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Russian Oligarchs: a Quantitative Assessment

Russian industrial tycoons, or "oligarchs", are notorious for their wealth, derived from the control over vast natural resources. They are also said to have exerted significant influence on Russia's national politics. Although the oligarchs' role in the Russian economy and politics is debatable, quantitative assessments can already be made. *Sergei Guriev and Andrei Rachinsky*, from the New Economic School/CEFIR in Moscow, explore how many oligarchs there are, what assets they control, and how well they manage them, allowing cross-country and historical comparisons. The article draws on the study of ownership concentration conducted for the World Bank's 2004 Country Economic Memorandum for Russia.

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Theme of the Issue: Corporate Governance

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Does Good Corporate Governance Shelter Investors from Contagion?

Russian 1998 financial crisis had adverse effects on countries far beyond the borders of the Russian Federation. Due to geographic proximity and close trade and financial links, the transition economies were among those most severely hit by the Russian virus. Proceeding from the assumption that there is a link between the severity of a crisis and the corporate governance systems in each affected country, *Anete Pajuste* of Riga Business School and SITE examines which firms were most affected by the Russian crisis and what mattered more, firm or country characteristics.

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Infrastructure in Transition: Regulation and Private Sector Participation

Efficient and accessible infrastructure services help to promote economic growth and to alleviate poverty. There is general support for this argument but less evidence on how this should be achieved in practice. Transition countries face significant infrastructure challenges, such as tariffs that do not reflect costs, extensive cross-subsidization, poor revenue collection, and time-worn service networks. Progress in infrastructure reform in the region has been hindered by a lack of efficient regulatory institutions, and by vested interests seeking to protect their positions of strength. What has the region learned from reforms so far, and how successful has private sector involvement been? *Alan Rousso* of the EBRD reports on the main findings of the EBRD's 2004 Transition Report.

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Challenges for Transition Economies, Challenges for the World Bank

The Europe and Central Asia region has experienced unprecedented challenges since the dissolution of the Soviet Union in December 1991. This vast region of 28 countries and 500 million people moved from centrally planned to market economies, and from communism to democracy. *Johannes Linn*, a former vice president of the World Bank for the Europe and Central Asia region, writes that four distinct sub-regions have emerged – the Central European countries and the Baltics, South-East Europe, Turkey, and the CIS countries – each facing unique economic and political problems and challenges.

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THE WORLD BANK

From the Managing Editor:

Dear reader,

The Newsletter is going through a transition of its own. From its original focus on transition news, the Newsletter has evolved — with the accumulation of experience, improved data, more rigorous thinking on transition and the increasingly different circumstances in which the transition countries find themselves — into a digest of new policy-oriented research and a calendar of important activities. As Richard Hirschler, the founder and editor for many years, is retiring, the time has come to move forward in the publication's development. A new editorial board has been appointed, consisting of Alan Gelb, Pradeep Mitra, and Boris Pleskovic, and I have agreed to serve as managing editor, overseeing the Newsletter's transformation.

The new editorial board wants to make the Newsletter one of the leading publications for policy circles concerned with transition, fostering debate among policy-oriented researchers and policy makers, particularly in the transition countries. The publication should cover the key policy issues and local/regional policy processes, offer analysis and lessons across countries, and present interdisciplinary work in fields such as economics, law, and politics. We want to cultivate the "newsletter" image in terms of design, but model its content on leading policy publications, with features and more debate-oriented contributions. Articles will be shorter, and the whole publication less voluminous. There will be four issues per year.

We aim to emphasize research from think tanks in transition countries and involve these institutions in the production of the Newsletter. Olga Mosina, of the Centre for Economic and Financial Research (CEFIR) at the New Economic School in Moscow, will serve as editor-in-chief, drawing on local editors from newly emerging centers of excellence in policy research. The Newsletter will be published in both English and Russian, with the Russian edition adjusted to improve impact among Russian-speaking policymakers.

Some new features have already been introduced in this issue. From now on, each issue will have a theme. This time the focus is on corporate governance, one of the most important topics in the region at the moment. The subject is scrutinized from several angles. The issue reports on recent research findings, including articles by Anete Pajuste, Chong-En Bai, and Sergei Guriev and Andrei Rachinsky. The articles by Mihir Desai and Alberto Moel, Krzysztof Obloj, and Andrew Weiss and Georgiy Nikitin provide specific country examples. The article by Stijn Claessens and myself briefly surveys one strand of the literature and suggests policy implications. In a special debate section, policymakers and others are invited to discuss the featured topic. In this issue William Browder, one of the leading shareholder activists in Russia through his Hermitage Fund, criticizes the development of minority "squeeze outs", while Viktor Pleskachevsky of the Russian State Duma argues in favor of the amendments to the Russian corporate legislation.

To underscore our evolution, we are changing the title for the publication to *Beyond Transition*. Other changes will be implemented gradually and in close interaction with our readers, so please let us now what you think as we proceed with our own transition.

Erik Berglof, Managing Editor

What's Inside

Theme of the Issue: Corporate Governance

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Russian Oligarchs: a Quantitative Assessment

Sergei Guriev, Andrei Rachinsky

A study of ownership concentration in Russia undertaken by World Bank in 2003 broadly confirmed stereotypes about the so-called "oligarchs". The concentration of ownership in contemporary Russia is higher than in other countries. The 22 largest business groups control about 40% of Russian industry. Micro-level data suggest that oligarchs run their assets better than other Russian private owners. While the relative weight of oligarchs' firms in the Russian economy is tremendous, the firms themselves do not appear excessively large by the standards of the global markets in which most of them operate. Historical experience from other countries, meanwhile, suggests that such a high level of ownership concentration can create considerable problems in building sustainable democracy in Russia.

Russian industrial tycoons, or "oligarchs", are the quintessence of Russia's transition to capitalism. An oligarchy, as discussed in Plato's *Republic* and Aristotle's *Politics*, is a form of government by a small group. In contemporary Russia, the term denotes a large-scale businessman who controls resources sufficiently vast to influence national politics. The first mention of oligarchs was probably made by Boris Berezovsky (by all accounts, an oligarch himself) who, in a 1996 interview with the *Financial Times*, named seven bankers who controlled about 50% of Russia's productive assets. Berezovsky said that these people exerted significant influence on Russia's state policy.

Are these oligarchs likely to be agents of economic and political change, or opponents of such change? On the one hand, oligarchs are the only feasible counterweight to the predatory and corrupt Russian bureaucracy; and they are a unique constituency that is both willing and able to lobby for the development of market institutions. They are also the only Russian owners who can afford to invest and restructure Russian businesses in a very hostile business climate. On the other hand, the oligarchs have weakened Russia's economy directly, by stripping assets from Russian firms and sending money abroad, and indirectly, by discrediting the ideas of private property and the corporation among the public at large. They have also weakened Russia's democratic institutions, by capturing federal and state agencies.

The debate about the role of the oligarchs will probably go on for decades. Several quantitative assessments, however, can already be made. How many oligarchs are there in Russia? What assets do they control, and how well do they manage them? Should the oligarchs' empires be broken? How high is the concentration of wealth in Russia compared to other countries? The study of ownership concentration conducted for the World Bank's 2004 Country Economic Memorandum for Russia attempted to answer these and other questions.

The World Bank study identified the structure of control in 45 Russian industrial sectors, including natural resources, manufacturing, construction, and market services. In the resource and manufacturing industries, 32 sectors were selected, representing 77% of total sales. We plied through lists of hundreds of intermediate owners in order to determine the ultimate owners, including foreign firms, individuals, and federal government and regional governments.

Are the Stereotypes True?

This ambitious project has confirmed common stereotypes. Indeed, ownership of Russian industry is highly concentrated: 22 large business groups control about 40% of industrial output, more than all other private owners put together. The assets of the largest private owners are concentrated in the natural resources industries.

Many of the differences observed between oligarch-controlled firms and other firms are determined by industry specifics. For example, oligarchs' control over large enterprises can be explained by the fact that they operate in industries where the average enterprise is large. Similarly, oligarchs' firms are on average more productive, but if we compare productivity levels of firms controlled by oligarchs and by other private owners within the same industries, the difference in productivity turns out to be insignificant.

Still, if we look at productivity *growth*, the oligarchs' enterprises have fared well, controlling for size, industry and location. In 2002, the oligarchs outperformed other private Russian owners by 8% in terms of total factor productivity growth. Their companies are inferior only to foreign-owned firms (which beat other Russian firms by 12%). It should be noted that fast productivity growth is associated with greater output growth rather than a dramatic decrease in employment.

Do oligarchs hold excessive market power in the sectors that they control? The sectors controlled by oligarchs are those that are highly concentrated. However, these are also the tradable goods sectors that are most subject to global competition. Except for ore and automotive manufacturing, all of these sectors sell to global markets. Ore production is mostly owned by the oligarchs' steel-making conglomerates, which use the ore as an input, so the problem of concentration is somewhat mitigated by vertical integration. The automotive sector, however, is a classic example of interest-group politics. Russian-made cars are not internationally competitive and the industry has always relied on protectionism, which has increased along with growing oligarchic control over the industry. Thus, except for the automotive sector, there seems to be little reason for concern over the oligarchs' excessive market power. Some oligarchs are important global players in their industries (especially in oil and metals), but none is a dominant market leader. Russia therefore does not need antitrust policies aimed at breaking up oligarchs' holdings.

Who owns Russia? Shares in sales and employment controlled by each category of owners in the sample

Owner category	Employment	Sales
Largest private owners (22 groups)	42%	39%
Other private domestic	22%	13%
Foreign	3%	8%
Regional governments	6%	6%
Federal government	15%	26%
No data	12%	8%

Russian oligarchs in an international perspective

Cross-country comparisons of wealth concentration are usually based on the share of stock market capitalization controlled by a certain number of families (e.g. ten). By this measure, ownership concentration in modern Russia is higher than in any other country for which data are available. However, in historical perspective Russia does not seem to be unique. Quite a few countries have gone through a period of high ownership concentration, but they have eventually moved on. Korean chaebols, Japanese zaibatsu, Swedish and Italian family firms, and US "robber barons" all enjoyed similar economic and political power; many acquired wealth with substantial support from the state (through direct subsidies, tax breaks, land grants, subsidized credits, etc). Not surprisingly, many of these dominant owners were at some point considered illegitimate by public opinion.

These countries have achieved high levels of economic growth, although the high concentration of ownership has in all cases slowed down the development of an effective democratic system. The most serious problem created by Russia's oligarchic capitalism is that privatization has not led to secure property rights. Russian voters still do not fully recognize the legitimacy of privatization. This has created a conflict between the core free market values (private property rights), on the one hand, and crucial democratic values (majority rule), on the other. However, the problem of the illegitimacy of concentrated ownership can not be resolved by a simple redistribution of wealth. Historical experience suggests that the size and composition of conglomerates depends on the institutional environment and market conditions. Hence, if oligarchs' empires are broken up and sold piece by piece, they are likely to reemerge as unified groups, albeit controlled by new owners. Nationalization will not work, either. The assets currently controlled by oligarchs can and should be run by private owners; there are no externalities or public good arguments involved, and the inefficiency of Russia's state-owned companies is notorious. It is not surprising that in our dataset privately owned firms consistently outperform public companies, controlling for industry, location, and size. The only way out for Russia lies in further financial development, the enforcement of competition policies, openness, lower entry barriers, and a more effective legal system

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OECD Corporate Governance Principles

The OECD Principles of Corporate Governance endorsed by OECD Ministers in 1999 and thoroughly reviewed in 2004 offer non-binding standards, good practices, and guidance on implementation, which can be adapted to the specific circumstances of individual countries and regions. According to the Principles, a good corporate governance framework should:

- Be consistent with the *rule of law* and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities;
- Protect shareholders' rights;
- Ensure the equitable treatment of all shareholders, including minority and foreign shareholders;
- Encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises;
- Ensure timely and accurate disclosure on all material matters regarding the corporation;
- Ensure the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Source: OECD, www.oecd.org

What Do Firms Disclose and Why? Enforcing Corporate Governance and Transparency in Central and Eastern Europe

Anete Pajuste

The countries of Central and Eastern Europe began their transition from different starting points and have pursued remarkably different policies. Yet today, their economic systems are rapidly converging. The contours of a new European capitalism are emerging, combining features of continental European capitalism with large controlling shareholders and elements of entrepreneurial, or founder, capitalism most associated with the United States. The core corporate governance challenge, however, remains the same: balancing the incentives of controlling owners to exercise governance with the protection of minority investors.

The emerging capitalist systems in Central and Eastern Europe share many features. Ownership and control of individual firms are becoming more concentrated, and corporate groupings are extending their influence. Policies aimed at severely restricting or eliminating controlling shareholders, the most potent governance mechanism in these countries, risk seriously undermining corporate restructuring and the ability of companies to raise external funds. Instead, efforts should be directed at ensuring that holders of large blocks of shares act in the interest of the company, enforcing extensive transparency regulation.

While other aspects of corporate governance rules often are highly controversial, there is broad unanimity regarding rules for providing information on who owns the firm and what governance arrangements are in place. Most of the Central and Eastern European (CEE) countries have already introduced the minimum disclosure standards stipulated by the Transparency Directive of the European Union. Several countries, however, have taken on additional commitments.

Our study explores the transparency rules in individual countries and the nature of information released by companies, with particular attention to the enforcement of disclosure requirements in different countries. Using a sample of 245 companies listed on CEE stock exchanges over the last six years, we construct an *availability index* based on the availability of annual reports on the company's website. To evaluate enforcement of disclosure rules, we then analyze 117 annual reports in terms of information on remuneration and shareholdings by management and the board, as well as related and affiliated party transactions. We construct an aggregate *disclosure index* based on the degree of detail the company provides.

The study shows that the level of disclosure varies substantially across firms, and there is a strong country effect on what companies disclose:

- The disclosure index is lowest in Romania, Slovakia and Poland, and highest in the Czech Republic and Estonia;
- What is disclosed depends on the legal framework and corporate practice in a given country, and it does not correlate with a firm's financial performance;
- Financial performance is strongly related with how easily information is available to the public, such that information is more available in larger firms, firms with lower leverage and higher market-to-book ratios.

Despite existing regulation, non-disclosure of the most basic elements of corporate governance arrangements is widespread. How could different forms of enforcement improve the situation? In answering this question, we differentiate between private ordering, private enforcement and public enforcement.

Private ordering can take the form of voluntary corporate governance codes, standards and company ratings developed by financial institutions, industry associations, the media or others. While these may be less credible than formal laws, this mechanism has significant potential in Central and Eastern Europe. Private enforcement of public law, i.e. actions by private agents to punish contract violations by using courts and state enforcement, is still underdeveloped and should be stimulated and improved. Public enforcement entails enforcement and prosecution by the state. Both have a role in influencing the overall effectiveness of the corporate governance system; they may overlap and can substitute and reinforce each other.

An important precondition for successful reform is the political will to support enforcement. Unfortunately, capacity-building for enforcement mechanisms is a long-term effort that is neither very visible nor politically rewarding. As a result, improvements in enforcing the rule of law should be expected to take longer than one might hope. When political will is lacking, increased transparency could facilitate more private initiatives. For example, by forcing firms to declare transactions with related and affiliated parties, other investors are given the opportunity to scrutinize such deals and, possibly, challenge them in court. Over time, increased information should allow investors to better evaluate the costs and benefits of different control arrangements in Central and Eastern Europe.

Anete Pajuste is an assistant professor at Riga Business School and a research affiliate at the Stockholm Institute of Transition Economics (SITE), the Stockholm School of Economics and the Baltic International Centre for Economic Policy Studies. ■

Corporate Governance in Poland: a History of Experimenting and Learning

Krzysztof Obloj

The modern history of Polish corporate governance dates back to 1989, when the 1926 Commercial Code was brought back into use. With thousands of state–owned companies set to be privatized, a major challenge in the 1990s was finding and training supervisory board members. In recent years, numerous corporate governance conflicts have highlighted the need for new measures and initiatives.

Corporate governance in Poland is regulated by a Commercial Code established in 1926, reactivated in 1989, and modernized in January 2002. The new code strengthened and clarified the powers of shareholders and supervisory boards, spelling out their competencies, responsibilities, and procedures. Changes in company bylaws, the approval of financial statements, and the election of supervisory and management board members, for example, must be decided at shareholder meetings. Most of these decisions can be adopted by a simple majority of all voting shares; only major decisions, such as those changing a company's capital structure, require a qualified majority of at least 75%. Like Germany, Poland vested the primary responsibility for the ongoing monitoring of company performance, operations, and managers in a separate supervisory board.

At the beginning of the 1990s, discussions about corporate governance were dominated by the daunting issue of who should serve on supervisory boards. With more than 7,000 state-owned firms slated to be privatized in the 1990s, demand for board members was enormous, and supply constrained. The state agency responsible for privatization set out to create future management board members through a four-week education program, capped by a complex series of exams. An international cadre of expert teachers was recruited for the program, including university professors of economics, law and business.

Those who passed the exams entered a pool, from which the State Treasury Ministry selected board members. From 1991—1993, when the capital market was still nascent, the process of appointing board members was not very political. The norms of professionalism and independence for board members were widely accepted and respected, even by politicians, as indispensable elements of the development of a market economy.

Over time, however, the norms of professionalism and independence were diluted by two major factors. The first was the return to power in 1993 and later in 2001 of the former communist party, renamed as Social Democrats. The former communists were used to the nomenklatura system, the common practice of requiring the approval of national, regional, and local communist party committees before allocating posts. Posts on supervisory boards became valuable assets, to be distributed in a controlled manner to party members and other political cronies. The second factor was the growing sophistication of international funds, local investors, and powerful state-owned companies (especially banks and insurance firms) about how they could use the system to manipulate capital markets. Seats on boards needed to be secured and controlled by people who would perform in accordance with the wishes of particular shareholders. These two factors led in the late 1990s to a growing number of corporate governance problems in Poland.

Between 1999 and 2004 shareholder conflicts, aggressive investment tactics, unexpected breaches of trust by former allies, and the mistreatment of minority investors all combined to employ hordes of lawyers, whose imaginative ideas and interpretations yielded hundreds of ways to bend corporate governance law. Some of the biggest corporate governance conflicts arose from inherent tensions between foreign investors looking to fit their Polish subsidiaries into a multinational network, and local investors seeking to maximize their in-country returns.

After the 2002 commercial code did little to improve this situation, a special initiative was launched to develop codes of good corporate governance practice, with the support of the Securities and Exchange Commission and the Warsaw Stock Exchange. The resulting Code of Good Governance Practices stipulates that dominant investors have special rights as they take larger risks, while minority rights should be protected without prejudice to the interests of the dominant investors. It promotes the idea of independent directors in the supervisory board and recommends that crucial decisions about the fate of the company be made only with their consent. The code also calls on supervisory board members to treat the interests of all shareholders and the company as equally important. Other issues treated in detail by the code are the preparation and execution of shareholder meetings, and the procedures for and organization of supervisory and executive boards.

In short, the market is learning, experimenting and trying to develop good principles and mechanisms for resolving investors' conflicting interests. There remains, however, a long way to go.

Krzysztof Obloj is a professor at the School of Management, Warsaw University. He has been a member or a chairman of more than 15 boards of public and private companies, including a chairman of Agora-Gazeta SA, the largest Polish media group; PZU SA, the largest financial and insurance group in Central and Eastern Europe; and DWORY SA, one of the largest chemical companies in Poland. He contributed this comment to the Newsletter. ■

Corporate Governance and Market Valuation in China

Chong-En Bai, Qiao Liu, Joe Lu, Frank M. Song, and Junxi Zhang

More than three hundred years ago, Adam Smith raised the issue of the separation of ownership and stewardship in joint-stock corporations. Centuries later, in 1932, the seminal work of Berle and Means argued that, in practice, firm managers pursue their own interests rather than those of shareholders. How can the conflict of interests between a firm's owners and its managers, and between controlling and minority shareholders, be resolved? A set of effective mechanisms is needed to ensure that the suppliers of finance get an adequate return on their investment, that the firm's value to its owners is maximized, and that the rights of shareholders are observed. In other words, good corporate governance is necessary.

Corporate Governance after the Asian Financial Crisis

The emerging markets crisis in 1997 and 1998 rekindled worldwide interest in the issue of corporate governance. In recent years, advocating higher governance standards has become a constant campaign, in which an increasing number of parties — academics, the media, regulators, corporations, institutional investors, international organizations, and shareholder rights watchdogs — have been participating. McKinsey & Company found in 2002 that the number of articles mentioning the term 'corporate governance' in major international economics and finance media had increased ten-fold from the pre-crisis period 1996—1997 to the period 2000—2001. In the academic literature, the crisis has spawned a voluminous body of research on governance related issues, especially in emerging markets.

Corporate Governance in China

The Chinese government opened stock exchanges in the early 1990s to raise capital and improve the operating performance of state-owned enterprises (SOEs). In less than twelve years, China's stock markets have grown to become the eighth largest in the world, with an aggregate market capitalization of more than $500 billion. Chinese companies, especially SOEs, have benefited substantially from the rapid growth in issuance and the general public's enthusiasm for the equity market. Meanwhile, stock market regulations have been evolving to address the tradeoff between growth and control. Even though issuance approval, pricing, and placement systems have been liberalized significantly, they are still tightly controlled, compared to other Asian markets. Nonetheless, poor governance practices are rampant among listed Chinese companies. In 2001, the largest shareholder of Meierya, which had been a profitable company, colluded with other parties and embezzled $44.6 million, or 41% of the company's total equity. In the same year, the largest shareholder of Sanjiu Pharmacy extracted $301.9 million, or 96% of the company's total equity.

Although Chinese companies, especially SOEs, obtain considerable capital from the public through banks and the capital market, they remain extremely inefficient. Recent official statistics suggest that about one-third of all SOEs are loss-makers, another third either break even or are plagued with impli-cit losses, and the remaining third are marginally profitable. Ineffective governance is widely believed to be the root cause of the lackluster performance. Thus, improving corporate governance should be a crucial objective of China's further economic reform.

To improve corporate governance, the government must strengthen laws protecting shareholder interests and improve the enforcement of such laws and regulations. It is equally important that firms act to improve the situation. The question, however, is whether firms have incentives to improve corporate governance. For a firm's corporate governance practices to have a positive effect on its market value, two conditions must be satisfied. First, good governance must increase the returns to firm's shareholders; second, the stock market must be sufficiently efficient that share prices reflect fundamental values. These conditions are more likely to be satisfied in mature markets than in emerging markets. Share prices in China are often considered to be driven by pure speculation and to bear no relationship to fundamentals. However, a series of surveys of institutional and private equity investors focusing on emerging markets conducted by McKinsey (*The McKinsey Quarterly*, various issues from 1999 to 2002) indicates that 80% of them are willing to pay a premium for well-governed firms.

Corporate Governance Mechanisms

In essence, good corporate governance consists of a set of mechanisms to ensure that the suppliers of finance get an adequate return on their investment. There are two competing views on the appropriate type of corporate governance: the market-based approach used in the US and the UK, and the control-based model commonly found in emerging economies and in continental Europe. The market-based model involves an independent board, dispersed ownership, transparent disclosure, active takeover markets, and well-developed legal infrastructure. In contrast, the control model emphasizes an insider board, a concentrated ownership structure, limited disclosure, and reliance on family finance or the banking system.

Broadly speaking, there are two classes of mechanisms to resolve the conflict between owners and managers and between controlling shareholders and minority shareholders. *Internal mechanisms* include the ownership structure, the board of directors, managerial compensation, financial transparency, and adequate information disclosure. *External mechanisms* include an active market for corporate control, the proper legal framework, and, finally, competition on the product market.

Quantifying Corporate Governance Mechanisms and Market Valuation

In our research we attempt to quantify several measures of corporate governance. Our analysis is based on a panel data set collected from firms' annual reports for the period between 1999 and 2001. We pay particular attention to an important characteristic of Chinese firms, namely the dominance of state-owned shares. Our analysis shows that:

- The largest shareholder in each firm holds a significantly large stake, with the average at 44.8% and the highest at 88.6%;
- A large majority (79%) of the publicly listed firms in China have a parent company;
- More than one third of CEOs are also either chairman or vice chairman of the board of directors;
- The proportion of outsider directors on the board is surprisingly high, with a mean of 70.6%;
- As for the measure of top managers' economic interest in a company, it is insignificant: typically they own very little of their companies' shares, on average only 0.1%;
- Neither dual listing nor multiple listing is common for Chinese firms: the average proportion of companies issuing H or B shares does not exceed 10%. Companies that issue shares traded on the Hong Kong Stock Exchange (H shares) or shares that are open mainly to foreign investors on domestic stock exchanges (B shares) are subject to stricter legal rules, so a dual or a multiple listing serves as a proxy for a better legal environment and financial transparency;
- More than 50% of companies are controlled by the government.

Conclusions

After controlling for industry-specific effects, we find that the results of our analysis are consistent with our theoretical predictions:

- Large holdings by the largest shareholder, the placement of the CEO as chairman or vice chairman of the board of directors, and ownership by the government of the largest stake all have statistically significant, negative effects on market valuation;
- The higher the degree of concentration among other large shareholders, the higher the firm's market valuation. Hence, potential competition for corporate control and the constraints imposed by other large shareholders on the largest shareholder's aspiration to tunnel are important determinants of valuation;
- Issuing shares to foreign investors has a statistically significant, positive effect on market valuation;
- The proportion of outside directors on the board has no significant effect on a firm's market valuation. This suggests that outside board members may not really be independent of management in China's listed companies;
- Increasing the shareholdings of top managers may not be value enhancing in China, perhaps because these shareholding are relatively small in the listed companies;
- The size of the firm is negatively correlated with market valuation, indicating that smaller firms have higher valuation.

"— And these are the main shareholders of our company"

Our findings have implications both for securities regulators and listed companies in China. Securities regulators in much of the world recognize the importance of corporate governance in enhancing firms' investment values. Various codes of best practice are imposed to improve a firm's overall standard of governance. Given the Chinese institutional background and the current level of capital market development in China, our study suggests that the government should unload the shares it holds and relax the transfer of corporately held shares. In so doing, the government should encourage shareholding by strategic investors, who have only an arm's length relationship with the controlling shareholder, so that they can become effective competitors for control of the firm. Regulators should improve the enforcement of regulations, especially disclosure rules, such that domestically listed firms fall under similarly effective regulation as firms listed abroad. The government should also encourage the emergence of accounting and auditing firms with good reputations, to facilitate more accurate disclosure. Chinese firms, meanwhile, should increase the independence of the board of directors from management, to improve the board's monitoring role. They should also employ reputable accounting and auditing firms, to enhance the credibility of their accounting reports. In so doing, they can increase the market value of their firm and thereby reduce the future cost of capital.

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Do Good Governance Provisions Shelter Investors from Contagion? Evidence from the Russian Crisis

Anete Pajuste

On Monday, August 17, 1998 the Russian government announced the devaluation of the ruble and a three-month moratorium on the payment of external debts by commercial banks. Within days, the ruble exchange rate plummeted, sending numerous commercial banks into bankruptcy depriving millions of Russians of their savings and jobs. This "black Monday" had adverse effects on countries far beyond the borders of the Russian Federation. Due to geographic proximity and close trade and financial links, the transition economies were among those most severely hit by the Russian virus. Which firms were most affected by the crisis? And what mattered more, firm or country characteristics?

Contagion Channels

A crisis in one country may be transmitted to firms in other countries through the following five channels: product competitiveness, an income effect, a credit crunch, a forced-portfolio recomposition, and a wake-up call effect.

The *product competitiveness* theory holds that if one country devalues its currency, exports from this country will become relatively less expensive in other countries. As a result, the competitiveness of domestic products against these imports decreases. If the product competitiveness effect is important, we would expect lower stock returns for firms that compete with imports from Russia.

The *income effect* suggests that as aggregate demand in Russia declines during the crisis, firms that export to Russia should face reduced demand, and thus lower stock returns.

The *credit crunch effect* occurs when a crisis in one country reduces international financial liquidity and makes borrowing for firms in other countries more costly. As a result, highly leveraged companies should be more negatively affected by the crisis and therefore experience lower stock returns.

The *forced-portfolio recomposition effect* implies that a crisis in one market can reduce the liquidity of individual investors, forcing them to sell assets in other countries in order to satisfy margin calls or meet regulatory requirements.

Finally, the *wake-up call effect* suggests that a crisis in one country can force investors to reassess the sustainability of macroeconomic fundamentals and corporate governance systems in countries with similar characteristics. Investors can react by pulling out from countries and firms that they believe to be the next crisis suspect.

The Effect of Firm, Industry and Country Characteristics on Stock Returns

A crisis situation offers a good opportunity to study the effects of firm, industry, and country characteristics on stock returns, as it represents an external shock to other countries in the region. This study proceeds from the assumption that there is a link between the severity of the Russian contagion for Central and Eastern European companies on the one hand, and the corporate governance systems and the level of financial development achieved in each country on the other hand.

Using company data from 417 firms in 10 transition countries (Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia), the study evaluated the effect of firm, industry, and country characteristics on short-term (one month surrounding "black Monday") and long-term (one year after the crisis) stock returns.

A preliminary look at the data reveals a substantial variation in stock returns across countries. Thus, average cumulative returns (buy-and-hold returns) fell by 32% in Latvia and increased by 4% in Slovakia one month after August 17. Returns fell further in Latvia a year after the crisis (by 76%), while they increased by 22% in Poland.

Which Effects Dominate?

Which effects — firm-level or country-level — dominated in transmitting the Russian crisis? To answer this question, the countries were divided into two groups, one with "good" corporate governance, i.e. with above median rule of law scores, and the other with "bad" corporate governance, i.e. with scores equal to or below the median. The *rule of law* scores (from Pistor et al., 2000) measure the tradition of law and order in a country and range from 0 to 10. This classification puts the Czech Republic, Estonia, Hungary, Poland and Slovenia into the "good country" group, while Croatia, Latvia, Lithuania, Romania and Slovakia are in the "bad country" group. The analysis shows that short-term returns were significantly lower in good governance countries, while long-term and total returns were significantly lower in bad governance countries.

The firms in the sample were divided into four groups, according to firm-specific characteristics:

1. Non-exposed firm in a "good" country,
2. Non-exposed firm in a "bad" country,
3. Exposed firm in a "good" country,
4. Exposed firm in a "bad" country.

Non-exposed firms are those that do not compete with imports from Russia, do not export to Russia, have higher sales growth, have lower leverage, are smaller in size, have less liquid stocks, and have a foreign blockholder among the owners.

Country Factors are Important

The analysis of cumulative *short-term returns* shows that firms exporting to Russia, as well as larger and more liquid firms, experienced significantly sharper declines in stock prices during the one-month period around the crisis. These results provide evidence that investors believe the income effect can affect firms with direct sales to the crisis region. Moreover, there is evidence of the forced portfolio recomposition effect in larger and more liquid firms that experience capital outflow due to investors' short-term liquidity constraints.

The analysis of cumulative *long-term returns* shows that firms that did not compete with imports from Russia, firms with a foreign blockholder, and faster growing, larger, more liquid and less leveraged firms overcame the negative effects of the crisis faster (i.e. the stock returns one year from the crisis were higher). Non-exposed firms had significantly higher total returns.

As for *total returns*, the study finds that, with two exceptions, exposed firms in "good" countries were hit less severely by the crisis than non-exposed firms in "bad" countries, suggesting that the country's legal environment played an important role in overcoming the effects of the Russian crisis. Only firms not competing with imports from Russia, and firms with higher sales growth in "bad" countries, experienced better stock performance than 'good country' firms competing with imports from Russia and with lower sales growth.

Thus, countries do matter, i.e. the legal protection of investors is an important determinant of stock returns, which can outweigh the importance of firm-specific characteristics. A "good country" label reduced the severity of the Russian virus across all firms in these countries, while firm-specific characteristics played a more significant role in countries with weaker corporate governance.

Conclusions

Stock performance varied substantially across firms and countries during and after the Russian crisis. Firms operating in industries that compete with major imports from Russia (product competitiveness effect) and in industries with major exports to Russia (income effect), firms with greater liquidity (forced portfolio recomposition effect), higher leverage (credit crunch effect), without a foreign blockholder, as well as firms operating in countries with a poor record of investor protection had significantly lower stock returns one year after the crisis. There is also a strong short-term forced portfolio recomposition effect: firms with a presumably higher institutional-investor presence, i.e., bigger and more liquid firms, exhibited sharp short-term decreases in stock prices.

The study provides additional evidence on the relationship between corporate governance and market efficiency. Stock prices in countries with higher rule-of-law scores absorbed the negative news about the Russian crisis much faster than stock prices in countries with lower *rule-of-law* scores. Stock prices in good countries reached bottom around one month after "black Monday", while stock prices in bad countries continued to deteriorate for an additional five to six months.

Finally, both firm- and country-level characteristics do matter in overcoming a crisis; however, firm-specific characteristics play a bigger role for firms operating in countries with weak investor protection laws. A "good" country label carries clear advantages. Maybe that is why it took so long to realize that there are also *Enrons* in "good" countries.

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Corporate Law and Governance System in Russia

Russia's 1996 law on joint-stock companies envisions the creation of a 'self-regulating organization, in which managers and large stockholders will voluntarily observe the legal code. Given a weak law enforcement environment in Russia, the idea seems quite reasonable. However, our analysis suggests that some provisions in the Russian corporate legislation may create problems for companies' governance systems. Below are just two examples, by way of illustration.

To secure the independence of **supervisory bodies** from the executive, the law imposes relatively tight restrictions on the concurrent holding of several posts. However, the restriction against executive officers assuming directorship, for example, can be easily ignored by eliminating a collective executive organ (one of five supervisory bodies), which exists at the discretion of the company. This legal loophole, along with the dominant insider ownership structure, does not effectively discourage opportunistic behavior among executive officers.

The **board of directors** is empowered to make a large number of important managerial decisions, which may not be delegated to executives. However, the law does not specify the executives' prerogatives in daily management, leaving the matter to the discretion of the company. Such a distribution of power is likely to result in a conflict between the board of directors and executives. In some companies, the board has been unable to obtain sufficient and reliable information on management's actions and is thus unable to make proper judgments on the company's activities.

We conclude that no law can set out a complete legal framework for a 'self-enforcing' organization. An effective governance system can only emerge with the development of the judicial system and further improvements in the Russian business environment

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Enforcing Corporate Governance

Erik Berglof and Stijn Claessens

Governments, private companies and international bodies have devoted much effort in recent years to the formulation of ever more elaborate rules of corporate governance. Whatever their source, these sets of rules are all remarkably similar. Yet practices differ substantially across countries and companies (OECD 2003). Many concerns remain regarding the effectiveness of corporate governance rules, as written rules are not adhered to and firms' pronouncements are not followed up by actions. Policymakers have come to realize that, at least in transition economies and developing countries, the key problem is the lack of enforcement, more than regulations and paper laws.

While problems of enforcement are common to development in general, they particularly affect firms seeking external financing. Financial contracts, after all, commit a firm to adhere to certain obligations, in particular to pay appropriate rates of return to the providers of external financing. A weak enforcement environment makes it harder for firms to commit to honor financial contracts and, thus, to attract external financing. This, in turn, slows financial development. Empirical evidence on insider trading, for example, shows that it is not the presence of laws but rather actions taken against insider trading that help to explain the development of securities markets. Another international study finds that the level of enforcement is much more important than the quality of laws on the books in explaining the turnover of chief executive officers (Defond and Hung 2003). This is not to say that laws are not important. Rather, laws alone do not suffice.

Below, we develop a rudimentary framework to help understand when corporate governance rules are enforced and suggest what can be done to improve corporate governance mechanisms in a weak enforcement environment. The analysis of various options should help understand which reforms most improve corporate governance practices and mitigate social costs.

Defining a Problem

Any recommendations on national policies relating to corporate governance must start by defining the corporate governance problem facing a particular country, as these problems vary considerably.

Corporate governance, in large part, aims to mitigate the following problem of commitment: how can investors be ensured that management will choose the right projects, exert sufficient effort, adequately disclose relevant information, and ultimately repay investors? Investors can reduce the likelihood of being defrauded or deceived by monitoring and, potentially, punishing management. Firms, in turn, may employ a variety of commitment mechanisms to overcome investors' concerns (see the table).

Which mechanisms are preferred will depend on the institutional development of the country, especially its contracting environment. A potentially important corporate governance mechanism may be hard to influence through policy, and mechanisms susceptible to policy intervention may not be very important. Policy recommendations should take both of these problems into account. For example, in environments where the court system functions satisfactorily, private litigation to protect minority shareholders is an option for improving large shareholder monitoring. In weaker enforcement environments, policy may have to focus on promoting private mechanisms and empowering shareholders by disseminating information (see the table).

In industrialized countries, many firms are closely held, yet minority investors have some means to challenge insiders and ensure a reasonable rate of return on their investment. They are consequently willing to provide external financing. In transition and developing economies, these means may not be available, and enforcement is generally weaker.

Private vs. Public Enforcement

Although enforcement is generally agreed to be critically important to economic performance and is the subject of a vast literature, there is no simple analytical framework. Issues related to enforcement can be classified in several ways. One distinction may be drawn between private and public mechanisms. Private initiatives to enforce contracts are critical to the functioning of any economy and can operate outside the legal system. Such initiatives may be undertaken by individual firms (e.g., reputation-building), between two firms (e.g., various forms of integration), or among several firms (e.g., industry associations with private conflict resolution and enforcement). Such private arrangements can later be standardized and encoded in public law. Laws, in turn, may be enforced privately through litigation, or publicly by the government. Under private law enforcement, private agents act within a legal or regulatory framework to punish contractual violations, using the courts to adjudicate and the state to enforce the final judgement. With public enforcement, the government provides the final enforcement system and acts as prosecutor. In the extreme case, the government has full control over all activities, there are no property rights or contracts to enforce, and laws are irrelevant.

An enforcement system thus consists of a continuum of overlapping mechanisms ranging from private ordering through private enforcement of laws and government-enforced regulation to full government control (Djankov et al., 2003). All mechanisms have costs, and there are tradeoffs between costs and benefits. Private and public initiatives often complement rather than substitute each other. The effectiveness of private enforcement mechanisms often depends on the effectiveness of public enforcement mechanisms. Public

Corporate Governance Mechanisms in Developing Countries and Transition Economies

Corporate governance mechanism	Relative importance in developing countries and transition economies	Scope for policy intervention
Large blockholders	Likely to be most important governance mechanism.	Ensure that rules protecting minority investors do not go too far in removing incentives to hold controlling blocks.
Market for corporate control	Unlikely to be important when ownership is strongly concentrated; can still take place through debt contracts, but requires bankruptcy system.	Remove some managerial defenses; require disclosure of ownership and control; develop the rest of the financial system to allow competing bids to be financed.
Proxy fights	Unlikely to be effective when ownership is strongly concentrated.	Promote technological improvements for communicating with and among shareholders; improve disclosure of ownership and control.
Board activity	Unlikely to be influential when controlling owner can hire and fire board members.	Introduce elements of independence for directors; train directors; require disclosure of voting; allow cumulative voting
Executive compensation	Less important when controlling owner can hire and fire.	Require disclosure of compensation schemes, and conflicts-of-interest rules.
Bank monitoring	Important, but depends on health of banking system and the regulatory environment.	Strengthen banking regulation and institutions; promote credit bureaus and other intermediaries.
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders.	Encourage interaction among shareholders; strengthen minority protection; enhance governance of institutional investors.
Employee monitoring	Potentially important, particularly in smaller companies with highly skilled human capital that can easily leave the firm.	Require disclosure of information to employees; possibly require board representation; ensure flexible labor markets.
Litigation	Depends critically on quality of laws, bias of courts, and general enforcement environment, but can sometimes work.	Facilitate communication among shareholders; encourage class action suits (but include safeguards against excessive litigation).
Media and social control	Potentially important, but depends on media competition and independence.	Encourage competition in and diverse control of media industry; inform and empower the public.

enforcement reduces the costs of private enforcement. But while more public intervention may mitigate market failure, it is more vulnerable to government failure and may not be the most efficient means of enforcement when private agents have better information, resources, and incentives. Private agents are particularly important when the general institutional environment is weak. A system of social control is necessary where both markets and government fail or cannot be expected to operate. More generally, social control is necessary to support the functioning of markets.

Each country will choose a different mix of mechanisms, and the optimal mix for many developing countries will differ from that observed in industrialized countries. Public enforcement can play only a limited role in weak institutional environments, as powerful controlling owners and managers will most likely find a way around the system. Private enforcement of public laws and the power of litigation and court intervention vary greatly across countries, depending on how well public enforcement institutions function. Russian investors, for example, almost never turn to courts, because the likelihood of success is miniscule and even if they win the judgement is often not enforced (Zhuravskaya et al., 2003).

When courts are weak, other enforcement mechanisms may be used to enforce good corporate governance. Policies promoting bank lending and financial development may help enforce corporate governance. Yet even here relative costs are important. In China, although court decisions are not always predictable or enforced, investors increasingly take their grievances to court. They do so because other mechanisms are either unavailable or even more costly.

The choice of mechanisms depends largely on the overall environment. Political institutions, as part of the general enforcement environment, may function poorly, be dominated by an absolute ruler, or be captured by special interests. Legal standards and the level of enforcement can also interact. A benevolent government can trade off the benefits of stricter legal standards with the costs of their enforcement. A benevolent government should set standards lower, because the costs of enforcing them are higher. In other words, legal standards and enforcement are complementary, and both can improve as countries develop. Laws and regulations, meanwhile, may be adopted not only to correct market failures, reduce transactions costs, and achieve social objectives, but also to extract bribes. Djankov, La Porta et al. (2003) find some support for this so-called tollbooth view, especially in developing countries, suggesting that policymakers should err on the side of more lax laws in weaker enforcement environments.

Conclusions

Ultimately, the effectiveness of many enforcement mechanisms hinges on the political sphere's commitment to enforce laws and regulations. Given the enormous potential gains from improvements in public enforcement, building support for reforming these institutions should be easy. Indeed, reforming enforcement institutions should be easier than changing basic investor rights, which often involves clear winners and losers. Many attempts to reform investor rights have been blocked by powerful opposition. Nonetheless, changes to investor rights do occur, often following financial and other crises.

A review of the literature highlights some general lessons on improving enforcement, not necessarily limited to corporate governance:

- Private-sector efforts to enhance enforcement are often more effective than government-led efforts, but the two forms of enforcement often complement one another. Securities regulation experience in the United States suggests that private ordering can precede and serve as a basis for public laws and for private and public enforcement of those laws.
- The balance between private ordering and private enforcement of public law depends on the quality of public laws and the strength of enforcing institutions. When the general enforcement environment is weak, private ordering may be the only hope.
- Improvements in enforcement more often result from bottom-up rather than top-down initiatives. Capacity building is often important to support private initiatives, and it helps build constituencies for reform.
- Top-down efforts to improve the legal and enforcement environment are difficult and rarely successful. Transplanting elements of foreign legal systems has generally not worked well, but the experience of accession to the European Union suggests that outside anchors can play a positive role in encouraging the implementation of reforms.
- In designing strategies for improving the enforcement of corporate governance, both the likely impact of a particular governance mechanism and the scope for improving the mechanism should be considered. A particular corporate governance mechanism may play a very important role in reducing agency costs but leave little room for improving enforcement.

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William Goetzmann: "The Outcome of Russian Public Capital Markets is Not Assured"

Q. You have studied corporate governance issues in historical and comparative perspective extensively and recently published "The history of corporate ownership in China". Based on your research, can you see any similarities between China, Russia, and other transition economies? Is there anything Russia can learn from other countries' experience regarding corporate governance?

William Goetzmann

A. Yes. The basic experience of all countries seeking to develop capital markets after not having had them for a long time is the problem of a complete legal framework for property rights. It is not enough to have a structure of laws, but apparently a tradition of practice and enforcement is important to establish norms of behavior.

The biggest challenge faced by Russia and China currently is not the lack of laws, but "loop-holes" in the legal system that allow the seizure of property and supression of information about companies. An important example of this is the current ambiguous environment for the financial press in China. Companies can sue reporters for slander even when the fraud they uncover in the press is true. Why? Because the right of legal appeal extends only to the provincial government level and companies have subtantial provincial government ownership interests. This is an example where the legal right to sue for slander is being used to support a conflict of interest between the local provincial government and the minority shareholders.

Q. What, in your view, are the worst "sins" of Russia's existing corporate governance system and what are the most pressing issues in this respect facing Russia?

A. I regard the recent examples in Russia of sudden corporate takeovers as a prime example of the exploitation of loopholes in the law. There is enough legal structure to justify the filing of complaints against a firm, enough to provide cover for the seizure of assets by a competitor at the expense of other minority shareholders. Like the China case I mentioned above, this may be a case of competing legal jurisdictions in a system in which all the problems have not been worked out, but it represents a real risk to the public capital markets. If there is a risk that your rights as shareholders can be suddenly taken away, despite a good national corproate code, why would you invest your money?

Q. In your view, what will the Russian corporate governance landscape look like in the coming years?

A. I believe that progress will not always be easy and that public sentiment will range from positive to negative as the inevitable growing pains continue for the Russian market. I do not regard the outcome of public capital markets as assured. The public capital markets could disappear if public confidence cannot be sustained. I think this would be unfortunate, given the great entrepreneurial energy in Russian society. The public capital markets work best as a means to finance innovation and new technological developments. They are democratizing elements themselves, because they allow legitimate entrepreneurs to get capital to create new companies.

I believe that the will exists in Russia to make progress. The governance landscape at the top levels is clarifying, and I think the real work to be done now is in the legal system of enforcement and combatting fraud.

Q. In your 1998 interview with *Businessweek*, you said that you would only invest your own money in countries with well-protected investors' rights. Six years after, have you invested your own money in any emerging markets?

A. I am still a pessimist with regard to emerging markets. I should qualify this a little bit, however. I regard the real estate market in the United States as an emerging market — very similar to the current Russian equity market, dominated by a few large players, low liquidity and subject to public swings in sentiment. I have some of my investment in real estate stocks and the rest in a mixture of US and international equities. I wish the market had done better since the year 2000, however.

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The 32nd annual meeting of the **European Finance Association** will be held from August 24 to 27, 2005 in Moscow. The conference will be hosted by State University — Higher School of Economics (HSE). The conference is jointly sponsored by HSE, Yale School of Management and Humboldt University of Berlin. More information about the conference is available at: *http://www.efa2005.org/*

Ownership Composition, Corporate Governance, and Performance: Evidence from the Czech transition

Andrew Weiss and Georgiy A. Nikitin

Poor corporate governance is often associated with diffuse ownership, poor regulatory control, and a legal system that is not able or willing to protect shareholder rights. If ownership is diffuse, individual owners either can't or won't pressure management to improve the company's performance. However, concentrated ownership is unlikely to solve these problems if the major shareholder also suffers from poor governance, or if its managers are not motivated to improve the performance of the companies in which the institution invests.

Using data on performance and share ownership in the Czech Republic from 1993 to 1997, we investigated how corporate governance problems at the shareholder level affect the performance of operating companies. After the Czech Republic privatized its previously state-run economy in the early 1990s, almost all companies became publicly traded, and the largest shareholders were either the national government or closed-end funds — publicly traded companies that invest in the shares of other publicly traded companies. Unlike open-end mutual funds, shares in a closed-end fund cannot be redeemed at their asset value, nor could new investments be made at the proportionate value of assets. Thus, the fund's price can fall below the value of its assets.

In the early 1990s, Czech citizens could buy a fixed number of vouchers at minimal cost. The vouchers were used to buy shares in operating companies or exchanged for shares in these funds, which in turn used the vouchers to buy shares of companies.

Fund managers' fees were a function of the fund's assets, not its performance. Since the fund could not attract new money, management could only benefit materially from the performance of the companies in which the fund invested if they planned to raise additional capital or market a new fund. The funds' shareholder base was diffuse and unsophisticated, regulatory control was lacking (the securities commission was not established until 1997), and the legal system was ineffectual. The term "tunneling" was invented to describe the process by which fund managers extracted all the value of the funds they managed, leaving only a shell. *Fortune* magazine called the manager of the largest family of funds "The Pirate of Prague". Due to these activities and the adverse publicity the sector received, the funds traded at large discounts to their net asset value. There was no realistic possibility of raising new money, thus removing the last meaningful incentive for fund managers to improve the performance of their investments.

The other large shareholder with poor incentives was the Czech government. The political appointees who managed the government's investment portfolio had no incentive to maximize shareholder value: the government never replaced the management of any company in which it was the largest investor. If poor corporate governance of a company's shares by institutional owners adversely affects the performance of the firm, then a firm whose largest shareholder was either an investment fund group or the national government would have poor performance, as we found in our study.

In contrast to the national government, when a municipality is the major shareholder, the local population may be better able to monitor management and would have both the incentive and means to improve corporate performance. The local electorate directly benefit from improved performance of municipal investments. Because the Czech political process was relatively open and honest, elected officials would be motivated to improve the performance of local companies. The evidence from China suggests that even if the political process is seriously flawed, village-owned enterprises can exhibit high levels of productivity (e.g. Wang and Jin, 2002). Unfortunately, we have only seven cases of companies where the major shareholder was a municipality. The statistical significance of our results therefore varied with the estimation procedure; however our point estimates consistently showed strong positive effects — often the largest for any ownership type.

Our best example of the effects of large shareholders with good corporate governance was foreign portfolio investors — generally western European firms. These owners were subject to regulatory controls and were likely to hold large controlling stakes. During the 1990s, the percentage of companies in which the largest shareholder was either an investment company or the central government steadily declined, while the percentage of companies whose largest shareholder was a foreign firm steadily increased.

Controlling for the type of owner, ownership concentration did not affect performance, but the type of owner had a large and statistically significant effect on performance. Firms with

Effect of replacing the largest shareholder with a foreign company on performance of Czech firms in 1993 — 1997

Replaced shareholder	Change in operating profit per worker, 000' CZK	Change in operating profit per unit of capital, 000' CZK	Change in investment rate, %
Investment Fund	84.01*	135.16*	74.47*
National Government	100.85*	171.02*	110.82*
Municipality	15.61	-26.44	-189.36

** Result statistically significant at 1% level* foreigners or municipalities as their major shareholders were more profitable and had higher investment rates than firms where the main owner was either an investment fund or the national government.

The results reported in the table used a dummy variable for the identity of the largest shareholder. We obtained similar results when we interacted ownership type with the percentage of shares owned by the largest shareholder, as a measure of the ownership effect (see other results in Weiss and Nikitin, 2004).

Conclusions and Policy Implications

It is widely believed that state ownership hurts productivity. However, there is nothing about state ownership in particular that causes these ill effects. When the major shareholder is a private company, such as a Czech closed-end fund, the adverse effects on performance were as bad as for a state controlled enterprise. Conversely, when the controlling shareholder is a public body, such as the local municipality, which has the motivation and ability to improve economic performance, performance was good. So the observation that privately owned firms tend to perform better than publicly owned firms probably does not always hold.

Countries with bad corporate governance are exacerbating their problems by discouraging foreign portfolio investors from taking large stakes in domestic companies. The domestic economy loses the benefit of the regulatory discipline of the country in which the investor is domiciled. Within countries regulatory authorities should police the corporate governance not just of operating companies, but also of large institutional investors such as pension funds and mutual funds. Legislation making it easier for the beneficiaries of pension funds to replace the trustees, or for the investors in closed-end funds to replace management or convert the fund to an open-end mutual fund, may have significant positive effects on overall economic performance.

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Czech Mate: a Case of Insider Expropriation

In 1991, Ronald Lauder, one of the heirs of the Estee Lauder cosmetics fortune, created a holding company, Central European Media Enterprises (CME), to invest in media properties throughout Eastern Europe. In a bid for the first Czech commercial TV station, CME worked together with a local company, CET 21, controlled by Vladimir Zelezny, a prominent Czech journalist, producer, and a former press official for the Czech government. The joint venture won the tender, and Zelezny became director of the new TV channel, TV Nova. While foreign ownership of media companies was not illegal, negotiations with the state Media Council left CET21 holding the license, awarding its exclusive use to an operating company majority-owned by CME. TV Nova prospered under Zelezny, gaining a 70% audience share within a year. Zelezny himself was a host of a weekly program, which became the most-watched program in the country.

By 1999, CME had bought out the other shareholders, including Zelezny, and held 99% of the operating company. Zelezny, however, set up a content production company of his own and the Media Council ruled that the license delegated to CME could no longer be exclusive. These developments undermined the proposed sale of CME. CME accused Zelezny of violating the operating company's exclusive right to acquire programming for TV Nova and dismissed him as a company director. He continued, however, as director of TV Nova and still controlled CET 21. A few months later, Zelezny retaliated by terminating TV Nova's service agreement with the operating company. Without a broadcast license, CME could not operate the TV channel. It was effectively put out of business and lost its entire market value.

Lauder sought to pressure the Czech government through political influence, a public relations campaign and, finally, sued the government in international tribunals in Amsterdam, London, and Stockholm. CME sought damages from Zelezny personally, and in separate actions, claimed that the Czech Republic and the Media Council violated international treaties by failing to protect CME's investment. Lauder managed a historic verdict against both Zelezny and the Czech Republic when, in 2001, the Stockholm Tribunal ruled in favor of CME and the Czech government paid CME more than $350 million, an amount equal to the annual budget of the Ministry of Health.

Our study demonstrates, first, that the power of insiders need not be defined by their ownership shares. Prominent insiders — such as leading employees and local representatives of multinational firms — can manipulate policy-makers, conduct public relations, and violate contracts in a manner that expropriates value from owners regardless of actual ownership. Zelezny's ability to divert the firm's value arose from his access to critical resources, his public image locally, and his ability to bend the rules of the game at will.

Second, the geographical and cultural distance between Lauder and Zelezny distributed decision rights in a way that allowed Zelezny to structure the joint venture opportunistically, to force monetization of his ownership in the company, and, ultimately, to expropriate the value of the asset.

Finally, local laws may be irrelevant to investor protections for many investments. Although Lauder appealed to the local courts, he also sought the protection of bilateral investment treaties. These treaties are increasingly used in response to expropriation, not just by governments, but also by managers and investors.

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Discussion

William Browder: The Threat of Minority "Squeeze Outs" in Russia

Despite the inevitable hand wringing over the ongoing Yukos affair, President Putin's first term witnessed remarkable advances in the protection of minority shareholders in Russia. The establishment of preemptive rights gave minority shareholders the ability to stop dilutive and preferential stock issuances. The Duma legalized ownership of partial shares, eliminating a common tactic by which controlling shareholders conducted abusive reverse stock splits and forcibly divested minorities left with less than a single share. The introduction of cumulative voting for board elections expanded minority participation in corporate affairs.

Regardless of these advances, however, minority shareholders in Russia continue to suffer regular attacks by majority interests. On June 27, 2004, the first major assault of Putin's second term materialized when four committee heads in the Duma introduced legislation that profoundly threatens the future development of minority shareholder rights in Russia and, more fundamentally, the credibility of Putin's economic agenda. In a sign of highly motivated support, the legislation passed the first reading in the Duma in just six days, a scheduling triumph virtually unheard of in the Russian legislative process. Technically introduced as a set of amendments to the Joint Stock Company Law, the so-called "Squeeze-Out Law" would permit a holder (or a collection of holders acting in concert) representing 90% of the equity in a Russian joint stock company to select and hire an appraiser to value the minority stake and to use this valuation as the basis of a compulsory buy-out offer to the minority shareholders. The divestiture of minorities is a *fait accompli* as soon as the buy-out offer is made, regardless of the price offered or the fairness or independence of the underlying appraisal. The only recourse granted to minorities in the draft legislation is to dispute the price in a Russian court, but not the sale itself. Minority divestiture at whatever price is inevitable.

If enacted, the impact of the Squeeze-Out Law would be devastating. More than 188,000 individual shareholders holding more than $3 billion in capital would be vulnerable to squeeze-outs in the largest Russian companies alone. Many of the minority shareholders in these companies are employee shareholders, pension funds and foreign investors. Indeed, every foreign public equity investor in Russia is by definition a minority shareholder.

Among the many structural failings of the Squeeze-Out Law, perhaps the most egregious is the enormous role and responsibility it creates for appraisers. While the inherent conflict with the majority shareholder overseeing the appraisal of the minorities' stake is obvious, the unique history of appraisals in Russia makes this all the more outrageous. Just one example: the appraisal issued in the 1999 privatization of the Russian government's 49% stake in the oil company TNK valued it at $67 million — a 75% discount to TNK's 1999 net income and a 95% discount to contemporary peers.

Such chicanery aside, the Squeeze-Out Law amounts to a blanket amnesty on a decade of corporate looting, mismanagement and shareholder harm by many Russian majority shareholders. Dilutive share issuances, rampant cronyism among management, abusive reverse stock splits, transfer pricing and other widespread abuses have together imposed a significant discount on Russian equities. The Russian market trades at a price-to-earnings ratio of approximately 7, compared to 24 in Hungary and 30 in Venezuela, another oil-rich emerging market.

Enabling controlling shareholders in Russian companies to conduct forced liquidations of minorities would do violence not only to the development of shareholder rights in Russia, but would endanger the remarkable record of recent economic growth in Russia by further concentrating economic power in the hands of a few market actors. Minorities, like the government, have a strong interest in the equitable and transparent accounting of profits. With minorities purged, some of the largest Russian companies will naturally evolve into closed, opaque and ambiguous entities, a development at odds with the Kremlin's much-publicized goal of doubling GDP in ten years.

Proponents of the Squeeze-Out Law predictably defend it by citing similar laws in western jurisdictions, specifically the United States and Western Europe. While such minority buy-out laws do exist, the similarities with the Russian proposal are precious few. Among developed economies, only the United States (Delaware) matches a threshold to initiate a squeeze out as low as 90%, with Germany at 95% and Italy and Switzerland both at 98%. More importantly, every western jurisdiction also incorporates legal, regulatory and other institutional safeguards to prevent minority shareholder abuse. These safeguards include: mandatory court or government review of the appraised value of the minorities' stake; "Fair Price" and other legal doctrines supporting minorities' rights to a fair buyout price; case law permitting minorities to sue to stop the squeeze-out from occurring at any point; and significant liability for the appraisers, officers and directors in the event the squeeze-out violates the fiduciary duty owed to shareholders or is otherwise fraudulent. Neither the Squeeze-Out Law nor the embryonic Russian judicial system incorporates any of these shareholder protections, which are essential to ensuring that a law permitting minority buyouts doesn't become a license for below-market shareholder purges.

William Browder is the CEO of Hermitage Capital Management, an investment advisory firm which manages the Hermitage Fund, the largest Russia-dedicated investment fund. He contributed this comment to the Transition Newsletter. ■

Victor Pleskachevsky: "I want to create a mechanism for transforming a public enterprise into a private one."

The State Duma Property Committee has spent four years looking into the problem of corporate relations in Russia, studying corporate conflicts and enterprise seizures. On November 15, 2004, parliamentary hearings were held on "The Main Guidelines for Improving Corporate Legislation", which elaborated a concept for improving corporate law. Some related bills may be introduced in the Duma before the end of the autumn session. Those bills already pending in parliament will be either adjusted to fit the concept, or rejected.

The concept encompasses legislation in five areas of corporate law: first, a package of laws to prevent corporate conflicts, the seizure of enterprises and corporate blackmail (greenmail); second, a package of laws to prevent the violation and abuse of shareholder rights, establishing a balance between majority and minority shareholders; third, a package of laws setting higher standards for open joint stock companies and creating mechanisms for transforming public companies into private enterprises; fourth, a package of laws on integrated structures (holding companies and concerns) and mechanisms for reorganizing and liquidating enterprises; and finally, a package of laws aimed at liquidating the legal surrogates that have emerged during the ten formative years of corporate law (authorized capital, partial shares, nominal share price, closed joint stock companies, "people's enterprises" in the form of joint stock companies, etc.).

The most controversial piece of legislation, allowing the owner of 90% of equity plus one share to buy out minorities, passed its first reading as early as spring. The bill sparked off quite a storm. Its opponents advance two main arguments: first, they claim that it is unconstitutional, and second, they focus on the problems that may arise in the process of appraising the block of shares owned by minority shareholders. As regards the former point, our main argument in favor of the bill's constitutionality is precisely the article in the Constitution which says that no one can be divested of a property right or the right to dispose of one's property except under a court ruling or on the basis of the law. As it is, in the absence of the proposed compulsory minority buy-out mechanism, majority shareholders often become victims of blackmail. How does it happen?

We demand higher standards of transparency and corporate governance from joint stock companies, which increases their costs. Major companies such as LUKOIL, Gazprom, RAO UES, of course, can sustain the extra load, because their shares are traded on the exchange. But the burden may turn out to be crippling for small companies, former state-owned factories producing candles, or small restaurants which became joint stock companies in the process of privatization. For them, being a joint stock company is unnatural: they have a score of shareholders and they are not going to offer their shares on the markets. So, they will have to reorganize themselves as non-public companies. And at that point they become the targets of blackmail by "professional minority stockholders", who say "Buy my shares at above-market prices, or else I won't agree to the transformation of the company." If this is not blackmail, what is? Not infrequently, these companies haven't been paying dividends for years, and now the "professional minority stockholders" want to have them at their mercy. That is why we are committed to creating a mechanism for transforming a public enterprise into a private one.

As for the problem of determining the fair market value of the block of shares being bought out, we introduce a mechanism for independent appraisal, the results of which may be challenged in a court. Under our bill, the majority shareholder hires an independent appraiser at his own cost and the minority shareholder cannot simply reject the appraisal. He has to come up with his own appraisal of the price, file a lawsuit and prove that the buyer has understated the price. If the majority shareholder has offered 100 rubles and you think your holding costs a million dollars, it is up to the court to decide, proceeding from independent expert assessments. And if, in the end, the judge rules that the market price is 150 rubles, you can challenge the ruling in the second, third instance, and so on. Most shares are not traded on the market. Of the 157,000 joint stock companies, only seven or eight are traded, accounting for 80 percent of market capitalization. During the past five years, no more than 100 companies out of 157,000 have traded their shares more than once.

Of course, there is room for abuse and corruption. But the court may come under pressure not only from majority shareholders, but from minorities as well. Our minority shareholders are not humble grannies or granddads, they are investment funds with huge potential and highly skilled lawyers who will uphold the maximum price in any court and fight to the last.

The bill seeks to restore the balance in the relations between minority and majority shareholders. We elevate to a new level not only their rights, but also their responsibilities. At present, both groups tend to abuse their rights. On the whole, this is not conducive to economic stability, so the current situation cannot be recognized as being optimal.

It is impossible to pass all the necessary measures as one package of laws, as we are dealing with a huge number of laws. This will keep us busy for two or three years. We won't solve all the existing problems, but we will take our corporate law to a higher level, as a coherent system of relations. The amendment discussed here can be instrumental in getting rid of just one problem: the problem of blackmail. But that is only the first step.

Viktor Pleskachevsky is chairman of the Russian State Duma's property committee and one of the authors of the "Squeeze-out" law. He contributed this comment to the Transition Newsletter. ■

From Research to Policy

Challenges for Transition Economies, Challenges for the World Bank

Johannes Linn

The Europe and Central Asia region has experienced unprecedented challenges since the dissolution of the Soviet Union in December 1991. This vast region of 28 countries and 500 million people faced a triple transition: moving from centrally planned to market economies, from integrated to fragmented economic space, and from communism to democracy.

The economic development of all countries in the region has followed the same trend since 1990: economic collapse, followed by a rapid recovery, as a result of which the transition economies of Europe and Central Asia have now become one of the most dynamic regions of the world. However, there are important differences among countries. In Central Europe and the Baltics the recession was relatively shallow and short: GDP fell to 85% of the 1990 level and the recovery had begun by 1993. In the CIS countries the recession was deep and long, bottoming out in 1996 at less than 60% of 1990 GDP. Fortunately, since 1999 these countries have experienced rapid and sustained growth.

The differences in economic performance, as well as the problems and challenges they now face, have been increasing over time. Four distinct sub-regions have emerged: the Central European countries and the Baltics, South-East Europe, Turkey, and the CIS.

Sub-regional Trends and Challenges

Central European countries and the Baltics had a quick turn-around and an extraordinary progress of integration with and into the EU. The Baltics present perhaps the biggest and the most astonishing success story. Despite having been part of the Soviet Union for decades, they were able to pursue deep and pervasive market reforms. As a result, they were able to integrate along with their Central European neighbors into the EU fewer than 15 years after the breakup of the Soviet Union. For all of the new EU members, the biggest challenge now is how to become the next Finland or Ireland rather than the next Eastern Germany — i.e., how to become flexible, dynamic and efficient knowledge societies. In order to do this, they need to deal with excessive labor market regulation, address corruption and governance weaknesses, and further improve the investment climate. They need to tackle fiscal deficits and find solutions for their unsustainable social security and pension systems, as these countries face rapidly ageing populations. These problems very much resemble those that many Western European countries now face.

Disintegration in *South-East Europe* was more violent and catastrophic than in the Soviet Union. Peace agreements and reconstruction in Bosnia and Herzegovina, Kosovo, and Serbia-Montenegro, as well as progressive, albeit still incomplete economic reforms, have opened prospects for European Union accession. Albania has been the greatest miracle of the region: its per capita income is now three times what it was in 1992. This could only occur due to the country's openness and integration with rest of Europe. The biggest challenges for the region are a peaceful resolution of the Kosovo conflict, normalization of national and regional politics, and continued progress towards EU integration, with a particular emphasis on governance and the investment climate.

Although not a post-communist state, *Turkey* has had its own transition path of a kind: its uneven economic development in the 1990s led to the financial crises of 2000-2002. Since then it embarked on several vital economic and political reforms, with privatization, banking and public sector reform, and tight monetary and fiscal policies topping the agenda. Improved political and macroeconomic stability have already supported significant economic recovery over the last two years and greatly enhanced economic prospects, including the possibility of an imminent start to EU accession negotiations. The country's biggest challenge in the near term is to maintain macroeconomic stability, improve the institutional environment and investment climate, and deal with regional imbalances. Over the longer term, Turkey risks being derailed on the way to EU membership or being negatively affected by political instability in the Middle East.

The collapse of the Soviet Union, with the accompanying breakdown of essential economic links, wrought tremendous economic and psychological costs of disintegration in all *CIS countries*. The reform process in this region has generally been slow, and the countries have had difficulties to reintegrate, although on both fronts there have recently been positive signs. The three biggest countries, Kazakhstan, Russia and Ukraine, are recovering rapidly at this point. Ukraine in particular is an unusual economic success story, thanks to the cumulative impact of reforms and the rapid growth of trade, both with the CIS and the EU. The poorer CIS countries of Central Asia and the South Caucasus have not fared as well and are still facing some serious problems, such as a lack of access to the world economy, high debt burdens, and poverty. Belarus and Turkmenistan are unique in having failed to implement meaningful market reforms and seem to be stuck in a time warp. The CIS region's biggest challenge is to make progress in its political transition. The absence of democratic governance will likely prevent institutional and governance reforms, inhibit the rebuilding of social infrastructure and the improvement of the investment climate, and limit regional cooperation and integration with rest of the world. In the short and medium term the economic outlook for these countries is quite positive, although longer-term prospects look less optimistic.

The World Bank's Ups and Downs in the Region

Apart from the fact that the Bank can be pleased with the economic recovery and overall progress that can now be observed in the transition economies of Europe and Central Asia, there are quite a few specific success stories: For example, the Bank was deeply engaged in supporting the successful economic reforms Central Europe undertook on its way to EU accession. In the Balkans, especially in Bosnia and Herzegovina, the Bank supported a lasting peace and post-conflict reconstruction process in a productive partnership with the European Union. We supported intensively the recovery of Albania, including some very successful community participation projects. The Bank was also instrumental with post-conflict support programs in Tajikistan, helping that country move from civil war destruction to sustained recovery. Intense negotiations and the implementation of a large structural loan for Russia helped prevent backsliding on market-oriented reforms under a communist-leaning government following the financial crisis of 1998. In Turkey, adjustment and investment lending and analytical work helped the country out of its financial crisis just a few years ago.

However, there were also cases where we made mistakes. In the poorer CIS countries the Bank was overly optimistic and did not recognize the depth of the economic impact of disintegration. In some countries, such as Belarus, Turkmenistan, Uzbekistan, Bulgaria and Romania, the Bank has not been as influential as it would like to have been. The loans-for-shares privatization program in Russia during 1995-1996 was a serious mistake, which the Bank should have opposed, although it clearly didn't have enough leverage at the time to change the outcome. In the case of Albania, we were late in recognizing the dangers posed by the Albania pyramid scheme, which led to a severe crisis in 1997.

More generally, the Bank was not very well prepared for the financial crises that occurred in Bulgaria, Russia and Turkey. Again, the point isn't that the Bank could have prevented the crises from occurring, but a more explicit consideration of the difficult balance between trying to prevent a crisis versus allowing it to happen should be part of the decision process in the Bank at an early stage as financial stress appears.

Finally, we have learned three important lessons over the years: First, the Bank must address corruption as a serious development issue everywhere, especially in the transition countries. Second, there is frequently a need for a broader regional perspective, rather than a narrow country focus. Third, the Bank should do more to analyze the political context and identify the winners and losers from the reforms that it recommends to its clients.

Challenges for the World Bank in the Region

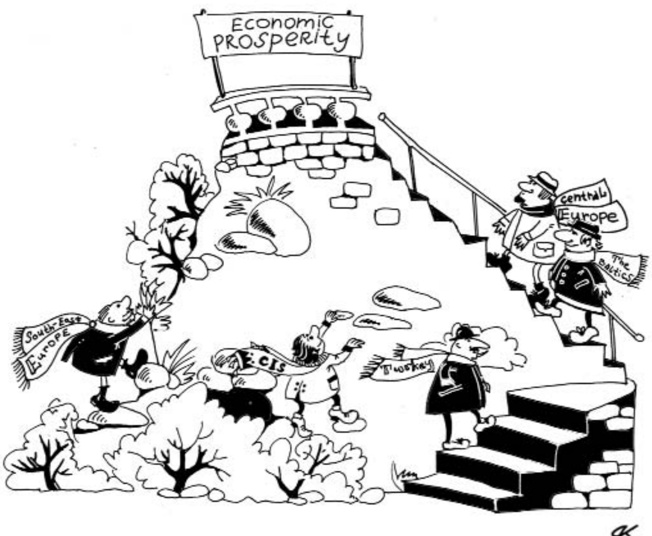
The challenges the Bank faces in Europe and Central Asia are a microcosm of the Bank's challenges worldwide:

1. In the middle-income countries the Bank needs to find constructive ways to stay engaged not only with advisory work, but also in lending, as this will be key to its survival as a global development finance institution. The Bank needs to become more client-oriented, offer lower-cost financial opportunities, and be more flexible and willing to work at a sector-wide level through broad-gauged programmatic loans (as distinct from narrowly focused loans for specific investment projects).

2. In the low-income countries, the Bank has a broadly good approach, with its support for Poverty Reduction Strategies aimed at meeting the Millennium Development Goals. But the key challenge will be to work more closely with governments, civil society and other donors for maximum effectiveness, broad-gauged ownership of aid-financed programs in the country, and harmonized donor assistance as a way to minimize the procedural burdens on recipient countries.

3. For countries that fail to carry out basic market-oriented reforms, the big challenge is to find the right intervention point. The Bank should focus on working with NGOs, local communities, mid-level government units, and young people, as it has done in Belarus. It should not push lending, but maintain a limited relationship and dialogue with government where possible. This commitment requires patience, realistic thinking and planning for the long haul.

Johannes Linn is currently a visiting fellow in economic studies at the Brookings Institution. From 1996 to 2003, he was vice president of the World Bank's Europe and Central Asia Region. The article is based on the author's presentation of his recently published collection of addresses and speeches "Transition Years: Reflections on Economic Reform and Social Change in Europe and Central Asia" at the World Bank. ■



Each region has its own path

Progress in Transition and the Link to Growth

Alan Rousso

The EBRD's 2004 Transition Report records a surge in reform in a handful of countries (mainly those in the waiting room of the European Union), a slowdown in the pace of reform in the advanced transition countries, and modest progress in a handful of CIS countries.

This geographic pattern of reform has been consistent over the past several years:

- Starting from a relatively low base, the transition process in south-eastern Europe (SEE) is continuing to gather pace, and the region is catching up with its neighbours in Central-Eastern Europe and the Baltic states (CEB). The prospect of accession to the European Union, which has already accelerated transition in CEB, is now speeding up progress in the accession candidates of Bulgaria, Croatia and Romania. Progress in the western Balkans has been more modest, and Bosnia and Herzegovina and Serbia and Montenegro continue to lag behind.
- In the CEB countries there remains considerable room for improvement in institutional reform. There have been some developments in this area, but the formal accession of CEB countries to the EU in May 2004 may have reduced the incentive for reform and contributed to a second year of limited progress, as measured by the EBRD's transition indicators.
- As a group, the CIS countries had another moderate year, with only the Kyrgyz Republic making noticeable progress. The reform process in this region has for a number of years shown signs of stalling. A particularly active — and in some cases turbulent — year of political transition may have contributed to this.

Reforms and Growth During Transition — What is the Link?

This modest progress in reform in the CIS countries comes against the background of strong growth in the region since 1999. At the other end of the reform spectrum, several new EU members have seen a significant slowdown in growth in recent years. It has become increasingly clear that the link between reforms and growth in transition economies is more complex than many policy-makers and analysts had originally thought. Does reform lead to growth? If so, to what extent and at what speed? Pro-reform governments may need reassurance that the long-term benefits of transition are sufficient to make any short-term pain worthwhile.

Three broad factors may explain improvements in macroeconomic performance and the fact that some countries are growing faster than others. These are: initial conditions, including the extent of inherited structural and macroeconomic distortions; the implementation of appropriate monetary and fiscal stabilization policies, resulting in lower inflation and sustainable fiscal deficits; and progress in market-oriented reforms.

There is broad agreement in the literature that initial conditions, especially in the first years of transition, are important, and that the early adoption of sound macroeconomic policies is good for growth. The area that has generated the most debate so far is the influence of reforms on growth. Most of the early studies argued that reforms are beneficial for growth. A common finding was that an increase in a reform indicator has a negative effect on growth at first but after a year has a positive influence that outweighs the initial decline (de Melo *et al.*, 2001; Merlevede, 2003). Several papers concluded that the initial-phase "liberalizing" measures have a larger impact on growth than measures to improve the institutional environment (Fischer and Sahay, 2000; Havrylyshyn and van Rooden, 2003). One reason for this result is that institutional reforms are harder to carry out. They also bring long-term benefits that may not have been visible in the short time-span available for analysis.

However, a number of recent papers cast doubt on the benefits of reform. Although the positive effect of reforms can be detected in the early period of transition, it tends to disappear in later stages (Fidrmuc, 2003; Lawson and Wang, 2004; Lysenko, 2002). This reflects the fact that there has been a marked acceleration in growth in some of the less-reform minded countries in the last four or five years, in parallel with a slowdown in the most advanced part of the region.

It is possible, however, that previous studies failed to take sufficient account of other relevant factors leading to growth. Once they are included in the equation, the benefits of reforms may become apparent again. Three additional variables can be considered:

- The potential for countries that suffered the deepest recessions to rebound more quickly;
- Changes in terms of trade, particularly in relation to oil prices, and dependence on oil imports or exports; and
- The impact of external growth, by weighting the real GDP growth rate in their main trading partner countries by export shares.

Additional Relevant Factors

Many transition countries have experienced severe falls in output over the past decade. In general, the further the decline, the greater has been the potential for a period of rapid growth once recovery has started. For most countries that had long, deep recessions, average annual growth rates in the recovery phase were in the range of 6—8% and even higher. For those countries that had relatively mild recessions, subsequent growth was generally more modest.

A second factor affecting growth in some countries, especially in recent years, has been the surge in commodity prices, and in particular the price of oil. This factor is especially important in the CIS, where several countries are oil-rich and others can benefit directly and indirectly through trade and other linkages.

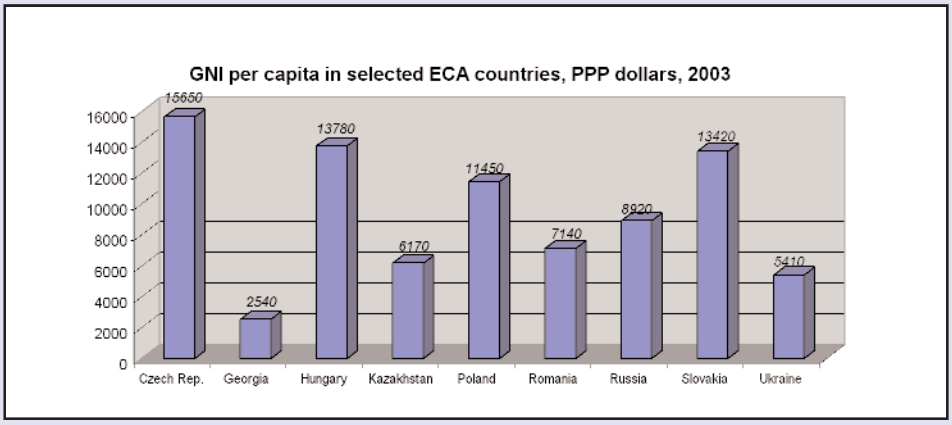
The third factor likely to influence growth in transition countries, which have become increasingly integrated into the world economy, is the economic performance of their main trading partners. If the main trading partners have buoyant economies, this can bring large benefits. However, if external demand is temporarily weak, this can lead to a short-term slow-down in transition economies and a worsening in their terms of trade. The prolonged period of modest growth in the EU—15 (the 15 member countries before the latest accessions in May 2004) in recent years has probably had an adverse effect on some of the new EU members, many of which conduct more than half of their trade with the EU—15. In contrast, the recent boom in Russia has had positive spillover effects for a number of other CIS countries.

If these three factors are incorporated in an econometric analysis (Falcetti *et al.*, 2004), the results show that reforms have a strong, positive effect on growth rates, with a one-year time lag. *Ceteris paribus*, an increase in the EBRD reform index by 0.1 would raise the growth rate the following year (and each subsequent year if the new level of the reform index is maintained) by between 0.3% and 0.7%. This is not a trivial effect, especially when cumulated over several years. Thus, a sustained commitment to reforms brings substantial benefits over the long term.

The results also throw some light on the causes of reform. Two points are worth noting. First, civil liberties and reforms are strongly linked. Countries that enjoy more freedom — that is, those with a lower index of civil liberties — have recorded higher average growth. Secondly, growth has a positive effect on the level of reforms in the same period. This suggests that countries may become locked into a "virtuous circle" — an increase in growth has an immediate positive effect on reforms, which in turn benefit growth in the following period, with further knock-on effects on reform and so on. However, countries should not take it for granted that once they enter this positive spiral they will remain there.

This article is based on the EBRD's 2004 Transition Report, published in November, 2004. The assessments of progress in transition are made by the economists in the Bank's Office of the Chief Economist. The section on reforms and growth was written by Peter Sanfey, Elisabetta Falcetti and Tatiana Lysenko. Alan Rousso is a senior political counselor with the EBRD. ■

Economic Prospects 2005: Eastern Europe & Central Asia



Regional trade arrangements helped Eastern Europe grow. With EU assistance, and with the aspiration of both EU and WTO membership, Eastern European countries have moved swiftly toward integration. The CIS has been burdened with incomplete reforms and a poor investment climate that have weighed down the region’s performance. The plethora of trading arrangements have been implemented only partially and fallen short of realizing trade potential. Under the CIS—7 initiative, trade regimes have been generally liberalized, but have been limited by regional trade and transit barriers.

Domestic consumption and investment in Russia and other CIS oil exporters were boosted by a surge in oil revenues, while the accession of several of the region's countries to the EU provided a further boost to investment demand and FDI.

Real GDP in Europe and Central Asia is expected to increase by 7% in 2004, up from 5.9% in 2003, and outstripping the 2000 peak of 6.7%. Regional growth is forecast to moderate over the near-term, with output rising by 5.6% and 5% in 2005 and 2006, respectively. In the next ten years, Eastern European and Central Asian growth is forecasted to average 3.5%.

Source: WDR 2005, Global Economic Prospects 2005 at http://siteresources.worldbank.org/INTGEP2005/Resources/ECAHighlightsENG.pdf.

Infrastructure in Transition: Regulation and Private Sector Participation

Alan Rousso

Efficient and accessible infrastructure services help to promote economic growth and to alleviate poverty. There is general support for this argument but less evidence on how this should be achieved in practice. Policymakers around the world continue to debate the best means of promoting infrastructure restructuring and investment. Nevertheless, there is broad agreement that creating and implementing an effective regulatory regime is an important first step, essential to commercializing infrastructure and attracting private investment.

The transition countries face, to varying degrees, significant infrastructure challenges, including: tariffs that do not reflect costs, with extensive cross-subsidization between different types of services and different consumer groups; poor revenue collection; as well as insufficient separation between operating and regulatory functions and between natural monopoly elements and areas that may be opened to competition. The main issue for transition countries is to maintain and upgrade service networks — which are often too extensive for current needs and in a poor state of repair — rather than extend networks, as is the case in developing countries. Transition countries also need to develop rules and regulations to encourage efficient, cost-effective, environmentally sustainable and affordable services.

Regulation is in Its infancy

In most countries, new laws and regulators have been introduced for telecommunications and electricity. For railways, the regulatory functions mostly still lie with the relevant government ministry, with the exception of only a few countries, such as Estonia and Poland. Water and sewerage tend to be regulated by municipalities. Romania is the only transition country that has established a national water regulator so far.

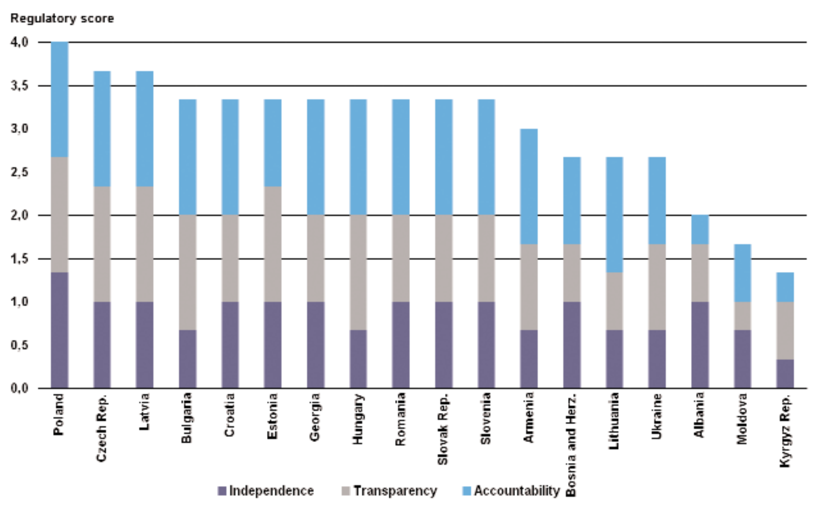
How new regulatory institutions actually function relative to established benchmarks can be assessed using the results of a new EBRD survey of regulators in the electricity, railways and telecommunications sectors implemented in summer 2004.

There are six key characteristics of an effective regulatory system: coherence, predictability, capacity, independence, accountability and transparency (Noll, 2001; Stern *et al*., 1999). The first three criteria depend on each country's wider legal and institutional framework and are general prerequisites for an effective regulatory system. The other three criteria are more sector-specific. The EBRD survey provides an indicative ranking of these attributes, allowing for cross-country comparison. Chart 1 summarizes the findings for the electricity sector.

Regulatory *independence* concerns the relationship between regulatory agencies and the government. The results of the survey suggest that government interference continues to undermine regulatory independence in many transition countries.

Accountability ensures that regulators enforce rules fairly while protecting the legal rights and economic interests of the state, operators and users. It is facilitated by requirements such as the publication of annual reports by the regulatory agency. The survey provided information on which regulatory agencies must publish an annual report and how many annual reports have been published to date.

Chart 1. Regulatory Quality in Selected Transition Countries, Electricity Sector

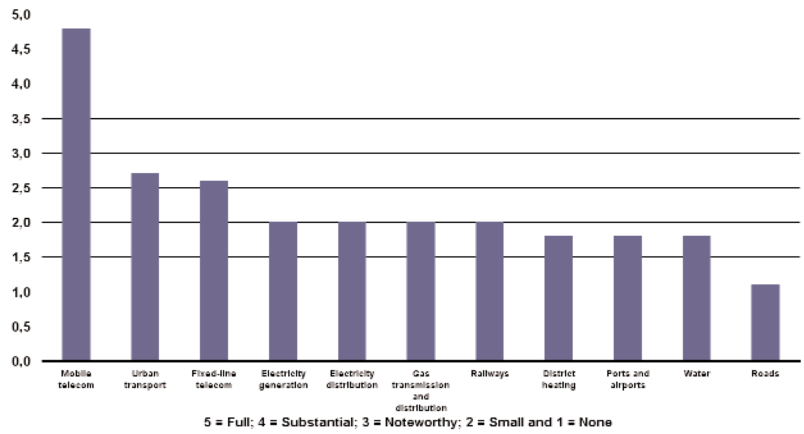


Transparency involves the right of stakeholders to be informed about decisions affecting them and also relates to the scope for corruption and secretive decision-making. One way of judging the extent of transparency is the frequency with which existing regulatory decisions, rules and policies are published (also electronically).

Regulatory quality tends to be higher in countries where the rule of law is observed, bureaucratic corruption is brought under control, property rights are protected and the media are relatively free (Levy and Spiller, 1994). Recent studies also show that investment in the telecommunications and electricity sectors tends to be greater in countries with political institutions that constrain arbitrary behaviour by political actors (Henisz, 2002; Henisz and Zellner, 2001). Given the high costs and long-term commitment involved, investors in infrastructure utilities want assurances against administrative expropriation and legal recourse in case it occurs.

Throughout the region, progress in infrastructure reform has been hindered by a lack of efficient regulatory institutions, and by vested interests seeking to protect their positions of strength. This is particularly evident in the area of tariff reform, where well-connected interest groups have often succeeded in blocking tariff adjustments. There are justifiable concerns about the impact of tariff reform on poor consumers, who may not be able to afford steep price rises. However, there are a number of ways to address these concerns, such as "lifeline" tariffs that allow a certain level of services to be provided free of charge. Infrastructure reform may be difficult, but it is not impossible.

Chart 2. Private Sector Participation by Sector



Private Sector Participation is Not a Panacea

Transition countries have sought private sector assistance both in financing the upgrade and maintenance of infrastructure services and in improving the management of networks. Notable successes have been achieved, particularly in reducing losses and improving the collection of payments. There have also been some high-profile failures. With hindsight, we know that expectations about the potential impact of private sector participation (PSP) were probably unrealistically high.

Why do governments seek private sector participation in infrastructure? The most obvious financial motive for privatizing infrastructure services is that it enables governments to raise funds from the sale of utilities' assets or from payments for concessions or leases. The total proceeds from infrastructure privatizations from 1992 to 2003 amounted to about $40 billion, at 2000 prices. Although infrastructure privatization has raised large sums in absolute terms, it financed just over 8% of the region's cumulative fiscal deficit between 1990 and 2002. Perhaps surprisingly, this is not a substantial contribution to the total financing needs of governments in the region.

Aside from financing, it has been argued that private managers seeking to maximize profits (frequently backed by additional equity resources) are generally better placed to improve labor productivity, optimize asset management and provide better services to the local population.

Where is the Private Sector Most Active?

According to EBRD's assessments, PSP is most advanced in the telecommunications sector (mobile telephony), followed by urban transport (mini buses) and, to a lesser extent, the electricity sector (see Chart 2). As far as regions are concerned, PSP is most present in CEB countries and the EU candidate countries of south-eastern Europe (SEE). Among the CIS countries, only Armenia, Georgia, Kazakhstan and Russia have noteworthy levels of PSP. In other CIS countries, PSP remains largely confined to mobile telecommunications and urban transport.

What Has PSP Achieved?

Systematic evidence on the relative performance of privately controlled utilities in transition countries is limited, due to a lack of data. However, there is some anecdotal evidence of utilities increasing productivity substantially, after being transferred to a private operator. A distinctive feature of PSP in telecommunications has been the effective implementation of new technologies, such as digital switching and mobile phones, which offer the prospect of improvements in productivity and quality of service. Additional evidence from the electricity sector suggests that the entry of private companies has tended to reduce overall distribution losses (by an average of 1.9 percentage points).

As lessons from past projects are absorbed, the shape of private sector participation is changing. Increasingly, the private sector is invited to provide management skills rather than to finance capital investment. This makes the arrangements less risky for both partners but no less difficult to structure. Short-term and often speculative investors have gradually been replaced by companies interested in longer-term strategic involvement in the region. Another important trend is the emergence of local companies, ranging from "national champions" in sectors requiring high capital outlays to small, dynamic companies active in municipal and regional markets.

This article is based on from the EBRD's 2004 Transition Report. The authors of the section on regulation are Alex Chirmiciu, Alan Rousso, Jon Stern and Maria Vagliasindi. The authors of the section on private sector participation are Gordon Hughes, Zbigniew Kominek, Andre Meier and Toshiaki Sakatsume. Alan Rousso is a senior political counselor with the EBRD.

Russian Rail Restructuring: Some Steps Taken, Some Remaining

Russell Pittman

Last year the Russian railways began implementing an ambitious three-part restructuring plan that is not scheduled to be completed before at least 2010. The three parts of the plan correspond roughly to the three principal steps that liberal reformers typically urge for the traditional infrastructure monopolies in developing countries: separation of operations from regulatory functions, elimination of cross-subsidization, and the introduction of competition where economically feasible. As always, the devil is in the details, and, despite significant achievements so far, many questions remain to be answered.

The first step has been taken: the old, monolithic Ministry of Railways has spun off the new operating entity, the Russian Railways Company (RZhD). RZhD remains state-owned. Nonetheless, it has already entered bond markets in a big way, aided by a BB+ rating from Standard & Poor's — no other Russian enterprise enjoys a higher rating. In addition, the investment-starved railway system has seen a large infusion of private capital, in the form of privately owned rolling stock.

This first step, however crucial, is still only a first step: the result is a more transparent and better equipped monopoly, but RZhD remains a monopoly. The next two stages may be more difficult, as each will face important opponents.

The principal goal of the second phase of the reforms is to end the subsidization of passenger services by freight services. In part, this is a standard good-government measure: if the government (and especially regional and local governments) want their citizens to travel by rail at a price below cost, arguably they should pay for that. But it is also a matter of financial health for RZhD: the experience of other countries, including the US, demonstrates quite clearly that if a freight railway is forced to subsidize passenger services, it is in danger of losing much of its profitable freight traffic to competitors who do not have to pay such subsidies, especially motor carriers.

Whether the coalition of RZhD executives and economic reformers is strong enough to move these subsidization costs from freight traffic to government budgets is not clear yet, but at least RZhD has incentives to try to make it happen.

The outcome of the third stage of reform, in which competition is to be created on the railways, is much less certain. Indeed, even the concept of competition is not clear yet, and RZhD has no incentive to hurry the process along.

In principle, RZhD is committed to a "vertical access" model for the creation of competition: RZhD would remain vertically integrated, controlling the infrastructure as well as operating trains, but it would allow independent, non-integrated train companies to operate on the RZhD infrastructure under non-discriminatory access terms.

Some reformers have argued for a complete "vertical separation", in which RZhD would continue to control the rail infrastructure but would not be permitted to operate its own trains. The advantage of this model over vertical access is that the infrastructure operator would have no incentive to discriminate against the independent train companies in terms of access price, service quality, and so on. Proponents of this alternative frequently cite the fact that the job of insuring nondiscriminatory behavior by the integrated RZhD will be the responsibility of traditionally weak Russian antimonopoly authorities.

RZhD counters such reasoning with the equally persuasive argument that vertical separation comes at a cost of lost economies of vertical operation, most conspicuously regarding train coordination and safety. Even if the problems experienced following vertical separation of the rail sector in the UK are not demonstrative evidence — some would argue that the problem in the UK was the manner of separation, rather than separation itself — they still provide a cautionary tale for a country like Russia, whose economy depends so heavily on its freight railway sector.

The RZhD reform plan also refers to the possibility of a completely different model for creating rail-on-rail competition in the third stage of reforms: by creating vertically integrated rail franchises that would compete with each other both over parallel routes and for shipping commodities to and from particular locations. This rail reform model, which has been used successfully in Argentina, Mexico and, to a lesser extent, Brazil, avoids the close day-to-day access regulation required by the vertical access model and the complete vertical dismemberment of the vertical separation model.

One reason for the great uncertainty surrounding this third stage of reforms is that it is not clear yet what agency or organization will be pushing for it. It is not in RZhD's interest to create effective competition for its monopoly. The Ministry of Economic Development and Trade, the Federal Antimonopoly Service, the new rail rate regulator — each of these faces formidable opponents as they seek to create a truly competitive railway sector in the Russia of tomorrow.

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World Development Report 2005: Findings and Implications for the Europe and Central Asia Region

Pradeep Mitra

I. Reducing policy-related risks and costs for businesses, closing the gap between policy declarations and implementation, and focusing on delivering the basics — these are some of the measures that can help create a better investment climate for everyone.

This *World Development Report* is about creating a climate in which firms and entrepreneurs of all types have opportunities and incentives to invest productively, create jobs, and expand, thereby contributing to growth and poverty reduction. Drawing on new research, including surveys of more than 26,000 firms in 53 developing and transition countries, and the Doing Business Project, which benchmarks regulatory regimes in more than 130 developing and developed countries, the Report looks at what governments can do to create better investment climates for their societies.

First, an investment climate that is better not only for firms but for society as a whole requires taxation and well-designed regulation (including removing still pervasive barriers to competition); good governance; secure property rights; the provision of infrastructure; and functioning financial and labor markets. Business costs, including weak contract enforcement and onerous regulation, can amount to more than 25% of sales — or more than three times what firms typically pay in taxes. Unreliable electricity supply and other infrastructure, crime, and corruption can impose costs that are more than double those of regulation. The costs of crime exceed 10% of sales in Armenia and Azerbaijan.

Second, governments need to reduce the policy-related and macroeconomic risks that are perceived as the top constraint on business in 28% and 23%, respectively, of the countries surveyed. The report shows that stronger competitive pressure, which can be promoted by trade liberalization, can boost the probability of innovation by more than 50%. Yet, unjustified and highly variable regulatory barriers that add to uncertainty are pervasive, and consistent and effective efforts to curb anti-competitive behavior by firms remain weak in most developing countries.

Third, gaps between policies and their implementation can be huge according to close to 90% of the firms surveyed. As a result, informal economies are often large, reaching 75% of GDP in Georgia and accounting for almost half of GDP in Russia. Governments need to tackle corruption and other forms of rent-seeking, to build credibility with firms, to foster public trust and legitimacy, and to ensure that their policy interventions are crafted to fit local conditions.

Finally, everything does not have to be done at once, nor is perfection required. Impressive results can be achieved by addressing the most important constraints, and by sustaining a process of ongoing improvements. For example, much progress has been made since the start of transition in countries of the World Bank's Europe and Central Asia (ECA) region, which includes all the transition economies of Eastern Europe and the former Soviet Union, as well as Turkey, although progress is variable across and within countries. Slovakia headed the list of reformers in 2003 and Lithuania was in the top six. Moreover, the ECA region as a whole matched the high-income OECD countries in investment climate reforms, with two to five times the number of reforms in other regions. Lithuania and Slovakia rank immediately after the high-income OECD countries in the top 20 in terms of ease of doing business in 2003. Latvia is among the fastest countries in which to register a firm, and displayed among the largest contributions to productivity from net entry, exceeding most OECD countries on both scores.

II. The ECA region is ahead of most developing countries but requires more reforms to rival high-income OECD countries.

Reflecting reforms over the last decade, the investment climate in the ECA region has moved from the back of the pack to just behind the high-income OECD countries, with the notable exception of labor market regulations (see the table). However, various aspects of the business climate still require substantial reform across the region to catch up. For example, Slovenia and Poland are among the slowest to enforce a contract, requiring an average of about 1,000 days, while costs as a percent of debt to be recovered are almost three times higher than in the high-income OECD countries, although admittedly less than half the cost in other developing regions (excluding the Middle East and North Africa).

Equally, in some dimensions various ECA countries compare unfavorably to developing countries from other regions. For example, in Ukraine and Albania, 44% and 55% respectively of firms report that senior management spends more than 10% of their time dealing with government regulations, worse than Brazil and Cambodia and close to the 49%—61% of firms with similar complaints in Kenya, Tanzania, Ecuador and India.

Reforms directly impact performance. As a percent of sales, business costs tend to be lower in those ECA countries where reform is more advanced. For example, in Poland these costs are well below 10% of sales, compared to almost 15% to more than 25% in China, Brazil, Algeria and Tanzania. Similarly, close to three quarters of firms in Poland, Hungary,

Rank of various regions according to selected business environment indicators

	Entry: Cost of startup as percent of GNI per capita	Protecting Investors-Disclosure Index	Cost of Enforcing Contracts: Percentage of debt	Legal Rights Index	Property Registration Cost (% of property per capita)	Rigidity of Employment Index	Exit: Recovery Rate (cents on the dollar)
OECD: High income	1	1	1	1	3	2	1
Europe & Central Asia	**2**	**2**	**2**	**2**	**1**	**4**	**2**
East Asia & Pacific	4	4	7	2	2	1	3
Middle East & North Africa	5	4	3	5	6	3	4
South Asia	3	6	5	5	5	5	6
Latin America & Caribbean	6	3	4	7	4	6	5
Sub-Saharan Africa	7	7	6	4	7	7	7

Source: Staff calculations from data in Doing Business in 2005 database at http://rru.worldbank.org/DoingBusiness/ExploreTopics/HiringFiringWorkers/CompareAll.aspx?direction=asc&sort=4

Slovakia and Tajikistan report facing significant competitive pressures, while the proportion is about 40% in Georgia. At the same time, even in a new EU member state such as Estonia, almost 50% of firms complain about regulatory predictability, while three quarters of Russian firms find the interpretation of regulations to be unpredictable — a higher proportion than in Indonesia, Pakistan or even Zambia (60%—70% of firms).

Investment also responds directly to improvements in the business climate. Firms in Poland, Romania, Russia, Slovakia, and Ukraine that believe their property rights are secure reinvest between 14% and 40% more of their profits in their businesses than those that don't share that belief. At the same time, firms in many countries lack confidence in the courts to uphold property rights. For example, in Moldova close to three quarters of firms have doubts in this area, and even in the Czech Republic barely half have faith in the courts, a lower figure than the 60% in Brazil or 80% in Malaysia.

For the ECA region as a whole, access to finance is not a major problem, with complaints from only 10% of firms (compared to 25%—65% of firms in other regions), reflecting the opening of the financial market to foreign investment and integration into the world economy. Infrastructure is more problematic, with close to a quarter of firms in the ECA region reporting serious obstacles in this area. However, here again ECA does better than all the other regions (30%—55% of firms complain) except for East Asia and the Pacific, with less than 20% complaining.

Labor regulations remain a problem in many ECA countries, with more firms concerned about this in Poland than in the Philippines, Kenya, Pakistan and Algeria. Similarly, although 43% of firms in Central and Eastern Europe report paying bribes that average 2.8% of sales, both figures are lower than in other regions (half to three quarters of firms pay 3%—7% of sales). Lithuania has been at the forefront of efforts to combat corruption, with the creation in 1997 of a Special Investigation Service that reports to the president and parliament.

III. The way forward … with continued international support.

Most ECA countries are well positioned to build on the successes of transition and tackle the remaining policy and institutional challenges. Slower reformers can accelerate their efforts and gain ground by emulating best practices learned from their neighbors. Faster reformers can adopt best practices from high-income OECD countries. The Report calls on the international community to assist this process by:

- Removing trade restrictions, subsidies and other market distortions in developed countries that harm the investment climate in developing countries. This can deliver benefits to developing countries worth more than four times the value of investment-related aid they receive;
- Providing more, and more effective, assistance to help governments improve their investment climates. Technical assistance on the design and implementation of policy improvements can be especially potent, but currently receives fewer resources than direct support for individual firms and transactions;
- Helping to tackle the huge knowledge agenda on investment climate issues, to provide more guidance to policymakers on the design and implementation of policy improvements.

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How Slovakia Transformed Itself from a "Black Hole" to an Investor's Paradise

Olga Gyarfasova

Slovakia has done more than any other country to improve its business environment in the past year. The World Bank "Doing Business 2005" report lists Slovakia as one of the 20 most business–friendly of the 53 developing countries surveyed. Cumulatively, reforms conducted over the past two years could add 2.5 percentage points to the Slovak economy's annual growth. *The Washington Times* called the new Slovak tax system "one of the best systems in the world", and many analysts, politicians, and businesspeople compare Slovakia to Hong Kong and Ireland in terms of economic performance and the investment climate.

A Model of Economic Reform

Some of the major reforms implemented in the past two years include:

- *Tax reform* was guided by key objectives: simplicity, neutrality, and efficiency. Progressive income taxation and two different VAT rates were replaced by a single flat income tax of 19% and a single VAT rate. Many loopholes were closed in order to end de facto subsidies to certain sectors, and a whole series of taxes were completely eradicated, such as the inheritance tax, a tax on gifts, the real-estate transfer tax, and the dividend tax, a move particularly appreciated by foreign investors.
- *Labor laws* were tightened to motivate the unemployed to seek work and adjusted to reduce the black economy. The unemployment rate is now slowly declining.
- The *pension system reform* replaced the old system, in which workers pay the pensions of retirees, with a new "three-pillar" system, which combined the pay-as-you-go model with obligatory personal pension accounts administered by private companies, as well as voluntary private accounts, in which people may put additional pension savings. The pension system is now rated among the most progressive in Europe.
- *Health-care reform*, which was passed by parliament very recently, requires that patients partly cover the costs of many medicines and non-essential medical services. Health-insurance companies will compete on an open market, and state-owned insurers will be transformed into joint-stock companies, potentially opening the door to private investors.

These achievements are especially remarkable considering that for years after Czechoslovakia split up in 1993, Slovakia lagged far behind its Visegrad neighbors. It was ruled by a coalition of nationalists, post-communists and other authoritarians under Prime Minister Meciar and lacked any significant political debate. State assets were literally given away to Meciar's "domestic capital-producing class", and economic reform was not even discussed. How has the country managed this drastic change?

While the focus of the coalition government formed after the 1998 elections was largely on restoring democratic principles rather than on structural transformation, it implemented several important reforms, such as in civil service. Economic reforms came to the fore after the 2002 elections. The fact that coalition partners in the center-right government under Prime Minister Mikulas Dzurinda had a common stance on key social and economic issues certainly played a big role. In developing economic and social policies, the government could rely on intellectual capital amassed in think tanks, nongovernmental organizations, and newspapers, all home to a reform-minded intellectual elite. The government also exploited a shift in public opinion towards free-market principles and away from socialist views. As a result, the reforms were all based on neoliberal ideas and supply-side economics.

Reforms Unloved, but Largely Unchallenged

Although support for the coalition has been quite weak, the reforms were helped by a certain degree of apathy among voters and the lack of serious political opponents. The left-wing opposition, along with some trade unions, tried to block the reforms by initiating a referendum that would have led to early elections. They won the referendum, but because of the low turnout (36%, with at least 50% needed) the results were annuled.

The greatest threat to the reforms lies not with political opposition or public disapproval, but with relations within the coalition itself. So far, the coalition has been held together by the ambitious reform program and, despite now being a minority government, looks likely to remain in office until 2006. Because no single party emerged a clear winner in the recent elections, the need for coalitions will remain in the future. Some of the present coalition members will necessarily feature in future governments, which will make it harder to reverse the reforms.

Thus, forecasters anticipate steady economic growth and strict fiscal discipline as Slovakia prepares to adopt the euro. Tax reform should boost foreign direct investment, new labor laws should reduce unemployment, while political decentralization should encourage regional growth and stabilize democracy. Despite this optimistic scenario, Slovakia faces urgent problems, such as deep regional disparities, widespread corruption, and the need to better integrate the Roma minority.

The American businessman Steve Forbes, owner of the influential *Forbes* magazine, believes Slovakia could be "the domino that pushes the rest of the EU, particularly 'Old Europe' nations Germany and France, toward a more free-enterprise, entrepreneurial era."

The piece is based on the article "From Black Hole to Leading Light" published in "Transitions Online" (TOL), http://www.tol.cz, on October 6, 2004. The author is an analyst at the Institute for Public Affairs in Bratislava. ■

Czech Bankruptcy Reform: A Light at the End of the Tunnel?

Ondrej Vychodil, Ondrej Knot

Only three countries of the 141 in the World Bank's Closing Business 2004 database — India, Brazil and Chad — have bankruptcy procedures that take longer than those in the Czech Republic. The average bankruptcy in the Republic takes more than nine years to complete, compared to an average of 21 months for the 'old' EU. Such lengthy procedures, combined with weak protection for creditors, allow managers to tunnel out the value from insolvent firms.

The effects of inefficient legislation on the Czech capital market are such that banks — already risk averse and facing harder budget constraints after privatization — are doubly reluctant to lend to firms.

In the summer of 2001, the government took a first step by proposing to draft new bankruptcy legislation, which would replace the inefficient Bankruptcy and Composition Act of 1991 (amended 20 times since). The core concepts of the reform include a more debtor-friendly approach thanks to a reorganization chapter, which allows the debtor to retain control over the firm, the re-introduction of the principle that secured debtors are entitled to the full proceeds of the security sale, as well as better protection for creditors, by enabling them to dismiss a court-appointed bankruptcy trustee and appoint a new one.

The urgent need to reform the bankruptcy legislation was highlighted by the corruption scandal surrounding the bankruptcy of Union Banka, a medium-sized bank, in spring 2003. The bank's managers made a deal with a "bankruptcy mafia" involving a bankruptcy judge, to keep full control over the bank. To ensure that the case would be brought to the preselected judge, the managers moved the headquarters to another city, where they filed for bankruptcy. The judge immediately declared the bankruptcy and appointed a trustee, who would act quickly in the interest of the incumbent management at the expense of the bank's depositors. Serious accusations were raised regarding the bank's managers, the bankruptcy judge, and the bankruptcy trustee, as well as highly positioned members of the state administration.

The case proved to be the tip of an iceberg, as similar practices were uncovered at large industrial enterprises. The events intensified the pressure from the media and the public for faster measures. However, the government's pace in preparing the reform remained unsatisfactory, and progress was impeded by the fact that the legislative work was in the hands of the same people who had been in charge of previous amendments.

To circumvent the government's sluggishness, several large Czech banks drafted an extensive amendment to the 1991 Act. The amendment, which significantly reduces space for corruption by increasing creditors' rights, limiting judges' discretion, and enhancing debtors' and trustees' accountability, is currently under discussion in the parliament. While the amendment would improve the situation, it does not address some other problems, such as a bias towards liquidating a bankrupt firm due to excessively strict conditions for the non-liquidation solution, late initiation, and the duration of bankruptcy procedures.

The first draft of the law presented in the spring of 2004 was heavily criticized from various sides. First, as in the current law, bankruptcy was again viewed mainly as a legal issue, and not one of management of an insolvent company. Second, drawing on U.S. legislation, the chapter on reorganization significantly increased the authority and discretion of judges, who were given the sole power to prevent the debtor from harming creditors. The case of Union Banka has shown, however, that, unlike in the U.S., the Czech system cannot rely on judges' integrity and competence in sophisticated commercial decisions, such as whether an insolvent firm should continue operation.

The government reshuffle in July 2004 provided a strong impulse for addressing the key problems in bankruptcy legislation. The government invited a broader panel of legal and economic experts to re-write the law and make it compatible with the existing institutional framework and the needs of the Czech economy. The resulting draft strengthens the rights of creditors, while giving them incentives to keep the firm operating whenever reasonable. The application of the bankruptcy chapter does not have to lead to a liquidation of the insolvent firm, as has usually been the case under the current law. The reorganization chapter is designed to minimize the risk that the debtor will abuse the system. What's more, the law sets time limits for some court decisions, gives managers incentives to initiate timely bankruptcy proceedings, and contains specific provisions for the insolvency of financial institutions. The new draft appears to have broad support across the political spectrum. Provided the parliament adopts the law in the beginning of 2005, it can take force in 2006.

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Bankruptcy proceedings in the Czech Republic, 2000 and 2002

	Number of bankruptcy proceedings 2000	2002
Total bankruptcy proceedings, of which:	14604	14646
Unresolved from the previous period	9694	10387
Resolved cases, of which:	4067	4429
Stopped proceedings	1955	1735

Source: www.ejustice.cz

Minimum Wage Increase in Hungary — a Radical Measure with Mixed Results

Miklos Koren

Picture a Hungarian mechanic and an insurance broker — which is more likely to hold a minimum-wage job? Wrong. It's the insurance broker. The minimum wage in Hungary defies economic intuition in other ways, as well. It was raised by 57% in 2001 and an additional 25% in 2002, an aggregate increase unprecedented among OECD countries.

This unexpected shock allows for a "laboratory experiment" on microeconomic factors, such as labor demand and supply, job loss and gain, and efficient — or "fair" — wages. But the drastic measure also had repercussions for macroeconomic aggregates, such as output and prices, government expenditures and tax revenues.

This brings us back to the insurance broker. While the majority of low-wage earners are unskilled workers at small firms in depressed regions, many professionals are also paid the minimum wage, because taxes and mandatory social security contributions levied on wages are much higher than those levied on entrepreneurial income. Many firms complement a low-wage contract, which carries social security benefits (healthcare, pension, etc.), with low-tax compensation schemes. For an average experienced skilled worker, this can cut total labor costs by a whopping 43%. The minimum wage increase was hence an attempt by the government to counter this tax avoidance. The government also aimed to compress wage distribution: by 2002, the fraction of workers paid the minimum wage rose to 17.3% from just 5% in 2000.

Such significant changes in relative wages tend, however, to bring about turmoil in labor markets. In Hungary, the steady upward trend in employment broke sharply in early 2001 (see figure), coinciding with the first minimum wage hike. Obviously, myriad factors other than the minimum wage, such as the global recession, may have influenced employment. Two recent studies, one by Kertesi and Kollo (2004) and another by Halpern *et al.* (2004), set out to separate these factors.

In analyzing labor market effects, Kertesi and Kollo find that the direct result of the minimum wage increase was the drop in demand for unskilled workers by between 1% and 3%, especially among small enterprises in depressed regions. Lower labor demand, in turn, increased the probability that low-wage workers would be let go. Workers earning 90%—110% of the new minimum wage were twice as likely to lose their jobs as workers in the control group, with just slightly higher wages (110%—125% of the minimum wage).

The probability that the unemployed will find employment may theoretically go either way after a minimum wage rise. On the one hand, better wage prospects for the low-skilled unemployed may increase the intensity of their job search or their willingness to leave unemployment — a *supply-side* effect much emphasized by the government. On the other hand, the destruction of low-wage jobs lowers the *demand* for entry in employment. Analyzing exit rates from unemployment, Kertesi and Kollo conclude that the negative demand effect outweighed the positive supply effect: low-wage workers were 14 percentage points less likely to find a job after unemployment than low-skill workers. Overall, the minimum wage increase significantly deteriorated the employment chances of people at the lower end of the wage distribution.

To examine the indirect macroeconomic effects of the minimum wage rise on labor tax revenues, prices, GDP and the budget deficit, the study by Halpern *et al.* builds a multisector general equilibrium model of the Hungarian economy. To model firms' tax-avoiding behavior, the authors assume that a fraction of firms only pay taxes and social security contributions based on the minimum wage. Since they have no direct measures or reliable estimates of the importance of this phenomenon, they vary this fraction between 10% and 40%.

The impact of the 2001 minimum wage rise is such that, as the demand for low-skill workers falls, aggregate employment drops by 0.6%—1.1%. The more tax avoidance in the economy, the farther the fall, because the minimum wage increase means an increase in effective labor taxes.

Even though companies are able to pass on some of their labor cost increase to customers, corporate profitability and hence investment plummets. This has a negative impact on real GDP, which declines by 0.6%—2%. At the same time, because of the increase in labor costs, consumer prices rise by 0.5%—1.6%.

As for the government budget, revenues from labor taxes and social security contributions rise by 0.6%—3% in real terms, depending largely on how much of the economy is engaged in tax avoidance. This is a small sum compared to the magnitude of the rise and the government's hopes that it could substantially "whiten" the grey sector. The rise could only have had a bigger effect on tax revenues if one is willing to assume that more than 40% of firms were playing the minimum wage game, which is an unreasonably large proportion.

Overall, because value added taxes comprise 57% of tax revenues and both corporate and value added tax receipts decline in real terms, total tax revenues are unchanged or decline slightly (by 0.4%). Since the structure of government expenditure is assumed to remain fixed, the budget deficit is largely unchanged. This probably underestimates the budgetary costs of the minimum wage increase, as many social security benefits are indexed to the minimum wage.

Who benefited from this policy in the end? Even though low-wage workers face a mix of better wage prospects and deteriorated job security, those lucky enough to keep their jobs must surely have welcomed the sizeable rise in their real wages. However, contrary to the hopes of the government and popular belief, tax revenues and the budget deficit have not been significantly affected.

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World Bank\IMF Agenda

AIDS Menacing Central — Eastern Europe, New Report Warns

A new IMF report, *The Macroeconomics of HIV/AIDS*, analyzes how HIV/AIDS adversely affects physical capital, exacerbates poverty and inequality, debilitates welfare programs, and impacts government finance and public services. An economy severely affected by AIDS may contract to some one-third of its initial size in three generations, unless the government is willing to spend an extra 3—4% of GDP.

Last year, in Central — Eastern Europe including the CIS countries, 1.3 million people were living with AIDS. Prevalence among the adult population (aged 15—49) was relatively low, at 0.6%. Even so, 49,000 people died of AIDS, and 360,000 people in the region became infected, according to UNAIDS, the Joint United Nations Program on HIV/AIDS. There is evidence that the epidemic has recently begun growing through heterosexual transmission in the region. In 2002, on average 41% of new infections were among intra-venous drug users, and 10% were through heterosexual transmission. The worst affected countries are Ukraine and the Baltic states, but HIV continues to spread in Belarus, Moldova, Kazakhstan, the Kyrgyz Republic, and Uzbekistan. The five Central Asian republics straddle major drug trafficking routes into the Russian Federation and Europe. On the whole, more than 80% of HIV-positive people in the region are not yet 30 years old. The report, released in mid-November, was written by Markus Haacker and Shanta Devarajan, the chief economist of the World Bank's Human Development Network, among others.

Management Action Plan Supports Middle-Income Countries

The World Bank is seeking to increase support for middle-income countries (MICs), where more than 70% of the developing world's poor people live. (About 2.6 billion people live in 76 middle-income countries, half of them in China). The Board recently discussed a Management Action Plan that should remove unnecessary obstacles to the Bank's analytical, financial, and risk management, as well as modernize and simplify its policies and procedures. The plan's specific targets include the reduction of transaction costs; pragmatic use of lending conditionality; increased flexibility in the Country Assistance Strategies of well-performing countries; expanded use of output-based disbursements; alignment of the Bank's analytical and advisory work with countries' priorities and circumstances; and improved dissemination of the Bank's financial and innovative products. A working party will be set up to articulate a common position on the need for supporting MICs and draft a framework for collaboration.

Economies in Transition: OED Assistance Evaluation

The Bank's initial strategy in the transition economies was relevant, but its effectiveness was limited by an underestimation of the need to focus on poverty alleviation and good governance, while rapid privatization was encouraged to promote private sector development without enough attention to the supporting legal and institutional framework. That was one conclusion highlighted in a new report by the Bank's Operation Evaluation Department (OED), titled Evaluation of Bank Assistance to the Transition Economies (available at *http://www.worldbank.org/oed/transitioneconomies/*). In the countries of the former Soviet Union, lending based on the expectation of a short, shallow transition recession led to significant indebtedness. The Bank has internalized these lessons and shifted its emphasis to poverty monitoring and alleviation and good governance in both lending and analytical work. The approach to privatization and private sector development has evolved considerably.

The evaluation examined five areas in depth: private sector development, governance and public sector management, the financial sector, social protection, and energy. The evaluation highlighted the importance of holding lending at prudent levels while building a solid knowledge base. Analysis of governance and poverty monitoring should be early features of an assistance program. A comprehensive, long-term approach is required to develop strategies for institutional change and public sector reform. Active programs of stakeholder inclusion should be widely replicated. The evaluation was carried out in partnership with the Swiss Agency for Development and Cooperation (SDC).

In its response, Bank management welcomed OED's evaluation and noted that it commended the Bank's performance as having been broadly successful. Transition in its political, economic and social dimensions was an unprecedented event and while a lot more is now known about it with the benefit of perfect hindsight, the longer depth and duration of the recession in the CIS compared to that in Central and Eastern Europe had not been foreseen by the Bank, its counterparts or anyone else working on those countries. The emphasis on rapid privatization was seen as appropriate both to create irreversibility in the face of what was seen by country counterparts as the danger of political reversal, especially in the CIS countries, and to stem the extensive asset stripping in public enterprises. Nor during the tumultuous period of the early transition could extensive analytical work on governance have been carried out in advance of lending. However, the Bank has learned from experience, and poverty monitoring and good governance are now key elements of its country programs.

Bretton Woods Sisters Launch Debt Data Base

The World Bank and the International Monetary Fund (IMF) in mid-November launched an online data base that offers access to external debt statistics for 41 countries, updated every three months. The database brings together external debt statistics published individually by countries that subscribe to the IMF's Special Data Dissemination Standard (SDDS). It provides policymakers and market participants with more timely data in a format that enables cross-country comparison, as well as better support for balance-sheet analysis and surveillance initiatives. The Quarterly External Debt Database, maintained by the World Bank, is available on the World Bank web site: *http://www.worldbank.org/data/working/QEDS/sdds_main.html.*

The database initially covers SDDS countries, but the goal is to extend participation to all countries where external debt data are available according to the SDDS requirements. "We expect that policymakers and analysts will find this online database, updated on a quarterly basis, to be a valuable tool," said Francois Bourguignon, the World Bank's Chief Economist and Senior Vice President for Development Economics.

World Bank Loans Support Romania's EU Accession

The World Bank Board of Directors approved two loans to Romania, totaling $275 million, to support infrastructure development and agricultural information systems. The Transport Restructuring Project ($225 million) — to be implemented over the next five years — has two major components: improving roads and the railway system. Bypass roads ("beltways") will be constructed around five major Romanian cities — Brasov, Bacau, Targu Mures, Reghin and Medias. Passenger and freight rail transport will be modernized through the implementation of an integrated computerized system. The MAKIS (Modernizing Agricultural Knowledge and Information Systems) Project, ($50 million) will help rural farmers increase their incomes. Farmers will be trained in methods of fertilization, increasing productivity, and the provision high-quality exports to EU markets. Major research institutions will also receive technical assistance. Since 1990, the World Bank has provided loans to Romania worth more than $4 billion. The 2004—2005 lending program is likely to be the largest, amounting to almost $850 million.

James Wolfensohn in Kazakhstan

World Bank President James D. Wolfensohn met with Kazakh President Nursultan Nazarbayev during a visit to the country in November. Wolfensohn outlined four areas — oil revenue management, health, education, and infrastructure — where Kazakhstan and the World Bank can work effectively together. "The World Bank is ready to partner with Kazakhstan in its journey to a more competitive and diversified economy," Wolfensohn said, adding that more investments are needed in infrastructure, education, and health. The new partnership between the country and the World Bank Group offers an innovative approach to enhancing the competitiveness of the Kazakh economy and helping the country diversify away from its reliance on oil and gas. In this regard, Kazakhstan is a pioneer in the development of new ways for the World Bank Group to work with middle-income countries. The keystone of the new partnership is the Joint Economic Research Program (JERP), co-financed by the World Bank and the Government of Kazakhstan. An agreement to extend the JERP for an additional three years was signed in Astana on November 16.

Scrutinizing Czech Investment Funds

The World Bank recently disclosed the findings of a report titled "Assessment of Governance in the Czech Collective Investment Fund Sector". It highlighted several key problems, including the potential for conflicts of interest between investment management companies, depositaries and unit-holders, particularly if an investment manager and depositary are part of the same financial conglomerate. The report also noted that the supervisory boards of investment management companies are not practicing oversight over fund managers and urged the regulation of abusive practices. The assessment is part of a joint World Bank — Czech government initiative to support financial and private sector development in the Czech Republic. An assessment of governance in the Czech banking system is to be completed in January 2005.

Caspian Environment Forum Focused on Sustainable Development

International financial organizations, donor governments, firms, NGOs, and representatives from five Caspian states met in Baku, Azerbaijan in mid-November, to discuss needed environmental investment to support local entrepreneurs, ecologists, and fishermen. The world's largest land-locked sea faces an array of environmental challenges: a stressed and eroded yet still unique biodiversity, with some species on the brink of extinction, continued desertification and deforestation, declining fish stocks, and unsustainable development of coastal areas and communities. The fluctuations in the sea level are inundating infrastructure, residential areas, farmlands and amenities, causing billions of dollars of damage while washing pollutants into the sea. During the conference, the five countries of the Caspian — Azerbaijan, Iran, Kazakhstan, Russia, and Turkmenistan — updated donors on current environmental investments, research and institutional changes. The forum has been organized through the Caspian Environment Program, a partnership between the five littoral states and their international partners, including the World Bank.

Yes to Moldova's Three Pillar Strategy

The World Bank's Board of Executive Directors in November expressed support to Moldova's Poverty Reduction Strategy Paper, adopted by the government in May 2004 and submitted to the World Bank and IMF in June. The strategy focuses on sustaining economic growth through a program of structural reforms; strengthening human development by improving education and health; and strengthening social protection and inclusion. The executive directors expressed concern over the slow progress in implementing structural reforms, increased government intervention in economic activity, and the unsustainable medium-term fiscal framework. They urged Moldova's authorities to rectify their policies, especially in areas such as state monopolies, licensing and regulation, land consolidation and agriculture subsidies, pension reform, and privatization.

New Country Partnership Strategy for Poland

The World Bank has begun the consultation process for its new 2005—07 Country Partnership Strategy with Poland. This document is intended to serve as the roadmap for the World Bank's work in the country until the middle of 2007. The draft proposes three core priorities: promoting growth and reversing negative debt dynamics by reducing the budget deficit and restructuring expenditures; improving the investment climate and enhancing competitiveness; and reducing poverty, encouraging social inclusion and raising employment. The strategy will be discussed with a broad spectrum of stakeholders and social partners, including civil society groups, politicians, businesses, academics, youth groups and trade unions. The strategy has been posted in the website of the World Bank's office in Poland: *www.worldbank.org.pl*. Following the consultations, the final version of the strategy will be presented to the World Bank's senior management for clearance in mid-January, 2005, and to the Board of Directors for approval in late March, 2005. Since Poland rejoined the World Bank in 1986, the Bank's commitments to the country reached almost $6 billion, across 41 operations. The World Bank is involved in such areas as infrastructure, competitiveness, and regulatory and financial reform, as well as health financing reform and higher education

Fraudulent British Health Care Firm Exposed

The World Bank announced the exclusion for four years of the Britain-based BIS Healthcare Group and its principal, Bruno Gomes, for fraudulent practices during the selection process of the World Bank-financed Croatia Health System Project (CHSP). The Bank found numerous instances of fraud in the contractor's proposal, concerning its claimed experience and qualifications. BIS Healthcare was contracted to provide consulting in the integration of a pilot health services component under the CHSP project. When the $2.42-million contract expired in 2002, due to delays in implementation only half of the original amount had been disbursed. BIS Healthcare will not receive any new World Bank-financed contracts during the exclusion period. The CHSP is financed by a $29-million IBRD loan and is expected to close June 30, 2005.

Strengthening Credit Unions in Transition Economies

A two-day workshop on Strengthening Cooperative Financial Institutions (Credit Unions) in Europe and Central Asia took place in Baku on November 10. The workshop, organized by the World Bank and co-hosted by the government and National Bank of Azerbaijan, gathered some 70 participants from 20 countries and several international organizations to discuss the role of credit unions in current development processes. As the host country's representatives pointed out, the development of the network of credit unions in Azerbaijan is crucial for meeting the agricultural sector's financial needs.

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Cheryl Gray, Joel Hellman and Randi Ryterman
Anticorruption in Transition 2: Corruption in Enterprise-State Interactions in Europe and Central Asia 1999 — 2002
2004, 99 pp.

Controlling corruption is an essential part of good governance and poverty reduction, and it poses an enormous challenge for governments all around the world. *Anticorruption in*

Transition 2 analyzes patterns and trends in corruption in business-government interactions in the transition economies of Central and Eastern Europe and the former Soviet Union. It points to some encouraging signs that the magnitude and negative impact that corruption exerts on businesses may be declining in many countries in the region. It also shows how some types of firms — most notably small private ones — encounter more corruption than others, and it underscores the importance of policy and institutional reforms in achieving long-term success in the fight against corruption. The longer-term sustainability of recent improvements is not certain, however, and the challenges ahead remain formidable.

Harry Broadman, James Anderson, Constantijn Claessens, Randi Ryterman, Stefka Slavova, Maria Vagliasindi, Gallina Vincelette
Building Market Institutions in South Eastern Europe — Comparative Prospects for Investment and Private Sector Development
June 2004, 410 pp.

This report is a collaborative effort between the World Bank and the EBRD. It studies impediments to investment and private sector development in the countries of South Eastern Europe — Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Moldova, Romania, and Serbia and Montenegro. The report yields new insights for improving the region's business environment and makes concrete recommendations for reforms that would ease the constraints on domestic and foreign investment, which are essential for economic growth in the region.

Shahid Yusuf, M. Anjum Altaf, and Kaoru Nabeshima (eds.)
Global Production Networking and Technological Change in East Asia
World Bank and Oxford University Press, 2004, 470 pp.
In the coming decades, East Asian economies must face the challenges of an increasingly globalized marketplace. This book explores the changing parameters of competition in East Asia and argues that success ultimately will depend on the ability of the region's firms to harness the potential of global production networks and to build their own innovative capability. Presenting the latest findings on global production networks and the evolution of technological capabilities, it provides researchers, students, and policymakers with in-depth information and analysis on key issues related to growth and development in East Asia.

Shahid Yusuf, M. Anjum Altaf, and Kaoru Nabeshima (eds.)
Global Change and East Asian Policy Initiatives
World Bank and Oxford University Press, 2004, 468 pps.

Many East Asian economies have grown briskly in the past few years. However, future development will depend on the quality and timeliness of regional and national policy actions. The policy agenda must address the problems that buffeted the region in the late 1990s — associated with the weakness of domestic institutions and policies in the context of globalization. These problems include financial shocks, rapid shifts in the competitiveness of major exports, changes in international production networking, and significant reconfiguration in the geographical composition of production systems that had provided the foundation for growth. The book is a collection of studies by leading experts in such fields as corporate and political governance, economic policy, globalization, higher education, legal reform, regional integration, and social protection.

Francois Bourguignon and Boris Pleskovic (eds.)
Annual World Bank Conference on Development Economics 2004: Accelerating Development (Bangalore conference proceedings)
2004, 388 pp.

The Annual Bank Conference on Development Economics (ABCDE) is one of the world's best known series of conferences for the presentation and discussion of new knowledge about development. First held at World Bank headquarters in Washington, D.C., in 1988, the ABCDE has become broader in scope as the world's economies have become more interconnected and challenges have become more complex. Presenting the proceedings of the May 2003 conference, the volume discusses such topics as fostering entrepreneurship, innovation and growth; challenges of development in lagging regions; participation, inclusion and results and scaling up and evaluation. Contributors to the volume include: Nicholas Stern, Senior Vice President and Chief Economist of the World Bank; Azim Hasham Premji, Chairman of Bangalore's Wipro Corporation; Francois Bourguignon of the Ecole des Hautes Etudes en Sciences Sociales, France; Partha Dasgupta of Cambridge University; and Justin Lin of Hong Kong University.

David Coady, Margaret Grosh, and John Hoddinott
Targeting of Transfers in Developing Countries: Review of Lessons and Experience
Regional and Sectoral Study, 2004, 124 pp.

Drawing on a database of more than 100 anti-poverty interventions in 47 countries, the book provides a general review of experiences with methods used to target interventions in transition and developing countries. It explores what targeting options are available and what results can be expected, while delivering information that will assist in selecting and implementing strategies. There is no single preferred method for all types of programs or all country contexts. Successful targeting depends critically on how a method is implemented. The enclosed CD-ROM includes a database of interventions, an annotated bibliography (PDF), and Spanish and Russian translations of the book (PDFs).

Deepak Bhattasali, Shantong Li, and William Martin (eds.)
China and the WTO: Accession, Policy Reform, and Poverty Reduction Strategies

World Bank Trade and Development Series. A Co-publication of the World Bank and Oxford University Press, 2004, 424 p

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Conference Diary

17th Annual Bank Conference on Development Economics (ABCDE)
January 27, 2005, Dakar, Senegal

Inaugural Address: Abdoulaye Wade, President, Republic of Senegal
Opening Address: Francois Bourguignon, Senior Vice President and Chief Economist, The World Bank
Keynote Address: Abdoulaye Diop, Minister of Finance and Economy, Senegal
Growth and Integration: Explaining African Economic Growth: The Role of Policy Syndromes, Augustin K. Fosu, United Nations Economic Commission for Africa (UNECA) and Stephen O'Connell, Swarthmore College; The Mystery of Growth Accelerations, Ricardo Hausmann, Harvard University
Financial Reforms: Perspectives on Financial Sector Reforms in Africa, Lemma W. Senbet, University of Maryland
Economic Development: Convergence and Development Traps, Jean-Claude Berthelemy, University of Paris 1, Pantheon Sorbonne
Trade and Development: Risks and Rewards from Regional Trading Arrangements in Africa-Economic Partnership Agreements (EPAs) between the EU and SSA, Lawrence E. Hinkle, The World Bank
Investment Climate: The Business Environment and Comparative Advantage in Africa: Evidence from Investment Climate Data, Benn P. Eifert, Alan H. Gelb, and Vijaya Ramachandran, The World Bank

Attendance at the conference is by invitation only. ABCDE-

Dakar will be followed by the Africa Regional Workshop on Growth and Poverty Reduction in Dakar on January 28, 2005

Information: For general information on ABCDE-Dakar see www.econ.worldbank.org/abcde. For information on ABCDE sessions, contact Boris Pleskovic, Research Manager, Development Economics, World Bank, 1818 H Street, NW, MSN MC4-402, Washington, DC, 20433; tel.: 202 473 1062; fax: 202 522 0304, email: bpleskovic@worldbank.org. For logistics information, contact Leita Jones, Program Assistant, Development Economics, World Bank, tel.: 202 473 5030, fax: 202 522 0304, email: Ljones2@worldbank.org.

Financing for Development in the ECE Region: Promoting Growth in Low-income Transition Economies
February 21, 2005, Geneva, Switzerland

The seminar is organized by UNECE as a follow-up event to the International Conference on Financing for Development held at Monterrey, Mexico, in 2002. The following sections are planned:
• Strategies for development and growth;
• Economic integration and trade;
• Financial management and sustainable growth in resource-rich economies.

Jose Antonio Ocampo, Under-Secretary General for Economic and Social Affairs, will deliver a key note speech.

Information and registration: United Nations Economic Commission for Europe, Economic Analysis Division, Palais des Nations, CH-1211 Geneva 10, Switzerland, Jaromir Cekota, tel. 41 22 917 2445, or Ralph Heinrich, tel: 41 22 917 1269, http://www.unece.org/ead/ead_sprin_sem_new.htm, email: unece.seminar05@unece.org,

Modernization of Economy and Nurturing of Institutions
6-th International Research Conference
April 5 — 7, 2005, Moscow, Russia

The conference is organized by the State University — Higher School of Economics (SU-HSE), with the participation of the World Bank and International Monetary Fund. Workshops will be held in 4 sections:
• Macroeconomic Policy of Modernization;
• Institutional and Structural Reforms;
• Social Policy;
• State and Legal Modernization.

Proposals for presentations at section meetings should be e-mailed to SU-HSE at: interconf@hse.ru by December, 20, 2004. Other participants should register by e-mailing to interconf@hse.ru by March 10, 2005 or by filling out the registration form at http://www.hse.ru/ic6/english.html.

Education Research in Developing Countries
March 31 — April 02, 2005, Prague, Czech Republic

CERGE-EI will host a global conference on educational research in developing or transition countries, sponsored by the Education Policy Research Network of the Global Development Network (GDN). Any researcher who is a permanent resident of a developing or transition country may participate. The fundamental goal of the conference is to strengthen capacity in developing and transition countries to carry out policy-relevant empirical research on education. The conference will discuss the following topics: improving the quality of education, education and development, education and inequality, cost of education, and education reform.

Information: http://www.cerge-ei.cz

EU Enlargement from a Business Perspective
1st International Conference
April 28, 2005 Keszthely, Hungary

The conference will discuss the economics of the enlargement, provide first-hand information on EU programs and funding available for SMEs in New Member States, and give practical advice on developing successful business strategies for entering new markets in Europe.

Information and registration: 1037 Budapest, Kunigunda 18, fax.: 361-436-9038, E-mail: eucenter@conference.org, Internet: http://www.eucenter.org/training/training.php.

The Ronald Coase Institute Workshop on Institutional Analysis
September 17—22, 2005, Barcelona, Spain

The workshop on institutional analysis is designed for social scientists early in their careers. Established institutional scholars will lecture on their own perspectives and strategies for work in this field. Participants will make two presentations of their own ongoing research. The annual meeting of the International Society for New Institutional Economics (ISNIE) will take place in Barcelona immediately after this workshop, on September 22 — 24.

To *apply: e-mail an abstract (350 words maximum) of an ongoing research project plus a one-page curriculum vitae, to workshop2005@coase.org by April 1, 2005. Additional information is available at: www.coase.org.*

The Institutions of Market Exchange
9th Annual Conference of the International Society for New Institutional Economics (ISNIE)
September 22-24, 2005, Barcelona, Spain

The conference program will include sessions on the application of institutional analysis to history, political science, law, and organizational behavior. Proposals to present a paper at the conference are due by March 1, 2005.

Information: http://www.isnie.org/ISNIE05.htm

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