The Capital Markets In Central Europe[1]

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Prague, December 1993.

Abstrakt

Přítomnost silného a dynamického kapitálového trhu je životně důležitá pro příliv zahraničního kapitálu a bude pomáhat domácím podnikům při hledání dodatečných zdrojů ve formě nových kmenových akcií. Účelem této studie je podat přehled o vývoji kapitálových trhů ve Střední Evropě a identifikovat hlavní problémy, spojující kapitálové trhy a zahraniční investice. Institucionální rysy kapitálového trhu, stejně jako jeho likvidita ovlivňují vstup zahraničních investorů. Úspěšná privatizace a makroekonomická aktivita rovněž podmiňují aktivity na kapitálovém trhu.

Převážná část zprávy se týká České Republiky, diskutovány jsou však částečně i kapitálové trhy Slovensko, Maďarsko a Polsko. Část I představuje dvě hlavní instituce - investiční fondy a Burzu cenných papírů. Jsou identifikovány hlavní problémy, týkající se těchto subjektů, včetně regulace, dohled a další institucionální prvky.

Část II je rozdělena do tří sekcí a popisuje ekonomické faktory, které předcházejí tvorbě kapitálového trhu. Tyto faktory působí ekonomické tlaky na vznik kapitálového trhu a tyto jsou diskutovány v první sekci. Další sekce identifikuje hlavní problémy, které brání rozvoji kapitálového trhu. Poslední sekce specifikuje hlavní podmínky pro efektivnější fungování kapitálového trhu a poskytuje některé závěry.

Abstract

The presence of strong and dynamic capital markets is vital for the inflow of foreign capital and will help domestic companies in seeking additional resources in the form of new equity. The purpose of this paper is to review the development of the capital markets in Central Europe and to identify the major outstanding issues in the link between capital markets and foreign investments. Part I discusses the institutional features of capital markets, as well as their liquidity that affects the entry of foreign investors. Successful privatization and macroeconomic performance also affect the activities on capital markets.

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[1] This paper was prepared for the working seminar of experts at the the Institute of Development Studies of Sussex University, September 20-21, 1993, and the EBRD presentation on Septmber 22, 1993 in London.

The bulk of the report covers the Czech Republic, but also included are Slovakia, Hungary and Poland. Part I reviews the two major institutions of the nonbanking financial sector - investment funds and the stock market, respectively. The main issues of the stockmarket and the operation of investment funds including regulations, supervision and other institutional features are identified.

Part II is divided into three sections and describes the economic factors which are conducive to the creation of capital markets. These factors constitute economic pressure to establish capital markets in the region and are discussed in the first section. The next section identifies the main issues which will be inhibiting the expansion of the capital markets. The last section specifies the main conditions for a more effective functioning of capital markets and offers some policy conclusions.

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INTRODUCTION[2]

The development of the non-banking financial sector in the former centrally-planned economies has generated considerable attention among policy makers in these countries and among financial experts in the West. The reason is very simple: the financial sector of these countries was extremely poorly developed under central planning and consisted, almost exclusively, of the banking sector. Capital markets were non-existent after the abolition of stock markets in the early stages of central planning and the non-banking financial institutions included only property, trade, travel and car insurance. It became very clear to the reformers in central and eastern Europe that in the transformation from central planning to market economy the introduction of capital markets had to occupy a central place.

The development of capital markets is vitally important to the emerging market economies for several reasons. With the abolition of central planning, the mobilization of domestic savings has become greatly dependent on the effectiveness of market instruments and institutions. Central planners had an advantage: they could easily mobilize domestic savings through price controls, indiscriminate taxation and effective elimination of choice for both households and enterprises. Since capital markets play an important role in attracting savings in market economies, their absence is a considerable handicap for these countries. In addition, these countries are in great need of long-term capital. Supply of capital currently comes primarily from banks but these are extremely risk-averse. As a result, most of the current lending takes the form of short-term or medium-term credits. Once again, stock markets are a possible answer to this problem.

The purpose of this chapter is to review the development of the non-banking financial sector in Central Europe and to identify the major outstanding issues in the link between the capital markets and foreign investments. We see the link between capital markets and foreign investments in four main areas. The first area concerns the institutional features of capital markets and the extent to which they affect the entry of foreign investors (for example, the role of investment funds and banks, regulations of and the organization of capital markets). The second area concerns liquidity of capital markets. For capital markets to be

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[2] In preparing this paper, I have greatly benefited from my discussions with top officials of the Ministry of Finance, Central Banks, the Stock Exchanges, regulatory bodies, journalists and businessmen in Prague, Budapest and Warsaw. I am also very grateful to comments of my friend and colleague dr. Griffith - Jones and to Charles Harman of Credit Suisse First Boston, Kate Mortimer of the British Know How Fund, Tad Rybczynsk of Hambros and the participants of the Sussex Seminar. The usual disclaimer, of course, holds.

active and thus interesting for foreign investors, not only must the demand for stocks and securities be high, but so must also be the extent to which it will be possible to sell these stocks and securities. This means that our study should identify specific barriers for entry of foreign investors as reflected in the legislative framework, institutional imperfections or government policies towards capital markets. The third area concerns privatization. Even though the private sector is a *sine qua non* of capital markets, the effect of the development of capital markets on privatization is far less obvious. Last but not least, the fourth important factor affecting the activities of capital markets is macroeconomic performance. The extent to which governments are successful in bringing down the rate of inflation plays an important role in attracting investors into capital markets. Fast growth of output will also be typically beneficial in this respect. Declining interest rates will, too, be conducive, *ceteris paribus*, to the growth of demand for equities and for fixed-income securities.

We shall cover four countries: the Czech Republic, Slovakia, Hungary and Poland, but the bulk of the report covers only the Czech Republic. It became obvious during the preparation of this report that full coverage of all four countries would exceed its scope. Details of each country's legislation, policies and institutions vary so much that it would be impossible to carry out a full analysis of each in the limited space of this chapter. However, the present analysis will include as much comparison as possible of the Czech capital markets with those of Hungary and Poland. The omission of specific treatment of Slovakia is not considered to be serious. The Czech and Slovak legislations, policies and institutions were identical until the end of 1992, when both countries were part of the federation but the subsequent introduction of national legislations and policies was insignificant in terms of the objectives of this chapter.

The study will cover a limited period. The development of capital markets in these countries is, not surprisingly, a 'living mechanism' which is in the process of evolution. This process will undoubtedly continue to change for some time until it is stabilized within a fairly firm structure. The description and analysis of the reform had to refer, therefore, to a particular cut-off period. For the purpose of this study the period is the end of April 1993. This effectively means that the report excludes those changes which might have taken place subsequently.

The final comment concerns the depth of our analysis. Most of the issues covered in this paper are highly technical and span a wide range of sub-issues. Due to limitations of time and space, the present analysis often touches only the surface of the issues in point. It is clear that better understanding of specific issues may require further analysis and work. Also excluded from the following discussion will be questions concerning macroeconomic policy. In particular, monetary policy is well known to be a major factor in influencing the performance of capital markets; it affects nominal economic aggregates and directly influences the level of interest rates, hence the attractivness of money markets as an alternative source of investment. It can also affect the liquidity of banks which are major actors in emerging capital markets.

The chapter is divided into two main parts. Part I reviews in sections 1 and 2 the two major institutions of the non-banking financial sector: investment funds and the stock market, respectively. Section 3 then identifies the main issues of the stock market and of the operations of investment funds regarding regulations, supervision and other institutional features. Part II starts with an introduction in section 1; it continues with a review of factors leading to pressures for establishing capital markets in the region in section 2 and with the discussion of impediments due to privatization in section 3. The chapter ends with a conclusion and some policy recommendations.

I THE STRUCTURE AND THE MAJOR ISSUES OF THE NON-BANKING FINANCIAL SECTOR

In order to better understand the role of the non-banking financial sector in the region, it is useful to begin with a brief review of the privatization process. Privatization is one of the key elements of the transformation process in the whole region. It is fully recognized that the introduction of market economy cannot be successful without a transfer of ownership from the State to the private sector. Even though the scope of privatization and the speed with which assets are or will be privatized vary from country to country, all countries of the region adopted privatization as one of the most important goals of their economic policies.

Nevertheless, the methods of privatization vary considerably in the region. They range from a highly centralized approach in the former East Germany, where all privatized assets are sold through a huge bureaucracy known as ’Treuhandanstalt’, to a highly decentralized and market-based approach pursued in the former Czechoslovakia. These two countries are also most advanced in this area, while others are still discussing their options in choosing among different methods of ’mass’ privatization.

The Czechoslovak Experiment of Privatization

The Czechoslovak experiment has been divided into 'small' privatization and 'large' privatization. The former typically covers smaller assets (restaurants, shops etc.) which are sold in auctions. In the course of 1991, the 'Government' privatized more than 24,000 units in this way. Large privatization covers other assets in all sectors of the economy with the aim of privatizing the major part of public enterprises. The additional important objective of large privatization was to privatize public assets rapidly, so more than 1,500 enterprises changed ownership by the end of 1992. It is hoped that an additional 2,000 enterprises will be privatized in 1993-1994. All above figures refer to the former Czechoslovakia.

Clearly, unusual speed of privatization requires unusual methods. The Czechoslovak experiment focuses on the 'voucher' scheme which is based on the distribution of vouchers to all adult Czechoslovak citizens for a small nominal fee. These vouchers are exchanged for shares of public companies in the same manner as investors buy shares in standard stock markets. Each citizen receives a limited number of vouchers (or rather, points) which he/she can bid for shares. The purchase can be made directly (in the absence of stock markets in Czechoslovakia this is done through post offices against the published list of share offers i.e. public enterprises offered for sale). Alternatively, individual citizens can invest their vouchers through investment funds, which have been spontaneously established on a large scale. In sum, privatization by the 'voucher method' means that assets are virtually given away free of charge to the population, that private ownership will be initially highly dispersed with the consequence of limited impact of owners on the management of acquired companies, and that the relative values of shares will be established - a highly desirable feature given the current difficulties in ascertaining the values of public companies.[3] There are currently no restrictions on the resale of actual shares by Czechoslovak citizens once they have acquired them against vouchers. It is anticipated that many will be sold and that these sales will take place through stock markets currently being established in the country, as we shall see below.

The 'voucher method' is not the exclusive method of privatization. Standard methods are also used, such as direct sales to domestic or foreign investors. In the first round of privatization in which about 1,500 public enterprises were privatized as noted above, direct sales to foreigners amounted to just over 200 deals. These deals are typically combined with the 'voucher method', i.e. a

[3] This is a general problem in all former centrally planned economies. The problem is the result of poor accounting practices and it also reflects the fact that companies have not yet faced real market tests.

percentage of shares is reserved for Czechoslovak citizens against vouchers, but, exceptionally, some deals have been allowed without any voucher reserve.

1. Investment Funds

Financial sector reforms in the region foresee the establishment of stock markets, investment funds and other financial institutions. As noted above, we shall use the example of the Czech Republic to provide some specifics and a more detailed description of the process of establishing these important institutions; we shall begin with a review of investment funds and proceed with a discussion of stock markets.

Investment funds have already played an important role in the Czech and Slovak Republics in contrast to Hungary and Poland, where operations of investment funds have been delayed by legislative and administrative difficulties. By 21 January 1992, 296 investment funds had been approved in the Czech Republic; about 170 investment funds had been approved in Slovakia. According to the then Federal Minister of Finance V. Klaus, 437 investment funds were actually functioning in 1992, in both republics. Voucher privatization has led to the investment of 8.53 billion of the designated privatization points. Of these 8.53 billion points, the investment funds will have at their investment disposal 6,13 billion points, or 72 per cent. These are points which have been invested through investment funds by their true owners, individual citizens. Together, the ten largest investment funds control about 40 per cent. of all investment points and about 56 per cent of all points that were allocated to investment funds.[4]

In contrast, the role of investment funds in Hungary and Poland remains limited. Due to the delays in passing the privatization law by parliament, the establishment of investment funds in Poland has been formally prepared but delayed in practice. The activities of investment funds are curently regulated by the Securities Act and cover only ’open-ended’ funds. ’Closed-end’ funds are not included. The absence of a legislative framework, together with discriminatory taxation of investment funds, is responsible for the fact that, in mid-l993, Poland had only one operating investment fund (Pioneer Investment Fund (Boston)).

In Hungary the limited number of investment funds reflects primarily extreme illiquidity of the Hungarian stock market and the absence of a mass privatization plan. The Hungarian sector currently has only 4 investment funds. They

[4] See M. Mejstřík, J. Burger: The Czechoslovak Large Privatization; Prague: Charles University, CERGE, Working Paper, No. 10, p. 17.

represent closed-end funds (3-5 years), must be registered on the stock exchange and are Hungarian-owned, even though foreigners get access to the fund shares. They own and trade primarily government securities. The small stock exchange liquidity of investment funds has been explained by the authorities by distortions in the tax system - the holders of investment units are reluctant to lose their tax benefits associated with the listing.

Types of Investment Company

The Czech law on investment funds opens the room for the establishment of both investment funds *per se* and mutual funds. The latter mobilize resources from sales of shares of funds which they create while the former do so by issuing their own shares which constitute their own equity. Investment funds can issue shares in the name only but must not issue employee or priority shares.

Establishment of Mutual and Investment Funds

Permission is required for the establishment of mutual and investment funds. The permission is typically given only if certain conditions are satisfied, such as conditions of subscription capital, internal organization, professional standing, staff and physical arrangements, and of notifications about the bank in which financial resources of the funds will be deposited. Authorities must be also notified about any changes in the management.

Types of Mutual Fund

Mutual funds can be 'open-ended funds' or 'closed-end funds'. The former has no restriction on the number of shares of the fund and repurchase agreements are also allowed. Closed-share funds are more limited in the sense that the number of shares of a given fund and the period during which the shares are issued are both limited. Repurchase agreements are not possible.

Capital

Capital of mutual and investment funds can be in the form of securities traded either in the domestic stock market or abroad. However, the choice of foreign stock market must be approved by authorities. The authorities also determine the proportion of capital in the form of securities. Capital can also be in the form of real estate and other tangible assets. The total amount of capital required to set up an investment or mutual fund is small: 1 million crowns ($34,000)[5] for funds established after 1991. For funds established before the end of 1991, the requirement was even smaller - 100,000 crowns (about $3,400).

Distribution of Benefits

[5] All dollar prices in the text refer to U.S. dollars

Principles for distribution of benefits are the same for both mutual and investment funds. Benefits are either distributed among shareholders or used to increase capital.

Spread of Risk

The Government has also decided to regulate the risk spread by imposing the following restrictions on capital and investment holdings:

* the total equity of any joint-stock company must not exceed 10 per cent of the capital of investment and mutual funds. There are additional but less significant restrictions;
* investments of mutual and investment funds cannot exceed 20 per cent of the total volume of shares of any given company, and are excluded from buying shares of other investment or mutual funds;
* fees are set at a maximum of 2 per cent of the total annual amount of capital

Conflict of Interest

There are also regulations concerning representations on the Board of Directors. For example, bank representatives cannot represent more than one third of all members of the Board. Members of Parliament, ministers and other public officials are excluded. There are also some restrictions on purchases by board members (e.g., own stock of shares).

Bank Control. Banks which manage financial resources of investment and mutual funds are obliged to verify the values of shares which are traded by these funds. Banks cannot own investment funds.

2. Stock Exchange

There seems to be a general agreement that administrative hurdles are the main constraints on the growth of foreign investment in the region.[6] The actual process of establishing stock markets in the region is arguably the least advanced component of institutional reform in the financial sector. The reform is well under way but the establishment of stock markets will be a formidable task. Due to their complete absence in the past, stock markets had to be created from scratch and this includes the adoption of legislative measures, finding suitable physical locations, training staff, establishing organisational rules, etc. So far, relevant legislation has been passed in all four countries and the first stock markets have already been opened in Budapest (Hungary), Warsaw (Poland), Prague (Czech Republic) and Bratislava (Slovakia).

The Prague Stock Exchange was established in April 1993. Neither its membership of the stock market nor its investment in it has any nationality restrictions; foreigners are treated as nationals. The stock exchange has 53 members including several domestic and foreign banks (see Appendix 2). The trading will take place in three sections: for companies with equity capital of more than 500 million crowns (section 1), for companies with equity capital of 100-500 million crowns (section 2) and the rest in section 3 (over-the-counter). Currently, the market is extremely thin - only seven securities are traded but representatives of the stock exchange hope that shares of between 20 and 30 companies will be traded by the end of the year. The stock exchange hopes to list in Prague about three hundred firms with over 500 million crowns in total equity, and twenty to thirty companies of that size in Bratislava by end 1994.

The Budapest Stock Exchange was reopened in June 1990 and is the most developed in the region with 25 shares traded on the market, four shares of investment funds and one so-called ’compensation note’. (See Appendix 3). The exchange currently has forty-five members; banks are no longer members (since l992) but they can have their own brokerage firms.

The Warsaw Stock Exchange was established in April l99l and opened in July l99l. By mid-l993 it was trading in twenty equities and seven governement securities. The market has been extremely active since the end of February/ early March l993. The stock market index increased about seven times between February and mid-September l993; the brokers were receiving on average 3,000

[6] See, for example, Z. Drabek: Foreign Investment in Czechoslovakia: Proposals for Fine-Tuning Measures of Policy Reform, Prague; Charles University, CERGE, Working Paper No. 4, February 1992.

orders from investors per day in mid-l993, only marginaly less than the average daily at the London Stock Exchange (3,200). The total market capitalization was about $l.5 billion at that time.

3. Major Issues

Investor’s Protection

One of the vital conditions for efficient stock market operations is to ensure that investors have an adequate protection against improper activities on the market. The most serious dangers comprise misleading claims of companies that float their shares on the market, improper activities leading to predatory and speculative mergers and acquisitions and, arguably, insider-trading.[7] Similarly, the supervisors of investment funds and/ or competition must ensure that interests of investors are protected and that fraud and other improper activities of investment funds are avoided. Regulators of the stock exchange must aim at protecting buyers and sellers of stocks and securities and avoiding fraud. In many well established stock markets, these issues are typically addressed with more or less detailed rules about company disclosures, about mergers and acquisitions and about insider-trading.

The formulation of the above mentioned rules in the Czech and Slovak Republics is currently less advanced in comparison with the other two countries. Neither the Czech Republic nor Slovakia has so far established a detailed administrative system of regulations to address these issues. The regulations have so far been formulated only in general terms in the Law on Securities. (Viz Appendix l). On the other hand, the process is quite advanced in Hungary and Poland even through the regulations of security issues in Poland are considered by Polish officials to be out of date and inadequate. In all countries under consideration the regulations on public equity listings cover the following areas: supervision and state control, disclosure rules and insider information. These topics will be now discussed with other relevant issues.

[7] As it is well known, the views about insider-trading are not uniform. There is a small but increasingly growing number of experts, who argue that insider-trading provide for a more efficient form of trade with shares. These views are not generally acceptable and they ignore, inter alia, equity considerations. More importantly, however, this is a general issue of regulation and the extent to which it should be used as a control mechanism. The alternative to regulation is competition. See, for example, W.J. Baumol, S.M., Goldfeld, L.A. Gordon and M.F. Koehn: "The Economics of Mutual Fund Markets: Competition vs. Regulation"; cf. O. Kýn: The Market with Vouchers and Investment Funds; The Fifth CERGE lecture on Practical Aspects of Privatization, Prague, 6 February 1992.

Supervisory Control

The supervisory control in the Czech republic covers all publicly traded securities and their actual trading, stock exchange as well as markets for unquoted shares, brokers, traders and the printers of securities. The responsibility for the supervisory control is with the Ministry of Finance. The supervisory control of investment funds in the Czech republic is also in the hands of the Ministry of Finance. As far as the activities of stock exchange traders are concernered, the ministry is entitled by law to award a licence to deal with stocks and securities, but this is only one of the necessary conditions to obtain a licence to trade in the stock exchange. Other conditions have to be fulfilled and the conditions are set by the Stock Exchange itself.[8]

The scope of supervisory control is rather rudimentary and covers only limited activities. The current regulations require the authorities only to ensure public access to approved prospectuses, to information about financial performance of the issues of shares, about the list of printing companies which are permitted to print securities and information about the list of security traders. The underlying assumption of the law, not stated explicitly, is that the question of propriety is also the responsibility of the supervisory authorities. This suggests that the responsibility lies with the licensing authorities.

The Hungarian supervisory system is one step ahead of the Czech one. The government has created the State Securities Supervision (SSS) which is a state body to supervise the public issue of, and trading in securities. The SSS itself operates under the supervision of the Ministry of Finance and its head is appointed by the Council of Ministers. The SSS approves and/or amends prospectuses prepared for the flotation of securities, gives licence to traders to engage in the trading of securities. For the public issues of securities in Hungary denominated in foreign currency or the marketing abroad of securities issued in Hungary permission is also required from the National Bank of Hungary. The SSS also supervises the Stock Exchange, where only banks could originally become members. Its effectivness in the early stages has been questioned by some domestic and foreign experts. The supervisory control in Poland is also organized along the lines of the Hungarian SSS through the Security Exchange Commission (SEC). The SEC is a government agency that reports directly to the Prime Minister. It regulates the listing requirements, the disclosure rules, capital requirements for brokers and other activities. It is also responsible for the supervision of investment funds, but no formal rules exist. The top regulatory body of SEC includes the chairman and it has two deputies, and representatives

[8] The conditions of the stock exchange are stricter than the conditions set by the ministry of finance.

of the Ministry of Finance, Central Bank, the Anti-Monopoly Office and the Ministry of Privatization. At present, the SEC proposes to include representatives of brokers and the stock exchange for consultations. In general, good supervision and good share listing are considered in Poland to be the main reasons for the activity of the Warsaw Stock Exchange.

Disclosure Rules

The disclosure rules about companies in the Czech Republic include a number of highly specific regulations. They seem adequate for the purpose at hand, even though there may be other areas of activities which are to be addressed in the future. Under current regulations the companies whose shares are publicly traded are required to publish annually the results of their financial performance. They also have to report to the ministry all changes in their financial performance which could affect the price of shares in point. These changes should include in particular the start of bankruptcy proceedings or the termination of activities of the company through official decision, merger or division of the company or any reduction of capital in excess of 10 per cent, legal disputes about the company's assets greater than 5 per cent or any changes in the supervisory, statutory or management bodies of the company.

In Hungary, the disclosure rules also include the requirement for companies to publish a detailed annual report. In addition, companies are required to publish quarterly shorter reports about their financial performance. The companies must also notify the stock exchange within 24 hours about special events such as changes in management, newly contracted loans, plans for mergers or aquisitions and issues of new shares. The dislosure rules appear to be sufficiently detailed to provoke criticism in the country among experts, who consider the regulations to be excessive.

Disclosure rules about investment funds seem to be more problematic. A recent independent report found that "usually a full prospectus of an investment fund with full disclosure of its capital stock, personal history of members of the board of directors, and a description of operational charges, is not widely available".[9]

Securitization

Another issue related to disclosure rules concerns the securitization of assets. Investors will require a proper security on their investments to minimize other than commercial risks. The present arrangements for their security are, however, considered by some experts as inadequate in all of the four countries. In

[9] See: M. Mejstřík and J. Burger: Voucher Privatization: Its Bulding Blocks in the CSFR; Privatization Newsletter in Czechoslovakia, Prague: CERGE, No., 3, January 1992

Hungary, for example, the ability of any single creditor to veto a restructuring plan of the debtor company may force some salvageable companies into premature liquidation.[10] The current Czech situation seems even more problematic where investors' security is typically protected by real (fixed) assets. However, those assets are not always reliably priced, therefore increasing the investors'risk as well as the costs of lending.

Insider Information

Once again, the Czech law on securities addresses only the major issues in general terms. The law specifies the circumstances which are subject to regulations about insider information in terms of access to confidential information. The important element of the ruling is that only information that could influence the share price is relevant. Further, the ruling restricts the activities of persons who have access to confidential information. These persons are not allowed to make transactions with shares about which they have confidential information. Similar regulations exist in Hungary, Poland and Slovakia.

Clearing and Settlement

There was a major discussion in the Czech and Slovak republics about the most suitable way of clearing and settling accounts of clients on the stock market. The discussion reflected to some extent the unresolved issues resulting from the attempted introduction of the fully computerized 'Taurus' system in the London Stock Exchange. Finally, the decision was taken to introduce a fully-computerized system of payments. The system was installed and adapted from French technology, and with considerable technical assistance of French experts.

While there seems to be general satisfaction with the decision to go with the highly computerized system, there have nevertheless been some voices of criticism. One of them pointed out that the actual transaction settlement consists of two independent circuits - physical settlement and the actual cash payment, which are not tightly integrated. In fact, the cash settlement should take place within three days. This could lead to some delays in the final settlement of transactions. In addition, the brokers' risks might unduly increase which in turn may lead to higher brokers' fees and hence higher transaction costs to investors. Recent reports already suggest amendment to the securities law to modify the role of the Central Register.[11]

[10] See Central and Eastern European Bulletin, 3O July, 1992.

[11] See Hospodářské noviny, Burzovní noviny, No. 11, 27 September, 1993.

In Hungary, the argument has been taken one step further. The stock exchange authorities argue that the clearing and settlement system should be separated from the stock exchange itself in order to shift the risk from non-payment elsewhere. They are proposing to establish a separate company to handle the clearing and settlement operations. The company would have its own capitalization and it should provide other services such as financial services and registration of shares.

In Poland, the settlement system is on the delivery-versus-payment basis. The settlement with the Deposit and Clearing Bank must be settled within T + 3 days, as in Prague, each investor must hold a securities account and a money account with a broker. The transfer of ownership takes place in dematerialized form. Even though this is considered to be an impediment to over-the-counter trading, the clearing and settlement system seems to work reasonably well. In general, the Polish officials are satisfied with their clearing and settlement system - they are able to satisfy 8 out of 9 recommendations on clearing and settlement made by the group of thirty.[12] Nevertheless, settlement and custody issues are allegedly the two most important factors which have discouraged institutional investors from investing on the Polish and on the other Central European stock markets so far. True incorporation into the major Western European settlement systems (Euroclear and Cedel) would be useful.

Role of Banks

The role of banks in capital markets has been surrounded by considerable controversy in many countries. The controversy has not been resolved in a uniform manner and the result is that the permissible range of activities of banks varies from country to country. The German universal system of banks is at one extreme while the prohibition to underwrite shares by commercial banks looms at the other extreme, such as in the United States. The main concerns of regulators are essentially two potential problems, which are lack of competition and dangers of serious conflict of interest. The division of the banking sector into investment and commercial banks is intended to address both issues. These issues are addressed in more detail in another paper of this volume.[13]

It may suffice here to summarize the main relevant points with regard to the banking sector of the Czech and Slovak Republics. While the original thoughts might have favored the separation of investment and commercial banks, the actual process has led to the creation of a system which makes the

[12] See Group of Thirty Publications, 199O M Street, N.W., Suite 450, Washington, 20036.

[13] See M. Kerouš: "Key Issues in Czechoslovak Banking: a Central Banking Perspective", prepared for this project.

banks'operations universal. There is no doubt that the role of banks is already beginning to be very substantial in different areas. First, virtually all banks are involved not only in commercial lending and in taking deposits, but also in the type of lending which has traditionally been considered in these countries as lending for investment purposes. In addition, some have already started activities which are typical of investment banks, such as issuing investment certificates. Nevertheless, it will take some time before the commercial banks will be in the position to get seriously involved in underwriting and other similar activities. In this respect, the situation in the Czech and Slovak banking sectors is similar to that in Poland, where banks are also searching for their best role and where their investment exposures (purchase of equities) is limited by the level of 25 per cent.

Second, there are extremely close ties between the major domestic banks and the non-financial sector, which explains the high level of debt of non-financial enterprises to banks. The total outstanding debts of industrial enterprises to the banking sector (termed 'primary debt') amounted to about 11.4 billion Czech crowns at the end of 1992 in the Czech Republic alone, or about $393 million. These debts are in addition to the total of 50 billion Czech crowns'worth of debts which had been originally on the books of banks but were removed from the balance sheets in the course of 1991. All these debts have been classified by the banking sector as 'non-performing', or highly doubtful.[14] Again, a similar situation exists in Hungary and Poland. In Poland, for example, where bad loans were recognized as a problem later than in the Czech Republic, high officials at the Ministry of Finance estimate that bad and doubtful loans constitute 20-30 trillion zlotys, or 20-30 per cent of bank assets.

Third, all major banks have established their own investment funds through intermediaries. This is an extremely important feature of the financial sector in the Czech and Slovak republics since investment funds have concentrated in their hands a majority of shares privatized by the 'voucher method', as noted above. Whether banks will participate, directly or indirectly, in capital market more actively than at present will also depend an the liquidity of capital markets. At present, they are less liquid than money markets.

Fourth, major banks have applied for, and received licences to operate as brokers in the stock market. This corresponds to the same pattern that has developed in Poland and Hungary. In fact, the Hungarian authorities at first

[14] The total debt of the non-financial sector was much higher - 94.2 billion of Czech crowns at the end of the third quarter of 1992, or US S 3.2 billion. The difference was the so-called "secondary" indebtedness, i.e. the inter-enterprise debt. To some extent, of course, the secondary debt would, under normal circumstances, have to be replaced by primary debt.

relied exclusively on banks as brokers, as noted above. It can therefore be assumed that banks are going to be active in all segments of the financial sector.

Thus the emerging trends in the Czech and Slovak banking sectors are for relatively powerful banks. At the same time, we shall probably also see the emergence of banks whose impact on the development of the non-financial sector in general and on the development of the stock market in particular remains unknown and may be rather worrisome. Strong banks often mean that the development of non-banking financial institutions is to some extent crippled. The example of this phenomenon is Germany, where capital markets have developed slowly and continue to be relatively thin. The fact that the banks' activities will be closely intertwined with the activities of investment funds and those of stock market increases the dangers of restricted competition and will need to be closely monitored.

Competing Markets for Shares

The peculiar feature of capital markets in the Czech and Slovak republics is the emergence of two markets for shares, the regular stock market and the newer RM-S market. The former refers to a typical stock market complete with regulations about stock market membership, organization of stock exchange, listing of companies and other typical activities of these markets.[15] In addition, members of the formal stock market have also agreed to undertake trading with unlisted shares in view of the anticipated offers of shares by households and investment funds. In other words, the representatives of the formal stock market intend to create a secondary market for shares.

Parallel to the formal stock market will develop a competitive market for secondary trading of shares - the RM-S market. The main function of this market is, again, to enable trading with shares obtained through voucher privatization. This alternative market has been developed from the computer system, which was originally used to distribute shares against 'points' in the course of voucher privatization. The main feature of this market is to enable the trading of unlisted shares - like the secondary trading in the stock market. It will rely on hundreds of 'collecting locations' which will collect information about intentions to sell and about shares on offer. The actual market clearance, without any prior 'means test' of companies, will take place on computers in the RM-S headquarters.

How the two systems will coexist remains unknown. Initially, at least, they will enter as competitors. The thrust for the RM-S market was originally justified on

[15] See also discussion further below.

the grounds of a big network of offices capable of handling offers of shareholders scattered around on a geographically large area, and on the grounds of considerable experience with voucher privatization. In contrast, the establishment of secondary trading in the formal stock exchange was justified on the basis of low transaction costs but this argument has recently been put into doubt.[16]

High transaction costs would, of course, be a major concern since they could represent a serious disincentive to invest in the capital markets. Some foreign experts have also argued that foreign investors will be put off by this 'over-the-counter' method of trading. Their argument seems to assume that such trading does not provide any protection for investors.

Other Transaction Costs Issues

In addition to the transaction costs issues discussed above, other relevant matters should be raised. Among those, arguably the most important question is the issue of costs of different instruments. These questions will have to be addressed by the authorities soon since there does not seem to be much logic in the pricing of different services. For example, each new issue of securities is subject to a fee of 1 per cent of the nominal value of the issue. Thus securities are currently not competitive with discounted bills[17] and the high fee has been subject to serious criticism.

Other Stock Exchange Rules and Regulations

Other stock exchange rules and regulations appear to have been worked out reasonably well in all four countries. Nevertheless, some, albeit probably minor, issues still remain and will most likely be addressed in due course of time. In addition, the stock markets in all four countries will suffer from other 'teething' problems which are and will be typical of all emerging market economies. These are problems related not so much to the actual rules and regulations but rather to their implementation. The problem of 'policing' seems to be a general difficulty of all four countries.

[16] The typical costs to the client in the RM-S market will be: 5 Kc to purchase the trade form, 30 Kc to give the instruction to buy or sell, 8255 Kc for settlement of the transaction and 0,5 % of the transaction amount exceeding 1 million Kc. The comparable costs of the transaction in the stock market will be: 0,25 % of the transaction, payment to the broker in the range of 0,6%-3% of the settled amount and a fee to the Center of Securities /unknown/. These figures come from an interview with Mr. L. Sticha, director of RM-S in Svobodne Slovo, 27 April 1993.

[17] See M. Durina: Jak získat finanční zdroje; Hospodářské noviny, 15 July l993.

One rule which has been widely discussed in the Czech republic and which has been rather controversial concerns the minimum size of companies to make them eligible for listing in the stock market. The current requirement has been set at 100 million Kc (about $3,5 million) which is considered by some experts as low. Another example is the requirement concerning the age of the company. The rules now state that companies older then two years can qualify for being considered for listing. Once again, this rule has been criticized as extremely generous but understandable in view of the ongoing transformation of these countries into market economies. Profit forecasts are also going to be initially of dubious value, partly due to the short history of firms noted above and partly due to the lack of experienced staff. This is likely to contribute to volatility of profits and hence volatility of share values, which in turn will put off foreign investors since they will be unlikely to offset the volatility of profits by large volume of traded shares.[18] Some experts have also criticized the rules concerning the presentation of the company prospectus, which they found vague. As a result, the liability arising from information provided in the company prospectus remains questionable.

The question of investors'protection still remains highly problematic. As noted above, neither the government nor the stock exchange has so far come up with detailed and firm rules about disclosures and rules concerning mergers and acquisitions. This is in contrast to the rules valid in Poland and Hungary where the rules are generally considered to be comprehensive, sufficiently detailed and strict. The lack of rules could be detrimental to interests of small and individual investors and it could also lead to predatory and highly inefficient acquisitions.[19] As yet, no rules have been set up for the maximum percentage of shares which can be acquired in the market and which must be reported either internally or in the form of a public announcement. Furthermore, there is no requirement of capital adequacy for securities traders, which could considerably increase the vulnerability of those traders trading with large volumes.

Taxation

A major policy issue affecting the future development of capital markets could be government taxation of capital gains and income. The heavier the tax burden,

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[18] See discussion in section II - 3 further below.

[19] The dangers arising from the lack of regulations about disclosures and mergers and aquisitions are well understood in this part of the world. Docent Pavlat, who has been one of the main leading forces behind the establishment of the Prague Stock Exchange has recentlly complained about the absence of rules to protect small investors and about the need to have a public discussion about the actual rules. See Rudé právo, 19 April 1993.

the stronger the disincentives to investors to invest their resources in the capital markets. In addition, heavy taxation of capital gains and other investment income will provide a strong disincentive to save. For these reasons, the rational government policy is to minimize the taxation of capital income, except in cases of highly speculative capital movements, in order to reduce the instability of capital markets.

The taxation level in the Czech Republic is currently higher than in most other Central and Eastern European countries.[20] In addition, there are signs that taxation of investment income could become a major issue both on equity and efficiency grounds. While the present level of taxation is roughly comparable to many other countries for the taxation of dividends and interest from securities the Government intends to raise the tax burden of investors. Interest income is currently taxed at a rate of 15 per cent for 'physical' persons (i.e. households) as well as for 'legal' persons, i.e. primarily for incorporated entities. However, interest taxation is currently under review and may be increased to 25 per cent. Income from deposit certificates is currently taxed at a rate of 15 per cent but the rate may be increased to 25 per cent. Dividends are taxed at a rate of 25 per cent. Thus the tax incentive structure is currently tilted towards deposits rather than towards equities and securities.

Exactly the opposite situation currently exists in Poland. The government policy favours savings rather than consumption, and investments into equities rather than bank deposits. Interest income is tax exempt and so are any capital gains (the latter currently have a 3-year time limitation). The tax on dividends is 25 per cent, but zero if all dividends are reinsvested.

The Czech law makes two further exceptions for the treatment of taxes from dividends. The tax rate on dividends paid by investment funds is 25 per cent but only on that portion of their income which is not subject to a different tax regime. For example, income (dividends) of investment funds from shares and other securities which they own, is taxed differently. The taxable income of investment funds which is subject to a 25 per cent level of tax is obtained only after the deduction from the total income of the dividends from these shares and other securities. The second exception is the tax rate applied on dividends paid out to banks which is the corporate tax rate, currently 45 per cent.

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[20] See, for example, a comparison in Central European, May 1992. The source refers to the Czechoslovak tax schedule before the tax reform of January 1993. Nevertheless, the reform did not lead to such changes which would fundamentally alter the conclusion.

An even more serious problem appears to be the taxation of capital gains. One aspect of the problem is the complexity of the capital gains taxation. Another is inefficiency and, with one exception, extremely high tax rates. At present, the government is following its commitment not to levy a separate tax on capital gains. Nevertheless, capital gains are taxable at rates which depend on circumstances. The taxation of capital gains of physical persons depends on whether the shares have been obtained from resources dedicated for business activities. If shares have been acquired from resources which were not obtained from business activities of the person, the capital gain is free of tax if the share has been owned for more than one year. (This seems to be a political concession made on behalf of individual citizens who obtained shares through voucher privatization.) If the share is owned for less than one year, the appropriate tax schedule is the tax on the person's income less costs of acquisition of the share. If the share is acquired from resources obtained from business activity of the person concerned the appropriate tax schedule is the tax on incomes from business activities. Capital gains of legal persons are taxed according to the corporate tax schedule.

It can be seen that capital taxation is heavy. In particular, the taxation of capital gains is likely to be highly detrimental as a government policy instrument to attract domestic savings and investments. For example, since top marginal income tax rates are as high as 47 per cent, the application of the income tax schedule would make investments in capital markets almost prohibitive. This issue will certainly have to be reviewed by the government without any delay.

In contrast, the Hungarian taxation of dividends and capital gains is normally l0 per cent, the same rate as the one applied on the interest from deposits. Investments in shares are also encouraged by 30 per cent tax deductions from taxable income and no tax is applied on dividends by institutional investors. As noted above, trading of investment funds is encouraged through tax concessions given to the holders of investment units (the tax concession does not apply in the case of government securities).

The tax policy includes other distortions. For example, while interest on bank loans is tax deductible, the same rule does not apply in the case of interest on bonds. The current system discriminates, therefore, between two types of corporate borrowing strategies, favouring borrowing from banks. In addresing all these issues it must be borne in mind that tax compliance in the stock exchange is likely to be higher than that in the private sector of self employed businessmen. The latter will provide an even stronger incentive for small investors to avoid stock exchange, as evidenced in Hungary.

Foreign Exchange Regulations

The Czech Foreign Exchange regulations are given primarily by the Foreign Exchange Law. The law determines the relevant conditions under which it is possible to dispose of foreign currency and make foreign currency transfers abroad. These conditions are fairly liberal for foreign investors in both the Czech and Slovak republics. The only restriction of note is the requirement of licence (permission) from the central bank to transfer investment funds within 12 months from the date of investment. In contrast to these short-term investments, long term investments into securities (i.e. more than 12 months) have no transfer restrictions. The restrictions noted above were motivated by the governments' concerns to minimize instability of capital markets. However, since portfolio investments are typically very fluid and are made by investors with short-term horizons the restriction could be a strong disincentive for foreign investments.

The Hungarian and Polish regulations of foreign exchange regimes are not much different. In Hungary, there are virtually no foreign exchange restrictions which would affect stock market operations. There are no restrictions on capital repatriations or income transfers. There are also no restrictions on transactions involving foreigners in terms of maturity of securities or sectoral allocations. However, the first issue of Government bonds and some other special issues have been reserved solely for foreigners while other special issues have been reserved for nationals only. The local issues for the nationals have carried more favourable interest rates. In Poland, the foreign exchange regulations include the requirement to report the exportation of currency of over $2,000, the approval of credits from abroad in excess of $l million, some restrictions an purchases of treasury bills (most likely to be removed from July l993) and on purchases of banks.

II PRIVATIZATION AND CAPITAL MARKETS

l. Introduction

There is no doubt that the recent growth of foreign investment in Central Europe reflects mainly the opening of these economies and, very importantly, the governments' decision to privatize public enterprises. In this sense, privatization has enabled foreign companies to wholly or partially acquire assets offered for sale or it has, at least, opened considerable opportunities for joint ventures. But the decision to sell public enterprises, as remarkable as it is, is only the first in the series of steps that have to be taken in order to marry the privatization and foreign investment. Privatization is closely linked to influences emerging outside the privatization process[21] and to factors endemic to the administration of privatization. The latter included, for example, delays in legislation, and the lack of rules and transparency on tenders, on hiring foreign consultants, on financing privatization transactions, etc. Delays have also been encountered in answering the most fundamental questions: which enterprises should be privatized and which should be left in the public sector, or how to privatize those enterprises which the governments had earmarked for sale. It is clear, that if any of these issues are not successfully addressed, the barriers to foreign investments will remain immense.

The purpose of Part II is to identify the main factors which originate in the privatization process and which can slow down the expansion of capital markets. This could be a serious weakness in the transformation of these countries and could stall the overall market reforms. The presence of strong and dynamic capital markets is vital for the inflow of foreign capital and will help domestic companies seeking additional resources in the form of new equity. It is no coincidence that the best performing economies in the world in recent years include the emerging economies in South East Asia, where we have witnessed an impressive emergence of capital markets. Clearly, the expansion of the manufacturing sector in these countries has been highly conducive to the establishment of capital markets. *Pari passu*, the existence of capital markets has played an extremely important role in augmenting domestic savings to finance a high rate of domestic investments and in strengthening the foreign exchange reserves of the countries.

Part II is divided into four sections. Section 2 describes the economic factors which are conducive to the creation of capital markets. Indeed, these factors constitute in many instances real economic pressures to establish capital markets in the region. Section 3 identifies the main issues which will be inhibiting the expansion of capital markets. The last section specifies the main conditions for a more effective functioning of capital markets and offers some policy conclusions.

2. Pressures for Establishing Capital Markets

Pressures for establishing capital markets in Central Europe are very strong. The financial sector reforms started in all countries with fundamental reforms of the banking sector. The countries are now entering the second phase which will emphasize the need for a greater role of the non-banking financial sector. As we

[21] These problems included, for example, political instability, lack of monetary and financial control.

have seen in Part I, the role of the non-banking financial sector will be very important. The importance of the sector emerges from the need of companies to mobilize resources for growth and restructuring and to intermediate the links between domestic and foreign investors and the corporate sector. Thus the pressures for establishing capital markets have their origins both on the demand and supply side. These are now discussed in turn.

Demand for Long-Term Capital

Arguably the most important reason for establishing capital markets in the region is the strong demand of the corporate sector for long-term capital. Financial needs of companies are great and they originate from the need to modernize their technologies, to finance the expansion of the private sector and to restructure existing companies. The needs are currently met primarily from bank borrowing which has been increasingly tilted towards short-term and medium-term credits. This adversely affects corporate investments, which typically have longer gestation periods and which require adequate ’recoupement’ periods to repay bank credits. It also encourages more specualtive investments which have shorter time horizons.

Table 1: Time Structure of Credits in the Czech Republic. a)

Billion Kč	12/91	03/92	06/92	09/92	12/92	03/93
Short-term	195.6	198.2	210.4	214.1	216.6	240.7
Medium-term	90.1	96.7	109.3	139.2	154.2	161.8
Long-term	209.7	204.9	202.4	198.0	207.8	202.6
TOTAL	495.4	499.8	522.1	551.3	578.6	605.1
Short-term	39.5	39.8	40.3	38.8	37.4	39.8
Medium-term	18.2	19.3	20.9	25.2	26.7	26.7
Long-term	42.3	41.0	38.8	35.9	35.9	33.5
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

Note: a) Excluding foreign exchange loans
Source: Czech National Bank

Related to this problem is the current leveraging of companies, which in many instances appears to be too high. Over-leveraged companies may require a change in the structure of financing which may be satisfied through greater equity financing. As indicated by gross debt data for the Czech Republic, for example, the debt problem appears to be indeed quite serious. As noted above, the total outstanding debt of the corporate sector amounted to 94.2 billion Czechoslovak crowns at the end of the third quarter 1992. This compares to the total amount of profits in the non-private sector of 18 billion crowns in the same period. In other words, the total debt exceeded total profit 5.3 times. The situation has been even more serious in Slovakia where the total outstanding debt amounted to 60.2 billion of Czechoslovak crowns, or about 15 times higher than the total profits of Slovak enterprises in the non-private sector in the same period.

Nevertheless, how important the current debt problem is remains uncertain. This is partly because, as noted above, a large part of the companies' indebtedness is due to secondary debt, i.e. inter-enterprise debt. The latter has in turn emerged partly because of the difficulties of companies to survive in a new market environment, which is a genuine market reason. The debt is quite sizeable in all four countries. In Poland, for example, the size is estinated about (300-400 trillion zlotys (about the same amount as the total outstanding credit to the private sector and in the Czech Republic, the size is relatively smaller (about 50 per cent of total outstanding credit) but still quite significant (more than 100 billion Kc). However, another reason has been the lack of financial discipline of companies which refused to pay their own suppliers in response to the failure to receive payments from their clients. In the latter case, the total company's debt should be adjusted for all receivables which have a real chance of being paid in order to ascertain the true debt service of this company.

On the other hand, the current debt problem is not the only issue. In addition to current liabilities, many companies in the Czech Republic have future liabilities which arise from the privatization of these companies. The financing of privatization of many companies has been provided by the government in the form of a liability to be serviced from the future profits of the privatized company. Furthermore, many companies are facing additional liabilities as we shall see below. It appears, therefore, that there are companies which will be in serious financial situations due to extremely heavy debt burden arising from current and future financial liabilities. How many companies, and the sectors in which sector they can be found, remains a big unknown.

Another important factor affecting demand for capital is the method of voucher privatization in the Czech Republic. The privatization has led to a significant dispersion of shareholding among individual investors and investment funds (See Table 2). As discussed above, the latter have been restricted by the law governing how they should spread their own risk and how much control they can get in each company. As a result, it is expected that many investment funds will seek to obtain a more effective control of companies by consolidating the shareholdings in their portfolio. This will lead to a shift in portfolio holdings of investment funds through transactions in capital markets.

Neither Hungary nor Poland has yet started its mass privatization program; the establishment of a market for secondary trading is, therefore, much less pressing.[22] The slow process of privatization is particularly serious in Poland. The process has been slow due to delays in passing legislation on the Mass Privatization Plan and by the lack of consensus on the selection of 600 companies that would be privatized as part of the Plan. This has greatly restricted the total number of shares available in the market and, together with booming demand for equities, it has resulted in the explosion of equity prices and of traded volumes as noted above. It is evident that the major issue of stock trading in Poland is currently not the lack of liquidity as in the Czech Republic but the shortage of shares. The recently approved law on Mass Privatization

[22] For a review of the Polish and Hungarian privatization program see, for example, Ben Slay: Poland: An Overview, and M. Marrese: Hungary Emphasises Foreign Partners; both in RFE/RL Research Report, Vol. l, No. 17, 24 April 1992.

should therefore go a long way in widening the stock market but the actual selection of companies still remains unresolved.[23]

Table 2: Key Dimensions of Czechoslovak Voucher Privatization

Privatized companies	Before reorganization	After reorganization
Total	1,491	1,491
-Czech Republic	943	988
-Slovak Republic	487	503
-Federation	61	0
Book value of property	Billion Kč	Billion $
Total value	299.4	10.3
-Czech Republic	206.4	7.1
-Slovak Republic	90.1	3.1
-Federation	2.9	0.1
Number of shares offered for sale	299,393,282	
-Czech Republic	212,490,000	with a face value of 1,000Kč, or $34.50
-Slovak Republic	86,900,000	
Number of participating investors	in millions	
Total	8.54	
-Czech Republic	5.95	
-Slovak Republic	2.59	
Unsold shares	in millions	% of total
Total	21.55	7.2
-Czech Republic	14.46	6.8
-Slovak Republic	7.09	8.2

Source: Planekon, Report of 31 December 1992, Washington, D.C..

[23] As of the end of September 1993, the agreement existed between 195 companies of the target of 600.

The Liquidity of Capital Markets.
On the supply side, there are two principal factors which are pushing for the establishment of capital markets. The first factor is the availability of long-term domestic resources which are not currently translated into long-term investments. The main reason is the absence of intermediation between the institutions which manage the resources and those which demand them, and the high level of interest rates which encourage the growth of bank deposits. The long-term resources available in these countries are the pension funds, medical and other insurance funds and social security funds. It appears that these funds are currently partly deposited with the banking sector and partly managed by the funds themselves. In either case, these long term resources are not translated into long-term lending of the banking sector as noted above nor are they reflected in long-term investments of the funds due to the absence of appropriate market instruments. Moreover, even in those situations in which some of these funds have been allowed by regulators to provide credit, such as in the case of the Czech Insurance Company, the result has been the same as in the case of the banking sector - the lending has been almost exclusively concentrated on short- and medium-term credits.

The very limited amount of long term investments is due, not only to the lack of market instruments but also to the limited availability of long-term resources. The lack of long-term resources reflects in turn the saving habits of economic agents, availability of credit and the effect of taxation. This can be quite well documented on the Polish example. The explosion in demand for equities in Poland in early l993 was due to the fall in interest rates, the increased availability of credit for purchases of shares (about 50 billion zlotys), and due to the abolition of capital taxation. In contrast, the liquidity of the Czech stock market has remained relatively limited, partly because Czech savers have not moved their savings out of bank deposits into the purchases of shares.

The second factor on the supply side is the availability of foreign capital. As it is well known, a large and ever-growing proportion of foreign investments in world markets takes the form of portfolio and indirect investments. This type of investment seeks liquid markets which enable the possibility of trading and 'exit' and which do not require direct involvement in the management of those companies whose shares are acquired by these investors. Moreover, there is plenty of evidence to suggest that some, and needless to say not an insignificant proportion of this type of capital, seeks opportunities in Central and Eastern Europe for which the establishment of capital markets is, therefore, vital. In Poland, for example, the share of foreign investors in the stock market trading is estimated to be currently in the range of 25-3O per cent.

The impediments to foreign investments are still numerous and they vary from country to country. In general, the impediments have institutional and policy origins. The major institutional matters include unresolved ownership rights (Czech Republic) and liability issues (all countries), which will be discussed further in the text as will be other impediments due to privatization. In addition, the countries also impose other restrictions on foreign investors: For example, Poland requires permission for foreigners to engage in (l) management of ports (sea, air), (2) agency or sale of property, (3) defence industry (4) wholesaling of imported consumer goods, (5) giving legal assistance, (6) banking, (7) stock-broking, (8) production of alcohol, cigarettes and medicines . The current Czech regulations restrict foreigners to the purchase of securities with maturity longer than one year.[24] Similar restrictions exist in the other countries. (9) The countries still suffer from some policy distortions such as pricing of land or energy or from unresolved problems of restitution. Once again, the specific policy issues may vary country to country and a detailed review of these issues would go beyond the scope of this study.[25]

The importance of foreign capital for domestic capital markets is increased by the additional fact that none of the countries in question has sufficient domestic savings to finance all the privatization deals, the restructuring needs and the expansion of the private sector. For example, the total domestic savings in the Czech Republic, a country with a traditionally high propensity to save, amounted to 551 billion Czech crowns at the end of April 1993.

In contrast, the financial requirements of privatization alone greatly exceeded this amount. The total book value of assets privatized through the 'voucher method' was (in the Czech Republic) about 206 billion Czech crowns in the first wave alone (see Table 2). This figure excludes assets to be privatized in the second wave of voucher privatization, the book value of which is estimated to be almost as high as the book value of assets privatized in the first wave. Excluded are also assets privatized through more standard methods and assets privatized in the so-called 'small privatization'. If we further allow for the fact that the book value of assets are typically greatly underestimated perhaps by a factor of 2-4, then we can see that domestic assets could not possibly be privatized through domestic capital above.

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[24] See, for example, the Polish Security Commission Information Handout, l993.

[25] Two other groups of impediment to foreign investments should also be noted - legal and administrative restrictions and the lack of infrastructure. For details, see, for example, Z. Drábek: Foreign Investment in Czechoslovakia: Proposals for Fine-Tuning Measures of Policy Reform; Prague: Charles University, CERGE, Working Paper, No. 4, February l992.

Furthermore, domestic resources may have to be ’matched up’ with foreign capital which acts as a *catalyst* to activate these resources. For example, the highly cautious behavior of domestic banks is partly due to the absence of proper instruments which would reduce foreign exchange risks (e.g., exchange rates hedging), and partly to their inexperience in evaluating the credit risk. Clearly, as much as foreign investors can benefit from joining the domestic banks and other financial institutions; the latter can and, to some extent, will benefit from partnership with foreign capital.

3. Impediments due to Privatization: Main Issues

Strictly speaking, privatization *per se* cannot be an impediment to the development of capital markets. Capital markets require profit oriented and commercially-driven entrepreneurs, who flourish best in the private sector environment. Even in countries which are not strictly capitalist economies but in which capital markets are developed, the entrepreneurs’ behavior is very close to that which one would expect in an economy dominated by the private sector. Nevertheless, under certain conditions privatization may become a burden or, at least, no longer prove conducive to the development of capital markets. In general, privatization becomes a hindrance if it is implemented poorly or slowly. Based on the most recent experience in the Czech and Slovak republics, Hungary and Poland, it is possible to think of several specific aspects of privatization which can become such impediments. These are now identified in the following discussion. It should be noted that the issues include only some, albeit perhaps the most important and relevant aspects of privatization.

<u>Sequencing of Restructuring</u>

It is widely accepted that many companies in all three countries will have difficulty surviving in a new competitive environment and will have to be restructured to assure their long-term viability. In the Czech Republic, for example, the number of enterprises with serious financial difficulties has dramatically increased between 1989 and 1993, as discussed above. The question has therefore been on the cards for some time whether or not the companies should be restructured before they are sold. This issue has been resolved quite unequivocally in the Czech Republic, where the decision has been taken to privatize all assets before they are restructured. A company is, therefore, sold ’as is’ and restructuring may take place only after the companies have been sold to their new owners. This reflects the policy of ’putting the government out of business’. In Hungary, the decision was taken after long discussions to restructure several companies before they were privatized. In Poland, the restructuring of essentially profitable companies is planned to be carried out at the same time as companies are transferred into the hands of specialized investment funds. Restructuring of unprofitable companies, however, has been delayed and different proposals continue to be discussed. Thus, the countries have embarked on paths which involve all possible options of sequencing, but each approach has adverse implications for the growth of capital markets. The Czech approach has simply meant that companies' restructuring programs and financial decisions including their access to capital markets has been delayed. In Hungary, the restructuring process is slow since it is highly centralized. In Poland, it was the decision about the general privatization and restructuring strategy which was delayed.

Pricing of Shares

The experience with these schemes is limited but, on *a priori* grounds, it is possible to identify two distinct cases of sales of companies before their restructuring which will have clear implications for the operations of capital markets - sales of strong and weak companies. The attempts to sell financially stronger companies through public issues are more likely to succeed than attempts to sell companies which are nearly bankrupt. On the other hand, sales of weak companies are bordering on the highly improbable. Moreover, even if such sales were to be possible through public issues, these shares could be sold only at appropriately discounted prices in order to offer prospects for their appreciation in the future - a crucial condition to attract venture capitalists. In both cases however, the trading of shares in the stock market is likely to be slow, at least in the early stages of capital markets as we shall now demonstrate.

The importance of the first group of transactions (sale of strong companies) for the evolution of capital markets is an empirical problem. There are reasons to believe that the number of 'strong' companies will vary from country to country. The Czech Republic will probably be at the more attractive end of the spectrum with Hungary and Poland lagging slightly behind. In general, however, the number of strong companies is likely to be relatively small - even in the Czech Republic. The main reason is the revenue-generating capability of most companies which remains largely untested. Most companies in the former socialist countries have not been exposed to the pressures of domestic and, mainly, Western competition, and their ability to survive in the new market environment will have, at best, a limited historical record. Exceptions will be companies with foreign - Western - participation or 'blue chip' companies with long industrial tradition e.g., Pilsner Urquell, Budweiser, Skoda, Becher, Moser, Petrof, etc.. Other companies which are likely to become attractive for investors are companies producing primarily for the domestic market and which are not threatened by foreign competition. These are companies in the so-called 'non-traded' sector - e.g., construction, transport, telecommunications and others.

Trading of shares of other companies will be much more difficult, if not impossible. Such companies can be considered to be 'weak' companies for several reasons. A part of the reason lies in the perception of managers and government officials who see the value of companies as unrealistically high. This has led to situations in which negotiations with foreign partners were protracted and excessively cumbersome. In some instances, the negotiations were abruptly stopped and the company withdrawn from the market and treated as non-saleable to foreigners on ’national security grounds’. All these examples suggest that the introduction of public offerings is likely to be slow in the beginning.

The alternative could be a market absorption of unrealistically priced shares with the consequence of price collapse in the subsequent periods. The example is the performance of shares in the Budapest Stock Exchange. After the initial excitement of the first equity issues in the market, investors reacted by purchasing shares at unrealistically high prices. The pricing of shares was evidently so problematic that the share prices collapsed by more than 30 per cent within of one year. Investors are more cautious today and overpricing of shares will become more and more difficult and, hopefully, less and less frequent. The Polish experience is very interesting in this respect because the stock market performance has been exactly the opposite.

The main reason for the difficulties in trading shares of the second - i.e. weak - group of companies is that the companies will often have to be restructured if they are to have any solid base for survival. The restructuring process may have to involve different aspects of company activities: restructuring of balance sheets, improvement of technology or management, requalification of the labour force, change in the product-mix, choice of markets, etc.

This does not necessarily mean that governments will have to intervene and/or carry out the restructuring of companies. What it does mean, however, is that whatever restructuring is to be made by the new owners must not be blocked by unresolved institutional or policy issues. Needless to say, there are still many left. These issues can be resolved only by a government action or through legal proceedings which, too, may require a prior government intervention. Some of these major issues are discussed in the following text.

Unresolved Ownership Rights Issues

All four countries have resolved the long-standing problem of unclear ownership rights by transforming in the first instance public enterprises into commercial entities such as joint-stock companies in which the State was the only (or the majority) owner. Unresolved remain, however, the ownership rights related to restitution in the Czech Republic. For example, several legal subjects have claimed ownership rights for the same asset. New claims for restitution are also being pushed for by different political parties, such as in the case of church property. These matters are considerably simpler in Poland and Hungary, where restitution of assets to their previous owners has not been allowed.

Another similar problem is the case of assets of certain enterprises, whose value is highly doubtful. Such assets include claims on foreign partners in the former Soviet Union which arose as a result of special trading arrangements in the past or in the absence of proper government or bank guarantees. In addition, there are also outstanding claims in several developing countries including, inter alia, Syria, Iraq, Lybia. In total, the outstanding claims of the Czech Republic on their partners abroad amounted to $7.9 billion at the end of 1992. The implication of these unresolved questions for trading in capital markets is quite evident. The valuation of companies with unresolved outstanding claims abroad will be difficult and highly controversial, and the shares of these companies will not be traded until the matter is resolved.

Unresolved Liability Issues

Together with the unresolved ownership issues, the privatization process has been hampered by unresolved issues on the liability side of the balance sheets of non-financial enterprises. The lack of resolution on these issues means that many enterprises are burdened today with excessive liabilities which are putting them in the position of insolvency. The problem with some of these liabilities is, however, that some of them have been contracted on dubious terms and are contested by the enterprises. The liabilities can be characterized under two headings (1) liabilities which arise from environmental damages and (2) liabilities which arise from contracts made on behalf of the communist governments, such as the development of nuclear power technology in the Skoda works in Plzeň, etc. As in the case of unresolved ownership rights, unresolved liability issues will result in difficulties in establishing the values of companies and, consequently, in pricing shares for flotation on the market.

Shareholders' names

Shareholding may often be highly dispersed. This is particularly the case in countries in which privatization takes place by means of the vouchers, which have enabled a distribution of shares across a wide spectrum of the population. The original voucher privatization was first introduced in the former Czechoslovakia, and is also the scheme which has led to the most dispersed form of shareholding. Dispersed ownership may have the disadvantage of producing an ownership structure in which no single owner has the dominating control; it may require a consolidation of ownership rights through trading of shares.

The need to consolidate shares in order to increase the concentration of shareholding raises a question of publishing the names of the (principal) shareholders. The practice of publishing names has been widely used in the Czech Republic, primarily in the context of sales to foreigners since all foreign investment deals have to be approved by the government. While understandable, the practice has meant that all foreign investment deals have automatically tended to attract much greater attention on the part of small investors who *a priori* had a greater trust for such deals than for deals which did not involve foreign investors. As a result the prices of shares have increased. There may be nothing fundamentally wrong with this system, particularly at this stage of the privatization process since financial and other information about companies has been rather limited. Nevertheless, there is no doubt that the publication of shareholders' names has resulted in the above mentioned biases.

The dispersion of shares is a major issue primarily in the Czech Republic. The reason is the greater role played by the voucher privatization in comparison to other forms of privatization in Poland and Hungary. According to CERGE's Privatization Newsletter, the total number of companies privatized by the 'voucher method' in 1992 - outside public tenders and auctions or direct sales - was 943, which constituted 29 per cent of the total privatized business units in that year, and represented 59 per cent of the total number of privatization projects. The numbers are much smaller in Poland and Hungary.

Trading of Unlisted Shares

Another uncertainty is the way in which unlisted shares are to be traded. Under present circumstances virtually all shares in the four countries remain unlisted but the issue is particularly important in countries in which shares have been acquired through the scheme. The issue is important in these countries because the scheme has enabled the distribution of a great deal of shares among a considerable number of investors and this has increased the importance as well as the scope for the trading of these shares.

As noted above, the channel through which the currently unlisted shares could be traded is, of course, the newly emerging stock exchanges in these countries. It is quite well known that representatives of these stock exchanges have indeed the ambition of becoming the major market for those shares. In practice, however, this is going to be surrounded by considerable difficulties. One reason is and will be the continuing difficulties of ascertaining the values of companies because of unresolved issues on their balance sheets as noted above. Another reason is the short endurance period of managers, and indeed that of the companies in general. The experience with many companies of this region is too limited, and the companies typically operate in a completely new competitive environment. This does not allow for a reliable and trustworthy credit assessment.

The alternative ’solution’, which has recently been proposed in the Czech Republic, is the RM-System which has had the mandate of trading shares obtained under the voucher scheme. As we have seen in Part I, this involved a market-simulating approach to clear the market for shares on the basis of a computer-designed iterative process of market clearing. A similar procedure is proposed for the trading of shares acquired by individual and collective investors. However, the problem with this scheme is that it would be based only on bids and offers collected by the Center which would then find a mathematical solution without a proper and a prior assessment of the company’s true credit risk. In other words, the scheme assumes that investors would have already done their background analysis on the companies - an analysis comparable to that which is required under the standard rules for the permission to float shares on established stock exchanges. It is unlikely that this analysis would be done by the Center itself which does not have the capacity to do so and, under the existing rules, the responsibility for the analysis and the company check has been given to the stock exchange. Moreover, in the absence of an agreement between these two institutions there is likely to be another delay in creating an efficient market place for these stocks.

Thus likely to be traded on stock exchanges are companies with foreign partners, wholly foreign-owned companies or companies for which there is an established ’track record’. This will highly restrict the number of companies in the position to claim a sufficiently long company history to convince investors, especially foreign investors, that these are companies which are inherently tradeable. As noted above, these will typically be companies with established markets abroad, in particular in the highly competitive markets in the West or companies which will have a captive market domestically. It should be added that the number of companies is likely to vary with the maturity of each country as an industrial economy. This is the main reason for finding more of these companies in countries like the Czech Republic.

Bankruptcy

The fundamental issue - one which is related to all of the problems defined above - is the question of bankruptcy laws. The bankruptcy laws are crucially important for a normal functioning of inter-enterprise relationships in order to ensure a timely and efficient enforceability of outstanding claims. The existence of bankruptcy laws is equally important for the privatization of public enterprises which is under way in the four countries of the region. It is clear that an effective transfer of ownership from the State to the private sector cannot be completed until all the unresolved issues of enterprises balance sheets discussed above are clarified. Until then, it will be impossible to convince any serious investor that shares offered for sale have a real positive value and/or notify them of the extent to which they must be discounted in the market. It is therefore not surprising that enterprise debt has increased considerably in all four countries. It is perhaps even less surprising that most of the debt has been the result of rising inter-enterprise debt, as noted above. The resolution of the bankruptcy problem is extremely complex, and its related issues discussed further below are common to all four countries.

The enforcement of bankruptcy laws, however, remains obscure. According to independent estimates in the West, bankrupt companies could account in the Czech republic for as much as 30 per cent of the total number of industrial enterprises. It is quite possible that the percentage is even higher in the other three countries. In Hungary, the total number of applications for law suits was about l2,000 from January l, l992, when bankruptcy law came into effect until mid-l993. These figures are clearly extremely high, suggesting that the potential unemployment problem in these countries is equally serious. Since the political implications of the unemployment problem are also highly sensitive it is very doubtful that the bankruptcy laws will be enforced in full and without any modifications to shift the burden of debt settlement from creditors to debtors. The first indication of this process is the bankruptcy law in the Czech Republic where the original version of the law has been amended after domestic discussions lasting for more than one year.

Here are the main modifications to the original bankruptcy law: (1) protection period of 3 months has been introduced, (2) privatized companies cannot be taken to courts for bankruptcy, (3) agricultural farms cannot be taken to courts for bankruptcy during the ’vegetation’ period, (4) in contrast to the previous draft, the law enables one to sell the whole entity of the enterprise which is under bankruptcy proceedings, (5) the amendment restricts the powers of management of companies under bankruptcy proceedings, (6) the powers of creditors are increased (e.g., the approval of all creditors is not required in all cases).

Settlement of bankruptcies also remains unresolved. The main issue is the question of how the outstanding claims should be financed. The government is currently considering the following methods of settlement: (1) purchases of the claims by the National Asset Fund, (2) purchases by the Consolidation Bank, (3) debt-equity swaps, (4) write-offs and (5) settlements between debtors and creditors. While theoretically attractive, these methods pose a number of problems. First, the National Asset Fund is by law only a collector of proceeds from privatization, and under no circumstances is it supposed to enter into management issues, let alone into collection of debts. Without appropriate changes in the law, the Fund would have to make its resources available for another institution such as the Consolidation Bank. Second, given the scarcity of resources the Consolidation Bank would have to be selective in the choice of debtors whose debts it would be prepared to finance. This amounts to a policy of 'picking winners' - a policy which the government has consistently rejected until now. Third, the use of debt-equity swaps is unlikely to be an effective instrument in view of the current regulations on banks which are stipulated in the Banking Law. The law restricts the bank holding of shares to 10 per cent of total assets of a given company. In addition, shares can constitute only up to 25 per cent of the bank's total capital and they can be held by the bank in question only for up to two years.

What all this means is that the process of bankruptcy proceedings will most likely be slow even though all four countries are seeking ways of making the process faster and more flexible. The process will be slow partly because of the likely recourse to the Chapter 11-type of clause which protects debtors from creditors for a period of three months, as noted above, and in some cases even longer. The three-months protection period has been already found by some agencies specializing in bankruptcy proceedings to be too short for settlements of disputes, and there will be pressures to extend it. In addition, the unresolved issues of the status of the National Asset Fund and of the powers of the Consolidation Bank will also take time to settle. Furthermore, the courts are also likely to be moving slowly due to the lack of experience with bankruptcy proceedings and due to budgetary constraints. The unresolved balance sheet issues discussed further below will make restructuring costs unclear, which will discourage foreign investors and encourage green field investments instead, wherever possible. Commercial banks have been also found to take a more cautious approach - they tend to seek an arrangement with their debtors rather than their bankruptcy. A good example of these problems is found in Hungary. Out of the total member of l2,000 law suits between l January and 30 April 1992, 6,000 were thrown out of court on grounds of formal irregularities. 3,000 cases have been pursued but the remaining 3,000 cases are pending without any official explanations of the reasons for the delay. The total number of actual bankruptcies has so far been only "a few dozen".

Other Unresolved Balance Sheet Issues

A great deal has already been written in the press about shortcomings of accounting practices in the former communist countries. The countries under consideration in this report are no exception. We have already discussed several issues concerning both the asset and liability sides of the balance sheets but there are other accounting differences which distort the companies' balance sheets. For example, one of these issues is the value of physical capital which is shown in the balance sheets of firms in terms of highly unrealistic accounting values. Depreciation rates have also no rational economic meaning since they are typically set without much relationship to the real depreciation under market conditions. Balance sheets are typically not prepared on the accrual basis, distorting the picture of an enterprise's financial position.

CONCLUSIONS AND SOME POLICY RECOMMENDATIONS

Capital markets in the Czech Republic, Slovakia, Hungary and Poland are in the early stages of development. For that reason, the markets are extremely thin both for securities and for equities and they are at present far from fulfilling their main tasks. We have not seen so far much activity among companies to raise capital outside the banking sector nor have we seen much active interest on the part of investors to position themselves in these markets. But we have to emphasize that these are only early stages, particularly since the privatization process has not so far reached the momentum for which the presence of capital markets is relevant and important.

Nevertheless, all four countries have made considerable progress in establishing the capital markets in the anticipation of much greater activity in the future. They all now boast stock exchanges which are well staffed and equipped with sophisticated payment and settlement systems; they have established regulatory bodies, passed proper legislations, opened the room for the establishment of various non-banking financial institutions such as investment and mutual funds and liberalized conditions for entry into the market. Foreign banks have been able to open their subsidiaries in the Czech Republic and Slovakia on the basis of the 'national treatment' principle and through them several of them have become members of the local stock exchanges. The conditions are slightly more restrictive in Hungary and Poland. In sum, the progress has been quite impressive and promises to attract considerable attention for future investors.

Initially, the attention will undoubtedly focus on the mass privatization in the Czech republic and Slovakia. It is expected that the privatization will lead to a considerable interest in secondary trading of shares due to anticipated attempts of households to adjust their wealth portfolios and cash in their equities, and due to the attempts to consolidate effective equity ownerships. Once the round of such transactions is completed the activity in stock exchanges will be more dependent on primary trading.

With the exception of mass privatization the establishment of capital markets and its related institutions is a necessary, but not sufficient, condition for capital markets to be active. It must be said that in spite of all the progress made so far, the future of these capital markets in general, and from the point of view of foreign investors in particular, is not entirely clear. The main reason are the persisting difficulties of different kinds which constrain the operations of the markets at present. We have divided these difficulties into three main areas - problems of liquidity, problems related to the institution of stock exchange, such as the role of regulations and regulatory bodies, and problems related to unresolved issues of privatization. The problems overlap in some instances and emphasize the interconnections between capital markets and privatization.

Liquidity

There is no doubt that the demand for capital will be very strong in all of these countries. The report has discussed some of the major reasons why the interest to issue securities and equities in the capital markets will emerge quite powerfully both from the government authorities and from individual companies. Much more unclear, however, is the supply of risk capital in the market. Risk capital is always in short supply but its scarcity in Central Europe will be particularly evident, partly because of the relative magnitude of demand for capital and partly because of the problems noted above.

The role of banks depends on the status of banking regulations. These currently restrict the equity exposure of banks in order to ensure their adequate liquidity as well as restrict the time exposure to equity holding in order to limit the banks' effective ownership and control of non-financial enterprises. The banks which have a significant amount of non-performing loans are unlikely to swap these loans for equity on a large scale since they would lose seniority on their claims and would have to get involved in activities in which they can hardly claim expertise such as the management of industrial enterprises. Moreover, banks currently prefer to deal with money markets rather than with capital markets, which are less liquid.

The main actor in capital markets in the Czech Republic will undoubtedly be the investment funds. How far and how active the funds will be, however, will also depend on a number of factors. The current government regulations restrict their effective control of companies by restricting their investment exposure. If the maximum permissible share will not give them the effective control, their demand for additional shares may be muted. In addition, some investment funds are themselves not very liquid and they will require access to bank credit. Furthermore, very few investment funds have so far even attempted to pool real savings of households. The scarcity of resources of investment funds could be a particularly difficult problem and will require clear and fairly liberal regulations on the part of the monetary and tax authorities regarding the provision of bank credit for the purchases of shares and the elimination of certain investment disincentives as we have seen above in the text.

Foreign investors may face a specific constraint of another kind. Foreign investors are typically protected in these countries by domestic legislation and by bilateral investment protection treaties. These treaties had been typically concluded at a time when companies were planning direct foreign investment in the partner country. The protection of indirect investments is, however, surrounded by a certain amount of ambiguity. The access to capital markets may be also restricted. The legislative or regulatory system of investment protection would therefore benefit from a clear and unequivocal confirmation of policy which does not discriminate between direct and indirect investments, and one which minimizes the number of restrictions (a ’negative list’).

In addition, the supply of risk capital may be generally impeded by several institutional and policy imperfections. First, investors’ security continues to be limited; it is currently provided primarily by real (fixed) assets. However, the value of such a security has also been adversely affected by unreliable pricing of these assets. In general, the provision of security has also been affected by inadequate information about companies and by various unresolved issues of balance sheets of companies. These matters will require the governments to ensure that adequate information is more widely available and that the government resolves matters such as those related to certain aspects of enterprise indebtedness or to liabilities for enviromental damages.

Incentives for portfolio investors must also be modified. It appears that most countries in the region have focused so far on those aspects of tax reforms which related to indirect taxes and to income taxes. The result has been a considerable improvement in these tax regimes but rather serious distortions in the case of taxes affecting investment activities. The Czech and Slovak tax regimes, for example, do not allow for specific capital gains taxes, and as a result the tax incidence from capital gains is almost prohibitive as seen in Part I. The structure of taxation of investment income is also distorted and will need to be changed. Another example of distortionary tax policies in the Czech system is the system of deductions from alternative costs of borrowing. Even though the countries have already had several amendments to original tax laws, it is becoming evident that more changes will be necessary in order to attract new investors, especially households.

<u>Stock Exchange Regulations</u>
Valuation of securities has been one of the major problems in the limited experience so far. The reasons have been identified and they include insufficient quality of information about companies, regarding in particular the financial disclosures of companies. Sometimes the problem has been that independent audits have not been required. Other technical difficulties have included sectoral and other restrictions for foreign investors in all countries, different regulatory enviroment for investment funds as compared to other financial entities in the Czech Republic and Slovakia, shortcomings in the enforcement of regulatory

measures as well as the lack of incorporation of settlement and clearing systems into the European networks in all countries. The major policy question is therefore whether governments today should intervene through tougher regulatory standards to increase the amount of available information.

Whether the government should or should not intervene in this matter, however, is still a matter of dispute among experts. As indicated in the text, the case for more regulation has been disputed by several prominent experts who argue that more regulation will not necessarily mean more efficiency and that there is a better, that is a more efficient , way of controlling the investment activities and that is competition. On the other hand, opponents argue that competition may be a more suitable way of more efficient securities markets perhaps only in mature and large markets, and that regulation may be justified on equity grounds. Even though the matter has not yet been resolved and the ’jury is still out’, the majority would argue for the case of an efficient regulatory network.

Privatization

On the demand side, privatization is a vital element of capital markets and will therefore play an important role in the development of capital markets of the countries concerned. At present, however, privatization may not provide a strong stimulus for the development of capital markets in the initial stages. One reason is that the number of companies which can satisfy the strict conditions for quoting on the stock exchange is relatively limited. Another reason for the absence of relatively good candidates is the need for restructuring of many companies - a process which is slowed down by the delays in the bankruptcy proceedings.

The difficulties to quote shares of companies are related to problems discussed in the text - limited historical records and serious structural difficulties of many companies. Thus, the countries in which public companies are, or will be privatized before being restructured must provide the conditions for private owners to acquire the effective ownership of these companies. This means that the conditions will have to be created for venture capital to step in where the State refused - perhaps justifiably so - to restructure the companies before their sales. These conditions must include the possibility for venture capitalists to obtain the majority or at least the dominant shareholding in those companies which will have to be restructured. Thus, an information network and centers have to be created to provide potential investors with the information about shares for sale and bids for purchases of shares. In the Czech Republic, these centers will include commercial and savings banks and brokerage firms. A more efficient clearing mechanism must be established for the acquisition of the required percentage of shares. In the case of the Czech Republic, a decision will have to be taken to decide which of the two existing institutions will perform the trading in order to avoid inefficiencies. The decision should also be taken in the process to determine whether it is in the interest of efficient equity trading to release names of shareholders or potential investors.

These are primarily institutional issues which will need to be addressed but there are also policy issues to be considered. In contrast to conditions just noted which refer to the organizational arrangements of the stock exchanges the following policy recommendations refer entirely to the policies towards privatization. Thus, unresolved ownership rights issues will call for the government to decide the extent to which restitution rights can be modified and, if so, how and what legislative steps need to be taken. Unresolved liability issues will require that the government decides which policy will be adopted in clarifying the liabilities for environmental damages and for debts contracted by enterprises on behalf of the communist government. Prior government decisions may also be needed in situations when investors are interested only in a part of a large company which constitutes a holding of sister companies. In sum, the contribution of privatization on the evolution of capital markets in Hungary, Poland and in the Czech Republic is likely to be small outside the ’voucher scheme’ in the beginning of the process. The markets will develop rather slowly particularly in situations which will require participation of foreign capital.

APPENDIX 1 Non-banking Financial Sector: Main Laws and Regulations

CZECH REPUBLIC

’Basic Conditions for the Admission of a Security to Stock Exchange Trading’, issued by the Stock Exchange, March 11, 1993;

’The Legal Act of April 21, 1992, on Securities and Stock Exchange’;

’The Commercial Code’, the Legal Act No. 513/1991, Col.;

’The Stock Exchange Rules’, issued by the meeting of stockholders of the Stock Exchange on April 21, 1993;

’The Regulations of the Shareholding Company - The Stock Exchange’;

’Regulations about the Stock Exchange Arbitration’, issued by the Stock Exchange.

- Law about Mutual and Investment Funds,
- Foreign Exchange Law 528/199O Col. and its Amendment of 22 April 1992,
- Law on Banks 21/1992,
- Law on Czechoslovak State Bank - 22/1992,
- On the Conditions of the Transfer of State Property to Other Persons, Act 92/1991 Col.,
- On the Emission and Use of Investment Vouchers; Act 383/1991, Col.

HUNGARY

Amendments to Act XXIV of 1988 on Investment by Foreigners in Hungary (HRLF No. 1990/1, No. II/3 - 4, 1991, 15 February 1991);

Act VI of 1990 on Securities and the Stock Exchange;

Interim Correction to Act VI of 1990 on the Circulation of Securities and on the Stock Exchange

Unified Text of Act XXIV of 1988 Regarding Investment by Non-residents in Hungary, Subsequent Amendments and Supplements (Nr. II/5, 1991, l March 1991);

Law IL of 1991 on Bankruptcy Procedures, Liquidation Procedures and Final Settlement (No II/23, 1991, 1 December 1991);

Act LXIII of 1991 on Investment Funds (No. III/2, 1992, 15 January 1992);

Law Decree No. l of 1974 Concerning Planned Foreign Exchange Policy and the Decree No. 1/1974 PM issued for its Execution in a Unified Contexture (No. III/19, 1992, 1 October 1992).

POLAND

- Prawo o Publicznym obrocie Papierami Wartosdowymi Funduszach Powierniczych, No. 15, 1991.

APPENDIX 2 Members of the Prague Stock Exchange in the Czech Republic

ČSOB, a.s., Praha, tel. 23332000, 233200, fax 2355105, 2366959
Investiční banka, a.s.,Praha, tel. 2365934, fax 2368934
VÚB, a.s., Bratislava, tel. 07/3192267, fax 07/3192268
Česká spořitelna,a.s., Praha, tel. 2359311, 2362565, fax 225572, 2357918
Poštovní banka, a.s., Praha, tel. 6842532, 68435321.260, fax 6842539
Banka Bohemia, a.s., Praha, tel. 2362261, fax 264594
Ekoagrabanka, a.s., Ústí n. Labem, tel. 047/213111, 28267, 213584, fax 047/23787
Agrobanka, a.s., Praha, tel. 69107671, fax 1566911315
Komerční banka, a.s., Praha, tel. 2354955, 21222038, fax 2368289
Živnostenská banka, a.s., Praha, tel. 21127000, fax 21127070
Interbanka, a.s., Praha, tel. 226668, 227886, fax 265658, 2350234
Creditanstalt Securities, a.s., Praha, tel. 206476, 206495, fax 296964
Credit Suisse First Boston Czechoslovakia, a.s., tel. 2317005, 2310426, fax 2317456
Crown Banking Corporation, a.s., Praha, tel. 2317936, fax 2311490
Efekta, spol. sr.o., Liberec, tel. 048/461389, fax 048/462716, 26997
EASTBROKERS, a.s., Praha, tel. 267339, fax 2327520
Zemská banka, a.s., Olomouc, tel. 068/22017, fax 068/23328
AB banka, a.s., Mladá Boleslav, tel. 0326/21764, fax 0236/23769
ABN AMRO Holding N.V., Praha, tel. 2313330, 2313316, fax 2313362, 2313672
Banka Haná, a.s., Prostějov, tel. 0508/3558, fax 0508/21241
Capital Market Consulting, spol. sr.o., Praha, tel. 7152148, 7152518, fax 7152882
Citibank, a.s., Praha, tel. 3334222, 3334111, fax 3334613
CONSUS, poradenské družstvo, Praha, tel. 266285, fax 267778
COOP BANKA, a.s., Brno, tel. 05/24511, fax 05/27042
C.S. FOND, a.s., Praha, tel. 2362471, fax 2369348
Česká banka, a.s., Praha, tel. 2688141, 264051, fax 262530
Českomoravská záruční a rozvojová banka, a.s., Praha, tel. 2963401.566, fax 295825, 205983
EVROBANKA, a.s., Praha, tel. 9911093, fax 9911041
Fond národního majetku ČR, Praha, tel. 225423, fax 261237, 260160
Harvardská burzovní společnost, a.s., Praha, tel. 7934580-85, fax 7934616
IC Banka, a.s., Praha, tel. 2361777, fax 2361776
imAGe , a.s., Praha, tel. 701787, 703012/370, fax 701787
Investiční a rozvojová banka, a.s., Bratislava, tel. 07/490819, fax 07/56632, 59484
Investiční společnost Bohemia, a.s., Praha, tel. 877116, fax 887115
KIS, a.s., Kapitálová Investiční společnost české pojišťovny, Praha, tel. 2315060, fax 2310240
KOMERO, spol. sr.o., Praha, tel. 3114410, fax 3114410
Kreditní banka, a.s., Plzeň, tel. 019/272656, fax 019/276758, 272741
MERX, spol. sr.o., Praha, tel.8535064, 8535447, fax 8535400

MORAVIA BANKA, a.s., Praha, tel. 2324183, fax 2320696
MOTOINVEST, a.s., Cheb, tel. 0166/267339, fax 0166/2139260
Oesterreicher a spol., spol. sr.o., Praha, tel. 2362471, 2313896, fax 2357229
Podnikatelská banka, a.s., Praha, tel. 4152871, fax 4152624
Pragobanka, a.s., Praha, tel. 776842, fax 774564
PRO-ANO, spol. sr.o., Praha, tel. 2354086, fax 2357065
RAXER, spol. sr.o., Praha, tel. 21422592, fax 21422588
REALITBANKA, a.s., Praha, tel. 6928080, fax 6921831
RENTIA, a.s., Brno, tel. 05/756363, fax 05/756363
Slovenská pol'nohospodárska banka, ú.s., Bratislava, tel. 07/215007, fax 07/215121
Slovenská štátna špořitelna, š.p.ú., Bratislava, tel. 07/2020305, fax 07/2020303
V.I.A., a.s., Praha, tel. 278254, fax 273520
Brněnské veletrhy a výstany a.s., Brno, tel. 05/3143101, fax 05/3142999
UNION BANKA, a.s., Moravská Ostrava, tel. 069/2271.2660, fax 069/211586

APPENDIX 3 List of Issuers

<u>Issuers of the traded shares</u>

Agrimpex Rt. (Foreign trade)	Budapest, 1051 Nádor u. 22 Tel: 111-34-60 Fax: 153-06-58
Bonbon Rt. (Trade)	Budapest, 1072 Nagydiófa u. 8 Tel: 121-44-31 Fax: 122-46-68
Budaflax Rt. (Textile industry)	Györ 9002 Pf. 110 Tel: (96) 15-108 Fax:(96) 11-274
Elsö Magyar Szövetkezeti Sörgyár Rt. (Beer Industry)	Martfű, 5435 Pf. 43 Tel: (56) 50-633 Fax:(56) 50-448
Fönix Rt. (Trade)	Debrecen, 4025 Széchenyi u. 35-37 Tel: (52) 11-722 Fax: (52) 18-072
Garagent Rt. (Foreign trade)	Budapest, 1012 Márvány u. 16 Tel: 156-72-55 Fax: 202-38-84
Hungagent Rt. (Foreign trade)	Budapest, 1023 Lajos u. 11-15 Tel: 188-61-80 Fax: 188-87-69
Kontrax Irodatechnika Rt.	Budapest, 1143 Hungaria krt. 79-81 Tel: 251-48-88 Fax: 252-57-68
Kontrax Telecom Rt.	Budapest, 1149 Egressy út 20 Tel: 251-48-88 Fax: 251-57-68

Műszi Rt.	Budapest, 1026 Érmelléki u. 13 Tel: 135-05-87 Fax: 135-05-87
Nitroil Rt. (Chemical industry)	Várpalota, 8105 Pf. 49 Tel: (80) 72-750 Fax: (80) 72-345
Novotrade Rt. (Holding)	Budapest, 1137 Katona J. u. 9-11 Tel: 112-20-95, 112-20-99 Fax: 111-30-30
Skála-Coop Rt. (Holding)	Budapest, 1092 Kinizsi u. 30-36 Tel: 118-93-61 Fax: 118-78-55
Terraholding Rt. (Trade)	Pécs, 7623 Nagyvárad u. 1 Tel: (72) 13-403, 27-310 Fax: (72) 27-290
Zalakerámia Rt. (Building industry)	Zalaegerszeg, 8900 Száchenyi tér. 5 Tel: (92) 19-637 Fax: (92) 12-070

Issuers of bonds (traded category):

Postabank Rt.	Budapest, 1051 József nádor tér. 1 Tel: 118-08-55 Fax: 117-13-69
Magyar Nemzeti Bank	Budapest, 1054 Szabadság tér. 8-9 Tel: 153-26-00 Fax: 132-39-13

CA Investment Fund (Listed category)	Budapest, 1051 Nagysándor J. u. 10 Tel: 269-07-11 Fax: 269-06-99

Europool Investment fund
(Traded category)

Budapest, 1052
Váci u. 19-21
Tel: 266-50-43
Fax: 117-91-74

Budapest Investment Fund
(Traded category)

Budapest, 1052
Deák F.u. 5
Tel: 118-62-09
Fax 228-62-09

APPENDIX 4 Poland - Listed (06/09/93) Companies on the Warsaw Stock Exchange

LP	Name and Activity	no. of shares (mill.)	book value 30/6/93	Market value 06/9/93 (mill.PLZ)	Market/ book value	P/E 06/9/93
1	BIG bank	16.413	575,131	3,561,592	6.19	36.4
2	BRE bank	2.00	822,000	2,220,000	2.70	22.3
3	EFEKT trade services	0.75	29,880	150,750	5.05	20.4
4	ELEKTIM electrotech	3.0	2,357,871	3,900,000	1.65	12.1
5	EXBUD constructions	1.0	430,229	1,025,000	2.38	12.5
6	IRENA glass	0.45	128,453	456,750	3.56	55.5
7	KABLE electic cables	1.0	138,417	358,000	2.59	45.3
8	KROSNO glass	2.2	403,775	585,200	1.45	57.8
9	MOSTOSTAL Exp constructionns	1.5	190,121	1,425,000	7.50	13.5
10	OKOCIM breweries	2.8	546,989	1,918,000	3.51	21.1
11	POLIFARB-CN dyestuffs	3.06	508,452	2,493,900	4.90	23.8
12	PROCHNIK garments	1.5	142,237	780,000	5.48	27.0
13	SOKOLOW meat processing	1.75	365,955	600,250	1.64	43.3
14	SWARZEDZ furniture	2.5	352,004	695,000	1.97	32.0
15	TONSIL electronics	1.5	99,842	390,000	3.91	-
16	UNIVERSAL foreign trade	15.0	379,849	1,132,500	2.98	150.0
17	WBK bank	6.4	2,332,730	4,832,000	2.07	18.4
18	WEDEL confectioners	3.2	1,129,480	4,464,000	3.95	16.6
19	WOLCZANKA garments	1.5	138,397	922,500	6.67	31.5
20	ZYWIEC breweries	2.0	388,194	1,900,000	4.89	20.0
	TOTAL		11,459,806	33,810,442	2.95	20.7