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Comments on **Simon Johnson – Andrei Shleifer: Privatization and Corporate Governance** paper prepared for CASE Conference "**Beyond Transition – Development Perspective and Dilemmas",** 12-13 April, 2002

Session V: Privatization and Corporate Governance. What makes it work?

The Growing Irrelevance of Corporate Governance in Transition Economies

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1. Introduction

Simon Johnson and Andrei Shleifer (henceforth: JS) have prepared a valuable paper, from which participants of this conference can learn a lot. They succinctly summarize the empirical findings of 30 fresh studies and more than 20 older ones pertaining to the causal relationship between the success rate of capital markets and the prevalence of a strong legal system.

JS begin and end with the same three-point tenet:

- effective privatization requires enforceable investor protection,
- investor protection rests on legal foundations,
- good laws need to be created, if not existing yet.

These points leave little room for disagreement. Able minded economists can subscribe to them without any reservation.

However, after a closer scrutiny, the message of JS's paper appears to be less powerful than these three unquestionable points suggest.

The paper can be criticized from at least two angles. First, the authors seem to pay little attention to the definition of their own key terms. They speak of "weak" and "strong" legal systems, "high" and "low" levels of corruption without properly defining what these terms might mean in different countries. We can ask, for example, whether the Chinese legal system can be viewed as a "strong" one, because corruption and embezzlement in that country are mortal sins, while in most European countries the death sentence was abolished long time ago. In a similar fashion, we may ask, whether corruption can be regarded endemic in a country like Hungary, where bribing the policemen on the street has become an everyday practice. Or alternatively, one can perhaps argue that the US economy is plagued more by

corruption, as evidenced by the recent "Enron *cum* Arthur Andersen"[1] scandal that reached the highest levels of political decision-making.

But I am not going to continue my criticism along these semantic lines. It seems more important from the overall perspective of the present Session, as well as of the entire conference to contemplate about the relevance of the findings of JS's paper in the light of transition economics. Section 2 will set out the theoretical background and conclude that corporate governance, as usually understood is rapidly loosing its relevance in the transition economies. Section 3 will examine this rather provocative statement from an East European perspective. Section 4 will argue that privatization should be assessed from those type of investors which dominate the markets in transition economies. JS tacitly assume that the typical investors are US-type managed funds. We will show that this is not the case. Section 5 enumerates the differences between the small Central and East European markets and the potentially vast Russian and Chinese markets. Section 6 contains the conclusion which suggests that the smaller Central and East European countries will never develop a fully-fledged capital market of their own. Hoping that these countries will join soon the European Union, such markets are not even needed.

2. On the concept of corporate governance

What corporate governance means in narrow, scientific terms can be defined in several ways, but it is easy to feel that the most frequently used definitions do not greatly differ from one another in the substance.

- "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" Shleifer-Vishny (1997).

[1] As a British newspaper ironically noted the *Fortune* magazine had voted Enron "the most innovative company of the year" for 2000 which had not been meant to be a joke at that time (*The Economist,* March 9, 2002).

- "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance" (OECD 1999),

JS begin their story with a direct reference to Coase (1960) seminal paper, and then they suddenly broaden the conceptual analysis by using the framework of the *principle-agent paradigm*. Without going into the discussion of this model, JS first state that good corporate governance is the solution to the principle-agent problem (which is correct) and then conclude that good corporate governance is important, because the agency problem is *the* greatest impediment of successful privatization policies both in the transition economies and other non-American markets[2]. This is where I have strong doubts. I think JS are probably wrong, although the view they represent here is widely shared in the literature. A few years ago an EBRD (1997) report summarized this view, as follows: "**The main factors governing growth are the same for both transition economies and market economies**." Let me try to show what is wrong in this argument.

Historically, the discovery of the importance of the agency problem (Berle and Means, 1933) implied a direct criticism of the neo-classical paradigm. In the light of this new paradigm, the firm was not seen anymore as a profit-maximizing black-box entity. Berle and Means noticed that firms were simultaneously controlled by two distinct groups of utility maximizing individuals and the interests of these two groups diverged. Investors are single-minded. Typically they are concerned only about the return on and the safety of their original investments, while managers are guided by different and sharply conflicting objectives (e.g. high salary, job security, luxurious work conditions, risk avoidance, pet projects, asset steeling, etc.). Later, the paradigm

[2] The names of China, South Korea, Malaysia, Chile and Germany are explicitly mentioned in the paper several times.

was enhanced by the recognition that the relationship of investors and managers is additionally burdened by the fact of *asymmetric information*.

Quite clearly, the two corporate government definitions quoted above fit well to the world of publicly traded companies, as they have been existing in the United States since the 1930s and some major international stock markets since the 1980s. Already 10 years ago institutions held 46% of American public stock.[3] Since then, the figure is probably higher. These companies regularly raise funds from institutional and private outside investors and therefore the unfair treatment or even the expropriation of these outside investors is a threatening real possibility. Who are those outside investors, whose concerns are analyzed in JS? JS's description fits primarily to large US-type pension funds and similar saving vehicles. For them corporate governance does matter in five interrelated areas:

1. the rights of shareholders,
2. the equitable treatment of shareholders,
3. the role of stakeholders,
4. disclosure and transparency obligations,
5. the responsibilities of the board.[4]

The loose interpretation of corporate governance

Unfortunately, the term "corporate governance" is often used in a broad, journalistic style. E.g.: "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, President of the World Bank, as quoted by an article in *Financial Times*, June 21, 1999. In other cases, the term is used as an euphemism meaning a call for private ownership, democracy, law and order. The following statement is quoted from an official OECD document that actually carries the term "corporate governance" in its title. "Good corporate governance ensures that companies use their resources more efficiently and leads to better relations with workers, creditors, and other stakeholders. Most importantly for a transition economy like Romania, good corporate governance enhances the confidence of domestic and foreign investors." (OECD, 2001 p. 6.).

Sometimes Johnson and Shleifer paint with a broad brush, too. In advancing their argumentation, they nowhere explain clearly where are the border lines between corporate governance, as a specific term regulating the relationship between investors and managers, and the legal system in general that regulates economic and political matters of a given country.

[3] *Harvard Business Review*, November-December 1991.

[4] This list corresponds exactly to the terminology and grouping of issues used in OECD (1999).

Beyond the black-box approach, however, the neoclassical paradigm had two other week points, which were not addressed by the principal-agency model:

- the assumption of constant return to scale and
- the assumption of single-layer company operation.

Let us recall that it was first the Marxist and then the Keynesian critique of the standard neoclassical model, which started to emphasize the importance of *increasing returns* (Marx 1867, Marshall 1890 Appendix H, Young 1928, Kaldor 1966). In a different context Kornai (1971) also used this argument, as a first-line criticism of his comprehensive attack against the general equilibrium theory (Walras 1874, Arrow and Debreu, 1954, Debreu 1959,). But only Kornai identified the second weakness of the neoclassical paradigm. In criticizing the Walrasian model, he rightly pointed out that large modern firms are typically multi-layer organizations, with headquarters at one location and subordinated entities in many other parts of the world.[5]

Once we introduce the concept of increasing returns into our analysis, the distinction among companies by size follows inescapably. Let me repeat: *size matters*. Even if we discard from our analysis the very small service-type companies – which is usual in the comparative privatization literature – still remains a long continuum between middle-size domestic companies on the one end and multi-billion dollar transnational corporations (TNCs) on the other. It is equally important to emphasize that size goes hand-in-hand with institutional complexity. Modern corporations have multi-level structures, *because* they are large.

The issue of size and the two consequences of size are completely ignored by JS's paper. It is simply assumed that all companies, be they American, German, Hungarian or Malay are large, unconnected publicly traded companies. What is more, JS tacitly assume that these publicly traded companies generate the bulk of GDP in each and every country, therefore the quality of the corporate governance regimes of these respective countries determine growth, financial stability and standards of

[5] The legal distinction between subordinated entities, legally independent joint stock companies, limited companies or branch offices is not important here.

living. This is simply not true. In most parts of the world, including Central and Eastern Europe, as well as the so-called emerging markets, non-public companies generate the vast majority of output, where the majority owner with an industry specific knowledge directly controls the firm.

3. The East European perspective

From the perspective of the transition economies much more can be said about the importance of the scale problem.

If we stay within the neoclassical paradigm, transition economics becomes a cookbook. Buy the book and learn how the former state owned enterprises (SOEs) could transform themselves into IBM or GE type of TNCs. Only a few macro- and microeconomic conditions need to be fulfilled:

- Create and maintain macroeconomic stability,
- Introduce a state-of-the-art corporate governance regime;
- Teach the new managers of the former SOEs how to find the optimal combination of inputs and how to apply state-of-the-art management techniques.

Although, it may sound simplistic and cynical to summarize in this manner the advices that were initially given to the governments of transition economies, I believe that this reflects correctly the quintessence of the early debates in the transition literature on privatization, stabilization and sequencing.

In reality, however, it should have been said in a crystal clear voice already in 1989, that the 5-10 thousand middle-size and large SOEs of Central and Eastern Europe didn’t have the slightest chance to become TNCs and/or to compete with the already existing TNCs. It should have been also publicly acknowledged and propagated that the viability and international competitiveness of de-etatized SOEs does not depend on the right combination of inputs, their capacity to innovate and learning modern

sales methods or their willingness to harden the budget constraint. The truth is that **already in 1989, the companies of Central and Eastern Europe were hopelessly disadvantaged against the existing TNCs in the worldwide size competition**.[6] This was and remains the crux of the problem. The suggested and often implemented round-about ways and means to "fix" this shortcoming by creating privatization intermediaries, supporting cross-ownership with banks[7] solved little at best and caused irreparable harm at worst. (Recent economic history knows only one counter-example: Nokia. But the success of the Finnish company, as a Hungarian proverb says, is only the exception which confirms the rule.)

In retrospect, it is quite obvious that size matters not only on the export markets of manufactures. From the very beginning of the transition, the large TNCs could easily penetrate and capture the traditional domestic markets of the former SOEs as well. In some countries, the penetration took place first on the traditional industrial markets, while services, including the financial sector were taken over later. In other countries, - e.g. the former GDR, the three Baltic countries or Hungary – the insurance and banking sectors were concurred already at an early stage.[8]

Where the scale effect is important, unit costs are considerably lower for TNCs which is a big advantage. Larger size also implies stronger financial power, which in turn can be used as a collateral to bank loans in supporting capital formation, new projects and research. Larger companies are more attractive to school leavers. They can offer higher salaries and a more promising carrier path. Established trademarks, such as Coca Cola or Citibank greatly increase the chances of success in marketing and public relations.

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[6] Politically, of course, such a message would have been difficult to embrace by the respective Central and East European governments. However, it was quite visible already at that time, that the former managers of SOEs had intuitively understood all this. Many of them resisted privatization, precisely because they new that their firms, be they big and powerful on the protected domestic market, were all ridiculously small in comparison with their international competitors As the president of Hungary's largest company said at one point: "The oil multies of the world are bigger by three orders of magnitude than the largest East European oil company. At some point, the multies will "hoover up" us all."

[7] This was explicitly recommended in an important study of the EBRD (Phepls *et al.*, 1993)

[8] For a recent overview of developments, see the proceedings of a series of UNCTAD conferences under the title *Privatization and Greenfield FDI in Central and Eastern Europe: Does the Mode of Entry Matter?* in Kalotay (2001)

In this context, it is particularly instructive to remind us what happened in the banking sector. In the former East Germany, West German banks took over 100 per cent of the market literary on the very first day of economic transition (i. e. with the introduction of the D-Mark on July 1, 1990). In the Baltic countries, it took 3-4 years for the Nordic neighbors to settle themselves. In Eastern Europe, the first post-communist Hungarian government had resisted for four years to sell banks to foreigners and only the costly and painful lessons of recapitalization forced the second government to allow the foreign domination of the Hungarian banking sector. After the Hungarian "capitulation" in 1995, the Czech and the Polish governments followed the lead, while the former Yugoslav republics, Bulgarian and Romania remained temporarily behind.

Practice showed also that once the penetration of TNCs begins into a certain market segment, it is difficult to find a "right" balance between TNCs and domestic firms. In the case of the banking sector, for example, the point-of-no-return was quickly achieved, when clients had to make a decision with whom they want to bank in the future. Will they keep their accounts with a domestic bank and risking another bank failure, or rather they switch to an "AAA"-rated OECD bank, where the mother company will guarantee their deposits under all circumstances? In the case of enterprises, this tendency has been further strengthened by the fact that TNCs operating in the manufacturing sector prefer to bank with the same bank worldwide. In this logic, the preference of the local management to bank with a locally owned bank simply doesn't make sense.

As I argued above, the importance attached to corporate governance in the transition economies hinges crucially on the neo-classical assumption about single-layer company operation. If this is the case, the interest of investors and managers need to be harmonized in a way, as it is described in the corporate governance literature. But the fact is that the privatized Central and East European companies are typically not self-contained single level entities. They are merely subordinated units of a TNC, headquartered somewhere else in the world. From the perspective of the TNCs, these Central and East European operations are not fully-fledge companies, or profit maximizing entities. Although these entities do have well

defined, but limited goal functions - production and/or distribution and sometimes even research and development – but it is not expected from them to develop a complete set of enterprise activities. Another consequence of the multi-level character of TNCs, that within these Central and East European companies, the principle-agent contradiction – i.e. the conflict of investors and managers – doesn't manifest itself at all. There is no need for governing bodies (board of directors, supervisory board) either. One or two designated managers directly represent the interest of the foreign owner.

Table 1 and 2 illustrate this point by presenting the evidence of Hungarian manufacturing and financial companies respectively. **Out of top 100 Hungarian companies, 63 are directly owned by a large TNC.** Quite clearly, the legal form of operation itself shows the irrelevance of corporate governance, the companies are not corporations, but limited liability companies only. From the top 100 largest companies, only 66 is operating as a shareholding company, in the other 34 firms there are only owners, but not shareholders. This, of course, excludes the possibility of public trading with the shares. The figures also reveal that even if it is technically possible, only 17 of the largest 100 firms were – at least at some point of their history - actually traded on the Budapest Stock Exchange or elsewhere[9]. Table 3 completes the Hungarian picture with the listing of all commercial banks. While these banks are all joint stock companies – because the law doesn't permit any other form – there are only three banks, where the distributed ownership structure may require sophisticated corporate governance measures.

[9] This complicated formulation is required, because there is a growing number of delisting from the BSE. In addition, there is a growing number of "dormant" shares without any trading at all.

Table 1

Largest 20 Hungarian companies (Ranked by 2000 net revenue)								
Rank	Name	Net revenue in HUF bn	Net revenue in Euro mn	Method of establishment	Present ownership form	Type of owner	Listed on the Budapest Stock Exchange	Nationality of top local executive
[1]	**MOL Hungarian Oil and Gas Rt.**	**1025,1**	**4 271**	**SOE --> partitioned**	**Joint stock company**	**Financial investors**	**Yes**	**Hungarian**
[2]	Audi Hungaria Motor Kft.	900,6	3 753	Greenfield investment	Limited liability company	TNC - strategic investor	No	German
[3]	Philips Hungary Kft.	639,7	2 665	Greenfield investment	Limited liability company	TNC - strategic investor	No	Dutch
[4]	IBM Storage Product Kft.	632	2 633	Greenfield investment	Limited liability company	TNC - strategic investor	No	German
[5]	Matáv Rt.	445,9	1 858	SOE --> partitioned	Joint stock company	TNC - strategic investor	Yes	Hungarian
[6]	Hungarian Electricity Works (MVM) Rt.	339,6	1 415	SOE --> partitioned	Joint stock company	State ownwership	No	Hungarian
[7]	**Panrusgaz Rt.**	**290,1**	**1 209**	**Greenfield investment**	**Joint stock company**	**Diversified ownership. 49% owned by [1]**	**No**	**Russian**
[8]	Flextronics International Kft.	245,1	1 021	Greenfield investment	Limited liability company	TNC - strategic investor	No	USA
[9]	Metro Holding Hungary Kft.	201,9	841	Greenfield investment	Limited liability company	TNC - strategic investor	No	Hungarian
[10]	GE Hungary Rt.	185,8	774	SOEs merged	Joint stock company	TNC - strategic investor	No	USA
[11]	Opel Hungary Kft.	178,9	745	Greenfield investment	Limited liability company	TNC - strategic investor	No	German
[12]	Hungarian State Railways (MÁV) Rt.	177,3	739	SOE unchanged	Joint stock company	State ownwership	No	Hungarian
[13]	Dunaferr Danube Steel Works Rt.	173,1	721	SOE unchanged	Joint stock company	State ownwership	No	Hungarian
[14]	**Tisza Chemical Works (TVK) Rt.**	**156,8**	**653**	**SOE unchanged**	**Joint stock company**	**Diversified ownership. Majority owned by [1]**	**Yes**	**Hungarian**
[15]	Westel Rt.	153	638	Greenfield investment	Joint stock company	100% owned by [5]	No	Hungarian
[16]	Budapest Electricity Work (ELMÜ) Rt.	136,5	569	SOE --> partitioned	Joint stock company	TNC - strategic investor	No	Hungarian
[17]	Tesco Globál Department Stores Rt.	126,4	527	Greenfield investment	Joint stock company	TNC - strategic investor	No	UK
[18]	Magyar Suzuki Rt.	126	525	Greenfield investment	Joint stock company	TNC - strategic investor	No	Japan
[19]	Hungarotabak - Tobaccoland Tobacco Trade Rt.	124,8	520	SOE unchanged	Joint stock company	TNC - strategic investor	No	German
[20]	Shell Hungary Trade Rt.	118,3	493	Greenfield investment	Joint stock company	TNC - strategic investor	No	Hungarian

Source:
Budapest Business Journal, Book of Lists, 2001-2002, p. 142. and author's own research.
Notes:
Without financial institutions. Some companies were first listed on, then delisted from the BSE
Bold typset indicates the companies where the diversified owneship structure justifies complex corporate governance methods.

Table 2

Largest 100 Hungarian companies Ranked by 2000 net revenue						
	Ranking					Total
	1-20	21-40	41-60	61-80	81-100	1-100
Method of establishment						
- SOE	4	14	16	13	16	63
- SOEs partitioned or merged	5	0	0	2	1	8
- Greenfield investment	11	6	4	5	3	29
Present ownership form						
- Joint stock company	14	11	17	12	12	66
- Limited liability company	6	9	3	7	8	33
- Other	0	0	0	1	0	1
Type of ownership						
- TNC - strategic investor	15	15	12	12	9	63
- Financial investors	1	0	2	0	2	5
- State or municipal ownership	3	3	2	1	1	10
- Other	1	2	4	7	8	22
Listed on the Budapest Stock Exchange or elsewhere	3	1	9	2	2	17
Nationality of top local executive						
- Hungarian	10	11	13	12	16	62
- Other	10	9	7	8	4	38

Sources and notes: See Table 1.

Table 3

Largest banks in Hungary: Ranked by unconsolidated total assets in 2001

Rank	Name		Unconsolidated total assets in Euro mn	Year established in Hungary	Largest shareholder(s)	Listed on the Budapest Stock Exchange	Nationality of top local executive
[1]	**OTP Bank**		**8 860**	**1949**	**Institutional investors (80%), small investors (20%)**	**Yes**	**Hungarian**
[2]	K&H Bank		4 708	1986	Belgian and Dutch Banks (99%)	No	Canadian
[3]	MKB		3 764	1950	Bayerische Landesbank group (99%)	No	Hungarian
[4]	CIB Bank		3 153	1979	IntesaBci S.p.A. (100%)	No	Hungarian
[5]	HypoVereinsbank		2 250	1993	HypoVereinsbank group	No	German
[6]	Raiffeisen Bank		1 934	1986	Raiffeisen Banking Group (96,3%)	No	Hungarian
[7]	Postabank		1 513	1988	State owned	No	Hungarian
[8]	Hungarian Development Bank		1 427	1991	State owned	No	Hungarian
[9]	ÁÉB		1 340	1922	Gazprom group (100%)	No	Russian
[10]	Budapest Bank		1 321	1988	GE Capital (100%)	No	US
[11]*	Citibank		1 309	1986	Citibank group (100%)	No	US
[12]	Erste Bank		1 135	1986	Erste Bank (99,3%)	No	Hungarian
[13]	**Inter-Európa Bank**		**723**	**1981**	**Italian banking groups (84%), institutional investors, small investors (15%)**	**Yes**	**Italian**
[14]	Commerzbank		607	1993	Commerzbank AG (100%)	No	German
[15]*	ING Bank		597	1991	ING Bank N.V. (100%)	No	Dutch
[16]	Takarékbank		573	1989	DG Bank (72%), Hungarian savings cooperatives (23%), Allianz Hungaria Insurance (5%)	No	Hungarian
[17]	Eximbank		470	1990	State owned	No	Hungarian
[18]	Volksbank		421	1991	Volksbank group (100%)	No	German
[19]	BNP Paribas		359	1990	BNP Paribas (100%)	No	Hungarian

[20]	Konzumbank	346	1986	State owned	No	Hungarian
[21]*	WestLB	321	1993	Westdeutsche Landesbank (100%)	No	German
[22]	Deutsche Bank	283	1995	Deutsche Bank (100%)	No	Hungarian
[23]	Merkantilbank	248	1988	Directy owned by [1]	No	Hungarian
[24]	Credit Lyonnais	193	1992	Credit Lyonnais (100%)	No	French
[25]	Daewoo Bank	173	1989	Daewoo Securities (100%)	No	South Korean
[26]	Hungarian Land Credit and Mortgage Bank	147	1997	State owned	No	Hungarian
[27]*	Rabobank	107	1995	Rabobank group (100%)	No	Dutch
[28]	Cetelembank	86	1996	Cetelem (99%)	No	French
[29]	Opelbank	78	1996	General Motors	No	Finnish
[30]*	Société Générale	59	1998	Société Générale (100%)	No	French
[31]	Hanwha Bank	51	1990	Hanwha group (99%), Hungarian Education Ministry (1%)	No	South Korean
[32]	IC Bank	48	1993	Malaysian individuals (100%)	No	Hungarian
[33]	Credigen Bank	41	1999	Sofinco (100%)	No	French

Source: See Table 1. and daily press reports.
Notes: * 2000
Bold typeset indicates the companies where the diversified owneship structure justifies complex corporate governance methods.

Commercial banks in Hungary Ranked by unconsolidated total assets in 2000

Rank	Name	Unconsolidated total assets in HUF bn	Unconsolidated total assets in Euro mn	Year established in Hungary	Largest shareholder(s)	Listed on the Budapest Stock Exchange	Nationality of top local executive
	(2)	(3)	(4)	(5)	(6)	(7)	(8)
[1]	**OTP Bank**	**1 931**	**8 046**	**1949**	**Institutional investors (80%), small investors (20%)**	**Yes**	**Hungarian**
[2]	K&H Bank	1 089	4 537	1986	Belgian and Dutch Banks (99%)	No	Canadian
[3]	MKB	790	3 291	1950	Bayerische Landesbank group (99%)	No	Hungarian
[4]	CIB Bank	680	2 833	1979	IntesaBci S.p.A. (100%)	No	Hungarian
[5]	HypoVereinsbank Hungária	501	2 086	1993	HypoVereinsbank group	No	German
[6]	Raiffeisen Bank	351	1 461	1986	Raiffeisen Banking Group (96,3%)	No	Hungarian
[7]	Postabank	331	1 380	1988	State owned	No	Hungarian
[8]	ÁÉB	329	1 372	1922	Gazprom group (100%)	No	Russian
[9]	Budapest Bank	321	1 335	1988	GE Capital (100%)	No	US
[10]	Citibank	314	1 309	1986	Citibank group (100%)	No	US
[11]	Erste Bank	200	833	1986	Erste Bank (99,3%)	No	Hungarian
[12]	**Inter-Európa Bank**	**152**	**633**	**1981**	**Italian banking groups (84%), institutional investors, small investors (15%)**	**Yes**	**Italian**
[13]	Commerzbank	145	604	1993	Commerzbank AG (100%)	No	German
[14]	ING Bank	143	597	1991	ING Bank N.V. (100%)	No	Dutch
[15]	Takarékbank	115	477	1989	DG Bank (72%), Hungarian savings cooperatives (23%), Allianz Hungaria Insurance (5%)	No	Hungarian
[16]	BNP Paribas	91	378	1990	BNP Paribas (100%)	No	Hungarian
[17]	Westdeutsche	77	321	1993	Westdeutsche Landesbank	No	German

	Landesbank				(100%)		
[18]	Volksbank	70	293	1991	Volksbank group (100%)	No	German
[19]	Deutsche Bank	67	280	1995	Deutsche Bank (100%)	No	Hungarian
[20]	Konzumbank	64	267	1986	State owned	No	Hungarian
[21]	Credit Lyonnais	42	175	1992	Credit Lyonnais (100%)	No	French
[22]	Daewoo Bank	42	175	1989	Daewo Securities (100%)	No	South Korean
[23]	Rabobank	26	107	1995	Rabobank group (100%)	No	Dutch
[24]	Société Générale	14	59	1998	Société Générale (100%)	No	French
[25]	Hanwha Bank	9	36	1990	Hanwha group (99%), Hungarian Education Ministry (1%)	No	South Korean
[26]	**ICB Bank**	**5**	**19**	**1993**	**Malaysian individuals (100%)**	**No**	**Hungarian**
[27]	Credigen Bank	2	8	1999	Sofinco (100%)	No	French

Source: See Table 1.
Notes: Some of the data in colomns (2, 6-8) reflect changes occured in 2001 and 2002.
Bold typset indicates the companies where the diversified owneship structure justifies complex corporate governance methods.

Another aspect of the multi-layer operation of modern firms is reflected in foreign trade. In contrast to the neoclassical paradigm, a firm's capability to produce "high quality-low price" goods is not a guarantee to find markets. The Central and East European companies have virtually no chance to market their products on world markets if they remain specialized in end-products. World trade of manufactures consists largely of intra-industry trade. For the small firms of Central and Eastern Europe the only alternative is to integrate themselves into the production and supply chains of TNCs.[10]

Following the logic of JS's paper, however, one can argue that introduction and propagation of good corporate governance is important for the transition economies, even if this can apply only to the domestic-owned middle-size companies. This argument can be developed further in three ways.

First, it can be said that good corporate governance is also good for the health and stability of domestic companies. After a closer inspection of the accumulated evidence, however, the reverse argument appears to be equally logical. It seems that

[10] As I explained elsewhere, Hungary was able to choose this strategy, because this option had been publicly discussed well before the transition period (Mihályi, 2000/2001, 2001).

the strength and the viability of *private*[11] middle-size domestic firms are based on non-formalized, quick decision-making, where the business instincts of a single decision-maker prevails over collective deliberations. It is a fact, that these domestic companies are extremely secretive towards all stakeholders, with the important exception of banks. There is little official communication beyond the legal minimum[12], company managers refuse to talk to the press about substantive matters, and even employees are not informed about company matters. On the other hand, these companies maintain close and open relationship with their banks, because they have to. This is where financing comes from. But all other stakeholders are unimportant.

Although, the lack of formal decision-making structures and the vehement rejection of transparency requirements may sound primitive for sophisticated model-builders there is no alternative for domestic, middle size firms, if they want to survive. Let us face it, flexibility, quick decision-making, secret operation and close links to creditors are the only specific factors rendering Ricardian comparative advantage to these middle-size firms *vis-à-vis* the very large TNCs.

The logic represented by JS's paper can suggest a second argument. Even these domestic firms would be better off, if they rely on equity financing rather than loan financing. Unfortunately, the scale effect argument creeps back again. The volume of capital requirements are too small, thus the unit costs implicated by an IPO and the subsequent presence on the stock market have proved to be prohibitive in many Central and East European countries.

A third way of arguing in favor of transparent corporate governance is to look at the motivation of domestic financial investors. Indeed, this proposition had been

[11] The word "private" is emphasized here to clearly differentiate the situation of *de nouvo* created private firms or privatized former SOEs from those which are still *de facto* state owned in one way or another. In Central and Eastern Europe there are many tricks how state ownership can be hidden behind the veil of municipal ownership, cross-ownership, ownership chains, differentiation among shareholders' class, etc. Unfortunately, the poor performance of these quasi-privatized firms is often falsely interpreted in the literature. Instead of discovering the "devil" of state ownership behind the veil, foreign observers explain everything in the context of *internal* and *external* control.

[12] In Hungary, the company law requires that a copy of the annual tax report has to be deposited with the Court of Registry within 30 days after the closing of the tax reports. Many companies deliberately break this law year after year and the prefer to pay a fine instead.

discussed at the beginning of the transition (Kornai, 1990, UN ECE 1994. p. 16.), and the conclusion was that foreign investors would not enter the Central and East European markets *until* they see that the domestic investors are fairly treated and well protected. Actual developments showed that the sequencing was reverse. In the Czech Republic, Hungary and in other places, domestic investors were unwilling to move until the foreign funds appeared. In retrospect, the explanation is quite simple. Only the very large foreign funds were able to generate sufficient liquidity for the stocks and thus a relative stability to the market as a whole. Without the participation of foreign funds, the domestic stock exchanges bound to be extremely volatile.

The economic success of the Baltic countries illustrates another interesting point. Due to the particularities of their post-1990 transition paths, the very smallness of these three countries almost equally impacted their equity and government securities markets, as well as their foreign exchange market (Sutela, 2000). There is simply almost nothing to invest in. These countries inherited zero debt from the USSR, central government balances have been quite good and pattern of foreign investment was in favor of long-term strategic investors (as opposed to financial investors). The example of the Baltics reminds us to the fact that asset markets are integrated in a horizontal way, too – once again a consideration missing from the neoclassical paradigm. In other words, the lack of sizeable bond and foreign exchange markets reduces the motivation of foreign investors to participate actively at the equity markets, even if these latter markets are perfectly liberalized and transparent (as it happens to be the case in the Baltics).

4. The Western perspective

Looking at Central and Eastern Europe with a neoclassical eye, the behavior of transnational foreign investors could be easily misinterpreted, which then lead to wrong forecasts. A the beginning of transition it was assumed that the willingness of privatization would automatically trigger a "pull" effect – the supply of investment possibilities would create its own demand. As said before, the neoclassical vision of firms' behavior didn't pay attention to the economy of scale, and variation of scale effects from sector to sector. In reality, FDI flows have always been concentrated in

those few sectors, where the scale effect is the largest (telecommunication, energy, information technology, pharmaceuticals, banking, etc.) In other sectors, everything – including the relatively low price of productive assets, the well-functioning R+D basis which was created during the last two decades of socialism, or the traditional East European trade marks – was totally disregarded.

Another mistake – almost inevitably following from the previous one – is the underestimation of geographical considerations. *Geography matters*.[13] As the eye moves eastwards on the map of Europe, the appetite of TNCs is continuously weakening. There are several factors working here: increased transportation costs, language and cultural differences. Landlocked countries have an additional disadvantage. In sum: bad location is a big handicap that even perfectly implemented corporate government reforms could not fully counterbalance.

The scale effect and the location effect often reinforce each other. The Central and East European experience shows that it matters a lot, which country is chosen first as an investment opportunity. Once a major investment takes place, say in the Czech Republic, it makes little sense for the same TNC or even for a competitor of this TNC to start business in the neighboring Slovakia.

Geography matters in another sense as well, and the paper of Johnson and Shleifer overlooks this point, too. In analyzing the dangers of expropriation, the term "investor" is used without distinction between domestic and cross-border investments. Once again, this is a consequence of their uncritical approach to the neoclassical vision of capital markets. In reality, **the danger seriously threatening the interest of cross-border investors is not the minority shareholder position.** For cross-border investors, three other risks are far more important:

- country risk,
- exchange rate risk and
- regulatory risk.

[13] The importance of geography was strongly emphasized by J. Sachs at a 1999 CASE conference, celebrating the 10th anniversary of Polish economic reforms.

To make the matter even more complicated, the firs two types of risks have to be considered in a regional, if not worldwide perspective. Financial investors are driven by herd behavior, which is a cause and a consequence of the contagion of crisis from one market to another.[14] Regulatory risks are important, because TNC concentrate their activities in network industries (which is in turn results increasing returns). The network industries, however, are usually regulated by national governments and/or supranational organizations.[15] If these regulations are not neutral or – for any other reason – severely constrain the freedom of the investor, this can do much more harm than the lack of sophistication in corporate governance.

5. The case of Russia, China and other monopolistic markets

All the above said needs qualifications, when the lessons of Central and Eastern Europe are transposed to the two largest former communist economies, Russia and China. Potentially both countries possess large markets, where size in itself is not a growth constraint for domestic companies. In theory, these domestic companies have a chance to reach dimensions comparable to established TNCs and can argue that this long process of capital concentration presupposes a well regulated capital market and good corporate governance for the participating companies. .

The case Russia already illustrates both the strength and the weakness of this line of thinking. First, it is true that large Russian corporations have already emerged some of which are already measurable by international standards. But it is noteworthy that the existence of all the large Russian companies is built on raw materials - chiefly gas and oil (e.g. Gazprom, Yukos, Sibur). If we add, that for historical reasons, these mining and processing companies were already large during the Soviet times, we can

[14] To make the matter even more complicated, recent evidences suggest that the herding behavior itself is not constant. It is a variable of the equation. In 1998, the Russian bond market crisis had far reaching contagion effects, three years later a disaster of major magnitude in Argentina sent much smaller shock waves around the world.

[15] The importance of national price and tariff controls are only the trivial examples in the energy and telecommunication sectors, but the role of the WTO, the ITU and the BIS are also important in determining profit-generating possibilities in the pharmaceutical, the broadcasting and the banking sectors, respectively.

conclude that the competitive Russian markets – as much as they exist – do not support the rise of giants. This implies that financial success of the already existing very large companies is much more dependent on the caprice of world market prices then on governance and management. (This argument can be extended to those Central and East European economies as well that were able or potentially are capable to develop a sizeable tourist industry on their seashores or Alpine mountains. The commercial viability of these enterprises is also more dependent on natural endowments + country risk + exchange rate risk than good corporate governance.)

Another factor that has already manifested itself in Russia is the vulnerability of the very large companies. In the financial crisis of 1998, the capital base of the existing very large banks melted like snow within weeks.

The case of China is less clear. While the size of the market is potentially even bigger than in Russia, for historical and cultural reasons it is less likely that the Chinese capital market will be really opened soon for US-type foreign managed funds. If the recent past is any guidance for the future, it seems more likely that mainland China will continue to attract capital from Hong Kong, Taiwan or Singapore along ethnic lines, rather than along purely commercial considerations based on relative factor prices and capital affordability.

6. Conclusion

This paper presented a provocative statement about the relevance of corporate governance for the transition economies. It was shown that if the term "corporate governance" is understood in a strict, specific manner meaning the set of rules defining the operation of publicly traded, large shareholding companies, then the relevance of this doctrine is rapidly diminishing. This is explained, first and foremost, by the fact that taken individually the markets of Central and Eastern Europe are too small and thus not conducive towards the emergence of truly large companies. As it happened, the privatization process in this region has been predominated by large transnational companies which directly own and control the local companies. For this simple reason, the agency problem hardly appears, if at all.

Another way of summarizing the lessons of the Central and East European transition process is to include the question of regional integration into the analysis. This allows to reflect for a second about the fate of former East Germany – once the most developed socialist country. As it is well known, East Germany was legally integrated into what used to be the former West Germany through constitutional changes enacted on a single day. In this newly created legal environment, the former East German SOEs had no time to adopt western type corporate governance structures – the companies themselves were simply "swallowed" by their hungry competitors.

The three Baltic countries represent a middle-case example in this continuum. In a way, Estonia, Latvia and Lithuania didn't aim, from the very beginning, at establishing a full set of domestic markets, but at an integration by becoming regions in the fully-established North-Western Europe (Sutela, 2002). Hungary, the Czech Republic and Poland have been aspiring at European Union membership since the collapse of communism. While in the euphoria of the first transition years, the authorities of all three countries were strongly dedicated to the development of stock markets and widespread popular stock ownership, first Hungary then the other two countries accepted that the majority of their large companies would become subsidiaries and/or branch offices of Western transnational corporations. And once the Central and East European countries join the European Union, the relevance of national corporate governance regimes will almost vanish without almost any trace.

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