

RETHINKING PRIVATISATION IN SERBIA

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Economic Reforms and Privatisation

During the last few decades, Yugoslavia has been developing a market-oriented, centrally planned economy. Economic agents were making decisions independently more often than not, and the habits and behaviour of the citizens were market oriented. At the beginning of the 1990s, steps were taken toward speeding up the conduct of market-oriented reforms of the system, including privatisation, which Yugoslavia had begun before any other country in transition. However, as a consequence of non-economic factors – disintegration of the single market of the former Yugoslavia and the international community – inclusive sanctions against Yugoslavia – the output and gross domestic product was more than halved and the formation and distribution of products were disrupted substantially. At the same time, structural reforms were arrested¹.

After hyperinflation during 1992 and 1993, which was the second highest in world economic history, the programme of stabilisation and economic recovery was launched at the beginning of 1994. It was successful in halting inflation and increasing gross domestic product, industrial output and external trade for a few years. However, market-oriented reforms were not continued, and consequently stabilisation and growth were not sustained. Moreover, FR Yugoslavia was severely damaged during the bombing campaign in March – June 1999. Ultimately, at the end of the 1990s Yugoslavia – a pioneer of transformation towards a market-oriented economy – was placed in the third group of economies in transition according to achievement in reforms.

After years of crisis the political changes, which happened in October last year, brightened the economic and overall forecast for the future. FR Yugoslavia was returned very quickly to the international community and to international organisations. The return to international financial institutions, like the IMF and WB, and lifting sanctions against Yugoslavia, were particularly important steps. Under those new circumstances one can see that the goals of a development strategy are, as follows:

- 1) process of transition toward market-oriented economy, which includes privatisation as a priority;
- 2) structural adjustment, which means that the role of services, small and medium scale enterprises and private sector in the economy has to increase, i.e. their share in the formation of gross domestic product. It also includes restructuring of enterprises and rehabilitation of the banking sector;
- 3) outward-oriented strategy, with an aim to increase total volume of foreign trade and particularly to encourage foreign investment inflow.

The Privatisation Process During the 1990s

It has to be stressed that the private sector was already strong in some limited areas prior to the 1990s. Firstly, agricultural sources, unlike other ex-communist countries but similar to the Polish experience, was more than 90% operated by private farmers. Due to the small single area of each family farm,

¹ The overview of tendencies during the 1990s is given in The Federal Ministry of Development, Sciences and Environment – FR Yugoslavia – 1998 Economic Survey, Belgrade 1999

agricultural production of those private farmers was not market-oriented, as the majority of agricultural production originated from socially owned farms – called combinats. Secondly, during the last decade of legal reforms, the sector of private, small business (small and medium scale enterprises and sole proprietorships) became strong. Although its share in formation of the gross domestic product is not yet satisfied (around 1/3 including agriculture), the number of SMEs became five times greater than at the beginning of the 1990s.

It is important to bear in mind that for decades the Yugoslav economy developed very specific so-called social ownership². To privatise socially owned companies it was possible to choose between two methods: a) indirectly – firstly, to nominate social ownership as a state ownership, transferring shares, after corporatisation, to state owned funds, like in Croatia or Montenegro, and then to privatise companies; b) directly – distribute or sell shares after corporatisation. From the beginning Serbia used the direct method of privatisation.

The privatisation process started in the early 1990s and went through three phases, with little progress. The first phase of privatisation was based on the Federal Law on Social Capital³. The model was workers and managers buy-out based, with relatively high discount for share acquisition. Among the former republics of SFR Yugoslavia, the process was fastest in Serbia, where around 2,000 enterprises started ownership transformation. In 1992 and 1993, due to hyperinflation, employees and employers who bought shares were highly motivated to do so. As a result, 43% of the total capital of Serbian firms was transformed by mid 1994.

The second phase was in fact a step backwards, as all transformation procedures were re-examined (recalculated). In an attempt to get all hyperinflationary gains, the government introduced a revaluation of the social capital, which was already transformed⁴. The consequence was that the first phase of privatisation was practically annulled. After revaluation, which was realised by the Government Agency for Capital Valuation, the share of private (share-holding) capital to total capital was pushed down from 43% to 35%. After this privatisation was halted in practice, as the legal framework was not operational any more, at the same time enterprises and employees expected a more favourable legal framework for privatisation, on the one hand. On the other hand, foreign investors could not realise any investment, due to the sanctions toward Yugoslavia.

The international circumstances for privatisation became relaxed after the Dayton agreement, as sanctions were lifted in 1996 and 1997. In an attempt to secure privatisation, a Ministry for economic and ownership transformation was established and the Ownership Transformation Act was introduced⁵. For the first time free share transfer was possible in respect of up to 70% of total capital of firms, and available, not only to the (former and current) employees, but to other citizens, like civil servants, pensioners, farmers, as well. Privatisation was based on the free will of enterprises, in fact all employees were to make decisions, as in the first phase of privatisation under the Federal Law on Social Capital. Voluntary privatisation was identified, by all economic experts being as the main shortcoming of a fast transition process.

All enterprises were separated into three groups: a) state owned, public companies – which for the first time became candidates for privatisation. There were enterprises on a republican level: PTT (Post and Telecommunications), JAT (Yugoslav Airlines), JZ (Railways), EPS (Electricity generation, transmission and distribution) and NIS (Oil industry). There were also more than 500 companies on the level of local communities; b) big socially owned enterprises – the government chose 75

² Officially, social ownership has been defined as that belonging to the whole society – to everybody and no one personally. In practice, however, when enterprise was profitable then profit was distributed to employees through wages (ownership was rather collective) and when an enterprise was non profitable then it asked the government for help (ownership became state type).

³ Law on Social Capital – Official Gazette of SFRY No 84/89, 46/90.

⁴ Amendments to the Law – Official Gazette of Republic of Serbia No 51/94

⁵ Official Gazette of Republic of Serbia No 37/97

enterprises for the special list those which held strategic importance for the whole economy, both profitable and non-profitable firms, and c) small and medium scale socially owned enterprises. All in all, there were more than 4,000 candidates.

There were three possible privatisation models: a) selling shares, which included the so-called first round, in which shares would be transferred to employees and other citizens free of any charge and the second round, in which shares would be sold to employees and other citizens with discount, but without any discount to different sorts of investors; b) the increasing in capital model, which was stimulative, as money from privatisation would not been transferred to state funds, but stay within enterprise and discount would be given to employees and citizens together with the right to get free shares; c) the debt equity swap model, with possible discount of up to 20% of the total debt.

In spite of the free will of enterprises to start privatisation, polls at the beginning of 1998 indicated high interest for privatisation of both those persons who were responsible within enterprises, and citizens. Different institutions pointed out that more than 80% of estimated enterprises would go private and the majority of them in a one-year period. However, realisation of the law did not manifest those expectations. The reasons were twofold. The law had serious obstacles, like the voluntary decision to enter into privatisation, which opened the door for those who opposed privatisation. International conditions for foreign investment by that time had become worse, as foreign investment into FR Yugoslavia was forbidden.

In more than three years, until February this year, only 800 enterprises had made the decision to become share-holding companies and start to transfer shares and sell them. That is around 20% of the total number of state and socially owned enterprises, who were candidates for privatisation. The total sum of the capital of privatised enterprises reached 6.5 billion DEM. The total number of employees in those enterprises are 216 thousand. From these figures one can see that the results were modest and especially unsatisfactory from the point of view of the need for fast structural adjustment in the Serbian economy and restructuring of companies. It is important to bear in mind that all those enterprises are efficient, but small and medium scale. This means that only one state owned enterprise – Telecom – was privatised with capital from the Italian STET and Greek telecommunication company OTE forming 49% of the total capital, during the short period of 1997, when it was possible. On the municipal level, one state-owned company was privatised as well (Sport and cultural Centre Pinki – Zemun). Not one enterprise from the special Government list started privatisation, although for some of them, the strong interest of respectable international companies was expressed, for instance: cement plants, pharmaceutical companies, food producers, breweries etc.

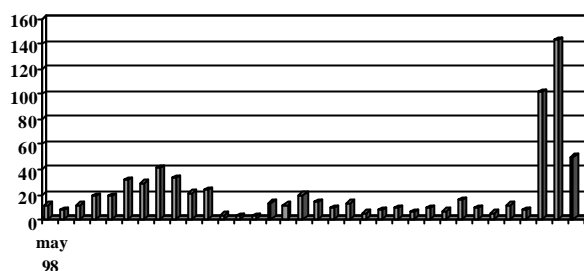
Table 1. Serbia - Enterprises entering the privatisation process

| | Number of enterprises |
|---|-----------------------|
| Applying for verification of capital valuation | 3,736 |
| - Decision completed | 2,226 |
| - Procedure under way | 1,300 |
| - Completed without decision | 170 |
| Round 1: enterprises entering the process | 795 |
| - Prospectus published | 771 |
| - Awaiting publication of prospectus | 18 |
| - Transformation abandoned | 6 |
| Round 2: enterprises entering the process | 350 |
| - Prospectus published | 44 |
| - Awaiting publication of prospectus | 4 |
| Number of employees in 795 enterprises | 216,401 |
| Total capital evaluated in 795 enterprises (mill DEM) | 6,544 |

Source: Ministry for privatisation 30th April 2001

The tempo of the process was slow with oscillations, because circumstances were changed and the approach of the government toward privatisation also changed. During 1998, only 180 enterprises entered the process of ownership transformation, the same as in 1999. The process was very slow during 2000, but at the end of the year several hundreds of companies decided to start privatisation in a hurry.

Graph 1. Serbia - Privatisation - monthly data



The first reason for such behaviour was the devaluation of the dinar in December. Before that employees were de motivated to get free shares, as the value of shares in hard currency was calculated on the basis of the official exchange rate, which was a few times less then the value calculated on the basis of black the market exchange rate. The second reason for the speed was related to the signals that the new law would be very restrictive for employees. During February, the Ministry for privatisation stopped any privatisation procedure until the new law is enacted.

Time to Rethink Transition and Privatisation

Political changes, which happened after 5th October last year, made more room for manoeuvre in the reforming process and brightened expectations. FR Yugoslavia returned quickly to the international community, to the United Nations and international financial institutions, and most importantly to the IMF and WB. Sanctions toward FRY were lifted and the EU again introduced preferential treatment for commodities imported from FRY. Industrial production, construction, and both internal and international trade, are increasing now. Those encouraging signs point to good economic forecasts for this year, which is important for the next reforming steps.

Those favourable conditions are very important if the government wants to secure privatisation. Precisely, the foreign channel for privatisation, with foreign investment inflow, is now opened. Also, *an* increase in economic activity gives more chance for those employees who will loose their jobs to be engaged again. The dilemma related to privatisation now is as follows: whether to continue in the same direction or to change approach? Unfortunately, after ten years transition experience in Central and Eastern Europe, it is not easy to answer, but rather more difficult than before, as transitory steps and paths are under consideration. This is not exclusively a dilemma for Serbia, either. So, it is necessary to examine privatisation in the broader context of complex market-oriented reforms if one wants an answer.

Rethinking Transition

Experience in the ten-year long transition gives enough arguments to envisage results from the point of view of the sequence and content of reforming steps. The discussion of those questions escalated two years ago within international financial institutions, particularly the World Bank and International Monetary Fund (Fischer S. & Sahay R., 2000, p. 4-5). It was partially related to the problems of the Asian financial crisis and fine-tuning financial policy in the global context, but mainly was related to

the mixed and inconclusive economic results of transition countries, particularly Russia. Russia's, mainly negative results and experience are particularly important as reform was based on the prescriptions of international financial institutions (Nellis J., 1999, p.2-3).

The discussion opened three crucial questions. The first question is related to the speed of transformation towards market economy, including privatisation. From the beginning of the transition project, the dominant approach was that speedy and radical reforms were necessary. The arguments for shock therapy were: a) reforms can not be realised step by step, but rather at the same time, b) reforms have to be realised immediately, because otherwise old attitudes can stop them. If one criticised this approach, pointing to the unsatisfactory results, those who advocated shock therapy, like Sasch J., Lipton D., Kornai. J., then argued that the shock was not strong enough or that reforms were not being realised aggressively enough and this was the reason for the bad results. In other words, market reforms were planned well, but realised in the wrong direction. On the other side are those who defended the gradualist approach (Stiglitz J.E., 1999, Nellis J., 1999). They argued that shock therapy was wrong, and the reasons for failure were much deeper, the main reason being a misunderstanding of the operating of a market economy. According to those authors, shock therapy inevitably led to prevailing negative consequences for the economy in transition, particularly social consequences. Citizens and employees were not ready to pay such a price and started to oppose further reforms. So, the balanced approach has to take into account several important issues, such as: a) the stage of development of a market-oriented legal framework and institutions; b) time, necessary to (re) build market conditions and for economic agents to adapt to the new environment; c) the consensus of different social groups, like employers, employees, pensioners, unemployed persons etc; d) external conditions and support.

The second question is directly related to privatisation. This question is: what is the most appropriate privatisation model? Although in all transitory economies a mix of models was used, one of them was dominant, but with differing importance during different phases of privatisation. From the beginning of the 1990s, the usual advice was to open the door for private initiative through privatisation and for the more efficient use of resources. However, it was an oversight that, in a market economy, ownership and control are separated. In this sense, the voucher model, which was advocated as a speedy and equitable model for privatisation, could be seen as not efficient. The workers buy-out model, as an insider model of privatisation, was attacked from the beginning. Firstly, because it led to self-management control, which is not efficient for the use of resources. Secondly, it closed the door for foreign investors, and thirdly, the process of privatisation with the workers buy-out model is time consuming. During the discussion within international financial institutions this was seen as more appropriate than the others. The main argument for the model was that the social costs, which are related to privatisation, are not too high and could be acceptable to all citizens. This argument again emphasised the need for a social consensus (Stiglitz J.E., 1999, p13-15, Nellis J., p.4).

The third crucial question for transition, particularly privatisation, is related to so-called big privatisation, i.e. privatisation of large enterprises. It is important to define the sequence in restructuring large enterprises, as their capital and number of employees are economically significant. Usually, one can argue that it is better to privatise them first, and then to restructure. The budget is too tight to use the rare resource of capital to restructure enterprises and, more importantly the investor who is ready to buy it is capable of choosing a better strategy for restructuring. However, so-called big privatisation became the most difficult question, as it is closely related to other policy measures, particularly social policy and the regulation of enterprise liquidation. The government has to beware of a possible domino effect, i.e. the possibility that too many enterprises and banks may go bankrupt.

Rethinking Transition in Serbia

Three crucial questions regarding the transition mentioned above, partly related to privatisation, have to be analysed within the Serbian legal framework and experienced practice. The transformation of the Serbian economy during the last decade was very slow with steps back and forth. This was partly due

to difficult international circumstances, but mainly due to the changing approach of the government towards transition, which incorporated encouraging and discouraging phases. From this point of view, at the beginning of 2001 there is a need for a faster transformation towards a market economy. This is particularly important for the process of structural adjustment and restructuring of existing enterprises. One can see that the main shortcoming of the contemporary situation is a lack of any clear transition strategy. The new government did not prepare an overall strategy for transition nor cope with reforms partially, so issues like fiscal reform and privatisation were without a clear perspective as to what would be the next steps. Although preparing the transformation strategy could consume a lot of time, the experience with fiscal reform and the law on privatisation indicated that without clear vision any partial reforming step could be difficult and even more time consuming. What's more, the planning and realisation of reforming steps separately, without overall coordination, would not lead to a positive final outcome.

Firstly, the gradualist approach to transition stressed the importance of the development of a market institution and laws. For successful privatisation, it is necessary to build institutions responsible for different aspects of the process. Slow ownership transformation during the last three years happened partly because several institutions were not established or did not operate. Among them the central register for securities was not established. Instead of it, a data basis for privatisation (data basis of enterprises and shareholders) was created within the Agency for capital valuation, which operates within the Ministry for privatisation, but with very limited human and technical resources. For fast privatisation this created a serious bottleneck, as the control procedure took longer than necessary. To overcome this problem it was necessary to establish the central register as soon as possible, and to transfer data from the existing data-basis within the Agency. Another important institution, which was established by the law but did not start to operate, was the Republican Share-Holding Fund. It would be responsible for taking care of shares, which by law were transferred to the Pensioner-Insurance Fund, and was responsible for the remainder of shares which were not sold during the privatisation process. Those shares, for instance, could be sold on the stock exchange and thus be used for rehabilitation of the Pension-Insurance Fund. An important role of the Republican Share-Holding Fund could, also, be in establishing sources for restitution to those persons whose property was expropriated or nationalised in the previous period. It also is important to establish several other institutions, like an agency for encouraging foreign investment, a developing bank etc.

Several laws have to be enacted in an attempt to complete the institutional and legal infrastructure for privatisation. Firstly, there must be a Law on Investment Funds, as FR Yugoslavia has no regulatory rules in this field, although the draft law has been prepared for several years. This law is particularly important if the Government wants to widen the possibilities for attracting foreign investment. Secondly, the Law on (trading with) Securities has to be amended to make more room for the development of the financial market and to regulate it in the right direction. This is partly the process of harmonisation of the legal framework for a market-oriented system with European Union Regulations. Thirdly, the former Privatisation Law (Ownership Transformation Act), besides the other shortcomings, created barriers to the secondary trading of shares. Precisely, there is a five-year limit on the sale of shares, which employees and other citizens get freely⁶. There are restrictive articles related to the pre-emptive rights of those who already have shares, as well. Both clauses have to be lifted by new regulations with the aim of speeding up the trading in securities.

Secondly, the discussion between the gradualists and those who advocate shock therapy raised the question of the dominant privatisation model. On the basis of the Hungarian and Polish experiences, it was argued that selling enterprises or the majority of their shares to strategic partners is the most efficient model of privatisation. However, gradualists instead advocated the insider model, as it is socially better accepted. The Serbian experience could be important for the discussion, as former privatisation law was based on the worker buy-out model while the dominant model in the new law

⁶ According to the Ownership Transformation Act the holder can sell in the first year only 10% of shares which have already been transferred to him/her, in the second and third year 20% per each year, and finally in the fourth and fifth year 25%, per year.

will be in favour of strategic partners. The insider model from the previous law was advocated as being appropriate to the Yugoslav past, specific social ownership and a legacy of self-management. On the contrary, the new law will give the chance to strategic partners to get more than one half of the total capital of companies, which are to be privatised. This change in the legal framework will encourage the foreign investor, but could be dangerous if foreign investment inflow stays modest.

The third question of transition is related to the sequence of steps in so-called big privatisation. Usually, the advice to the government responsible for the process of transition was that an efficient solution is to privatise first and then to restructure large firms. The environment for big privatisation in Serbia in the past ten years was irregular because of sanctions. So, one can argue that in those circumstances the government had no choice other than to start partial restructuring of large enterprises as a unique chance for some large, non-profitable firms to survive. The new law on privatisation is in favour of strategic partners, which means that foreign investors are expected to now start restructuring after privatisation. So, under regular conditions the regular sequence of steps in big privatisation could be realised.

The New Law on Privatisation

Privatisation is among the most important issue of transition, which will influence the final result of reforms. The dilemma – to continue with the same model or to prepare different one – is not easy and the several months the Ministry for privatisation spent preparing the draft law was unexpected because there were signals that it would be an easy and quick task. The draft is ready now and some of the crucial new points can be commented on and some additional questions addressed. Those are: the different approach to different categorises of companies, the plan for privatisation, compulsory privatisation, whether the main channel of the process would be based on foreign investment and consequently, a smaller portion of shares would be offered to employees and other citizens.

So-called big privatisation must be realised and treated separately from small privatisation. It is a time consuming process and the experience of transitory countries has pointed out the need for a 5-10 year period to complete it. The big privatisation has to be realised case by case, preferably with foreign investors as strategic partners. The support of a government in the restructuring process of large companies is desirable. The former Serbian privatisation law stipulated a case-by-case approach with an important role for the government in leading the process. So, it can be argued that the law was not a barrier for speedy big-privatisation, but rather unfavourable circumstances were important. The government was free to fix the portion of capital, which would be offered to the strategic partners. The draft Law on Privatisation predicts the same approach. For big-privatisation candidates are state-owned enterprises and large socially-owned firms, as before. The important news is that the public tender method will be used to choose strategic partners for all large enterprises. Lifting the sanctions made way for this method, as before that public tender could not be used, as foreign partners from the EU and other developed countries could not apply for privatisation. The agency for privatisation within the Ministry would be the institution responsible for managing the procedure of privatisation of those large enterprises. It has to be stressed that one can see that this could be a purely administrative approach, which does not exclude the possibility for corruption. The appropriate solution could be that the Ministry for privatisation instead of the Agency engage some strategic advisor (consulting companies).

Introducing compulsory privatisation can be marked as the most important news and *sine qua non* of the success. It was clearly pointed out by a majority of Yugoslav economists that the main obstacle for speedy privatisation in the former law would be the free will of employees to make the decision to privatise small and medium scale enterprises. Practice proved this prediction right. In addition, the draft law stated that all small and medium scale enterprises have to enter and complete the procedure within a period of four years. Although one can argue that this period is arbitrarily (artificially) defined rather than based on some certain estimation, it can be understood as appropriate considering that the mandatory period of the government is four years, as well. Those enterprises, additionally, are

pushed to enter privatisation as soon as possible, because over time the portion of shares which can be transferred to employees free of charges is decreasing. If the enterprise did not start privatisation after a four years period the draft law predicts that social capital would become state-owned and the government would manage privatisation.

The plan of privatisation, which will be adapted yearly, is predicted in the draft law for the first time. The reasons for such a plan could be transparency, controlling reasons and publicity of the process. The plan would be linked to the fiscal year, because income from privatisation would be transferred to the republican budget and used to cover budget deficit i.e. transitory costs, the same as in other transitory countries. It would be based on a prediction of the income from the privatisation of state-owned and large socially owned companies.

Foreign investment inflow through strategic partnership for Serbian firms is not only desirable, but also necessary. Without any doubt, both employers and employees are interested in foreign partners, among others, bringing: know-how, technology, standards, resources for firm restructuring and finally, an increase in the efficiency of operating. However, one can argue that the interest from foreign partners is probable over estimated. The non-economic risk of investment into Yugoslavia is very high, even with the increasing tendency, because of political problems in the South of Serbia, between Serbia and Montenegro related to the federal concept, and the problems within FRY Macedonia. So, the period in which the process of privatisation could take place with investments from foreign strategic partners would be longer than it is desirable. The balance between the two channels of privatisation: with foreign partners and employees (managers) buy-out, existed in the former law, but disappeared in the draft law. One can predict, with high probability, that after four years the government will conclude that the interest of foreign investment for privatisation is too weak. So, the law would be changed to introduce a voucher method with the aim of speeding up the process.

A very important issue related to the above-mentioned is that the draft law gives fewer rights to employees and citizens than before. The Ownership Transformation Act gave the chance to the majority of citizens, who have ever worked in socially and state-owned firms, including those employed in institutions, to become owners of shares free of charge for up to 70% of the total capital of small and medium scale enterprises. It is important to bear in mind that this was appropriate to several decades of self-management legacy. The law was enacted on the basis of the consensus of all-important interest groups: employees, trade unions, employers, and pensioners. On the contrary the draft of the new law is not based on such a consensus, and this could be dangerous for the final results of the reforms. After the ten-year economic crisis, Serbian citizens are tired and probably not ready to accept new sacrifices, like losing their personal rights.

Other issues in related areas

Privatisation is, though very important, only part of the transition process to an open, market economy. There are several aspects of the economic, legal and institutional infrastructure in Serbia which require restructuring and reform, not only to facilitate privatisation, but also as a part of the general transition process.

The banking system is going to need reform, both technically and from the point of view of corporate control. Two sharply separate groups of banks exist now in FR Yugoslavia⁷ (Serbia): a) old, large state-owned banks whose capital and volume of operations prevail, with $\frac{3}{4}$ of the total banking sector, but who have ruined capital, huge foreign debts and debts toward citizens (based on the frozen foreign saving deposits of citizens); b) new, privately-owned small banks, whose tight resources cannot give

⁷ The banking system is a Federal responsibility.

the chance of sustainable economic recovery. Reform of the banking system is a very complex process, which needs time, large financial resources and foreign support. This reform would have three lines of closely coordinated activities. Firstly, the rehabilitation of state-owned banks, not all but those which can survive and operate in an international setting. Secondly, the development and increase of the capital of private banks through fusions and strategic partnership with foreign banks. Thirdly, it is necessary to make room for respectable foreign banks to enter the Yugoslav financial market.

One of the important lessons from transition countries proved Kornai's prediction that for reforms to be successful, the most important thing is the spontaneous development of a new private sector (Fischer S. & Sahay R., 2000, p. 6). Privatisation of already existing companies is very sensitive from a political point of view and essentially important for the introduction of hard budget constraints to the level of economic agents. However, it is not useful to waste time and energy in an attempt to prepare a perfect legal framework for fast privatisation. More important, probably, is to coordinate the support for small and medium scale enterprises in private hands. The speedy increase in the number of those firms in the first half of the 1990s, later stagnated, pointed to the huge potential and energy of entrepreneurs. One can see that foreign investors would rather establish a new entity alone or together with domestic partners, than be faced with ruined machinery and the over-employment of existing enterprises. At the same time, new private firms would be the rational way to solve the problems of those who will lose their jobs, by self-employment. So, the government has to encourage this process.

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