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Privatization, Foreign Investment and Corporate Governance: Theory and Practice in the Czech Republic

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IES Occasional Paper: 1/1999

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Bibliographic information:
Mejstřík, M. (1999). “Privatization, Foreign Investment and Corporate Governance: Theory and Practice in the Czech Republic.” IES Occasional Paper 1/1999, IES FSV. Charles University.

Privatization, Foreign Investment and Corporate Governance: Theory and Practice in the Czech Republic

Michal Mejstřík*

September 2000 (English version)

Abstract:
The corporate governance issues are seen by the author as the key barriers for further enterprise development within Czech Republic. The theoretical notions and assumptions of corporate governance are compared with the Czech institutional prerequisites and practice that results in a „Czech biased, bivalent" form of corporate governance. Next part is devoted to the analysis of the ownership structures and its influence on banking corporate governance failure that resulted in different restructuring profiles of particular types of companies. The foreign controlled companies seem to represent long-term standard of behaviour, with new internal and external contractual architecture, although these may in future be partially eroded in an environment with prevailing incomplete contracts used by number of participants for their individual benefit. Institutional changes following „acqui communitaire", support of foreign investments and privatization of remaining state banks are seen as a consensual policy point of departure.

Keywords: corporate governance, privatization
JEL Classification: G28, G38

Acknowledgements:

Paper is based on the results of EU-ACE Research Project P96-6171-R „Corporate Governance, Privatization and Industrial Policy" and grant of GAČR No. 402/99/06066.

First draft was presented at the conferences of the World Bank on Financial markets, Prague , November 1998 and the conference "INVESTOR EXPECTATIONS IN A GLOBAL MARKETPLACE - The role of Corporate Governance-Can Central and Eastern European Companies Meet the Challenge?" Prague, Czech Republic, November 5th-7th, 1998.

I would like to express my gratitude to Vladimir Halama of EEIP for his work on the English version of this paper and for a number of invaluable suggestions he has made. The remaining errors and omissions naturally remain my responsibility.

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1. Best Practices in Corporate Governance : Theory

The term **“corporate governance**”, although commonplace since 1990´s, has not been often used very consistently. In its narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive, the term is stretched to include the entire network of formal and informal relations involving the sector of joint stock companies and their consequences for society in general. For the purpose of this paper I will follow Keasey et al (1997) in defining corporate governance to include “the structures, process, cultures and systems that engender the successful operation of the organizations” that is line with a notion of firm as a set of contracts (Jensen, Meckling(1976)). I will also quote Keasey et al (1997) findings in this chapter.

In contrast to the simple governance scheme of single owner-manager, the complications start with the initial sale of external equity that produces the basic institution of corporate governance -a board accountable to shareholders, elected non-executive directors, independent auditors, etc.

Hence the underlying problem of corporate governance as recognised since Adam Smith (1776) lies with the **separation of beneficial ownership and executive decision making** in a joint-stock company. Such a separation allows - if it does not actually encourage - the firm´s behaviour to diverge from the profit-maximizing, cost-minimizing ideal..

Keasey et al (1997) do also stress that the absence of consensus on the definition brings fundamentally different analyses and solutions. **Fundamental disagreements** cover also key questions such as what , if any, restrictions should be placed upon contractual freedom of the shareholder, as a resource owner, to maximize his financial reward from such sources.

The Principal-Agent, or Finance, Model is the dominant academic view of corporation. It rests on the premiss that markets - particularly the markets for capital, managerial labour, and corporate control - provide the most effective restraints on managerial discretion, and that the residual voting rights of shareholders should ultimately commit corporate resources to value-maximizing ends. It sees a firm´s existing corporate governance arrangements as the outcome of a bargaining process which has been freely entered into by corporate insiders (mostly managers and employees) and outsiders. Following the initial sale of external equity, by committing future managers to particular monitoring and accountability procedures, the original owner-manager is able to increase the marketability of claims to the firm´s future profits and hence maximize the potential sale price of the equity issue.

In the typical publicly quoted Anglo-American corporation the role for the individual shareholders "voice" is strictly limited. Nevertheless, access to liquid stock markets (combined with the existence of mandatory bids under certain circumstances) gives the shareholder virtually unrestricted, low cost exit opportunities. Therefore, given the high costs associated with collective action by shareholders -particularly small shareholders, **exit dominates over voice**. Notwithstanding the limited role for shareholder voice in this model, one important source of power is seen as remaining with shareholders - namely the right to vote - in Anglo-Saxon world usually on the basis "one-share-one-vote" decision rule. Most authors share the opinion that there is one important issue upon which shareholders should **always have a right to vote - on takeover approaches.**

The Stakeholder Model of corporate governance is a challenging approach reflecting mostly German and Japanese environment . In contrast to Finance Model, it is based on the assumption that the goal or objective of the corporate is wider than the maximization of shareholder welfare alone. That is why well-being of the groups having long-term association with the firm,and therefore an interest or "stake" in its long-term success, should be explicitly reflected. Those groups might be employees , sometimes also suppliers and customers. Those interests should then be particularly safeguarded in decision-making, which creates further costs and somewhat changes optimal behaviour.

It has long been recognised that **ethical behaviour reduces the costs of social association**. In 1992 Arrow had already described truth-telling as a public good: lying may produce individual gain but, if prevalent, it raises the costs of information-gathering for all. More specifically, economic relationships typically have a co-operative game characteristic:

- **full co-operation maximizing the participants´ joint pay-off especially in repeated game**

- "**cheating"- i.e. exploiting any contractual incompleteness to one´s own advantage, remaining the dominant strategy in one-shot game**.

Firms which build a reputation for ethical collaboration over a long period are able to substitute co-operative outcomes for unsatisfactory cheating ones. These relationships - the internal and external "contractual architecture" of the firm - may be the source of considerable competitive advantage. Furthermore, firms which have established such a reputation will enjoy an advantage in attracting new trading partners -whether as customers, suppliers, or employees - precisely because the latter know that the former can be expected to maintain their reputation.

Hence, ethical behaviour is not at all in conflict neither with the principal-agent model nor with stakeholder-agency theory. If ethical behaviour is the strategy that maximizes long-term profits, then shareholder-principals should encourage their manager-agents to practise it. Unethical temptations, where cheating is the more likely approach, occur in situations which are perceived as unstable or short-lasting. This perception may of course be a faulty one. "Grab all you can and run" is a natural reaction of many economic agents in newly set up economic environment.

A Western executive, who had witnessed how the legal system catches up, with smaller or greater delay, with those who breach even the spirit of the law, is hesitant to sacrifice likely life-time earnings for a one time gain. His Wild East counterpart has no such experience and therefore strongly discounts future losses derivable from behaving dishonestly. **Such a situation calls for rapid counter-active measures, otherwise the government´s slowness or weakness in acting leads to a spread of behaviour motivated by short term opportunism.**

It does not bear stressing that a tradition of managerial ethics did not exist in Czechoslovakia, where Communist Party appointed managers lived in a system which led to a conscious hypocrisy on a mass scale. Privately, the motto was „you are robbing yourself and your family if you don´t steal from the State". State property in Czechoslovakia encompassed everything except for a narrow range of personal belongings. It is therefore understandable that subsequent to the transition one could witness wholesale stealing from shareholders, business partners, creditors, suppliers, etc, particularly as in the initial period most of these still had as their main owner the State. Being smeared in local newspapers (at least in those which you do not own) is a tolerable fate if you have an escape option of being rich in the Bahamas or in Paraguay. Influential Western nations, in their inability to curb the behaviour of countries which provide tax havens and non-extraditable asylum to rich money launderers, have contributed to this moral hazard temptation. .

For a number of obvious reasons, individuals´planning time frames are shortened in situations characterised by wholesale systemic changes. Economic agents have no experience to guide them in estimating the probability of outcomes or the stability of prevailing external circumstances. Unknown long-term costs and benefits are therefore heavily discounted.

In the Czech setting, the opportunities were naturally largest for those belonging to the managerial and administrative elite of the previous regime. They had the knowledge of which records are kept where, they had retained signature rights entitling them in many cases to authorise transfers of property, rights which they could not be sure of keeping for long. In such cirumstances, and lacking the safety net of golden handshake contracts, even the most conservative managers in the Anglo-American corporate tradition would be under a a strong temptation to steal the assets under their care rather than continue to manage them.

In 1990 the supervisory rights of Ministries over enterprises in which they were still the sole shareholder were severely curtailed. Managers reacted by setting up a multitude of trading companies which siphoned off company income both in purchasing the inputs and in selling the production. This practice was neither monitored nor punished and, through imitation, rapidly spread among even the less unimaginative or timid members of the managerial class. While some practiced a degree of subterfuge by registering as owners and directors of these companies their relatives or friends, others did not go as far as that - after all, such evident conflicts of interest were not made illegal until 1996.

2. Corporate Governance and its Environment in Czech Republic

Emergence of tradable shares and opening of the capital market created certain prerequisites for establishing efficient corporate governance. Major corporate governance issues have been, however, raised by the Czech process of transition to a market economy. Most authors share the view that he pure act of transferring ownership of assets from state to the private sector does not establish of itself the conditions for enhanced corporate governance, which would in turn generate greater enterprise efficiency. Problems arise because of:

- privatization is an unrepeatable process and has conflicting economic, financial and political objectives of particular interest groups (foreign vs. domestic buyers – either insiders or outsiders).

- In voucher privatization the government administratively enforced the 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 small investors, no matter how small. Naturally, those expectations could hardly be met at once. The government , however, had not 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. The government thus had resigned for quite a long time its role in cultivation of rigid institutional and legal framework of capital markets and creation of relevant expectations within investing and managerial public.

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

- Banking institutions effective both in Anglo-Saxon and German sense had been absent.

- Underdeveloped institutional and legal frameworks mean 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;
  - 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 voucher privatization. No political will to enforce the limited existing law was shown.
  - 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) led to superficial and misleading audits provided even for the most important corporates.
  - Rating quotes by recognised rating agencies have been unavailable and external investors had to decide under conditions of 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 has been neither monitored nor sanctioned.
  - Business courts were flooded by minor cases that should be 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. Judges apprehensive about making a decision can delay them even further by abusing the procedural rules.
  - Judicial independence and irremovability means that even blatant misbehaviour of judges was punished only rarely. Judges are also not bound by decisions reached in similar cases by their colleagues. There is no 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 is virtually impossible to establish except where the accused confesses, an outcome which is naturally quite rare

- Business courts registering changes in statutory bodies 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 until 1999 not fully enforced.
- Payments of unpaid promissory notes or bills of exchange can hardly be enforced when institution such as executor was missing,

Within such a difficult institutional framework the particular corporate governance models appear in a different light:

i) The Anglo-Saxon principal-agent approach to corporate governance has met insurmountable difficulties so far due to absence of its preconditions.

- There had been no access to liquid stock markets that would give the shareholder unrestricted, low cost exit opportunities. Particularly the liquidity of trading with small fragments of shareholdings has been negligible.
- There had been no take-over barriers but enormous acquisition premia. Only in 1996 has the mandatory bid in case of take-over by majority 50% shareholder been introduced. Buy-out prices, based on the easily manipulable public market prices, were low. In most cases, however, distribution of shareholding into the hands of 2 or 3 legal entities was sufficient to preclude the necessity of any buy-out.
- Minority investors had not been protected. They could rely neither on sufficient information flow nor on protection of profit share to which they were entitled. The extremely limited role for shareholder voice in this model, **right to vote, was further limited to shareholders present at the general meeting (no proxies).** Issues such as takeovers – an issue of such importance that most authors agree that shareholders should always have a right to decide on it – were decided at remote locations with limited and very costly access for small shareholders.
- Class actions were not allowed, which further increased the transaction costs for dissenting shareholders. While some attempts had been made to create associations of small shareholders (for example "OSMA - Ochranné Sdružení Malých Akcionářů"), exit at a loss is in practice the only action a small shareholder can take.
- There has been a general tendency to leave public markets and go private not only for small to medium size companies, but also for many large corporates, either to escape the few restrictions on their activities which a listing entails or, in case of companies taken over by foreign capital, in adherence to the parent company policy.
- The limited number of IPO´s taking place so far have been cases of income transfers from controlled companies rather than a genuine subscription from the public.
- In case of genuine IPOs, the par value of almost all listed Czech companies would have to be lowered to obtain a P/E ratio exceeding bank deposit rates. Rules for changing the issued share capital are particularly cumbersome when it comes to lowering the par value.
- Companies in any case are not interested in behaving in a way which would give them a chance to obtain capital on the share market because they anticipate that no-one would risk their money in a joint stock company over which he does not have control.
- A **vicious circle** had been set up. Companies do not accommodate small shareholders since the gain of so doing are lesser than the costs. Small shareholders´ negative response to this

both causes and reinforces this behaviour. Unethical behaviour of companies thus makes the cost of financial intermediation through the stock market prohibitive.

ii) The stakeholder model

In the Czech republic, this model has been explicitly intended to be applied in limited number of cases e.g. in partial privatization of large and smaller corporates with regional monopoly (such as local distribution companies of energy, gas and water etc.). Their most relevant clients - municipalities - were allocated registered (non-tradable) shares according to the number of inhabitants that in total represented a blocking minority (34% according to the Czech law) in order to increase their "voice".

Limited minority shareholder protection and weak voice, expected low dividends and the temptation to sell for acquisition premium to the generous international investors brought most of municipalities to sell. They sold options to their registered and barely transferable shareholdings through entering into very complex option-, future- or loan contracts. Cash hungry municipalities, with their own idea about more efficient disposition with the acquired shareholding, disregarded the stakeholder model - evidence of mistrust and loss of interest in administratively enforced corporate governance stakeholder model.

The implicit use of the stakeholder model can be seen with growing frequency in debt-equity swaps in financial restructuring of companies with excessive bank debt and unpaid arrears to the suppliers. Due to the weak position of creditors vis-à-vis shareholders in the Czech law, there is always a danger that such a solution enforced by particular large bank creditor with special relationships to the company management might cause a harm to the minority shareholders.

If we take the stakeholder model in its more general meaning, that is, companies behaving in a way which does not maximise the direct interest of its shareholders, then it must be said that little official encouragement was given to the notion of "good corporate citizenship" propagated in countries such as Germany or Japan, which actively advocate the social contract model of public life. Nevertheless, companies did on many occassions go beyond their legal duties in curbing environmental emssions, in supporting sporting and welfare activities in their community, etc.

A more perverse example of this had occurred in the behaviour of major banks with majority State shareholding. Through informal channels, politicians and bureaucrats had successfully convinced the executives of these banks to provide inviable loans to large companies, also still dominated by the State, arguing that this was necessary to "support privatisation" or to "rescue" such companies by giving them breathing space while they were adjusting to the new competitive environment. These loans, with almost no exceptions, turned out to be unrecoverable and the recipients are now either in bankruptcy or in pre-bankruptcy proceedings of one kind or another.

Such subversion of hard budget constraints, something to which the government had publicly committed itself to, had arguably imposed greater costs on the State budget and on the minority shareholders of these banks than if these enterprises had gone through a bankruptcy process earlier.

iii) **Single owner**

The single owner - manager approach typical for closely held or privately held companies and its modifications had got widespread . It is often considered as the most straightforward way to govern the enterprise without public financial markets resulting in reduction of firm's direct information costs. The limited firm's reporting, however, makes firms non-transparent to its business partners, while non/compliance with low information disclosure requirements have not been sanctioned. The decisive role in external financing is taken by bilateral loans provided by banks as the only monitoring institutions. World-wide this model has been used by small and medium sized companies while until recently in German or Japanese environment such a model reflected governance of many large corporates.

iv) Czech transitory CG model – large shareholder behaving as single owner

The markets for capital and corporate control transformed themselves into **the bivalent form** when only "0" or "1" are the values for corporate control. There is no market for "smooth" quantities of shareholdings, only a **market for majorities**. In the Czech corporate world, gaining a voting majority gave the majority shareholder a feeling that he can dispose with the entire profit, not just with his share of it. The controlled company was forced to enter into disadvantagous contracts with trading vehicles set up by the dominant shareholder. Profits, and not infrequently assets, were stripped away from the company. In the opinion of commercial lawyers, police prosecutors and judges, there was no viable way in which this practice could be deemed illegal. News that a controlling portion of company´s shareholding was concentrated by one shareholder was almost invariably followed by a rapid decline in that company´s share price.

In effect, the costs of take overs in Czech Republic were reduced by half since the acquisition of one half (sometimes less) of issued shares allowed the dominant shareholder to appropriate all the potential profit to himself. Although legislation requiring a shareholder to make an offer to purchase the shares of the other shareholders after passing the 50% threshold was eventually implemented, it was easily circumvented by acting through more than one corporate entity. As a result, the dominant shareholder came to possess all the advantages of a **single owner** on the backs of those remaining shareholders who had been unwilling or unable to sell out while the dominant shareholding was being concentrated. Moreover, since the acquisition was typically financed by bank loans, there was no downside risk in case the company subsequently failed through bad management or asset stripping. The loans would remain unpaid and the banks ended up owning worthless shares that had been pledged as the security for the loan.

Many dominant shareholders went a stage further and used their voting power to cancel the public tradeability of the shares (before legislation mandating an offer to purchase the shares of the other shareholders at net equity value was passed). This spared them the cost and nuisance of having to comply with informational requirements imposed on publicly traded companies, though these were negligible in comparison with the requirements prevailing in Anglo-American public markets.

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 dominant strategy was "**cheating"- i.e. exploiting any contractual incompleteness in largely unregulated environment to one´s own advantage.**

3. Initial Ownership Structure and Establishing Corporate Governance Prerequisites

The key task - facing also Czech economy in transition – that is, to transform state-owned enterprises (SOEs) into value maximizing concerns, have been addressed at first in rapid change of ownership both by standard sales (most frequently for small and medium size SOEs) and by voucher privatization (significant part of medium and large SOEs). The analysts agree upon the fact, that besides the firms with dominant insider ownership by managers and employees, "the most pervasive governance structure resulting from the mass privatization program in the Czech Republic was **outside ownership**, either dispersed among private voucher holders or more concentrated with PFs and the National Property Fund. The incentives and governance structures of the PFs, and in particular their financial relationship with banks, greatly influence the restructuring outcome in the privatized sector" (see Transition...EBRD(1995)).

Dominating Ownership Structures

Voucher privatization was merely an artificial primary issue or IPO (Initial Public Offering) by which ownership interests were transferred from the state to private entities. Transfer of stock to the hands of voucher shareholders (individual or corporate) had not meant by any means finding definite owners, nor any increase of corporate capital (see Mejstřík, 1997). The accelerated creation of the capital market for over 2000 publicly tradeable issues for more than 6 million small investors resulted in significant transaction costs, as it led to spontaneous expansion of numerous servicing institutional personnel (e.g. 520 securities dealers, hundreds of investment funds and 153 investment management companies).

842 Czech companies offered in the first wave more than 50% of their shares for vouchers, and the voucher investors have become the most important owners, followed by non-voucher investors such as direct investors. The core was dominated by several institutional owners – investment funds.Given the above described characteristics of corporate governance and its institutional framework, the voice of coalitions of those funds had dominated at the general meetings over unorganised dispersed shareholders, who have usually not used their voting rights. Table below illustrates the analysis of effictive voting power votes at

Table 1

Relative power of investors in companies after first voucher privat. 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)

919 Czech firms privatized in the first voucher privatization wave (we intentionally subtracted the votes of very small shareholders, who usually did not take part in voting). One to four funds could have established a majority in 727 joint stock companies.

While a diversification rule to protect investment fund shareholders limited IF´s ownership of the total nominal value of securities issued by the same issuer to 20%, several funds were usually controlled by one investment management company.A substantial portion of Czech and Slovak economies was thus controlled by several corporate entities that had established the most successful investment management companies.

Who controlled those funds?

Dominating institutional owners belonged to several power groups, mostly concentrated either around well established financial institutions (especially state-owned large banks or insurance companies) or, much more rarely, around privately owned financial groups emerging in reaction to the opportunities provided by voucher privatization (these are marked in italics in table 2 below). Frequently, the ownership relations were not separated hierarchies but mutually interconnected non-transparent cross-ownerships (see Mejstřík,1997).

The equity capital of the private parent companies was low, but was multiplied inside financial groups created through subsidiaries and "sub-subsidiaries", or by explicit and implicit loans, which they extracted from controlled companies.

Totally inadequate protection of ownership rights and weak institutional structure had led to corporate governance which did not lead the companies to behave in an efficient way. Managers of many investment management companies were able to replace passive investor´s behaviour and enjoy all the advantages of controlling industrial holdings without consent of the mass of their minority shareholders, and often to detriment of their interests. Quite a number of investment companies listed in Table 2 conducted themselves in a manner which would elsewhere be deemed unethical, to say the least. Nevertheless, they escaped any avderse repercussions.

Table 2:
14 largest financial groups in 2nd and 1st waves of voucher privatization

Ranking in the 2nd wave	Second wave			First wave		
Investment company within Financial Group	Pt.	%TFP	%TP	Rank in CSFR	%TPF	%TP
1.A-invest, Agrobanka	*320*	*8.2*	*5.2*	*14.*	*1.8*	*1.3*
2.Expandia, Chemapol	306	7.8	5.0	-	-	-
3.Harvard CC	*292*	*7.5*	*4.7*	*3.*	*10.5*	*7.4*
4. OB Invest , CSOB	198	5.1	3.2	18.	0.8	0.7
5. KIS, Ceska Pojistovna	187	4.8	3.0	6.	5.5	3.9
6. IS Podnikatelská.	*157*	*4.0*	*2.5*	-	-	-
7. YSE	*156*	*4.0*	*2.5*	*16.*	*1.2*	*0.8*
8. Czech coupon	152	3.9	2.5	21.	0.6	0.4
9. PPF	130	3.3	2.1	10.	1.9	1.4
10. SIS, Ceska Sporitelna	**124**	**3.2**	**2.0**	**1.**	**15.6**	**11.1**
11. IKS, Komercni Banka	**124**	**3.2**	**2.0**	**5.**	**7.6**	**5.4**
12. MorCe IS	113	2.9	1.8	-	-	-
13. PIAS, Investicni Banka	98	2.5	1.6	2.	11.9	8.5
14. CS Funds	94	2.4	1.5	24.	0.8	0.7
Top 14 Funds´ Financial Groups	2451	60.1	38.2	-	77.6	55.4
Total Funds	3920	100.	63.5	-	100.	71.3
Total Vouchers	6170	-	100.	-	-	100.

%TP - % of total points in the first resp. second wave; %TPF - % of total points in funds;
RANK - ranking in the first wave
Source: Marcinčin and authors calculations in Mejstřík (1997) chapter 4.2

State-Owned Commercial Banks Failure and Behavioural Formulas of Owners

Large state-owned financial institutions that gave birth to the biggest groups of managed funds and their managing investment companies (indicated in table 2 in bold), were, however, not thoroughly privatized. These, as well as the companies which they controlled, effectively remained in State ownership. Portfolio companies that they directly and indirectly controlled had been influenced by state-owned banks´ policies and by management appointed by state, both of which were heavily influenced by their desire to accommodate what the management perceived as the wishes of governmental agencies.Banks´ ownership of these companies had a long term impact on their asset quality due to the violation of principles of prudential banking . This resulted in the granting of bad loans. It had not implied only leverage privatization buyouts based on bank loans. in 1994-96, large banks provided credits enabling ownership transfers between domestic investors and consolidation of shareholdings in enterprises privatized formerly by vouchers. This was a serious failure of the banks, observable mostly at the banks “controlled” by the state (with rare exception of CSOB). Instead of enforcing discipline of the largest debtors (etc. Chemapol, CKD Praha, SKODA Pilsen, controlled by Czech “would be” capitalists) and pushing them towards enterprise restructuring, they surprisingly granted them further loans for leveraged acquisitions of voucher privatized companies and even foreign companies.

The larger they were, the more political and economic power they represented. This clearly slowed down bankruptcy legislation (due to the misuse of argument – “too big to fail”). Experience suggests that resulting ownership bubbles inevitably face bad future (they usually break at the first recession). Bad loans should have been settled through the collateral contracts or written-off at the bank’s costs. The prisoner’s dilemma explains relevant behavior sufficiently.

The atmosphere of tempting acquisition opportunities had been undoubtedly contributed to by abovementioned ”bivalent form” of Czech corporate governance focused on majority control. It had alsostrengthened the conflict of interests between corporate owners´ and creditors´ roles within all financial groups.

Under imperfect governance structure the ownership alliances of banks have not supported, either domestically or abroad, any initial public offerings (IPO) of indirectly owned corporates that would inject into them external equity highly needed for restructuring. Banks were afraid of dilution of their shareholdings that might eventually lead to a loss of corporate majority.

Disregarding several cases of share capital increase that copied ownership structure of principal owners, all companies had to rely on their internal sources and further credit lines, which worsened corporate capital structure and their interest rate sensitivity. This in turn slowed down the innovations and increased firms´ cost of capital.

This specific development might have been avoided, based on the experience of countries exposed to the similar problems with corporate governance. Number of companies have not needed their doubtful “safeguard” coming from domestic over-indebted firms stimulated by their size (“too big to fail” illusion), by their undoubtful political influence (both over special cases and general institutional framework changes) and by unrepeatable “fourth wave privatization” opportunities.

4. The No-Holds-Barred Restructuring of Czech Ownership Structures

We have noticed at the stock market the consolidation of shareholdings of principal investors, often based on insider information misusing informational asymmetry at the cost of small, shareholders.

We have already indicated other serious resulting ownership changes when analyzing data on share ownership and registered the fact that small investors had not actually influenced company policy. We have been able to demonstrate that in a vast majority of the privatized companies, few large investors had owned enough shares to be potentially in control of the company. This could be seen from their willingness to form temporary alliance in order to combine their shareholdings into majority stake that would bring them a considerable majority premium. The legal restriction of maximum 20 percent stake for portfolio investors (privatization funds) had not been effectively enforced and hence it was misused for shareholding consolidation and sale with capital gain.

Renewed transferability of stock ownership had nevertheless allowed the entry of suitable owners even in ”strategic” companies and passed the responsibility for the unpopular decision to sell to foreign owners to domestic citizens. The effectiveness of the process was not, however, dependant on artificially stipulated rules of voucher privatization and coupons ("investment money" equally distributed amongst domestic citizens).

The standard rules of the capital market are set forth by rules of the market itself, arising in a complex environment of commercial, civil and criminal law and the actual operation of the law system. In a standard legal environment, shareholders have instruments in their hands to force companies to behave in their interest. Instead of attempting to create a stage in which standard market mechanisms would prevail, the government rigidly stuck to the a completely inadequate legal framework as it existed in the days of the first privatisation phase..

In spite of the fact that generally available aggregate data on new owners had not been available (legislation allows information from the Center for Securities only when a single shareholder acquires more than 10 percent stake), fragmented data from capital market suggest plenty of acquisitions of both larger and smaller companies, resulting in rapid concentration of property rights. It was contributed by the total lack of protection of minority investors until 1996 and by the absence of takeover regulation.

From the individual small investor’s side one should notice that over one third of them sold their shares acquired in the first privatization wave that resulted in over two million empty accounts in the Center for Securities. Some intended to sell from the beginning, the other panicked. From the other side, the capital market has disciplined itself when many smaller companies privatized by vouchers and introduced overnight to the public markets have been sparsely traded, their prices have fallen dramatically in spite of their good but often undisclosed performance (even profitability). Surprised investors have been selling their stake and the prices have fallen further. Generally many smaller companies have not been suitable institutions for public trading at the institution of (emerging) capital market.

Disregarding profitability of those smaller companies but due to the low liquidity of their shares, these shares have not fitted to the type of institutional portfolio investors such as many investment and mutual funds that had acquired them in the voucher privatization. The rational institutional portfolio investors have been often selling their shares and adjusting their portfolio to more liquid shares of (bigger) companies. This process of separation of different types of shares had been institutionalized e.g. into separation of the biggest Czech investment privatization fund into three smaller funds with more homogeneous portfolios. The portfolio of the fund with shares of smaller companies was advertised „to be for sale“ after a while.

When the price of many small companies declined to 10 - 20 percent of nominal value, some strategic investors have often emerged to form a bid and take over silently. This acquisition might have been initiated by the management through a MBO. In fact these have been leverage buyouts supported by the willingness of the banks to accept the tangible assets of undervalued companies as collateral. The mass of these M & As resulting in rapidly growing shareholders´ concentration has got its nickname - „third privatization wave“.

In this wild evolutionary process many smaller, voucher privatized companies have been bought back by single investors (private person or legal entity) and left public markets. There might be no loss for public markets that temporarily contributed to the (re)valuation of the recently privatized companies instead of government officials. This evolutionary market has lead to wide spread ownership changes, **dealing towards the majority stakes and to forming of more concentrated ownership structures of those smaller and medium size companies. These have not been, however, sufficient prerequisites for "deeper restructuring".**

This tendency of evolutionary market leading to wide spread ownership changes, dealing towards the majority stakes and to forming of highly concentrated ownership structures, can be observed also for most of larger companies**. Corporate governance based on principal-agent interplay** with common profit interests of fragmented shareholders and managers **of large companies has not started to work yet due to institutional imperfections (see above). Corporate governance based on Czech way is, however, seen as a very short-term oriented ("one shot game") and inappropriate from the long term enterprise development point of view.**

We can conclude by the statement that in evolutionary process described above, Czech voucher privatization played a role of temporary but very costly intermediary that opened the space for finding out the new ownership structures. To some extent, the Czech government happened to be a victim of its own earlier success. It mostly failed to gradually regulate within standard framework some natural, evolutionary changes (such as fund-holdings transformation) that allowed limited transparency of those changes, cheating, wider and permanent presence of short-sighted owners, uninterested in longer-term perspective. It resulted in very limited enterprise restructuring. The resignation to protect at reasonable extent minority shareholders ownership rights lead to the loss of many pro-market minds born in voucher privatization.

5. Foreign Direct vs. Portfolio Investment

One of the expected developments based also on corporate governance scheme No. 3 has been a rapid but fluctuating inflow **of foreign direct investment (FDI)** both into privatised companies (in contrast to limited and fluctuating amount of portfolio investments) and green field projects (see table 3 below). Results of our survey confirmed the positive impact of foreign owned companies on restructuring (see below). While the largest individual foreign direct investments were usually based on the limited number of case-by-case privatisations (frequency and size volatility influenced the fluctuations in time series), the voucher privatisation inspired large numbers of medium size investments of strategic investors who gradually took over many domestically voucher privatised companies, controlled temporarily by funds. Since 1995 there has been the growing number of green field foreign investments as well.

At the end of 1998 FDI in equity capital totalled USD 12 bil. And the overall FDI volume (including CNB preliminary data on reinvested earnings and credit relations with foreign investors) stood at USD 13.5 billion . It is comparatively low with USD 18 billion for Hungary but the inflow is growing (USD 2.5 billion just for 1998, USD 4.9 billion for 1999) that will be fostered by number of large acquisitions. Foreign investors have derived confidence from the political stability of the country and its rapid privatisation programme The formerly prevailing environment consisting both from imperfect institutions, and from comparatively slowly growing - later stagnating - economy, and internationally low FDI incentives, had not produced many incentives to bring in large volumes of FDI inflow in order to increase capital stock of acquired companies. This is gradually changing for the better. Surviving limits to the FDI can be found in the unwillingness of some strata of society to adjust to a market economy.

Table 3 Balance of Payments

In billion USD	1992	1993	1994	1995	1996	1997	1998	1999
1. Current Account	**-0,3**	**-0,1**	**-0,7**	**-1,3**	**-4,3**	**-3,2**	**-1,0**	**-1,1**
- trade balance	-1,9	-0,5	-1,4	-3,7	-5,9	-4,6	-2,6	-2,1
- balance of services	1,5	1,0	0,5	1,8	1,9	1,7	1,9	1,0
2.Financial and Capital account	**0,0**	**3,0**	**3,4**	**8,2**	**4,3**	**1,1**	**2,6**	**2,5**
- direct investments	1,0	0,6	0,7	2,5	1,4	1,3	2,5	4,9
- portfolio investments	-0,03	1,6	0,9	1,4	0,7	1,1	1,0	-1,4
- long-term capital	0,3	0,8	1,1	3,4	3,1	0,9	-0,9	-0,3
- short-term capital	-1,3	0,06	0,7	1,0	-0,9	-2,2	0,0	-0,7
3. errors, exchangerate differences	0,2	-0,1	-0,3	0,6	-0,8	0,3	0,4	0,2
4. decline in forex reserves	**0,08**	**-3,0**	**-2,4**	**-7,5**	**0,8**	**1,8**	**-1,9**	**-1,6**

Source: Czech National Bank Monetary Reports, Prague

Since 1989, the foreign direct investment has especially been concentrated in the transport and communication sector, (17% of total FDI to June 30, 1998), banking and insurance (12%), the transport equipment sector (11.6%). Investments in the financial, food and trade sectors have been increasing. The major investors in the Czech Republic originate from Germany, USA, Netherlands, Switzerland and Great Britain, which respectively have accounted for 27%, 14%, 13%, 10% and 8% of FDI to June 30, 1998.

6. Enterprise Restructuring

Additional financial debt burden had been accumulated as a result of the cost of privatization and subsequent leveraged acquisitions, accelerated especially by the chain acquisitions of number of firms by the largest companies. It has further worsened their capital structure and relatively increased their cost of capital.

As illustrated above and and also in our EU-ACE survey (see Mejstřík, Zemplinerová, 1998), **significant amount of enterprise restructuring (both reactive and proactive)** has already been achieved, both within sectors of economy as a whole and within firms, which started to place more emphasis on liquid customers both in developed nations and in domestic markets ("liquid" customers are those closer to the final consumer downstream in the production process,). Deeper financial restructuring should be expected after new owners, who had taken over the firms, implement their plans. The expectation is that adequate restructuring could lead to more liquidity among firms, reducing the problem of inter-enterprise debt.

Particular sectors and branches have been restructured in very different extent. The **restructuring neglecta** has been widely recognized in railways and some other non-privatized network industries such as energy and gas supply and distribution. The lobbies of trade unions and other vested interest groups in those unrestructured sectors prevented any further change and kept for example the wage growth parallel with inflation, in spite of sharp decline in labor and capital productivity.

The experience of Czech Republic, Poland and Hungary suggests that this situation generated in unrestructured industries permanently threatened negotiations about rational wage increases in most other industries. L**imited restructuring** can be found also within large heavily indebted Czech conglomerates (Chemapol Group, Skoda Plzen, CKD Holding) that accumulated further debt due to chain acquisitions financed by credits. Those firms became financially distressed and responded to the reduction of their cash-flow by letting their arrears grow. Their stretched budget was heavily hit by any sign of recession such as slowing down of governmental projects. Trying to avoid the bankruptcy threat, these conglomerates took advantage of incomplete legal framework within this "unrepeatable game", relied upon their sizeto exercise political influence and diversified their risk through the formation of subsidiaries. No management energy was left available to focus on key competencies or on sanation through a sale of unmanageable subsidiaries. Given their financial weakness, most of restructuring projects have been out of control, new product development had not been completed and the confidence of customers became seriously eroded.

In 1995-6, in temporarily improved macroeconomic situation and domestic demand led by internal growth, number of firms responded by **adaptive restructuring** oriented towards particular segments of high domestic demand which was being satisfied in growing extent by imports.

Nevertheless, this demand led growth generated a negative net trade balance and had to be corrected by the monetary and fiscal restriction. Government expenses had to be cut, further accumulation of municipal debt could not be sustained, GDP growth was interrupted. As a result, in 1995-97 the partially restructured enterprises exhausted their sources of domestic demand led growth and accumulated further "secondary" debt (i.e. debt which arises from unpaid receivables).

Some industrial companies, mostly **foreign controlled**, have properly responded to demand and market signals (GDP growth at OECD countries generating stronger demand) properly by **deeper restructuring** – by cost adjustments (including a temporary decrease of real wages succeeded by quick wage growth after rapid productivity growth was achieved), by new products and technologies, more active marketing, etc., frameworked by a new **"contract architecture"**. They significantly increased their non-price competitiveness (e.g. VW – Škoda cars) and became the engine of **outward-looking, export led growth** stimulated by foreign demand growth. Sectors exporting market segments with higher value added (machines, equipment) sold mostly at the highly competitive OECD markets. These companies also had a lower cost of capital of those firms as they could borrow more cheaply at the international markets via their parent companies.

Czech analysts sometimes talk of a two speed economy, where the more rapidly growing segment is represented by the more effectively governed, deeper restructured, foreign controlled companies. In 1997, profitability measured by average ROEBT reached in (non-financial) foreign controlled corporates over 12%, while ROE was 3.7% for other large private non-financial companies and 3.1% for public sector firms. The same gap was reported in the first half of 1998 .

The most important point tostress here is that over time these corporates have applied in relationships with their suppliers and customers much more demanding external “contract architecture” than other Czech companies. Customers have had to pay their liabilities in time and suppliers have had to deliver their products in audited quality “just in time”, requiring innovations and capital expenditures. If those conditions were not met , they would be excluded from suppliers´ list, which would have meant their departure from those few “islands of stability” within the wilderness of the Czech enterprise sector. Yet even these few “islands” are eroding. In 1997 Czech Statistical Office Yearly published data suggesting that the payment discipline of large foreign controlled firms has probably seriously deteriorated (their payables overdue doubled). In this respect they have got closer to Czech company “standards”, set by companies unfairly gaining competitive advantage and lowering their cost of capital at the expense of their suppliers.

7. Final conclusions

- The key task, to transform state-owned enterprises (SOEs) into value maximizing concerns, have been addressed at first in change of ownership, both by standard sales (most frequently for small and medium size SOEs) and by voucher privatization (significant part of medium and large SOEs). The voucher privatization itself had been only an of artificial primary issue, a means of transformation of ownership from the state to private entities. Transfer of stock to voucher shareholders has not by any means meant finding more permanent owners or achieving the necessary increase in corporate capital.

- Creation of the capital market for large number of stocks and investors had imposed sizeable transaction costs (large stock broking industry had been born that is being downsized).

- The initial ownership structure of companies was unexpectedly characterised not by dispersed owners but by institutional owners - funds ("outsiders"), dominated by several power groups mostly concentrated around financial institutions. This caused a conflict of interests between their roles as owners and as creditors, as well as inefficient financial intermediation caused by suboptimal allocation of savings of depositors to productive capital.

- Until 1997 government rigidly relied upon laboratory environment of the first privatization stage where the **imperfect legal framework** was totally inadequate for the efficient functioning of market economy. Supported by the strong voice of a number of Czech would-be capitalists (later usually bankrupted due to excessive debts and neglect of restructuring), the Government accepted the **prevalence of "incomplete contracts"**, which led to a general unenforceability of assumed contractual obligations, unassailable position of debtors vis-a-vis creditors, of majority shareholders vis-a-vis minority shareholders, and undervalued the destructive effect of poorly and slowly functioning independent courts.

- Even after some of the inadequacies in legislation of capital market regulation were removed starting in 1994-1995, the government did not manifest political will to supervise compliance with regulatory rules applicable to behaviour of the most important institutional owners - funds and investment management companies. Those in control of invetment management companies were allowed to abuse the existing contractual incompletenesses to their individual benefit and transform to their advantage collective investment vehicles(CIVs) without consent of the mass of their minority shareholders, to the detriment of their interests.[1] Many of the investment management company executives preferred short-term profit rather than long-term interest in developing the administered funds and companies. Certain variant was represented in the enterprise ownership by the alliances of funds sponsored by the large state controlled banks that have usually supported at least a reactive restructuring and viable enterprise development. A deeper restructuring was however impeded by their owners/creditors conflict of interest and they had no interest in external injections of additional equity capital.

The positive educational feature of the voucher privatization process for the wider public was undermined by the publicity given to a number of blatant cases of transgressions against minority shareholders. Specifically, the pro-market sentiment born in voucher privatization was undermined by government´s failure to regulate properly some opportunistic measures (such as transformation of investment funds into ordinary companies which were outside the protection of legislation dealing with sollective investment which limited transparency minority shareholders ownership rights open to abuse..

Economically, this contributed to a seriously biased corporate governance, the departure of many portfolio investors and a poor performance of Czech capital market limiting the possibility of restructuring for voucher privatized SOEs. Consolidation of shareholdings in this non-transparent environment attracted leverage takeovers by financially weak but well-connected players counting on short term speculative from re-selling. The transaction costs for enterprises significantly grew Before more stable ownership structure that might initiate capital injections from outside was achieved, enterprises faced significant transaction costs. The more stable ownership structures started to be dominated by the foreign, strategic shareholders.

We noted above that economic relationships typically have a co-operative game or prisoner´s dilemma characteristic: full co-operation maximizes the participants´ joint pay-off in the long-term ("repeated game") but "cheating"- i.e. exploiting any contractual incompleteness to one´s own advantage, remaining the dominant strategy in one-shot game.

On the example of foreign controlled companies we illustrated the hypothesis that firms which build a reputation for ethical collaboration over a long period are able to substitute co-operative outcomes for unsatisfactory cheating ones. These relationships - the internal and external "contractual architecture" of the firm undoubtedly happened to be the source of considerable competitive advantage. Furthermore, firms which have established such a reputation have established themselves as "islands of microeconomic institutional stability" and enjoyed an advantage in attracting new trading partners - whether as customers, suppliers, or employees - precisely because the latter knew that the former can be expected to maintain their reputations.

[1] Management companies´ control over the investment funds was on the basis of management contracts. To preclude the possibility of fund shareholders voting in a new board, which could then enter into a different management contract, owners of management companies acquired a portion of funds´shareholding. In view of the fact that funds´ shareholding structure was initially totally dispersed, the costs of acquiring a dominant voting bloc, and therefore a continuing control, was extremely low, at any rate until Motoinvest initiated a number of take-over battles for investment funds in 1996.

Hence, the ethical behaviour is not at all in conflict either with the principal-agent model or with stakeholder-agency theory. If ethical behaviour is the strategy that maximizes long-term profits, then shareholder-principals should encourage their manager-agents to practise it. The experience confirms that this behavioral structures based on the long term objectives were more often present in companies owned by long-term strategic investors..

Nevertheless the one-shot advantages based on legal imperfections (e.g. of capital market legislation for mandatory bid) can hardly be missed by rational foreign investors in spite of their long-term orientation.

Ethical temptations are always present in situations characteristic by unrepeatable opportunities such as privatization process based on incomplete contracts within imperfect institutional framework. Cheating based just on contract incompletenesses adopted as strategy leads to the outflow of needed capital from companies, undermines their restructuring and deepens their indebtedness. Economic recession would then result in the bursting of holding company structures, with serious economic losses. As we have already mentioned, in historical situations of that type there is an acute need of governmental activities to speed up institutional changes that would clarify rules and sanction the unacceptable behaviour of managers and owners. L von Mises saw the basic institutional characteristic of market economy in the fact that "the owner himself is liable, as it is just him at first, who absorbs the damage caused by mismanagement of enterprise". This aspect should be taken into account both in the long run (amended bankruptcy law) and in the short run (revitalization programs).

Our conclusions also suggest that government should enter into (well-defined) privatization contracts, preferably with serious foreign investors whose influence leads to a more wide-spread adoption of more responsible corporate governance and corporate behaviour in the economy.

The neglect of microeconomic foundations and institutional changes should be never repeated.

Many hidden and unsolved problems had already accumulated in the meantime. Pension scheme was left intact and the restructuring steps such as early retirements contribute to its gradual collapse. Restructuring problems of workout of sizable bad debt (25% of GDP) concentrated in state-owned Konsolidacni banka have secondary effects.

Besides the already implemented managed floating of Czech koruna that provided a kick off depreciatory stimulus (short-lived, due to the subsequent interest rate differential), many institutional changes have been discussed and adopted by the parliament.

New, less imperfect, capital market regulation was foremost among them. Since April 1998, the inefficient government capital market supervision by the Ministry of Finance had been replaced by independent regulatory Commission. that might be complemented step by step by self regulated organization of market players that had already initiated first self imposed regulation based on fragments of future binding code of conduct. Amended Business code and Security Act adopted by Parliament in September 2000 reshaped the intitutional environment further.

The adopted decision on rapid privatization of remaining government controlled banks into the hands of serious foreign investors follows the path of recommendations.

Nevertheless, ahead of the parliament and government that were born in June 1998 election, there is still a long way on the road to implementing and perfecting new laws along the line of EU´s "acqui communitaire". .

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