Ownership transformation (incl.utilities and financial sector) - the institutions matter : The Czech lesson to be learned

Presented by

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Content

1. Basic ownership transformation
2. Privatization and Corporate Governance – „Ownership matters, but institutions as well“
3. Privatisation as One-off Game
4. Adjustment of foreign investors – FDI Inflow and Performance
5. Privatization of Strategic Network Companies (Gas)
6. Development of Private Financial Sector , Bank Privatizations Costs and proceeds, Improved Regulation: Towards the EU integration

Initial Asset Ownership Goals

- Before 1989 the Czechoslovak economy was centralized, all major companies were owned by the state
- The Czech economic productivity trends and trend had been unsatisfactory compared to the development in western Europe
- After the political changes in 1989 there have been a strong public demand for shift from centralized economy to the free market model that had proven to be more effective
- Large amount of property was shifted from the state to private companies
- Many new enterprises started from the scratch or due to the Greenfield investments („from the bottom“)
- Bankruptcies – growing importance form of ownership transformation

Types of ownership transformation in CR vs.Russia

Types	Method	CR 1991-1994	CR 1995-1996	CR 1997-2004	Russia
Top-down ownership transformation	• property restitution • small privatization • coupon privatization •property sales of different form • shareholdings sales •land own. transformation • municipalization	intensive completed completed intensive limited partial intensive incl. stakes in utilities	limited - - intensive mostly domestic, FDI to telecom partial limited	Unfinished - - completed intensive for banks, utilities mostly to FDI partial limited	None completed minority stakes mostly to insiders loans for shares loans for shares delayed 10 years limited
Bottom-up enterprise development	• domestic start-ups • green-field foreign direct investments	very intensive very limited	moderate limited	moderate very intensive	intensive very limited
Consolidation of ownership	Mergers and acquisitions	Mostly domestic leveraged LBO	Intensive domestic leveraged LBO	Intensive domestic and FDI	intensive domestic leverag. LBO
Bankruptcies	Amended Composition and Bankruptcy law implementation	limited	limited	Intensive after banks enforced loan repayments	delayed and limited
Financial corporate consolidation by the state agencies and reprivatization	Takeover of non-performing loans and companies by KOB or CF, later by CKA (Czech Consolidation agency)	Creation of Konsolidacni banka (KOB) and large banks recapitalization	Small and medium banks stabilization and consolidation by CF and CNB that failed	Intensive large banks pre-sale cleaning from non-performing loans to KOB or CKA, reprivatization and assets resale	limited , especially banking by ARCO Agency for restructuring Credit Organizations

Source: Mejstřík M.,2003,chapter 18 In:Parker D., International Handbook on privatization, Elgar, London

Privatizations of Czech Strategic Companies to be completed

Privatization program				
Name	**Sector**	**BookV in bn CZK**	**Stake for sale**	**Exp. closing**
CEZ	Energy	114	68%	2006-
6+2 EDC	Utility	45	50%	2003
CT	Telecom	98	51%	2005
Transgas	Utility	40	97%	sold to RWE 12/2001
8 GDC	Utility	20	50%	sold to RWE 12/2001
Unipetrol	Chemical	27	60%	2005
KB	Banking	19	60%	sold to SoGe 11/01
Cra	Telcom	11	51%	sold to Bivideon in 10/01
CKD DS in bancruptcy	Transport systems	1	100%	quasi privatization - Siemens 12/01

Utilities´ privatizations require well defined regulatory (institutional) framework in compliance with international standards – see Gas case below

Privatization and Corporate Governance - „not only ownership matters, but institutions as well“

Mlcoch(1994),Mejstrik(1997,1999), Sachs,Zinnes,Eilat (2000), Kikeri,Nellis(2002)

Privatization (both Coupon and Sales) and Imperfect Institutional Framework

- In coupon privatization **the government administratively enforced the artificial initial public offering** of large number of nearly two thousand share issues and their public tradability. Among most of participants it has created expectation about overnight emergence of liquid and functioning market with shares for all investors, no matter how small. Naturally, those expectations could hardly be met at once. The government, however, had resigned for quite a long time to supplemented administrative rules applied in centralized, “laboratory phase” of share distribution by implementation of institutional market framework that would generate involvement of at least the best corporates in their public tradability and a willingness of investors to invest into them and form standard capital market.

· **The assumptions of well-functioning markets** - particularly the markets for capital, managerial labour, and corporate control - had not been met.

· **Banking institutions effective** either in Anglo-Saxon or in German sense had been **absent**.

· **Underdeveloped institutional and legal frameworks** meant that important necessary conditions for effective corporate governance had been absent. For example

§ **Most contracts had incomplete character and it was difficult to enforce them** (around 40%vel by Pistor(2000)), CGR indices... ;

§ Non-banking financial institutions were left without proper regulation and supervision. These were the collective investment vehicles (mutual or investment funds, pension funds, insurance companies), the decisive domestic “investors” born mostly by share redistribution in coupon privatization. No political will to enforce even the limited existing law was shown (Hanousek ,Roland (2001)).

§ **Monitoring and accountability procedures have been weakly performed** inside the company (the compliance officers as a part of self-governance process absent) and outside. **Superficial auditing rules** (e.g. absence of any explanatory notes to the accounts) led to superficial and misleading audits provided even for the most important corporates such as CKD, Skoda...with Enron-like impact for the shareholders (95%lost)

§ **Rating quotes by recognized rating agencies have been unavailable** and external investors had to decide under conditions of inefficient capital markets,monitoring- significant uncertainty . It is not surprising that **portfolio investors both domestic and from abroad have lost their appetite. The field was thus left open to insider investors** and insider trading and this development has been neither monitored nor sanctioned.

§ **Business courts** were flooded by minor cases that should have been dealt with in a different manner. Cumbersome rules of procedure and evidence mean that cases take too long to resolve, while the backlog keeps increasing and exceeds several years. First-come-first-served system means major cases are dealt with only after long delays unless intensive lobbying is applied. Judges apprehensive about making a decision can further delay these cases by abusing the procedural rules. Judicial independence and irremovability has in practice often meant that even blatant misbehaviour of judges was punished only rarely. Czech judges are not bound by decisions reached in similar cases by their colleagues. There is little attempt to judge the cases in light of the intention of the legislation. Formalistic approach by the judges has meant that collusion or intention to defraud was virtually impossible to establish except where the accused confessed, an outcome which is naturally quite rare.

§ Business courts registering changes in statutory bodies only with long delays increased the lack of transparency. Challenges to registering changes in registered share capital, many of which have been nothing more than blackmail, have also been dealt with slowly. This hampers financial restructuring or initial public offering of new equity.

§ **Bankruptcy code** has been incomplete and was not being fully enforced until 1999.

Coupon privat: Relative power of investors in companies after first wave, adjusted

Investors	50%	40%	30%	20%	10%
Foreign investors	33	40	45	45	51
Domestic direct investors	24	30	40	47	58
Temporary hold. of NPF	56	88	135	173	293
Permanent hold. of NPF	3	7	11	11	21
Shares to be sold by banks	12	17	30	47	61
Additional Restitutions	4	6	7	11	52
Investors	**50%**	**40%**	**30%**	**20%**	**10%**
Single Largest Fund	146	231	442	737	895
Two Largest Funds-cumulative	473	644	782	974	916
Three Largest Funds-cumulative	669	760	847	892	918
Four Largest Funds-cumulative	727	790	860	897	918
Five Largest Funds-cumulative	754	809	867	900	918
Six Largest Funds-cumulative	761	817	869	902	918
Ten Largest Funds-cumulative	768	821	872	903	919

Source: Laštovička, Marcinčin , Mejstřík (1995)

Many shares fragmented but...**core power concentrated**

The Privatization as one-off Game

Privatization and Corporate Governance
- „not only ownership matters, but institutions as well“

Privatization is an one-off process and has conflicting economic, financial and political objectives of particular interest groups (foreign vs. domestic buyers – either insiders or outsiders).
Given the unrepeatable character of privatization and incompleteness of most of contracts and of institutional framework itself, many actors in the corporate sector, not just the managers but also investment funds and asset management companies, played a one-shot game at the expense of managed companies and their own minority shareholders as well.
The rational behavior in such a game is well described by „the prisoners dilemna“ . Then to no surprise there was a temptation for a dominant short term strategy of “cheating”- i.e. exploiting any contractual incompleteness in largely unregulated environment of privatization to one´s own advantage. Such a model describes wider Eastern Europe environment (both Czech and Russian) of recent past.

Corporate Governance Models

Anglo-Saxonian approach

Problems:

Right to vote limited

High transaction costs

Very low liquidity

Single owner

Problems:

Limited information

Low transparency to business partners

Stakeholder model

Limited in the CR: Blocking minority of local distribution companies to municipalities

Problems:

Inefficient governance, Loss of interest

“Czech“ transition model

0 or 1 approach: large shareholder behaving as single owner

Problems:

Disadvantageous contracts

“tunnelling“

Coupon Privatization and Imperfect Institutional Framework

Main Results :

- **No financial proceeds but temporary Political Gains due to the giving away ...but later social contract with small investors broken and Political Loss**

- **instead of large functioning capital market overnight high transaction costs for quasisecurities industry, non-transparent ownership structure with dominating funds´ ownership and insider trading – loss of confindence to non-bank financial sector and collective investment vehicles(CIVs) prevailing in pension, insurence and savings deposit systems in mature economis as well as loss of foreign portfolio investors** ;(blocking pension reform etc.)

- **without a proper institutional framework the corporate governance in the biased form** causes (more? than in mature markets) **huge loss of value of traded companies to the shareholders** (Black(2001) estimated for Russian large companies multiple of 2-10 mostly due to selfdealing risk subfactors such as risk of assets stripping, share transfer pricing (as there is a room for managers to loot the value of minority shareholders, siphon off the profits or tunnel).

Bank Lending Failure with Asset Bubles followed by the Poor Performance of Large Industrial Customers

Within given corporate governance model number of banks provided Privatization and Acquisition Lending to highly leveraged related conglomerates in order to create TBTF groups with soft budget constraint backed by the state. Czech Asset Bubles broke in the first 1997 recession and resulted into huge NPLs and fall of many businessmen. 71% of **related lending** in Russia was not repaid according to Laeven (2001)- result?

Possible solutions: support by the government – inefficient but keeps

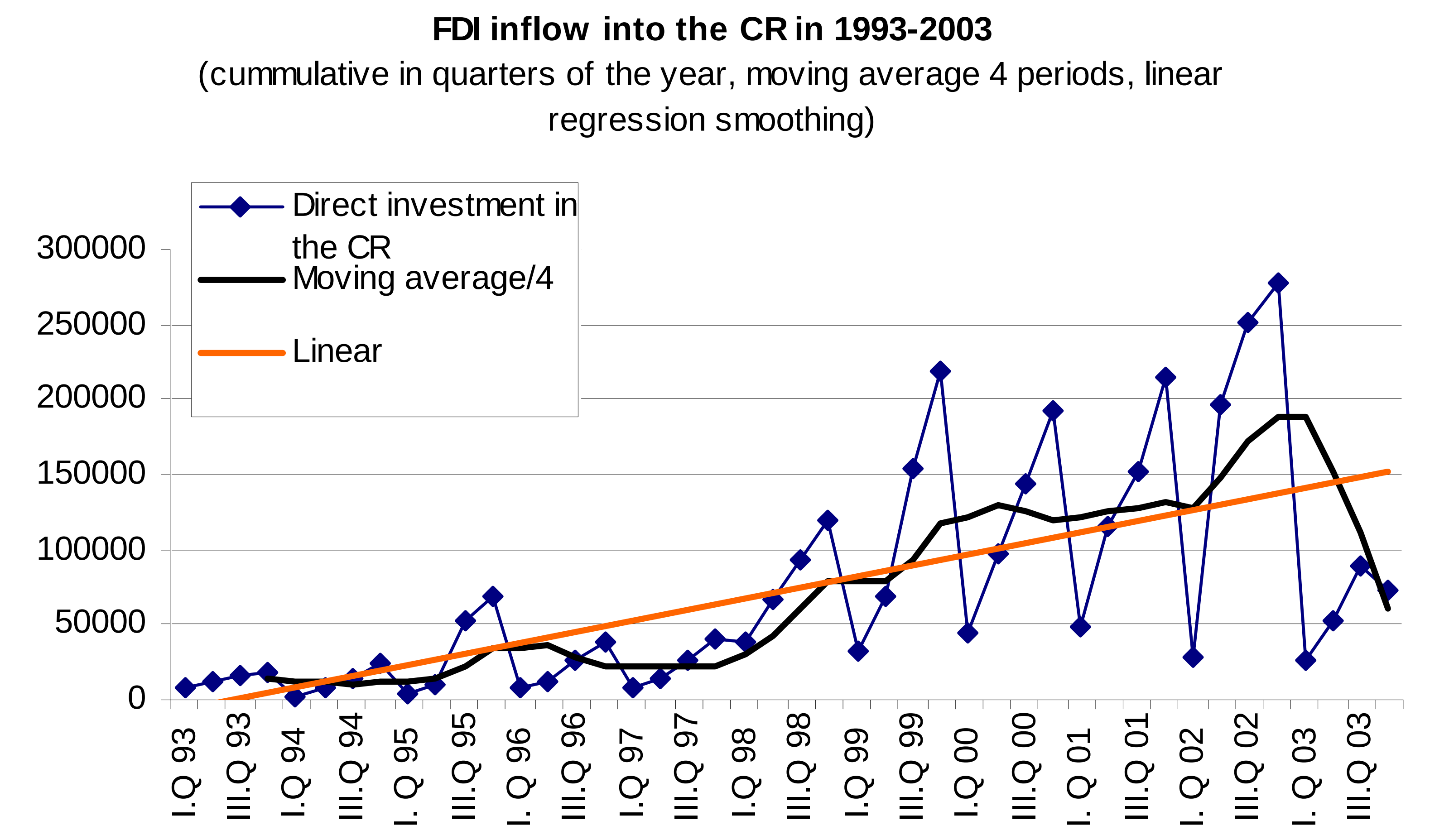
-mergers with other domestic companies – a lack of domestic capital ----- reprivatisation to foreign owners – often positive results, but not always (inadequate investor, lack of knowledge of the local environment, etc.)

-bankruptcy procedure with going concern sale (to Siemens) or liquidation

In the CR, Czech Konsolidacni agency owns the majority of non-performing loans. It is preparing sales of those assets in selected packages on the market. Other instruments: debt-to-equity swap

Investors´ Adjustment to the Institutional Framework has been reflected in the Balance of Payments of the CEEC

In case of the emerging countries with inherent risks of financial crises FDI liabilities seem to be safer form of financing then debt or other form of non-FDI obligation irrespective of country risk factors such as income level and degree of openess (Fernandez-Arias,Hausman(2001)), but FDI negatively modifies foreign exchange market, its volatility.



Source: Czech Statistical Office

FDI – comparison of countries (1)

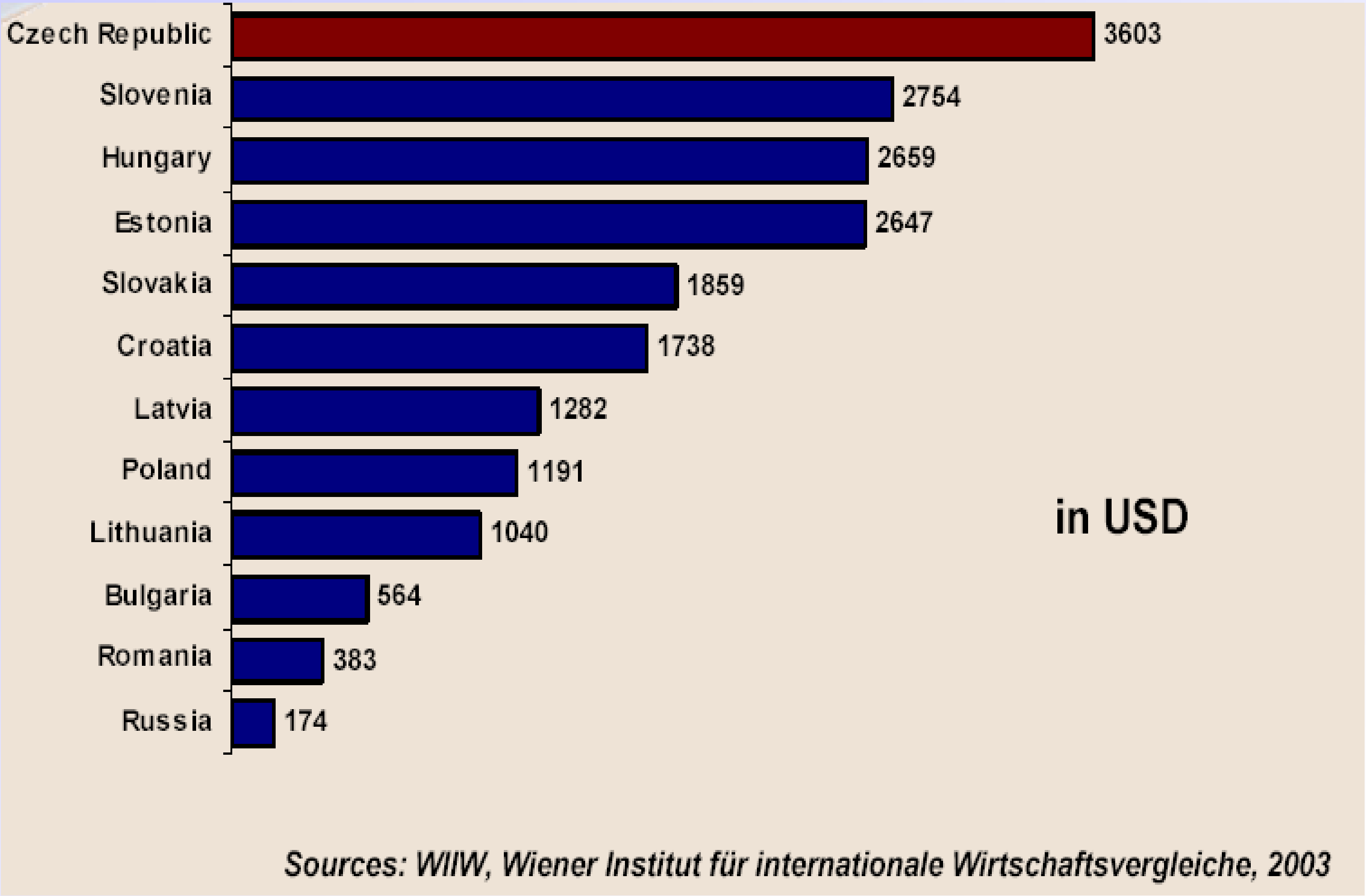
- The Czech Republic has attracted one of the highest FDI inflows relative to GDP among the emerging countries in 2000-2002 with FDI exceeding 8% of GDP

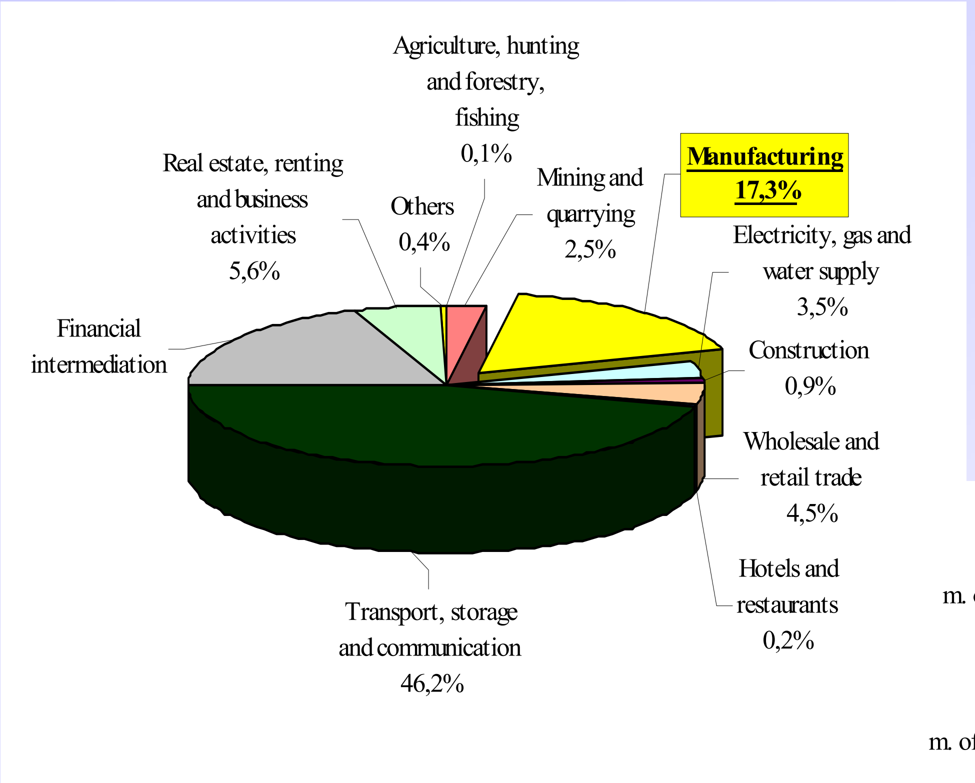
Year	FDI into CZ (USD m)	% of GDP	FDI into CEE countries per capita in USD			
			Czech	**Hungary**	**Poland**	**Slovenia**
1997	1 300	2,4	126	214	127	189
1998	3 718	6,0	361	202	165	125
1999	6 324	11,6	615	196	188	91
2000	4 986	9,7	484	170	233	91
2001	5 641	9,9	545	n/a	n/a	n/a
2002	Est 9 305	12,2	902	n/a	n/a	n/a
1990-2002 cumulated FDI per capita			3 788	3 047	1 178	2 504

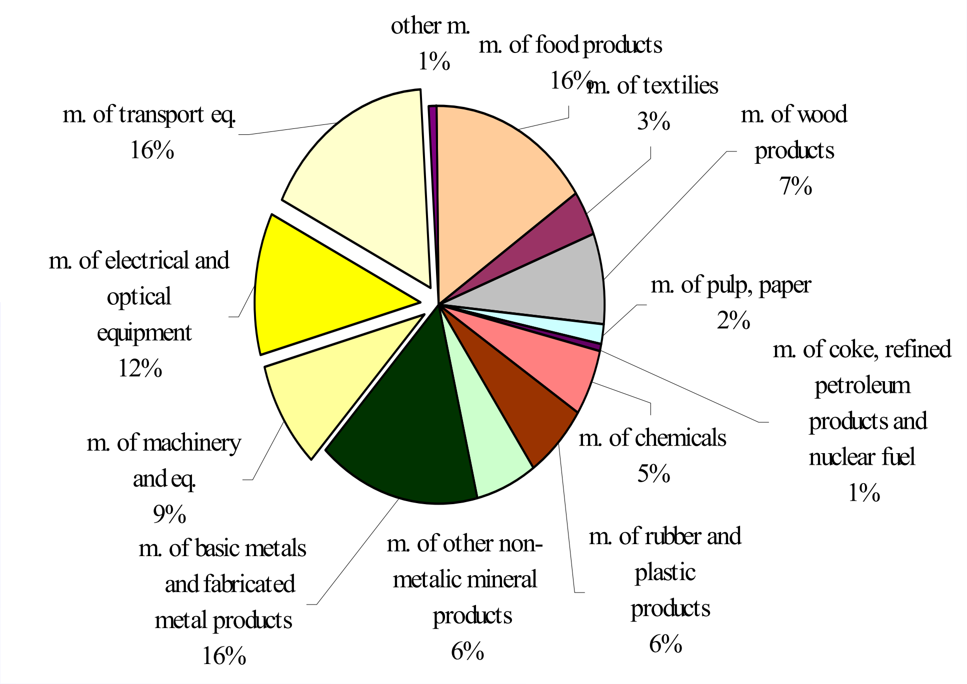
Source: Czech National Bank (CNB) web page (until 1997 data included FDI in equity capital, starting from 1998 data on reinvested earnings and other capital have been included in FDI flows) and WIIW Vienna for per capita comparative data estimates

FDI – comparison of countries (2)

FDI stock per capita, as of 2002

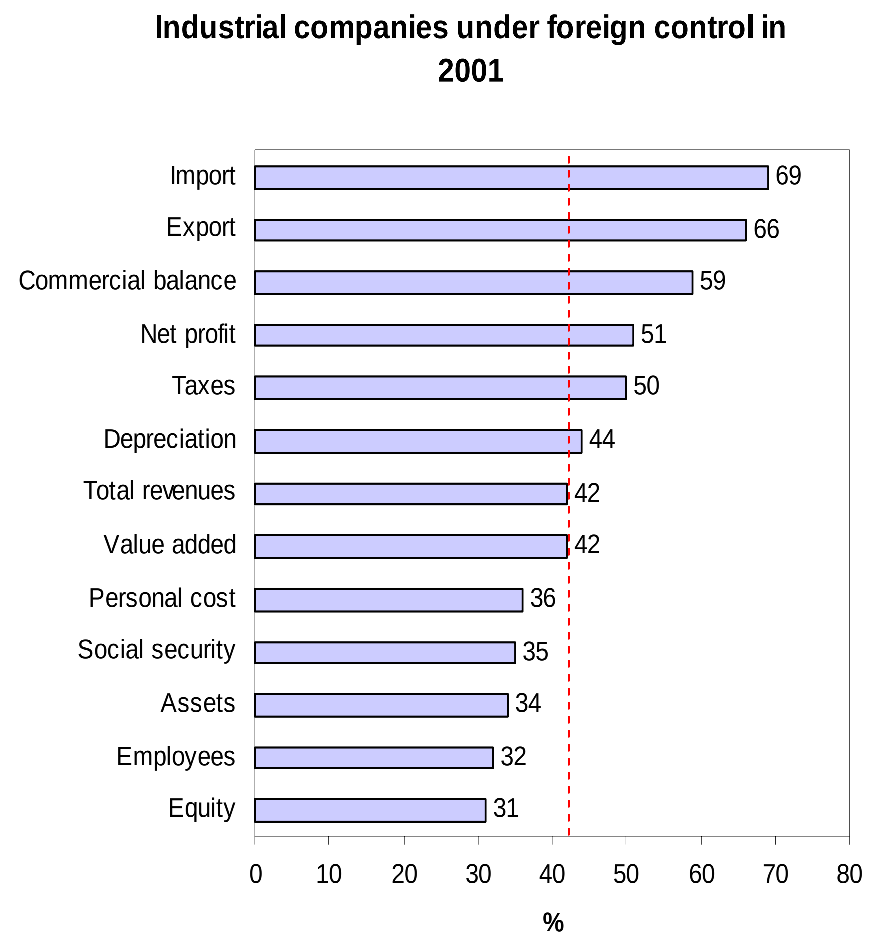




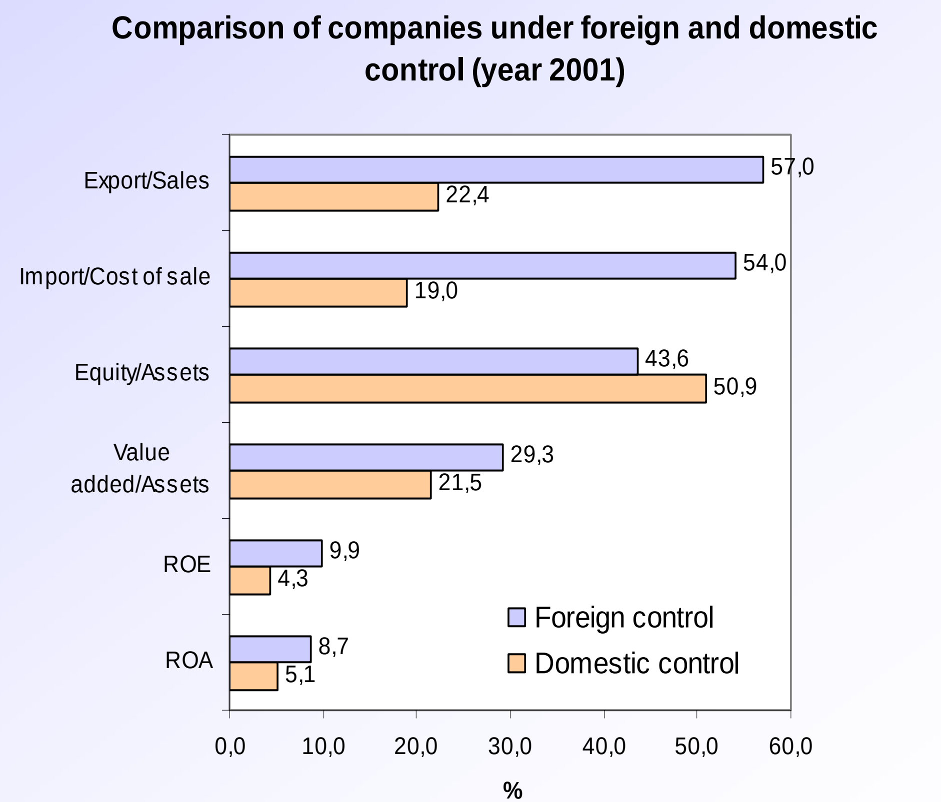


FDI industry structure in the Czech Republic (2002)

Performance of Companies under foreign x domestic control in the CR



Source: Neumaier (2002)



Foreign controlled companies usually play repeated game in order to keep the good reputation

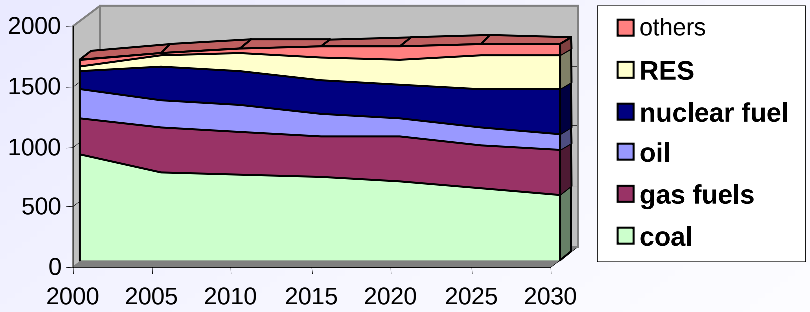
The Czech Energy Market

- The power generation in the Czech Republic is mostly based on coal-fired and nuclear plants and both are base-load. In 2003, ca. 67% of total electricity generated in the country was based on coal and about 31% was produced in nuclear plants and 2 % in water power plants.
- Temelin, a new nuclear plant has been fully in service since April 2003 with an installed capacity of 2000 MW. They are expected to replace old, inefficient coal fired plants on the one hand, and on the other hand, the current government intends to support exporting electricity generated with the excess capacities.
- Both coal and nuclear have high political profile.
- Gas is currently used in industry and household, not

  used in power-generation. The demand structure of the

  final consumption is expected to change in the following way: coal and oil will decrease (from the current 13% and 24% to 12% and 21% in 2005); and the final consumption of gas, heat and electricity is expected to increase.
- The energy import dependency of the Czech republic is expected to rise from 32% in 2000 up to 71% in 2030

Primary energy sources (PJ)



Source:Czech Energy Policy, March 10, 2004

Primary Energy Sources are getting more diversified

Czech State Regulation in Energy Industries & Energy Market Opening

1) Government (Ministry of Industry) => **ENERGY ACT (458/2000 ammended in December 2004 according EU gas liberalization directive) incl. quality requirements for available energy supply through network services at reasonable costs**

2) Energy Regulation Office (ERO) => **HOUSEHOLDS PRICE CROSSSUBSIDIZATION FROM INTERNATIONAL TRANSIT OVER, INCENTIVE PRICE FORMULAE PPI-X in REGULATORY DECREES, DECREES SPECIFYING THE MARKET OPENING IN ORDER TO PROTECT CONSUMERS´ RIGHTS OF BEST AND CHEEPEST CHOICE INCL. SUPLIERS´ SWITCH**

!

3) State Energy Inspection => Supervision,enforcement and Penalties (incl.quality standards)

Energy Act– Speed of Gas and Electricity Market Opening to foster outside competition by regulated Third Party Access to networks

Gas Market Opening

- January 1, 2005 – at least 28% market opening, eligible customers currently defined as those with consumption higher than 15 mcm
- January 1, 2006 – all customers except household
- January 1, 2007 – all customers will be eligible

Electricity Market Opening

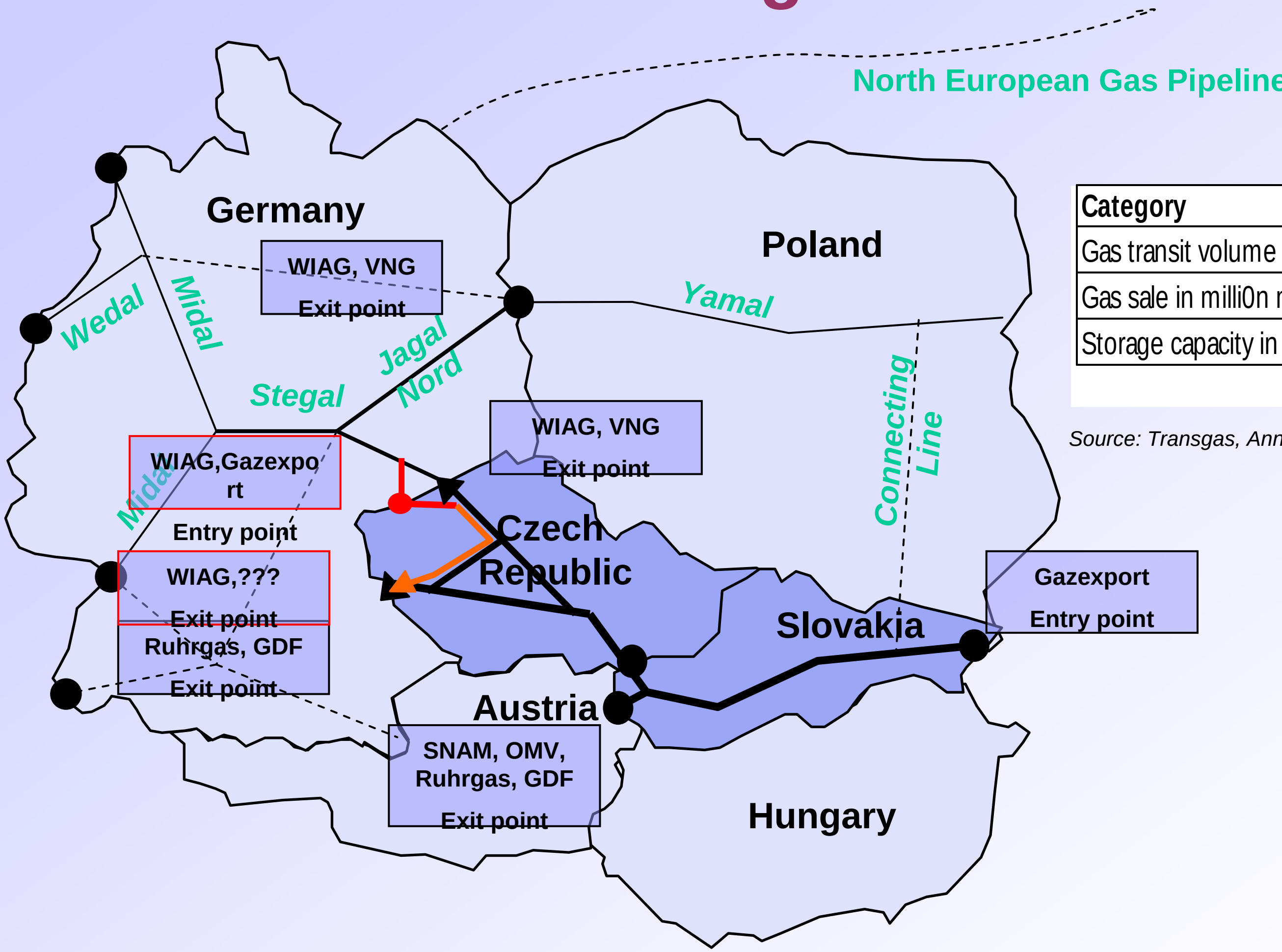
- January 1, 2002 – eligible customers those with consumption higher than 40 GWh per year (cca 30%)
- January 1, 2003 – eligible customers those with consumption higher than 9 GWh per year (cca 40%)
- January 1, 2005 – eligible customers those with consumption higher than 100 MWh per year (cca 50%)
- January 1, 2006 – all customers shall be eligible

Privatization in the Gas Sector

Czech Republic strategic transit and distribution network: Stepwise. New regulatory framework enabled drafting of more complete and fair privatization contract. Bidders accepted,fully sold

Russian strategic production, export and foreign investment co: minority stake sold (audit imperfections), still government controlled

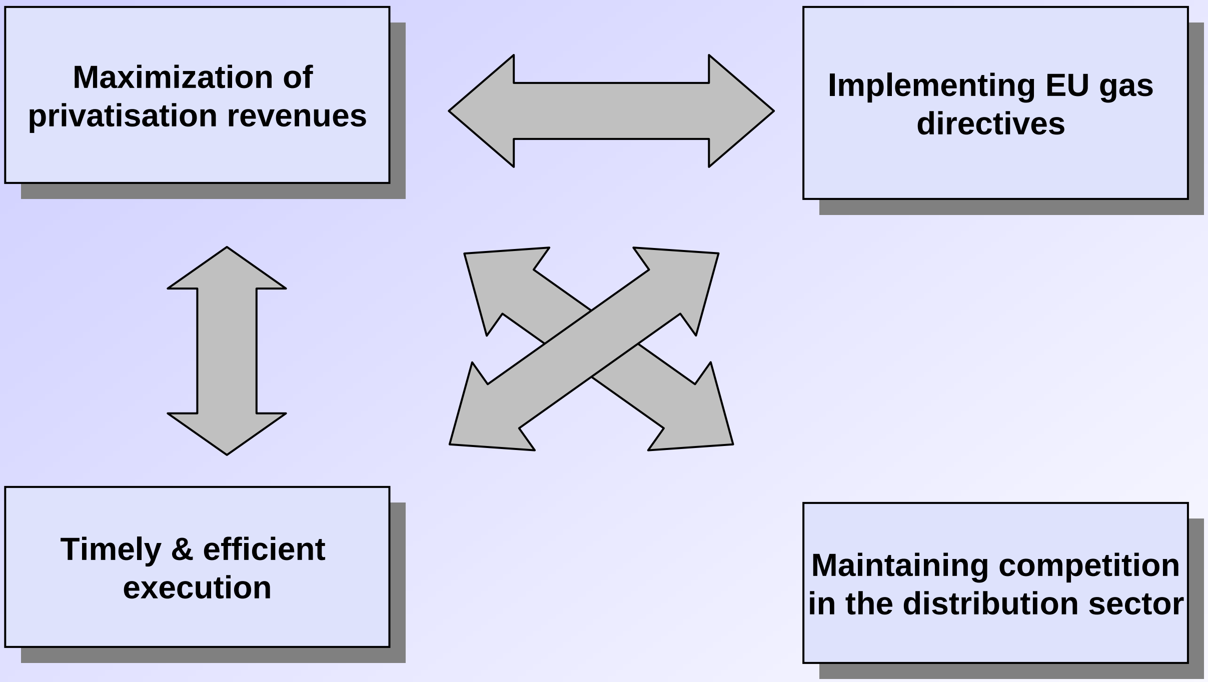
Gas transmission through the Czech Republic



Category	2001	2002
Gas transit volume in million m^3	44,220	44,220
Gas sale in milli0n m^3	9,802	9,340
Storage capacity in million m^3	2,040	2,045

Source: Transgas, Annual Report

What are/were the main Government's Objectives in privatization?



- **Price has been a key factor in the evaluation of the bids**
  - **The process was accelerated due to the budget pressure on the government.**

- RWE Gas

winning price = 4,1 bln. EUR

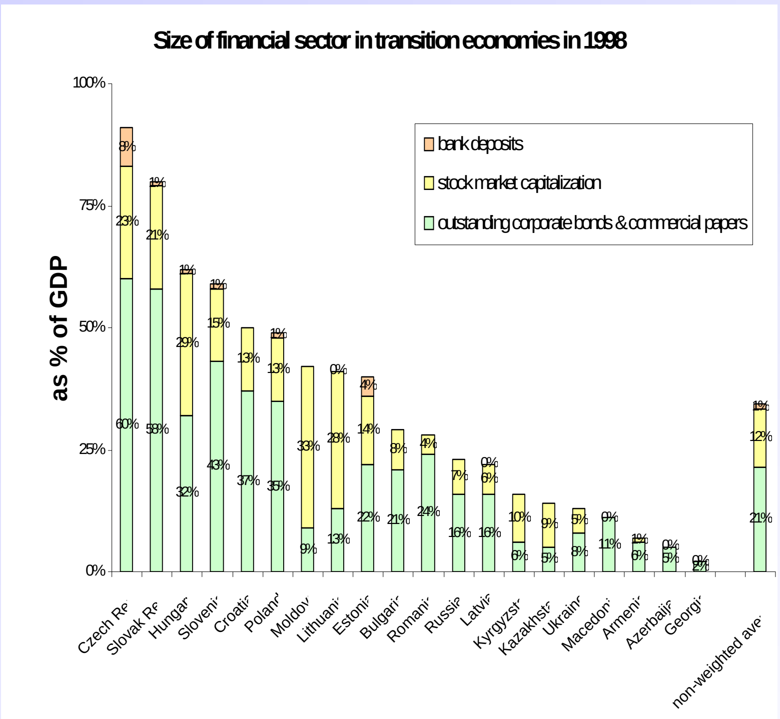
Development of the Private Financial Sector – especially here not only ownership matters but institutions as well.

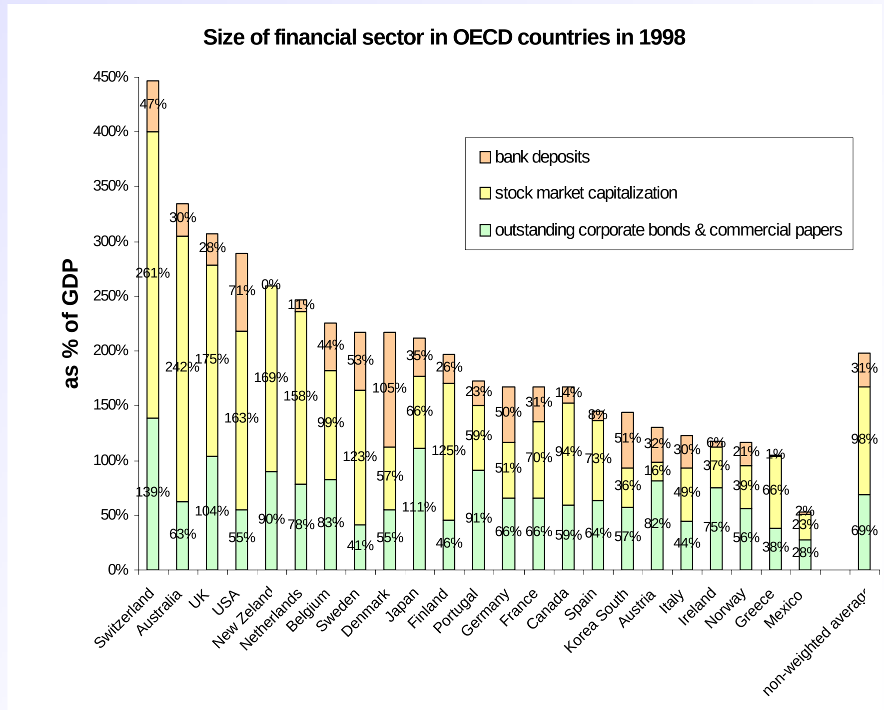
High level financial intermediation in the CR with bank domination („Bank-dependent economy“) at the competitive market

Relatively low level financial intermediation in Russia with highly concentrated deposit market

Financial Sector Structure – Bank dependent CEE - Czech economies

Comparison of CEE, Czech and OECD financial institutions size in 1998 – *bank deposits in green, stock market cap in yellow,outstanding corporate bonds+compaper in red*





…with huge grow potential of bank disintermediation

Source: Kawalec,2000

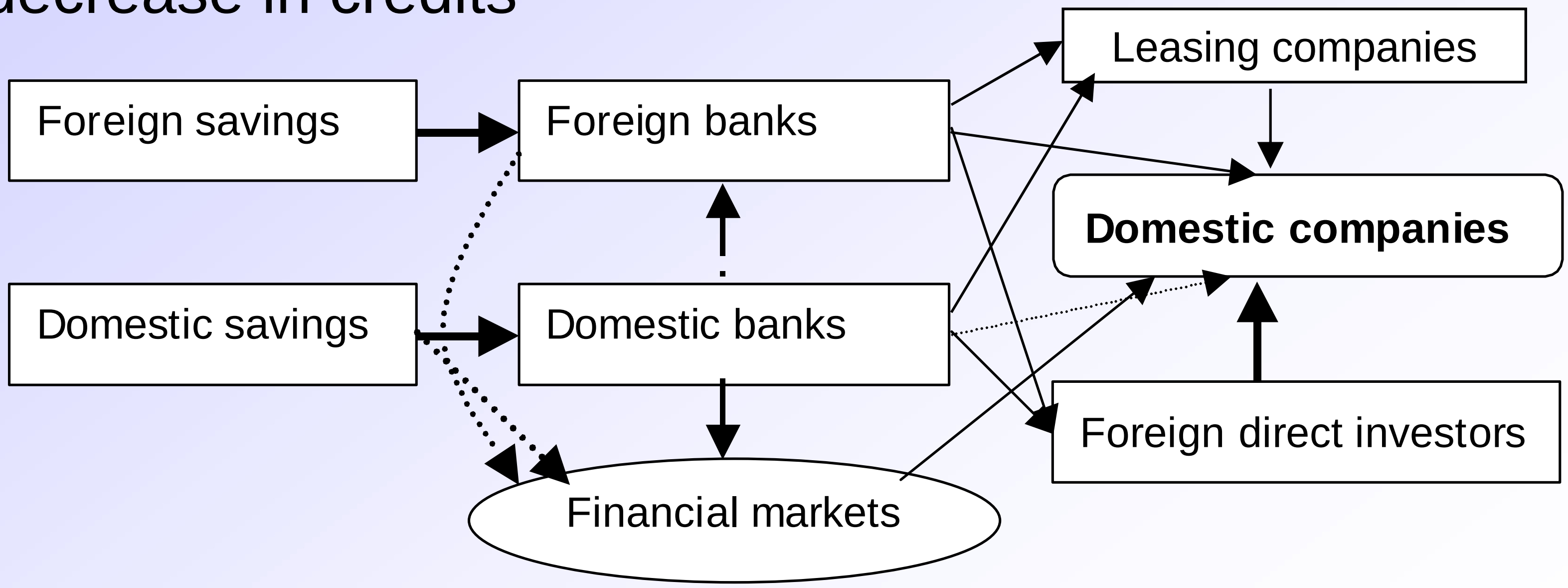
Joint Features

- Credit crunch
- Voucher privatization and corporate governance
- Poor performance of large industrial customers
- Ownership rights in banks and banks privatization
- NPLs and Failure of a high number of banks
- Necessity to increase the reliability
- Post-privatization phase in the banking sector
- Establishment of new regulations and institutional framework
- Orientation towards the EU

Credit Crunch

-increased money supply in the economy was caused by the FDI inflows and activities of foreign banks

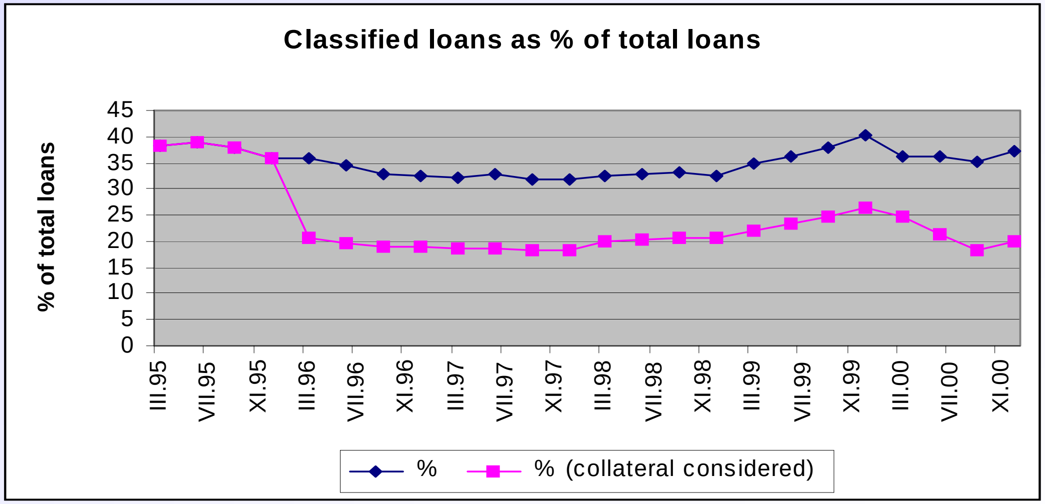
- domestic banks (big 4 respectively) showed a decrease in credits



Behaviour of Banks in Mid´90s

Violation of principles of prudential banking: i.e.

- Bank financed Privatisation buyouts with incomplete contr.
- Acquisition „related“ Lending contributing to Asset Bubles
- Instead of enforcing discipline of largest debtors and pushing towards restructuring they granted further loans



Reasons for Poor Performance of Banks

a) General = Institutional framework

- ***Economic transition*** – unstable environment – mainly at the beginning of transformation
- Missing or improper ***regulatory framework*** (too late, often amended)
- Inefficient central bank supervision and audit – in early ´90s
- in 1996-1999: ***macroeconomic problems + tight monetary policy***
- ***Late privatisation, forms of privatisation***

b) Commercial banks

- Lack of bank ***management skills***
- ***Moral hazard***, High level of ***corruption***, bank ***fraud***, dishonesty
- Lack of ***capital***

Supervision and Regulation

New trends:

- supervision on a consolidated basis

- harmonization with the EU and BIS

- accounting in banks in line with international accounting standards (IAS)

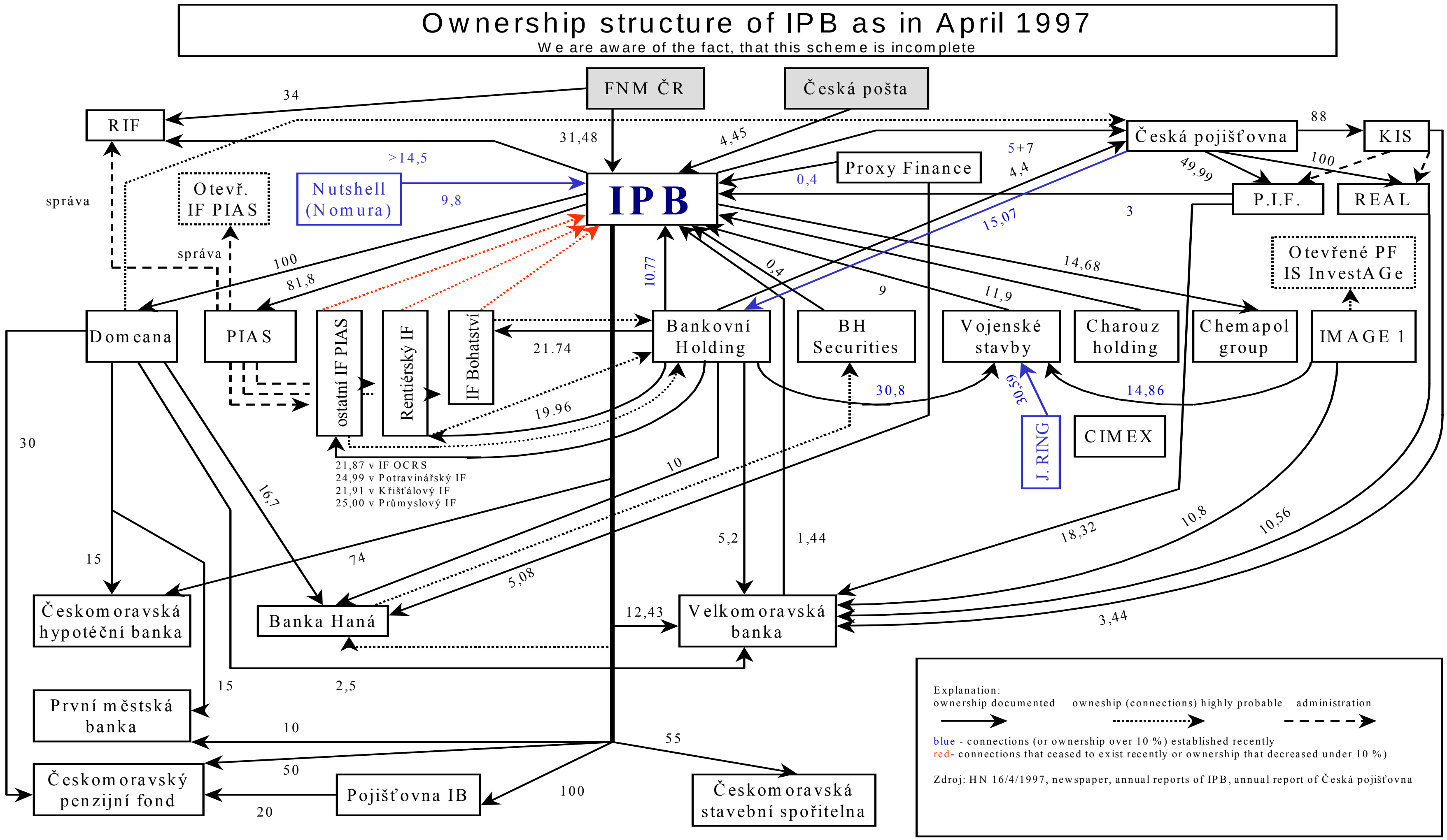
- new rules on capital adequacy and exposure, provision creating

Challenges:

- improvement of co-operation among different supervisory bodies on both domestic and international fields and staff education and stabilization

- further harmonization and up-dating on the basis on market development

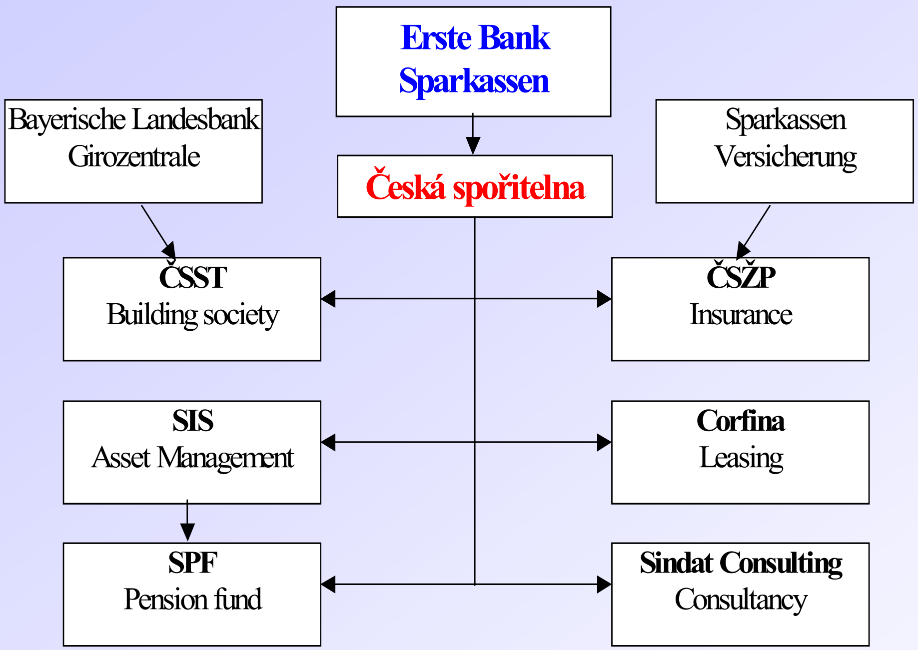
Supervision on Consolidated Basis I.



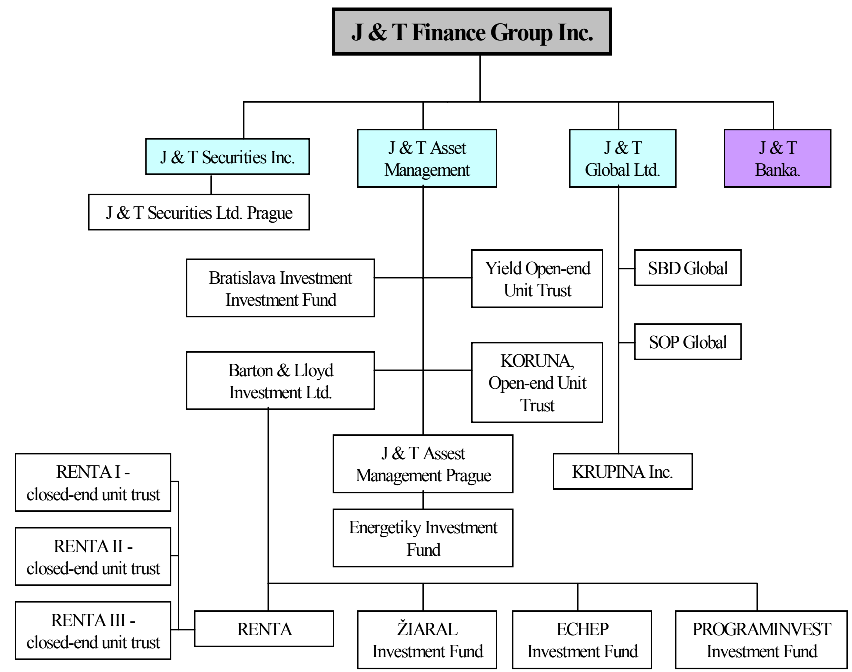
Source: Chmelik, 1997

Supervision on Consolidated Basis

- in the Czech Republic only for banking holdings so far (financial or mixed holdings supervisory legislation being prepared)



triple supervision…



partial supervision…

Costs of Stabilization (and delayed banks´ privatization) plus Financial Restructuring of Companies for Taxpayers

Total direct expected costs: CZK 400 bn = EURO **12 bn (inc.CZK 300 in CKA)**

Per capita: CZK 40 000 = EURO 1200

Further costs: interest, opportunity costs, lower income from privatization, etc. were not included

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Total proceeds from banks´ privatization:

CZK 107 bn = EURO 3 bn

17 out of 63 licensed banks were taken into forced administration and lost the license, 8 merged etc.

Czech Fiscal innocence (since 1918 – Rasin) lost – in spite of privatization proceeds consolidated public budgets debt has grown from neglectable 10% to 30% GDP just in few years partially due to transformation costs.

!

Ownership Development of Big Banks

Government

Coupon privatisation

Government + Privatisation funds (grand daughters of banks)

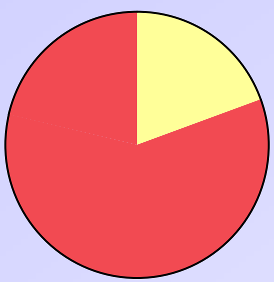
Cross-ownership

Gradual sale
of majority stakes

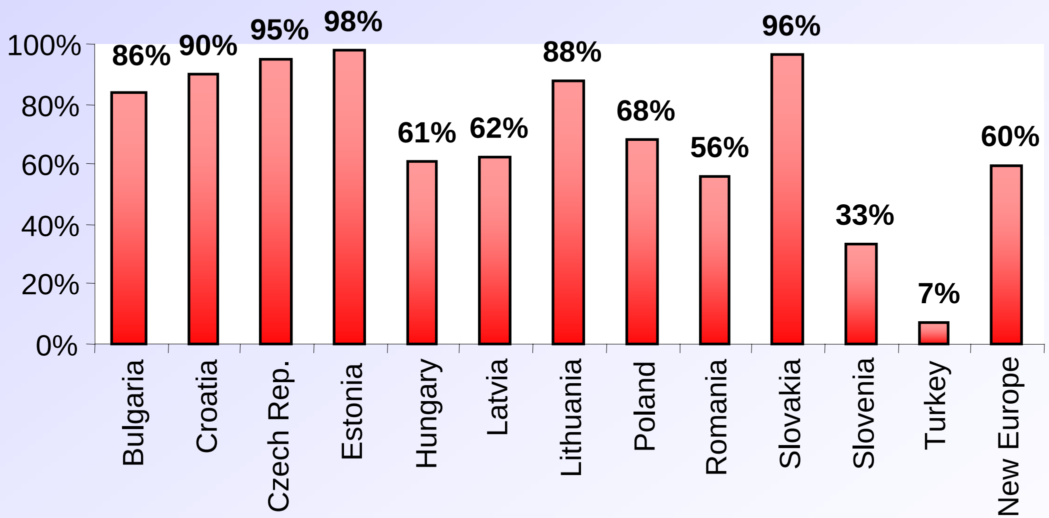
95 % of Czech bank assets controlled from abroad

DUE TO A FAST AND EFFECTIVE RESTRUCTURING PROCESS, THE MAJORITY OF BANKING ASSETS IS IN PRIVATE OWNERSHIP WITH INTERNATIONAL GROUPS CONTROLLING CA. 60% OF BANKING ASSETS

NE(12) Total assets by ownership, 2002



Market share foreign owned banks (assets), 2002*



- Foreign ownership has been basis for restructuring and transformation of the competitive environment. Still some market restructuring expected as privatisation ends and given further consolidation
- In Turkey HSBC and UCI entered the market in 2002, being among the first large FDIs in the local banking sector

Source: New Europe Research Network Steinbichler(2004.)

*For details see note (1)

NEW EUROPE IS ONE OF THE FEW AREAS IN THE WORLD, WITH SIGNIFICANT COMPETITION AMONG CROSS-BORDER COMMERCIAL BANKING GROUPS. A FEW PLAYERS SEEM TO STACK UP.

Data as at Dec. 2002 (1)

NE banking groups	Nr. of branches	Consol. Assets (bln Euro)	Total Net Profit (mn Euro)(4)	# of countries with active banking presence
UCI (2)	1,333	29.8	349	7
ERSTE	1,221	25.4	291	4
KBC (3)	1,021	31.8	200	5
HVB / BA	880	22.1	304 (5)	8
SOCGEN	614	17.6	357	4
RZB	524	11.8	107	8
INTESA	419	12.5	178	3
CITIGROUP	215	14.1	178	7

(1) 100% of total assets and profit after tax for controlled Companies (stake > 50%) and share owned for non controlled companies (I.e. 50% Koc)
(2) Including Koç FS and Zivnostenka (3) Including Nova Ljubljanska Banka (4) After tax, before minority interest; (5) HVB only pre-tax data available

Source: UCI Economic Research Steinbichler(2004)

Consolidation of Corporate Governance within Financial and Industrial Sector

- ***M&A with other domestic companies*** – usually ST=one-off game based on contract. incompleteness, a lack of domestic capital, unacceptable risks (IPFs)

- Better ***legislation and enforcement*** *Additional costs of bank regulation and supervision* vs. ***State subsidy***: usually moral hazard and inefficient, but large bank's pre-privatization clean-up ? *State konsolidacni agency owns the majority of non-performing loans. Sales of those assets in selected packages on the market or debt-to-equity swap*

- ***Acquisition by foreign owners*** : repeated LT game - if present value of future business attractive (such as pension funds, insurance, Škoda Auto, cleaned banks) New contractual architecture from inside international corporate standards. But not always positive (inadequate investor, market change) and gradual erosion if not supported by the improvement of weak local contracts.

Post-privatization Phase in the Banking Sector: Towards the Integration.

Basic signs:

•Workout of high risks loans concentrated in Consolidation agency

• standard prudential policy incl.stricter credit policy new up-to date products and services (mainly direct and internet banking) EU compatible with parent banks, increased efficiency incl. gradual lay-offs,new EU compatible softwares, supervision from the parent company

Challenges:

- **Czech banks and other fin. intermediaries will join highly competitive EU market that will test their competitiveness in the long term. Those markets are full of volatility and new risks and the success for all is not guaranteed.**

- **New acquisitions of current foreign owners of banks can happen overnight due to the ongoing consolidation within EU with the goal to utilize sector's potential economies of scale and scope**

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Czech Republic in Comparison with Other EU Countries

Country	Area (1000 km2)	Population (Million inhabitants)	GDP in PPP (USD billion)	GDP per capita in PPP (USD)	GDP % growth	Inflation rate (%)	Unemployment rate (%)	Current account (% of GDP)
Austria	84	8.18	255.9	31 300	1.9	1.8	4.4	-1.3
Belgium	31	10.36	316.2	30 600	2.6	1.9	12.0	3.6
Czech Republic	79	10.24	172.2	16 800	3.7	3.2	10.6	-3.3
Estonia	45	1.33	19.2	14 300	6.0	3.0	9.6	-6.1
Finland	338	5.22	151.2	29 000	3.0	0.7	8.9	7.5
France	547	60.66	1737.0	28 700	2.1	2.3	10.1	-1.7
Germany	357	82.41	2362.0	28 700	1.7	1.6	10.6	3.1
Hungary	93	10.00	149.3	14 900	3.9	7.0	5.9	-5.3
Ireland	70	4.02	126.4	31 900	5.1	2.2	4.3	-2.3
Italy	301	58.10	1609.0	27 700	1.3	2.3	8.6	-1.3
Poland	313	38.64	463.0	12 000	5.6	3.4	19.5	-0.8
Portugal	92	10.57	188.7	17 900	1.1	2.1	6.5	-4.3
Slovakia	49	5.43	78.9	14 500	5.3	7.5	13.1	-1.8
Slovenia	20	2.01	39.4	19 600	3.9	3.3	6.4	-0.1
Spain	505	40.34	937.6	23 300	2.6	3.2	10.4	-3.3
Sweden	450	9.00	255.4	28 400	3.6	0.7	5.6	9.4
United Kingdom	245	60.44	1782.0	29 600	3.2	1.4	4.8	-1.9

Source: CIA, 2004 estimates