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## **Economic Transition Phase II: Private Sector Development**

**Richard E. Stern**

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## **Abstract**

This paper studies private sector development in transition economies. To address this issue, many economist have focused on the issue of privatization, assuming that privatization is a proxy for private sector development. But as the experience of countries such as Poland has revealed, privatization, though important, is only part of the story. This paper takes a more comprehensive approach and considers the development of the private sector as the nexus of a policy agenda establishing a solid legal and institutional framework and promotes both privatization and the growth of capital markets. Though the analysis focuses on a handful of countries, the main conclusions are applicable to other countries in transition.

## **Keywords**

Economic development, economic growth, economywide country studies

## **JEL-Classifications**

O11, O4, O57

#### **Comments**

The ideas expressed in this paper are the solely those of the author and in no way reflect the ideas and view of the International Monetary Fund..

## Introduction

This paper studies private sector development in transition economies. To address this issue, many economists have focused on the issue of privatization, assuming that privatization is a proxy for private sector development. But as the experience of countries such as Poland has revealed, privatization, though important, is only part of the story. This paper takes a more comprehensive approach and considers the development of the private sector as the nexus of a policy agenda which establishes a solid legal and institutional framework and promotes both privatization and growth of capital markets. It is argued that obstacles to private sector growth stem from inadequate legal and institutional frameworks and from barriers to the development of capital markets. Though the analysis focuses on a handful of countries, the main conclusions might be applicable to other countries in transition as well. The remainder of the paper is organized as follows: the next section presents methodological issues, the second section details the progress in private sector development, the third section sets out a framework for studying private sector development, the fourth section briefly presents cross-country experiences, the fifth section discusses the way in which programs can be designed to eliminate obstacles to private sector development, and the final section offers some conclusions.

## I. Methodological Issues: Definitions and Measurement Biases

A first issue to be addressed is why attention should be paid to the development of the private sector. It is clear that the development of the private sector in itself is not a sufficient condition for high levels of economic growth. Rather, private sector development is interpreted as an "index" of the progress made in a transition economy from central planning to market-driven allocation of resources. It is argued below that the development of the private sector depends on the development of strong legal and institutional frameworks as well as the continued widening and deepening of capital markets. Both of these conditions are signs of strong progress in transition. Thus, private sector development can be interpreted as a proxy measurement of the transition process.

A fundamental issue facing the study of private sector development is determining what is private and what is not. This issue has both micro- (firm level) and macroeconomic (aggregate) dimensions. At the micro level, for example, is a firm that has gone through the privatization process and only 30 percent of assets have been transferred to private hands considered private or still in the state sector? From a political standpoint, this firm may be called private by the government (perhaps to fulfill privatization quantity targets), though effective control is still in the hands of the state. At the macro level there is the additional

problem is that countries might define the private sector differently. Most countries consider the private sector the "non-state" sector. But state-owned enterprises might be considered non-state, thus over-estimating the extent of private sector development. Thus, even with strict guidelines defining what is private and what is not, the measurements, especially at the macro level, are imprecise at best. For the purposes of this paper, the private sector is defined as the "non-state sector"; thus firms whose assets have been even partially divested by the state are considered private.

The two most common measures of private sector development are total output by the private sector as a proportion of GDP and employment in the private sector as a percentage of total employment. Both of these measures are imperfect. As regards the output/GDP measure, at the macro level it is commonly accepted that official statistics in transition economies do not fully capture private sector activity. Much of the activity is hidden to avoid taxation. Thus it is reasonable to assume that the actual level of private sector-generated output is actually higher than reported. At the same time, private sector development measured by output contribution magnifies the importance of private sector development in general. In most transition economies, the source of private sector development is primarily the entry of new, small businesses--predominately in the service sector (such as catering and tourism) as well as small-scale retail trade. In the data, it might appear that private sector development is large because the growth of small sized businesses measured as a percentage of GDP is magnified by the simultaneous sectoral output declines in manufactured goods, industrial production in general, and agriculture both in terms of volume and employment since. Thus, the data are biased upwards due to rise of small firms, and not necessarily due to private sector control of traditionally large sectors (large as a percentage of GDP) such as heavy industry and manufacturing.

The employment measure also has its biases. First, this measurement might understate the true private sector contribution to the economy because in most cases, a private firm would use less labor than its state-owned counterpart, such that the number of workers may be low but total output may be high. Thus the greater efficiency of the private sector (in theory) suggests a lower number of workers (i.e., productivity of labor is higher in the private sector) than in a comparable state sector firm. The other problem is again under-reporting. To avoid social contributions (on the firm side) and income tax (on the worker side), a worker's labor may go unreported and therefore the total number of workers employed in the private sector might be understated.



## II. Theoretical Design

This study identifies four factors which are necessary but not sufficient individually to generate private sector development.<sup>1</sup> These are:

1. institutional foundations to create the environment conducive to private sector development;
2. privatization;
3. the development of domestic capital markets either before or in parallel with private sector development;
4. the availability of capital (domestic or foreign);

To date, many countries in transition (CITs) have not fully implemented all of these "pillars" of private sector development simultaneously and as a result, there have been formidable constraints in the ability of the private sector to grow. In many cases, economic policy has explicitly impeded or prevented the development of at least one of these foundations. In the cases where the impediments have been removed eventually, valuable time has been lost and private sector development was substantially inhibited.

At the same time, it is clear from cross country analysis that there is not an optimal order of sequencing of these factors. Many countries (such as the Czech Republic and Russia) chose to begin economic reform with privatization as the center piece, whereas others (Poland, Estonia, and Latvia) chose to set up the institutional foundations first before privatization. All countries have found that the shortage of capital (domestic and foreign), either due to credit constraints or to insufficient financial market depth and breadth is perhaps the most binding constraint on private sector development.

### 1. Institutional Environment Conducive to Private Sector Development

The foundations of private sector development is made up of a strong, transparent, and consistent set of laws and institutions which allow newly privatized firms to enter and exit markets. Not only does this necessary condition require the adoption of laws and commercial code, but it also requires that the legal framework be implemented in practice. Many countries such as Latvia have adopted the necessary legal infrastructure (though with shortcomings) but have been slow in implementation, resulting in commensurately slow private sector development and low levels of foreign direct investment.

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<sup>1</sup>The above factors assume that macroeconomic foundations (price liberalization and stabilization that followed the freeing of prices) are already in place.

At a minimum, CITs need:

- a set of laws governing the incorporation of firms;
- a transparent commercial code;
- a competition policy and institutions dealing with competition;
- a consistent set of laws governing all aspects of privatization;
- a set of laws governing land reform and ownership;
- clear bankruptcy legislation;
- laws defining the legal rights of foreign participants in the domestic market;
- laws governing foreign investment.

Technically, these frameworks form the foundations for private sector development for a government to enact. Some of these laws are politically contentious, especially those involving the rights of foreign investors and bankruptcy laws. Thus, adoption of these laws is sometimes difficult.

More difficult is the implementation of the laws, especially the laws on bankruptcy and insolvency. Though most CITs have now adopted the entire set of legal and institutional foundations, very few have initiated bankruptcy proceedings. The lack of implementation especially of bankruptcy laws puts new firms at a disadvantage to privatized firms because privatized firms face a softer budget constraint than their start-up competitors.

## 2. Privatization

### a. Background

Privatization is conventionally viewed as the kernel of private sector development because it is the divestment of assets formerly held by the state. Its importance is magnified by the fact that the act of privatization reduces the liabilities to the state and thus (in theory) reduces the budgetary burden on the state (in terms of reducing the level of state credits and subsidies to enterprises). In practice, however, many countries are finding that privatization does not in itself necessarily provide the catalyst for private sector development. At the same time, newly privatized enterprises cannot work efficiently in markets which allow for distortions due to an insufficient legal framework. Thus, privatization is perhaps a necessary but by no means sufficient condition for private sector development.

The goals of privatization are clear: privatization of state assets in transition economies aims to facilitate the creation of a market economy based on private ownership with a reduction in state intervention in the market. Equally as important, however, is the *process* of privatization. That is, the privatization process can also be the catalyst for financial market

development (with the appropriate supporting policies and institutional structures--i.e., the other three pillars). Through "corporatization", the division of assets into shares which ultimately can be traded as securities, privatization can become one vehicle through which equity markets can be established. Thus, the process of privatization can contribute to financial deepening and widening. Finally, privatization is one means through which economic restructuring can take place, especially if ownership is concentrated such that effective corporate governance and external monitoring can take place.<sup>2</sup>

## **b. Overview of the privatization process and differences between programs**

Both the goals and the process of privatization have been studied extensively in literature, ranging from "how to" manuals<sup>3</sup> to comparisons of the efficacy of privatization methods<sup>4</sup>. The literature tends to focus more on the process of privatization instead of its effects on private sector growth. In many cases, the literature uses the percent of assets transferred from state to private hands as the unit of measurement instead of assessing the contribution to output made by privatized firms.<sup>5</sup> The other main shortcoming in the literature is the cursory treatment of the necessary linkage between privatization, private sector development, and capital market development and access.

Privatization is usually divided into small and large scale programs; the size of the assets or the labor force, the method of asset transfer, and the type of asset are the criteria for determining in which program an asset will be privatized. Small-scale privatization in most countries have been carried out through direct sale of assets or restitution. This method of privatization proved to be fast and effective. Given both the high level of popular support for small-scale privatization<sup>6</sup> and the relatively straight-forward nature of the process, most countries carried out small-scale privatization in the early stages of economic transition and the resulting privatized units (mostly stores, restaurants, small businesses, and service-oriented enterprises) began to operate quickly.<sup>7</sup> Much of the growth of the private sector in the early years of transition (1991-1993) can be attributed to small-scale privatization. At the same time, much of the "informal sector", i.e., the economic activity that is not recorded but assumed to contribute to GDP, comes from small privatized or semi-privatized firms.<sup>8</sup> Thus the experience of small-scale privatization appears to be uniform across countries in transition.

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<sup>2</sup>See EBRD (1995), p. 18 for a more detailed discussion of the effects of privatization on the process of restructuring.

<sup>3</sup>See for example Ceska, Charap, and Stern (1993) which deals with small-scale privatization.

<sup>4</sup>See, for example Lieberman et al. (1995) or the Frydman, Rapaczynski, and Earle series of studies (1993, 1994).

<sup>5</sup>These measurements might be chosen for lack of sufficient data.

<sup>6</sup>Excluding privatization of agriculture which remains a contentious issue in some transition countries.

<sup>7</sup>EBRD (1995), *op. cit.* p. 16.

<sup>8</sup>The EBRD estimates that 10 percent-25 percent of GDP is made up of informal activity by small firms, many of which were created through privatization.

Large-scale privatization, on the other hand, differs greatly across countries in transition in terms of scope, process, pace, timing, and perceived result, though the goal to transfer state-held assets to private ownership through mass participation is shared by most transition economies. Most countries have implemented some variation of the model in which firms are corporatized and then sold for either vouchers (which are distributed for a nominal fee) or cash. At the same time, it is the differences in the program design and execution that impact the development of the private sector in general. Some of the differences between the programs include:

- scope of privatization (i.e., who can participate and which assets are included in the program);
- regulations governing voucher use and ownership;
- speed of implementation of the mass privatization program;
- methods of asset transfer.

The scope of privatization is the most important aspect of privatization. First, which assets are included in which program is extremely important. Many countries (notably, the Czech Republic) exclude the most profitable and highest profile firms from the mass privatization program, selling the assets directly after identifying a strategic investor or by not privatizing it at all. Governments claim that these exclusions are done to ensure that the enterprises' future is secured through the identification of a strategic investor (often times a foreign investor) and such restructuring happens quickly to prevent or minimize output loss. For example, firms such as the Czech car company, Skoda, were sold outside the large scale privatization process to Volkswagen and Latvijas Gaze (the Latvia Gas Company), part of which is in the process of being sold to strategic. Critics claim that what is left in privatization programs consist of firms which are either insolvent or need substantial restructuring to survive. Though there is merit to this claim, it need not necessarily be true across all countries. In general, countries tend to sequester the most economically and politically important firms out of the general privatization process, but leave enterprises of varying degrees of solvency and viability in the program.

Who can participate in privatization is also extremely important. Many countries have chosen to keep foreign investors out of the process of privatization at least initially (Latvia and the Czech Republic through explicit means, and Russia indirectly through its policies--see below) in order to "protect" national interests and to prevent a "fire sale" of viable assets to Western investors.<sup>9</sup> One effective means for limiting foreign participation is by prohibiting foreign investors from buying vouchers while requiring that at least 50 percent of asset purchases be made in vouchers. As many countries in transition (CITs) have discovered, excluding foreign

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<sup>9</sup>See Stern (1996b) for a more detailed study of host country impediments to FDI. This subject will also be treated more completely below.

investors from the privatization limits both the success of privatizing firms as well as eliminates an important source of capital used for investment and restructuring.

The speed of implementation of privatization appears to affect its outcome. That is, the faster the transfer of assets, the faster the process of restructuring begins, and the more credible the government's program. Programs such as Russia's and the Czech Republic's, which were designed and implemented quickly appear to have been successful. At the same time fast implementation of programs (such as Russia's) has drawn a lot of criticism because it is seen as trading off efficiency for equity.

Most large-scale privatization programs involve auctions to transfer assets. Programs differ in terms of who (citizens, foreign residents, or foreigners) can participate and whether the auctions are international or domestic tenders. Again, in economically and politically sensitive cases (energy companies, telecommunications, strategic export enterprises, etc.), governments prefer to sell the assets on a case-by-case basis.

### **3. Linkage Between Privatization and Capital Market Development**

The degrees of linkage between the privatization process and financial market development vary considerably between those that have consciously linked privatization programs to the development of financial market (the Czech Republic and Poland) to those which have not linked privatization to financial market development (Latvia), to those which have begun to link the two (Russia and Estonia).

The connection between the financial deepening and widening and privatization has worked in three different directions: trading of shares of enterprises on primary and secondary securities markets, creation of privatization funds (which act as mutual funds), and involvement of banks. Most mass privatization programs began with corporatization of firms as a first step toward selling off the assets. In some cases, such as the former Czechoslovakia, the government seized the opportunity to combine the transfer of shares with the development of the securities market, such that privatized firms could sell shares in equity markets. The equity based system would allow for anonymous trading, continual market valuation of assets, diffused ownership (which could minimize risk), and the ability to raise external capital.<sup>10</sup> Thus the securities market would be "jump started" by a core of newly privatized firms, providing the foundation for expansion of the market by new firms.

A second important link between privatization and financial market development has been through the creation of investment funds. These funds act as mutual funds and brokerage houses. In most cases, voucher holders can deposit vouchers in a fund in exchange for

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<sup>10</sup>Refer to Stern (1994) and Stiglitz (1991) for discussion of equity-based financial markets and economic development.

shares of the fund. In some countries the funds themselves can raise capital by selling shares on the securities market. Funds in turn buy shares of privatized firms. Despite the fact that most countries have restrictions on the percentage ownership any one fund can hold in a given firm (20 percent in the Czech Republic, for example), funds have been able to gain controlling shares of firms either directly or through partnership with banks or other funds.<sup>11</sup> The net result is that funds have become an important part in enterprise restructuring, as well as a concentrated source of funds for investment. Countries in which funds have operated as a part of privatization experience have had faster private sector growth (the Czech Republic and Poland).

Finally, the inclusion of banks in the privatization process (as in Poland) has also helped link the privatization process to financial market development. Banks have been involved in debt-for-equity swaps of firms being privatized as well as participating directly in privatization through ownership of investment funds.

#### **4. Availability of capital**

The limited availability of capital is perhaps the most binding constraint on the private sector. The ability to secure capital for restructuring or investment remains low. On the domestic side, the banking sector in most CITs remains unable to provide investment capital to firms due to excessively high interest rates in some cases, or in most cases, due to the fact that few firms have either the collateral or a long enough history to satisfy bank lending requirements.<sup>12</sup> Newly privatized firms tend to face the collateral problem and new start-up firms face both problems.

There is a rich theoretical literature discussing the impact of the availability of capital on the development of markets and on economic growth.<sup>13</sup> The literature demonstrates that the growth of an economy hinges on market entry of new firms that exhibit increasing returns to scale production processes (which in practice translates into high-technological content).

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<sup>11</sup>The literature on corporate governance argues for concentrated ownership as opposed to diffused ownership because it lowers the costs of monitoring and thus the restructuring process becomes more efficient. See Diamond (1984) for a rigorous proof of the above proposition.

<sup>12</sup>See EBRD (1995), chapter 6 for an thorough discussion of the impediments to investment in transition economies.

<sup>13</sup>Much of the availability of capital literature is related to the Anew growth literature" and shows that capital in the firms' production functions exhibits increasing returns to scale behavior. The greater the access to capital, the greater the level of output at the firm level. Thus, at the macro level, even a small increase in the level of capital should produce a large aggregate output effect. (see Dornbusch and Renoso (1989), Fazzari, Hubbard, and Peterson (1988), Fry (1982), Gertler (1988), Gertler, Hubbard, and Kashyap (1988)), for examples of these models). Other work (Murphy, Schleifer, and Vishny (1989) and Stern (1992)) look at agglomeration effects of capital. That is, in order for economic development to "take off", there is a threshold level of capital that needs to be reached (most easily through financial deepening and widening). When enough firms have access to capital, economic development accelerates due to increasing returns to capital. Foreign capital is a catalyst to this process because especially with direct investment, foreign capital combines human capital with physical capital and thus there is more "bang for the buck".

Since the main constraint on the ability of new firms to be created is capital, it is imperative for capital markets to develop at a minimum simultaneously with the creation or augmentation of new sectors and preferably ahead of firm creation and preferably be in place as rapid entry of new firms begins. Additionally, each economy has a specific "threshold" of capital market development which must be reached before economic growth takes off. Adapted to CITS, the literature implies that capital market development is a necessary condition for private sector development and that capital markets need to be deepened and widened simultaneously with privatization and new firm creation in order to create the economic environment for sector and aggregate growth.

Transition economies where privatization is linked with financial sector development--especially those with a investment funds as the catalyst for both the growth of the securities market and for restructuring (and solid corporate governance)-- experience less of a shortage of credit (relatively) with firms undergoing privatization. The main reason is that firms whose majority share is held by a fund tend to have access to bank lending (as many funds are linked to or directly own by banks). In addition, many of these firms (especially in the Czech Republic) are also traded on the securities market.

Foreign direct investment (FDI) is a possible means to mitigate the capital shortage problem, but few countries have actively encouraged FDI. FDI is critical to private sector development because it allows the flow of both physical and human capital into a country with little adverse impact on the trade balance. FDI deployed in the export sector has a second order effect of creating new export markets.<sup>14</sup> Additionally, there is a growing evidence that FDI acts to "prime the pump" on domestic investment as a spillover effect.<sup>15</sup>

Most countries have FDI legislation on the books, but few have either harmonized their other institutional factors and legal codes to allow for foreign participation in domestic markets or have removed administrative barriers to FDI. Non-tangible barriers, such as a complex approval process as in Russia has deterred many foreign investors.<sup>16</sup>

Privatization is perhaps the most logical route through which FDI can enter a host country. Estonia and Poland are good examples of countries which actively encourage foreign investors to participate in privatization while simultaneously stimulating FDI into new ventures. Russia opened up privatization to foreigners in legal terms but has made it difficult for firms to actually participate in the process. In the spring of 1996, Latvia began to allow

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<sup>14</sup>Stern (1996b) argues that FDI into the export sector doubly benefits the host country because the foreign investor is likely to have established markets in his/her home country or region. Thus, in addition to the transfer of human and physical technology, a host country firm might have access to a foreign market that otherwise might be closed.

<sup>15</sup>See EBRD (1993), chapter 4.3.

<sup>16</sup>See Stern (1996a) in the case of FDI into Russia, and Lankes and Venables (1996), section 3 for a more general discussion.

foreign participation in most sectors, both in the context of privatization and in the creation of new firms, except for those firms economically and politically sensitive such as wood processing (one of Latvia's largest exports).

### **III. Cross-Country Comparisons of Private Sector Development**

This section briefly surveys the experience of private sector development in selected countries in transition. The small sample was chosen to cover the range of countries which have the longest history and which represent different starting points from the perspective of transition. The countries include: the Czech Republic, Poland, Russia, Estonia, and Latvia. In addition, each of these countries pursued different overall strategies with respect to private sector development.

Due to the differences in approach toward private sector development, each country studied has had varied degrees of success in creating a dynamic private sector. Table 1 presents an overview of the results to date in each country.

#### **1. The Czech Republic<sup>17</sup>**

##### **a. Background**

The Czech Republic began transition immediately after its separation from the Eastern Bloc in 1989. It is clear that the geographical location of the Czech Republic (as an EU border country with Germany and Austria) gives the Czech Republic a distinct advantage over its eastern neighbors--especially in the area of FDI. But it is argued here that the linkages between the four pillars have been the major catalyst of private sector development. The main focus of the program was on privatization, and the foundation of private sector development was based on both the process of privatization and the outcome. Most of the legal infrastructure was adopted during the first two years of transition (1990-1992) such that the basic framework was in place before or at the beginning of the privatization process.<sup>18</sup> As with other CITs, bankruptcy legislation was the last to be adopted (April 1993) and has not been used extensively.

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<sup>17</sup> Descriptions of events that took place before January 1993 refer to Czechoslovakia. Thereafter, they pertain to the Czech Republic. Unless otherwise noted, data refer to the Czech Republic itself as does cumulative data.

<sup>18</sup> Basic legal framework is defined as commercial codes, competition laws, basic laws governing domestic investment, privatization laws, restitution laws, laws governing FDI, tax codes, and bankruptcy laws. It should be noted that most countries adopted bankruptcy laws late in the process of legal reform. The Czech Republic adopted its bankruptcy law in 1993, two years after privatization began.



The process of large-scale privatization occurred rapidly. The voucher-based system was divided into two "waves", the first from 1992 to 1993 and the second from 1994 to 1995. The key to the success of the Czech program was the participation of investment privatization funds (IPFs). These funds, which began to appear in the Fall of 1991 added dynamism to the privatization program. The biggest funds (by value of assets) are privately-owned and associated with either a bank or an insurance company.<sup>19</sup>

Initially, FDI was encouraged through incentive programs (most of which ended in December 1993) but not directly allowed in privatization until mid-1993.<sup>20</sup> Thus in 1993, privatization was opened up to foreign investors, and in 1995 the National Property Fund retained the shares of selected enterprises for the sole purpose of finding a foreign owner. Most of these firms required large infusions of physical and human capital (the telecommunications system and a petrochemical firm, for example) and in some cases foreign investment was preferable to domestic investment. Property ownership by foreigners is only allowed if the foreign entity sets up a Czech-registered business (this constraint is not considered by investors to be a deterrent to FDI).

A second goal of the privatization program was to facilitate the development of the capital market. When the IPFs began to buy vouchers rapidly, the Government implicitly encouraged IPFs by not interfering in their activities initially and allowed them to proliferate. In addition, the Prague Stock Exchange was set up in 1992, and is the most liquid and dynamic stock exchange in Eastern Europe.<sup>21</sup> IPFs have become the catalyst for equity trades on the Exchange.

On the banking side, the Czech Republic has moved quickly to privatize banks, recapitalize them, and remove bad loans from the books. To this end, a Consolidation Bank was set up in 1991 as a means of trading bad loans for bonds. The success of this scheme is mixed. The level of bad loans to total loans is 25 percent, despite the program to eliminate them. At the same time, many new banks are solvent. Despite the solvency of the banking system, credit creation remains low. As in other CITs, potential borrowers lack adequate collateral to secure loans.

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<sup>19</sup>In fact, over 50 percent of all assets in the privatization program are held by the top 6 funds, 5 of which are associated with a bank or insurance company. Data from Stern (1994).

<sup>20</sup>The Government initially believed that prohibiting FDI in privatization would give Czech nationals the first chance to acquire domestic assets. But the advent of IPFs (some of which were foreign-owned) made this prohibition difficult to enforce.

<sup>21</sup>Though small by American standards, total capitalization of the Prague Stock Exchange is approximately 50 percent of GDP.

## **b. Results of private sector development in the Czech Republic**

The dynamism of the private sector growth in the Czech Republic is reflected in the results of privatization. By the end of the second wave of privatization, approximately 95 percent of all large enterprises were sold. Out of the total number of voucher points available, 72 percent (out of 6.1 billion points) ended up in the hands of IPFs, the 10 largest IPFs gained control of over 51 percent of the investment points.<sup>22</sup>

The involvement of IPFs was the key to the success of privatization and to the development of the financial market. First, IPFs concentrated ownership of firms which has both accelerated the process of enterprise restructuring and, due to their ties to financial intermediators, have been the source of fresh capital.<sup>23</sup> IPFs have been the major players on the Prague Stock Exchange both in trading shares of companies and trading their own shares. In addition, IPFs have been the recipients of foreign capital which has provided a new source of capital for restructuring firms in their portfolios. Finally, IPFs have provided an instrument for hedging risk, in the same way mutual funds diversify risk in Western economies.

Given the financial width and depth of the growing Czech financial market, foreign investors are attracted to the Czech Republic. Though the level of FDI is not as large as was envisaged before transition, the cumulative FDI stock was over US\$3 billion in mid-1995, making the Czech Republic one of the largest recipients of FDI in CITs in levels and the second in the region in per capita terms behind Estonia.

Thus, the private sector in the Czech Republic growing quickly because the legal infrastructure was in place early in the transition process, privatization moved quickly and efficiently through the voucher system, and perhaps most importantly, privatization was linked to the development of the financial market. This linkage has proved to be important because it has set up the foundations for the securities market and has simultaneously expanded possibilities for both (foreign) portfolio and direct investment.

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<sup>22</sup>Data source: Lastovicka and Mejstrik (1995).

<sup>23</sup>It should be noted that the Government has restricted the total amount of holdings in one firm to 20 percent. Most IPFs are themselves owned by financial intermediators or by a consortium of intermediators. Thus IPFs have found ways around this restriction by either teaming up with other funds or by pooling enterprise shares with their parent companies that are also allowed to own up to 20 percent of a firm's shares.

## 2. Poland

### a. Background

Poland's route to private sector development has been a very different one from that of Czech Republic. Unlike other CITs, Poland began transition with about 1/3 of total production stemming from the private sector. Most of the private sector output was in agriculture, which was not nationalized during central planning. The EBRD estimates that 60 percent of GDP is produced by the private sector and of that, approximately 80 percent is produced by new enterprises. The key to the rapid growth of the private sector has been due to the creation of new enterprises, while the privatization process has been stop and go. Relative to other CITs, privatization has moved slowly, with only 50 percent of large-scale privatization completed as of 1995.

Poland's legal framework for all areas of private sector development was essentially in place by 1993. Laws such as the commercial code and bankruptcy were adapted from pre-World War II legal codes. Due to the existence of a skeletal legal system, the institutional framework for private sector development was basically functioning by 1990. The advantage of having a legal framework in place early in the process (relative to other CITs) was that both domestic and foreign investment began to flow in quickly.

Large-scale privatization has moved slowly, mostly due to political reasons (i.e., with each successive change in government, the program has been modified, necessitating additional parliamentary approval). Voucher privatization was delayed until 1995. Enterprises can be privatized either through liquidation and direct sale of assets or via commercialization (dividing the firm into shares) and sale through the voucher system.

The voucher/mass privatization scheme included the creation of investment funds; these (initially 15) funds were set up by the government and then turned over to foreign and domestic fund managers. Unlike the Czech funds, the Polish funds are closely regulated by the government. Specifically, the government controls the number of funds allowed to participate in privatization and allocates corporatized firms to each fund instead of allowing the funds to bid competitively for enterprise shares. Once an enterprise is assigned to a fund, the fund has full control over the shares.

Like the Czech program, funds play a role in linking the privatization program with the development of the financial market. The Warsaw Stock Exchange (WSE) was re-inaugurated in 1991. The number of firms listed had grown to 44 by mid-1995, due to the advent of investment funds, the increased number of commercialized firms, and mostly due to the entry of new firms. Capitalization of the WSE has grown from 2 percent of GDP in 1991 to over 12 percent in 1995.

The legal and economic environment for foreign investment into Poland is extremely favorable. Foreign investors are accorded national treatment, and in some cases (as in privatization), there are special incentives. Property ownership is allowed with the approval of the Ministry of the Interior for all investments above 50 percent of the total share.

The banking sector has been privatized and the Government has implemented a strong set of prudential regulations. Poland has moved forward on the recapitalization of banks since 1993. There is significant foreign participation in bank restructuring in Poland, which should accelerate the process of improving the solvency of the system. Other intermediaries are being created, such as the entry of 40 new insurance companies--11 of which are foreign-owned, which is facilitating financial deepening.

#### **b. Results of private sector development in Poland**

Poland is the regional leader in the number and rate of new firm growth. EBRD estimates that the rate of growth of new firms (of all sizes) has averaged 20 percent per year since 1991. Though many of these enterprises are small and in the service sector, there are new large enterprises as well. Many of the large enterprises are wholly or partially owned by foreigners. FDI in Poland remains high (estimated to be around US\$2 billion in mid-1996).<sup>24</sup> Research done on FDI into Poland reveals that the number of investments is high, capitalization per investment is low, and that the source of investment stems mainly from the Polish diaspora.<sup>25</sup> Despite the size of investments, it appears that FDI is a catalyst for private sector development based on the connection between sectors which receive FDI and the level of private sector contribution to total sectoral output.<sup>26</sup>

Financial sector development in Poland has been rapid as well at least at the institutional level. In addition to the growth of the securities market, financial intermediaries (insurance companies and mutual funds not directly related to the initial 15 privatization funds, for example) are entering the capital market. The banking system is becoming stronger. However the growth of private sector credit remains small, as banks are hesitant to lend to new enterprises despite excess demand. But FDI appears to be alleviating this constraint to some degree by providing some start-up capital.

Poland's private sector development has focused on the creation of market conditions conducive to new firm entry, which includes an emphasis on financial widening and deepening. The strategy appears to be paying off, as the relative share of state-owned

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<sup>24</sup>Estimate from the UN Economic Commission for Europe. Results of FDI through the first half of 1996 in all CITs will be published by the UN-ECE in late November, 1996.

<sup>25</sup>For example, see Matija Rojec, Patrick Artsien, John Dunning, Maria Illes, Wlasyław Jermakowicz, Marjan Svelicic, and Alena Zemplerova (1995), *Foreign Direct Investment and Privatization in Central and Eastern Europe*. Ace Project 92-0108-R.

<sup>26</sup>See Stern (1996b).

enterprises to total output continues to fall rapidly. Also, the focus on financial market development early in the transition process should facilitate rapid growth in the long run.

### **3. Russia**

Private sector development in Russia appears to be moving quickly, due to the rapid and extensive privatization program. EBRD estimates that the private sector accounted for 55 percent of output at the end of 1995. At the same time, data measuring the contribution of the private sector output to GDP is perhaps more unreliable than in other countries. First, Russia's definition of what is actually private is not clear. Russia measures private sector activity as anything not wholly state-owned; thus, firms which are partially owned by the state are counted as private, even if they continue to be run by the state. Second, the level of private sector activity which goes unreported in Russia is notoriously high (the same may be true in other countries as well). Thus these two conflicting caveats to measuring private sector suggest that the data should be used with caution.

#### **a. Background**

Of all the countries considered in this study, private sector development in Russia faces the most formidable constraints. Unlike the other CITs, Russia began transition after 75 years of central planning; thus, unlike the other countries in this study, few if any Russians ever lived in a market economy. Given this fact, Russia had to completely redesign its legal system to create an environment conducive to private sector development. It is also evident that the political turmoil since independence has impeded the adoption of new laws. The slow process of legal reform has led to problems of inconsistency. That is, in some cases (such as in the areas of competition and bankruptcy law), old Soviet-era codes were in place alongside new market-oriented laws. The existence of conflicting laws has led to confusion on the part of entrepreneurs, especially because they do not know which laws are enforceable and which are not.<sup>27</sup> As of 1996, most of the legal structure is in place and the inconsistencies between laws has been eliminated. But it is clear that the long period of confusion has been a constraint on entrepreneurial activity.

On the other hand, privatization has moved extremely quickly in contrast to the development of the legal infrastructure. The two waves of mass, voucher-based privatization (1993-1994, 1995-1996) have transferred close to 95 percent of all assets in Russia off of the States' books. The actual process was heavily biased toward worker/manager buyouts. In some cases this system eliminated the need to find buyers for firms and thus allowed the program to move quickly. There has been much criticism over the program, mainly because it appears

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<sup>27</sup>Foreign investors in particular are sensitive to lack of transparency. Investor surveys cite this uncertainty as a leading deterrent to FDI in general. See Stern (1996a), part III for a detailed discussion of deterrents to FDI into Russia.

to have resulted in a divestiture of state assets without effectively changing the structure of the firms. Thus the process of privatization does not in itself move firms toward restructuring by linking the new owners with sources of capital as it does in both the Czech and Polish cases.

Investment funds play a role in the privatization, though much smaller than in the Czech Republic and Poland. EBRD estimates that 29 percent of privatized assets are controlled by the funds, compared to 60 percent of shares are controlled by the workers and managers of the firms privatized, and the remaining 11 percent is owned by the State.

Investment funds have traded shares of their portfolios as well as their own shares on the various equity markets that have been created in Russia, thus providing a link between privatization and financial market development. Most of the trading is done over the counter, instead of in the 70 major exchanges. Both Russian and foreign investors are permitted to trade and fast growing equities and bond markets have attracted many domestic and international funds to enter the market. As a result, market capitalization has increased to over US\$22 billion in 1995. The majority of trading has been in Government T-Bills.

Despite the strong impediments to investment in general in Russia, foreign portfolio and direct investment do flow into Russia, though admittedly at a much lower rate than was envisaged at the beginning of the transition process.<sup>28</sup> The presence of foreign portfolio capital has resulted in the growth of non-bank financial instruments such as international hedge funds and investment funds and insurance companies. However, these new instruments are small in terms of capitalization thus far. For the most part, FDI has been into the service and consumer goods sector.

Despite the proliferation of the equities market, the banking system remains fragile. As a result of the 1995 banking crisis, stronger prudential regulations were imposed on banks. The Government expects that the adoption of stricter regulations such as minimum capital levels will curb speculative behavior, reduce the number of operative banks, and encourage lending to the private sector.

#### **b. Results of private sector development in Russia**

Russia's growing private sector has been impeded by slow adoption of a legal infrastructure, lack of political will by the Government, and difficulties in dismantling the centrally planned system in a country where private sector activity had officially ceased to exist for 75 years. Despite these constraints, the private sector has still grown since 1991. The rapid growth of

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<sup>28</sup>Cumulatively, the Russian Ministry of Finance reports that FDI has reached about US\$3 billion by the end of 1995, but *ex ante* expectations were that Russia would receive at least 1 billion of new investment a year. The actual growth rate of FDI into Russia has fallen, as have the inflow levels since 1994.

private sector activity in Russia is attributed to the privatization program. About 80 percent of the labor force worked in privatized enterprises by the end of 1994. The rest of privatization was stalled due to political reasons and was resumed in late 1995.

The linkage between privatization and the development of the financial market in Russia has been strong, as evidenced by the rapidly growing equities and bond markets. Both the funds and the involvement of foreign intermediaries (mainly investment houses) have helped to widen (though not deepen) the capital market.

Due to the fact that the banking sector has been more focused on speculative investments than private sector lending, it is not surprising that credit to the private sector has not grown very quickly.<sup>29</sup> The lack of domestic capital generation underscores the need for more foreign investment.

FDI remains low as measured on a per capita basis (US\$11 per capita) and the level is low (cumulative stock: US\$3 billion, compared to US\$2 billion in the Czech Republic and about US\$8 billion as of mid-1995 in Hungary)<sup>30</sup> given the size and diversity of the Russian economy. These low levels of investment are attributable to a large extent to the political and economic uncertainty.

## **4. Estonia**

Private sector development in Estonia has taken place at a rapid pace. Though EBRD estimated the private sector contribution to GDP at 65 percent in 1995, it is likely that figure understates the true level. Estonia's rapid growth of private sector stems from the simultaneous development of institutional infrastructure, privatization, financial deepening and widening, and encouragement of FDI.

### **a. Background<sup>31</sup>**

Unlike the other CITs, Estonia concentrated its early legal and institutional reform efforts on creating a hospitable environment for foreign investment. To that end, the government accorded foreign investors national treatment immediately after independence. Most of legal infrastructure governing commercial activity and banking reform was adopted in 1993. It is interesting to note that bankruptcy reform was implemented in late 1992, before the adoption

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<sup>29</sup>EBRD estimates that pure private sector development in Russia has grown from 14 percent to 25 percent of total GDP (1992-1994) and the non-State sector has grown from 25 percent-62 percent over the same period. EBRD distinguishes these two measures to clarify the difference between Russia's definition and its own.

<sup>30</sup>Data from Stern (1996a).

<sup>31</sup>For a comprehensive overview of private sector development in Estonia, refer to the 1996 Recent Economic Developments in Estonia EBS/96 /114 .

of the commercial code. The completion of the legal foundations for private sector development was done in 1995 and involved formalizing corporate governance mechanisms and harmonizing accounting systems to EU standards.

Estonia's move to privatize was slower than its efforts to encourage new firm entry and FDI. The Estonian program was not implemented until mid-1993 and the goal of privatization was not simply to privatize but to bring about simultaneous privatization and restructuring. To this end, although the government implemented a voucher-based system, most large enterprises were sold via tenders based on an investor's ability to provide both capital and instill effective restructuring and governance. Despite the risk of slow, cumbersome process, privatization moved quickly, and 98 percent of all large enterprises have been privatized.

In Estonia, vouchers have not acted as a link between financial markets and privatization. Vouchers themselves are being used for the purchase of housing and land. Though a secondary market for vouchers formed, the nominal value of the coupons dropped to about 18 percent of their face value as of June 1996. The reason given was the lack of investment opportunities available to voucher holders.

The formal securities market in Estonia (the Tallin Exchange) began operation in the spring of 1996, though the first financial instruments were issued and traded in early 1993. The main players on the Tallin Exchange are banks and a few new investment funds. Despite the late start of the exchange relative to other CITs and despite the low number of active traders, capitalization of the exchange has grown to almost 5 percent of GDP (Summer 1996).

Bank restructuring began early in the transition process, but it was only after successive banking crises (in 1992, 1993, and 1994) that the Bank of Estonia instituted a strong set of prudential regulations, including high minimum capital requirements. As a result the number of operating banks has dropped to less than 20 by 1996.

#### **b. Results of private sector development in Estonia**

Estonia's success in private sector development can be attributed to its encouragement of both start-up firms and FDI. EBRD estimates that 10,000 to 12,000 new firms have entered the market in Estonia. Like Poland, the initial program concentrated on creating an economic and legal environment conducive to private sector activity. Like Poland, Estonia focused its privatization program on restructuring, rather than on rapid divestment of state assets. But unlike Poland, privatization occurred quickly perhaps because of the prominent role of foreign investment into the process.

The domestic capital market infrastructure in Estonia is thinner than might be expected given the level of private sector development and the extent of credit creation. Though investment



funds exist in Estonia, they rarely have become the strategic investor in firms to be privatized, nor have they become active participants on the Tallin Stock Exchange. Thus, there is little connection between privatization and equity market development. At the same time, given the fact that the Tallin Stock Exchange has not been in operation long, the level of stock market activity is surprisingly high, approximately EEK 4.5 billion (or 9 percent of GDP compared to the Riga Stock Exchange which is capitalized at approximately 1 percent of GDP). But at present, the securities market lacks a diversity of instruments, though the role of insurance companies is growing. Thus most of the capital market activity is concentrated in the banking sector.

Estonia's banking system is still in the process of transition. Banks are still failing, though the rate of failures has dropped.<sup>32</sup> At the same time, in part due to high portfolio capital inflows, banks are able to extend credit to the private sector (or more correctly, the non-government sector). In September 1996, credit to the non-government sector was approximately 19 percent of GDP.<sup>33</sup> The demand for credit is high, owing to the growth in number of new firms, and the private sector is able to borrow.

Foreign investment and especially FDI in Estonia has been successful from the beginning of transition. The main source of foreign capital is Finland, which shares both linguistic and cultural ties with Estonia. In per capita terms, FDI in Estonia is approximately US\$295, by far the highest in transition economies. FDI has become an engine for private sector development in Estonia, providing both the physical and human capital for new firms to enter markets. Also, the encouragement of FDI in the privatization process has also helped to both speed the process along and provide fresh capital for restructuring.

## 5. Latvia

The growth of the private sector in Latvia has been slower as compared with many CITs. The rate of private sector development in Latvia has been impeded by the uneven implementation of the institutional framework which has constrained privatization, the slow growth of the domestic capital market, and foreign investment. Despite these problems, a private sector has developed, but it is difficult to tell whether this new private sector will constitute a sufficient basis necessary for rapid economic growth. At present it appears that new firms are satisfying repressed demand for goods and services not provided under central planning.

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<sup>32</sup>From 1992-1995 the number of banks dropped from 42 to 21, from 1995 to mid-1996, the number has dropped to 16. Data from the *Eesti Pank Bulletin*, No. 4, 1996.

<sup>33</sup>The comparable figure for Latvia is at about 7 percent of GDP. It should be noted that the figure for both countries was calculated by using the level of domestic credit in non-government sectors. In the case of Latvia, the figure includes domestic credit to enterprises, most of which are still state owned.

### a. Background

Despite the fact that Latvia began the latest transition in 1992, it has took four years to adopt more thorough legislative and institutional frameworks necessary for private sector development. Though basic legislation was completed within the first two years of transition, the legal framework surrounding privatization, FDI, and capital market development was not completed until 1996. The incomplete legislation led to two discernable problems. First, programs such as privatization have taken much longer to complete than expected. Second, the long process resulted in the persistence of government participation in markets, with possible distortions and other adverse effects on private sector growth.

Large-scale privatization in Latvia can be divided into two periods: 1993-1995 and 1996 onward. The initial period of privatization began in September, 1993 when the first distribution of voucher began and was further supported by comprehensive privatization law (February 1994) establishing the ground rules the voucher-based system. Vouchers had a face value of 28 lats and could be used to buy shares of assets, land, apartments, deposited into an intermediary, or sold on the secondary market. As of August 1996, a total of 106.7 million vouchers have been distributed to 2.5 million residents at a nominal value of 3 billion lats. Though most of the asset transfer was done through public auctions, there have been 3 international tenders (one in December, 1994, the other two in 1995) and a fourth is to be completed by the fall of 1996.<sup>34</sup> The intention of the privatization authorities was to make voucher payment the focus of large scale privatization. Accordingly, the February 1994 law stipulated that at least 50 percent of payment for assets was to be made in vouchers.

A transition economy undergoing privatization, bank restructuring, and receptive to foreign investment has the unique opportunity to link these programs to the development of a domestic capital market. On the securities side, privatization in particular offers a one-time chance to divest state assets while creating primary and secondary securities markets which can be a constant source of firm valuation, risk-spreading, and eventually, new capital. Latvia initially missed this opportunity by not linking privatization with securities market development. On the banking side, credit is tight and thus the level of debt financing, which often is the initial source of domestic capital in a CIT, is low. All of these factors combined with low levels of FDI contribute to a severe capital shortage which in itself is perhaps the most binding constraint on private sector development.

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<sup>34</sup>Initial results from the fourth international tender suggest that there is little interest in the companies being offered. The Privatization Agency has decided that this international offering is going to be the last, due to low demand.

## b. Results of private sector development in Latvia

Like most CITs, the source of Latvia's current private sector development primarily stems from the rapid entry of small businesses, predominately in the service sector (such as catering and tourism) as well as small-scale retail trade. The importance of the growth of small sized businesses measured as a percentage of GDP and employment is magnified against the backdrop of sectoral output declines in manufactured goods, industrial production in general, and agriculture both in terms of volume and employment since 1992.<sup>35</sup>

The result of the various privatization programs as of end-1996 is that only 10 percent of large enterprises have actually been privatized.<sup>36</sup> Latvia has now entered the second phase of privatization, which began with a series of laws adopted in 1996 designed to eliminate the problems experienced in the first phase of privatization, by speeding up the process and attracting foreign participation. To date nearly all (1,300 units) have been approved for privatization, 393 of which have signed sales agreements. Second, changes in liquidation procedures now allow for liquidated firms to be sold either as one unit or in pieces which should accelerate the process. Next, the ability to buy land both under-privatized enterprises and as an asset in itself was formalized, and a law extending the right of land ownership has been prepared and will shortly be considered by the Parliament.<sup>37</sup> Moreover, nearly all sectors have been opened to foreign participation in privatization.<sup>38</sup> Additionally, foreign investors were granted the right to purchase vouchers, allowing them to participate directly in privatization.

Despite positive legislative changes, such as the removal of restrictions on foreign participation in both asset and land privatization and the opening of most sectors to any potential buyer, privatization in Latvia still faces informal obstacles. One strong impediment in large-scale privatization is the process itself. The approval process is both long and complicated. With each level in the approval process, there is an opportunity to slow down or even stop privatization from happening. While, these problems might have stemmed more from a lack of political will than from explicit barriers, the process itself allows for these

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<sup>35</sup>The Latvian Ministry of Economy reports the following:

**Growth of GDP by Sector**  
(in constant 1993 prices, percentage over the preceding period)

	1993	1994	1995	Q1:96
Agriculture	-19.4	0.8	-1.5	2.5
Manufacturing	-32.4	-10.6	-7.7	-5.5
Services	6.6	8.7	-0.9	5.3

<sup>36</sup>Data from the Ministry of Economy (1996) and Latvia Privatization Agency (1996).

<sup>37</sup>However, the existing law restricts a foreign investor who wishes to purchase the land under a privatized enterprise to hold no more than 49 percent equity in the privatized firm.

<sup>38</sup>Only a few sectors remain closed to foreign investors such as those pertaining to national security. Foreigners can now buy land except in a 10 km radius of the frontier.

informal obstacles to exist which can prove to be more formidable than the explicit barriers. For privatization to move more quickly, there must be a commitment on the part of all parties involved to accelerate the procedure by both streamlining it and eliminating the informal barriers.

In banking, credit to private enterprises has fallen from 16 percent to 7 percent of GDP from the period of the banking crisis (June 1995) to February 1997. This decline in credit is attributed to the fallout of the banking crisis. That is, the number of operative banks has declined steadily this year to 36 (only 13 of which can accept deposits), as a result of the implementation of strong prudential banking regulations and banking supervision in the aftermath of the banking crisis. For example, minimum capital requirements for banks have been raised from LVL 100,000 to LVL 1 million as of April 1996.<sup>39</sup> Though credit interest rates are currently low, dropping from 34 percent at end-1995 to 20 percent as of September 1996, deposit rates were at 9 percent (three month maturity) and thus the interest rate spread remains large.

Perhaps the most serious constraint on obtaining bank finance is the lack of usable collateral for new start-up firms, without collateral, doubts about the viability of newly privatized firms makes it difficult for banks to lend. Land registration is one means of providing collateral. In Latvia, the process of land registration has moved slowly, with only 10 percent of all land registered as of mid-1996.<sup>40</sup> Two reasons are usually cited for the slow registration of land: high cost and large time investment to complete the process. Estimates of the cost of registering land range from the official cost (LVL 30) to reported actual costs of LVL 280-300 (approximately US\$600). Most enterprises are on multiple units of land, which makes the process very expensive. Second, the process of registration, which includes getting all the necessary approvals could take from 6 months to one year to complete. Third, land owners fear that registration will increase their tax burden because land is a taxable asset.

On the securities side, the Riga Stock Exchange currently trades 7 out of the 26 firms listed; thus the exchange is neither comprehensive nor very active.<sup>41</sup> One reason for the lack of interest in the Riga Exchange is the absence of proper and transparent regulatory mechanisms. In particular, the absence of a securities and exchange commission deters potential members because the "rules of the game" are not known. In addition, there are

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<sup>39</sup>See EBS/96/172 for an in depth discussion of financial sector developments in Latvia.

<sup>40</sup>The Government envisages that by end-1996, 20 percent of all land will be registered and by end 1997, 30 percent.

<sup>41</sup>The Riga Stock Exchange began trading on July 25, 1995 and currently lists two companies, Unibanka (which constitutes 75 percent of the trading volume) and Riga Transportation Fleet (3 percent), while adding T-Bill quotations (7 percent), mortgage notes (13 percent), and other listings (2 percent). Total capitalization of the market is LVL 39.8 million, approximately 1.3 percent of GDP. The level of turnover in the Riga Exchange has been falling since its peak earlier in 1996. This is compared to the Czech Republic, in which the Prague Stock Exchange is capitalized to about 50 percent of GDP. Latvia source: Baltic News Service; Czech source: Lieberman et al. (1995), p. 36.

currently no start-up firms listed on the Riga exchange. The growth of the exchange to a large extent depends on the rate of privatization. The more large enterprises are privatized, the larger the list of trading companies on the exchange and the larger the level of capitalization.

FDI in Latvia has increased since 1992, but it remains low in comparison with other CITs. EBRD estimates that the level of FDI per capita in Latvia was US\$65 in 1996. Until 1996, there were many formal restrictions to FDI, ranging from exclusion of direct foreign participation in privatization to severe constraints on which sectors can receive FDI. Most of the legal restrictions were eliminated in 1996, and the Government's commitment to attracting FDI appears strong. However, despite the fact that a bill allowing foreign purchase of land has been submitted to the Parliament, it has yet to receive its first reading. Investors see this as a sign of lack of political will and commitment toward FDI.

## IV. Conclusions

The brief survey of the five countries in transition suggests the following lessons about private sector development:

- Establishing a solid legal infrastructure early in the transition process and comprehensive enough such that it covers all areas of private sector development is a critical first step in the process;
- The sequencing of privatization is less important than a speedy completion of the program;
- Establishing linkages between privatization and capital market development (through investment funds) is essential;
- Encouraging FDI involvement in privatization speeds up the process as well as facilitating simultaneous enterprise restructuring;
- Encouraging FDI is also an important part of private sector development especially given capital market constraints;
- Developing domestic capital markets is essential, given that the single most binding constraint on private sector development is the shortage of capital;

Establishing solid legal infrastructure is the first necessary condition for private sector development. As both Latvia and Russia have found, without the legal framework to support the other main areas of private sector development (privatization, domestic capital market development, and foreign investment), it will be difficult for the private sector to grow, given both distortions in the market and lack of knowledge of "the rules of the game".

Second, the varied experiences of the sequencing of privatization suggest that privatization itself need not be first item on the transition agenda as long as the legal and economic environments are conducive to the entry of start-up firms (as in Poland and Estonia). Once privatization begins, however, it is important that it be completed quickly to enhance credibility. Thus, as long as the private sector grows, it is less important if the source of growth is privatization or new firm entry as long as both take place. The psychological importance of privatization should not be underestimated. Though the tangible results may or may not catalyze private sector development, depending on the individual conditions in each country, the fact that the process is moving ahead is a sign of governmental commitment to developing a private sector. That is, if residents see that privatization is happening quickly, it might shape expectations that transition is happening and is irreversible. In many CITs, changing expectations is a necessary condition to stimulating private sector development. Once an economy is privatized, it becomes increasingly difficult to reverse private sector development. Thus both domestic and foreign investor perceive the economic risk of policy reversal as minimized.

Third, all of the above country experiences suggest that the fastest, most efficient means of developing the capital market is to encourage linkages between privatization and the equity market via the use of investment funds. The funds themselves can be a catalyst for equity trading, providing both the volume of shares and continued activity in the market. Countries that have not encouraged the use of investment funds tend to have a more rudimentary equity market system. Because CITs need financial widening (and deepening) and due to the fact that many transition economy banking systems are not extending much credit, it is imperative that alternative forms of intermediation be developed.

Similarly, participation of foreign investors in the privatization process (as in Estonia and Poland) can be a catalyst for private sector development because it provides additional human and physical capital. Given the severe shortage of capital facing most private entrepreneurs, FDI is one means of alleviating this constraint. Further, FDI will increase the possibility of fast and effective restructuring and installation of good governance mechanisms.

Finally, alleviating the constraint on capital means that domestic capital markets must be widened and deepened. This reform must start with the banking system and involves allowing insolvent banks to fail and recapitalizing potentially solvent banks. Additionally, sound monetary policy is necessary for the creation of rational lending and deposit rates. And, equity market and alternative instruments should be developed through the adoption of appropriate government legislation, a stable economic environment, privatization, and foreign investment.

Table 1: Cross-Country Comparison of Private Sector Development<sup>42</sup>

	Visegrad Countries		CIS		Baltic Countries	
	<u>Czech Republic</u>	<u>Poland</u>	<u>Russia</u>	<u>Estonia</u>	<u>Latvia</u>	
Estimated Size of Private Sector <sup>43</sup>	70%	60%	55%	65%	58%	
<b>I. Legal/Institutional Framework</b>						
When Adopted	1991	1992	1991	1992	1993	
Completed <sup>44</sup>	1993	1995	1995	1995	1996	
<b>II. Privatization</b>						
Estimated % of Large Scale Completed <sup>45</sup>	95%	50%	95%	98%	20%	
When Program Implemented	1992	1990	1993	1993	February, 1994	
Major Method of Asset Transfer	Voucher/some Direct Sale	Liquidation/Voucher/FDI	Vouchers/emp buyouts	Vouchers/Direct Sales	Vouchers/Tenders/Auction	
Driving Force in Privatization	Investment Funds	Workers/managers/ FDI	Workers/ Managers	Strategic Investors/Funds	Individual Investors	
FDI Allowed? <sup>46</sup>	Initially no, then yes in 1993 with OK of Ministry of Privatization.	Yes from beginning with approval from Ministry of Privatization.	Yes in theory, but many barriers in practice.	Yes, without restriction	Yes, in theory since the beginning of the program but effectively not until January 1996 when foreigners were allowed to purchase vouchers.	
Links with Financial Market?	Yes through IPFs	Yes, through officially sanctioned investment funds	Yes through both foreign and domestic investment funds	Yes	Yes, in theory through investment funds, but not used in practice.	

<sup>42</sup>Source: EBRD (1995) unless otherwise noted.

<sup>43</sup>Figures from EBRD (1995) and measure the level of private sector activity as a percentage of GDP.

<sup>44</sup>Completed in this context denotes that the basic legal framework (conforming to developed market economy standards such as the EU, US, or Japan) is adopted by the government in the following areas: commercial codes, privatization, FDI, capital market development, and bankruptcy.

<sup>45</sup>Following the EBRD convention, the criteria used in defining large-scale privatization is determined by individual governments. Therefore the threshold used in one country for an enterprise considered for large-scale privatization may differ from the other countries.

<sup>46</sup>Sources: Czech Republic, Poland, and Russia: Lieberman et al. (1995); Estonia: Recent Economic Developments (1996).

	Visegrad Countries			CIS		Baltic	Countries	
	<u>Czech Republic</u>	<u>Poland</u>		<u>Russia</u>		<u>Estonia</u>	<u>Latvia</u>	
III. FDI								
FDI per capita as of 1/1/95 in USD	289	40		11	295		8	
Results	National treatment, foreign investment among highest in region	National treatment, FDI an integral part of the privatization program		Formal barriers, reduced, but FDI deterred by risk	National treatment, highest level of FDI per capita in CIT		Barriers reduced in 1994, still waiting for results	
Foreign Ownership of Land	Yes, if foreigner registers as a Czech company	Yes with permission of the Ministry of the Interior. In some cases, land purchased through privatization must be cleared with the Ministry of Privatization.		In theory buildings and land may be purchased in privatization, but very difficult in practice.	Property ownership allowed, especially when associated with a business.		Property ownership allowed, land ownership now being considered by Parliament.	
IV. Capital Market Development								
Banking Sector Reform	Most Banks privatized. Banks restructuring under guidance of Consolidation Bank. Bad loans constitute 25% of total loans.	Bank privatization in process. Banks are restructured before being privatized. Prudential regulations strong and enforced. Bad debt problem being solved with restructuring.		Most banks private. Following 1995 banking crisis, stronger prudential regulations have been adopted. Most banks are still undercapitalized	Most Banks in Estonia are private, though the government retains some stake in the largest. Restructuring and recapitalization underway.		Privatization of banking almost completed. Prudential regulations strengthened as a result of 1995 banking crisis.	
Capitalization of the Stock Market <sup>47</sup>	50% of GDP as of 1995	12.6% of GDP as of 9/95			4.7% of GDP as of 8/96		1.3% of GDP as of 6/96	

<sup>47</sup>Sources: Czech Republic: Lieberman et al. (1995); Poland: EBRD (1995); Estonia: IMF Staff estimates; Latvia: Baltic News Service (on-line).



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