). However, 6% of adult Polish citizens were not aware of this right, and 10% were doubtful (difficult to say). 67% of respondents were

<sup>7</sup> In February 2005, the authors conducted a research in co-operation with GfK Polonia, on a representative sample of 1000 adult Poles.

<sup>8</sup> The survey was conducted on 393 full-time and part-time students.

aware of the possibility to demand a repair from the seller. The situation is similar in the case of the right to demand exchanging a faulty/ poor quality product or service – 67% of surveyed consumers were aware of it. About a half (53%) of Polish consumers are aware of the possibility to return a purchased faulty product, and demand a refund of expenses (100% of the product’s/service’s price). The least (37%) of all consumers know the regulation according to which they can demand a price reduction in case they purchase a faulty product, or poor quality service.

During the period between September and December of 2004, every tenth polish consumer purchased a faulty or poor quality product or service. Of those consumers 31% did not decide to vindicate their rights. Of those who decided to intervene, 29% demanded exchange from the seller, 20% demanded repair on the basis of warranty; other rights were executed sporadically. For years, the most frequently complained about products have been: footwear, household and electronic equipment, and food. The above is confirmed by the records of free advice and legal aid provided by the Polish Consumer Federation (Table 2).

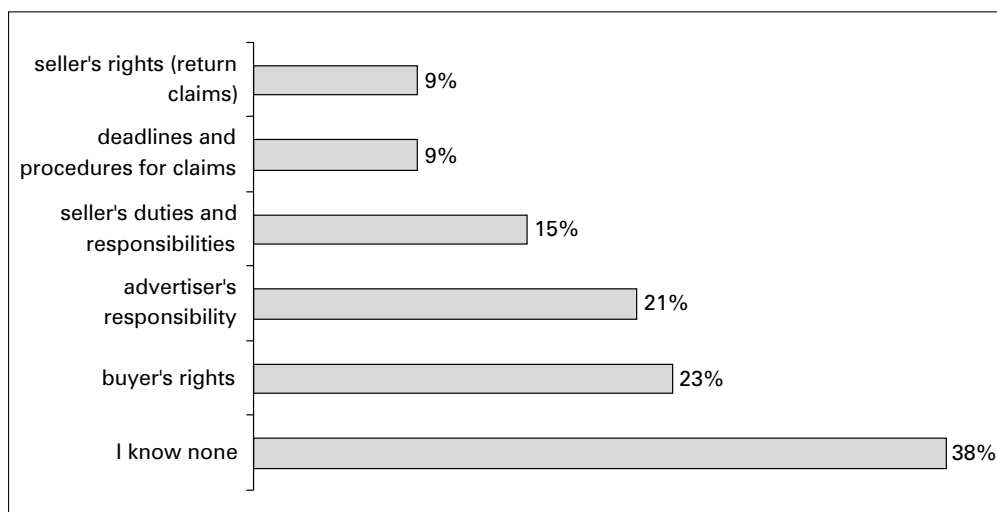
**Table 2. Types of advice provided by the Polish Consumer Federation during the years 2003–2004**

Type of problem reported	Type of aid					
	Written applications in the name of the consumer	Written advice	Direct advice	Telephone advice and interventions	Legal suits	Cases brought to arbitrage courts
Total	8743	4814	45828	69727	736	1334
Services						
Banking	354	242	1510	2877	18	6
Insurance	234	169	1347	1501	79	9
Building and decorating	1351	431	3998	4933	105	169
Car	225	299	2099	2664	33	15
Laundry	171	85	797	1391	33	52
Tourist	188	126	472	707	27	8
Other	1232	650	5446	8510	31	49
Industrial products						
Mobile phones	336	252	1741	3208	6	22
Computers, video & hi-fi equipment	448	291	3208	5850	42	78
Household equipment	437	198	2860	6582	34	73
Footwear	2071	899	10929	14752	256	697
Other	1696	1172	17421	16770	72	156
2004						
Total	8438	5101	42547	67830	695	1311

Source: Polish Consumer Federation.

The knowledge of other areas connected with conditions of sales of goods and services is relatively low, which is confirmed by the results shown in Figure 2.

**Figure 2. The knowledge of questions connected with the regulations concerning the conditions of sales of goods and services (% of indications)**



Source: original research, 2005.

### 2.3. The Attitude Towards Reading Contracts and Information on Packaging About Goods and Services

The level of consumer awareness is defined by conviction about the necessity to read information on products or packaging before purchase, as well as reading full text of a contract (including the small print) before using the service specified in the contract, which the customer is to sign. Such attitude can significantly protect customers from breach of their interests, and post-purchase discomfort. More Poles read contracts (perhaps as a result of unfavourable earlier experiences of their own, or of acquaintances, concerning problems resulting from too brief reading of contracts, or not reading them at all), than information on packaging (Table 3).

**Table 3. Reading texts of contracts and information on packaging or products before purchase**

Reading the text of contract before using a service		Reading information on packaging or product before purchase	
Yes, carefully	40%	Yes, carefully	27%
Yes, briefly	36%	Yes, briefly	50%
I do not read	9%	I do not read	23%
I have never used such services	15%		

Source: original research, 2005.

Contracts and information on packaging are carefully read mainly by people between 30 and 65 years of age, with academic education, inhabitants of large cities and Warsaw.

In a situation of danger, or breach of their consumer rights, Polish consumers have the right to free consultation or aid from institutions and organisations concerned with consumer protection and education.

The need to seek information about institutions and organisations protecting interests of consumers certainly increases when a consumer's economic interest has been violated.

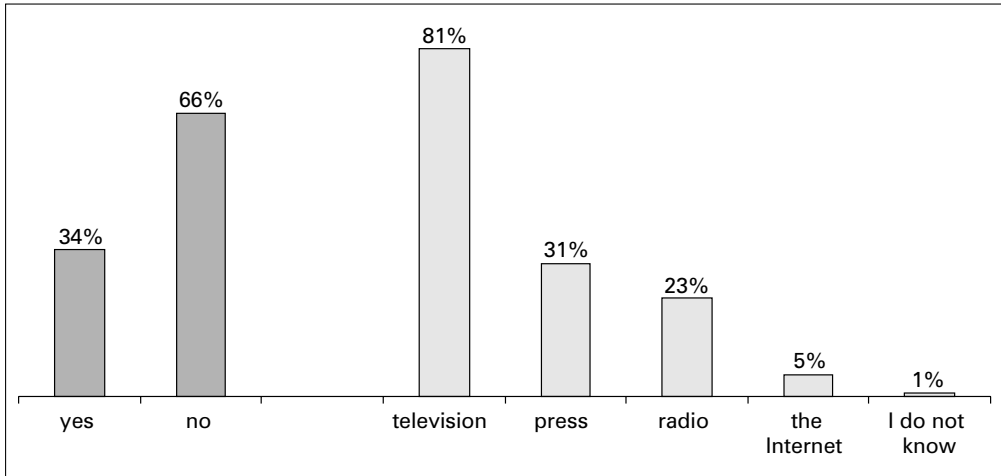
#### **2.4. The Attitude of Polish Citizens Towards Consumer Education**

While relating to problems connected with consumer education, it is difficult not to mention the words of J. F. Kennedy: "Consumers, by definition, include us all. They are the largest economic group in the economy, affecting and affected by almost every public and private economic decision. (...) But they are the only important group in the economy (...) whose views are often not heard."

After over 40 years those words have not lost any of their significance, importance, and are perfectly up to date as far as Polish consumers are concerned. According to statistics provided by institutions and organisations concerned with consumer protection and education, consumer rights are often violated. Therefore, as well as it is necessary to introduce legislation concerning sales of goods and services aimed at creation of conditions facilitating satisfaction of consumers' needs by protecting their interests, it is also important to conduct educational actions by various institutions and organisations dealing with consumer protection and education.

According to the research conducted in February 2005, every third Pole knows publications or programmes focusing on consumer rights (Figure 3). It is hardly surprising, that the media most commonly commenting on the topic are the television and the press.

**Figure 3. The knowledge of publications and broadcasts on the subject of consumer rights**

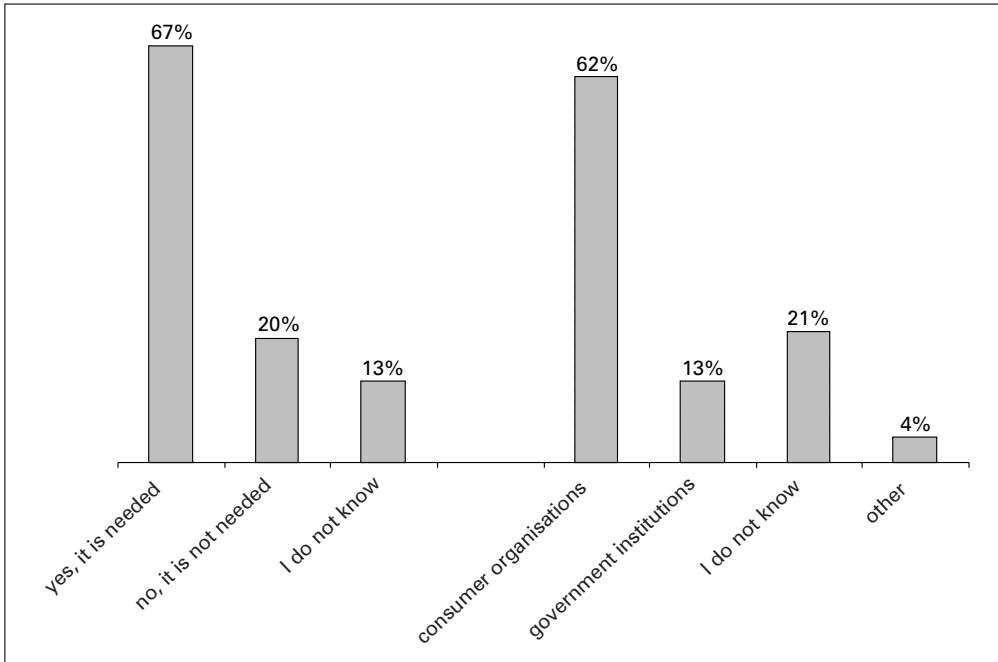


Source: original research, 2005.

Consumers regard the media (television, daily press, radio) to be the best predisposed to educate on protection of consumers' interests. It is worth reminding, that the Office for Competition and Consumer Protection and the Polish Consumer Federation are very active in the field of rising awareness of Polish consumers. One example is the programme broadcasted by Channel II of Polish Television (TVP II), entitled "Konsument" ("The Consumer"), sponsored by the Office for Competition and Consumer Protection (UOKiK).

The press proved to be the second most suitable medium. Consumers see the need for publication of a magazine devoted to broadly understood consumer issues (the rights, protection and education). 67% of respondents would welcome such publication. They reckon that it ought to be published by consumer organisations (62%) or by government institutions (13%) – see Figure 4. Of all the institutions and organisations concerned with consumer protection and education, UOKiK received the highest approval – 22% of indications, directly behind the quoted media.

**Figure 4. The need for a magazine devoted to consumer rights, protection and education; its editor**



Source: original research, 2005.

### 3. Recapitulation

It can be said that a weak consumer is an easy target for manipulation and dishonest economic practices; a strong consumer is an equal partner at the marketplace. A strong consumer is a responsible person aware of his or her rights, and capable of executing those rights. As A. Lewicka-Strzalecka puts it, awareness of ones influence and sovereignty is an important element of a modern consumer's responsibility. Responsible consumers can ensure, that the market is not entered not only by products for which there is no demand, but also by those, which violate ethical norms or harm the environment<sup>9</sup>.

The above comments indicate that, in spite of their weak position, consumers act as partners in the act of exchange. They are not necessarily bound to be passive participants of the market game.

Based on those considerations, the following conclusions can be formulated. The level of consumer awareness in Poland is insufficient. Education of consumers

<sup>9</sup> A. Lewicka-Strzalecka, *Konsument: suweren czy wasal biznesu?*, www.cebi.pl

is necessary, i.e. informative and advisory actions including not merely informing about the rights and obligations of a consumer, but also rationalising his or her market behaviour.

Both government institutions and consumer organisations implementing the consumer policy ought to broaden their informative and advisory operation in various forms. This remark particularly concerns local consumer ombudspersons, who by definition, as the institutions closest to consumers, are to effectively protect consumer interests.

There is a necessity to intensify education on consumer rights. The educational aspect is particularly emphasised in the countries of the European Union, especially with regard to the groups, which are most at risk (e.g. children and teenagers). Education ought to be addressed not only to consumers, but also – or perhaps most of all – to businesses. They too present profound ignorance about consumer rights, although one informed producer, tradesperson or service attendant means a thousand satisfied customers, the rights of whom have not been violated.

The research indicates, that the most effective medium, due to its scope, is television. Nevertheless, consumers encountered publications concerning consumer issues in other media – the daily press and the radio. It needs to be remembered, that different media are addressed to different groups of consumers.

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# Gender Dimension of Economic Transition in the CEE Countries: Implications for Female Entrepreneurship Development

## 1. Introduction

The transition from the commanded to market oriented economy in former socialist countries of Central and Eastern Europe (CEE) has proven to be a complex process initiating immense changes which have been challenging all dimensions of economic, social, political and human development. Job insecurity, high rates of unemployment, increase of poverty and other economic and social hardships have been some of the adversities the transition has imposed on the CEE countries. At the same time newly established democratization and liberalization of economic and political life of countries opened up new opportunities for individual initiative, creativity and leadership especially through development of a private sector and entrepreneurship. However, the costs and benefits of the transition proved to be disproportionately shared by men and women in CEE countries, burdening more women than men.

Similar to the experiences of any other CEE country, the economic transition of Croatia has resulted in a widening of gender differences in all sphere of their life. Even though the women make up more than 50% of total Croatian population, their participation in economic and political life has been undermined as it is worldwide. Women's position in the labor market has been evidently deteriorated compared to their male counterparts, being more and longer unemployed and

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having fewer job opportunities than men due to the discriminatory practices in hiring and employment policies especially in the private sector (Thomson, 2002). Those who select entrepreneurship and self-employment as a way of generating income and improving their chances on the labor market face specific gender barriers, e.g. glass ceiling, that hinder an enterprise development.

The paper<sup>1</sup> discusses women's positions within transitional context, especially from political, economic and entrepreneurial point of view. The purpose of the paper is to emphasize the importance of including gender perspective into policy making in the region by raising awareness of women's underutilized human capital. Using the example of Croatia as a typical transitional economy, the paper addresses some common issues related to empowerment of women in business and social community especially through female entrepreneurship development. A number of suggestions and measures identified in this paper to support female entrepreneurship may serve as a general guide for national or regional decision in promoting women entrepreneurs as an important human resource for economic development.

## 2. A Gender Perspective of the Transition in the CEE Countries

The process of creating a market economy in former socialist countries has proven to be a striking process marked by economic shocks both external and internal, political changes and social costs that have been borne unevenly by different population groups, especially by gender<sup>2</sup>. A body of research shows that the costs and opportunities of the transition process across the region undergoing social, political and economic restructuring have been affecting more women compared to men (Kantor, 2004; Thomson, 2002; Nowicka, 2004; Ruminska-Zimny, 2002).

Both men and women have witnessed the turmoil of the transition reshaping the economic, social and political arenas of the CEE countries. A review of transition to a market economy in the CEE countries shows similar unfavorable trends affecting the whole population (see: Dokmanovic, 2004). However, the burden of the negative trends weighs more heavily and more often on women than on men

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<sup>1</sup> This paper is revisited version of the conference paper presented at the 13. Nordic Conference on Small Business, Tromso (Norway) held on 10–12 June 2004. The full paper can be viewed at [web.bi.no/.../a6cb7066ea59eda6c12567f30056ef4d/\\$FILE/Barkovic&Borozan.pdf](http://web.bi.no/.../a6cb7066ea59eda6c12567f30056ef4d/$FILE/Barkovic&Borozan.pdf)

<sup>2</sup> Gender has been defined "as the social differentiation of women and men through processes which are learned, changeable over time and vary within and between cultures. At the economic level, gender appears as a sexual division of labor in which some types of work are strongly associated with women and some types with men. The costs and benefits of the sexual division of labor are unequally shared between men and women to the disadvantage of the latter" (Elston, 1993, p. 237).

and the feminization of poverty has been observed as a very important indicator of such a transition process. This has been evident in all transitional societies regardless of differences in the speed of transition, the success in developing a market economy and increasing gross domestic product (GDP). Women proved to be victims of transitional process in many aspects (Vaknin, 2004) among them political, economic and entrepreneurial ones which are examined in this paper.

The process of democratization of transitional economies' society continues with limited participation of women. While most of the European countries made a step forward in increasing an average rate of women parliamentarians<sup>3</sup>, a reverse happened in the transitional economies. During the social and communist era, the proportion of women in national parliaments counted from 20% to 40% while nineties brought a decline to a range from 2–18% (Nowicka, 2004). Such a low level of women in parliaments and other decision-making positions constrains their impact on various processes of institution building such as for example market style welfare systems. In addition, paternalistic tendencies prevail in most of the transitional economies.

Women jobs are mostly consumed by male-dominated privatization and male-biased technological modernization. While men in the CEE countries are 3 times more likely to find a job, 60–80% of all women's jobs were lost and the highest rates of unemployment could be found among middle age and older women. Women account for 50–70% of unemployed across the region and many suspects that such number is probably under-reported<sup>4</sup>. Women are often excluded from retraining programs confined to simple computer job trainings mostly clerical in the nature and low skilled while men are mostly engaged to assimilate new and advanced technologies. According to Ruminska-Zimny (1995) several trends have been recognized in the transitional counties:

- 1) a rise of female unemployment,
- 2) slow integration of women into private sector activities,
- 3) sectoral segregation of women's jobs,
- 4) persistent wage gap in favor men.

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<sup>3</sup> In mid-80's there were only 5 democratic Western European states with more than 20% of women in their national parliaments while there were at least 9 CEE countries that had more than 20% of women in their parliaments. In 1999, the average rate of women parliamentarians was bigger than 20%. More in the CEE Network for Gender Issues: Gender Aspects of Employment/Unemployment in Central and Eastern Europe, World Bank Conference "Making the Transition Work for Women in Europe and Central Asia"; Washington DC, June 7–9, 1999, [www.europeanforum.bot-consult.se](http://www.europeanforum.bot-consult.se), accessed September 8, 2004.

<sup>4</sup> The existing male-female gap in unemployment is probably greater due to the underestimation of female unemployment rates. The reason lies in the tendency to use employment offices data which omit those not recorded out of whom the majority are women.

Career advancement of women has been evidently constrained. It is much more difficult for women to climb organizational ladders to gain more powerful positions in economic, but also cultural and political sphere of life. For example, there are only 10% of women in Hungary among general managers, approximately 25% assistant managers and 30% of top executives (CEE Network for Gender Issues, 1999). The percentages do not vary greatly across the region.

The number of women entrepreneurs in all transitional economies is rather lower than men. Numerous studies (e.g. Ruminska-Zimny, 2002; Thomson, 2002; Kantor, 2004) confirm lower levels of women's entrepreneurial activities as well as significant gender specific barriers starting businesses. The female entrepreneurship, e.g. self-employment, in transition economies has been predominated by men and has been emerging more out of necessity than opportunity<sup>5</sup> although self-employment as such is discussed as an attractive option of female labor since it is characterized by a high degree of autonomy and flexibility.

Despite of their participation in the labor market, women hold major responsibility for childcare and family. The benefits of the previous social welfare system (paid maternity leave, child care, free health and education, pension security, job security, etc.) have been reduced due to the privatization of the public sector as well as by serious of reforms of social services that are becoming less supportive for a working women shifting more burden and tasks in an ordinary life of a women. Reforms of social security presupposes the transferring of social costs on the poor; shortening of maternity leave together with the lack of daily childcare financially acceptable (e.g. kindergartens) makes harder on women to enter labor market or to return to it (Milidraj-Smid, 2004).

According to Dokmanovic (2004) several points summarize the status of women in transitional economies:

- women are representing the most marginalized and the biggest social group adversely affected by the economic transition, especially privatization process;
- continuous deterioration of women's economic and social status across the region;
- discrimination of women at the labor market in terms of age, wages, etc.;
- greater unemployment of women than men;
- lack of resources and opportunities for women as economic agents;
- insufficient participation of women in decision-making and policy creation;

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<sup>5</sup> Opportunity entrepreneurship is defined as perceiving a business opportunity due to the, for example, glass-ceilings or a desire for self-fulfillment. Necessity entrepreneurship has been defined as absent or unsatisfactory options, or entrepreneurship as a last resort.

- marginalized groups of women, such as rural women, minority women, elderly women and the like, experience the biggest social and economic hardships;
- deficient attention to gender issues in public policy and economic sphere.

These observations are more or less valid throughout the world regardless of the country's wealth or political system, but in the transitional economies compared to developed economies they are more intensive and subjected to in-depth analysis. It is evident that social and economic position of women varies across the world being more unfavorable in the countries of transition and developing countries than in developed ones (Kantor, 2000). Such discrepancy can be attributed, among many social, economic and political factors, to the socialistic heritage and transitional process.

### **3. The Headway of Manifold Roles of Croatian Women**

The status of Croatian women in politics, economy and entrepreneurship goes in the same line with the worldwide and regional experiences of women mentioned before. They are politically under-represented, economically less active and locked into typical female domains in business and social life. The political, economic and entrepreneurial portray of Croatian women reveals that their abilities, skills and knowledge are often channeled into tackling the female issues such as education, social services and the like and that their entrepreneurial abilities are reflecting more necessity than pursuing business opportunities.

#### **3.1. Women in Political Arena**

Opposite to the pre-socialist period when women in Croatia had been economically, politically and socially deprived of the same rights like men, socialism, which after 1945 brought along the right to vote for women, meant a significant change in women's position within the system. It had introduced the principles of gender's equality and parity that legally granted women rights equal to those of men in their economic, social and political lives. However, the gender specific legislation typical for socialistic countries enacted in the 1960–1970's prevented women from certain careers especially highly paid occupations (Bliss and Garratt, 2001). Such legislation worked in favor of Croatian families making women more oriented towards the functions of mothering and homemakers, while at the same time causing disruption in the equality of women. The lack of a developed service sector and evident socio-political structure that has been marked by the separation of male and female roles ensured that women with full time jobs

were responsible for the majority of the housework. According to Sroda (1992) and Bishop (1990) Eastern European women performed 60% more housework than Western women. Also, they held majority of lowest paying and often monotonous and unsafe jobs concentrated in textile and food industry, educational and health services, earning 65% of the average man's wages.

In socialistic system, women were not proportionally represented at higher levels of decision-making bodies. This is vividly illustrated by the data on women's participation in Croatian Parliament (Sabor) in Table 1.

**Table 1. Participation of women in the Croatian Parliament, 1958–1990**

Phases	Period	Women delegates
octroyed phase	1958–1965	24,1%
competition phase	1965–1984	7,9%
key phase	1984 – democratic changes	18%

Source: Lovrin-Grgic, 2002.

The high expectations of Croatian women, regarding their position in the public and political life, from the start of democratic transition has been logical and understandable but the effects of transition to competitive market economy and democracy have not been translated into progressed socio-economic and political opportunities for female population.

After the political system changes and after the first multi-party elections, participation of women in Parliament, County and Municipal Assemblies, was drastically decreased from 18% to low 4,8%, which included Croatia into the same group of countries with Iran, Sudan and Romania. After elections in 1995 out of 127 seats in the House of Representative only 11 (8,7%) were held by women and in the House of Counties out of 68 representatives only 4 were women<sup>6</sup>. Therefore, during the first years of transition period in Croatia, political changes marginalized women and removed them from the sphere of public life and political decision-making. After parliamentary elections held on January 3,2000 the situation started to change for the better and women started to participate in political life of the country as carriers of political changes reaching the level of 33%<sup>7</sup>.

<sup>6</sup> Data obtained from 'The Status of Women's Human Rights in Croatia', Fall/Winter 2000, www.babe.hr, accessed on April 20, 2004.

<sup>7</sup> Eight other countries have achieved a 30% share of seats for women in parliament. They are: Sweden, Denmark, Finland, Norway, Iceland, Netherlands, Germany, and South Africa. Progress of the World's Women 2000 Executive Summary; United Nations Development Fund, 2000, www.unifem.undp.org, accessed on April 20, 2004.

### 3.2. Women in Economic Arena

The volatility of Croatian economy in 1990's caused by the breakdown of the former socialist system and the Homeland War (1991–1995) have shaken the sociopolitical situation of women, as more women have been pushed into the labor market to compensate for the loss of purchasing power within the household. Under the pressure of the global economy and accompanying economic and social liberalizations, more and more Croatian women are entering the job market being driven not only by conventional factors of poorer macroeconomic performance on the national economy, but also due to a sense of devaluation of domestic role and a desire of self-fulfillment (Muragai, 1999).

Croatian women had a significant role in development of private sector and transformation in general, however the benefits from socio-economic transition have not been equally distributed (RRIF 5/2003; ZAPI 2003; Population Consensus, 2001). According to the official statistics (2003) the share of women in the total number of unemployed reaches 56,4%, in informal economy 65% and part-time employment up to 86%. Among long-term unemployed persons in Croatia 60% are women. Women are holding the majority of jobs in public sector, 52% and only 39% of jobs in private sector. It has been estimated that only 30% of total entrepreneurs in Croatia are women. They are also trailing men when it comes to self-employment (28%). At the level of management within organizations, top management positions belong to only 27% of total employed. Women tend to earn less than their men counterparts up to 75% of average salary men earn which is found similar to such experiences in other CEE countries. To summarize it, women are significantly constrained to developed careers as men in many aspects of business life<sup>8</sup>.

Generally speaking, the era of transition has put Croatian women in hardship causing their unfavorable position in society and workplace. As a result, they are often under-represented in well-paid positions, improperly trained for careers in the new economy and lacking institutional and policy support to activate more in labor market while handling demanding role in the family. The results of survey conducted in the second half of 2002 in the frame of the University Fellows International Research Consortium, international organization directed

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<sup>8</sup> American scientists state three factors that constrain women to achieve career similar to their men counterparts:

- 1) absenteeism of women from work place (e.g. maternity leave);
- 2) communicational climate which suffers from stereotypes (woman as sexual object, woman as mother, etc.);
- 3) invisible barriers as products of those stereotypes and which operate through "glass ceilings", keeping women in so called women areas or women activities (Wood, 1993).

See in: Leinert-Novosel S., *Politika zapošljavanja žena*, *Politička misao*, vol. XL, br. 3, 2003, p. 113.

to research of business operations revealed that the legacy of former regime and the traditional role of women manifested through above mentioned reflect to women's own perception of career advancement and career options. Hence, for example, moderation, subordination, servitude, keeping a low profile and similar behavior are still very much present. New values such as pro-activity, independence, ambition, risk taking, self-initiative, responsibility, successfulness and similar that market oriented economy requires are not unknown to women yet they are still not perceived as key criteria for career advancement (Borožan *et al.*, 2003).

Even though the transition of Croatia has not been gender neutral, it has created new opportunities for women to improve their chances on the labor market through entrepreneurship and self-employment. These opportunities are not yet fully realized by Croatian women but they have been viewed as a way of empowering women in economic, social and political sense since entrepreneurship is not just a business form but the way of behaving as well.

### 3.3. Female Entrepreneurship

As in other transitional economies across the region, SMEs in Croatia have a great potential to be powerful source of economic growth accounting for more than 99% in the total business enterprises. The number of SMEs per 1000 inhabitants in Croatia has reached a two-digit number of 13,7 as it is case in most transitional counterparts, though less than in Czech Republic (85,1), Poland (45,6) or Hungary (27,4), the countries that is Croatia mostly compared with (Falcetti *et al.*, 2003).

Nearly all SMEs are privately owned and the private sector dominates economic activities of transitional economies. About 60% of GDP in Croatia comes from the private sector which proves a significant improvement since the beginning of transition process with 11% of Private sector/GDP ratio. The structural indicators of SMEs development in Croatia compared to other European countries do not show greater deviations and are approximately identical to SMEs data in developed European countries (see Falcetti *et al.*, 2003). It has been evident that a spirit of entrepreneurship appears to be emerging in Croatia.

According to the share of employment, the SME sector in Croatia employs more than 60% of working population. Thus, it has been expected that the SME sector should continue contributing to a positive overall employment growth and remain the most vibrant part of the national economy when it comes to the job creation in the country.

In spite of all problems encountered or maybe because of them, more Croatian women are increasingly interested in entrepreneurship. This is supported by the fact that 27% of all employers in Croatia are women, as managers or as

entrepreneurs. Thus, there is a real need for supporting female entrepreneurship in Croatia particularly regarding following reasons:

- 1) the government support of entrepreneurship should intensify even though a progress has been made;
- 2) women entrepreneurs have proven to be different than men on several important dimensions and therefore the incentives for their entrepreneurial advancement should be tailored to their specific needs.

Even though more and more women are “pushed into” the labor market, larger number of women in labor force did not translate into an increased number of women in entrepreneurship. Similar to the case of female entrepreneurship around globe in general and transitional economies in particular, Croatian men start their own business more often than women.

Entrepreneurial climate within a country has significant impact on propensity of women for entrepreneurial activities. The research at Babson College supports this thesis (Echeverri-Carrol and Brandazza, 2002). Based upon the survey on a representative sample of 1 000 adults, the rate of new business creations has been estimated. The results suggested significant difference among countries in new start-ups. When diversified by gender, the data showed relatively similar start-up participation rates for women and men in the USA and Canada, both countries having high levels of entrepreneurial activities measured by TEA (Total Entrepreneurial Activity) index<sup>9</sup> – 11,94 and 8,01 respectively. Opposite showed to be true for countries with low levels of entrepreneurial activities where start-up participation rates were significantly disproportionate for women and men<sup>10</sup>. The case of Croatia follows this line of reasoning. Croatian TEA index of 3,69 in 2003 (all participating countries’ average is 6 878) has been lower than in countries with similar socio-cultural and economic heritage such as Hungary or Slovenia. This has been reflecting on women engaged in entrepreneurial activities where men become more than two times often entrepreneurs than their female counterparts (Table 2). It is evident that men are more entrepreneurial inclined whether entrepreneurship is seen as an

<sup>9</sup> The TEA index is uniquely created indicator by GEM which measures a total entrepreneurial activity within a country. It combines the number of persons active in start-up process or managing business not older than 42 months. The identification of those persons is obtained by survey on random sample of at least 2000 adults in country participating in GEM project. More on TEA indexes on the official GEM site, [www.gemconsortium.org](http://www.gemconsortium.org).

<sup>10</sup> According to GEM (2003), the highest levels of entrepreneurship among women has been noted in Thailand where 18,5% of women surveyed are entrepreneurs, India 14,1%, Argentina 11,5%, China 11,0%, New Zealand 10,6%, Mexico 10,3%, Chile 9,5%, Korea 8,6% and the United States (8,1%). The lowest levels of female entrepreneurship has been recorded in Japan 0,6%, Belgium 1,5%, Russia 1,6%, France 2,1%, Hong Kong 2,3%, Spain 2,6%, Sweden 2,6%, Singapore 2,7% and Slovenia 2,9%.



opportunity or threat which is in congruence with world statistics – in 39 GEM countries men are 1,8 times more engaged in entrepreneurship than women.

**Table 2. TEA index by gender in Croatia, 2003**

Gender	TEA total		TEA opportunity		TEA necessity	
	2002	2003	2002	2003	2002	2003
Female	1,58	1,42	0,74	0,53	0,64	0,72
Male	5,12	3,69	3,20	2,95	1,05	0,42

Source of data for 2002: GEM for Croatia, Singer e. al., 2003

Source of data for 2003: Singer et al, 2004, working materials

It is interesting to notice comparing GEM reports of the years 2002 and 2003 that the TEA indicators for both female and male have decreased. According to statistics in table 9, there are less men who are becoming entrepreneurs out of necessity or because of the opportunity, while women show increase in becoming entrepreneurs out of necessity and decrease due to the opportunity pursued.

According to TEA indices categorized by age and gender (Singer *et al.*, 2003), the level of entrepreneurial activity does not vary greatly among women considering the age while it reduces progressively with the age when it comes to their male counterparts. The difference in the level of entrepreneurial activities between women and men converges at age 55 and higher, while the highest disparity is in the age of 25–35.

### **Constraints to Advancement of Female Entrepreneurship in Croatia**

Women entrepreneurs often face barriers not usually encountered by men (Gould and Parzen, 1990): lack of socialization to entrepreneurship in the home, school, and society; exclusion from traditional business networks; lack of access to capital and information; discriminatory attitudes of lenders; gender stereotypes and expectations, such as the attitude that women entrepreneurs are dabblers or hobbyists; socialized ambivalence about competition and profit; and lack of self-confidence.

Constraints affecting women entrepreneurs in Croatia range from various perceptions and social norms that are institutionalized in various aspects of socio-economic life in the country. Most common problems cited as major constraints to greater female entrepreneurship development in Croatia are similar to those world-wide (RRIF 5/2003): difficult access to financing, information; insufficient skills and knowledge and education opportunities; overburden by work and child/household responsibilities; gender division of labor and gender role socialization.

Women in Croatia experience less opportunity than men to gain access to credit for various reasons. Mostly it is due to weak collateral position since women often are not owners of real estates or they show greater unwillingness to use household assets as collateral. In some cases, women complain that some loan officers show a bias against female entrepreneurs.

Access to information is a general problem of SMEs due to the competition over information with larger companies which have more power and resources to access it. Information is best obtained in Croatia through informal networks, membership in various associations and engagement in various activities and events. Women have greater difficulties to engage in such activities and events, that often take place after working hours, than men due to their additional work as homemakers.

Gaining relevant and additional knowledge and skills for women is also more difficult since their responsibilities and work at home leave them less time available for attending formal and informal trainings. Also, trainings and educational programs tailored to women's need both professional-wise and organization – wise are currently insufficient in Croatia although they have been emerging lately (e.g. seminars and workshop organized by regional Centers for entrepreneurship across the country).

Noted problems are concerning the fact that women tend to engage in entrepreneurial activities which are of lesser value markets implying less innovation as well. Namely, many women entrepreneurs engage in low value markets where barriers to enter are less in number but in turn such sector is more crowded and thus offering less opportunity to further grow and develop especially using innovations.

The common denominator to some of problems stated is the fact that women do need to cope with work and family. Petrović (2002) states that women are overburden by the responsibilities at work and home. Croatian women have it more difficult than women in more developed countries to combine their duties as homemakers and workers; they have it more difficult compared to men which proves to be true for all transitional economies<sup>11</sup>. It seems that women of transitional economies have been victims of generating new roles in economy while not having traditional roles in family revisited.

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<sup>11</sup> For example, women in world, e.g. Australia, work 38 hours at home alone doing housekeeping and providing childcare compared to 16 hours of man's engagement at home activities. Combined with working hours at work, women work 1,5 months more than men. The more dramatic results come from Central and Eastern Europe where women work 85 hours at work and home together compared to men who work 70,6. Twenty years ago women in transitional economies worked 70 hours per week which represented a significant difference compared to 55 working hours of women from Western countries (Petrovic, 2002).

This is partly due to general economic conditions (e.g. lower incomes buy less help in the house, for example housekeeper or electric appliances or less free time in general) but to society's perception of woman's role in the household where women typically do most of the housework and child care themselves. Vučinić-Palašek (1995) states most of the women in Croatia are employed while being housekeepers at the same time at home (44%) being responsible for most, if not all, housework and family care; more rare cases are successful employed women with career who share their housework and family care with other members of the family (9%).

Also, society is less informed about successful businesswomen, particularly entrepreneurs. According to the results of MediaNet (RRIF 5/2003), familiarity to business women of Croatia is much less than familiarity to women in politics or media. Out of 406 people surveyed (18 years and older), 80% could not name a single business woman in Croatia while only 1,7% surveyed could name only three business women. On question about women in politics, surveyed people named spontaneously 30 various names. These results imply that there is a serious lack of awareness of economic activities and successes of Croatian women in the business community. Less women's contribution to the national economy is known, less is the possibility to develop and fully utilized women's potential as economic agents.

Women entrepreneurs differ from male entrepreneurs not only in problems they are facing but also in reasons for starting a business as well as their goals and factors they perceive as success (compare TEA indices by gender in Table 2). Using current periodicals, newspapers and on-line research on women entrepreneurs in Croatia, some of the most cited reasons why Croatian women start their own businesses are following:

- some women start businesses out of the same reason as men do and that is to pursue a window of opportunity, respond to a need to utilize their knowledge and experience;
- unemployment, being result of privatization and corporate downsizing that affects women more than men since they are usually at the bottom of the corporate level and tend to be dispensable, is a strong impulse for self-employment and entrepreneurship development. Also, numerous women prefer to start up their own business rather than to pre-qualify believing that a change in vocation will not bring better employment possibilities;
- most women who start their own businesses tend to be highly motivated individuals and have great need for achievement;

- copying with family and work at the same time has been a reason for some women to start up their businesses in order to have more flexible working hours and have more time for family matters.

When it comes to their business goals, women often state that long-term development, continuous innovations and upgrading of quality are among the most important ones, as well as long-term capital accumulation and investment. The most important factors they perceive as important for a success concern innovation and creation of something new and better, continuous learning human relationship within their organization, improvement of emotional IQ of their employed, professional attitude, moral and legal behavior.

Based upon above elaborated, it is safe to conclude that women entrepreneurs in Croatia differ from men in many aspects – from obstacles and intensity of those obstacles they face up to reasons, goals and success factors of their businesses. These differences should be taken into consideration while creating a policy that will integrate gender perspective into promoting SME sector development.

## **4. Conclusion**

While the economic and social position, i.e. participation of the women in CEE countries was granted by the constitution and law on policy of full employment, the transitional turmoil has greatly changed the women's participation in the business, political and social arena. Studies across the region have been showing that women in transition have been more affected by the new macroeconomic policies, privatization and institution building as compared to men.

Gender trends across the region show that women were affected more by the employment reduction caused by the economic recession, closure of plants and other hardships attributed to the economic transition. Women are generally doing worse than men when it comes to sectoral changes lagging behind men in pursuing the opportunities that development of the private sector is offering and often are constrained in participating in most dynamic branches of industry and service sector. Even though increasing number of women appears as self-employed and entrepreneurs, they do so more out of necessity than opportunity often facing barriers to enterprise development that are in nature and scope gender specific. In addition, women participation in public life, i.e. politics and at other decision making levels have been modest which represents a barrier for their political, social and economic empowerment. Wage gaps further support the persistence of gender asymmetry in the labor market. The paternalistic tendencies, that prevail in the CEE countries, point out that transitional societies still nurture

the male breadwinner approach that stereotypes views of gender roles in private and business life.

Creating a market economy together with a democratic society requires such policies that would ensure the equality of opportunities regardless of gender. The special attention should be given to:

- to specific anti-discriminatory labor market legislation that will provide equal opportunities for both men and women to compete for jobs;
- support of self-employment and female entrepreneurship and reduction of gender specific barriers that prevent women to access credit, information and training necessary for enterprise development;
- establishment of family friendly and supportive policies that will lessen the burden of working women allowing to balance better between family care and work;
- recognition of women's role in politics and at the decision making positions in order to ensure the consensus on transition policy benefiting both genders.

Development of female entrepreneurship in Croatia addresses the issues that are equally shared by other transitional economies. Entrepreneurship and self-employment could be seen as a reaction of women to gender inequalities as well as a response to job insecurity, job losses and poverty caused by the transition process. Supported properly, female entrepreneurship could contribute to the development of the region in the future through poverty alleviation, generating employment and economic, social and political empowerment of women.

There are at least two aspects of promoting and advancing female entrepreneurship in Croatia – at the policy and research level. The research of women entrepreneurs should take into consideration three following issues (Wilson, 1998):

- 1) there is a lack of empirical evidence that explains many things about how women operate in their business community, and even less on female entrepreneurs in Croatia. Research questions should delve into how women view entrepreneurial success, how they view their roles and businesses, how they balance their families with their businesses, and how they make decisions;
- 2) women entrepreneurs should not be studied as a homogenous group because they show differences in goals and motivations they try to achieve through their own business, i.e. women who start their own business in order to achieve greater balance between the work and the family may have completely different growth strategies than women who are either main income generators in their household or have great career ambitions combined with a strong need of achievement;

3) gender aspects of SMEs is a challenging task to research since women in business, i.e. entrepreneurship cannot escape the wider society that greatly defines their roles, activities, economic and non-economic values. Thus, holistic approach to investigate the gender asymmetry in SME sector is more appropriate than simple unidimensional one.

Policy efforts to promote women in entrepreneurship should be focused on various issues out of which some include following:

- promoting women entrepreneurship through enabling easier access to finances, information and development of skills and knowledge through formal and informal educational institutions;
- establishing new innovative ways by local governments and companies for child care and family support (e.g. continuous support to pre-school child care, developing and implementing job-sharing policies, flexible working hours, more part-time jobs);
- increasing public awareness and respect towards female entrepreneurship through strengthening women's organizations, lobbying, increasing their number in political decision making bodies, etc.;
- promoting female entrepreneurship and entrepreneurship in general at earlier phases of children's education (e.g. high school level) so that young girls are exposed to entrepreneurship and its values in order to develop sense of confidence and skills to pursue any opportunity as well as to capitalize on it in later years;
- modifying overall social climate and cultural stereotypes that discourage women in pursuing business opportunities;
- developing complete support system for female entrepreneurship from start-up process to creation of so-called support networks;
- supporting participation of Croatian business women and entrepreneurs in international networks in the region and globally (e.g. participation of Croatian female entrepreneurs in Eurochambers', "Network for Supporting Female Entrepreneurs");
- developing mentoring programs through which well-established women entrepreneurs coach and mentor female entrepreneur beginners in order to help them overcome initial business difficulties;
- using more "best practice" approach to enhance female entrepreneurship as well as to promote female activities in all sectors and not only in gender socialized one (e.g. encouraging women to enter more IT and high-tech sector).

These policy implications may serve as a general guide for national or regional decision in promoting women entrepreneurs as an important human resource for economic development.

The time has come when civilization reach of society has been measured by women representation in its public, political and especially economic life. Gender sensitive policies and gender awareness should be accompanied by the change of social climate free of stereotypes and discrimination in order to utilize women's economic, natural and cultural values as a fuel for economic and social development.

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