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Executive Summary

Privatization in the Czech Republic did not create transparent property relations. The post-Communist Czech state does not have the ultimate power in the economy, anymore. A new, complex economic power structure is on the rise in the Czech Republic. At the center of this new power structure stand the banks, financial institutions, and mega-corporations.

The Czech Republic privatized most of its companies through the two waves of its famed voucher privatization. Several people questioned whether the resulting property structure indeed divests the state from its ownership rights. Voucher privatization has created investment privatization funds (IPFs) which buy shares in companies. IPFs are run by investment companies owned by large banks in which the state has controlling interest. Some claim that this constitutes a chain of ownership from the companies to IPFS to investment companies to banks to the state, and that the state can use this chain to interfere with how companies are run.

The events of the third wave of privatization — a spontaneous rearranging of property relations developed in the previous two waves — suggest, that though the state has remained an active player in many areas of the economy, it does not exercise its influence primarily through ownership or ownership chains. The paper focuses on a series of hostile takeovers of large IPFs by a small brokerage firm named Motoinvest.

Another concern about voucher privatization is that it does not create pressures for restructuring. So far, voucher privatization has not created active owners, even though many companies carried out important changes. Those, however, resulted more from market pressures, than from activities of the new owners.

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1 I would like to thank Petr Plecley, Klara Vlachova, Daniel Munich, Andy Schwartz for their instructive comments.
Introduction

At the time the transition from state socialism began in Eastern Europe there was a general agreement, that the socialist economy had failed and a market economy dominated by a private sector was necessary for economic progress. Socialist economies all had their private sector. Small-scale, traditional, labor intensive, often informal and criminalized, this private sector nevertheless played an important role in certain areas of planned economies, such as services, agriculture or residential construction. The novelty of the transition to a market economy, thus, was not the creation of a private sector, but the rise of a private sector that included corporate actors. In the old private sector individuals participated in the economy as individuals, with unlimited personal liability, little formal organization and without the possibility of forming corporate, legal entities. What the economic transformation had to create was the private corporation. The private corporation has important characteristics: 1. it separates individuals and economic units, 2. and it makes business property divisible among several owners.

Privatization, thus was not simply the transfer of state property to individuals. In principle, in a socialist economy whenever an individual purchased anything in a state store state property was “privatized.” It was not even the transfer of productive assets from state to private possession that is peculiar to privatization, since people often bought goods, such as cars or sewing machines, which they later used for production. What makes privatization distinct is the transfer of state corporations into private hands.

The birth, or rather rebirth, of the private corporation in the region redefined the relationship between individuals and economic units. In the private sector under socialism this connection was simple. There was a one-to-one relationship: the individual was the unit. The private farmer or the moonlighting repairman was his own firm. The advantage of this simple arrangement is that the incentives for the individual and for the firm coincide. Who is responsible is clear and transparent. The disadvantage is that it excludes complex division of labor and the use of expensive capital.

In the state sector the connection between individuals and the economic unit was defined by bureaucratic rules, whereby all those in charge of a company were employees of the state. This arrangement could sustain complex division of labor and the use of expensive capital, but here the incentives of individuals were decoupled from the interest of the unit and responsibilities were vague and fuzzy.

Privatization was to make corporate ownership relations unambiguous and transparent. Under state socialism, it was never clear who was in charge and who was responsible, who was to blame and who was to be rewarded. While on paper the state was the owner of all corporate assets, ownership functions were distributed among various ministry departments, party administrators, local state bureaucrats and managers. The state budget redistributed profit and loss
in a way that it was impossible to say if a company was an asset or a liability for the national economy. Privatization was to put an end to these ambiguities. By assigning ownership to well-defined private owners, privatization was to clarify rights and responsibilities. At the same time, it was to structure incentives in a way that individual rationality would coincide with global efficiency. The main benefit of privatization was to be the creation of corporate owners, who are sensitive to market signals and thus have a real interest in restructuring lopsided, bloated, inefficient companies.

Initially there were debates about how early in the sequence of reforms should privatization occur. Some argued that some restructuring is necessary before privatization, but no one disputed that private owners will eventually follow market forces better than the state. Czechoslovakia decided that privatization should precede any form of restructuring. The only change that was to take place before privatization was commercialization, making the legal structure of the companies compatible with a capital market. Czechoslovakia embarked on a quick privatization scheme, with its famed voucher privatization as its centerpiece. What kind of owners did voucher privatization create? What happened to the state’s role in the economy? And finally, do new owners exercise their ownership rights to restructure enterprises?

A series of events, dubbed the “Third Wave of Privatization,” that has started in the Czech Republic in the fall of 1995, sheds some light on these questions. While the first two waves of privatization transferred formal property rights from the state to citizens, the “Third Wave” rearranged the relations the first two created.

**Privatization in the Czech Republic**

Privatization began in late 1990 when the Czech Republic was still a part of Czechoslovakia. Among the first important steps was the passing of a new commercial code in November 1991, which created the legal framework for private corporations, and which was largely modeled on similar laws in Germany.

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2 The phrase “third wave” has been coined earlier. Smaller transactions that began earlier that year were sometimes referred to by this label.

3 The Czech commercial code distinguishes between commercial companies (obchodní společnost) and cooperatives (družstvo). The more important category of commercial companies are further subdivided into partnerships and companies. There are two types of partnership: general commercial partnership (verejna obchodni spolecnost or v.o.s.), which is unlimited partnership, and limited partnership (komanditni spolecnost or k.s.). There are two types of company: limited liability company (spolecnost s rucenym omezenym or s.r.o.) and joint stock company (akciová spolecnost or a.s.). Almost all large firms are joint stock companies or, less frequently, limited liability companies.
After the “velvet divorce” from Slovakia in 1993, while privatization in Slovakia became embroiled in political struggles, the Czech leadership of prime minister Vaclav Klaus, who was the finance minister in the previous government, carried on with the plan. The Czech privatization program contained several methods for divesting state property. It included restitution, the auctioning off of small units (mostly shops, pubs and property shedded by larger enterprises) and the privatization of large firms through sales to private buyers, transfers to municipalities and to the social security fund. Voucher privatization was only one, albeit the largest part of the privatization program. The book value of all capital in the Czech Republic -- including houses, national monuments and the railroads -- was estimated at 2,604 billion Czech Crowns. The Ministry of Privatization was given jurisdiction for joint stock companies worth 679 billion Crowns. The equity in companies on offer was over 322 billion in the “First Wave” in 1992 and 298 billion in the “Second Wave” in 1994. Less than 10 percent of joint stock companies were to be privatized by not using the voucher method.4

The First Two Waves of Voucher Privatization

After companies participating in voucher privatization had been transformed into joint stock companies, vouchers were offered to citizens. In the fall of 1991, investment companies were formed to manage investment privatization funds (Investicni Privatizacni Fondy or IPFs) and began to advertise. In the first wave, citizens were entitled to one booklet representing 1000 investment points. The booklet cost 1000 Crowns. To validate the booklet, one also had to purchase a special stamp for 35 Crowns. The entire cost of a valid voucher booklet was about $35 or a fourth of the average monthly wage at that time. Initially, the First Wave of privatization was met with indifference. Few people understood the process or saw the benefits of owning pieces of paper signifying ownership shares in companies assumed to be decrepit and teetering on the verge of bankruptcy. Interest did not begin to grow until November, when Harvard Capital and Consulting, one of the investment companies, began to offer the option of cashing out in a year to anyone who put their booklet into its care. Harvard promised to buy the shares -- into which the vouchers turned -- at a guaranteed price of around 10,000 Crowns. Other investment companies followed suit. IPF managers could make such an offer because the price citizens paid for their booklets was only a token sum compared to their value. The precise asset value of these coupons was hard to ascertain in the absence of a real capital market. Experts, however, estimated that the real value of each voucher booklet was around 30-40,000 Crowns.

4 The actual figures are in dispute. In absolute terms they should be taken as estimates that indicate the ball-park of actual values. The numbers in comparison to each other give a sense of the relative magnitude of these values.
In the beginning few people knew anything about stock markets and nobody knew how the Czech stock market would behave. Investment companies were optimistic, however, and even encouraged voucher owners to cash out. A bullish market reinforced their initial optimism. The market, however, turned bearish in 1994, especially after the Second Wave was completed, and has been in the doldrums ever since. With hindsight, the biggest risk IPF managers took with their cash-out offer was illiquidity. In a sluggish stock market such as the Czech one is today, selling shares for cash is not easy. Had a large number of clients decided to make a run on the company and cash out after a year, investment companies would have been in serious trouble. They took this risk counting on loans from banks, on selling real estate and ultimately, if all else failed, on a bail-out from the government eager to see the program succeed.

That investment companies were counting on government intervention as the last resort was all too obvious. This made the government initially nervous about IPFs. They also feared fraud and that large IPFs would try to tinker with the workings of the stock market. As a result, investment companies were also required to deposit all their securities and funds with a bank of their own choosing. IPFs were put under the supervision of the Ministry of Finance, which can follow their investment activities and has special access to their accounts. To what extent the Ministry has the resources and the will to watch closely the day-to-day operations of IPFs is unclear.

Czech IPFs are curious creatures. They are unlike mutual funds in the US because, in principle, the actual power rests with the individual owners, that is, the people who trusted their vouchers to the fund. They can decide over management at the shareholders’ meeting. These shareholders contract an investment company, which then makes all the decisions. Yet with tens of thousands of small investors each holding only a small fraction of the shares the managing company is free to do as it sees fit. IPF managers can exploit their information advantage and the collective action problem the owners face the same way any enterprise manager accountable to a large number of small investors.

The start-up cost of an IPF was not very high. The most difficult chore was to get people to hand over their vouchers. This involved advertising and the administrative task of collecting the

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5 The anxieties of the government were focused on Harvard. Harvard’s spectacular success and the fact that Harvard was unrelated to any established financial institution worried the government and the legislature most.

6 Last year at the shareholders’ meeting of one of the ten largest investment companies, of the 260,000 individuals who invested into the IPFs handled by the company only 217 showed up representing about 20,000 investors.

7 This same investment company managed shares in 126 companies in the spring of 1995.
booklets. Paying for television commercials made up the bulk of the initial investment. Building confidence was not easy, however. Funds that could tie themselves to large banks had more credibility. Signing people up with the IPF required an apparatus. IPFs associated with banks were again at an advantage as they were able to use the banks' nationwide networks of offices. Those without this option, such companies as YSE and Harvard, used college students on commission to gather vouchers.

In the first wave over 72 percent in the second 65 percent of the vouchers were trusted to IPFs. There were over 400 IPFs in 1994, though the largest 20 IPFs held about half of all vouchers.

Voucher privatization was a smashing success. Six million Czechs participated in the first and 6.1 million in the second wave. It was politically popular. People got something for almost nothing. It was quick and well administered. Vouchers bypassed, though did not conquer, the biggest obstacle to privatization: the lack of new capital. At the end of the second wave of voucher privatization the Czechs could claim that the private sector now comprised over 70 percent of their economy.

The Corporate Chain: State, Banks, Investment Companies, Investment Funds, Companies
Lack of new capital and the fragmentation of ownership rights were the two disadvantages associated with voucher privatization. The first one was left unresolved. Voucher owners did not offer new resources for companies. The second, fragmentation of ownership rights, was created by the vouchers themselves. IPFs seemed to solve this second problem. While themselves suffering from the problems of dispersed ownership, the IPFs reconcentrated ownership at the enterprise level and created owners, who, in principle, were able to put pressure on enterprises to carry out necessary changes. Though there was a 20 percent cap on how much ownership an individual investment company through its IPFs could have in one enterprise, investment companies could circumvent this limit. An investment company could use its mutual funds to gain another 20 percent or could collude with managers of other funds holding ownership shares in the enterprise.

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8 Another argument against voucher privatization was that it would fuel inflation. This objection proved to be unfounded. Some economists argued that issuing vouchers is like issuing money (with limited use). Contrary to these expectations, inflation actually dropped after the first vouchers were distributed and now Czech and Slovak inflation are the lowest in the region.

9 Another trick is to buy shares in excess of 20 percent, obtain ownership rights but do not transfer ownership title.
While some of the larger investment companies, such as Harvard or YSE, were privately owned, most of them were created and staffed by the largest banks. There were some smaller, private banks, such as Zivnostenka Banka, Agrobanka and the Austrian Creditanstalt, running their own IPFs. The largest IPFs, however were managed by investment companies of the largest four banks, Komercni Banka, Investicni a Postovni Banka, Ceska Sporitelna and Ceskoslovenska Obchodni Banka. These banks, three of them spin-offs from the Czech National Bank, were and still are to a large extent, in state ownership. Their shares were owned by one or more of the following state institutions: the Ministry of Finance, the Czech National Bank, the National Property Fund or the Restitution Fund.¹⁰

Yet, if companies were owned by IPFs controlled by investment companies, which were run by banks, which, in turn, were owned by the state, did privatization succeed in creating private owners? Do we see the invisible hand of the market? Or the hidden fingers of the state pulling on a long chain extending from the state through the banks through investment companies through the IPFs to the companies? (See Figure 1, page 30.)

A chain of ownership is possible only when the links are made up of corporations. Only corporations can be both owners and property owned by others. This putative chain, then, would be nothing more than hiding state ownership and control behind a succession of seemingly private corporations.

The Corporate Chain: Companies, Investment Funds, Investment Companies, Banks and the State

The link through ownership from the state to companies captures only one possible flow of political influence, whereby the state manipulates the companies through this chain. Yet, the ripples can go in the opposite direction, as well. It is equally possible that companies will use the chain to influence the state. The trade off of concentrating ownership through powerful IPFs and banks, is that these financial intermediaries will always be tempted to lobby the state on behalf of their companies. This risk is especially great, when 1. these intermediaries control many poorly performing companies, when 2. the stock market does not provide a way of getting rid of poor performers, and when 3. the state is closely involved with those financial intermediaries. For the

¹⁰ The National Property Fund owns 48 percent of Komercni Banka and 45 percent of Sporitelna. The Fund's share in Ceskoslovenska Obchodni Banka is only 19.6 percent, but another 26.5 percent is owned by the Czech National Bank, which is fully state owned, 20 percent by the Czech Ministry of Finance and 24 percent by the Slovak National Bank, since the bank serves both the Czech Republic and Slovakia. In the case of Investicni a Postovni Banka the National Property Fund owns 32.9 percent and the Restitution Fund and the Czech Postal Service, a state owned company, are also among the owners. The figure are from April 1996.
first two reasons, these financial institutions are stuck with bad companies, which gives them the incentive to lobby, while the third gives them the opportunity to do so.

What is the nature of the thread running from the state through the banks, through the investment companies to the firms -- or back: from companies through IPFs and banks to the state? Is this thread strong enough for the state to intervene and influence decisions at the enterprise level or for companies to put sufficient pressure on the state? Did this 'chain of command' simply replace the bureaucratic command line of central planning? (We know well, that even under central planning influence between state and firms were going in both directions, if not with equal force.) Is it a chain of command? If this chain exists, are ownership and control sufficiently attenuated through this chain of principal-agent relationships so that the state has no or little power at the enterprise level and the enterprises have no capacity to influence the state?

**Potential Signs of Direct State Intervention**

Prime Minister Vaclav Klaus' ideological stance is vigorously opposed to direct state intervention of any kind. In Klaus' mind, ending state intervention as quickly as possible is the prime reason for quick privatization. In the spring of 1993 he exhorted his colleagues in Eastern Europe:

"Having withstood requests for help, for bailing out, for protected markets, for subsidies, and for modernization and demonopolization of state firms, the government must initiate a rapid and comprehensive privatization process as the precondition for further changes; as a mechanism for finding real and, therefore, responsible and rationally behaving owners; and as a final blow to the ambitions of government bureaucrats to control the economy."

Once privatization was completed, the government must take a hands-off approach. In an interview in 1995 Klaus declared:

"I am a stronger opponent of industrial policy than anybody in the world. Industrial policy is impossible. It is incorrect and irrational. I know how hopeless it is to sit down in my office and try to decide anything about any industry. It is wrong a priori, so I am against any form of industrial policy and I think that my arguments are stronger than the standard theoretical arguments. I know how impossible it is in reality."

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Yet, politicians are notorious for saying one thing and doing another. Many people observed
that the inflexible, forceful and undoubtedly sincere rhetoric of Klaus is very far from the flexible
and pragmatic policies he pursues.12

Finding out if the string running from the state to enterprises is tight or loose is not easy. In
interviews managers of companies and IPFs vigorously deny any undue influence. They claim that
their relationship is completely business like. Banks are equally tight lipped. They often happen to
be the main lenders and account handlers of the companies their IPF management company has a
stake in, but not always. Banks are at pains pointing out that organizationally IPF management,
lending and accounts are separated. It is also true that because of the 20 percent rule companies
often have a choice between more than one banks, because their shares are held by more than one
IPFs.

Yet there are various indirect signs of potential state intervention. The three most often
mentioned is low unemployment, few bankruptcies and preferential treatment of domestic bidders
in privatization. In the next section, I will argue that though the state does intervene in many
ways, its intervention is not primarily through the corporate chain.

Low Unemployment

Unemployment in the Czech Republic is spectacularly low. It hovers around 3 percent, a
figure that very few countries in the world can match, and which looks miraculous by East
European standards [Table 1]. (For Tables see page 29.) It is often alleged that the explanation
for this stunningly small number must be state intervention.13 According to this view, the state
dissuades enterprise managers from radical downsizing to avoid social tensions. This might suit
old-style managers just fine. They are reluctant to take radical initiative and hope to muddle
through.

Yet figures show that the structure of the Czech economy is changing. There is a decrease
in mining and agriculture and an increase in construction, trade and banking [Table 2]. Though
these changes are less impressive once compared to similar figures from Hungary, they are
nevertheless signs of economic adjustment [Table 3].

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12 The discrepancy between Klaus’ rhetoric and policies is smaller than it seems. Klaus is a
Hayekian conservative liberal. As a conservative, he has a certain respect for the status quo, which
happens to be at odds with liberal ideas.

13 In the Czech Republic between 1990 and 1993, the economically active population declined by
only 11.1 percent compared to 14 percent in Poland, 16.6 percent in Slovakia and 24.4 percent in
Central Statistical Office, p.47. This decrease, though smaller than in other countries, also suggest that
a large number of people simply leave the work force without showing up among the unemployed.
These are mostly women and people who take early retirement.
Moreover, the rate of inflow into unemployment is the same in the Czech Republic as in other East European countries where unemployment is in the double digits. Where the Czechs are different is the rate of outflow. Those who became unemployed are quick to find new jobs. This is partially explained by the large boom in the service sector, anemic under state socialism. Aided by a rapidly growing tourist industry, private stores, restaurants, travel agencies, and other service establishments soak up most of the workers made redundant in factories. But, curiously, there are jobs to be filled even in industries that are on the decline, such as mining and manufacturing. In the North Eastern region of Moravia, famous for its mining and heavy industry, OKD, one of the largest employers and the biggest Czech coal mining company in the country, cut its work force by 62,000 or over 60 percent. Nevertheless, the Ostrava based company complains that it must hire Polish guest workers, as few Czechs are interested in the back breaking jobs the mines can offer. With one of the highest regional unemployment rates in the country standing still only a little above 5 percent, laid off workers would rather take their generous severance pay and a 2000 Crown monthly allowance. They receive this allowance for years over and above their unemployment compensation or pay they get in their new jobs.

The government does intervene with subsidizing job creation and job training, though it never spent as much as its neighbors. Active labor market policies abated since Klaus became prime minister. The Czech unemployed can count on benefits that are less generous than their Hungarian counterpart receives, and thus there is a strong incentive to return to work. In North Eastern Moravia there are large government projects to rehabilitate the ecosystem ravaged by decades of mining. Many miners who left OKD are now busy planting trees.

Another way the state intervened in employment was a centralized wage policy that tied wages to increase in productivity. These policies that were mandatory for any firm with more than 25 employees, regardless whether they were privately or state owned, kept wages low. While the brake on wages kept inflation in check, it also made economizing on labor less pressing for companies.

Few people would argue that unemployment in the Czech Republic is suspiciously low. This low unemployment rate is the primary reason why industrial productivity in the Czech Republic grew only by 2.1 percent between 1990 and 1994 compared to 15 percent in Hungary and 13 percent in Poland.

Few Bankruptcies

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14 These data are from ongoing research by Daniel Munich at CERGE-EI in Prague.

Others see the state’s hand in the low rate of bankruptcies. The Czech bankruptcy law was announced 1991, but took effect only in April, 1993 after its introduction was postponed twice. Since then the number of bankruptcies has remained very low. Those who believe that the string from state to companies run tight, point to the high proportion of bad loans in the banking system that, according to their argument, keep feeble firms afloat. According to Investicni a Postovni Banka, in 1995, 38 percent of all bank loans were non-performing. Since bad loans are not in the banks’ own economic self-interest, this might be a sign of state intervention.

The distribution of these non-performing loans is important. Non-performing loans at Investicni a Postovni Banka, for instance, make up only 16 percent. The biggest holder of bad debt is Konsolidacni Banka. Konsolidacni Banka was created by the government in February, 1991 with the purpose of freeing the still young and weak banking system from all the bad revolving loans — the loans used for keeping inventory — companies accumulated before 1991. Konsolidacni took these loans at a favorable interest of 13 percent for 8 years, at a time when inflation was over 50 percent and the CMEA markets began to collapse. Since its inception Konsolidacni’s main job was to manage these loans with the help of state subsidies. These subsidies, about 30 percent of the overall value of these debts, were paid with earnings from privatization. By the end of 1995 another 30 percent of the original debt was paid off by the companies with the rest to be paid by 1998. During its five years of operation about two dozen — or less than 1 percent — of the companies with accounts in Konsolidacni Banka have gone bankrupt. Konsolidacni undoubtedly saved many companies from bankruptcy. It even swapped debt for equity and acquired ownership in five companies. But Konsolidacni has no IPFs.

Nevertheless, several small banks did go under in the last year and a half because of foolish lending practices. None of them had major IPFs, however. Others propose a different explanation. The reason why banks don’t foreclose on bad debts is not that the banks must accommodate the political objectives of the government. Banks follow their own interests. If a company files for bankruptcy, banks are the only secured creditors. Their loans are collateralized and they receive property in case of bankruptcy, after wages, severance pay, taxes and the administrative costs are paid. Yet the property is worthless, unless the bank can sell it. With a very sluggish market in industrial real estate and machinery, the banks expect to take a big loss. On the other hand, being the only secured creditor, they know that no other creditor will

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16 These are Zetor, an agricultural machinery manufacturer, Skoda Mlada Boleslav, the car company, Letov, Aero Vodochody, two aviation companies, and CSA, the Czech national airline.

17 In fact, holding property while waiting for a buyer to come along can be quite costly.

18 The courts are also not trusted to handle bankruptcies expertly and quickly.
ask for bankruptcy, because other creditors are unlikely to receive much after the bank takes its own cut.19 Banks thus prefer to use their secured debt to work with companies to solve financial problems.

Another motivation that makes banks reluctant to initiate bankruptcy procedures is that they worry about the general perception of their portfolio.

Many large firms avoid bankruptcy by getting away with not paying social security taxes. The most infamous case is Bohemia Arts, the private holding that owns Poldi Ocel in Kladno, which was 5.6 billion Crowns in arrears when the National Property Fund started to clamp down. Other companies accumulated hundreds of millions in unpaid social security taxes so far without punishment.20

Again, it is not clear what lies behind this permissiveness. The National Property Fund, the agency that can pull the plug on these companies, is reluctant to do so as long as the new owners meet their payments to the Fund. Unpaid social security taxes are not their direct concern.21

Favoritism towards Czech Buyers in Privatization

While most of the large firms have been put up for voucher privatization, several firms were sold partially or entirely to domestic investors. These domestic Davids often acquired property in competition with formidable foreign Goliaths. Probably the most famous example is the privatization of Skoda Plzen, the largest machine manufacturer that employs every fiftieth person in Bohemia, and which produces everything from trolleybuses and locomotives to turbines for electric power plants. Nero, the company of Lubomir Soudek, a dynamic manager and entrepreneur, who was ousted as Skoda’s CEO in 1991, bought the machine manufacturing giant for 300 million Crowns in competition with one of the largest German companies, Siemens. Soudek did not even have this money (which is a small amount considering the size of Skoda Plzen), but got a loan from Komercni Banka. Komercni Banka also has a 10 percent share in Skoda and Investicni a Postovni Banka holds another 9 percent. The National Property Fund kept 16 percent. Thus Soudek is in full control, as long as he can convince the two banks, represented on the board of directors to go along.22 The result is a delicate and very close cooperation between the banks in which the state has large interest, and Soudek.

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19 Since March 1996, when the Bankruptcy Law was amended, non-bank creditors enjoy better protection.

20 For instance, Intercom owes over 300 million and Vlarske Strojirny over 250 million.

21 Non-payment of taxes can land the owner in court, but court proceedings can drag on for a long time.

22 The two banks are also represented on the board of supervisors.
Large foreign companies lost out in their bid for Poldi Ocel, Kladno, the legendary steelworks, immortalized by the novelist Bohumil Hrabal, the birthplace of the Czech labor movement. A German, an American and a Swedish multinational made offers to buy Poldi. All lost to Vladimir Stehlik, a Czech architect. The same happened in the case of HTT-Tesla, Pardubice, a producer of communication equipment for the military, which ended in the hands of a Czech general.

A nationalistic rhetoric, stressing the importance of domestic ownership is in evidence even in Klaus' fervently free-market harangues. Some suspect that hand picking domestic owners is a way the government keeps its influence over the economy and ascertains that a loyal, domestic capitalist class emerges.

Giving property is, however, not the best way of keeping state influence in companies. New owners may not feel obliged to follow the state's directives once they have seized ownership, unless they need the state for the successful operation of the company. State orders or loans from state banks, special regulations or the state's help on foreign markets can be all valuable, but none of them are unknown in developed capitalist economies. What is unique to the Czechs is a form of privatization whereby the domestic investor gains only gradual control over the company, while he is closely monitored by the state. Moreover, the loan is given by one of the state banks. In this chain the IPF is replaced by the domestic entrepreneur, who is controlled by the government both directly, and indirectly, through the banks. Skoda Plzen was privatized through such an agreement. Soudek gains ownership over Skoda gradually, as he fulfills his obligations he agreed to in the purchase contract. This kind of supervision is next to impossible if the new owner is a foreign investor.

**Investment Funds and Restructuring**

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23 Poldi is one of the few large enterprises that is a limited liability company. In fact, the company, which is named after the mother of the philosopher Ludwig Wittgenstein, and was originally owned by the Wittgenstein family, is run by Stehlik as a family business. His oldest son is the executive director, another son is “rector of Art studios,” and his wife is in charge of the charity fund.


25 In the case of Poldi Ocel in Kladno, Stehlik’s bid won in competition with a German, an American and a Swedish multinational steelmaker. Stehlik got Poldi under a different arrangement, which did not involve close state supervision. As of the summer of 1996, the National Property Fund is in the process of repossessing Poldi, as Stehlik is delinquent on his payments. There is, however, an unexpected obstacle: the sales contract had no provisions for non-payment!
Since the need for privatization is argued on the basis of higher efficiency of private ownership, one should ask the question: are IPFs active owners? Are they engines of restructuring? One study conducted in 1994 found that firms owned primarily by IPFs restructure more than enterprises owned by the state, individual small investors, employees or managers. But changes in IPF owned companies are less than in enterprises owned by foreigners or big, domestic investors.  

Part of the problem is the 20 percent limit. Another reason why investment companies are not more vigorous is the diversity of their portfolios. It is just not possible to pay attention to hundreds of companies, especially in the beginning when managers are still inexperienced. In the first few years, IPFs could not get strongly involved, even if they wanted to. This might change as IPFs consolidate their holdings and keep larger shares in fewer firms, and as fund managers learn to run their funds.

Even if these problems were resolved, IPF managers complain that there is no market for company managers. If, as a first step, they fire old management at the company, they will not be able to replace them. Talented people, they lament, start their own business or want to work for multinationals.

The other question is whether IPFs have the incentive to spend energy mending firms. Fund managers are under little competitive pressure. IPFs are a lucrative business. The company that manages the IPF could pay dividends of 20-40 percent on the 1035 Crowns purchasing price, by paying only 0.5-1 percent on the actual value of the shares.27 Thus investment companies could keep their customers happy with low returns on the value and could pay themselves a large management fee, which is usually set as 2 percent annually of the total value of the managed assets. Even if the value of IPFs is sliding deeper and deeper, IPF managers can still collect large sums, which they can use in their own business pursuits.

Principal-Agent Problems in the Chain

26 Alena Zemplinerová, Radek Lastovicka and Anton Marcincin, Restructuring of Czech Manufacturing Enterprises: An Empirical Study, Prague: CERGE-EI Working Papers No. 74. See also, Radek Lastovicka, Privatization and Restructuring under Transition, Prague: CERGE-EI Working Papers No. 82. There is a serious question of causation, as it will be discussed below. It is possible that IPFs buy into companies that are already in the process of restructuring. It is not IPF ownership that leads to changes, but changes are signal for IPFs to select the company into its portfolio.

27 This year, the IPF managed the investment company of Komercni Banka will pay 280 Crowns per coupon book about 28 percent return on cost. This corresponds to 14 Crowns per share and the average value of a share on June 20 was 1,259 Crowns, a return of 1.1 percent on value.
Even if there is a chain extending between companies and the state, we can still ask: how tight it is and whether the ripples going up and coming down neutralize or reinforce each other. The state may have a certain set of objectives, but the banks may have another and IPFs yet a third. The state may be interested in keeping companies afloat, but banks are also interested in not giving out bad loans to keep poorly performing companies from bankruptcy. Governments come and go, but the bank must endure.

IPFs unable to get rid of their poorly performing shares will have to stick it out with a company. Thus they may become agents of the company betraying the bank, and go and ask banks for favors. But IPFs are ultimately the creation of those banks and their bond to their bank is even stronger. There is a double link between fund managers and banks. Many of the IPF managers came from the bank’s personnel and they have loyalty to their previous colleagues. But if that fails, IPF managers can be fired by the bank.

Even if the government was able to line up banks and IPFs, it is far from clear if it has sufficient number of hands and fingers to pull those strings. Under socialism a huge state administration was employed to administer the economy. Exercising coordinated — and covert — monitoring and control of all enterprises would be costly, if not impossible. Running the entire economy through the Ministry of Finance and the National Property Fund means a different and a much weaker form of state intervention than was exercised in a planned economy.

The state's ownership rights are diluted by every step that it loses controlling interest. There are companies where the majority of the shares belong to private IPFs — IPFs not controlled by banks with sizable state ownership — and individual private investors.

Loops in the Chain

The chain also has loops in it. Most bank owned investment companies manage IPFs that own shares in the bank. Thus ownership comes full circle: from bank to investment company to IPF back to the bank. Since the bank appoints the IPF managers, the representative of the IPF is the de facto subordinate of the bank manager. Thus the manager of the bank can exercise ownership rights without actually being an owner. In the case of Investicni a Postovni Banka, the funds managed by its investment company, Prvni Investicni a.s., own 10 percent of the bank’s shares. It so happens that Prvni Investicni a.s., not directly represented on the board of directors or supervisors, but as the second largest shareholder it has a strong say in the composition of employees of the company.

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28 Czech commercial code follows the German model. Each joint stock company has a board of directors responsible for the day-to-day operation of the firm, and a board of supervisors that meet a few times a year. Both are elected by the shareholders. One third of the board of supervisors represent employees of the company.
both. In the case of Ceskoslovenska Obchodni Banka its investment company OB Invest has less than 10 percent stake in the bank, but it has a seat on the board of supervisors.

In certain cases, such as, Brnenské veletrhy a vystavy a.s. (BVV), a large company specializing in organizing trade fairs and business tourism, privatized companies set up IPFs that then buy shares in their mother company. BVV owns Moravskoslezsky veletrzni IPF, which has ownership stake in BVV and sends one person to the board of directors. Thus management has one more vote at board meetings.

Loops strengthen the position of managers, who gain de facto ownership rights. Bank managers can employ their IPFs to represent their interest vis-à-vis other owners, including the state. Companies, like BVV, can use their IPFs as a counterweight against bank managed IPFs.

Breaks in the Chain

One should notice that the chain from state to company is not a continuous chain of ownership. After all, the first Two Waves did happen and citizens, and not investment companies, own the shares of IPFs. Investment companies merely control IPF shares, albeit their control is difficult to challenge for any individual shareholder (see broken lines in Figures 1-3).

The reason why loops are possible is because the chain is not continuous. Discontinuity allows managers to set up IPFs and gain ownership rights in their own company without actually paying for it, just as the state can distribute property and hold onto it at the same time in the putative chain scenario. The break, or discontinuity of ownership, is what distinguishes loops from self-ownership and cross ownership.

Self-ownership is when company A owns its own shares. Simple self-ownership is discouraged by law, thus self-ownership usually happens through company B. Company B is owned by company A, and company B is owned by company A. The circle is completed without a break in the ownership chain. Cross-ownership, which is more common, is when the company A has shares in company B and B has shares in A. Both companies have a measure of independence, B is not simply the creature of A, as with self-ownership. This, however, does not mean that A and B have an equal relationship. Chemapol, a large holding company has shares in Spolana, Neratovice, a company manufacturing industrial chemicals. Spolana also has shares in Chemapol. But while Spolana’s ownership in Chemapol is a token, Chemapol has strong influence on Spolana.

The links in both self- and cross-ownership are those of ownership. Loops, peculiar to voucher privatization, always have a break in them. What loops accomplish is that they collect and rechannel fragmented ownership rights to the company or bank.
The existence of loops points to the weakness of a state-to-company chain. By acquiring ownership rights — though no actual ownership — managers can stand up against other owners, including those representing the state.

The break weakens the putative power of the state in another, more obvious way, as well. Because the hold of investment companies over IPFs ultimately depend on the trust and/or paralysis of small investors who own the IPF shares, if those share-owners were to take a more active role, IPF managers would have to act as real owners and not as agents of banks or the state, or of company managers. A group of young people recognized the precariousness of the investment companies’ hold on IPFs and launched a private takeover of the large bank managed IPFs. They called it the “Third Wave of Privatization.” What they set out to do was no less than cutting the links from state to enterprises by buying out small investors in IPFs. By gathering a small but sufficient portion of the shares they set out to take over those funds. Once they installed new management they used the IPF’s funds to gain control over enterprises.

While doing that they have unwittingly executed an experiment. If indeed the state was exercising influence through this chain, any such intervention had to provoke strong response from the government. And if indeed the political influence of companies and financial intermediaries were that strong, they would be able to propel the government into action to defend them. Just what happened and how the state reacted can thus help understand the real role of the state in the economy.

A Found Experiment

On October 23, 1995 a small, little known provincial bank, Plzenska Banka, originally created to finance investment projects in and around the city of Plzen, began a television advertisement campaign. “Small-shareholders, weep!” so the slogan went. In well-crafted commercials, a factory worker and an elderly woman complained that the large IPFs pay them little while their managers are getting rich. “No money, no influence. All we have left is our tears.” In the next few days millions of households received a thick envelope with the slogan: “The Third Wave of Privatization” prominently printed on it. The envelope contained three letters, each of a different color. The first, blue letter offered to buy the investment shares of small investors at the going rate on the stock exchange. The pay was to be a retirement account with very favorable terms at one of the largest private pension funds. The second, red letter offered to take over the shares from the IPFs that managed them at that time. It promised that it would consolidate the shares and either sell them at a good price or pay higher returns, depending on the owner’s wishes. The third, gold letter, offered to buy the shares for cash at their market price.

For days the name of Plzenska Banka was all over the media.
Motoinvest

Very soon it became revealed, however, that Plzenska Banka was only an instrument. The player behind the campaign was an even smaller brokerage firm, Motoinvest, a company of 15 young people, all between the ages of 19 and 28. Motoinvest was founded in 1991 in the town of Cheb with the minimum capital required for incorporation: 1 million Crowns. Its first years were unremarkable. In a year the company was granted the licenses to trade in securities, and at the end of that year Motoinvest became a member of the Prague Stock Exchange. In January, 1994, the company moved from Cheb to Prague and in August the base capital was raised to 30 million. Motoinvest made its first transaction on the Prague Stock Exchange in September of that year. At this time it already began to buy shares in IPFs as well as in banks, such as Plzenska Banka. In May 1995, the basic capital was further increased to 300 million. At least some of the money came from a successful private entrepreneur who had made his fortune trading computer equipment. Around that time the largest shareholder of Plzenska Banka, Ceska Pojistovna, the largest Czech insurance company, sold a large portion of its shares to an individual, who later turned out to have made the purchase for Motoinvest.

Motoinvest, now in control of a bank, stepped up its takeover efforts. In the Czech Republic shares can be traded either through the stock exchange, or directly, off-the-floor, or through a computerized system operated by the company RM-System. Off-the-floor trading happens when two companies agree selling or exchanging shares. The largest part of stock trading occurs off-the-floor.

RM-System was designed for individuals wanting to trade their shares. It has store fronts in many cities and people can walk in and offer their shares or make purchases. The transaction is then carried out through a nationwide computer network that keeps track of each offer, sale and purchase. Motoinvest used this system (most likely, along with off-the-floor deals) and to avoid raising the suspicion of large IPFs, it made purchases under many different accounts. The accounts were of small ghost firms. According to the laws in effect at that time, anyone who obtained 10 percent of the share had to declare its acquisition. Motoinvest split the 10 percent between two or more accounts. Once in possession of 10 percent of the shares, Motoinvest had the right to call a shareholders’ meeting. At these meetings Motoinvest unceremoniously sacked the investment company and put its own people in charge.

One of the first banks whose IPF Motoinvest raided was Agrobanka, the largest private and the fifth largest commercial bank in the country. Agrobanka quickly struck a deal and joined Motoinvest. Now the small brokerage had the deposits of two banks at its disposal.

The nominal owner of Motoinvest is TARA, a.s., which is owned by physical persons. The 15 young people are only employees.
Motoinvest’s Strategy: The Triple Discount

Motoinvest’s strategy was simple. They recognized the weak link in the system: investment companies did not own their funds. They also recognized that they can gain full control over companies at a triple discount. First, they noticed that shares on the stock market were undervalued (according to their estimation by 60 percent). Moreover, their experience showed that buying into a company did not drive the price of the company up. This already meant a large discount of price-to-value to exploit. But there was a second discount: By buying controlling interest in a firm, one can act as the owner. Buying 51 percent always gives complete command. With a few exceptions, minority shareholders enjoy no protection. Where ownership is highly fragmented even a smaller share may be sufficient for full control. Using the IPFs provided a third discount. By obtaining control over 10 percent of the shares, Motoinvest had the entire capital of the IPF at its disposal, capital that it otherwise would have had to borrow at high interest. So Motoinvest could gain control of a company by obtaining half or less of its shares, combining the 20 percent packets of several IPF. They could get control over those packets by buying only 10 percent of the shares in an IPF at a 60 percent discount. In a hypothetical case of company X where Motoinvest gained 51 percent by combining three IPFs Motoinvest could obtain complete control by paying only 3.06 percent of the value of the company. If one adds to this the fourth rebate that Motoinvest’s money was already leveraged by the deposits from Plzenska Banka and Agrobanka, one can see how a little can go a long way.30

Did this chain of discounts result in a chain of ownership similar to the one described earlier, except that at its end not the state stands but Motoinvest? No, the result was quite different. First, in this chain of ownership there is no break. Motoinvest owns the IPFs. Moreover, Motoinvest has its representatives present at each link.

Motoinvest’s declared goal was to put an end to the passive style of ownership the IPFs represented. Once in control, they claimed, they would force enterprises to radically overhaul their operations and swallow the bitter pill of restructuring. To what extent they lived up to this promise may be too early to say yet, but I will discuss this issue later.31

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30 According to the Czech commercial code 10 percent is sufficient for calling a general meeting of shareholders. The meeting has a quorum if at least 30 percent of the shares are represented by someone present. If there is no quorum, the second meeting is called without a quorum requirement. Most issues are decided by simple majority. A few special decisions must be made with two-thirds of those present. These include decisions concerning the articles of association, increase or decrease of registered capital and the winding up of the company. (Commercial Code Sections 184-187.)

31 Since then emphasis of Motoinvest’s philosophy has shifted somewhat. This is what their new, English language corporate flyer has to say:
“What is the purpose of the existence of Motoinvest? Motoinvest wants to contribute to the situation when the Czech industry will be not only successful but also will remain Czech.”
The Banks' Response

The large banks whose IPFs were targeted sprung into action as soon as they recognized what was happening. The four banks most affected were Komercni Banka (KB), the largest bank in the country and the best rated financial institution in Eastern Europe, Ceskoslovenska Obchodni Banka (CSOB), the fourth largest bank, as well as two private banks, Credit Anstalt of Austria and Zivnostenska Banka, a national institution before World War II, now a bank in German hands. As a first step, the large banks tried to force Ceska Pojistovna, in which they have large ownership share, to oust Motoinvest from the board of Plzenska Banka. Ceska Pojistovna, however, was no longer the largest shareholder of the bank. This attempt created high drama, whereby two boards of directors, one made up by Motoinvest and another by Ceska Pojistovna, were denouncing each other, each claiming to be the one and only ruler of the small bank from Plzen. Ceska Pojistovna argued in despair, that even though it sold its shares to Motoinvest, it had not actually completed their transfer and it was still in charge. This argument held little water and in the end Motoinvest won.

The large banks immediately put pressure on other banks not to lend to Plzenska Banka. They also turned to the Czech National Bank to investigate Plzenska Banka to find out if any illegal acts hid behind the campaign. The investigation was most interested in finding out if Plzenska Banka broke the law by taking money from illegal sources. Not even a "deep audit" of Plzenska Banka's books, however, could find anything illegal. Thus Czech National Bank had to chastise Plzenska Banka for being imprudent using too large of its assets for investing in securities and forbade the Plzenska Banka to continue its raid. At this point Agrobanka stepped into the limelight. Motoinvest's second and larger financial backer promised to continue where Plzenska Banka left off. Investicni a Postovni Banka, the fifth largest Czech bank with sizable state ownership, a significant player in the IPFs market, and the largest shareholder of Agrobanka protested. Yet its protest was less than forceful. The takeover campaign miraculously spared all the IPFs managed by Investicni a Postovni Banka’s company, Prvni Investicni a.s..

There was another reason why Motoinvest avoided confrontation with Investicni a Postovni Banka. Investicni a Postovni Banka, unlike the other banks, was more cautious from the beginning. While the other banks had very few shares in the IPFs their companies managed, Investicni a Postovni Banka bought shares early on and had over 20 percent in some of them. To wrest control from Investicni a Postovni Banka Motoinvest would have had to purchase too many shares in those funds.

The Stock Market's Response
To everyone's surprise during this period the Czech stock market continued its downward slide.³² Neither the Motoinvest campaign, nor another, separate event, the appearing of an American investor, Michael Dingman, buying USD150 million worth of shares from Harvard IPF, could turn the tide. Prices of the raided funds increased, however. In September and October, the price of Kvant shares grew by almost 100 percent and began to lose quickly that gain after CSOB struck a deal with Motoinvest. IPF KB shares jumped over 50 percent, most of the rise taking place after October 23. The IPFs of Credit Anstalt and Zivnostenska saw a less dramatic increase in their share prices. The rest of the market remained inert, untouched by the Third Wave, even though, the Motoinvest group was buying shares in companies intensely.

The State's Response

That the banks defended their turf is not much of a surprise, but could they count on the support of the government? What was the government's response to the Third Wave of Privatization? A few days after Motoinvest's campaign became public, Vaclav Klaus issued a terse written statement. "I responsibly proclaim that [the Third Wave of Privatization] has nothing in common with privatization which the government organized in the past years in the form of the first and second waves of coupon privatization." According to Klaus, Plzenska Banka “misused” the phrase. The government also protested against the television campaigns which in its opinion was dangerously undermining the public's confidence in privatization and was liable to create panic. The National Council on Advertising also condemned the ad campaign.

The Motoinvest group obliged. The next day the old commercials were pulled and the “Third Wave” slogan disappeared. In the meantime, Komercni Banka wanted to remove its IPF's shares from open trading. Unexpectedly, the Ministry of Finance through the Stock Exchange Commission refused permission.

By then the papers were full with elaborate speculations about the possible criminal elements behind Motoinvest. The Ministry of Interior was called in to investigate. Minister Jan Ruml, the bearded ex-dissident-turned-chief-of-law-and-order, one of the most trusted members of Klaus' cabinet was asked about the case in a television interview. Ruml announced that he sees no reason for starting a criminal investigation against Motoinvest. This was a clear signal, along with the Finance Ministry's decision against Komercni Banka, that the government was not hostile to Motoinvest and was not about to lend its muscle to quash the Third Wave. In the following months, Ruml would take the same position publicly, again and again.

²² In 1995 the market lost 20 percent of its value in dollar terms. Since the Crown was very stable that year, the fall in Crown terms was similar. One of the reasons of this downward slide is the large number of companies on the Czech stock exchange. There are 1,635 companies, more than in any other country in the region. Many of these companies do not belong there. They have very little basic capital, their shares show little movement and they will never attract new investors.
Very soon Libor Novak, second-in-command in the ruling party, ODS, gave an interview to the private television network, Nova, voicing the opinion, that the Third Wave of Privatization was good and necessary “in its content.” Only its “form” was unfortunate because it could have denigrated the success of voucher privatization. This reflected Klaus’ position, as well.

In November the Ministry of Finance, which like most anybody, first learnt about the Motoinvest campaign from the press in October, began an investigation of Motoinvest. The investigation found only a few, minor irregularities. Motoinvest was quite pleased with the government’s behavior and it was especially satisfied with the conduct of ODS leaders.

While the government was clearly not trying to stop Motoinvest, it faced tremendous pressure from banks to do just that. It was also concerned that the increasingly desperate banks would continue their warfare. Plzenska Banka was already ostracized and Agrobanka was to face similar sanctions. The destabilization of the fledgling stock-market was of great concern, too. Thus the government expressed its wish to see the crisis resolved as soon as possible without taking sides.

OB Invest, the IPF management company of Ceskoslovenska Obchodni Banka, was the first to start negotiations with Motoinvest. It quickly agreed to buy the group’s shares at an undisclosed price that included a handsome mark-up. Motoinvest promised to leave Kvanto, the IPF in OB Invest’s care, alone. The money for the purchase came from Ceskoslovenska Obchodni Banka. Thus the bank became de jure owner of the IPF, fortifying its management control with ownership rights. In a second step, some of Ceskoslovenska Obchodni Banka’s shares were passed on to companies owned by the bank.

Having failed pulling out of the stock market, managers of IPF KB, the IPF of Komercni Banka, had to follow OB Invest. Komercni Banka, too, paid a hefty sum to buy out the Motoinvest group. Creditanstalt decided to sell its investment company to Motoinvest, and thus handed the Motoinvest group two IPFs. Zivnostenka decided to play a game of chicken. They began to buy into their own IPFs keeping ahead of Motoinvest. Though the fate of these IPFs is not settled, yet, it seems that Motoinvest is giving up.

Komercni and Ceskoslovenska Obchodni Banka, as well as Zivnostenka, thus regained control over their IPFs. Yet they paid a very high price that they could have avoided had they been able to count on political intervention by the state.

The Motoinvest group ended up with the control of a financial empire estimated to be worth between 80 and 100 billion Crowns. This included two banks, a series of IPFs, two pension funds and many companies.

Privatization, Ownership and the Role of the State

The experience (or experiment) of the Third Wave suggests that there is no chain of command extending from the state to companies. This does not mean that the state does not get
involved with particular companies if it sees it fit. The state does occasionally come to the rescue of companies in big trouble. But it is not an ownership chain through which it carries out its interventions. Privatization may not have created clear and well-defined owners, it may have not resulted in an ownership structure that is highly efficient, but it did result in the disengagement of the state as owner.

The Aftermath of the Third Wave

**Banks in Transition**

From the vigorous reactions of Komercni, Ceskoslovenska Obchodni and Zivnostena Banka it is clear, that unlike the state, banks play a more direct role. Most of the large banks bought into their IPFs to avoid the replay of the Third Wave. Komercni Banka now owns directly or indirectly 40 percent of its investment fund. Thus the Czech economy moved closer to the ownership structure it had in the 1920s and 1930s, when big, universal banks had considerable ownership shares in companies. Though, there seems to be no uniform strategy all big banks follow, a Czech version of finance capital, similar to the German model, may be on the rise.

Even though the Prague stock exchange is the largest in Eastern Europe, Czech companies raise capital primarily not on the stock market but through bank loans. The banks loan to companies more easily if they can keep close eye on the doings of the enterprise. One way of assuring close monitoring is buying shares in the company. Ownership entitles them to have a seat on the board of supervisors, or if they feel the company needs even closer supervision -- on the board of directors. Banks and companies work informally with each other. Companies are not shopping for loans and the banks are willing to soften budget constraints for the companies by being more generous in lending and in observing deadlines.

Banks are conservative institutions, they are unlikely to act as agents of radical change. They will most likely to passively monitor companies as much as possible, and intervene only if they feel that their money is in danger.

The future of Czech banks may take unexpected twists and turns. The government announced it will gradually sell its share in the banks. The government’s and the bankers’ biggest

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33 The companies argue that most of their problems are the results of government decisions they had to follow before 1990. If the government ordered them to sell their wares to the Soviet Union, and the government profited from the sale, the company should not be the only one bearing the consequences, when the Soviet market collapses.

34 When I asked any of the participants of the Motoinvest affair, why the banks insisted on keeping the IPFs, not a single person answered with some well-defined economic interest on the banks’ part. To them the issue was power. Power, of course, can translate into economic benefit in the long run.
fear is that Czech banks will be gobbled up by big Austrian and German banks. If the Czech Republic will join the European Union, by 2005 it must open up its banking to other Union members.

**IPFs in Transition**

IPFs are in transition, as well. A recent study by Coopers and Lybrand found that while in 1994 IPFs still dominated the boards of directors of companies, last year their role receded as management teams are taking over. This indicates decreasing direct involvement of IPFs in the operation of companies. At the same time, the study found that last year ownership became more concentrated. IPFs and other owners try to consolidate their holdings in fewer number of companies. This is a sensible approach if the IPFs' main goal is to increase the sales value of their holdings. A larger packet is worth more than the sum of the value of its parts. Partly because of their vulnerability, which the Motoinvest affair revealed, partly because of the 20 percent limit and the Finance Ministry oversight, IPFs are losing their appeal. IPF managers are looking towards other corporate forms, such as joint stock companies, which do not encounter these limitations. A series of private IPFs, including the ones managed by Harvard, are now transformed. Bank-owned IPFs do not take this route. They consider this a violation of the trust of small shareholders and do not want to jeopardize their reputation. Moreover, IPFs suit banks just fine. Now that they have large ownership in them and no one will be able to repeat Motoinvest's ruse, they are comfortable. They do not need to own more than 20 percent to monitor the company.

Last year IPFs posted an 11 billion Crown loss. Since IPF managers are paid not according to the profitability of IPFs, but after the value they manage, managers made money. Their pay was less than last year because of the downward slide of the stock market. As a result more and more IPFs will fold.

**Companies in Transition**

Did the ownership change brought about the Third Wave result in more vigorous restructuring of companies?

So far IPFs, in general, have not been major players in restructuring enterprises. It remains to be seen if the Motoinvest group will be any different. Motoinvest has set about to reform only a single medium sized factory of its large empire. Slovacké Strojíny Uherský Brod is a machine factory producing industrial cranes. Under socialism SSUB had about 90 percent of its production.

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35 One of the reasons why share prices did not increase when the volume of trade was considerable, was that IPFs were swapping shares among themselves.

36 Recently, the Investment and Mutual Funds Act was altered, now requiring the approval of 2/3 of the shareholders to transform an IPF into an ordinary joint stock company.
filled by military orders. By the time Motoinvest took over SSUB over 70 percent of its production was for export and the company was over its crisis that struck in 1991.

First, Motoinvest changed the top management. They quickly demoted the general manager, who then tried to join forces with the union in resisting the new owners. He was fired. His successor was one of his deputies. Several of the seven manufacturing units that made up SSUB were replaced. They cut middle management by approximately a third, dismissing about 100 people altogether or 5 percent of the whole work force. Few if any blue collar workers were laid off. SSUB needs workers and it has a hard time finding them in a region dominated by the largest Czech car factory. They must employ Slovak guest workers.

Apart from bringing in more loyal leadership and cutting some of the bureaucratic staff Motoinvest reorganized the trade department, creating two in the place of seven, with larger and more disciplined staff. This is where their efforts ended. SSUB is bound by long term contracts Motoinvest must honor. These contracts limit the changes Motoinvest can enact. Motoinvest is also limited by lacking the personnel to engage more deeply with SSUB. They use outside consulting and put consultants on the board of directors. Another telling sign that Motoinvest is not envisioning more vigorous changes is that it decided not to invest its own money into SSUB. It pledges only to reinvest whatever profit the company makes. SSUB cannot expect capital infusion from its new owner.

The experience of the Stratton Group, the investment group managing the holdings of the American financier Michael Dingman, also suggests that the Third Wave is unlikely to bring aggressive ownership. Stratton acquired large stakes in eight companies, including the chemical company, Spolana,37 and Plzensky Prazdroj, the famous beer factory, the brewer of Pilsner Urquell.38 Stratton did not hold onto Spolana and Plzensky Prazdroj, for long.

Spolana has completed a major investment project recently and now it has state of the art technology in manufacturing normal alpha olefin, a base for producing plastics, detergents and greases. The company was already breaking even in 1995. After a shuffle of shares with IPF Harvard Stratton controlled 30 percent of Spolana, the second largest stake after the National Property Fund, which still held one half of the shares. The next largest owner with mere 9


38 The others are Sepap, Olsanske Papirny and Biocel, three pulp and paper factories, Sklo Union, a glass manufacturer, Moravske Naftove Doly, an oil firm, Prafska Teplarenka, a utility providing heat in and around Prague and Ceska Namorni Plavba, an ocean shipping company.
percent was Chemapol, a company that used to be the foreign trade state monopoly for chemicals and minerals under socialism.

The National Property Fund announced that it would sell its stocks in Spolana by February 1996. All Stratton needed was to buy 21 percent more from the Fund to reach majority and gain complete control over Spolana. Management, appointed by Chemapol was understandably nervous about their own future, not knowing what to expect from Stratton. Stratton achieved that the board of directors imposed limitations on the authority of directors, who could not enter into new binding contracts without permission. Then shortly before the Fund's shares were put up for sale, Stratton made a surprise announcement. It would sell its entire ownership stake to Chemapol. The terms of the sale is not known and it is possible that this was what Stratton wanted all along. An equally plausible scenario is that Stratton was no match for Chemapol, which has powerful connections to the Fund. Stratton may have wanted Spolana, but it may have gotten convinced that it would not be able to acquire the shares from the Fund it still needed for full control.

Stratton's fling with the most famous Czech brewery, Plzensky Prazdroj, a Czech institution, that manufactures the world famous Pilsner Urquell, was proved equally short lived. Stratton together with Harvard had 31 percent stake in the brewery, which exports only an eighth of its famous beer, most of it to Germany. Management at the brewery for a long time had great difficulties adjusting to new market conditions. Stratton brought in consultants who earlier worked for Anhauser Busch, the American beer maker and drew up big plans to increase export. Yet half a year after Stratton got involved, it quickly gave up its ambitious designs and sold its shares to Investicni a Postovni Banka.

In both cases, Stratton's temporary ownership made little difference for these companies. These companies, however, went through major restructuring even though neither Motoinvest nor Stratton was able to or willing to enact radical changes in them. Changes happened before the new owners acquired these companies, and they were in response to market pressures that emerged as a consequence of the collapse of Eastern markets. It was markets and not ownership that made a difference.

The least reformed of the three was Plzensky Prazdroj. Producing mostly for a domestic market of a country with the largest per capita beer consumption in the world and considered by Czechs as a national symbol, Prazdroj suffered no sudden crisis when the CMEA folded. There has been increasing competition from other Czech beer producers (the most aggressive one was Radegast), but the Plzen brewery holds 25 percent of the Czech market which is supplied by 6 large and 78 smaller breweries. Yet even Prazdroj changed its management, cut overhead, reorganized domestic marketing and built a new, modern bottling plant before Stratton appeared on the scene.
If the companies that received new owners in the Third Wave appear to be more reformed that is because the Third Wave targeted companies that already mended their ways.

**Companies buying companies and building empires**

The object of the Third Wave is not so much to introduce strict owners who would force the companies to submit to the discipline of the market. To the contrary, the Third Wave creates new property groupings for circumventing market pressures.

Financial groups are not the only collecting companies. Some large companies also began to acquire others. Skoda Plzen bought Tatra and Liaz, two large and embattled truck manufacturers. Skoda Plzen, which is often confused with Skoda Mlada Boleslav, the maker of Skoda cars, is now building its own car division. Soudek negotiated with Stehlik to buy Poldi, but so far no agreement has been reached. Instead of contracting Tatra or Liaz, both companies are in serious financial trouble, Skoda Plzen prefers administrative coordination with these two companies over market relations.

Skoda has other types of acquisitions, as well. Skoda’s owner-manager, Lubomir Soudek, is now determined to purchase all companies that have the Skoda name, except for the car maker in Mlada Boleslav, which was purchased by Volkswagen. Soudek explained that he cannot let other, “inferior” companies ruin Skoda’s reputation.

Chemapol is also on a buying spree, Spolana being only one of its acquisitions. It has major stakes in various chemical companies including 25 percent in Synthesia, which used to manufacture the infamous plastic explosive, Semtex. Chemapol seeks to control the Czech chemical industry by collecting potential competitors under its wings.

BVV is another company shopping for firms. It owns several hospitality establishments, has large stakes in two engineering firms and a spa, and recently it purchased a Brno company manufacturing sporting guns. BVV holds shares in more than 70 companies.

Skoda, Chemapol and BVV illustrate one of three strategies of acquisitions, though each company mixes the three strategies. Skoda buying Tatra and Liaz is expanding vertically, acquiring upstream and downstream companies. Chemapol is purchasing horizontally, to possess competitors of a market segment. Finally, BVV is investing in a portfolio of unrelated companies.

**Conclusion**

Property relations in the Czech Republic are simultaneously becoming more concentrated and more complex. Banks, financial institutions, such as Motoinvest and companies, such as

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39 All Skoda firms are named after Emil Skoda, the engineer and entrepreneur, whose industrial empire was broken up and nationalized by after 1945. Skoda in Czech means “too bad” or “pity.”
Chemapol, BVV and Skoda, are emerging as large holdings. The control over the shares of micro-investors -- the strategy that was dominant earlier -- is slowly being replaced by real ownership rights.

At the same time property relations become more and more baroque. There are more and more examples of self- and cross-ownership. The complexity of property relations is often strategic. Individuals can devise complex corporate facades to hide their identity and interests. The way Motoinvest took control of Plzenska Banka is a case in point. Ceska Pojistovna may not have sold its shares in the bank, had it known that the buyer was Motoinvest. The remaining shares of Ceska Pojistovna would have been worth much more, if no owner had a large share of the bank.

Indeed, it often happens, that owners seeking controlling interest buy shares from other owners through a proxy company. In the case of Plzenska Banka, the proxy disappeared, but that does not always happen. In some cases, the proxy lends the money for the transaction and stays on. The two owners are in a strong coalition and act as a single company. To further cement their bond, they buy into each other’s companies as an insurance against the other’s defection.

A new law, designed to protect small investors provides another reason for creating deceptive networks. In April, 1996 the Czech legislature amended the Commercial Code, to take effect on July 1, 1996. The amendment requires majority owners to offer to buy out minority owners. In principle, this should make it more difficult to take Motoinvest’s second discount, to have full control over property in which one pays for only 51 percent. Thus in the future, those who want controlling interest will obtain it split between two corporate entities. Neither will have enough share to have to buy out the other shareholders, but the two together will have the necessary votes to have complete control.

The state does not have the ultimate power in the economy, anymore. A new economic power structure is on the rise in the Czech Republic. At the center of this new power structure stand the banks, financial institutions such as Motoinvest, and mega-corporations.
### Tables

**Table 1.**

Unemployment Rates in Eastern Europe

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<tr>
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<tr>
<td><strong>Czech Republic</strong></td>
<td>0.7</td>
<td>4.1</td>
<td>2.6</td>
<td>3.5</td>
<td>3.2</td>
<td>2.9</td>
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<td><strong>Slovakia</strong></td>
<td>1.5</td>
<td>11.8</td>
<td>10.4</td>
<td>14.4</td>
<td>14.8</td>
<td>13.1</td>
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<tr>
<td><strong>Bulgaria</strong></td>
<td>1.5</td>
<td>11.1</td>
<td>15.3</td>
<td>16.4</td>
<td>12.9</td>
<td>11.1</td>
</tr>
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<td><strong>Hungary</strong></td>
<td>2.5</td>
<td>8.5</td>
<td>12.3</td>
<td>12.6</td>
<td>10.9</td>
<td>10.9</td>
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<tr>
<td><strong>Poland</strong></td>
<td>6.1</td>
<td>11.8</td>
<td>13.6</td>
<td>16.4</td>
<td>16.0</td>
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<tr>
<td><strong>Romania</strong></td>
<td>NA</td>
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<td>8.4</td>
<td>10.2</td>
<td>10.9</td>
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**Table 2.**

Net inflow of Labor in the Czech Republic (Percentages)

<table>
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<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
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<tbody>
<tr>
<td>Agriculture</td>
<td>-7.97</td>
<td>-7.18</td>
<td>-0.59</td>
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<tr>
<td>Forestry</td>
<td>-0.56</td>
<td>1.42</td>
<td>4.76</td>
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<td>Mining</td>
<td>-4.28</td>
<td>-0.49</td>
<td>-8.38</td>
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<td>Manufacturing</td>
<td>-0.57</td>
<td>-1.28</td>
<td>1.05</td>
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<tr>
<td>Electricity, gas, water</td>
<td>-3.6</td>
<td>1.85</td>
<td>-1.15</td>
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<tr>
<td>Construction</td>
<td>2.71</td>
<td>2.60</td>
<td>3.48</td>
</tr>
<tr>
<td>Trade</td>
<td>3.48</td>
<td>3.18</td>
<td>0.16</td>
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<tr>
<td>Transport</td>
<td>1.57</td>
<td>-0.13</td>
<td>0.96</td>
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<tr>
<td>Banking</td>
<td>13.68</td>
<td>12.17</td>
<td>5.24</td>
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<tr>
<td>Other</td>
<td>1.60</td>
<td>0.91</td>
<td>1.19</td>
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**Table 3.**

Net Inflow of Labor in Hungary (Percentages)

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<thead>
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<th></th>
<th>1993</th>
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<tbody>
<tr>
<td>Agriculture and forestry</td>
<td>-14.09</td>
<td>-6.35</td>
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<tr>
<td>Mining</td>
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<td>Manufacturing</td>
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<td>Electricity, gas, water</td>
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<td>1.25</td>
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<tr>
<td>Construction</td>
<td>-5.96</td>
<td>-12.57</td>
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<tr>
<td>Trade, hotels, restaurants</td>
<td>5.35</td>
<td>-10.37</td>
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<tr>
<td>Transport</td>
<td>-6.24</td>
<td>-0.95</td>
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<tr>
<td>Banking, real estate</td>
<td>-20.58</td>
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<tr>
<td>Public sector</td>
<td>0.53</td>
<td>0.75</td>
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</table>

*Calculated from Labor Account, January 1, 1995, Budapest: Hungarian Central Statistical Office*
Figures

Figure 1.
Figure 3
Loop 2.