Dissertation
zur Erlangung des akademischen Grades eines Doktors (Dr. rerum politicarum)
der Wirtschafts- und Sozialwissenschaften der Universität Hamburg,
Fakultät Wirtschafts- und Sozialwissenschaften

Die EU und die europäische Osterweiterung aus institutionentheoretischer Sicht

Eine kritische Untersuchung, ob die Tschechische Republik wirtschaftlich für den Beitritt zur Europäischen Union vorbereitet ist

vorgelegt von

Sasan Esmaeili Djavadi Langeroudi
(MBA, MA)

Erstgutachter: Prof. Dr. Voegeli
Zweitgutachter: Prof. Dr. Hoffmann

Lübeck, Mai 2005

The EU and Eastern Enlargement from an Institutionalist point of view

A critical evaluation of Czech Republic's economic readiness for accession to the European Union

by

Sasan Esmaeili Djavadi Langeroudi
(MBA, MA)

A dissertation submitted to the Centre of International Studies,
Faculty of Economics and Social Science,
Department of Economics and Politics
University of Hamburg,
in partial fulfilment of the Degree Dr. rerum politicarum
May 2005

Abstract

The developments within Central and Eastern Europe at the beginning of the 1990s had a tremendous impact not only in shaping the new face of Europe but they also challenged the most significant policy tool within Europe, namely the European Union.

In June 1993 at the Copenhagen Council, the EU decided to start accession negotiations with those countries who could cope with the democratic and economic challenges of the membership.

This thesis tries to discuss critically at least two issues regarding these developments. It tries to offer an analysis of the reasons why the EU had made the decision to enlarge eastwards, even though the advantages were not clear. A further aim will be to raise issues about the criteria set up by the EU in order to determine an applicant country's readiness for membership. A case study of the Czech readiness will be the focus of analysis.

The EU has determined that any state may apply to become a member of the Union so far as it fulfils the criteria of being an independent, democratic European state and has a functioning market economy as well as meeting the obligations of the Acquis Communautaire. Therefore, this thesis discusses in its first part the issue of European identity and the question, whether the Czech Republic could be considered as being European. The second part deals with two further issues. Even though the Czech Republic is European and an independent state, does it fulfil the other two conditions of membership, namely, the criteria of being a democracy and having a functioning free market economy. The latter will be the focus of analysis. By applying the tools of two institutionalist approaches, specifically the "Sociological Institutionalism" and "New Institutional Economics" the author tries to evaluate critically the economic readiness of the Czech Republic at the beginning of 2004.

Acknowledgment

Writing this thesis would have been a difficult task without the contribution of my supervisors, family and friends. Therefore, I would like to thank my supervisor Prof. Dr. Voegeli from the University of Hamburg for his intellectual advices and his encouragement. Without his support the completion of this thesis would have been very laborious.

Also my thanks to Prof. Dr. Hoffmann (University of Hamburg) who served this thesis as a second supervisor.

Many others have helped to overcome the challenges I had to face regarding the language. In this context I owe special thanks to my cosine, Padi Peyrovan, who did not hesitate to support me, even though she was fully busy with being a top manager and mom at the same time. I owe also many thanks to Jenifer Obstoj for her language advices through out the whole work.

Last but not least I would like to thank my parents and my sister who were always a source of support and encouragement.

Contents

List of Tables

List of Figures

List of Appendices

Abbreviations

AML	Anti-Money-Laundering
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
bln	billion
CAP	Common Agriculture Policy
CEEC	Central and Eastern European Countries
CFP	Common Fisheries Policy
CKA	Ceska Konsolidacni Agentura (Czech Consolidation Agency)
CMEA	Council for Mutual Economic Assistance (Comecon)
CNB	Czech National Bank
CPI	Country Corruption Perception Index
CS	Ceska Sporitela
CSFR	Ceskoslovenská Federativni Republika (Czech & Slovak Federative Republic)
CSOB	Ceskoslovenska Obchodni Banka
CSSD	Czech Social Democratic Party
CZK	Czech Koruna (Czech Crowns)
DCF	Discounted Cash Flow
DEM	Deutsche Mark (German Mark)
DEU	Democratic Union
DG	Directorate-General (of the European Commission)
DM	Deutsche Mark (German Mark)
DZJ	Pensioners for a Secure Life
EA	European Agreement
EC	European Community

ECU	European Currency Unit
EEA	European Economic Area
EFTA	European Free Trade Association
EIB	European Investment Bank
EMU	Economic and Monetary Union
EP	European Parliament
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
FAU	Financial Analytical Unit
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
G7	Group of Seven (western economic powers): Canada, France, Germany, Italy, Japan, United Kingdom, USA
GDP	Gross Domestic Product
GRECO	Council of European Group of States against Corruption
HCC	Harvard Capital and Consulting
HSD-SMS	Movement for Self-Government Democracy-Society for Moravia and Silesia
HZDS	Movement for a Democratic Slovakia
IC	Investment Company
IGC	Intergovernmental Conference
IMF	International Monetary Found
IPB	Investicni a Postovni Banka (IPB)
IPF	Investment Privatization Funds
IR	International Relations

ISPA	Instrument for Structural Policies for Pre-Accession
JHA	Justice and Home Affaires
KB	Komercni Banka
Kcs	Czech Crowns (Czech Koruna)
KDU-CSL	The Christian Democratic Party-Czechoslovak People's Party
KOB	Konsolidacni Banka
KSCM	The Communist Party of Bohemia and Moravia
LB	Left Bloc
LFS	Labour Force Survey
LSU	Social-Liberal Union
MEBO	Management and Employees Buy-outs
MOP	Ministry of Privatization
NAFTA	North American Free Trade Agreement
NAO	National Authorising Officer
NIE	New Institutional Economics
NPAA	National Programme for the Adoption of the Acquis
NPF	National Property Found
ODA	Civic Democratic Alliance
ODS	Civic Democratic Party
OECD	Organisation for Economic Cooperation and Development
PAV	Public Against Violence
PCA	Partnership and Cooperation Agreement
PHARE	Pologne-Hongrie: Assistance à la Restructuration des Économies
PIE	Price / Earning Method
PPS	Purchasing Power Standards

PSE	Prague Stock Exchange
QMV	Qualified Majority Voting
RA	Revitalisacni Agentura
RMS	RM System
Sapard	Special Accession Programme for Agriculture and Rural Development
SCP	Prague Securities Centre
SEC	Securities Commission
SEM	Single European Market
SOEs	State Owned Enterprises
SPAD	Share and Bond Market Support System
SPR-RSC	The Assembly for the Republic-Republican Party f Czechoslovakia
TCA	Trade and Cooperation Agreements
TCE	Transaction Cost Economics
TINA	Transport Infrastructure Needs Assessment
US	Freedom Union
USA	United States of America
USD	US Dollars
USSR	Union of Soviet Socialist Republics
VAT	Value Added Tax
VW	Volkswagen

Chapter 1 Introduction

The fall of the Berlin Wall and the disintegration of the former Soviet Union, have changed the face of Europe in the last decade. In particular, the former communist countries have had to undergo several changes.

The changes are economic, social, cultural and political in nature. The first three types of changes can be seen as a result of the last named. This has a similarity to developments which previously occurred in Western European markets about forty years ago as well as in countries like Portugal and Spain 25 years ago when these former central planned economies underwent revolutionary changes.

As a consequence, principal goals such as the privatization of production, market economy including price reforms, enterprise reform and stabilization of the economy had to be achieved. Last but not least the management decision-making processes had to be decentralized within these new economies (Zloch-Christy, 1994).

It was assumed that the transition in post communist countries would be a rapid process once privatization and private property rights were in place. In other words, once the microeconomic essentials were introduced, markets and individual incentives would fuel the transformation to a capitalist economy.

In this context, in order to support the political and economic transformation, the European Union decided to play a more significant role. Aid programmes such as Phare[1] had been set up to establish and promote the reconstruction of the markets within these countries. As a result, many of the former communist countries completed their preparation for membership of the European Union. The four Visegrad countries, the Czech Republic, Poland, Hungary and Slovakia, the Baltics (Estonia, Latvia, and Lithuania) as well as Bulgaria, Romania and Slovenia had all been given special status as applicants for membership (Redmond, Rosenthal, 1998).

In July 1997, the European Commission recommended that the Visegrad countries and Estonia were essentially functioning market economies; therefore, negotiations should start with these five countries. This recommendation appeared even though the Commission underlined that details such as capital markets needed further development and maturity.

At the end of the 1990s, it was obvious that the process of transition had proved more difficult and prolonged than the eminent economic advisors had suggested.

Nevertheless, the Brussels European Council in 2002 announced the membership of these countries for the year 2004.
The critical question remaining here is the readiness for accession of these applicant countries, especially for economic criteria such as the banking sector's preparation and the competitiveness of small and medium size enterprises.
Thus, the subject of this dissertation will be a case study on one of the applicant countries within the first tranche, namely the Czech Republic. The goal is to analyse the changes in the economy from the beginning of the 1990s up to the present day and to determine if the Czech Republic is ready to join the European Union.
As Newton and Walsh (1999) have noted, the Czech Republic, once seen as "the economic miracle of Central Europe in the golden age of the early 1990's", has been subject to a period of economic and political crises since 1997. This turmoil made it difficult for the Czech Republic (at the beginning of the 21st century) to satisfy the criteria for membership in the European Union within the agreed time frame.
The European Union always refers to common EU norms and values. Therefore, the first question to investigate is the following:

1. Is there a European identity? And if yes, is the Czech Republic part of this so called "Common European Identity" and therefore European?

2. Taking different theoretical approaches into account, what was the EU's motivation to expand eastward?

From the Czech's point of view:

3. Can the Czech Republic be considered as a democracy?

4. So far, do the implemented economic reforms satisfy the EU norms in order to guarantee a successful integration within EU markets?

5. And are these necessary EU norms and codes of conduct embedded and institutionalised within the daily political and economic proceedings?

This thesis will introduce the reader to the overall concept of "European Identity" in the next chapter.
It will cover the criteria for establishing which countries are considered European from a member of the Union's point of view and what makes potential members eligible to join the Union.

The first section of the second chapter will also provide an overview on the applicant countries philosophy and rhetoric regarding European Identity. The Visegrad countries' for example have continuously attempted to appear a more integral part of Europe and have even gone as far as calling other European nations "Europe's others".

The second part of this chapter provides an overview of the current theoretical approaches in order to find an explanation for the eastern enlargement of the EU, even though it may seem that this expansion has more disadvantages than advantages for the current members.

The author will try to explain the European Enlargement from an institutionalist point of view.

In this context, two institutionalist approaches will be the main focus. The attempts of both, the "Sociological Institutionalism" and the "New Institutional Economics", seem to justify the recent movement by the European Union. Particularly important are the rules made by the different European institutions as well as those norms, values and routines embedded within these institutions. Due to these factors as Rosamond (1999) defines, institutions are like carriers of "beliefs, knowledge and understandings" not only do they establish "ways of doing things", but also they shape the behavior of the actors.

Scott (1995, p.33) provides a broader definition of institutions:

"Institutions consist of cognitive, normative and regulative structures and activities that provide stability and meaning to social behaviour. Institutions are transported by various carriers - cultures, structures, and routines - and they operate at multiple levels of jurisdiction."

Scott's definition delivers a useful framework to analyse the EU. The different links and ties dominating the process of European Integration can be found within each of these three pillars (Laffan, 2001):

Table 1: ***The Regulative, Normative and Cognitive sources of the EU***

Regulative	***Normative***	***Cognitive***
Treaties Law	Values Norms Roles	Symbols Identities
Legitimacy Legality Regularity	***Legitimacy*** Moral Dimensions	***Legitimacy*** Taken for granted Prevalence

Source: Scott (1995)

As Laffan (2001) highlights further, the EU is regulated by law and especially institutions have a "regulative dimension". These dimensions are both formal and informal, shaping the daily policy making processes of the European Union. Moreover, in the context of European Enlargement, if one state wants to join the EU, it has to accept the "Acquis Communautaire"[2] which determines the rights and obligations attached to the EU system as its institutional framework. These formal and informal rules are the core of the "New Institutional Economy" where the emphasis is on the determination of the hierarchy within a given policy system and its decision making structure. For instance, institutional arrangements are seen as guidelines made by trading partners in order to moderate certain economic relationships.

The second pillar represents the normative dimensions within the European Institutions. The EU has always been labelled not only as a rule-setting body but also as a community with norms and values. Norms and values create a sense of institutional culture. Furthermore, they also play a role in the stability of political systems. One example is the "effort by all institutions to respect the subsidiary principle", or the informal voting practices within the Council of Ministers in order to bring the different opinions together and not overrule significant minorities (Blumer, 1998).

These norms, values and codes of conduct embedded within the institutions are the focus of "Sociological Institutionalism". For the sociological institutionalism these norms and values shape the way in which humans view the world and how they behave. It refers to the ways in which meanings, ideas and practices become embedded and institutionalized over time. For instance the EU's response to the application of Greece, Spain and Portugal was mostly driven forward in order to promote and strengthen the newly developed democracies in these countries.

Moreover, in the context of European enlargement the Copenhagen Criteria have shown a strong normative character where the emphasis is on "democracy, the rule of law and the protection of human rights".

One could say that over time the EU has developed "well-entrenched" norms that became embedded within the policy-making system. The applicant countries are "socialized to these norms" during the interim period of signing the accession treaties and the incorporation (Laffan, 2001).

Finally, the cognitive pillar plays an important role. Even though this pillar does not have as much weight as the two previous pillars, nevertheless, "symbols matter enormously to political and social life". Therefore, the development of symbols such as the common European driving licence, or the "recently" introduced common European currency the "Euro", plays an important role in the formation of identity within the EU.

Taking the approaches of "Sociological Institutionalism" and "New Institutional Economy" into account, the author will start to analyse the readiness of the Czech Republic for accession to the European Union from an institutionalist perspective.

Finally, chapter two provides a brief introduction to the historical background of the enlargement and the EU's experience with the previous enlargements including the differences between the most recent and the current enlargement.

Chapter three gives an overview of the political and economic criteria which were drawn up by the Copenhagen European Council in 1993. The EU agreed to improve market access for applicant countries in cases where, for example, their economies are functioning market economies and they are able to cope with competitive pressure and market forces within the European Union.

For instance the following four conditions have been set up by the EU as a prerequisite (according to the Copenhagen criteria):

1 Equilibrium between demand and supply is established by the free interplay of market forces.
2 Barriers to market entry and exit are absent.

3 The legal system, including the regulation of property rights, is in place.
4 The financial sector is sufficiently developed to channel savings toward investment.

As one can see the EU has defined a set of clear criteria which has to be achieved by the applicant countries in order to be incorporated. From a NIE point of view, the Central and Eastern European countries have to achieve these formal rules determined by the EU.

In cases where the criteria have not been fulfilled, their incorporation into the European Union would be at risk. Furthermore, from a sociological institutionalist perspective, the EU has put itself under pressure. If the CEE countries achieve those criteria successfully, the EU has to incorporate them, since the notion of "promise keeping" is an extremely important factor in the context of world-wide policy making. Here, in order to be recognized by other organizations, keeping the promise is understood as socially fundamental for the European Union.

Continuing this topic, chapter three will present the basic and core purposes of the Copenhagen and Madrid European Council from an institutionalist perspective. It is important to define the political and economic determinations which these two councils have drawn up in order to make the applicant countries ready for a successful accession.

Chapter four gives an overview of Czech history and the events which caused the separation of the former Czechoslovakia and tries to analyse the question if the Czech Republic could be considered as a democracy, which is one of the key criteria for a successful membership. Following this the author will analyse the economic transformation of the Czech Republic since the breakdown of communism and the introduction of a free market mechanism.

Chapter five analyzes Czech fiscal and monetary policy and provides an overview of the privatisation process in the Czech Republic. Especially the so called "voucher privatisation" will be discussed and its effects on fast-track transformation of property will be evaluated.

Even though Czech privatisation might have been swift, at the end of the 1990s it was obvious that the privatisation scheme had failed to create ownership in a large number of companies.

Continuing this analysis, chapter six explores the level of foreign investment in the

Czech Republic and gives a crucial evaluation of capital markets. The Prague Stock Exchange (PSE) as well as the banking sector will be the subject of analysis. It will be important to determine the degree of the structural reforms introduced in this sector. From an institutionalist point of view one could say that Czech capital markets will only be ready for accession when EU laws and norms are implemented as determined in the Acquis Communautaire as well as in the accession treaties.

One could say, if the implementation of those rules is not completed, it will be difficult for the Czech Republic to cope with competition pressure within the EU once it has joined the common market.

At the end of the 1990s it was obvious that the Czech financial sector had several problems to deal with. For instance, the Czech government still had to introduce both successful shareholder control and public company culture in order to minimize inadequate corporate disclosure. Taking this into account, chapter six determines the current banking reforms and gives a critical evaluation of the financial sector in the context of enlargement. For instance, in this chapter the author analyzes the prerequisites:

1. *Is the Czech banking sector ready to operate within EU markets?*
2. *Has the Czech Republic successfully adhered to the EU's basic norms and rules for a free market economy?*

Chapter seven will give an overview of the Czech economic readiness. In the summer of 1997, it was clear that Czech prosperity was partly built on illusions. The so called "miracle" in the East was slowing down. In 1999, the Czech government introduced a number of laws in order to reform the banking sector and its compatibility with European norms.

As the author's research in 2001 has shown[3] the Czech financial sector was not ready for accession by the end of the 2001. Three years have since passed and the question still remains as to how successfully the Czech government could tackle the problems illustrated within the Commission's report. As it will be shown here, the commission regarded the Czech Republic as a functioning market economy, but at the same time it set precise measures which had to be undertaken by the Czech government in order to prepare the country for a successful membership.

The research will focus on the norm construction and development within the Czech institutions and economic markets.

The thesis at its first stage identifies the institutional arrangements within the economic context and tries to answer the question as to what extent common European norms and codes of conduct have been established. Formal rules can implement the necessary alternations, but are these formal rules accompanied by the underlining informal rules which built a key factor in securing the Czech economic competitiveness?

Notes:

1 Phare Pologne-Hongrie: Assistance à la Restructuration des Économies; Poland and Hungary: Assistance for Economic Reconstruction (extended to other CEECs).

The Phare Programme has become the financial instrument to support the ten associate CEECs in order to prepare them for accession to the EU. For those non-associated countries (Albania, Macedonia, Bosnia-Herzegovina) it supports their transition to democracies and market economy.
This programme can be outlined as follows (DG IA Information Unit):

1. "*Main channel for the EU's financial and technical cooperation with the countries of central Europe (CEECs)*
2. *Set up in 1989 to support economic and political transition, Phare had by 1996 been extended to include 13 partner countries from the region*
3. *Originally allocated ECU 4.2 billion for the period 1990-1994, the Phare budget was increased to ECU 6.693 billion for 1995-1999*
4. *Support for the legislative framework and administrative structure as well as projects promoting democratization and civil society, and investment in infrastructure, including cross-border cooperation*
5. *Financing of investments linked to the applications of the acquis in order to help candidate countries to improve their enterprises and infrastructure (70% of the budget)"*

2 An important part of the accession negotiations has been the implementation of EU laws, norms and values into the political system of the applicant countries. The so-called "Acquis Communautaire" is the core element in this context. As the President of the Council, the Danish Foreign Minister determines at the opening of negotiations with the applicant countries in February 1993:

"Accession implies full acceptance by your countries of the actual and potential rights and obligations attached to the Community system and its institutional framework, known as the acquis communautaire. This includes:

1. *the content, principles and political objectives of the treaties, including those on European Union.*
2. *legislation adopted pursuant to the treaties, and the case law of the Court of Justice.*
3. *statements and resolutions adopted within the Community framework.*
4. *International agreements and agreements concluded among themselves by the member states relating to Community activities"*

3 Esmaeili D. L., S. (2001), The Czech Republic and its economic readiness for accession to the European Union, A dissertation submitted to the Centre for Social Science, Liverpool John Moores University, Liverpool

Chapter 2 Identity, Theory and Historical Background

"…, the primary rationale for enlargement is neither economic nor security-related. Indeed, it is arguable whether there would be any enlargement at all if economics and security were the only reasons being put forward. … enlargement is about, and is integral to the EU's identity." (Long, 1997, p.4)

2.1 European Identity

As stressed in the first chapter, after the collapse of the Soviet Union the main objective of many European countries, not only in Central and Eastern Europe but also within the Mediterranean region, has been the accession to the European Union.

Harmanci (2001) underlines the values such as democracy and, maybe more important in the context of European identity, the notion of diversity, which "is tied to European culture". This way of life within Europe, "encourages common habits of political behaviour and trust". Moreover, conditioned upon these values, the European citizens and communities have developed "a sense of we-ness"! And it is exactly this so called "we-ness", which has been the force for the applicant countries to incorporate themselves within the EU.

Therefore, this chapter will deal with the identity of Europe. The first part of this chapter will try to define whether there is any common European Identity. By the evaluation of this question the author will also take into account the notion of "other-ness" in the context of European identity formation. Further, the subject of analysis will be the applicant countries' rhetoric about the common European identity. The logic behind this chapter is to develop a point of view that throughout the last 12 years (after the fall of communism in Europe) the new democracies in central and eastern Europe have been trying to make themselves more European by identifying other nations as Europe's "others".

Prescott (2000), for instance, emphasises the rhetoric of the Czech government (after the "velvet divorce" in 1992) about the Slovak part of Czechoslovakia. Here, the government has shown a tendency to portray the Slovaks as being an "Asiatic" state in order to highlight their own "European-ness".

It is mainly this rhetoric used by CEE countries which reflects an overall discourse of European identities. This tendency entails a risk of including new members at the expense of further excluding other states.

2.1.1 Identity

In order to understand the development of identity within Europe, one should firstly try to find a definition for identity.

Identity is something that is unique within each individual person. The identity of a person,

"implies the continued existence of that indivisible thing which I call myself, (…), my thoughts, and actions, and feeling, change every moment: they have no continuity, but a successive, existence; but that self, or I, to which they belong, is permanent, and as the same relation to all the succeeding thoughts, actions, and feelings which I call mine." (Reid, 1785, p.3)

Parehk (1995) underlines that the identity of one individual is shaped by different incidents such as upbringing, childhood experience, adult life, dreams, myths. As a matter of fact only the individual's answer to the question of "who am I and whom am I coming from?" seems to build a basic definition of identity.

Therefore, only when the process of personal identity is complete can the building of cultural identity be started. In this context one should take into account that people have a strong need to belong to a social group. As Carr (2001) defines, individuals place themselves into some kind of category through which they try to distinguish themselves from others. Acting within a group the individuals accept both the group as a whole and its identity and at the same time they try to keep their "own personal image".

Social groups, on the other hand, tend to define themselves through ideas positively accepted by the members. These ideas shape how the members interact and communicate with each other. Therefore, one could say that the function of these ideas is in defining "the social groups as an entity which is distinct from other social groups" (Marcussen, Risse, Engelmann-Martin, Knopf, Roscher, 1999). The notion of "others"or "strangers" plays a crucial role in the formation of collective identities.

Especially in the context of European identity, the question of "who is self and who is other to the fore" seems to be of importance (Neumann, 1999).

As the Treaty establishing the European Community declares that "any European state may apply to become a member of the Community", so it is important to define the common "European identity". For instance the application of Morocco in 1986 for membership was rejected with the argument that Morocco is clearly "non-European" (the organization is only open for European countries!).

Here the question arises "what defines "European-ness"? Moorish rule in Spain until 1492 as well as French colonial administration and trade ties across the Mediterranean, were not enough in order to refer to a common history. Stressing this a little further one could look at the incorporation of the former German Democratic Republic into the EU without having applied for it. It was only the political weight of its "bigger brother" the Federal Republic of Germany which made incorporation sure, not even a referendum on this agenda took place (Neumann, 1996).

Thus, the question of "who is a European State" and "who can not apply for membership because of its "otherness?" remains the crucial element for the definition of a common European identity.

2.1.2 The making of Europe

As Gerard Delanty (1995) highlights in his book about the origins of the "Idea of Europe", the term Europe began to emerge with the decline of classical Greek civilisation. Before this event the idea which dominated Greek society was the superiority of Greeks against the "barbarians" of Europe.

However this point of view changed after the decline of Greek civilisation. Here the focus of the "otherness" became the lands east of Asia Minor, with the exception of Persia after it was conquered by Alexander the Great.

After the defeat of Macedonia by the Roman Empire "*the Greek civilisation moved from the eastern Mediterranean to its western shores*".

However, also the Romans had never developed a strong sense of European identity since the core of their empire was located within the eastern Mediterranean and not in the north part of the European continent. Therefore, one could say that for the people of Antiquity, the division between the north of Europe (where the regions like Scandinavia, the British Isles, and most of the present Germany were excluded from Europe) and the southern parts was much more significant than the east-west division.

It was the division of the Roman Empire by the Emperor Diocletain in 286 that shaped the differentiation between the east and west of Europe. In the centuries after this event it became obvious that Constantinople was presenting itself as the bridge between east and west. Thus, the notion of Europe subsequently was associated with the western parts of the Roman Empire and Rome, whereas the idea of the Empire came to refer to Byzantine (Constantinople) in the east (Fischer, 1957).

As a result the term “Occident” refers to the west of the Empire and “Orient” for its eastern part. Europe and Occident became synonymous for Christendom since the centre of “Latin Christianity” was based on the west part of the empire (Wallach, 1972).

The emergence of Islam from the seventh century was a turning point in European identity formation. After the establishment of the “Islamic Empire” and the fall of the “Visigoth Kingdom” in Spain (in 711 a.c.) the clash between Christianity and Islam became obvious. And it was this development which shaped the formation of the “Eurocentric” worldview based on the Christian religion. From now on the newly established Islamic world-system was the main threat to European Christendom, or putting it in the correct terms, to the “European Christian West”.

Taking these developments into account Delanty (1995) determines that the idea of Europe emerged after “facing the Islamic threat”. It was from this point on when the uniqueness of the European identity began to emerge. Moreover, the north-western part of the continent became more and more associated with the term Europe since the Mediterranean (e.g. Spain, Sicily, Crete) were lost to Islam. Therefore, Europe was identical “with the notion of a Christian commonwealth, with the emphasis being on the north-west”.

That meant from now on, to be Christian did not define one as a Roman but as a member of the “universal Christian polity”, and Europe was the “secular identity of Christendom”. It could be said that the idea of Europe shifted away from a geographical expression to a cultural idea.

The separation of the two parts in Europe, namely Greek Christianity in the east and Latin Christendom in the west, also had an impact on the identity formation in Eastern Europe. The west Slavs, namely Poles, Hungarian and the Czechs believed in Latin Christendom and the east Slavs, such as Russians, Bulgarians and Serbs in Christian Orthodoxy.

The developments within Eastern Europe will be the focus of analysis in the fallowing section.

The next challenge to the formation of a common European identity was in the fifteenth century, when the Ottoman Empire emerged. This empire geographically controlled between a quarter and a third of Europe at the height of its influence on the continent.

The so called “we-ness” of European Christian identity appeared once again as the

Turks reached the gates of Vienna in 1683. It was again the threat of an Islamic Army which brought the European leaders together in a "Holy Alliance" financed by the Pope, Innocent XI. Although the Turks were defeated and Vienna was delivered from its siege, the Turks remained as the dominating power in East Europe until 1918 (Delanty, 1995).

It could be said that the idea of a common European identity emerged as Christianity was under threat. Two events in the European history brought this forward: the rise of Islam in the seventh century and the emergence of the Ottomans in the fifteenth century.

Until and after the diminution of both these threats there was no common sense of identity among the European nations. Furthermore, the differences between the two churches in the east and the west of Europe seemed to be more significant than the so-called "Barbarians" at the gates of Europe!

2.1.3 The formation of Eastern Europe

As Delanty (1995) says, the term "Eastern Europe" is a misleading term. Eastern Europe consists of two historical regions within south-east Europe. On the one hand one has the Balkans on the other hand the "lands In-between", which means the lands between Germany and Russia (e.g. Poland, the Baltic Republics, the Czech Republic, the Slovak Republic and Hungary).

Due to their location, both of these regions have never been fully integrated within European metropolitan cores. They have always been seen as "frontiers" or "transition zones" between Western Europe and Eurasia.

As a matter of fact the idea of Europe *"remained the cultural model of the western core states"*!

2.1.3.1 The Balkans

The Balkans seen from the geographical point of view are certainly a part of the European Continent. However, their proximity to Asia Minor and the decades of Ottoman rule had excluded them for a long time from Europe.

This region is especially significant because of its heterogeneity. Nowhere else in Europe can one observe the clash between east and west better than in this region. For instance, the Balkans are dominated by three religions namely Sunni Islam, Roman and Orthodox Christian. Thus, the Balkans formed the border of Europe by which Latin West and the Muslim Orient are separated. As a consequence the Balkans remained the frontier between the Habsburg and Ottoman Empires.

Furthermore, the reason why the Balkans have never been a part of the European identity is not only based on the Muslim threat within this region but also the division between Christian Orthodoxy and Roman Catholicism. In the eyes of the western European nations Orthodoxy was seen as semi-oriental and therefore, as foreign to the "identity of the Latin West". The differences between these two Christian worlds were as enormous as between Christianity and Islam.

As a result the Balkans have never really been recognized and integrated by the west. One could say, it was an "anomaly" within the European power-system, they remained "the Achilles heel of the balance of power" (Delanty, 1995).

2.1.3.2 The "Lands In-Between"

Palmer (1970) defines the areas between eastern central Europe and Russia[1]- due to their location- as the so called "Lands in-between" (known by German historians as "Zwischeneuropa").

The western Slavs have always been the subject of political interest between the two bigger empires namely Russia and Germany. Moreover, Poland for instance was not only a frontier zone between these two powers but also between Germany (Prussia) and Austria. For the western European countries Poland was nothing more than a "buffer zone" against Russia and its Asiatic culture (Delanty, 1995).

The eastern and central European states have never been nation states for a longer period of time, especially since Germany viewed these territories as one which had to be incorporated into "Greater Germany". Since the late eighth century the western Slavs became more and more "vassals of German rulers", due to their role as a target terrain for German colonization (Zaroff, 1955).

The so-called "Drive to the East" by the Germans started in the tenth century, but the aim of their expansion at the beginning was more or less the preservation of the eastern borders. It was not until the second wave in the twelfth and thirteenth centuries that large scale colonization, with massive military support, took place (Knox, 1980).

Later on, after the emergence of the Ottoman Empire, the autonomous development of these regions was once again prevented due to the rivalry between the bigger powers namely Austria, Prussia, Russia and the Ottoman Empire, making the independent development of this region impossible.

Moreover, Lewis (1993) underlines the fact that for the west European countries the slaves had a semi-oriental characteristic like Jews and Muslims. Therefore, they were sold as Slavs[2] to Islamic lands in return for oriental products!

After World War I and the fall of the Ottoman and Austrian-Hungarian Empire the new independent states were mostly unsuccessful because of their characteristic as separate small states. Once again they were a buffer zone between two bigger powers, this time between Germany and the Soviet Union. It could be said that their independency was limited. After the beginning of the World War II these states were occupied by Germany and then, after the decline of the “Third Reich”, by the Soviet Union.

From 1945 on they have been a “forward defence area” for the Soviet Union in case of war against the western allies. It was not until 1989-1990, that these states became truly independent (Matthews, 2000).

Concluding these thoughts one could say that the western Slavs, the Poles, Czechs, Slovaks and Hungarians have never really been part of the western European common identity. They have mostly been seen as the "frontier" or the "buffer zone" to either Russia or Ottomans. Thus, the appeal of a common (western) European identity (since the fall of the iron curtain) by the applicant countries’ politicians is more than doubtful. The western part of Europe only started to recognize these countries as central Europeans after the communist threat was over.

2.1.4 The “others” in Europe

In the first part of this chapter the term “others” has been clarified as part of the identity formation. Being incorporated within a group does not only create a, “we-ness”, it creates also several “others”!

For instance German political and scholarly elites have seen the country’s past as “other”. Also the traumatic experiences of the French people during the two world wars lead to the definition of the Germans as their significant “other” and the political elites within French society have traditionally added the United States of America as the “others” to their culture. A final example concerns the British Isles, where there is still “a feeling of them vs. us between England and the Continent” (Marcussen, Risse, Engelmann-Martin, Knopf, Roscher, 1999). Thus, one could say the notion of “otherness” is always part of identity formation. In the context of

European identity there has always been two significant “others”, namely Turkey and Russia.

The aim of the following section is to define their “otherness” if there is any, in order to understand the formation of Central and Eastern European Countries' identity after the events of 1989 at the expense of the Turks and Russians.

2.1.4.1 The Turks and the Ottoman Empire

The Ottoman Empire was the dominating political power in Europe for 500 years, until the end of World War I. The Ottoman Empire at its height included not only modern Turkey and the Arabic speaking areas in the Middle East and North Africa but also a quarter of the European Continent.[3]

After conquering Constantinople in 1453 the Ottomans surged further into the European continent and had reached the gates of Vienna by 1683. It was from this moment onward that the Turks were put into the role of “others”. The alliance of the western European countries defeated the “Ottoman-Islamic” military threat. Hence the Ottoman influence shaped the notion of the Turks as “evil, un-Christian and non-European” (Tunander, Baer, Einagel, 1997).

Harmanci (2001) argues that the nature of the Ottoman threat to Europe changed in the eighteen century. Since Ottoman military pressure was decreasing, the “other” was perceived more as an ideological than a military threat. The Ottoman Empire and with it, the “East”, including the eastern part of Europe, was representative of the “bad habits and the despotic system”, whereas "modern ideas" dominated the western parts of Europe!

Even though the Turks tried to modernize their political system from the mid-nineteen century by promoting the institutional modernization and reorganizing provincial administration, education and the judiciary (the so called “Tanzimat reforms”) as well as by the establishment of western style military weapons and tools such as naval construction methods and tactics, they remained the “others” in Europe (Kadioglu, 1996 and Inalcik, 1998).

Moreover, the creation of the modern Turkish state with the separation of religion and state by Kemal Pascha “Ataturk” could not establish the modern Turkey as a fully integrated European state. It was the rise of nationalism within Europe which prevented this![4]

It was not until the end of World War II and the expansion of communism that

Turkey took on another role. Based on its geopolitical importance during the Cold War, Turkey's "other-ness" was transformed by the western European Nations into a "partnership". It could be said that although Turkey became an "ally", it has never be seen as a part of the common European "we-ness".

The situation changed after the collapse of the Soviet Union and its satellite states in Eastern Europe from 1989 onward (Harmanci, 2001). There was now no need for an ally to secure the eastern borders of the democratic western countries. From now on Turkey was not perceived as a team member, she was seen as an "outsider" or "acquaintance in trade relations". At the heart of this new Europe was the notion of unification and Turkey came to be perceived as "other". Therefore, the countries of Central and Eastern Europe are considered as strategically more important for the unification of Europe than Turkey (Safioleas, 1999).

Turkey however, does not fit into the newly emerged European identity, it still remains Europe's "other" at the beginning of the 21st century.

2.1.4.2 Russia

"Some in the West are trying to 'exclude' the Soviet Union from Europe. Now and then, as if inadvertently, they equate 'Europe' with 'Western Europe'. Such ploys, however, cannot change the geographic and historical reality. Russia's trade, cultural and political links with other European nations and states have deep roots in history. We are European. Old Russia was united with Europe by Christianity (…). The history of Russia is an organic part of the great European history (…)" (Gorbachev, 1988, p.190)

As it has been demonstrated before, European identity was not only formed due to the successful campaign against Islam (and later on the Ottoman Empire), but also against the "Mongols" with whom Russia became associated.

Due to its location (Europe and Asia), Russia has always been treated as "Eurasia", even though Russia did not expand beyond the Ural Mountains (often used as European borders) it was seen in Western Europe as Asia. The Western European countries associated Russia for a long time with the Mongols since the whole country was ruled by them in the thirteenth century. Moreover, it was Russia itself who turned eastward in the sixteenth century in order to colonize north eastern Asia. One could say that both the Balkans and Russia, as well as the so called "Slavic belt" have been seen by the West as a threat due to the fact that they always built a "spring-board" for Asiatic Powers to invade the western parts of Europe.

Also important in this context is the role of the Russian Orthodox Church, which increased the split between Russia and Europe. The Russian Orthodox Church saw itself as the protector of Orthodoxy against both the Ottoman Empire and the West with its Latin Christianity.

Therefore, Russia could not accept the idea of European identity “along with the religion it regarded as an unholy schism” (Delanty, 1995).

However, it was not until the eighteenth century that the western European powers began to see Russia in two parallel ways. After Peter the Great became the new tsar in Russia, western civilization began to see his accession to the throne in two different ways. Certainly he was seen as a barbarian because of how he behaved, but he also showed a willingness to learn from Europe.

As a consequence the western European powers hoped that Peter, as a new Baltic and European leader, could be an “ally against the Turks”. Thus, Russia remained throughout the eighteenth and nineteenth century a “fully fledged player” within the European political system. In other words Russia was seen as a “legitimate player in the Concert of Europe”. However, Russia developed a special character once again after the establishment of “Soviet Russia”, due to the expansion of the Nazis; during World War II Russia was seen as part of Europe, albeit a “somewhat errant part”!

It was Russia’s political and military dominance during the “Cold War” which put it in the role of “barbarians at Europe’s gates”, unable to take the opportunities offered after the events of World War II to establish themselves as a democratic country within the western European political system. The western powers therefore, saw European civilization “under siege by Soviet barbarians” (Neumann, 1999)!

From 1989 Russia did not feature anymore in the role of Soviet "barbarians" but it still served as Europe’s “other” along with Turkey, especially in the rhetoric of the applicant countries. The evaluation of these tendencies will be the subject of analysis in the following section!

In conclusion one could say that since the fall of the “Iron Curtain” the question remains whether Russia’s relationship with Europe should be seen in the context of a rapid integration within the west European political system or should Russia remain as “Eurasian” (Neumann, 1996)?

As Neumann says, Russia (like Turkey) stands out for its five hundred years’ history of always:

"(…) just having been tamed, civil, civilized, just having begun to participate in European politics, just having become part of Europe. Since the Enlightenment it has, furthermore, been seen as a pupil and learner, whether a successful one (…), a laggard who should learn but refuses to do so (…), a truant (…), or a gifted but somewhat pigheaded one (…)" (Neumann, 1999, p. 110)

2.1.5 The applicant countries' rhetoric

"Russia is not just as one more European power but as a singular civilization, another civilization (…) totalitarian Russian civilization is the radical negation of the modern West." (Kundera, 1984)

As it has been highlighted above, to the author of this thesis the integration of central Europe, especially Poland, the Czech Republic and Hungary, is taking place by defining certain countries as Europe's "others". In this context it is especially Russia that has been the subject of exclusion by the intellectual and political elites of those applicant countries.

Neumann (1996) determines that the term "Central Europe" was created by Polish, Czech and Hungarian dissidents from the late 1950s onward in order to appeal to western European countries that "Central Europe" has always been a part of the West and was isolated by the forcible assimilation into the Soviet Union.

This is, as Neumann (1996) demonstrates, the first structural feature of applicant rhetoric, namely the "integration of the applicant states in a common geographical and historical Europe". The second step (after defining themselves as European) is the attempt to define the neighbouring state to the east as non European. For instance Czech politicians try to emphasize their "European-ness" by pointing at the Slovaks as the "others". To them, western parts of former Czechoslovakia namely Bohemia and Moravia, have been under Austrian jurisdiction within the Austrian-Hungarian Empire, whereas Slovakia has been ruled from Hungary. Another example in this context is Slovenia, which underlines its "European-ness" by pointing at the Croats and their "Balkan" character, due to the fact that Slovenia had been:

"a province of Austria and Croatia had been ruled from Budapest, Slovenians are now beginning to be proud that Vienna is closer to Ljubljana than Belgrade." (Delanty 1995, p.136)

Finally, Hungarians try to present the Romanians as non-European. As a matter of fact what was called Eastern Europe during the Cold War is now being called Central Europe. Moreover, the term "European identity" is used to put this region into a new position. In other words, into a position where it has to be protected by the western

European countries, from the threat of non-European states such as Russia.

However, it could be said that the term “Central Europe” was used by the Czech, Hungarian and Polish intellectuals in reference to the western European countries as a “we-group”. Later on, a number of western academics took on this definition. For instance Hyde-Price (1996) suggests that Czech Republic, Hungary and Poland should be treated differently owing to their unique history.

As Sedelmeier and Wallace (2000) determine, the idea behind the formation of the European Community was always to overcome the division of Europe. This was confirmed during the Rhodes European Council in December 1988 as well as in Strasbourg one year later.

The European Union views the eastern enlargement not only as a historic opportunity but also as an obligation for the Union to unify the continent (Verheugen, 2001). Or in Santer’s (Commissions former president) words (1998):

“…the collapse of the Iron Curtain ended the Cold War and presented us with a unique opportunity to unite Europe…We have a historical and moral duty to seize this opportunity.”

As it could be seen, western European politicians showed a tendency to underline the European-ness of Eastern Europe. Since then, they have emphasized this region as “part of Europe”. Another example, especially in the context of the Czech Republic, was delivered in van den Broek’s speech in 1998 to the Forum 2000 conference in Prague, when he stated:

“I am glad here in the heart of Europe, in Prague, … This reinforces my conviction that enlargement of the European Union is more than simply a political or economic process: it is another milestone in the development of our civilisation.”

Central and Eastern European Countries are considered by the old EU members as part of the European family and thus fulfilling the first condition of the accession namely the criteria of “European-ness”.

2.2 The theories of enlargement

“Theory helps us to see the wood for the trees. Good theories select out certain factors as the most important or relevant if one is interested in providing an explanation of an event (...). Theories are of value precisely because they structure all observations.” (Stoker, 1995, pp.16-17)

In the case of the EU enlargement students of regional integration will be confronted

with the inescapability and the value of theoretical work based on this topic. Within this context the “Integration Theory” has in recent years become the theoretical wing of the EU studies movement. However, many of the factors which are involved in this discussion are beyond the remit of any established IR theory (Rosamond, 2000).
Furthermore, since the EU and the process of European Integration are just too complex to be analysed by a single theory, there are several attempts to explain the reasons for the EU’s decision to enlarge to the east.
It is important to understand why the process of CEEC accession has developed in the way it has. Therefore, the aim of this chapter will be the determination of the decision to enlarge from the perspectives of the most predominant and contesting institutionalist theories. The question to analyze is:

- Which were the reasons for the European Union to enlarge eastwards?

In the following the main theories will not only be determined in order to make the reader familiar with their context but also their theoretical paradoxes and dilemmas will be highlighted. Later on, especially in chapters 4 and 5 where the Czech Republic’s economical transformation is subject of analysis, the author will try to find more evidence, if there is any, to support the present theoretical approaches.

2.2.1 Rationalist Institutionalism

The fundamental premises of the rationalism theory have dominated the study of international relations throughout the 1980s.
In the first stage of its theory the rationalist theory determines the individual’s environment as anarchic. Within this theory the individuals are described as materialistic and egoistic. Especially in this situation individual actors’ interests and preferences stabilize over time (Wittenberg, 2000).This goal-directed behavior determines the individual’s response to international relations. Therefore, it is obvious that individuals (in the case of the EU member states) have an interest to maximize their goals in the context of international relations. They may not be interested in the welfare of others!
Kegley and Wittkopf (1997) highlight the following four steps which are always part of the rationalist decision making process:

1. *Problem recognition and definition*. This means that policymakers begin to decide as soon as they are confronted with an external problem which they have to deal with in order to be aware of future challenges. In this stage policy makers start to gather all relevant facts and information about the characteristics of the international environment and trends.

2. *Goal selection*. The next step includes the identification of relevant facts and their ranking in a hierarchy (from most to least preferred) after information is gathered to a satisfactory degree.

3. *Identification of alternatives*. In this stage all alternatives related to the new circumstances are not only defined but also their costs are estimated.

4. *Choice*. Here the best alternative which has the highest chance of being achieved is selected.

From a rationalist point of view a decision made by the individual will avoid taking unnecessary risks with the individual's welfare. In other words the individuals (in this case: EU member states) will collaborate with other countries when it seems to have advantages or when it is necessary, but they will avoid needless foreign entanglements (Jackson, 1995). Therefore, the enlargement preferences of the state actors vary with the level of expected gains or losses from the integration of CEE countries. Moravcsik (1998) tries to go one step further by analysing the rationalist process of policy making after national preferences are formed.

In a rationalist theory negations are disaggregated into a causal sequence of three stages. As described above, the first stage is dominated by the formation of national preferences, following this is the second stage which highlights the interstate bargaining process and finally it is the institutional choice which builds up the last stage. This means that governments formulate a consistent set of national preferences which have to be realised by international bargaining with one another. Only after this stage is achieved to their individual satisfaction, do they delegate sovereignty in international institutions which secure the agreements they have made. It has to be said that Moravcsik underlines the fact that states preferences "need not necessarily be uniform across issues, countries or long periods of time". They could vary based on the exogenous changes from the economic and ideological environment in which European integration takes place. The following table summarises this process:

Table 2: ***National preferences, interstate bargaining, and institutional choice***

Stages of Negotiations	*National Preferences Formation*	*Interstate Bargaining*	*Institutional Choice*
Alternative independent variables underlying each stage	What is the source of underlying national preferences?	Given national preferences, what explains the efficiency and distributional outcomes of interstate bargaining?	Given substantive agreement, what explains the transfer of sovereignty to international institutions?
	Economic interests or Geopolitical interest?	Asymmetrical interdependence or Supranational entrepreneurship	Federalist ideology or Centralized technocratic management or More credible commitments? ↓
Observed outcomes at each stage	Underlying national preferences	Agreements on Substance	Choice to delegate or pool decision-making in international institutions

Source: Moravcsik (1998)

Here the most “basic and parsimonious determinant of bargaining power” is embedded in the relative size of the absolute gains which are available to each party.

Taking these statements into account the eastern enlargement of the EU seems to be difficult to explain from a rationalist point of view. And since enlargement should increase the benefits and reduce the risks and costs of interdependence between the EU and the applicant countries, one could say that only those countries within the Union which have a relatively high degree of interdependence with those applicant countries will be favourable to enlargement.

As Schimmelfennig (1999) highlights Germany, Austria and the Scandinavian countries are more in favour of the EU eastern enlargement than France, Italy, Spain and Portugal. This means on the one hand that countries like France could be afraid that a power shift in favour of the northern members (especially Germany) would take place. The CEE countries would be more likely to side with northern countries within the EU decision-making process because of their support during the accession negotiations.

On the other hand, the northern countries themselves would have an interest in EU enlargement not only because of their historical (for example between Finland and

Estonia) and economic interest but also because of their greater geographical proximity which makes those northern countries more sensitive to negative developments in the CEE countries. This is one reason why Germany and the other northern states have a greater interest in stabilization through enlargement. In this context Germany, especially, has an interest in the "multilateralization of its disproportionately high unilateral transfers" to those applicant countries (Paretto, Sigmund 1993).

This egoistic behaviour (from a rationalist point of view) could be the reason why countries like Spain and Portugal tried to block the trade liberalization between EU and CEE countries during its first stages. Also the demand for side payments at the Essen meeting in December 1994 where the EU decided that the Community will spend the same amount on the southern members as on Phare aid to the East (Süddeutsche Zeitung, 1994). The characteristic of the rationalist decision-making process, where the target is to reach the "best" decision possible explains the division between northern and southern European countries.

Finally, one could describe the dilemma with which the rationalist theory has to deal with in Schimmelfennig's (1999, p.25) words as followed:

"(…) rationalism fails to account for the fact that the Community has later committed itself to Eastern enlargement and has remained on track in spite of frequent blockages and delaying tactics and in the absence of a deal on the necessary reforms. (…) rationalism cannot explain how egoistic preferences and instrumental bargaining behavior could produce a collective outcome that did not reflect the relative power of states but the constitutive norms of the community."

As Schimmelfennig (1999) points out, "rationalism is a good starting point for the analysis". It seeks to find explanations for the first stage of the enlargement process, by defining each member states' self-interests.

In the case of the EU member states it defines each nation's preferences, which are basically driven by economic or geopolitical interests. These self interests dominated the formation of bargaining process during the first phase of the enlargement process (e.g. the division in the EU between the northern countries in favour and southern members opposing it).

However, the rationalist theory doesn't take into account the importance of international organizations. Here, international institutions play a secondary role. They are seen as an instrument to increase efficiency and reduce problems facing the national states. Therefore, long term benefits based on stable institutions guaranteeing economic security are not considered. Most literature regarding the rationalist theory seems to give an explanation for the short-term interest of each member state, but does not pay much attention to the long-term benefits. The uncertainties concerning the long term political, economic and security benefits might be the reason for this.

Within the rationalist theory there is one approach which tries to find an explanation of the issues of membership in organizations and EU eastern enlargement. The contents of this theory will be analysed in the following section.

2.2.1.1 Club Theory

Cornes and Sandler (1986) define a club as a group of individuals deriving reciprocal advantages from sharing goods. Here, in order to explain the nature of international organizations the concept of “divisible” goods is the dominant factor. In this context a good is indivisible:

“when a unit of the good can be consumed by one individual without detracting (…) from the consumption opportunities still available to others from that same unit.” (Cornes, Sandler 1986, p.6)

Cornes and Sandler argue further that in the case of EU enlargement, membership could become a problem since there would be greater competition for goods, which force them (members) to be rival consumers at the same time. In other words, current members cannot use goods as much as they would like due to the fact that other (new) members are using the goods as well. Therefore, the enlargement of the EU can only take place if the costs of sharing are well balanced throughout the new member’s contribution. In addition the accession of new countries means that heterogeneity within the EU will rise.

Taking this theory into account one could say that the cost of decision making within the Community will be much higher than it is at the present time. Also important is the fact that with an enlarged EU the number of potential blocking coalitions will increase disproportionally, so that even qualified majorities are more difficult to build (Wilming, 1995).

Moreover Raunio and Wieberg (1998, p.558) argue that even an enlarged EU with three new members in its first stage (including the Czech Republic, Hungary and Poland) will have huge impacts on the voting power within the Council of Ministers. They draw the following conclusions:

"*1. All current Member States lose voting power under each decision rule, with large states particularly disadvantaged.*
2. The voting power of small and medium-sized states increases in relation to the larger Member States
3. The six large Member States, now including Poland, get a lower share of voting power as the decision rule becomes more stringent.
4. The smaller Member States are advantaged by tighter majority requirements."

Furthermore, majority voting will not only be reduced to the degree of control for each state but also administration costs will increase due to the higher number of official languages which have to be interpreted (Kerremans, 1998).

The club theory emphasizes more the power and interest based rationality of each member state, thus organizations with fewer members are more effective than those with more, and the more there are the more difficult it is to make decisions (Schimmelfennig, 1999).

As it can be seen through the analysis above, also here, most of the literature seems to pay more attention to the enlargement disadvantages facing the "club", but alongside with the disadvantages also the long term advantages for the members states should be taken into account too. From the club theory's perspective the marginal and potential benefits should outweigh the costs of increasing competition for the shared goods. The question therefore is, are the long term advantages sizeable enough to outweigh its disadvantages?

For instance, would long term benefits resulting from trade with CEE Countries not outweigh potential losses of voting power for Germany?

Here it could be argued that over the long term, profitable cross-border transactions and a growing economic interdependence could be more profitable for the old members than the outlined disadvantages!

2.2.2 Neorealism

To understand the neorealism approach one should look at the realism theory which builds the basis for this approach.

Realism counts the state as the most important actor within the world policy area, based on the fact that it does not answer to higher political authority. Realism also describes the acquisition of power as important because state power is the only power which guarantees the survival of the state within a hostile environment.

Therefore, the principle of "self-help", whereby the state is dependent on its own resources in order to promote its interests and protect itself, is one of the pillars of this approach.

Here, the state ideological and ethnic preferences are not decisive, and self-interest is the dominating principle (Kegley, Wittkopf, 1997).

Neorealism goes one step further by underlining the anarchic structure within the global political system as the main driver of foreign policy behavior. It is this influence which therefore, shapes policy behavior (Keohane, 1986).

So one could say that neorealism is a:

"sophisticated restatement of realism that explains the perpetuation of the state system with references to the structural properties of states. (…) Neorealism is thus a theory of how the structural properties of anarchy provide particular sets of limitations upon possibilities for action in international politics". (Rosamond, 2000, pp.202, 132)

Waltz (1979) highlights the fact within the neorealist approach that states firstly do not prefer to join international organizations simply because such commitments reduce their sovereignty and relative power. Organizations are only built if they are necessary in order to defend their position in the international policy structure.

However among the scholars there is criticism of the neorealist approach which should be highlighted here. Linklater (1995, p.251) argues:

"A) Neorealism lacks an adequate account of the relationship between the units and the system, and underestimates the capacity of states to promote international political change.

B) By lifting the system of states out of the cultural practices in which it is embedded, neorealism fails to grasp the immense significance of contemporary moral and cultural change.

C) Neorealism has also set its normative sights too low and devalues the contribution which critical approaches are making to the study of international relations."

In Cox's (1981, 1983) words, neorealism failed to account for changes within the world politics. Neither human ideas nor practices play an important role.

The neorealist perspective suggests that the EU will consider enlargement if it secures their position within the global economy.

This means eastern enlargement should improve EU's economic power base in order to balance the international power structures in their favour or to reduce threats from other organizations and regions in the world (Schimmelfennig, 1999).

As Schimmelfennig notes further, this argument puts the neorealist in a position from which he cannot explain the EU's eastern enlargement. This conclusion derives from two factors. Firstly the Central and Eastern European Countries would not increase the EU's (common) power. The short- and mid-term consequences of the eastern enlargement would bring a higher consumption of EU's resources without adequate compensation. In other words the accession of even the five most economically developed CEECs (Czech Republic, Estonia, Hungary, Poland and Slovenia) would weaken and not strengthen the relative economic power base of the EU.

Schimmelfennig argues further, from neorealism perspective there are no real perceived economic threats regarding the position of the CEECs. In the case of enlargement, on the one hand the applicant countries would not be able to improve the position of the EU against the two biggest EU competitors namely USA and Japan. On the other hand the EU does not fear that the CEE Countries could come under the control of one of its competitors simply because of the regions economic dependence on Western Europe. Therefore, neorealism can not argue for or against an eastern enlargement, it is neither necessary nor useful for power balancing purposes within global economic competition.

This assumption drawn by Shimmelfennig takes only the short- and mid-term consequences into account. However, taking the long-term gains into consideration, enlargement could improve the EU's economic power and so make an enlargement to the east meaningful from an neorealism point of view.

Since neorealism underlines the anarchic structure within the global political system as the main driver of foreign policy behaviour, the geopolitical goals of such an enlargement should also be considered. Threats to the security of states are one of the reasons why states advocate inter-state alliances. As a result, the EU could be in favour of an expansion to the east because it generates positive geopolitical externalities. For instance, looking at the enlargement process from the beginning, one could say that member states started the negotiations with strong geopolitical and economic- oriented preferences.

2.2.3 Neoliberalism

After the end of the Cold War in the late 1980s there was a rise of dissatisfaction with the realist and neorealist theory concerning international politics.

Vasquez (1993) describes in his model, how both theories failed to predict the peaceful end of the Cold War. Furthermore, it became obvious that realism's approach could not be an adequate guide for international politics simply because it failed to develop an explanation for many questions and problems (such as ecological deterioration, economic underdevelopment, etc.) of the new post-Cold War political situation (Scholte, 1993). Especially here, it was neoliberalism theory which examined the basic tenets of "classical liberalism and post-World War I idealism" in a new and fresh way. Neoliberalist's approach tries to prove the conditions under which the overlapping interests among states could result in cooperation.

The debate between neoliberalism and neorealism is dominated by six different characteristics from which two are of special significance in the context of EU enlargement (Baldwin, 1993, pp.4-8):

"A) Relative versus Absolute Gains. Although it would be misleading to characterize one side as concerned with relative gains and the other as concerned only with absolute gains, neoliberals have stressed the absolute gains (and common interests) from international cooperation, while neorealists have emphasized relative gains (by assuming that actors will ask, "Who will gain more?").

B) Priority of State Goals. Neoliberals and neorealists agree that both national security and economic welfare are important, but they differ in relative emphasis on these goals (with neoliberals stressing the latter and neorealists the former)."

Within the neoliberal approach the international system is characterized by complex interdependence. This means that states are not the only important actors in post Cold War politics, they (states) will treat actors such as multinational corporations as also important. In this context corporations act as "transmission belts", making government policies in different states more "sensitive" to one another (Kegley, Wittkopf, 1997).

Schimmelfennig (1999) underlines from a neoliberalist perspective, that military power is losing effectiveness because of the increasing international interdependence. States are more concerned about maximizing their welfare in different political and economic areas, so that the idea of economic security has meanwhile acquired a resolute political agenda. Western governments want nothing more than to provide these economic securities for their citizens and for the state as a whole.

Buzan (1991) defines the predominant characteristic of a state (in order to guarantee economic security for its citizens) as the adoption of the most advanced and successful practices elsewhere in the international political system.

This is not only the reason why countries such as Spain, Portugal and Greece joined the European Union in the 1980s. The newly independent Central and Eastern European Countries suppose that the adoption of the EU system will increase the welfare of their citizens. Therefore, full membership in the EU seems to be the ultimate way to reach their "economic security".

In this context, what could be the motivation for the present EU member states to enlarge eastwards?

As already discussed from a neoliberalist point of view the EU will only enlarge if the enlargement results in "net absolute gains" for its members. Moravcsik (1998) analyses a positive decision from the EU member states in favour of enlargement in terms of patterns of commercial advantages", "interest of powerful domestic producer", and "the relative bargaining power of important governments". By taking these factors into account Moravcsik argues that enlargement would bring aggregate benefits to the present members, so that an accession of the applicant countries could take place.

It is highly doubtful if the EU member states could expect any "gains" from the enlargement. As Schimmelfennig (1999) highlights, on the one hand trade with the EU accounts for 40-65% of the total trade of most CEE Countries, but on the other hand only 5% of EU exports go to CEEC markets. Here the CEEC seem to gain more advantages through trade with EU member states. Countries such as Spain, Portugal, Greece and Italy which specialize in the agricultural, textile and leather sectors will face higher competition as a result of enlargement. It is also clear that individual member states such as Germany would benefit significantly more than the EU states due to historical links and cross-border trade relations with CEE countries. Germany's trade with those countries accounts for 9% of its total external trade. Schimmelfennig argues further from a neoliberalist perspective, that "the EU members are able to reap most of the fruit of trade integration", due to the current association treaties and multilateral agreements, "without granting the Central and

Eastern European Countries full membership".

A possible enlargement would cost current EU member states more than the potential benefits.

Therefore, from a neoliberal perspective, an exclusion of CEE Countries from the EU is more plausible rather than an accession because the potential "net absolute" gains are not predictable.

One should bear in mind that Schimmelfennig emphasizes those aspects which can be explained by the neoliberal approach, however, there are studies of the long-term outputs which cannot be explained from a neoliberal perspective.

For instance, on the one hand EU members could reap most of the "fruit" only with granting association agreements to the CEECs, but on the other hand bilateral agreements between CEECs and USA or Japan could allow these rivals to enter to a strategic market-region next to the European Union with all its advantages of low cost production facilities and relatively well educated and trained workforce.

Further it is highly questionable if some industrial sectors in the Mediterranean countries will face higher competition from this region. During the year 2004 the leader and shoe industry in Spain faced strong competition not from the CEE countries but from China. Moreover, if the long-term gains are so uncertain why are a number of multinational enterprises such as the German car producer VW which took over the Skoda plants in the Czech Republic, seeking to invest in this strategic region?

Finally, if the economies of CEE countries develop like those of Spain and Portugal once they entered the EU, it is highly possible that in the long term exports from the EU into the CEE regional will rise as well!

2.2.4 Sociological Institutionalism

"An approach to institutions emphasizing their capacity to socialize actors and thereby influence interests and identities…" (Rosamond, 2000, p.204)

"Institutions become the mechanisms through which the world is rendered meaningful to social actors. For sociological institutionalists, interests and identities are endogenous to the process of interaction that institutions represent. Interests as well as the contexts of action are socially constructed by institutional 'scripts'. " (Rosamond, 2000, p.119)

Since the beginning of the 1990s sociological approaches have been challenging rationalist theories about international relations.

As it will be demonstrated, sociological institutionalism emphasizes much more the informal norms and formal rules which are embedded within the institutions. These norms and rules shape the way in which humans view the world and the way that they behave. It determines the characteristics of institutional norms within domestic politics and international relations (Pollack, 2001).

Therefore, it could be said that sociological institutionalism refers to the ways in which meanings, ideas and practices become embedded and institutionalized over time. This approach emphasizes more the processes of social learning which emanate from participating in these practices. It generally tends to look at ways in which actors follow patterns which have already become established.

For instance within the EU policy there is a common norm that the output and outcome of decisions and processes should not "permanently damage the interests of one or more members". Further, in order to build a counterweight to the greater power of larger states, there is a norm of maintaining the balance in representation and decision rules between large and small states (Laffan, 2001).

In the context of EU enlargement it is interesting to look at the ways in which these norms and values embedded in the daily policy making process of the EU influence the decisions which are made by the member states.

Reus-Smit (1997) explains, the European Union is based on liberal political norms and ideas. The fundamental practices within the community are based on liberal human rights, individual freedom and political rights. The debate about the EU's role in the protection and promotion of human rights and democracy has a long history and tradition. The observer of this history does not need to search long to find evidence of this tradition. The European Court of Justice for instance has already in the 1960s determined the communities demand for fundamental rights as part of the EC's "legal heritage" (Alston, Weiler, 1999).

In addition it was exactly the protection of these basic (Western) norms and values, especially the articulation of human rights and democracy within the newly independent CEE Countries that was the focal point of EU policy at the beginning of the 1990s. Here not only the promotion of democracy and human rights had to be a distinctive goal for Central and Eastern European Countries, but also the commitment to upholding democratic principles had to be guaranteed.

It was the Copenhagen European Council in June 1993 which underlined the conditions which had to be achieved for the successful accession of the applicant countries. Those conditions were defined as followed:

"The candidate countries had to achieve stability of institutions which guaranteed the democracy, the rule of law, human rights and respect for and protection of minorities." (Merlingen, Mudde, Sedelmeier, 2001)

Wittenberg (2000) describes in his thesis that it was not only the West that was offering sympathies to the democratic forces but also it had been supporting the norms of democracy and liberal ideas within the Soviet Bloc. Especially here the EU has encouraged the former communist countries to act in accordance with Western norms and ideals in order to resist totalitarianism (Fierke, Wiener, 1999).

After being politically free the CEE countries were able to "follow the Western model as it had been demonstrated to them". To them, Europeanization was synonymous with economic benefits, enculturation into dominant European values was connected with high social standards and welfare. In other words institution – building according to European models was the first step in reaching the final target of being part of the one of the powerful world economies, namely the European Union (Fink, Hafner, 1999).

The establishment of these EU norms and rules is shaping the way that institutions behave in the applicant countries. For instance Neumann (1996) highlights the racist tendency in Estonian politics towards Russians in the late 1980s and early 1990s.

Political conversations about Russian women - who "had been raped by Mongols and Tatars for centuries and so were contaminated by an Asiatic gene pool" - were dominated by such racist stereotypes. It was the "cultural hegemony of a European standard against racialism" which changed this specific strand of politics in Estonia.

Another example is the relation between politicians and the military in Poland. As Neumann highlights (1996, p.20):

"(…) One of Walesa's lines was to play down the need for clear-cut civil control with the military. When the opposition was nevertheless rather efficient in fighting this gambit, it was partially because they could refer to the existence of a European 'standard', where civil-military relations were concerned, and the need for Poland to adhere to that standard in order to be treated as 'Beitrittsfähig' by the EU."

As one can see, the norms and rules embedded within the EU Institutions are already shaping the way that politicians act within the applicant countries' political systems.

The applicant countries had not only to be democracies as described above, they also had to establish an open market economy with free competition, and they had to accept the entire acquis communautaire.

Therefore, by introducing the acquis, CEE Countries opportunities to join the European Union are increased. This commitment is supported by the fact that states which share fundamental values of an international community and adhere to their basic norms are entitled to join the organization (Schimmelfennig, 1999). At the beginning of the enlargement process the European Commission has evaluated a draft (the so-called "Agenda 2000") in which the achievements of each applicant country are measured according to various criteria. In this report the progress towards the applicant countries is highlighted as followed:

Table 3: ***The progress toward the applicant countries 1997 (Agenda 2000)***

Candidate State	*Political criteria*	*Economic criteria*	*Acquis*	*Administrative Reform*	*Final Proposal*
Slovenia	Fulfilled	fulfilled	needs efforts	indispensable	positive
Hungary	fulfilled	fulfilled	needs efforts	indispensable	positive
Czech Republic	fulfilled	fulfilled	needs efforts	indispensable	positive
Poland	fulfilled	fulfilled	needs efforts	indispensable	positive
Estonia	fulfilled	fulfilled	needs effort	indispensable	positive
Bulgaria	on the way to fulfilling	limited	uncertain	substantial reform needed	negative
Latvia	satisfactory, but the Russian-speaking population to be better integrated	serious difficulties	with considerable effort should be able	indispensable	negative
Lithuania	fulfilled	serious difficulties	with considerable effort should be able	indispensable	negative
Romania	on the way to satisfying	serious difficulties	uncertain	substantial reform needed	negative
Slovakia	does not satisfy	satisfactory, but needs progress	needs effort	reform is taking place	negative

Source: The European Commission (1997)

In addition one could say that the EU has put itself under pressure to begin accession negotiations with the Central and Eastern European Countries because they have been supporting the democracy movements within the Soviet Bloc throughout the decades of the Cold War as described above.

Taking these conclusions into account within the context of enlargement one could say that the EU's continued movement towards eastern enlargement is an attempt to save on the one hand the identity of the Union and on the other hand to reaffirm external opinions and perceptions "by way of keeping its promise to the CEEC applicants"(Wittenberg, 2000).

The loss of popular support for democratic institutions and a free market economy would be the consequence, if EU actions are not consistent with past promises.

However, here Helene Sjursen's (2002) critic about the sociological institutionalism and its attempt to explain the eastern enlargement should also be taken into account.

Sjursen argues that norms not only constrain actor's behavior and identity but "constitute the preferences and world-views of actors". Therefore, enlargement is not only based on the norms of a "liberal democratic international community, but on a community-based identity" (Sjursen, 2002, p.508).

The exclusion of the CEE Countries from the EU in the long term could lead to nationalist tensions and ethnic rivalries in the former communist countries, creating a security threat for the European Union (Fierke, Wiener, 1999).

2.2.4.1 Security aspects of enlargement

"…post-Cold War Europe is characterised by an economic multipolarity conjoined by a military bi-polarity that has been eclipsed, for the time being, by the economic and environmental concerns of the states occupying the European security space." (Sperling, Kirchner, 1997, p.4)

As Leff (1997) determines after the breakdown of communism, the most significant threat the countries of Central and Eastern Europe faced were internal ones. Consequently these countries began to speak at a very early stage of transition about a "security vacuum" within this region, underlining their fear to become a "grey zone" next to the western European countries and started to demand security guarantees from the EU. The insecure situation in Russia, the war in the Caucasus and the Balkans, were examples of how local conflicts could spread throughout this region. From the western European countries' point of view, at the end of the 1980s the Cold War had become a diminishing threat since Gorbachev took office. Here conflicts were settled in almost “predictable negotiations”.

However, the situation changed dramatically after the events of 1989. Even though the military threat was reduced and new perceptions of security had become the cause for concern.

For instance Buzan, Waever, De Wilde (1998) determine four new security sectors, namely the economic, environmental, political and societal sectors as now being the main concern in the European security agenda. For Sperling and Kirchner (1997) economic security plays a key role in the post-communist security architects. Not the military capability of a country is important rather the economic capability is decisive. In this context, actors such as the EU are of special importance due to their rule and norm setting role.

Therefore, the first attempt to adjust to this new situation was the response by NATO in offering the Partnership For Pease (PFP) plan to the CEE countries. The plan was supposed to improve the cooperation between NATO and CEECs and at the same time maintaining the prospect of membership for these countries in the near future.

Also the European Union realized its historic opportunity in ensuring peace and stability in Europe. Community members share common external borders and the security of these common borders is an important element within the EU policy.

Smith (2001) underlines the importance of this pillar during the negotiations of the Treaty on European Union (TEU) in 1991 with the implementation of the so-called Common Foreign and Security Policy (CFSP). This treaty as well as the Amsterdam Treaty underline the following common interests of the Union regarding its foreign and security policy (Smith, 2001, p.8):

1. *Safeguarding the common values, fundamental interests, and independence of the EU*
2. *Strengthening the security of the EU and its members in all ways*
3. *Preserving peace and strengthening international security*

Moreover during the Lisbon European Council in June 1992, the EU modified its interests regarding regional security. These interests are:

1. *An interest in the political and economic stability of a region or country*
2. *The existence of threats to the security interests of the Union*
3. *Strengthening democratic principles and institutions*
4. *Promoting regional stability and regional cooperation (Smith,2001, p. 9)*

Therefore, it could be said that with the fall of the Iron Curtain the EU saw itself in a changing political environment affecting its security agenda. The EU recognized at a very early stage, the need for political as well as socio-economic stability in Eastern Europe. Through agreements such as the EA's (European Agreements) the EU in its role as a new "security community" developed a new relationship with these countries. In this context the application of EU norms and values regarding democracy have played significant role.

2.2.5 Globalization, Regionalization and the European Union

" These revolutionary changes (embodied in globalization) will enable us to escape from the … bipolar view of the world, and to enter at last into an era … in which all of us -large and small- former slaves and former masters- will be able to create what your former President Lincoln called 'the family of man." (Vaclav Havel, 1990)

2.2.5.1 Globalization

In the past two decades the world economy has shown an increase in internationalization. It is dominated by uncontrollable market forces, and transnational corporations, which locate themselves wherever they can generate advantages. This development tends to underline the fact that a global economy has emerged or is in the process of emerging, within this context national economies are becoming more and more irrelevant (Hirst, Thompson, 1999).

Thus, the aim of this chapter will be the analysis of so-called "globalization" and its contribution, if any, to European integration.

For the observer of this process it is not easy to find a definition as there is no common interpretation in today's literature of what "globalization" is. A number of definitions exist which try to describe this phenomenon, but they all have their own interpretation. However, most of the writers seem to agree that there are six aspects which are recognized as the most important drivers of the recent changes within the world economy.

Firstly, the explosive growth of global financial activity since the 1980s seems to be the first aspect of this process. In other words the integrated operations of the transnational banks and investment firms have increased so much, that national economic management is now highly characterized by interdependence between the nation states. Their scale and scope have been transformed from national to transnational participation (McKenzie, Khalidi, 1996).

Secondly, the increasing importance of the "knowledge structure" plays a dominant role. In other words computer networks are shaping the scale of economic and political activities.

The creation of computerized, transnational data networks are now one of the most important factors of capital flows. Not only has the speed of data transfer increased, but also the costs of data processing have declined. High-speed computers and large databases now allow more flexible production, distribution and (cost-effective) monitoring (Herrera, 2002).

Thirdly, the transnationalization of technology, especially the huge progress throughout the telecommunications and aerospace technology, has "enormously quickened the diffusion of standards and know-how" (Amin, Thrift, 1994).

The fourth aspect is the rise of transnational economic diplomacy and the globalization of policies, the so-called "political globalization". Political decisions in one part of the world can cause worldwide consequences at a local level. This is due to the richness and complexity of the interconnections within the global order. As a result institutions such as the G7 and the EU have become (especially in the past two decades) more powerful (Held, McGrew, 1998).

Fifth, there is a rise of global oligopolies. Based on technological innovation and the greater transnational mobility of capital and the changes within the transport and communication sector, companies today operate globally in order to remain competitive.

Finally, the rise of "global cultural flows and "deterritorialized" signs, meanings and identities" based on the movements of immigrants, refugees and guest workers across national boundaries, seems to promote globalization (Amin, Thrift, 1994).

In conclusion, it can be said that the changing nature of the financial world, the emergence of new technologies and the liberalization of world-wide trade seems to be the main factor which has created a new dimension of intra-enterprise trading. Taking these developments into account one could go a little further and highlight the new worldwide economic characteristic where states which are acting alone in the global context are not longer able to protect their citizens, nor are they able to manage and regulate their economic forces. Thus, they are losing their economic governance. One way out of this dilemma seems to be the building of regional organizations such as NAFTA (North American Free Trade Agreement), ASEAN

(Association of South East Asian Nations), or even the European Union.

2.2.5.2 *Regionalization*

Since the experiments of the 1950s for the establishment of a security community, free trade area and a common market have outreached their original targets, the regional integration theories seem to attract more and more the attention of scholars and students in this field. It is the theory of regional integration which seeks to contribute mostly the discussion of internationalization, transnationalization and, last but not least, the globalization of markets.[5]

2.2.5.2.1 Definition

The term regionalization describes the process within a geographical region in which concrete patterns of transaction are built. In other words it leads to higher levels of economic interdependence in this region.[6]

Economic regionalization is promoted by markets, private trade, investment flows and by the policies and decisions of enterprises, especially the increase of intra-firm trade and the growing number of international mergers that play an important role (Hurrell, 1995).

Also important in this context are the state-led negotiations on regional free trade agreements. Nation states seek to promote the process of regionalization by providing the private corporate actors with the framework which is necessary to operate transnational and more regional business (Hveem, 1999).

This process is well described with Mommen's definition (1998, p.27) as follows:

"Domestic policies shape the regionalization process when sufficient opportunities are offered to states in order to gain the required comparative advantages for a successful shift to outward-oriented economic policy. The regionalist trend received its original impetus from multinational companies interested in delocalizing their production units in order to lower their production costs."

2.2.5.2.2 The "New Regionalism"

As Hurrel (1995) points out, since the late 1980s there has been a tendency which seems not only to have strengthened the existing regional institutions but also has created new regional associations among states. This development has built a network of transactions across national boundaries and within a given subregional area (Hveem, 1999).

The "Single European Act" in 1986 and the negotiations forced by the US government in the late 1980s in order to create a regional free trade area with Canada are the most apparent drivers of this tendency. Moreover the developments in East Asia (APEC and ASEAN for instance) where, in the last two decades, a number of agreements have been signed in order to promote regional preferential trade, are also of particular importance (Fry, 2000). As Higgott (1998) further highlights, both the US and Europe have recently faced competition from Asian countries because Asian countries, such as those in the ASEAN, have realized that they have to come together in order to attract foreign direct investments. Taking a national route is not enough because they have to compete with other regions, not with other single states. Taking these developments into account it is interesting to look at the trade figures since 1980 within these areas.

Schott (1991) shows in his notes the members of each trading block have increased their trade with other members of their group. In order to have an overview the table below shows the developments of intra-regional trade in the EC, North America and in East Asia during the 1980s:

Table 4*: Intra-regional trade in EC, North America and East Asia 1980-1989*

Region	1980	1986	1989
EC 12			
Exports	53	57	60
Imports	48	57	57
Total	51	57	59
North America			
Exports	33	40	40
Imports	32	31	33
Total	32	35	36
East Asia			
Exports	34	28	35
Imports	32	38	40
Total	33	32	37

Source: Scott (1991)

This development seems to be discussed in the recent literature as a reaction to globalization. The identification of potential related to and excluding tendencies between "regionalization" and "Globalization" on the other hand will be the target of the next chapter.

2.2.5.3 Globalization versus Regionalization

So far, the past three sections have outlined the nature of the two dominant theories which try to explain the internationalization of finance and production. This section takes the question a little further by exploring the links between the two phenomena. There are different ways in which the relationship between globalization and regionalization can be described.

As highlighted in the last chapter a number of regional projects have been (to an extent) a response to global competitive pressure. It was, for example, in the mid 1980s when several institutional developments within the EU started to reinforce the project of European integration (Hveem, 1999).

In terms of understanding the reasons for these developments within the EC since the mid 1980s one should view the ideas of the former president of the European Commission, Jacques Delors. He perceived the dangers facing Europe "as coming from the other regions of the Triad" such as NAFTA. The fact was that the European Community was falling behind other advanced capitalist regions. The creation of the "Single European Market" could be a challenge for a European regional economy in which "the actors would gain economies of scale" by adapting to the new European identities and ideas (Ross, 1998).

However, Hay (2000) highlights there are two issues of the regionalization process which are of special importance. Regionalization can be viewed as a response to globalization because it is more trade diverting, in this case regional trade agreements secure not only welfare gains in a certain region, they also promote common values and problems. Thus, by creating a regional trading block it is more rational for those nations who have been trading with other countries outside the regional trading bloc "to import from within the regional bloc" where the conditions for trading are improved. Once again using the EU as an example, one could say the elimination of trade barriers and the formation of a customs' union in goods have put forward the process of regional economic integration, the so called European "Model" (Hurrell, 1995).

On the other hand by promoting intra-regional liberalization, regional developments can be seen as stepping-stones to the globalization of liberal trade. Those who are in favour of this theory underline the trade creating consequences of regional trade blocks (Hay, 2000).

For instance, the developments in the EU and APEC have been responsible for a number of globalization aspects from which the following three are of special significance:

"1. the replacement of national markets by world markets;

2. the decline of geographical determinants of financial location and the internationalization of the division of labour;

3. the continued strengthening of multinational and private policy-making structures vis-à-vis the public authority of the state"; (Strange, 1995, pp.55-74)

Developments within the European Union could have a particularly important effect in promoting new globalization, since any political and economic change (where four of the G7 member states are trying to merge as a community sharing the same interests) causes challenges in other regions in the world.

As Jilberto and Mommen (1998) determine, regional economic integration "has to be understood as one of the key factors in the process of globalization". It is the process of regionalization which creates the institutional and political framework for the elimination of trade barriers. By removing trade barriers the process of world-wide capital accumulation is advanced because now national economies are able to cooperate more closely around "regional gravitational poles".

One should also keep in mind that competition between these trade blocs could emerge as described above. Especially the restructuring race between Europe, Asia Pacific and North America (the so called "triad regions") is dominating recent globalization tendencies more and more. In this sense the EU could be viewed as a dynamic component of globalization.

Taking these issues into account the next chapter goes a little further by exploring the role of the CEECs and looking at the possible advantages of an eastern enlargement for the EU. The question here remains to what extent the applicant countries will strengthen the EU's position as a regional bloc within the growing globalization process.

2.2.5.4 The EU as regionalizing force and the role of the CEECs

As it has been assumed above, it is obvious that regional free trade areas are becoming more and more competitive trading blocs which could potentially be engaged in trade wars. Therefore, for an individual state it is a question of survival to join a regional bloc (Fry, 2000).

The markets within CEECs are small markets with a small number of resources and weak purchasing power.

Taking these developments into account, the movements within the Central and Eastern European Countries for joining the EU seem to be a logical consequence in order to protect their economies against trading blocks in the long term.

The advantages for the candidate states are more obvious when taking into account the fact that the accession guarantees a "kind of global governance". Especially the EU seems to set up the institutional arrangements for the development, implementation and control of rules. These rules not only guarantee the necessary regulations within the economic, social and environmental fields but they also seek to fortify the balance between competition and cooperation (Dijmarescu, 2001).

However, in the recent literature about EU enlargement one question seems to be the main topic of discussion; is it necessary for the European Union to enlarge eastward in the context of the growing globalization and regionalization forces since an enlargement is not advantageous from the beginning? In order to find an answer, it is important to look a little closer at the EU and examine the process of European integration.

As Scholtbach (1998) states, the EU has become a key player in world trade together with the United States and Japan. Moreover "the EU has shifted its traditional policy of protection of its markets to penetration of others".

The new associations towards Central and Eastern Europe (the so called "European Agreements") combined with aid programmes such as Phare has been the driving force for the economic recovery in these countries. Trade liberalization was one of the first steps which had been established in those transition economies. This "modern equivalent of Marshall Aid" is of course not without strategic consideration on the part of the EU.

Marek and Baun (2002) point out that regional policy is one of the key aspects of the acquis communautaire. Structural and cohesion funds are major components of the

EU aid budget for the candidate countries. The structural funds make up 90 percent of all structural spending. Here, the most important objective is to promote those economically backward regions. In order to satisfy the criteria of accession the candidate countries have to adopt the institutional and administrative requirements. And since the balance between regional and central governance was significantly underdeveloped after the events of 1989-1990 the CEE countries had to implement such policies.

As a first consequence regional institutions were set up according to the Commission's demand. Marek and Baun (2002) state further, that the Czech Republic for example has made at the end of 2002 "substantial progress" in establishing "the institutional and administrative requirements of the EU regional policy". Therefore, one could say that based on these developments the incorporation of the candidate states could mobilize regional interests and could lead to a greater regionalization within this area.

Nevertheless, the markets within Central and Eastern Europe are vast markets which, if developed, could stimulate and increase European output (Hirst, Thompson, 1999). As above these markets could strengthen the position of the EU against the other major players within the globalization process, namely the United States and Japan. For instance, according to the Commission's statistics, exports to the eastern European region grew by 64.8 % between1995-1998. This development is estimated to be three times faster in comparison to EU exports to other markets (Dijmarescu, 2001).

However, it is not only this consideration which could explain the interest of the EU in a successful eastern enlargement. For the EU it is of particular importance to tie up economic relations with lower income countries on its borders such as the Czech Republic. In the context of globalization and the growing power of multinational companies, the individual European governments try to control at the European level those developments which are no longer controllable at the national level.

For instance, the developments set up through the SEM (Single European Market), has changed the action of Japanese companies. They are now supporting the European market from local affiliated companies instead of imports from Japan. This decision has been supported by the new opportunities which bigger European markets offer Japanese companies (Hine, 1992). One could take this a little further by exploring the importance of low income countries to individual EU countries.

Germany for example needs “to have Western neighbours to its east”[7]! Germany has not only an interest in westernization of the new democracies in Central and Eastern Europe but also in political and economic stability (Scholtbach, 1998). Forced by external circumstances such as international operating companies (e.g. Japanese) taking advantage of low income countries next to the European Union, the EU will need to expand its borders to the east. As Rosamond (2000, p.182) determines:

“what might be called globalization, competitive threat, informal integration or global economic change often appears in the literature as a form of external regulatory shock that forces a policy response from within the European Union.”

By doing so the EU will not only acquire but also strengthen its role as a super national actor in a globalized world, where both international and regional blocs are its challenges.

2.2.6 New Institutional Economics

“Sometimes an institution seems to mean a framework of laws or natural rights within which individuals act like inmates. Sometimes it seems to mean the behavior of the inmates themselves. Sometimes anything additional to or critical of the classical or hedonic economics is deemed to be institutional. (…), or activity instead of feeling, or mass action instead of individual action, or management instead of equilibrium, or control instead of laissez faire, seems to be institutional economics.” (Commons, 1931, p.648)

Another important school that refers to the role of institutions and their contribution to the European integration process in the context of the European Union is the so-called “New Institutional Economics” (NIE).

This theory tries not only to explain the market but also the social, economic and political institutions that govern everyday life. Here the focus is on rules and institutions and their influence on decision making processes. North (1996) in his analysis about the institutions highlights that they not only affect the performance of the economy related to production costs but they also have an impact on transaction and transformation costs which, together with the production costs, make up the total costs within a given economy.

As North (1996) suggests institutions “include any form of constraint that human beings devise to shape human interaction”. Thus, conditioned upon institutional pressure, individuals are forced to undertake certain activities in their daily life or they are permitted to act independently in certain situations!

Taking these considerations into account the New Institutional Economics distinguish between the “institutional environment” and “institutional arrangement”. Institutional environment is dominated by background constraints (the so-called “rules of the game”) which limit or lead individuals’ behavior. These constraints are either formal such as constitutions, laws, property rights, or informal rules like social conventions and norms. How important these rules (formal and informal) can be will be examined a little further in the following section. Continuing these thoughts “institutional arrangements” are specific guidelines which are made by trading partners in order to moderate certain economic relationships. Contractual arrangements such as non-profit organizations and business firms are instances of institutional arrangements (or the so called “governance structure”) (Klein, 1999).

In conclusion one should bear in mind that other supporters of the NIE also take into account the role of organizations and the result of their interaction with the institutions. These developments will also be the subject of analysis later on in this chapter.

2.2.6.1 Formal and informal rules

North (1997) underlines three different features of **formal rules** within an economy. Starting with political rules, one could say that their aim is mainly to determine “the hierarchy of the polity” including the decision-making structure and the determination of “the explicit characteristics of agenda control”. The resoluteness of property rights is the target of formal economic rules. Last but not least the rule of contracts is also highlighted. Their objective is to fix clearly the limitations of particular (trade) agreements in exchange. Thus, by enforcing contracts the firms have the reduction of business costs as a target and hence economic efficiency. Taking the European Union as an example, political rules could be those, which were set up by the Nice Treaty. This treaty, like the previous one, was established by the jurisdictions of each member state and the definition of common rules was their main purpose. Also bodies such as the European Court of Justice could be defined as an institution, whose main focus is the enforcement of formal rules (Topan, 2001).

Informal rules are those such as codes of conduct, norms of behavior, and traditions which dominate the daily interactions not only between individuals but also within social relations, business activities and governing structures. Thus, it could be said that informal rules are part of the culture within a society. They may be enforced spontaneously and decentralized but they help to clarify a number of exchange problems which are not effectively solved by formal rules. For instance, the informal rules which arise in the context of business exchanges make these exchanges possible by reducing "measurements and enforcements costs" which influence the effectiveness of these exchanges (North, 1996). Assuming the definitions above one could say that in order to make an economy efficient, the combination of formal rules complemented by informal rules is unavoidable.

2.2.6.2 Transaction Costs, Principal/Agent and Collective Action Theory

As Doner and Schneider (2000) highlight in their essay on New Institutional Economics even among the representatives of NIE there is no common agreement about the core sets of problems within this theory. There are, in general, three major sets of problem areas which demand an institutional solution.

These three problem areas will be briefly introduced in the following section in order to make the reader familiar with the types of analysis within the New Institutional Economics. One emphasis of the NIE is the so-called "**Transaction Cost Theory"** also referred to as **"Transaction Cost Economics" (TCE)**. Here the transaction between the parties is underlined as a bilateral relationship. Not only does the search for appropriate partners, the bargaining process and the enforcement and monitoring of agreements create costs, but the implementation of transactions between parties produces transaction costs which are the result of the incomplete information available [the so called: uncertainty] (Richer, 2001). Thus, due to the incomplete information at the time of contract making, economic organizations face transaction costs because the contracts are usually incomplete. In the Transaction Cost Theory "the future holds genuine surprises", therefore, the contracting options from the beginning are limited. As a matter of fact there is a general demand within the markets for institutions to help handle this uncertain situation and to reduce transaction costs (Klein, 1999).

Doner and Schneider (2000) emphasize the importance of public rules and institutions at the micro level which reduce transaction costs (e.g. property rights). Also at the political level, political exchange between the actors causes high transaction costs.

Other representatives of NIE monitor the "**Principal-Agent problem**". For instance, within modern corporations in today's business, owners and management are faced with exactly this problem. Here the management (agents) tries to "exploit information asymmetries" in order to increase the firm's profits but it is exactly this activity which makes it very difficult for the shareholder (principals) to control the manager. The focus of the "Principal-Agent theory" is more about hierarchy and control.

Due to this consideration it could be said that this strand of NIE is more relevant for the study of corporate governance efficiency, transparency of enterprises and corruption in the bureaucracy!

Finally, the problems of "**Collective Action**" represent the third strand of the NIE. The core of this strand is based on common interests:

"…common interests within a group would not lead to collective action to further those interests if some members had the opportunity to free ride on the efforts of others to provide the collective goods. Individual rationality would lead to collectively suboptimal outcomes." (Doner, Schneider, 2000, p.8)

At the private level individual action (individual rationality) could lead to market failure and the under-provision of collective goods. Cooperation and collective action would put the members in a better situation.

Therefore, Collective Action Theory is mostly used to analyse policy decisions and their outcomes which would benefit the whole collective. The table below shows in sum the efforts of these three types of analysis:

Table 5*: Types of Analysis in the New Institutional Economics*

	Transaction Costs	***Principal/Agent***	***Collective Action***
Relationship	Exchange	Hierarchy and control	Cooperation
Components/Analytic Tools	Information costs; costs of searching, bargaining, and enforcement	Asymmetric information and opportunism	Free riding / Selective Incentives
Manifestation in the private sphere	Imperfect markets Market failures (externalities, public goods)	Suboptimal contracts (e.g., sharecropping) distortion of corporate governance adverse selection and moral hazard	Market failure under provision of public goods (e.g., training) tragedy of the commons
Manifestation in the Public Sphere	Increase property rights political instability non-credible policies and time inconsistencies political transaction costs	bureaucratic dysfunction and expansion corruption regulatory capture other elements in public choice	Rent seeking undersupply of public goods

Source: Doner, Schneider (2000)

2.2.6.3 Organizations and Institutions

Also subject to focus in the NIE is the role of organizations and their influence on institutional change. Organizations are viewed in the NIE as objects which are designed in order to maximize the property of their creators.[8] Organizations are not the result of institutional pressure, they are "created as a function".

Further, in order to be successful the organization has to acquire knowledge, skills and learning including not only "communicable knowledge" but also "tacit knowledge".[9] In this context, rules that push forward the development of the latter kind of knowledge are of special importance if organizations want to be efficient.

In conclusion, one could say that rules are "crucial to effective organizations", for it is necessary and important to have rules which eliminate both failed economic and political organizations. The relationship between organizations and institutions is reciprocal: on the one hand the evaluation of organizations (the way that they come into existence) is shaped by institutions but on the other hand organizations play a significant role in the evaluation of the institutional framework (North, 1996).

2.2.6.4 NIE and the enlargement of the EU

As outlined earlier in this chapter, one emphasis of the NIE is the evaluation of transaction costs (and their special importance) between parties or economics.

Topan (2001) remarks, that if one wants to understand the national states' movement to give up national sovereignty to a supranational body, one has to consider the advantageous reduction of several transaction costs resulting from such a move.

The first stage of analysis of the Transaction Cost Theory takes information gathering into account. In the case of the European Union one could say that the accession of a new member certainly includes transaction costs, especially those costs arising from the introduction of new rules. However, trade barriers will also be reduced and new information about external trade barriers will occur putting the contractual parties into a new advantageous position.

There are a number of other transaction costs for both the member states of the EU and the applicant states, deriving from monitoring contract performance of each national state or the changes within the rules that have to be undertaken due to the changing environment, but all these costs are assumed to be much higher if national states act in bilateral contracts instead of in multilateral agreements (Topan, 2001).

Concluding this chapter it is important to stress the importance of formal rules in the context of European Integration. These rules are laid down in the “acquis communautaire” and these prerequisites are precisely the conditions which the Central and Eastern European Countries have to adopt in order to successfully join the EU. Especially here, trust plays an important role between the contractual partners. As Topan (2001) points out trust is essential because there is a "time-lag problem between advances and their quid pro quo". For instance, the CEE Countries get substantial support through European funds such as Phare, but (in return) their pay-off could take decades since the development of efficient and competitive markets in Eastern Europe is progressing slower than the EU had expected. Due to the EU’s informal rules, the European Union has to incorporate the CEECs if they achieve the acquis requirements successfully. If the EU rejects the accession even though the applicant countries have achieved the criteria, the reputation of the EU will be damaged. However, the European Union as an international economic power cannot afford its reputation to be harmed, so the task of the incorporation of applicant countries is a necessary step in the context of the EU’s world-wide policy activities.
Nevertheless one should also take into account that transaction costs will remain at a high level if the applicant countries’ economic structure and that of the member states differ too much from each other.
Furthermore, in an NIE approach the efficiency of markets within the EU will be a consequence of the role of institutions. Only those institutions which provide the economy with political and economic stability on the one hand, and the (institutional) flexibility needed to take new opportunities (such as eastern enlargement) on the other hand will provide the framework for an efficient economy.

2.3 The experience of previous enlargements

The Rome Treaty which was signed on 25th of March 1957 by the original six member states (France, Italy, the Federal Republic of Germany, Belgium, the Netherlands and Luxembourg) left an open door for new members to enter. This is due to article 237 of the treaty which indicates: “Any European state may apply to become a member of the Community” (Rome Treaty).
Since 1957, countries have joined the EC for different reasons and, as a matter of fact, the EC has been enlarged four times. On the one hand, all these enlargements have been dominated by common fundamental factors such as the pursuit of political,

strategic and economic advantages. On the other hand, the EC has gained benefits from these enlargements, which will be described in more depth in the following section.

The first enlargement took place in 1973 when Great Britain, Ireland and Denmark joined the European Community. For the British government this step was a necessary one due to the fact that Great Britain's rate of economic growth was lagging behind the EC countries. Ireland had to join the Community because of its close trade links to the United Kingdom and in Denmark's case, it was due to the "German market-oriented" Danish export production (Redmond, Rosenthal, 1998).

The first enlargement was also a challenge for the European Community itself. Common policies in new areas such as in the regional, environmental and technology sectors had to be implemented and evaluated. Furthermore, not only was there an agreement for closer cooperation in policy areas such as foreign affairs but also new institutional arrangements, namely the European Council and the European Parliament had to be devised (Maresceau, 1997).

However, it could be said that the economies of those new EC countries were "broadly compatible" with the Community members (apart from some sectors within the Irish economy). Therefore, their accession was less complicated in terms of economic assistance by the Community (Mannin, 1999).

The second and third enlargements in 1981 and 1986 saw the accession of three southern (Mediterranean) countries (Greece, Spain and Portugal). These countries had been relatively less economically developed in comparison to the European Community member states. They had been ruled by totalitarian regimes until the mid-1970s (Michalski, Wallace, 1992).

Security was an additional factor that dominated the EU's support for these countries' accession into the Union, meaning enlargement was "presented as a means to project stability and enhance security" in those newly developed democracies. This idea, which dominated EC policy, was based on common shared rules and decision-making practices necessary for liberal democracies to remain stable. This policy was seen as being the EC's role, the provider of stability for those applicant countries (Long, 1997).

From the economic point of view the markets within these countries were performing in previously totalitarian countries, nevertheless they already had a functioning market economy. The economic levels have not been comparable with those of the member states but the EC accession meant "the acceleration of their economic development". Mannin (1999) underlines the fact that through the adoption of structured policies and their backing by the EU, the new members were expected to be able to deal with the challenges facing them within the "emerging Single European Market" (SEM).

One could say that these countries have performed remarkably well to achieve their economic goals once EU rules and policies had been integrated into their economic systems (Michalski, Wallace, 1992).

In this instance, the challenge the EU faced with the second enlargement was larger than the first enlargement. The Community had to change its policies, especially in terms of regional funds "as a mechanism for transfer of resources to the less-favoured" regions of member states (Maresceau, 1997).

Another example in the case of the second and third enlargement is the evaluation of the Common Fisheries Policy (CFP) within the EU. The accession of these two countries (Portugal and Spain), not only doubled the number of fishermen and increased the fleet tonnage (65%) as well as production (45%), but also forced the modernization of the fleets by the Community, since the fleets of these two applicant countries were older than the average of the Community (Lequesne, 2000).

Finally, the fourth enlargement took place in 1995 with the accession of three EFTA (European Free Trade Association) countries, namely Austria, Sweden and Finland.

As Redmond (1994) highlights, for the two Scandinavian countries, Sweden and Finland, joining the EU seemed to be the only way to fully participate in the EU's single market. Austria's monetary link to Germany on the other hand, had already supplied a successful model of economic integration. As a matter of fact, Austria had been moving towards integration with the Union for some years before its accession. This fourth enlargement was characterized by a "shorter" and "smoother" process, based on their being prepared and their experiences within the European Economic Area (EEA) (Mannin, 1999).

Also important in this context, the fourth enlargement brought the EU into new directions such as towards a Baltic policy since the new northern members had a special interest in this region (Long, 1997).

Furthermore, it should also be noted that this latest enlargement not only shaped new policy directions, it also connected with a considerable deepening process such as the commitment to Economic and Monetary Union and the increasing levels of responsibility of the European Parliament (Maresceau, 1997).

Moreover, Wallace (2000) underlines the social dimensions of this enlargement, for example the establishment of a common security as well as justice policy and the moves to construct a form of European defense autonomy.

One could assume that the accession of new members was always connected with costs in terms of tariff barrier relaxation and policy changes which had to be undertaken as described above. However, the long-term impact of the latest enlargement and the previous one have all had clear benefits to the European Union (Redmond, 1994).

In his thesis (2000), Wittenberg underlines the fact that as a consequence economic ties were intensified significantly and led to mutual welfare gains (functional spillover). All enlargements brought new "leadership" and "areas of activities" to the European Union. The affects could be pointed out as follows (Granell, 1995):

- With the accession of Denmark, Ireland and the United Kingdom new democratic processes had to be implemented within the European Parliament, and especially in the case of Great Britain, new world dimensions faced the EU due to its transatlantic and Commonwealth ties.
- The accession of Greece, Spain and Portugal did not only shape the social and cohesion dimensions of the EU, but also included new Latin American links for the Union.
- The latest enlargement forced a new policy in social standards and environmental matters. Moreover, Austria and Finland brought new links to Russia and the East European countries due to their historical and geopolitical links to this region.

The previous enlargements have converted the Union from a membership of six to a membership of fifteen European states. The implications for both the new countries as well as the European Union have been great. However, we could note that they had clear benefits for all sides. However, the current enlargement and its benefits for the EU are not clear since the next eastward oriented enlargement will take place under other conditions and with a number of differences.

2.4 CEECs and the historical background

As Mannin (1999) states, after Gorbachev took office as Secretary General of the Communist Party of the Soviet Union (March, 1985), the ideological boundaries within the Union started to be removed, especially those which concerned a blockage of policy relationships between the EU and the Council for Mutual Economic Assistance (CMEA).

One could say that before this event relations between the EU and the Central and Eastern European Countries were virtually non-existent. These centrally planned countries under rule from Moscow did not engage much in foreign trade (Sedelmeier, Wallace, 2000).

From 1986 onward, negotiations between the European Commission and individual CMEA countries started and built new grounds for relations between the European Community and this region. However, later in 1987, due to the dangerous situation in Poland and its economic consequences, a Western Bank credit was set up including round table talks. These developments ended in September 1989 with the creation of the first non-communist Polish government. Following these developments, Hungary's signature under the United Nations Convention on Refugees introduced the collapse of communism in Eastern Europe, thus the "Brezhnev Doctrine symbolically died" (Mannin, 1999).

The unexpected unification of Germany and the building of non-communist governments in Poland, Hungary and the former Czechoslovakia (in 1989) created new and democratic movements within these Soviet satellite states, which came as a surprise to the European Union.

As Sedelmeier and Wallace (2000) note, the EU had been unprepared for these democratic changes. On the one hand it was acting under time pressure and uncertainty but on the other hand it was clear that the EU had to implement a new "European Policy", since the Community saw itself as the main driver in the context of reintegrating the continent and supporting the new democracies within Eastern Europe.

Within the same context we should note the role of Germany. Mannin (1999) underlines Germany's acknowledgment of its "historical debt" but also saw the advantages it would receive through new markets in Eastern Europe, especially in Poland, Hungary and Czechoslovakia. One should further bear in mind the fear of the

German government facing a “migratory leakage” in case of instability within this region, which also dominated Germany’s support to assist the transformation of the CEECs.

Therefore, the support policy of the EU included the following features:

1 *“enthusiastic pledge of support for changes*
2 *consensus that the EU should be the main channel for policy*
3 *hyperactivity and a proliferation of initiatives*
4 *a focus on “normalization” and technical relations, and*
5 *short-termism” (Sedelmeier, Wallace, 2000, p. 432)*

As a consequence, at the end of 1989 bilateral agreements on trade and economic cooperation had been signed with Hungary and Poland (extended later to other CEECs). These so-called Trade and Cooperation Agreements (TCAs) would support political and economic reforms as well as the development of relations between the EU and these countries. Later on, the EU signed the Partnership and Cooperation Agreements (PCAs) with countries such as Russia, Ukraine and Moldavia in order to built a closer link for broader cooperation with those countries (Mannin, 1999). Nevertheless, as early as 1990 it was quickly made clear that the level of transformation and democratization required a higher degree of response from the European Community, since the initial provision of financial support and expert advice turned out to be not enough to push forward the economic recovery of the CEECs (Preston, 1997, Wittenberg, 2000).

Thus, as illustrated in the introduction, the Phare Programme was set up in order to support financial and technical developments within the countries of Central Europe. This programme amounted to approximately ECU 1.47 billion in July 1992 (Mannin, 1999).

A third step which has been undertaken by the European Union, is the establishment of the “European Agreements” (EAs). These agreements were signed bilaterally from 1993 onward with each Central and Eastern European country. Their aim was the creation of a free trade area during a period of ten years (Hughes, 1998). The Union committed “to remove trade barriers faster than the partner countries”. The tariffs should have been removed totally by the beginning of 1995, with the exception of sensitive sectors such as textile, steel and agriculture. The table below shows the different agreements signed with Central and Eastern European Countries at the beginning of their transition process:

Table 6: ***The agreements and assistance programmes with CEECs until 1998***

Country	***Form of agreement***	***Aid/technical assistance programme***
Albania	*TCA*	*Phare*
Belarus	-	*Suspended relations*
Bosnia	*TCA (pending)*	*Phare*
Bulgaria	*EA*	*Phare*
Croatia	*Limited*	*Suspended*
Czech Republic	*EA*	*Phare*
Estonia	*EA*	*Phare*
GDR	-	*Structural funding*
Hungary	*EA*	*Phare*
Latvia	*EA*	*Phare*
Lithuania	*EA*	*Phare*
Macedonia	*TCA*	*Phare*
Moldavia	*PCA*	*Tacis**
Poland	*EA*	*Phare*
Romania	*EA*	*Phare*
Russia	*PCA*	*Tacis*
Slovakia	*EA*	*Phare*
Slovenia	*EA*	*Phare*
Ukraine	*PCA*	*Tacis*
Yugoslavia	*Suspended*	*OBANOVA (special assistance programme)*

Source: own graph based on Mannin (1999)
* Tacis: Technical Assistance for the Commonwealth of Independent States

The limitations of the EAs started to frustrate some of the CEECs, especially the Visegrad Group. They also underlined in 1993 their "aspiration" to become full members (Preston, 1997). Hence, it was not until the Copenhagen summit in June 1993 that the EU promised the Central and Eastern European countries which were associated with the European Union that they could become members as soon as they were able to satisfy the necessary economic and political conditions. The EU accepted membership as a goal and agreed to improve market access if these countries achieved a level of stable institutions guaranteeing the rule of law, human rights and democracy. Further, their ability to adapt the acquis as well as a functioning market economy capable of coping with competitive pressure within the EU markets had also been agreed (Copenhagen Council, 1993). These criteria set up during the Copenhagen Summit will be explored a little further in the third chapter.

In this context, based on the EU's commitment of accession and incorporation of those countries that adhere to its basic norms and values from a sociological institutionalism point of view, the EU has the responsibility to keep its "promise" of enlargement in order to be accepted as an important and influential body within the world policy process.

However, at the Essen Council meeting in December 1994 the "White Paper" was drawn up which introduced a pre-accession strategy based on the Commission's proposal. The White Paper delineated the acquis and listed all the relevant legislation and policy areas within the EU's administrative infrastructure being hit in the case of a fifth enlargement and also established measures which had to be undertaken by the CEECs in order to implement legislation and regulatory systems (Preston, 1997).

Sedelmeier and Wallace (2000, p.444) determine the pre-accession strategy as:

1. **identification of key acquis essential for the creation and maintenance of the internal market in each sector**
2. **suggested sequencing for legal approximation: priority measures to be tackled first (but not priorities between sectors)**
3. **specification of administrative and organizational structures for effective implementation and enforcement**
4. **suggested adaptation of Phare assistance for pre-accession strategy**
5. **Technical Assistance Information Exchange Office**
6. **monitoring of implementation of recommendations"**

Following these developments in December 1995, Madrid's European Council asked the Commission to draw up a report regarding the individual applicant's readiness for accession and to determine the impacts of enlargement on the EU. The Commission was also asked to set dates for opening of accession negotiations with the CEECs (Redmond, Rosenthal, 1998).

In 1997 two important events dominated the process of enlargement. Firstly, there was the European Council meeting in Amsterdam, with the signing of the Amsterdam Treaty by member states.

This treaty not only forced the extension of Qualified Majority Voting (QMV) and regulated the number of commissioners in the case of enlargement; it also forced a revision of institutional arrangements and a provisional agreement on the number of Members of the European Parliament (MEPs). Further, it demanded that accession negotiations should start with applicant countries:

"…according to the stage which is reached in satisfying the basic conditions of membership and in preparing for accession." (The Treaty of Amsterdam)

The second important event in this year was the Commission's first opinion on Eastern Enlargement, which was published in July. None of the applicant countries was judged to fulfill all the criteria defined during the Copenhagen Council meeting. Nevertheless, the Commission recommended "a differentiated strategy" based on the fact that the Czech Republic, Estonia, Hungary, Poland and Slovenia were likely to fulfill the conditions. The commission suggested that accession negotiations should start with these countries.

At the Luxembourg European Council in December 1997, the Council agreed to begin accession negotiations "in line with the Commission's recommendation". Formal negotiations would be opened simultaneously with all ten CEEC candidates (Mannin, 1999). As a matter of fact, accession negotiations were opened on 31 March 1998.

In March 1999, during the Berlin European Council the EU had decided the extent of accession aid and post-accession receipts for the CEECs. The EU would support these countries with aids of 6.45 billion Euros in 2002 to 16.78 billion in 2006 (Sedelmeier, Wallace, 2000).

Finally, the Nice Treaty signed by the EU member states in December 2000, modified the EU's organization and voting rights and identified institutional changes which had to be implemented in order to make the eastern enlargement successful from the beginning. These changes had to be achieved in areas such as:

1. Majority voting (extended to more areas)
2. Rebalancing votes (medium sized countries such as Spain an Poland, gained more influence)
3. The European Commission
4. Flexibility (greater integration in certain areas could be now achieved by groups of eight or more countries)
5. Charter of Rights (Proclaimed) (Nice Treaty, 2000)

In June 2001, at the Göteborg European Council the EU underlined that negotiations with the best prepared CEE Countries could be finished at the end of 2007. Finally, at the Seville European Council (June, 2002), the Council reaffirmed that negotiations with Cyprus, Malta, Hungary, Poland, the Slovak Republic, Lithuania, Estonia, the Czech Republic and Slovenia should be concluded by the end of 2002 if the “present rate of progress” continued.

It also underlined the likelihood that the Treaty of Accession with those countries could be signed in spring 2003. The target at that time was to gain the participation of these countries as full members in the election for the European Parliament in 2004 (EU, Presidency Conclusions, 2002).

Concluding this at the European Council meeting in October 2002 in Brussels, following the Irish referendum, where the Irish voted in favour of the Nice Treaty after rejecting it the first time, the council confirmed the accession timetable. Negotiations with the applicant countries listed above were finally concluded at the Copenhagen Council in December 2002, and the Accession Treaties were signed in Athens on April 16, 2003. The Council also determined the budgetary and financial issues from 2004 onward, including the level of payments for the structural and cohesion funds (EU, Press Releases, October 2002).

In principle it could be said that at the beginning of the twenty first century these countries fulfilled the political criteria of accession, however the European Council in Brussels still underlined its hope that from the beginning of 2004 the applicant countries would be able to “fulfill the economic criteria and to assume the obligations of membership” (EU, Press Release, 2002).

2.5 The challenge of East Enlargement

The enlargement of the EU eastward has profound and far reaching implications not only for the applicant countries but also for policies and decision-making processes within the European Union. Never before have so many countries applied for membership of the EU and never before has the Union had to face an enlargement in such dimensions. The current enlargement will increase the Union’s population from 370 up to 450 million.

Historically, the previous enlargements saw the accession of two to three countries which already had economic ties to each other as well as to the EU. This time, the social changes and dimensions involved within the process are different and more difficult than previous enlargements, simply due to the fact that simultaneous political and economic transition has posed the former communist and centrally ruled countries much greater challenges.

For instance, Maresceau (1999) argues that the combined GDP of the ten potential new members is less than 4% of that of the Union. Moreover, the average national income per head in 1997 has only 30% of the EU average. Preston (1997) calculates that Greece, the poorest EU member state, receives 4 to 6 percent of GDP from EU structural funds. Taking two of the accession applicants into account this amount would rise in the case of the Czech Republic to 13 percent of GDP and 34 percent in the case of Romania and Bulgaria. Long (1997, p.8) goes one step further and defines:

"Unfortunately for the EU, unlike the previous enlargements, there is little prospect that the next enlargement will rise the average GNP of the EU. Generally, the applicants are poor to very poor, and can thus be expected to be in various ways a drain on the EU budget…"

On the other hand there are those who point out another development in this context. Here, for example, a study of the Commission in 2001 has shown that the level of GDP for the current members could increase by 0.7 percentage points on a cumulative basis and, in the case of the applicant countries, the growth of GDP annually would be between 1.3 and 2.1 percentage point (EU, 2002a). Here, one should also take into account the tendency within the EU's language to underline the positive aspects of enlargement. The Commission, for instance, points out the following aspects of enlargement (EU, 2002a):

- Peace, stability and prosperity within Europe
- Economic growth and job creation possibilities
- Increased quality of life for all citizens across the European Continent
- Increased cultural diversity including the interchange of ideas
- Strengthening of the Union's role within world policy

At the same time the Commission draws the following costs of an eventual non-enlargement:

- Lower economic growth within the CEECs and the expropriation of economic gains for the current members
- Not joining the EU would weaken the incentives for economic reforms in CEECs
- It would undermine the democratization process within the CEE countries and increase political instability

- The EU would have massive problems to tackle the issue of crime, illegal immigration and terrorism
- Euroscepticism would increase within the current member states

However, Wittenberg (2000, p.6) highlights concerns about the eastern enlargement of the EU in the following three categories:

1. *"Budgetary (redistributive concerns)*
2. *Institutional (reformist concerns)*
3. *National (introspective concerns, including security concerns)"*

Laffan (1997) argues that one of the major problems will be the impact on the Common Agricultural Policy (CAP) as well as structural funds policy, as the budgetary costs could be enormous. For example, the Commission estimates for the Structural Funds for this region an annual amount of 25.5 billion euros for 2004, 2005 and 2006 (EU, 2002a).
The impact on the budget could be disastrous where a country is large demographically as well as poor in comparison to the EU countries. For instance, Poland has a large agricultural sector and as Dinan (1999) highlights, the production in this sector is fragmented and is driven by a high number of smallholdings, which are an essential part of the social and economic structure of Poland.
The CAP will be a problem, simply because in the case of an enlargement it is estimated that the agriculture sector will devour 50% of the EU budget. EU funds such as Structural Funds and Economic and Social Cohesion will be the sources of assistance for this sector (Long, 1997).
Therefore, the Common Agricultural Policy and the Structural Funds have to undergo major changes. Furthermore, Preston (1997) perceives two other problems in this context. The two biggest payers for the budget, namely Germany and Great Britain, will be unwilling to spend more money for those funds, particularly in the case of Germany. During the first three EU enlargements Germany was willing to contribute to this budget but since German unification "this willingness has declined markedly". The present beneficiaries of these funds, Greece, Spain and Portugal probably won't allow a shift away from these aid programmes to the poorer regions of the CEE Countries.

These countries also fear the competition their industries will face in certain sectors. In the case of Spain it is the Spanish steel industry which will have to compete with low-quality steel from the CEEC. In the case of Portugal it is the textile and clothing industry which will be affected by an eastern enlargement. This sector accounts for 36.6% of total manufacturing employment and 30% of total exports. Taking these figures into account, one could understand Portugal's interest in protecting this sector against competition from CEEC producers. Beach (1997) therefore, argues that some member states will take a protectionist stand during the accession negotiations.

However, as the enlargement process has shown, particularly the negotiations in Cannes 1995, when compensation was given to the Mediterranean countries, including the implementation of a new Mediterranean policy, the reservations of these countries against the new expansion to the east was diminished. As a matter of fact, enlargement was not the subject of discussion anymore, it was taken for granted (Torreblanca, 2001).

Another important challenge in the context of eastern enlargement is the impact that the increased political, social and economic diversity will have on the EU institutions (the higher the number of members within the club the greater is the diversity among them!). Redmond (1994) argues that decision making will become more difficult; Long (1997) suggests that "consensus finding" and "new voting blocs and blocking minorities" will become significant problems.

Institutional reforms have become "a kind of precondition for the accession". At the Amsterdam Summit the achievement of collective agreements was discussed at length, since smaller countries joining the EU would harm the decision-making structure (Edwards, 1998). Especially here the Belgian, French and Italian government argued that the process of enlargement should also deal with institutional issues (Sedelmeier, Wallace, 2000).

Also important in the diversity context is the issue of the environment. Long (1997) underlines the fact that the new potential members will have enormous difficulties complying with EU rules affecting the protection of the environment, especially the implementation of EU standards will be difficult for the applicant countries to achieve in the short term.

Some environmentalists consider that the accession of the eastern European countries will reduce the EU's commitment to environmental protection and will have a potentially negative impact on environmental policy (Perkowsk, 1998).

Environmental issues could become less important during the accession negotiations in comparison to political and economic considerations.

CEECs could become full members without the adoption of the acquis regarding environmental measures. In this case the new members would have production-cost advantages, since the older member states are forced by EU law to implement more stringent and costly regulations (Wittenberg, 2000).

Concluding these thoughts, the widening of the European Union means for the CEECs a further penetration of their societies by Western European ideas and economic interests. An enlarged Union of up to twenty-five members or more will be based on very difficult principles of integration and multilateral cooperation (White, Batt, Lewis, 1998).

For instance, the Commission has already declared that enlargement will extend, "(western) European governance and standards throughout the continent". The Commission views these future developments in a positive way and determines the areas as follows (EU, Press Releases, 2002, p.2):

1. **"better administration**
2. **improved judicial systems**
3. **better protection of minorities**
4. **more effective crime prevention, especially cross-border crime**
5. **better control over illegal migration**
6. **enhanced monitoring of products, and in particular food safety**
7. **stricter environmental standards and controls"**

Taking these developments into account one could say from a NIE perspective, the CEECs are doing well in preparing themselves for the accession, particularly if they want to join the EU, they have to accept the "Acquis Communautaire". By fulfilling these criteria applicant countries implement the rights and obligations attached to the EU system. Especially the regulatory dimensions, such as formal rules, are of particular importance in the context of pre-accession preparation. On the one hand these processes of information gathering and the introduction of new rules (before the accession of new members) are seen as transaction costs. On the other hand NIE emphasizes that these costs emerge only once and are substituted through the advantages of the removal of trade barriers as well as increased policy-transparency based on the fact that for future policy transactions the information costs will be less than in the case of non accession. Also important are normative dimensions of the EU, such as the protection of minorities which are also subject to consideration by the applicant countries.

Finally, the EU also has to deal with the timing and sequencing of eastern enlargement. Long (1997) underlines the fact that: “there will be a need to tell some applicants that it is not their turn yet”. This was the case with two applicant countries, namely Bulgaria and Romania, who were told in 2002 that not only their economies but also their political and administrative systems are not ready for accession in 2004. These two countries are now waiting for accession in 2007.

Here, the question remains whether the EU’s generosity would create problems later on. As Hughes (1998) highlights, the “needs in transition” and the “detailed requirements of EU membership” are two different subjects. Certainly a successful enlargement of the European Union offers new trading opportunities for all countries from east to west and north to south.

It is without doubt that in the case of further opening of the CEEC markets the new democracies within Eastern Europe will be more integrated into the political and economic structures of Western Europe.

The “New Europe” shaped by the EU will have an enhanced role as a global actor in the economic, technological and political policy areas, including its leadership position in the new European Continent (Mannin, 1999).

Nevertheless, some issues still remain highly questionable. For instance, the Commission’s desire that higher environmental standards of the European Union, after being implemented in Eastern and Central European Countries, will help to reduce cross-border and global pollution. At the present it is highly debatable if the CEECs will be able to implement EU environmental laws, since it will be too costly for them.

Furthermore, only in the case of the Polish accession will the impacts of the CAP be more than cumbersome.

In conclusion, one could say that it is the Commission’s duty to make sure that enlargement is not over-costly for the current members. The timing and sequencing of the enlargement is an important factor.

The EU’s generosity by the choice of countries could impede the development of the European Union in the future if the applicant countries become members (of the club!), without really being ready for the competitive pressures within the EU. Evidence of this could be the attachment of new conditions by the Polish government during the Copenhagen European Council in December 2002. The Polish government expressed its wish to get both higher quotas for its agricultural products as well as a significantly higher amount of funds from the CAP budget as agreed during the pre-accession negotiations.

Notes

1 e.g. Poland, Czechoslovakia, Hungary, in general the western Slavs!

2 The term ‘Slav’ grew out of these developments.

3 e.g. Greece, Bulgaria, Romania, Serbia, Albania, parts of the former Yugoslavia, Hungary and Bohemia.

4 Harmanci (2001, pp.12) highlights especially this characteristic of nationalism in the context of the identity formation. As he describes:

“Nationalism appeared as a descriptive term for people and uses characteristics that not only define, but exclude. Factors such as language, ethnicity, religion, a mythical history and historic homelands are powerful forces in promoting nationalistic feeling. (…) Nationalistic appeals for dubious action are justified on the grounds that the “people”, who are sovereign, absolve individuals of any guilt. In context according to Islam, God is the only sovereign existence and is the only guide that people had to follow. After the war of independence Ataturk declared, ‘sovereignty belongs to people not to God nor to any imperial (human) dynasty’ having said that Ataturk rejected the Islamic republic and introduced the very first feeling of nationalism (…)”

5 *”Internationalization is a process initiated and managed by public authorities. It opens up national political economies to transactions abroad. The defining criterion is that it is state-managed, at least de jure.*
Transnationalization results in the same outcome - an opening up of economic transactions. But private, non-state agents initiate and manage this process. It transcends national boundaries as a flow not of diplomatic exchanges, but of spontaneous individual or group behavior” (Hveem, 1999, pp.72-73)

6 As Hveem (1999, pp.72) defines in this context one should also bear in mind that regionalism could be a driving force for regionalization:

“Regionalism is the body of ideas promoting an identified geographical or social space as the regional project. Or it is the presence or the consciousness of an identity that represents one specific region. It is usually associated with a policy programme, strategy and it normally leads to institution-building”.
But regionalization can emerge without any influences forced by a regional project!

7 Garton Ash, T. (1994), “Germany’s choice”, Foreign Affairs 73(4), pp.65-81

8 As North (1996) determines the term organization stays for political bodies such as political parties, economic bodies such as companies and last but not least social and educational bodies such as churches, clubs and schools!

9. Tacit knowledge is acquired by practice and in contrast to communicable knowledge it is only partially communicated (North, 1996).

Chapter 3 From the Copenhagen Summit 1993 to 2002

"… The benefits of integration are numerous, interconnected and multifaceted. European integration opens up market opportunities contributing to wealth creation of a business-friendly environment in which companies can grow and prosper." (UNICE, 1999, p.1)

As illustrated in the last chapter, the current enlargement presents itself not only as a challenge for the EU; it could also have far-reaching consequences since the current eastward enlargement is different from the previous one.

The candidate countries had to implement both a "western style" democracy as well as free market economies. The EU is more involved in the integration process in comparison to the previous enlargements. Furthermore, the EU has set up more general criteria than are necessary for a successful accession unlike the previous enlargements (Hughes, 1998). In particular the Copenhagen Criteria of 1993 play a key role in the context of the EU eastern enlargement. The targets of these criteria will be highlighted in the following section.

3.1 The Copenhagen Criteria and the sociological approach

At the beginning of 1993, it was clear that the EAs signed with the Central and Eastern European Countries were not enough to support their transformation to democracy and a free market economy within this region. As Sedelmeier and Wallace (2000) underline, not only "the scale and difficulties of the transformation process became more obvious", but also the dissatisfaction of the population regarding the reform process and the decline of support of the citizens was alarming.

The frustration of the CEECs, especially the Visegrad group, ended with the Declaration of April 1993 when countries (Czech Republic, Slovakia, Hungary and Poland) expressed their wish to become full members of the European Union (Preston, 1997).

Particularly the gap between EU rhetoric and substance was a subject of complaint. Therefore, a policy shift among the member states started in favour of full membership of these countries in the medium-term.

In Germany it was Chancellor Kohl who supported the efforts made by the Commission in order to push forward the integration process of the CEECs. These efforts were also supported by the Spanish Prime Minister, Felipe Gonzales, and by Beniamino Andreatta, the Italian Foreign Minister (Sedelmeier, Wallace, 2000).

One could say that on one hand the positive support by the Commission and on the other hand the fear of potential instability within Europe threatened the democracy process. In particular, the political instability in countries such as Poland and Slovakia and the developments in the Balkans, especially Bosnia, put the European governments under pressure to rethink their relationship with the CEECs and to move it to "the top of the EU agenda" at the European Council meeting in June 1993 (Mannin, 1999).

European security order was now a key factor. The "spillover effects of political instability" within this region had to be prevented (Friis, Murphy, 1999).

Taking these events into account the movement by the EU at the Copenhagen European Council in favour of the accession strategy and the expansion to the east could be examined within a sociological institutionalist approach. The promise of the EU during the democratization process of Central and Eastern Europe from 1989 is the crucial element within the process. The EU announced an eventual membership if these countries could cope with the democratic challenges they have been faced with since regaining their independence.

The promotion and adoption of EU norms and values and its democracy based on a liberal economy would push them to a favourable position of accession. However, the alarming developments within a number of Central and Eastern European Countries as mentioned above put the EU under huge pressure.

Hence, the decision made by the EU at the Copenhagen Council to start accession negotiations with those countries can be understood as a response to these developments. The notion of "Promise-Keeping" builds the crucial factor in this context. The EU had to keep its promise which was essential to the identity of the European Union as an important global player.

3.2 The Copenhagen European Council 1993 and NIE

"…the associated countries of Central and Eastern Europe that so desires shall become members of the Union. Accession will take place as soon as an associated country is able to assume the obligations of membership…" (Council of Ministers, Copenhagen European Council, 1993)

The European Union member states agreed on the eventual membership of the CEECs as a goal and agreed at their summit in Copenhagen to improve market accession including additional obligations to the EU.

The Copenhagen Criteria, which had to be achieved by the applicant countries, were defined as followed (Council of Ministers, Copenhagen European Council, 1993):

1. **“stability of institutions, guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities**
2. **a functioning market economy**
3. **the capacity to cope with competitive pressure and market forces within the Union**
4. **capacity to take on membership obligations (the acquis), including the adherence to the aims of EMU and political union”**

These criteria were set up in order to support the CEECs during the reform process as well as preparing them for membership. Therefore, the fulfillment of these criteria is essential if a country wants to join the Union. From these criteria economic readiness, the ability of the candidate states to implement the acquis successfully and the existence of a functioning market economy are of special importance.

Following the Copenhagen European Council meeting the EU launched a more rapid opening of its markets and reduced its tariffs on CEECs products from 4% to 2%, with the exception of steel, textile and agriculture products, by 1995 (Mannin, 1999). Important to note here is the decision of the Union within the terms of the Phare budget to underline the development of infrastructure as a Phare target. Hence, it was estimated that up to 5 percent of the Phare budget was available for infrastructure projects (yenicag, 2003). The removal of taxes and tariffs and the reduction of legal and technical trading barriers were forced through in order to improve trade liberalization among the CEECs and the EU. The targets of the EU’s strategy regarding the removal of trade barriers could be determined as:

1. **The establishment of market economies within the CEE Countries by boosting the internal transition process**
2. **The liberalization of trade among CEECs and the EU, with the inclusion of their membership as the final objective**
3. **The growth of GDP (Danish Trade Council, 2002)**

In other words, within the economy of the applicant countries prices should be liberalized and supported by a legal system guaranteeing property rights as well as the compliance of contracts. Barriers within the market should be removed so that market entry and exit is safeguarded by an "equilibrium" between demand as well as supply. Furthermore, the macroeconomic stability should be ensured and supported by an independent central bank coordinating policies regarding the stability and growth of the economy. By doing so the applicant countries should be able to establish a developed financial sector that is capable of dealing with competitive pressures within national markets as well as in European markets once they have joined the European Union (yenicag, 2003).

In conclusion, one could say that based on a better allocation of resources through the removal of trade barriers, welfare gains and economic growth within the future member states is very likely. Improved capital efficiency, intensified competition and efficient production are other advantages that could arise for both the applicant countries and for the European Union itself (Danish Trade Council, 2002).

A further target of the Copenhagen criteria was the support and assistance of the CEECs in terms of human rights and minority protection. The respect of fundamental human rights and freedom is a prerequisite of membership. Therefore, a number of laws governing these issues were attached to the Copenhagen criteria. The applicant countries are expected not only to sign for their commitment to democratic principles, but also to implement them into their daily life (yenicag, 2003). For instance, during the 1990s, the Slovakian government was criticized by the European Commission. The Commission expressed its concerns about the treatment of the Hungarian minority by the Slovak government. Moreover, within the Baltics, the Estonian and Latvian governments have been admonished by the commission regarding the naturalization process of non-citizens. The developments have been seen as too slow, especially the situation of the Russian speaking minority was not satisfactory (Hughes, 1998).

Finally, at the Copenhagen Summit (1993), the structural relationship of the CEECs with the institutions of the European Union was the subject of consideration.

The council suggested that the associated countries should enter into a structural relationship with the EU institutions in the context of a reinforced and extended multilateral dialogue and with a focus on matters of common interest.

Sedelmeier and Wallace (2000) define this policy shift as:

1. **Political dialogue: shift from a bilateral to a multilateral framework**
2. **Extension to other EU policy areas (multilateral meetings at ministerial level and heads of state government), mainly in the common policy areas of energy, environment, transport, science-technology and Justice and Home Affairs (JHA)**
3. **Common foreign and security policy**

Taking these developments into account the NIE and especially the "Transaction Cost Theory" define the transaction between two parties as a bilateral relation. The enforcement and monitoring of agreements in this context is costly for both parties since the information sources are incomplete. However, the contractual partner could reduce these costs when such institutions necessary to handle the uncertainty are established. The decision made at the Copenhagen European Council 1993 to create a better structural relationship between the CEE Countries and the institutions of the European Union could be seen in this context as an attempt to reduce future transaction costs. As mentioned previously, the CEE Countries have to implement the "acquis communautaire", the so-called EU norms and rules, as a pre-condition in order to successfully join the Union. This means that not only the implementation of those rules into legislation and administrative structure and the judicial system should be the target, but also their adaptation in daily life is of significant importance (yenicag, 2003). An example referring to the importance of these formal rules is Slovakia. In the mid 1990s, Slovakia seemed to have big problems establishing a stable institutional system that guaranteed the rule of law and democracy. Therefore, in its opinion on the readiness of the applicant countries in agenda 2000 (July 1997), the Commission addressed its concerns about the developments in Slovakia and forced the government to respond more rapidly to those negative tendencies. In Agenda 2000 the Commission therefore expressed its concerns:

"…the rule of law and democracy are not yet sufficiently deeply rooted… A democracy can not be considered stable if the respective rights and obligations of institutions such as the presidency, the constitutional court or the central referendum commission can be put into questions by the government itself and if the legitimate role of the opposition in parliamentary committees is not accepted." (Agenda 2000, 1997a)

Thus, one can say that the establishment of democratic institutions based on EU formal rules is seen as essential within the context of New Institutional Economies. Nevertheless, as Hughes (1998) underlines, at the end of the 1990s democratic institutions were in place in all CEE Countries. Formal rules and institutional procedures such as fair elections and the separation of power had been adopted and implemented successfully into the political systems of the applicant countries.

3.3 The Copenhagen European Council 2002

"… we finished with the right balance between the wishes of the candidate countries and what the present Member States considered feasible, … the conclusions from Copenhagen also concern the question of the participation of the new Member States in the institutions of the EU…" (Anders Rasmussen, Danish Prime Minister, 2002)

At the Copenhagen European Council in December 2002 the accession negotiations with the candidate states, namely Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia, were completed.

It was agreed that the enlargement treaties would be signed on 16 April 2003 in Athens and on 1 May 2004 the ten countries would accede to full membership. At that point the treaties were subject to approval by the member states parliaments as well as the applicant states (including referendums on the enlargement issue within the applicant countries).

In addition, agreements on the budgetary and financial issues of the enlargement were achieved. The determination of expenditure requirements such as agriculture, structural operations, internal policies and administration for the years 2004 until 2006 were determined as shown in the following table:

Table 7: ***Maximum enlargement - related costs for 10 new member states (Million Euros 1999 prices)***

	2004	**2005**	**2006**
Heading 1 Agriculture, of which:	1.897	3.747	4.147
1a – Common Agricultural Policy	327	2.032	2.322
1b – Rural development	1.570	1.715	1.825
Heading 2 Structural actions after capping, of which:	6.095	6.940	8.812
Structural fund	3.478	4.788	5.990
Cohesion Fund	2.617	2.152	2.822
Heading 3 Internal Policies and additional transitional expenditure, of which:	1.421	1.376	1.351
Existing policies	882	917	952
Transitional Nuclear safety measures	125	125	125
Transitional Institution building measures	200	120	60
Transitional Schengen measures	286	286	286
Heading 5 Administration	503	558	612

Source: Presidency Conclusions, Copenhagen 2002

Furthermore, two eastern European Countries, Bulgaria and Romania, have been told, that they will have to wait until 2007 for their entry to the European Union. The EU acknowledged the achievements in their progress towards meeting EU membership conditions, but further reforms were necessary in order to put these two countries in a position of accession. Therefore, the Council agreed to increase financial support for these countries.

Turkey was told that the country had taken big steps forward in fulfilling the political Copenhagen Criteria but it still did not fulfill all criteria. The Commission was asked to present a draft concerning Turkey's progress by the end of 2004 (Danish Presidency, 2002).

In conclusion, it is important to highlight the decision made by the EU at the end of 2002 to complete the accession negotiations with the ten applicant countries from an institutionalist point of view.

As it had been noted previously, the implementation of EU formal rules laid down in the "acquis communautaire", as well as the adoption and development of informal rules within daily life, are crucial factors for the applicant countries.

Sociological institutionalism emphasises more the process of social learning, which emanate from participation in practices. Here, the ways in which actors follow patterns, which have become established in various ways, are the focus of this approach. Therefore, the process of EU enlargement could be seen in this light. The enlargement process started more as interest-based negotiations but in the end it was a normative outcome, highly based on common EU norms, ideas and traditions.

It could be said that the EU has a long history in the protection and promotion of human rights and democracy and has supported the CEECs from the beginning of their independence as well as during the transition process. At the Copenhagen Council meeting in December 2002, the EU underlined the fact that the candidate countries have achieved stability of institutions guaranteeing democracy, the rule of law and human rights. Therefore, the EU had to keep its "promise" of accession and concluded the accession negotiations during the Council meeting in Copenhagen including the alignment of the accession timetable for the subscription of the accession treaties in the year 2004.

In 2002 almost all of the candidate states could fulfill the political criteria of accession. For instance in the case of the Czech Republic the Commission determines (Regular Report 2001, p.18):

" Since that time (1997), the country has made considerable progress in further consideration and deepening the stability of its institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities… The Czech Republic continues to fulfill the Copenhagen political criteria."

Furthermore, the Commission characterizes the Czech economy as a "functioning market economy" in each of its so-called "Regular Reports" from 1997 until 2003.

However, the Commission underlines (e.g. Regular Report 2002) the Czech Republic's need to progress further towards medium-term fiscal consolidation in order to be able to cope with the competitive pressures within the EU and to fight corruption as well as economic crime, since progress towards these problem areas has been regarded as "insufficient" (e.g. Regular Report 2001). Therefore, the candidate states economic readiness remains highly questionable.

As it has been underlined in the theory chapter especially in the context of the two approaches NIE and sociological institutionalism, which deliver the theoretical basis for this research, not only the common norms and rules, but also the European identity play a significant role in the context of the EU enlargement. In Sjursen's words (2002, p.508):

"It is Identity that drives enlargement towards eastern Europe and motivates the EU to accept its costs. It shows that the decision on enlargements is the result of an understanding of who the Europeans are and what it means to be European."

The identity part of the thesis tried to give an overview of the European identity formation. Despite its paradoxes and dilemmas, it could be said that for the European Union the CEE countries are part of the common European identity and therefore Europeans. After been separated from the rest of Europe for 40 years, they are now adhering to the common norms and values.

Since Central and Eastern European countries are seen as Europeans, two other aspects are of importance. Firstly, are they democracies and secondly if yes, have they established a free market economy based on EU norms?

3.4 The norm setting role of the Commission after 1989

"(we) cannot truly call ourselves a European Union if we restrict our membership to the countries of western Europe… There is a moral obligation…of saying that if the European idea is a legitimate and genuine one, then it must be available to all the democracies of Europe who meet the relevant criteria and aspire to share in the growth of the European Union." (Rifkind, 1996, the Economist, p.13)

As demonstrated within the first two chapters, the EU's move to enlarge towards eastern Europe is driven by a number of different factors. From the beginning the European integration process was created not only in order to protect the market economy and the liberal democracies within Europe, but also in order to overcome its political division. As Smith (1996) outlines, there exist four different types of boundaries which play an important role within the enlargement process, namely the geopolitical, institutional/legal, transactional and cultural aspects of enlargement. Especially in the context of this work the institutional and legal boundaries play a significant role.

The EU within world policies is recognized as both a community based on democratic norms and as a promoter of democracy and liberal ideas. Since its formation, the European integration process has been based on a complex institutional framework, procedures and norms which affect the enhancement of this unique project.

The enlargement process has always been seen as significant in terms of the political, moral and historical importance in overcoming differences in Europe. Enlargement will bring more stability to the CEE countries as well as to the European Union itself. The European Commission has underlined the perspectives of peace, prosperity, democracy and the rule of law. These aspects of enlargement are defined as being the main and crucial advantages of the European integration process.

Moreover, enlargement is expected to raise the profile of the European Union as an international economic player. As Long (1997) recognizes, the applicant countries are aware of the EU member states' commitment to democracy, free market economy, the rule of law and European norms. Therefore, one of the crucial elements of European identity is the openness of the EU to enlargement.

The CEECs have historically viewed the EU as a promoter of democracy and an honest broker. Once more, as sociological institutionalism emphasizes, the notion of promise–keeping is extremely important since the EU's ability to act is dependent on the recognition of others. Thus, from the very beginning of the enlargement process to CEECs the EU defined a set of criteria related to the democratic norms and free market economy rules. These so-called "acquis communautaire" represent the norms and values within the liberal (economic) democracy of the EU member states. The development and implementation of these norms and rules across the CEECs increases their chance of accession and is, in effect, the crucial element by which their readiness will be judged.

Since the European commission was seen as a guardian of the treaties, it had to monitor and support the process of successfully socialized CEE countries.

Therefore, it is significant to define the policy, as well as policy instruments used by the EU and its commissions, in order to support the CEEC in their efforts during the first years of transition establishing EU norms and rules regarding democracy and free market economy. The following questions will be investigated:

Which instruments were used by the EU Commission in order to support these efforts and what was their aim?

Furthermore, the EU in its enlargement strategy has determined that by the time of accession, the criteria set up in Copenhagen, the so-called "Copenhagen Criteria", have to be met by the applicant countries. In particular, the adoption and implementation of the acquis relating to the single market are seen as being the crucial elements since the CEECs' markets have to withstand competitive pressures within the EU markets. In addition, the existence of a functioning market economy would add to the further development of business activities and raise economic standards. In this context, in the Copenhagen as well as the Madrid European Council decisive steps were undertaken by the EU in order to set up the basic obligations for the applicant countries to develop EU norms, values and codes of conduct.

3.4.1 The Copenhagen and Madrid European Council and their normative impacts

The forthcoming eastern enlargement presents itself as a greater challenge for the European Union compared to earlier enlargements.

As previously demonstrated, the EU is more involved with the current enlargement process. This is due to different factors. One of these is that the countries of Central and Eastern Europe did not have functioning market economies, unlike the previous enlargements. Thus, the EU had to create specific criteria and conditions including more financial aid programmes in order to prepare these countries for accession.

The first significant steps on the part of the EU were undertaken during the Copenhagen European Council in June 1993. As it has been shown previously, it was obvious that the EU had to move its "institutional and legal boundary" towards eastern Europe in order to support the security and stabilization process within the CEEC countries. By doing so the EU hoped to combat the possible "political instability spillovers" which could take place close to its borders (such as the conflict within the former Yugoslavian Republic) (Friis, Murphy, 1999).

In Copenhagen the EU stated that it would be possible for Central and Eastern European countries to be members if they were able to establish the political and economic criteria defined by the European Commission. Among these the stability of institutions, a functioning market economy and the ability to withstand competitive pressure within EU markets are seen as the most crucial obligations.

The Madrid European Council in December 1995 emphasizes the strategy of CEEC integration, the strengthening of their administrative and judicial structures by transposing Community legislation into national law. As the EU (2001a) underlines: "This is a prerequisite of the mutual trust required by the EU membership", and as it has been defined within the context of NIE, "trust" is seen as a prerequisite for contracts. Here, the confidence between the actors could result in future co-operation only if the actors believe that the costs as well as the benefits are uniformly distributed (Topan, 2001). Therefore, in order to make the CEECs fit for accession, three main areas were identified as the focus of the EU's attention (Regular Report, 1997):

(1) the development of the market economy

(2) the adjustment of their administrative structure

(3) the creation of stable economic and monetary environment

The Madrid European Council determined that negotiations should begin six months after the IGC summit had taken place. At the same time the European Commission was called on to draw up a draft which comprised a detailed analysis of the applicant countries' political and economic situation as well as an analysis regarding the consequences for the EU. It could be said that the Madrid European Council strengthened the normative aspects of the EU and undertook another important step by incorporating the Schengen Treaty into the acquis (Friis, Murphy, 1999).

From a sociological point of view, the Madrid European Council marked an important movement on the part of the EU. By offering full membership to the CEECs the EU was forced to deliver on its promise.

3.4.2 The role of the European Commission

As Sedelmeier and Wallace (2000) highlight, the European Commission through its "activism and leadership" played a crucial role within the enlargement process. The Commission from the very beginning not only coordinated the EU's policy towards the CEE Countries, but also took an important role in helping the new democracies of Central and Eastern Europe to successfully establish EU style democratic norms and policy models. Through the TCAs the Commission could further develop relations between the CEECs and the European Union. A more technical economic support was provided through the Phare programme.

The Phare programme as well as other programmes set up by the European Commission in order to support the CEECs' efforts in establishing a free market economy will be discussed in the next section.

However, in order to feature the political and economic issues which had to be taken into account by the applicant countries, the assistance provided by the Commission also included standards analysis and descriptions of each country's actual economic situation. The ability of the candidate countries to take on the acquis and its complex requirements received significant attention here. The Commission saw the main challenge in ensuring the compatibility of the CEECs' political and economic framework with those supernational norms of the EU (Newton, Walsh, 1999).

Therefore, the Commission addressed the CEECs' institutional structures very carefully and determined how near the applicant countries were to meeting EU standards and policy norms. It also provided assessments of the implementation of the necessary administrative structure in different areas and identified those areas which needed EU funds in order to create the adequate institutional framework (Hughes, 1998).

Due to the commitment of the Madrid European Council the Commission prepared its opinion on the applicant countries' readiness in a comprehensive framework, called "Agenda 2000".

Agenda 2000 was presented in July 1997 and determined both the impact of enlargement on EU policies as well as its opinion about each candidate countries' readiness for accession negotiations. The Commission suggested that negotiations should begin with the Czech Republic, Estonia, Hungary, Poland, Slovenia and Cyprus because these applicant countries were regarded as being the most successful in establishing democracies and free market economic conditions compatible with EU standards. It was not until the release of this opinion that the EU began to be more specific about the enlargement timetable. Here, it was once again the Commission which pushed forward a more enhanced enlargement policy by setting up a 5 year medium-term target for accession. By defining these parameters the Commission represented itself as the "centre of the enlargement debate" (Sedelmeier, Wallace, 2000).

3.4.3 Commission's instruments

The European Commission as the centre of the enlargement process can resort to three instruments in order to support the applicant countries efforts in establishing the conditions needed for a successful accession. This chapter assesses the nature and the aims of these instruments and emphasizes their importance in establishing the institutional framework. Especially in the context of NIE the existence of adequate institutions is expected to contribute to a generally stronger economic performance.

3.4.3.1 The Phare programme and its institutional setting approach

One of the first action programmes set up by the EU in order to support the developments within the CEECs was the so called Phare programme (Pologne-Hongrie: Assistance à la Restructuration des Économies).

It was firstly created in order to assist Poland and Hungary in their efforts to establish a democratic society and was extended later to other Central and Eastern European countries. A new service in the Directorate-General for External Relations was created in order to determine the operational targets of the programme (Sedelmeier, Wallace, 2000).

The Phare programme is a set of development priorities based on the assessment of 3 information sources. Firstly through the Accession Partnership Programme, this lists each country's weaknesses and defines priority areas to be taken into account. Secondly, through the so called National Programme for the Adoption of the Acquis (NPAA), where detailed plans are given on how the applicant countries prepare themselves in fulfilling the priorities of the Accession Partnership Programme. Thirdly, the National Development Programme as well as the Commission's "Regular Reports" are further sources of information in order to define the priorities of the Phare programme.

The Phare programme focuses basically on two key budget areas. The first budget area regards the acquis related investments, accounting for 70% of the available funds. Here, co-financing of investment in economic and social cohesion, like the member States ERDF (European Regional Development Fund) and ESF (European Social Fund), are provided in order to strengthen the regulatory infrastructure, making it compatible with the acquis (e.g. investments which are needed in order to put the food safety structure in place).

The second priority is given to the area of institutional building which accounts for the remaining 30% of the budget. Here, the funds are allocated in order to create the "structure, strategies, human resources and management skills" and so to strengthen the development of the economy (EU, 2002d).

For instance, in 2001 the Czech Republic received about 65.4 million Euros from the Phare programme to be concentrated on a number of priority areas. Funds were allocated Czech Republic in order to:

1. **strengthen civil society**
2. **apply EU directives in the railway sector**
3. **ensure that the government is capable of implementing the aquis in the areas of agriculture, environment, Internal Market rules and regulations**
4. **strengthen the administrative capacity to implement the acquis**
5. **improve economic and social cohesion (Regular Report, 2001)**

One of the main instruments is the twinning programme, which seeks to assist the adoption of institutions responsible for the enforcement of EU legislation and code of conduct. Here, one should take into account that not only the adoption of these rules is a focusing issue, but also that their effective and efficient implementation is seen as another important element. Thus, the training of civil servants, public officials and professionals such as judges and environmental inspectors, were key factors in establishing adequate institutions.

In order to assist these countries in developing an effective institutional framework, experts from the current member states were sent to the countries of Central and Eastern Europe. This process of twinning could be basically described as follows:

The Commission identifies weaknesses in the administrative structure of the accession countries. These countries are asked to develop a project in order to reform the identified sector. Thereupon, the EU member states are asked to mobilize experts for a certain time frame capable of assisting the applicant countries with these developments (EU, 2002d). In other words, based on a carefully developed work programme, EU experts are sent to candidate countries, normally headed by an official from both countries (applicant and member), in order to support the ongoing processes of (administrative) restructuring.

The twinning programme's focus was mainly in the agriculture, environment, justice, home affairs and regional policy areas. However, some reforms have decentralized and devolved the management of Phare from Brussels to the delegations. It channeled the Phare funds through the so called National Authorizing Officers (NAO) in supporting investments, not only in the above listed areas but also in new areas such as in economic and social cohesion, as well law enforcement measures such as the fight against economic crime.

In this context the Pre-Accession Report in January 2002 (EU, 2002e) emphasizes in the Czech Republic the successful assistance provided by the Phare programme during a number of twinning projects. For instance, the project "Fight Against

Economic Crime" had a duration of 13 months and aimed to assist the law enforcement bodies in the Czech Republic. The Czech authorities, namely the specialized police services for combating economic crimes and the specialized office for combating economic crime and corruption, were accompanied by the Interior and Justice ministries of three member states (Germany, Italy and United Kingdom) in their efforts to combat economic crime.

Furthermore, in Germany, Italy and Great Britain, 70 Czech police specialists and prosecutors participated in 8 study and on-the-job training visits regarding the area of know-how development. In the Czech Republic itself another 300 specialists participated in 12 seminars assisted by Community specialists regarding standards for investigating serious economic crime. Another project was launched on 17 January 2002 together with the UK Home Office, in order to provide training programmes concerning the further development of government policy in terms of fighting organized crime, including practical advice and training support.

3.4.3.2 The ISPA and Sapard

The "Instrument for Structural Policies for Pre-Accession" (ISPA) funds investments in areas of the environment and transport. ISPA aid is available for the years 2000-2006 in order to speed up the development of legislation within these areas. 1080 million Euros has been made available for the necessary implementation.

The environment related part of ISPA mainly concerns drinking water, the treatment of waste water, and air pollution issues. The transport related part of the budget regards the acquis enlightenments and is related to the Transport Infrastructure Needs Assessment (TINA networks). In other words, through different projects supported by these funds, the Trans-European Transport networks will be extended in order to develop good transport connections between EU members and the applicant countries.

Here, suggestions are gathered from everywhere, only their proposal through formal ISPA application is necessary. These suggestions are submitted to the Commission by each National ISPA coordinator and the Commission decides, on the basis of the ISPA Management Committee's opinion (this committee is composed of member states' officials), if the project will be implemented or not.

Another important instrument is the so-called Sapard (Special Accession Programme for Agriculture and Rural Development). The objective of this programme is to back the developments within the agriculture and rural sector, as well as the implementation of the acquis regarding the CAP. This programme includes a number of priority measures. Here are just some examples:

1. **investment in agricultural holdings**
2. **improving the processing and marketing of agricultural and fishery products**
3. **improving the structures for veterinary and plant-health controls**

The budget amounts to 540 million Euros. One significant advantage is the management structure of these projects which is undertaken by agencies operating in the applicant countries. The agencies are not only responsible for selecting and managing the projects, but also for their control and payment procedures. It is hoped that the applicant countries can gain some experience in how to apply and implement Community rules. The procedure is as follows: each country sets up an authority which has to develop a national plan. This plan relates to improvements in different areas (e.g. market efficiency) which have to be achieved during a period of up to 7 years from 2000 onwards.

From October to December 2000 the Commission decided, on the basis of these proposals, the most favourable agricultural strategy to be implemented (EU, 2002d).

The following table shows the amount of funds which the Czech Republic has received from these three pre-accession instruments:

Table 8*: Phare, ISPA and Sapard budgets for the Czech Republic (million euros)*

Country	*Indicative Phare allocation for 2002*	*ISPA Budget Provision for 2000**	*Sapard Annual allocation at 2001 prices*
Czech Republic	103.8	66.9	22.9

* Second tranche of 2000 projects included

Source: Own draft based on EU (2002d)

Chapter 4 Czech History

As stressed in chapter 2 (within the identity section) the history of Central Europe has been a history of diversity. The location of the area between the different European empires is particularly important. This region has been used over centuries as an area in which the European empires played out their conflicts.

As a matter of fact, the nations located here have never existed for a long period of time as independent states. Czech history does not differ very much from the common Central European history.

Therefore, this chapter will represent for the most part the developments within the Czech Lands. The main focus will be on events from 1989 until the present day in order to give a brief insight into the political transition process made by this applicant country.

4.1 The Czech Nation

The settlement of the Czech Lands dates back to the fifth century when the first wave of Slavonic tribes settled in the lands of Bohemia and Moravia. It was not until the end of the ninth century that the first Czech state, under the Przemyslid Family, appeared on the map of Europe (Cesko-online, 2002).

Under the rule of this family the Czech Lands expanded to the whole of Moravia and to Silesia. Also ties to the Holy Roman Empire were strengthened (Mauritz, 2002).

In 1212 Przemysl, Otakar I, received the so-called "Golden Bull of Sicily". This meant that Bohemia was proclaimed as a kingdom underlining the privileges of Czech kings and the fact that the lands of Bohemia were not subject to the Holy Roman Empire (Universität Würzburg, 1996). It was also during this time that German settlers started to colonize the border regions of Bohemia and Moravia. Even though German settlers were part of the local community, sharing the development of the Czech Lands, they kept their native language over the centuries.

The Przemyslid (Premyslid) family extended its power under Otakar II (1253-1278, the King of Gold and Iron) to the Alpine lands of today's Austria by defeating the Hungarian king in two battles (1256 and 1260).

Otakar II was killed in a battle against his rival Rudolf Habsburg, who took power in the Alpine Lands of Austria, establishing there the core of "Habsburg's Power".

Following these events the last male member of the Przemyslid Family, Wenceslas III, died in 1306 without a successor (Mauritz, 2002).

With the election of John of Luxemburg as King of Bohemia (1310) the Luxembourg dynasty came to power. Under his rule the kingdom expanded its borders again, including other territories such as Lusatia. His son, Charles IV (1346-1378), extended Bohemian power and prestige. For instance, the foundation of the first university in Central Europe was one of his achievements. However, after becoming the ruler of the Holy Roman Empire he made Prague into the centre and capital of his kingdom (Hoensch, 1997).

In 1419 Bohemia was faced with the Hussite Revolution (named after the religious reformer and preacher Jan Hus, who formed a movement with the aim of fighting corruption in the Catholic Church and was burned in 1415). This revolution started with the “First Defenestration” of Prague, when a crowd of Hussites threw seven members of the Czech Town Council out of Prague’s New Town Hall windows. Once they had gained power, the Hussites implemented new economic, political and religious reforms. They also defeated five crusader armies sent by the Pope and the newly elected Holy Roman Emperor, King Sigismund of Luxembourg, who wanted to regain power over the Czech Lands. In spite of the fact that they had been militarily successful, the Hussite era lasted only a few decades.

In 1471 Vladislav Jagellon was elected King of Bohemia and after his death in 1526 both crowns, the Bohemian as well as the Hungarian, were “unoccupied”. Ferdinand I of Habsburg, who was also Jagellon’s brother in law, seized power and Bohemia and Slovakia came under the rule of the Habsburgs, but most of Hungary was taken by the Turks in 1526 after the battle of “Mohacs”. It took the Habsburgs more than a century to regain Hungary from the Turks (Hoensch, 1997).

However, the Czech Lands remained within the Habsburg Empire. It was not until the “Second Defenestration” in 1618 when Czech non-Catholic “Estates” threw the vice regent of the Austrian monarch from the tower window at Prague Castle when the Habsburg faced resistance within the Czech Land. This rebellion was the start of the “Thirty Years’ War” in Europe, which caused millions of deaths (Mauritz, 2002). The non-Catholic Estates were defeated in 1620 during the “Battle of the White Mountain”. It was from this point on that the recatholicization of Bohemia began (Universität Würzburg, 1996).

The Habsburgs were defeated in 1859 when they were driven out of Italy, and again in 1866 by Prussia. By excluding Austria, Prussia unified Germany.

Due to these factors and because Francis Joseph (the Austrian emperor) wanted to strengthen his position in Hungary, the Austrian and Hungarian "Dual Monarchy" was launched giving the Hungarians a dominant position in comparison to other nations within the Empire. As a matter of fact, other nationalities such as the Poles or the Czechs were never "permitted to share political power". From now on the Czechs were ruled from Vienna, whereas the Slovaks were under Hungarian control (Lcweb, 2002).

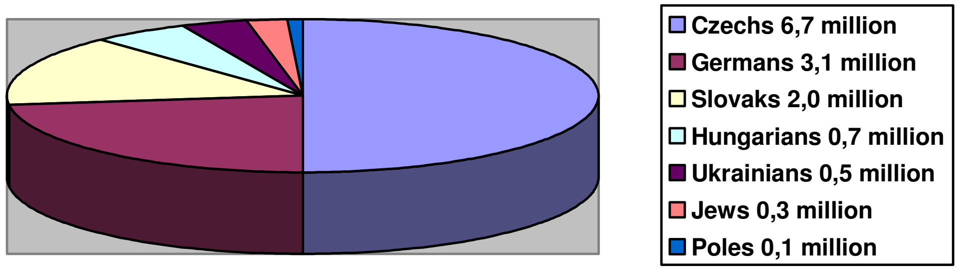
This status remained until the end of World War I. The postwar political developments and the creation of Czechoslovakia are the subjects of the following section.

4.2 Czechoslovakia 1918-1989

After the events of 1918 a National committee was formed. It proclaimed the independence of Czechoslovakia on October 28th 1918. Concluding this proclamation, and based on the Versailles Peace Agreement, Czechoslovakia was defined as a joint state by Czechs and Slovaks which appeared on the political map of Europe. It was made up of Bohemia, Moravia, (small parts of) Silesia, Slovakia and Ruthenia (Hoensch, 1997).

According to Bombik and Samson (1997) the newly created state was not made up of only two ethnic groups. The Czechs represented the majority with fifty percent of the population, the Slovaks counted for fifteen percent of the population. The biggest minority group was the ethnic Germans with 3 million people making up twenty three percent of the population. The following pie chart shows the ethnic groups which existed in 1921 within Czechoslovak borders:

Figure 1: Ethnic groups in Czechoslovakia (1921)



Therefore, the newly created state was too weak from its beginning and too divided among its ethnic groups. The Germans, Hungarians as well as the Polish minority for example, were all in favour of joining their ethnic families in the bordering countries, namely Germany, Hungary and Poland (Leff, 1997).

One should consider further that Czechoslovakia could not only be distinguished from an ethnic, but also from an economic point of view. The Czech Lands were more industrially developed than Slovakia where the agricultural sector was more dominant (Newton, Walsh, 1999).

In Slovakia only 17% of the population was employed within the industrial sector, whereas more than 60% of Slovaks were engaged within the agriculture and forestry sector.

Nevertheless, it could be said that the new state of Czechoslovakia accommodated 70% to 80% of all industry previously located within the Austrian-Hungarian Monarchy (Lcweb, 2002).

During the inter-war period Czechoslovakia was considered one of the world's ten most industrialized and richest countries. Not only its industrial power, but also its democratic system was unique within Eastern Europe. It could be said that Czechoslovakia was one of the few states in Europe with a parliamentary system.

However, one should also bear in mind that after 1918 the right of self-determination was refused to the Sudeten-Germans.

The Sudeten territory was included into the Czechoslovak state without a referendum having taken place. Furthermore, a number of laws discriminating the Sudeten-German rights were passed by the Czechoslovak parliament. For instance, the "rural reforms" took place (after 1918) without any German participation. It distributed

30% of Sudeten territory to non-Sudeten-German owners.

Also, a law regarding the official language obligated the knowledge of the Czech language as a prerequisite in order to be a public official. As a result, ten thousand German government officials lost their jobs (Habel, Kistler,1993).

Even though from 1926 German politicians like Prof. Spina (Secretary of State for Employment) or Prof. Mayr-Harting (Minister of Justice) were members of the Czech government, the situation did not really change. Many amendments to the existing laws were agreed upon, but their implementation never took place. The dissatisfaction within the Sudeten-Germans grew.

The situation changed in 1933 as Hitler came to power in Germany. As a matter of fact, Czechoslovakia and its German population became a target of Hitler's propaganda (Leff, 1997).

It was due to these events that in October 1938 the German Army occupied the "Sudetenland" with the approval of the British and French governments. Both governments were in favour of an appeasement policy in response to Hitler's aggressive expansionist policies which were once again forcing Europe into a continental war. Hence Czechoslovakia had to hand over the "Sudeten" part of the Czech Lands.

In March 1939 the rest of Czechoslovakia was occupied by the German forces and it was divided into two parts, a Czech Protectorate as a part of the new German Empire (the so called "Third Reich") and in an independent Slovakia which, none the less, was a satellite state dependent on Berlin's will.

During the war the Czech population was used for labour, aiding the German war effort. It is estimated that between 36.000 and 55.000 Czechs were killed in concentration camps. The Jewish population of 118.000 at that time was "virtually annihilated" (Lcweb, 2002).

After World War II Czechoslovakia was restored again and, justified by a collective German guilt, the German population of Czechoslovakia was driven out of the Czech Lands favoured by the Western allies.[1]

Following these events the communists won the first postwar election in 1946 but they could not obtain a majority in the parliament.

However, they managed to gain control over the key ministries such as the Ministry of Interior, thus it could be said that the communists had a strong "grip on power".

In 1948 the communists took advantage of their power and launched with Moscow's support the communist age in Czechoslovakia with the leading role of the communist party (Habel, Kistler, 1993).

As a matter of fact, Czechoslovakia became a satellite state within the Soviet dominated eastern part of Europe.

In 1968 an attempt was made by Alexander Dubcek (the Slovak communist leader) to decentralise the power of the communist party and to democratize the country. Dubcek initiated a number of reforms. The implementation of the federal state and the removal of censorship are examples of these reforms. His objective was the embodiment of "socialism with a human face" (Leff, 1997).

However, the Soviet leadership was alarmed and decided in favour of counteractive measures at a Warsaw Pact conference in order to stop the disconcerting counter-revolutionary movements in Czechoslovakia. The intervention of Warsaw Pact troops on August 20th 1968 reinstalled the old communist regime and overturned the reforms implemented by Dubcek (Newton, Walsh, 1999).[2]

Czechoslovakia remained under Soviet rule until 1989 and the so-called "Velvet Revolution". Its mass protests and demonstrations shaped the new face of Czechoslovakia.

In the context of EU enlargement it should be kept in mind that these historic events had a strong influence on Czech policy formation after the "velvet revolution".

The Czechs saw a moral obligation for the countries of western Europe to support their attempt in gaining access to the NATO and EU. They always underlined the historic debt of western European by referring to the western European countries' policy of sacrificing small countries in order to keep the peace in Europe in 1938.

For the Czechs, the West betrayed Czechoslovakia not only in 1938, they did it also during the Yalta conference in 1945 when it was agreed between the Allies that Czechoslovakia would be liberated by the Soviet army even though American troops had reached the Czech Lands earlier than their Soviet counterparts.

Yet again the Czechs saw themselves betrayed by the West during the "Prague Spring", when the western countries did not undertake any actions to prevent the invasion of Czechoslovakia by Warsaw Pact troops (Smoke, 1996).

Therefore, a refusal of NATO and EU membership would have been seen by the Czechs as another betrayal by the West. The western European countries had a historic obligation to support their accession attempts.

4.3 *From Czechoslovakia to the Czech Republic*

The events of 1989 which took place in eastern Europe put the Czech communists under pressure. Examples of these new political circumstances in the rest of eastern and central Europe include the developments which took place in countries such as Poland where a mixed solidarity-communist government was installed, including a non-communist prime minister and the commitment of the Hungarian leadership to "competitive elections" in September 1989.

In Czechoslovakia the developments were less rapid than in Poland and Hungary. Nevertheless, the so-called "Velvet Revolution" which took place in the Czech Lands and Slovakia, similarly challenged the "power monopoly" of the communist party and put the central government under pressure to implement democracy.

Ultimately, the communist leadership had no choice but to introduce democratic reforms; however they seemed only capable of "ad hoc responses" in the context of the new situation they were faced with. A student demonstration was brutally suppressed on November 17th; this suppression was the beginning of the final crisis in Czechoslovakia when the communist leadership found their "backs against the wall" (Leff, 1997). From this point on, in Prague and the Czech Lands, dissidents from Charter 77, headed by Václav Havel, formed the so-called "Civic Forum". It was this movement which organized the strikes and protests in Prague against the leading rulers of the communist party. Furthermore, a similar organization called "Public Against Violence" did the same in Slovakia (Newton, Walsh, 1989).

The protest reached its height as industrial workers, who had been the last hope of the communist party leadership, joined the protest and participated in the symbolic two-hour general strike at noon on November 27th, the so-called "revolution in the lunch hour".

This development of losing the support of the privileged workers was the last straw for the communist party. Following these events the official media finally withdrew censorship and initiated the collapse of the system.

On November 29, article 4 of the constitution guaranteeing the legal basis for communist party rule was rescinded. A new government with a new twenty-person cabinet was formed, including five non-communist members. However, the number of non-communist government members was not enough for the people on the streets. New demonstrations and a second general strike forced the communist members of the government to resign within days.

Under these circumstances the government had no other choice than to agree to a more representative cabinet until the scheduled election in June 1990 in which President "Husak" resigned and was succeeded by Václav Havel who, as the spokesman for Civic Forum, represented the new political movement in Czechoslovakia (Leff, 1997). The transition to a stable multiparty system in Czechoslovakia was a much slower process in comparison to Poland or Hungary. As Lewis, Lomax and Weightman (1993, p.165) say:

"… the basic features of a potentially durable party system only began to take shape about a year after the collapse of communist rule, and almost six months after elections were held on 8 and 9 June 1990."

The winners of the 1990 elections were clearly the Civic Forum and the Public Against Violence. However, the divergence inside Civic Forum began to grow shortly after the election due to the fact that different political ideas based on different economic programmes were gathered together.

As a consequence the Civic Forum splintered into a number of different parties. In Slovakia developments were similar where Public Against Violence split into various political parties.

Therefore, parties such as the "Civic Democratic Party" (ODS) with its leader, Václav Klaus, in the Czech Lands and the "Movement for a Democratic Slovakia" (HZDS) headed by Vladimir Meciar in Slovakia gained power, shaping the policy process from then on. These two parties obtained power after the 1992 June elections. The ODS built a coalition with the Civic Democratic Alliance (ODA) and the Christian Democratic Union (KDU-CSL) in the Czech Lands. In Slovakia it was the HZDS in cooperation with Slovak National Party which built the government coalition. The leader of the HZDS, Meciar, supporting the separation of Slovakia, successfully mobilized nationalist emotions during these summer elections. It was Meciar who ensured his parliamentary majority by including the separatist Slovak Nationalist Party. The latter had gained 8 percent of the votes within the Slovak part of the republic, and was therefore represented in the Slovak parliament with fifteen seats (Lewis, Lomax, Wightman, 1993; Newton, Walsh, 1999).

As a result of this policy shift, the new leadership in Slovakia began to ask for more independence from the central government which meant a less powerful position within the federal system of the central government in Prague (Kaiser, 1995). The following table shows the development within the political party system of Czechoslovakia and its influence of government coalition building between the years 1990 and 1992:

Table 9*: The Government of Czechoslovakia and the federal states 1990 and 1992*

I. Governments following the 1990 Elections	
Federal Government:	Coalition of Civic Forum, Public Against Violence, Christian Democratic Movement
Prime minister:	Marian Čalfa (PAV, Slovak)
President:	Václav Havel
Finance minister:	Václav Klaus (Civic Forum, Czech)
Foreign minister:	Jiři Dienstbier (Civic Forum, Czech)
Economics minister:	Vladimir Dlouhý (Civic Forum, Czech)
Federal Assembly Chair:	Alexander Dubček (PAV, Slovak)
(Disintegration of Civic Forum early 1991 did not change the composition of the government)	
II. Governments following the 1992 Elections	
Federal Government until January.1993:	Coalition of Civic Democratic Party (Czech), Movement for Democratic Party (Slovak), Christian Democratic Union/ People's Party (Czech)
Prime minister:	Jan Stráský (Civic Democratic Party)
President:	none. Havel resigns after re-election failure without replacement
Czech Government 1992:	Coalition of Civic Democratic Party, Christian Democratic Party, Christian Democratic Union, Christian Democratic Party, Civic Democratic Alliance
Prime minister:	Václav Klaus (Civic democratic Party)
President (1993-2003)	Václav Havel
Slovak Government 1992:	Coalition of Movement for a Democratic Slovakia, at times in cooperation with Slovak National Party
Prime minister:	Vladimir Mečiar (Movement for a Democratic Slovakia)
President (1993-1998)	Michal Kováč

Source: own table based on Leff (1997)

One should bear in mind that a majority of Czechs as well as Slovaks still did not believe that a separation was necessary.

Even though Meciar could mobilize the national sentiments in Slovakia later during the summer; nevertheless at the beginning of 1992 poll after poll showed that a majority of the Czechoslovakian population did not want the division (Boguszakova, Gabel, 1996).

The following two tables show public opinion between 1990 and 1992 of the separation of Czechoslovakia into two independent states:

Table 10*: Public opinion about the split of Czechoslovakia November 1991*

	Czech Republic (n=1209)	*Slovakia (n=1360)*
Strongly agree	5%	10%
Agree somewhat	8%	13%
Neutral	9%	19%
Disagree somewhat	22%	23%
Strongly disagree	56%	35%

Source: Deis 1992

Table 11*: Public opinion about the split of Czechoslovakia summer 1992*

	Czech Republic (n=603)	*Slovakia (n=562)*
Unitary Czechoslovakia	38%	14%
Dual federation	19%	27%
Federation of more than two republics[3]	18%	8%
Confederation	3%	30%
Separation	16%	16%

Source: Pehe, 1992

More importantly, in this context the public believed that this issue would be settled by a referendum especially because it was promised several times by the government.

However, it never took place and by the end of the summer the feeling of public opinion grew, "that there was something inevitable about the split" (Boguszakova, Gabel 1996).

According to Pridham and Vanhanen (1994), on the one hand a majority in Slovakia tend to favour a greater autonomy than was agreed in the constitutional amendments of 1990. On the other hand the Czech population had voted for parties which believed that "anything weaker than a federal system was neither practicable nor desirable".

These two different developments in the Czech Lands as well as in Slovakia with "majorities committed to divergent programmes" initiated the "Velvet Divorce".

Ultimately, Czechoslovakia split into two independent states in January 1993, the Czech Republic and Slovakia (Lewis, Lomax, Weightman, 1993).

In the Czech Republic legislative power is exercised by the parliament's two chambers, namely the Chamber of Deputies and the Senate. The Prime Minister is the head of the government which has to have the support of the majority within the Chamber of Deputies.

In this context from 1992 to 1997 three parties, the Civic Democratic Party (ODS), the Civic Democratic Alliance (ODA) and the Christian Democrat Union (KDU-CSL) governed unchallenged in the Czech Republic. It was not until the elections in 1998 that the Czech Social Democratic Party (CSSD), led by Milos Zeman, gained power (Brusis, Dimitrow, 2001). The table below shows the election results in 1998:

Table 12*: Election outcomes to the chamber of Deputies and the Senate (1998)*

Parties	*Chamber of Deputies*		*Senate*	
	Percentage	**Seats (200)**	**Percentage**	**Seats (81)**
CSSD	32.3	74	-	23
ODS	27.7	63	-	26
KSCM	11.0	24	-	4
KDU-CSL	9.0	20	-	17
US	8.6	19	-	4
ODA	-	-	-	7
SPR-RSC	3.9	-	-	-
DZJ	3.1	-	-	-
DEU	1.4	-	-	-

Source: Podraza (2000)

After these elections the two strongest parties, namely the Social Democrats (CSSD) and the Civic Democratic Party (ODS) signed an agreement which enabled the CSSD to take over the government.

The ODS gave in this agreement two substantial assurances. The party would not “initiate a vote of no confidence” against the minority government as well as their refusal to support such a vote initiated by other parties within the Czech Parliament. The government guaranteed to consult the ODS before important decisions were made (Linek, 2002).

It could be said that the ODS could maintain a key role after this election even though they were not part of the government.

On the 14 and 15 June 2002 the voters in the Czech Republic had to elect a new parliament for a four year mandate. The outcome of the general election was the endorsement of the two governing parties. The Czech Social Democratic Party and the Civic Democratic Party, as described above, had been cooperating with each other since 1998 based on the so-called "support without participation" agreement (euractiv, 2002).

Concluding these thoughts it should be noted that on 13 December 2002 accession negotiations with the Czech Republic were finally completed and the treaty itself was signed on 16 April 2003. In a referendum which was held on the 13 and 14 June 2003, the Czech citizens voted in favour of membership of the EU. Therefore, the Czech Republic will join the European Union on 1 May 2004.

One should recognize that in the Czech Republic not only a multiparty system was established which created a good basis for the continued transition to democracy and a free market economy, but also a new constitution. The new institutions have successfully provided the necessary framework for a stable democracy.

From a sociological institutionalist point of view, formal rules are of special importance. Having established a democracy which guarantees the stability of the political institutions, the rule of law and human rights is an essential part of the context of central European countries' application for membership. The democracy process should be able to fulfill the social standards and formal rules of the EU.

Also from a NIE point of view, formal rules, including political rules, are part of the crucial elements in the context of EU enlargement. Establishing democratic institutions and rules which are compatible with those basic norms and rules of the European Union reduces the transaction costs and makes an accession more reasonable.

As mentioned in the first part of this thesis the aim of the following chapters will be the determination of the Czech Republic's readiness for accession to membership in the European Union.

Notes

1 The so called “Benes Decrees” initiated the nationalization of coal mines, heavy industry, food production, bank and private insurance companies. These Presidential Decrees also included the confiscation of those properties belonging to the Germans (Sudeten Deutsche), at the same time they lost the citizenship of the Czechoslovak state (Radio Prague History, 2002).

2 Also during the mid-1970s, the Czechoslovak dissidents began to regroup themselves. They soon became known as Charter 77, including Christian dissidents, anticommunists as well as ex-communists. They were not only in the favour of a Czechoslovak government adhering to human rights and forcing reforms within Czechoslovakia, the dissidents also shifted their interests in favour of “dreaming about Europe”. From now on, the attempt was undertaken by the Czechoslovak dissidents to shape the country’s history in favour of a common western European identity (Leff, 1997).

A typical example for this policy attempt is Milan Kundera’s assumptions that even though eastern Europe was “kidnapped, displaced and brainwashed” by the Soviets, it was still part of western culture and identity only separated from it through the tragedy of communism (Kundera, 1984).

3 This opinion refers to the proposal to restructure the Czech Republic into Bohemian and Moravian Republics in a tripartite federation with Slovakia. Some favoured an alternative proposal of adding a Prague and Silesian Republic to this Tripartite Federation.

Chapter 5 Economic Transformation

Since the Velvet Revolution of 1989 the economy of the Czech Republic has undergone several and different changes. The aim of this chapter will be the evaluation of those changes and their consequences for the Czech economy as well as Czech citizens.

The focus will be on the norm implementation and their institutional embeddedness. From an institutionalist point of view the level of norm construction and institutional adoption are the key issues in the context of economic restructure, thus one could say that CEEC's have an incentive for norm-implementation.

The question is if the legal system and the regulatory reforms are in line with EU norms. Therefore, their acceptance, institutional adoption and the stage of their diffusion and construction within the Czech economy will be the subject of analysis.

For instance, since norms and institutional rules play a significant role in influencing economic actors and in shaping their behavior, they are more than crucial in the context of economic readiness:

1. **Is the necessary legal environment regarding corporate governance, corruption and bankruptcy implemented so far within the Czech economic system?**

Moreover,

2. **Are EU-norms and codes of conduct embedded and accepted in the social context?**

The acceptance of these norms, their promotion and stability would not only guarantee the transparency and efficiency of the Czech economy but also the successful liberalization of the economy.

5.1 The Privatization Process

One of the major challenges the Czechoslovak government had to face was the privatization of the economy. The Czechoslovak federal government and later on the Czech government have chosen basically three different ways to privatize the economy, namely restitution, small-scale and large-scale privatization.

Restitution and small-scale privatization seem to be more successful in comparison to large scale privatization. Thus, the following section will give only a brief review of both restitution and small-scale privatization. However, a detailed analysis will be given on the failures of large-scale privatization.

5.1.1 Definition

" Privatization is the mechanism which redefines property rights and should thus bring about de novo the basic institutions of a market financial system including corporate governance of managers, equity ownership, stock exchange and a number of financial intermediaries." (Lipton and Sachs, 1990, pp.293-341)

In the context of privatization, as Zijlstra (1998) points out, achieving efficiency at the micro as well as macro level is one of the most important issues. The CEEC could be used as an example to show how difficult the transition process can be. Since the Central and Eastern European countries showed a lack of "domestic private saving, capital market institutions and shareholder culture" (Cave, Valentiny, 1994), a successful privatization needs to improve the fiscal situation through efficiency.

Moreover, it must reduce existing state administrative control over the financial sector while at the same time permitting a narrow and limited state supervision at the beginning of the privatization process.

A successful privatization involves the sell-off of assets previously owned by the state. This attempt includes also the restructuring of state-owned enterprises so they are able to compete within a free market economy.

This process can only be successful if the legal and administrative institutions are set up and are capable of creating an environment in which the fortitudes of the market can operate effectively. It is also important to note that in the context of a successful privatization the government must have the capability to introduce a well-functioning financial structure which can generate capital assets by selling state owned shares to the public (Zijlstra, 1998).

The next section will take these assumptions into account and will define the different methods of privatization which could transfer a former central-planned economy to a functioning free market economy. Keep in mind that there exists a wide range of privatization programmes with different targets. Their comparability with the improvement of efficiency as well as their fiscal position may be questioned.

5.1.2 The different methods of privatization

As it has been highlighted above, privatization can be characterized by different objectives.

For instance, Gros and Steinherr (1995) argue that privatization could be dominated by objectives such as "shortest possible time, selecting the right buyers, safeguarding employment and obtaining investment guarantees".

The first attempt in the context of privatization seems to be whether privatization should be accomplished on a fast-track or by using a slower process to safeguard the transition process. Those who are in favour of a slow privatization tend to argue that the state will be able to restructure state-owned enterprises (SOEs) before selling them. A slower process could arguably give the companies more time to prepare themselves for the competition they will face within globalized economies.

Managers in the new globalized economy will need enough time to acclimatize themselves to the new economy in which they now have to operate. The slower privatization would also allow managers to look for experienced personnel to cope with the new trials facing them in the new globalized economy. The slower economy would allow managers to reschedule production activities. It would also allow managers to accomplish proper analysis into setting efficient capacities. Managers could also properly research into the reinvestment of new, more efficient machinery and plant if necessary to keep the company competitive. By doing so the management could attract a higher price in comparison to a fast-track privatization (Zijlstra, 1998). It is also important to note that the restructure of companies in terms of their financial, organizational and physical structure could take years if not decades to accomplish (Bornstein, 1999).

A fast privatization strategy, on the other hand, could deliver the SOEs new private owners who will be capable of putting a successful restructuring into effect and, by doing so, support the political changes once state socialism has collapsed. In this case, a slow privatization attempt is seen as a process which could delay or, more significantly, "avoid" the privatization of SOEs (Pavlineck, 2002). It is further assumed that a fast-track privatization will further avoid bureaucracy which could influence the process of privatization.

Once the decision on which process of privatization is made, either fast-track or slow -track, the government has to face the question: "To whom and how" privatization should take place. Zijlstra (1998) evaluates different ways of doing so:

(I) Classical privatization: the state delivers its share of the SOEs to the highest bidder.

(II) Mass Privatization: the government delivers a large portion of its shares to the public, making sure that everybody can participate. The so-called "vouchers" are distributed to the public at no-cost or very low ostensibly.

(III) Privatization through employee and management buy-outs: This method is directed toward small- sized enterprises with 100-500 employees.

(IV) Small-scale privatization: This is an attempt to privatize small state-owned assets such as shops and restaurants to buyers (with low capital) by selling them directly or lease these assets if the required capital is not available.

(V) The restitution of former privately-owned SOEs (before the Communists took over) could illustrate an initial phase of the process.

The table below shows the different ways of privatization and the possible buyers.

Table 13*: The different ways of privatization*

		To Whom			
How to privatize		Existing managers and workers	General population	Previous Owners	Foreign or domestic private firms
	By Sale	Employee and management buy-outs	Stock market flotation.		Joint ventures, foreign direct investment
	By Free Distribution	"Spontaneous privatization" employee management takeovers of assets	"Voucher privatization"	Restitution	

Source: Cave, Valentiny (1994)

There are three other privatization options which should also be considered:

(VI) By establishing guidelines of privatization and the termination of centralized allocation of production the state can introduce the "self-transformation" of enterprises

(VII) "*Organic or growth privatization*": Here the state sector "shrinks naturally while the private sector expands"

(VIII) "*Covert privatization*": this variation occurred mostly in Russia, where, for instance, the state owned assets of enterprises were sold (hidden) to private operators at low market prices ("*distorted pricing arrangements"*)

From the list above, one can see that the government can use several ways of privatization in order to transfer from a command to a market economy. In particular, the privatization of the ownership structure of large-scale industries seems to be very difficult. Ultimately, there is no guarantee of a smooth transition in the privatization of state assets to private hands. The table below gives a brief overview of the privatization methods used within the three following Visegrad countries: Czech Republic, Hungary and Poland. The determination of the Czech privatization process will be the subject of the next chapter.

Table 14*: Privatization methods in Visegrad countries*

Method	***Czech Republic***	***Hungary***	***Poland***
Restitution	Return of physical property expropriated by communist regime after February 1948	Financial compensation for expropriations by fascist, pre-communist and communist regimes after 1939	No programme approved
Management and employee buy-outs	Negligible in absence of specific programme	Nominally EBOs, actually MEBOs; minor role in privatization	MEBO by lease-purchase; significant role in privatization
Mass privatization	Free vouchers to bid in auctions of OC shares; private IFs important; major programme completed	Interest-free 5-year loans to buy IPO shares; weak programme abandoned	Free share certificates in 15 NIFs, to which 60% of OC shares transferred; major program under way

Source: Bornstein (1999)

EBO: Employee Buy-Outs; **IPO**: Initial Public Offering; **MEOB**: Management and Employee Buy-Outs; (**N**)**IF**: (National) Investment Fund; **OC**: Operating Companies

5.1.3 The Key issues of privatization

One of the issues each Central Eastern European Country or each transition economy must face from the beginning is the problem of transparency. It is very difficult for the post-communist government to give a clear picture of the value of SOEs. This is largely due to the fact that no balance sheet or book values of those enterprises to be privatized exist.

For example, as Bornstein (1999) underlines, "no land was valued properly or plant and equipment shown at historical prices". Adding to these problems the implementation of economic reforms had also an impact on the balance sheets and income statements. Therefore, different methods such as "the price/earning method (PIE) or discounted cash flow (DCF) are used in order to evaluate the value of the SOE.

In order to make the transition process more transparent, principles and criteria for decisions should be announced in advance and implemented. Secondly, it is important that all the buyers have the same opportunity to access information about the available shares. The evaluation of transparency by the government is one of the key issues in the context of privatization. There also needs to be a legal environment which allows a safe and costless information exchange. Policy makers need to pay attention to institutional reforms and the enforcement of laws and regulations. This is particularly important in the context of property law (CERGE-EI, 2001).

From an institutionalist perspective, the creation of the required institutions and the introduction of EU laws and norms needed to present the basic conditions to fulfill for the transition economies. That is only if they want to join the European Union. Thus, it is of significant importance to look at the given institutional framework of the transition economies (in this case, the Czech legal environment) in order to determine its readiness for accession. As Zijlstra (1998, p.7) underlines:

"The institutional framework established by the state becomes a central vehicle for reconciling the general public to such unfamiliar norms. Perhaps the state's most important function is to lay out rules of the game."

The government must set up a number of institutions to monitor and supervise developments during the transition process. The role of each institution is significant during this process. The executive, legislative and judicial organs of the state, especially the executive branch, should be responsible for the design and implementation of the privatization method. For instance, measures such as the creation of agencies within the executive responsible for the different types of economic activities are crucial. These agencies should create and supervise the regulations necessary to implement successful corporate governance.

Another example of this could be the creation of a single agency through the ministry of finance which has to represent, in the SOEs, the interests of the state. Other agencies such as a competition agency could adopt monitoring issues in the field of cartel-behavior. These are only some possibilities that would help the state not only monitor the processes of economic developments, but also to safeguard the whole transition process.

Keeping in mind the importance of the legislative element within the state, the parliament should be deeply involved in setting up the legal framework to ensure and secure the free and legal development of the economy (Bornstein, 1999).

The judicial branch will also need to play a key role within the context of bankruptcy and property rights. Ruling within the scope of their judicial responsibility, they could ensure the efficiency of the economy.

In conclusion, one should also take into account the importance of the emergence of corporate governance during the process of transition. This is essential for an economy in transition since the replacement of the old system will create circumstances whereby insider dealing and corrupt practices can flourish. Thus, the development of the adequate forms of corporate governance is one of the crucial elements.

Further, the enforcement of bankruptcy laws is also necessary in order to improve corporate control and to enforce property rights. The following characteristics should be determined by bankruptcy laws. They should:

> *"(A) Make a credible threat of loss of control to incumbent management*
>
> *(B) Establish mechanisms, such as mandatory competitive bidding, that maximize the asset value of firms undergoing bankruptcy proceedings*
>
> *(C) Minimize the likelihood that bankruptcy proceedings are initiated when enterprises are illiquid rather than fundamentally insolvent*
>
> *(D) Protect the interests of both junior and senior creditors" (Gros, Steinherr, 1995, p. 287)*

As research by Bornstein (1999) has shown, there are several crucial issues during the privatization process which dominate the transition of a communist central-planned economy to a free market economy:

1. **A single privatization agency should deal with privatization problems as well as monitoring the process. By doing so, it also represents the ownership interests of the state.**
2. **Most of the privatization agencies have a lack of adequate and experienced staff; therefore they should be assisted by external consultants.**
3. **The problem of transparency should be resolved and all market elements should have the same access to information tools.**
4. **Corrupt practices during the transition process should be carefully monitored and if necessary measures should be taken to prevent such practices**
5. **Various methods have to be used in order to evaluate the prices of state assets properly.**

Taking the crucial factors listed above into account, the following section will discuss the process of privatization and the methods used during the transition process in the Czech Republic.

5.1.4 Czech privatization

As mentioned in the previous chapter Czechoslovakia was preparing a far-reaching reform package to be introduced at the end of the 1960s. However, with the invasion of Warsaw Pact troops in 1968, these plans were thwarted and the old communist central government was reinstalled. This suppressed any kind of reform attempts. In fact, all politicians who were in favour of the liberalization of the system were expelled from the communist party. The central government relied throughout the 1970s and 1980s on neo-Stalinists.

At the end of 1980s, the Czechoslovakian regime still opposed Gorbachev's reform plans (Pehe, 1998). As a matter of fact, the Czechoslovakian economy was strongly based on a command economy. Even though Czechoslovakia (especially the Czech part of the country) was one of the most industrialized countries within Central and Eastern Europe, its private sector remained the smallest in this region.

Unlike its neighbours Poland and Hungary, where economic reforms had been introduced under the communist regime, Czechoslovakia remained under a "strict command economy" (Preskett, 2001). For instance, as Leff (1997) highlights, Poland's agriculture sector had been highly privatized since 1956. In Hungary, private activities had been allowed to operate under central command during the 1970s and 1980s. In Czechoslovakia, it was not until 1988 that the communist government came up with a new (joint venture) law. This law permitted the operating of foreign capital and investment in the enterprise sector. Bear in mind that in Poland and Hungary, privatization had begun before the installation of the first fully democratic government between 1988 and 1990. In Czechoslovakia, on the other hand, there was "no wild or spontaneous privatization". Here, the state-owned enterprises accounted for 97% of national product in 1985 (Armstrong, 2002). The table below clearly shows the private sector's disadvantage in terms of the country's GDP. The private sector accounted for less than 5% of the GDP in 1989. In comparison, Hungary and Poland's private sector accounted for approximately 16%-30% of the GDP.

Table 15*: Private sectors' share of GDP during 1989-1994 (in percent)*

Year	*CSFR*	*Hungary*	*Poland*
1989	<5	≅16	28-30
1992	16-20	≅39	≅45
1994	60	55	55

Source: Gros and Steinherr (1995)

5.1.4.1 The Privatization Targets

Due to the developments described above, at the end of 1980s the Czechoslovak economy was dominated by state control. From the beginning, the target of privatization was clear. The economy should be privatized as quickly and fairly as possible. In order to have a successful privatisation, the state defined a clear set of privatization targets.

The SOEs should be privatized within a period of three years. The government's aim was to increase the efficiency of the economy as well as safeguard macroeconomic stability. The government expected that a fast and large privatization would take the pressure away from the state to aid loss-making state-owned enterprises. The government wanted both a change in enterprise management behavior as well as to increase the responsibility of the citizens. Privatization was seen as an attempt to educate the voucher holders quickly on the movements of the free market economy (Simoneti, 1993).

One should take into account that during the Czech privatization process there were very few management or employee buy-outs (MEBO), as shown in table 14.

There were few buy-outs for two different reasons. First, managers needed to borrow money from banks to purchase their own company's shares. Second, buy-outs were rare because management lacked adequate company knowledge and also had a lack of corporate control. This meant that they were in the position of earning good management fees without actually being under shareholder pressure (Pavlinek, 2002).

There was also a lack of foreign participation during the first two waves of privatization. This was due to two factors as Schöllmann (2001) points out. The government was afraid of foreign participation because it thought that foreign investors had no knowledge of local enterprises. Therefore, they were not expected to be able to deal with the enterprise's problems since they were less familiar with local conditions.

Foreign investors were also seen by the public as "exploitative", which meant that the public did not believe foreign investors would operate in the best interests of Czech enterprises. Many also believed that foreign investors could potentially seek to gain control (Preskett, 2001).

Leff (1997), on the other hand, argues that at the beginning of the privatization process the government found itself confronted with the following question: who could afford to buy the state-owned enterprises? It was obvious that only foreign buyers and foreign money could provide the necessary capital. However, at the same time the government recognized that massive foreign buy-outs would have given foreigners "disproportionate political and economic influence". The Czech politicians were especially afraid of selling off state assets to their dominant neighbours; namely the reunited Germany. The Czech government did not want to face an economy which was influenced by German capital and economic dominance as it was during the late 1930s and early 1940s under the Nazi leadership of Germany.

At the time of liberalization, there was a strong sense among the public that the so-called “family jewels” should remain in Czech hands.

However, at the time of the privatization, the government concluded that it had to distribute enterprise shares to the citizens in such a way that everybody could participate in this process. Selling out large SOEs to foreign buyers while the country made its first experience with the free democracy would have been politically incorrect.

For instance, the Czech government would certainly retain a controlling share in the Czech traditional enterprises such as Pilsner Urquell and Budweiser (Badvar) breweries.

Taking into account the given public and political circumstances, privatization in Czechoslovakia (and later in the Czech Republic) was based on three different methods. The first part of the next section will analyze the process of restitution. Following the restitution section, the so-called “small-scale privatization” and its successes will be the subject of analysis. The final section will examine the failures during the large-scale privatization phase which is crucial for explaining the Czech Republic’s economic crisis during the late 1990s.

5.1.4.2 Restitution of Property

As Newton and Walsh (1999) point out, the restitution of property is defined as the process during which properties have been given back to the original owners. These properties had largely been confiscated after the communist party took office in February 1948. Not only was it meant as an initial phase of the privatization process, but also the government wanted to adjust its political and moral debts to make up for the mistakes of the past. This process was viewed as the first step in returning to democracy and the rule of law.

The government had to deal with another important issue in the context of reinstitution at the same time. The question the government faced was how to start the process without being faced with eventual German claims. The government was particularly afraid of property claims from Sudeten-Germans (Sudeten-Deutsche). This group had been deported from the Czech Lands after the surrender of the Nazis in Czechoslovakia in 1945. The Czechoslovak public was especially opposed to any concessions regarding the claims of the Sudeten-Germans (Leff, 1997).

With all of these considerations, restitution laws such as Act No. 403/1990 Coll. were passed by parliament, making sure that property was given back to former owners. The restitution laws covered property that was taken away from the owners after the communist putsch in February 1948. Compensation for these losses beyond that date was not subject of the restitution. One should also take into account that at the same time these laws laid down a clear deadline for restitution claims. The former owners or their descendants had only six months after the finalization of the laws to claim their property. The final date was set for September 30, 1991 (Hazlett, 1995).

By setting the date of compensation after the communist take over in February 1948, the Czechoslovak government excluded some Jewish property which had been confiscated by the Nazis after their occupation of Czechoslovakia in 1938/1939 and the following years (Bornstein, 1999). As Leff (1997, p.189) points out:

"The dilemma was how to grant at least symbolic restitution to them (Jewish Holocaust survivors) without opening the door to similar treatment for the Germans."

To avoid these complications, in May 1994 the Czech government came up with an additional paragraph completing the restitution law guaranteeing the return of properties to the Jewish families of the Holocaust victims. However, before this change was made, several additional problems arose. One problem the Czech government faced was that the law did not include the claims of 8200 political prisoners and 3100 widows of executed prisoners during the Second World War. Since time was running out for these victims, the Czech government made the decision to pay a symbolic payment of up to $ 3700 until the German government would face its historical debts and pay compensation for these victims[1].

The restitution law also overlooked some problems with restitution to religious organizations. In 1990 and 1991, the Czechoslovak government did restore some property for religious use but was very hesitant to return some national monuments such as Prague's St. Vitus Cathedral, because public opinion was opposed to such returns. When all was said and done, approximately 10% - 25% of all state-owned apartment housing and retail shops were privatized by restitution (Bornstein, 1999).

5.1.4.3 Small-Scale Privatization

Leff (1997) suggests that the small-scale privatization of smaller firms were a much easier problem to deal with for the Czech government. A quarter of them had been given back during the restitution process. The remaining portion of the small trade and service establishments were delivered to the public through "small-scale privatization". The small-scale privatization transferred properties to the public that could not be restored to former owners.

These small, family-run businesses were supposed to be able to adapt quickly to the changed economic circumstances. As the Czech government found out, the best candidates for the acquisition seemed to be the small businesses' employees. The employees were the people who were familiar with the successful running of run the businesses (Frydman, Rapaczynski, 1994).

The government started with the privatization of these small units of the economy, such as small retail stores, small workshops and restaurants, soon after the restitution process was complete. This time the government did not set up a short time frame as it did during the restitution process. The small-scale privatization started in 1991 and was officially finished on 31 December 1993. In order to allow potential domestic interest (but with limited investing power) the government decided to lease these properties (Newton, Walsh, 1999). Most of the property was initially leased for a period of 3 to 5 years (van Engen, 2000)

If the government failed to find domestic buyers, foreign buyers were able to seek the acquisition of these properties (Newton and Walsh, 1999). However some 22,212 small units were distributed to private hands through public auctions with a book value of 23.6 billion Kcs (Czech Crowns).

Almost 69% of all small-scale privatization assets set aside by the government were sold by the end of October 1992 (Takla, 1994).

The small-scale privatization proved to be one of the more successful elements of the privatization process. It cared for the development of new ownership and it also created new consumer markets. It was crucial in job creation and in some cases it absorbed the labour "flowing out" of the ineffective big state-owned enterprises sector (World Bank, 1995).

5.1.4.4 Large-Scale privatization

The vast majority of the state-owned enterprises within Eastern and Central Europe had three common characteristics (Perotti, Frydman, Rapaczynski, 1994). The state-owned enterprises were overstaffed and fitted out with old equipment. Combined with low efficiency, the enterprises were plagued with very low profitability (if any at all). The core of the industry was often dominated by enterprises which employed

500 to 1000 employees. Therefore, the state had to implement a fast privatization programme for various reasons. By not privatizing these assets, the state would have kept control and would have dominated this sector. If the state had retained control, it might have forced a closure to the development of a healthy economic structure. Political pressure on the governing parties kept a number of these non-profitable enterprises functioning. A major reason for this was the preservation of jobs. This was one of the primary targets for the government in economic transition. If many people were out of work, high unemployment rates could potentially undermine the development of the whole market situation. The separation of this sector from the state through a rapid privatization task was the only solution. New stakeholders were expected to invest and restructure these companies. This was also expected to cause additional spillover effects to the entire industrial sector.

5.1.4.4.1 Voucher privatization in the Czech Republic

The first target of the post communist countries was to create a functioning market. In the case of the Czech Republic, large-scale privatization seemed to be the ultimate solution. This would be funded mostly through the locally available capital and savings. Large-scale privatization includes methods other than voucher privatization. The ultimate factors affecting the privatization process is the nature of the enterprise and the time needed to privatize.

There are three categories of enterprises which are normally privatized during such a large-scale privatization of former communist ruled countries (Takla, 1994).

The first category includes enterprises characterized "by the perceived relative ease and speed of their privatization". The second category of enterprises is privatized during the second wave after the initial privatization has taken place. This grouping of enterprises is normally dominated by large engineering, chemical, and metallurgical companies. This group could also include parts of the public utilities sector. The final category includes those enterprises which are required to stay under state control for a longer period of time. Integrated in this grouping are industrial branches such as railway and airports.[2]

Czechoslovakia favoured the voucher privatization approach because of its speed of ownership transformation. This approach was very unique in Eastern and Central Europe.

Voucher privatization is dominated by a complex bidding process during which shares are acquired by voucher holders. This kind of large-scale privatization distributes state-owned assets to public hands, as shown below, in a nearly free distribution (Fryman, Rapaczynski, 1994).

However, the nearly free distribution seems to be a shortfall of voucher privatization. It does not create capital for the government. It also does not allow large firms to show a growth in their profits. Voucher privatization also distributes assets to thousands of micro-investors. This makes corporate control very difficult, if not impossible (Rona-Tas, 1997).

Voucher privatization does have a number of advantages worth mentioning. The first advantage lies in the ability of the government to gain support by the citizens through voucher privatization. The citizens who support this are those who perceive the democratization and privatization process as a fair process. The population can participate in a large number and gain their first experience with capitalism without investing too much of their savings in uncertain businesses.

As a consequence, the population will be encouraged to support the new movements towards democracy and the implementation of economic reforms (Cave, Valentiny, 1994).

Another advantage of voucher privatization is the typical fast development of the stock exchange after the vouchers are exchanged for shares. In the case of the Prague Stock Exchange, for instance, trading started in April 1993 after the first wave of privatization was closed.[3]

A third advantage of voucher privatization is explained by Marcincin and Wijnbergen (1997) as "additional economic stimulus to investors". This is based on the assumption that through the voucher scheme, direct investors can buy small portions of the enterprise assets instead of buying the majority of the shares. The voucher scheme enables them to gain "de-facto majority control". This gives stock buyers the ability to buy the rest of the share portions if the enterprises' shares become profitable. This balances the uncertain economic environment for potential direct investors.[4]

5.1.4.4.2 The process of voucher privatization

Czechoslovakia started voucher privatization in 1992. As a first step, all enterprises were expected to deliver a privatization plan (privatization project) for themselves. This plan included a list of assets, a new developed corporate structure and a plan for the route of the privatization process (Leff, 1997). Enterprises' managers were in the best position to create these plans and projects due to their knowledge of the enterprise. Managers submitted 21.3 percent of the privatization projects. Privatization plans could also be submitted through anyone else such as foreign investors. Nevertheless, 81.8 percent of all approved projects by the Czech government were submitted either by the managers or insiders. Outsiders submitted such privatization projects but only a few of them were selected by the government (Zemplinerová, Laštovička, 1997).

By the end of 1992, a total of 11,163 privatization projects had been suggested and nearly 3,500 were approved by the Czech privatization ministry (Marcincin, van Wijnbergen, 1997). The table below shows the dominant position of voucher shares among other options of share distribution during the first wave of privatization.

Table 16: ***Distribution of shares in the Czech Republic December 1992***

	Percent	*Value in mn Kcs*
Coupons	62.19	238,345
Direct sale to domestic buyers	1.74	6,683
Temporarily held by NPF	15.49	59,354
Permanently held by NPF	0.09	327
Free Transfer	11.33	43,406
Direct sale to foreign investors	1.73	6,647
Employee-owned shares	1.53	5,846
Indirect sale	1.59	6,099
Restitution	4.32	16,540
Total	100.00	383,247 ($13,405 mn)

Source: Takla (1994)

During the first phase, all enterprises were transformed in joint-stock companies and were under the control of the National Property Fund (NPF)[5]. As a next step the government gave some basic information about the individual companies such as the financial situation, the number of employees, sales, costs and ownership structure to the public. After this information was available, the government started with the first wave of privatization (Hanousek, Tůma, 1998). Every Czechoslovak citizen who was 18 or older could participate in the voucher privatization. They could get vouchers for an amount of 1000 Kcs[6] in a maximum of 10 listed privatization companies. This first wave was carried out between May and December 1992. After purchasing these vouchers the citizens were able to exchange these vouchers for shares so that once the process was finished, the SOEs were in private hands (Armstrong, 2002).

However, the process was not successful at the beginning. During the first month after the privatization programme began, only 500,000 adults out of 11 million adults (total number of adult persons in Czechoslovakia) bought voucher books (Leff, 1997). The situation changed when Harvard Capital and Consulting (HCC)[7] entered the privatization stage. HCC promised to pay ten times the purchase price within "a year and a day". This solely depended on the condition that investors entrusted their voucher booklets to HCC. The promise was accompanied with a massive TV marketing campaign and a successful network of agents, who canvassed voucher holders "as they queued to purchase their voucher booklets at the post office". This aggressive marketing strategy ensured that HCC gained some one fifth of all voucher booklets which were purchased through the government during the first wave (Brom, Orenstein, Takla, 1994).

The campaign found its imitators, so that about 400 investment privatization funds emerged at the end of 1991 in order to buy the majority of vouchers from Czech citizens. Many of these imitators used the same strategy, namely, promising huge returns in a few years time once the IPF are aware of the vouchers (Pehe, 1998). By the end of the first voucher privatization around 70% of vouchers were in the hands of the so-called Investment Companies (IC) and their Investment Privatization Funds (IPF). As Brom and Orenstein (1994) determine, out of 11 million citizens who could have bought voucher points, some 8.54 million participated in the first wave. These IPFs were categorized by their size. The first group of so-called "giants" represented those IPFs who could generate more than 200 million coupons. The following is a list of the seven largest IPFs:

Table 17*: The seven giant investment companies by number of voucher points*

Investment Companies	*Voucher Points*
Česká Spořitelna	950 million
Prvnř Investiční	714 million
Harvard Capital and Consulting	639 million
Všeobecna Uvěrová Banka Invest	501 million
Komerční Banka	466 million
Česká Pojíšt' ovna	334 million
Creditanstalt	220 million

Source: Brom and Orenstein (1994)

The next ICs could be categorized as "large". This category consisted of investment companies that could generate 100-200 million voucher points. The next category included medium sized ICs able to generate 10 to 90 million voucher points. The last category contained the small ICs who could collect a small percentage (≈4%) of total voucher values. The following table gives an overview of the six largest ICs and their portion of voucher points they could gain during the privatization process:

Table 18*: The six large investment companies by number of voucher points*

Investment Companies	***Voucher Points***
Slovenské Investice	188 million
Slovenska Sporitelna	169 million
Prvá Slovenská Investičná	136 million
První Privatizační Fond	118 million
Živnostenská Banka	118 million
Slovenská Poisťovňa	117 million

Source: Brom and Orenstein (1994)

Voucher privatization was implemented in two waves. Throughout the first wave, which was divided into five rounds, almost 998 state-owned enterprises with a book value of 300 billion Kcs were involved. The start of the second wave was delayed due to the separation of Czechoslovakia at the end of 1992. It was launched in 1994. This time, only Czech citizens were allowed to participate. Also, companies involved were from the strategic and sensitive economic sector. The second wave was further divided into six rounds of bidding and some 676 enterprises with a book value of Kcs 155 billion were offered by the privatization ministry. This round officially ended in 1995 (Newton, Walsh, 1999).

The following table shows the basic facts regarding the second wave of the Czech privatization:

Table 19*: Basic facts of the Czech Republic's second wave of privatization*

	Wave 2
Number of enterprises entering the voucher scheme	861
Book value of shares allocated for vouchers in the second wave (million)	155.0
Citizen participation (million)	6.16
Average accounting value of assets per participating citizen (Kcs)	25,160
Percentage of voucher points with privatization funds	63.5%

Source: own table[8]

Throughout the second wave of voucher privatization only 63%-64% of the available shares were invested into ICs. This shows the loss in confidence by citizens in investing through IPFs when comparing these figures with 72% from the first wave. As a result, only 3 giant ICs could gather more than 200 million booking points.

These two official privatization waves were completed in 1995. The state still owned a large number of assets in SOEs especially in the banking sector at that time. The consequences for this development will be the subject of analysis.

Nevertheless, the two waves of privatization were not completely free of mistakes. A number of problems appeared as a result of the voucher privatization. These problems will be examined within the following section.

5.1.4.5 The Privatization Developments

The Czech privatization process has been unique in comparison to the past developments in Central and Eastern Europe. The following section gives an overview of how the role of the investment companies, banks and the Czech state affected the privatization process.

5.1.4.5.1 The state's role

A list of measures needed to succeed in privatization was highlighted at the beginning of the first chapter. For instance, the transformation of the legal system, along with the creation of adequate institutions supporting and monitoring the privatization process, should be important parts of these actions undertaken by the government to secure the privatization process.

Further, the government has to monitor the conditions of the market before tendering offers (Zijlstra, 1998). The government must also judge the individual enterprises readiness for free market conditions before allowing them to operate in this field. Those companies needing more time for restructuring at the time of the first wave should not be included. The institutional framework and the rule of law are the core elements needed to balance the macroeconomic stability. Determining the degree of the state involvement from the beginning of the transformation process is of special importance. Unfortunately, the Czech privatization programme was characterized by its “non-involvement”.

The state kept its policy of non-intervention regarding the voucher scheme to allow ultimate consumer choice. This is one of the reasons why ICs could act for a long time without any limitations (Frydman, Rapaczynski, 1994).

The government did not come up with a first set of limitations for the ICs until 1998. The Securities Commission (SEC) was established and supported by new laws governing the ICs. This institution began to re-license the funds under state administration to increase the discount on asset values. After this control was taken, the discount on net assets fell from an average of 32.8% in January 1998 to 11.5% in June 2000 (Armstrong, 2002).

The two waves of privatization, however, did not eliminate all state-owned assets enterprises. In a number of companies the state remained a majority shareholder. The state retained a blocking majority in the banking sector, primarily in some strategic commercial banks. This domination was given throughout the 1990s (Bornstein, 1999). State-owned enterprises control continued until the year 2001 due to the Commission’s report. It was not until 2002 that this began to change.

Of the fourteen largest investment privatization funds, eleven were established and owned by state-controlled banks. Further, four of the largest IPFs were owned by banks in which the state held controlling interest through the National Property Fund (NPF) (Pavlinek, 2002).

The government kept a strong interest in the largest enterprises to prevent their disastrous collapse which could have jeopardized the whole economic development. As a result, banking regulations have never been effective. For example, bankruptcy law developed over a long period due to the slowness of the government. Since a large number of the funds were controlled by the state-owned banks, “the privatization process went full circle: from the state to the state” which harboured progress (Pehe, 1998).

5.1.4.5.1.1 Bankruptcy developments in the Czech Republic

"In the neoclassical view bankruptcy should volley unproductively allocated resources back to the productive sector. This may also be the case for transition economies. Bankruptcies are sometimes referred to as a restructuring device." (CERGE-EI, 2001, p.69)

The Czech bankruptcy policy was from the beginning based on political goals. One should note that the government's aim was to secure social freedom by protecting the economy and avoiding mass unemployment caused, probably, by a large number of giant state owned enterprises not capable of surviving within a free market economy. Therefore, the government did not want to introduce bankruptcy legislation before new owners for the SOEs were determined.

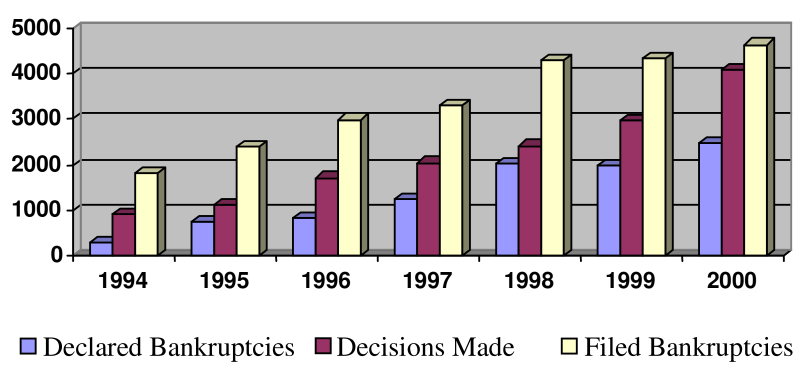
The government in fact implemented a new bankruptcy law in 1991 but it only affected smaller enterprises. Especially here the government was concerned about the bad debts of those enterprises being prepared for privatization. Moreover, the government tried to keep the situation stable by forcing some measures through the NPF. The NPF for instance financed a number of bankruptcy programmes in order to proceed with the privatization of the "sick" SOEs. In April 1993 the Czech parliament amended the bankruptcy legislation, but it still was not sufficient and effective enough since the procedure took a long time. For instance, a newly privatized company could only have been put under bankruptcy petition two month after the shares had been distributed to the share holders. Moreover, the company was protected from its creditors for another three months and, if they so wished, they could ask for an additional three months enabling the debtor to continue with its business activities without actually facing a sufficient "recovery" or "revitalization" (Takla, 1994, Brom, Orenstein, 1994, Gros, Steinherr, 1995).

Bear in mind that the law was designed to give the debtors the opportunity to act jointly with their creditors in order to solve their illiquidity problem. The government expected that both parties, the companies as well as the creditors (in most cases banks), would share the costs, and therefore some additional credits were expected to be granted by the banks. Rona-Tas (1997) underlines the fact that these laws were designed in order to "accommodate the loose relationship between banks and companies".It could be said that during the Czech privatization process banks seemed to be the only secured creditors, but at the same time the banks had to handle an enormous number of bad loans. By the end of the 1990's, this development had caused a financial crisis in the banking sector.

However, in 1996 and 1998 new amendments were added to the existing bankruptcy laws. Firstly, these amendments ensured a more rapid procedure of the bankruptcy process, in order to make the whole system more transparent. It could also be seen as an attempt to protect creditors from “debtors’ asset stripping”. Secondly an obligation for petition filing was set up forcing the debtor and its management in the case of a bankruptcy threat to undertake such measures. The major amendments were added in the year 2000. The dominant role of courts was restricted by transferring part of the competence to the trustee. In doing so the protection of public interest, as well as fair distribution among creditors, were guaranteed, mainly because the new amendment restricted the debtor in his activities concerning the assets (CERGE-EI, 2001). Other measures such as a new Act on Public Auctions or the Act on Court Executors had been passed in order to put in force the rights of “legal entities”, but as it is said in the Pre-Accession paper of the EU, it is not possible to determine how successful they are, since the development and the effective emplacement of these new laws takes years to be judged by their success (EU, 2001a).

As an outcome of the developments highlighted above, one can observe a rapid growth of bankruptcy petitions in the Czech Republic since 1998. As the diagram below shows, at the beginning of the privatization process and throughout the mid-1990s the number of filed bankruptcies was very low due to the government’s policy of safeguarding the large SOEs in order to avoid an economic collapse.

Figure 2: Bankruptcy development in the Czech Republic (1994-2000)



Source: CERGE-EI (2003)

The amount of declared bankruptcies started to rise after a significant policy modification on the part of the government was introduced. Therefore, more bankruptcies were likely to happen. The rate of bankruptcies increased during the mid-1990s by 50 percent, but after the introduction of the last amendment in 2000 it increased by 88 percent (CERGE-EI, 2003).

The Commission's Country Report (Regular Report, 2003) welcomes the amendment to the Commercial Code and the preparation of a new bankruptcy law, but at the same time it underlines the fact that in order to improve the skills of judges and trusties the necessary training still has to be provided, especially since their ability to do so is seen as crucial in restructuring those enterprises with continued financial problems.

In general, it should be taken into account that although the new amendment seems to achieve its goal; nevertheless the Czech bankruptcy law does not allow the restructuring of the companies. The filings lead "to bankruptcy procedures or refusal to declare, but almost never to restructuring".

Furthermore, from an institutionalist perspective, the current bankruptcy legislation seems to be too slow to support economic developments. The Czech Republic clearly needs a stronger legislative framework in order to tackle the problems within the enterprise sector.

The strengthening of the judiciary is one of the key issues in this context. Much work has to be done in terms of education and training. The Czech government should support a specialization of judges in this regard. By doing so the Czech authorities would guarantee the full application of the laws.

The problem is not the issue of changing the laws, but it is their application. The investors remain cautious, due to the problems of enforcing the law. Bankruptcy cases in the past had been handled very slowly, moreover adjudication has been difficult to execute. Thus, these cases should be resolved more quickly and with more transparency. The Czech Authorities have to set up the necessary institutional framework in order to ensure the smooth functioning of the bankruptcy laws so that legal actions can be undertaken more swiftly.

At the time of writing, it could be said that the Czech Republic will join the European Union in 2004 without really having implemented the necessary institutional framework regarding the bankruptcy-law issues.

5.1.4.5.1.2 Corruption and the institutionalist approach

"Corruption involves the abuse of official power for private gain, through misappropriation of state property or bribes for favours in its disposition." (Bornstein, 1999, p.67)

Kaufmann and Seigelbaum (1997) determine there are some key issues within a privatization process which amplify the opportunities for corruption. One of these factors is the degree of transparency within the privatization programme and the rules and procedures governing the process of transition.

The less transparent privatization rules are the more the degree of corruption grows. The lack of this transparency seems to be the most obvious cause of corruption within the Czech business economy.

In the Czech case, voucher privatization was introduced rapidly and it was supposed to distribute shares of the state-owned enterprises into public hands.

However, at the same time the government set up only a few rules governing the whole privatization process and therefore the opportunities for fraud were apparent from an early stage of the privatization programme (Anderson, Wagstyl, 1998).

Corruption is a common phenomenon in transition countries and was dominating the Czech economy from the beginning of the transition process. This might be partly caused because of the communist past when small gifts and bribes were a norm in handling state administration (Lizal, Kocenda, 2000).

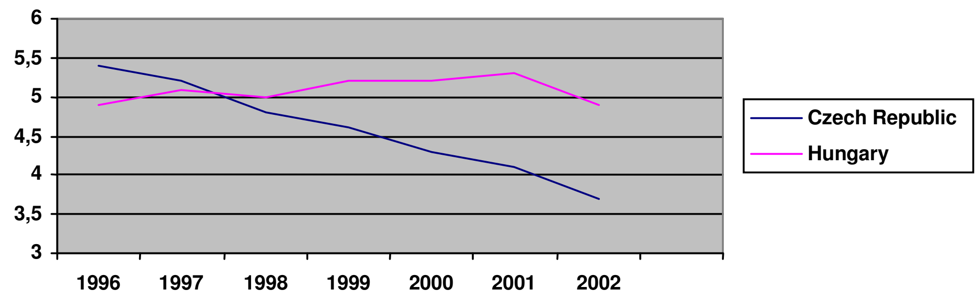
According to the Commission's regular reports in 2002 as well as 2003 it still continued to affect business activities within the Czech economy just before the country was about to join the European Union. As a study by EBRD in 1999 shows, 26.3% of Czech companies admitted giving bribes. Also a report by CERGE-EI (2000) shows corruption was one of the key problems of the Czech economy.

The so-called Country Corruption Perception Index (CPI), which is based on a survey of business people, risk analysts and the general public, shows the Czech economy's corruption problem.

This index measures (on a scale of 0 to 10) the degree of corruption prevalent in the investigated economy. Here, 10 points represent a very clean and 0 points a highly corrupt business environment. The graph below gives the development of the CPI from 1996 to 2000 in the Czech Republic and compares this development with that of Hungary for the same time.

In the Czech Republic, corruption has been getting worse, whilst in Hungary the level of corruption seems to be more stable.

Figure 3: Corruption Perception Index: Czech Republic and Hungary 1996-2002



Source: Own draft based on CERGE-EI (2003)

Taking this analysis and the observations of the European Commission into account, the developments in the Czech Republic regarding corruption are alarming.

The Commission expresses in its Report 2001 on the Czech Republic's progress toward accession its concern about economic crime and the consequences for the business climate within the Czech economy. Particularly the so-called "tunnelling"[10] of assets has become a huge problem. The Commission points out the need for the Czech authorities to implement more serious law enforcement and court convictions.

Furthermore, in the Country Report 2002 and 2003 the Commission underlines that according to a survey undertaken by the Czech government itself, the situation is not improving. The report determines that the number of corruption-related crimes has increased. Especially corruption within the administrative police department is still present. Corruption also continues to affect the healthcare, banking, judiciary and intelligence services as well as the political sphere.

The Commission points out several weaknesses within the anti-corruption policy. Among these, the lack of trained and qualified staff supporting police investigations and a lack of capacity are the dominant problems. Further, not only is there an absence of sufficient political support for public administration, but there also exist a need for institutions to fight against corruption.

An analysis by GRECO (Council of Europe Group of States against Corruption) in 2003 has shown that almost one year before the scheduled accession, the issue of corruption causes a serious problem and is likely to increase.

The main institution which is affected is the police force, but other public entities such as judges, state attorneys or customs officers are involved in corrupt activities.

Taking the level of corruption into account the accession of the Czech Republic into the European Union is more than questionable from an institutionalist point of view.

Sociological institutionalism emphasizes the norms, ideas and rules which are embedded within the institutions and, in the case of the European Union, the norms which characterize the Union as an institution of liberal ideas promoting democracy. The existence of these norms and ideas in the daily institutional interaction of the applicant countries is understood as a prerequisite on their way to joining the European Union. Each of the Commission's Reports shows clear evidence that the basic EU norms, namely the commitment of the institutions to democracy and the rule of law do not exist within Czech executive institutions (such as the police department). The inability of the Czech authorities to improve the situation remains crucial.

Concluding these thoughts also from a NIE point of view the accession of the Czech Republic is doubtful since the effectiveness of the economy depends on the quality of the institutions.

The European Commission underlines the fact that the institutional arrangements are not sufficient to fight corruption within the Czech economy. The absence of institutions, qualified personnel and political support are still key issues, making an improvement of the situation almost impossible.

Changing the behavior of citizens seems to be the key issue. Lizal and Kocenda (2000) found out that the misuse of public goods was socially accepted since the state was considered to be the "enemy".

"Of course, after forty years such behavior had to become not only a socially acceptable norm and sometimes even a norm of proper morale not only on the citizens' level but also on the administrative level." (Lizal, Kocenda, 2000, p.5)

Not without reason a GRECO Report in 2003 firstly emphasizes the importance of public perception of corruption. If the government only focuses on combating corruption without the necessary enlightening of the citizens, a climate could accrue in which corruption is considered to be normal and acceptable behavior. This development on the other hand is incompatible with EU norms and ethics.

A second step which is recommended is the adequate training of officials in special investigative techniques and the setting up of guidelines in order to be more efficient in combating corruption. The further training of these police forces with priority given to the "Unit for Combating Corruption and Serious Crime" is also crucial (the strengthening of the Ombudsman institutions should also be more in focus).

Finally, in order to implement the government's programme against corruption, the following steps are recommended by the Council of Europe Group of States against Corruption as being important in shaping an effective anti-corruption task force (GRECO, 2003, p.17):

I) *the body/ies in charge* (should be) *clearly identified*

II) *a series of very specific and measurable objectives and the detailed steps required to achieve them*

III) *awareness of this programme is increased both throughout Czech public institutions (…) and the public in charge*

New Institutional Economics points out the importance of institutions providing effective markets. Here, the existence of the necessary institutions guarantees political and economic stability and reduces transaction costs. The institutional framework is the core element of a successful and efficient economy. Further in the second chapter the importance of trust in this context has been highlighted. Within a given common economy the actors have to co-operate with each other in order to distribute costs and benefits equally. This does not exist in the Czech business environment since corruption is dominating economic activities.

The "Principal-Agent Problem" is a key issue in the Czech case. In a corrupt business environment, company managers tend to work in their own interest instead of on behalf of the shareholder. A successful development of free markets is thus very problematic.

In conclusion, it could be said that two years before the accession (2002 /2003) the absence of the essential institutions is more than obvious in the case of the Czech Republic.

Thus, from an NIE perspective it is highly questionable whether the accession of the Czech Republic in 2004 would be advantageous for the European Union as well as for the Czech Republic itself. An accession consequently costs more since the institutional arrangements (e.g. in the case of corruption) are not sufficient. The question remains whether a delayed timetable for the accession would have been a better alternative since it would have given the Czech Republic more time to undertake the necessary steps to prepare itself. At the time of this proposal's completion the Czech Republic has just started to implement the first measures in this context, and their success remains to be seen.

5.1.4.5.2 The role of ICs, IPFs and Banks

The first two privatization waves (1992 and 1994) enabled the Czech public to participate in the privatization process either by a direct acquirement of company shares or indirectly through the ICs and their funds, the so-called "Investment Privatization Funds". This development was the subject of analysis earlier in this chapter. It is important to note that one IC was able to set up and manage several IPFs and not only one[11] (Brom, Orenstein, 1994).

The government had several reasons to allow ICs and their IPFs to operate during the privatization process:

1. **IPFs should have act as a bridge between voucher holders and firms**
2. **They were supposed to increase the efficiency by changing the way of the old activities**
3. **In the long term they should establish a new capital market**
4. **Returns were expected to be invested into the market**
5. **The former SOEs were expected to be restructured**
6. **Within the enterprises a new corporate governance was expected to be created**

However, at the end of the 1990s it was obvious that the IPFs had failed to reach these targets. There are several factors which have caused this failure. It could be said that IPF did not become "good owners" since they failed to introduce a successfully restructuring programme (Pavlinek, 2002, Leff, 1997).

According to Armstrong (2002) and Rona-Tas (1997) there were two reasons for the failure of the IPFs. The smaller funds did not have the resources enabling them to undertake successful restructuring. They were understaffed and inexperienced. The managers were not able to observe the performance of each company's portfolio. Further, if IPFs did decide to fire a company manager in order to restructure the company by replacing the manager, they were not able to find an appropriate successor because of a lack of experienced company managers. And even if they were lucky in finding a newcomer, his performance was still highly questionable since he did not have enough knowledge about the company he was going to be in charge of. Therefore, insiders were always preferred who could implement the restructuring of the enterprises.

Since the large IPFs had been set up by the largest banks, they had another problem to deal with. Banks such as the Commerce Bank[12] dominated not only the ownership of the IPFs, but also at the same time the enterprises' management received huge credits from the same banks. In other words banks were judging the creditworthiness of companies in which they held shares through their Investment Companies. This led to a serious conflict of interest within the newly privatized enterprises since the banks were not only the shareholders, but also the creditors. Here the banks have shown throughout the 1990s the tendency to grant loans to those enterprises which were in financial trouble without forcing them to restructure their production process as well as financial resources.

Another important issue concerning the banks was their ownership by the state. These banks were (until 2001/2002) largely state owned. As a matter of fact the state kept its influence over the former SOEs, although they were supposed to perform in a free market economy. As a survey by CERGE- EI (2002) highlights, in 1998 most of the largest strategic enterprises were still under state control. However the failure of the IPFs to implement a successful restructuring process after gaining shareholder control as well as the behavior of the managers to act in their own instead of shareholder's interests undermined the confidence of public investors. They started saving money instead of investing it within the financial markets. As a result only 45 of the 450 original IPFs were active in August 2000 (Anderson, 2000).

Furthermore, the ownership of the banks by the state also seems to explain the poor performance of the IPF managers. The safe business environment, brought about by the weak regulatory framework and fragile laws, had created a situation in which fund managers found themselves under little competitive pressure. The low rate of bankruptcy during the 1990s provides evidence that the enterprise manager could act relatively protected from real free market competition.

In conclusion, it could be said that the IPFs failed to generate new investment capital. Consequently, the restructuring of the former state owned enterprises was very slow and in some cases it did not take place at all.

5.1.4.5.3 The institutional framework

Efficiency is one of the key factors when a transition country makes the first efforts to evaluate free market conditions. To guarantee efficiency the legal environment, including an institutional framework, needs to be in place in order to safeguard a rapid, less costly and secure exchange, minimizing the transition costs. The existence of the proper institutional environment is essential in the context of successful market development.

During the privatization process of the Czech economy the first institution which was created in order to support the transition was the National Property Fund (NPF).

This institution was founded by the government in 1991. The first task of the NPF was, once the majority of the SOEs shares were transferred to the NPF, the approval and implementation of the privatization projects. One should keep in mind that the NPF was not part of the state body even though its presidium was elected by parliament (OECD, 2001a).

The NPF played a key role. Not only did it keep the shares in those companies which could not be distributed to the public or a private investor, but also it set aside the strategic holdings. These so-called "strategic holdings" represented those enterprises shares, which the state was "unwilling to relinquish" (Zijlstra, 1998).

However, throughout the 1990s the NPF was not able to examine its role as a large shareholder within the Czech industrial sector. It made serious mistakes as Boland (1996) points out. For example the attempt to sell both the steel company, Poldi Ocel and Spolana, a chemical company in 1996, went badly wrong.

For a long time the NPF had neither the strategy nor the tools in order to do justice to its role as a strategic shareholder.

A second important institution set up by the Czech government in order to take care of the Czech industrial and banking struggle, was the Konsolidacni Banka (KOB), funded through the Finance Ministry in 1991 (OECD, 2001a). Until 1998 the primary role of the KOB was to attend to the Czech government's interests. The intention of the government was, as determined earlier through its bankruptcy policy, to prevent the collapse of many privatized former SOEs.

For instance, Brom and Orenstein (1994) highlight the fact that at the beginning of the 1990s the KOB purchased 15 billion Kcs ($ 500 million) of Czech bank's bad loans for 80% of their nominal value. Its basic role was to provide capital to the banking system in order to avoid its collapse. Until 2001 the KOB was not able to tackle the problem of its bad loans portfolio. Therefore, it had to improve its financial situation by trying to sell some of its loans to new strategic investors otherwise its portfolio would run the risk of a Czech budget deficit. However, due to the problems in the Czech industrial sector the government authorized the KOB to create a subsidiary in order to push forward the restructuring of the enterprises.

The Revitalizacni Agentura (RA) was therefore established in May 1999. It was expected to implement plans of financial restructuring, identifying strategic investors for those companies with financial difficulties as well as negotiating with banks and creditors. The operations of this agency were ended by 2002 (EU OECD, 2001a), and its achievements remain to be seen. The government also established in 1998 the Securities Commission (SEC) in order to push forward the restructuring process. One of the first steps made by this agency was to force all close-ended funds to become open until 2002 (Armstrong, 2002). By doing so the agency hoped to solve the companies' illiquidity problem and to enhance the public's (shareholder's) confidence.

In conclusion, it could be said that throughout the 1990s and during the years 2000/2001 the institutional framework within the Czech economy was dominated by their primary role as a representative of the Czech government. Their actions were characterized by the government's policy of safeguarding the privatization process, especially avoiding the bankruptcy of the former SOEs.

Taking the figures of the OECD (2001a) into account one could observe the dominance of the state through the NPF. For instance, in June 2000 the NPF still had a share in equity capital of 282 joint-stock companies out of which 38 were strategic companies and 244 were non-strategic[14]. The table below shows clearly the dominance of the NPF in six selected strategic joint-stock companies with activities in different industrial sectors until 2000/2001:

Table 20*: The share of NPF in selected strategic joint-stock companies*

Company	*NFP share*	*Sector*
Ceske radiokomunikace, a.s.	51.00 %	Radio and telecommunications
Paramo, a.s.	70.87 %	Refinery
Ceska sporitelna a.s.	45.00 %	Banking
Chem. Zavody Sokolov, a.s.	73.74 %	Chemical industry
Komercni banka, a.s.	48.74 %	Banking
Jan Becher-Karlovarska Becherovka, a.s.	59.00%	Foodstuffs

Source: OECD (2001a)

As Armstrong (2002, p.19) notes in her research, in 2001:

"One of the major problems the Czech Republic experienced was in trying to adopt Western institutions without the infrastructure and legal framework to support them. Although the institutions were quick to look like those in the West it will still be some time before they act like them."

From an institutionalist point of view it could be said that Czech institutions started to fulfill their task of company restructuring and banking privatization from 2000/2001 onwards. At present it is not possible to judge whether the institutional arrangements have been successful or not. Nevertheless, one crucial issue remains to be considered, whether the EU's commitment to accession by 2004 was not a rigorous decision. It could be said that the institutional arrangements in the Czech Republic have just been modified from the mistakes made during the first decade of transition. An accession of the Czech Republic 2007/2008 would give the institutions more time to establish the framework needed in order to justify the EU's institutional norms and values.

5.1.4.6 The Obstacles to the Privatization Process

During the Czech privatization process more than 400 investment funds emerged in order to gain the majority of vouchers from the citizens.

As Brom, Orenstein (1994), Rona-Tas (1994), Boland and Robinson (1996) and Leff (1997) highlight in their studies, the IPFs were set up by investment and insurance companies which, on the other hand, were mostly owned by banks. For instance, the investment company of Investiční Banka was named Prvni Investiční which, once set up, founded eleven other investment privatization funds.

These banks, in turn, were still state-owned either directly or indirectly through the National Property Fund.

Although the government tried to regulate this so-called “cross-ownership” from the beginning of the transition process, it failed to prevent its negative development.

For example, due to the privatization laws the banks were not permitted to bid for shares in other banks; however, many of them have circumvented this appraisal through subsidiaries.

Moreover, the situation is not only based on a “one-way” cross-ownership, many independent ICs (in their portfolio) have shares in banks that control other ICs. This development of cross-ownership within the Czech industrial and financial sector has caused serious problems for the enhancement of both the privatization process and for the development of a free market economy itself.

As a result the Czech financial sector found itself in a coordinated business environment rather than in an environment dominated by competition[15]. As Boland and Done (1996) describe, the ownership of the ICs by the banks increased the lending portfolio of many banks. This policy was partly backed by the state since the Czech government kept the majority of shares in the most strategic Czech banks. The situation did not change until 1997-1999 after the Czech Republic entered an economic crisis.

The extensive cross-ownership within the financial and industrial sectors inhibited the growth of share value, because IPFs were under little pressure from real free market competition. Boland and Robinson (1996) highlight the fact that companies did not have access to credit under competitive conditions and many companies were prevented from going on the market in order to raise “fresh equity”, but this movement would have been exactly the necessary step to be undertaken by the enterprises. Thus, the Czech economy suffered for a long time from a lack of supply of long-term domestic capital. As a matter of fact, economic growth slowed down since the economy needed high levels of investment in order to generate high economic growth rates.

As it will be shown in the following chapter, this situation remained throughout the first decade of privatization. It began to change in 2000-2002 after the Czech government started to privatize those banks in which it held strategic shares. Many of them were sold to foreign buyers in order to change the cross-ownership situation. Therefore, the performance of the IPFs and ICs could be questioned (at the time of writing) once they were exposed to real market conditions and the competitive pressure facing them within EU markets. The ownership changes forced by the government were only implemented in the two years before accession to the Union. The results remain to be seen.

5.1.4.6.1 The Problem of Corporate Control and Transparency

The Czech privatization process was from the beginning dominated by a lack of transparency as well as corporate control. The reasons for these developments and their impacts will be the subject of consideration within the following sections.

The lack of required laws and institutions had a huge impact on the transparency performance from the very beginning of the transition process, but this lack of adequate institutional arrangements was multiplied by other mistakes accrued through the Ministry of Privatization (MOP) itself. For instance, one of the primary failures of the MOP during its choice of privatization projects to be realized, was its failure to take into account the different criteria and methods that were possible. As determined earlier, mostly those projects submitted by the company managers had been chosen. Foreign investors therefore, did not have much influence to shape the privatization process[16]. However, adding to these problems of transparency, the problem with corporate governance also had an impact on the slow performance of Czech enterprises.

As Gros, Steinherr (1995), Corbett, Mayer (1991) show, there are two basic approaches in the context of corporate control. Firstly, the outsider model basically used in Great Britain and USA. Here, the ownership is divided and characterized by the separation of ownership from control functions. As a matter of fact, only a few incentives for outside investors to participate in corporate control exist.

On the other hand, the insider model is applied in most of western Europe and in Japan. This model favours a concentration of ownership and its involvement in controlling issues. The major shareholders are designed to be in charge of corporate control. One of the weaknesses of the latter model is the high probability of “moral hazard” as Gros and Steinherr (1995) determine. The problem here is that the shareholder might be lead into temptation to extend credits to the enterprises in which they hold shares. This is particularly precarious in the case of bank-ownership of the enterprises. The analysis will show that this seems to be exactly the development which occurred in the Czech Republic as a result of the cross-ownership circumstances.

Nevertheless, it should be taken into account that the insider model could be successful in the context of small-scale privatization when owners and managers are the same. The transfer of assets is then much easier and more efficient in comparison to the outsider model. Taking the small-scale privatization of the Czech economy as an example, one could perceive the implementation of this method as a success. This seems to be different in the case of large enterprises and the “voucher privatization” method.

How influential the ICs could be in terms of corporate governance depends on their portfolio. If they have holdings in a few companies, they are more likely to gain control, but since the ICs concentrated their activities in a large number of enterprises, it turned out to be very difficult for them to gain corporate control if they had wished to do so[17].

The IPFs on the other hand were characterized by a lack of transparency and information sources, making insider dealing and fixed business transactions one of the main drivers of the economy. This seems to be the main failure of the Czech voucher privatisation; it failed to build proper corporate governance so that structural changes were not carried out.

5.1.4.6.1.1 Principal-Agent problem

As it has been shown in the second chapter, one strand of the NIE represents the principal–agent problem. Here the manager (agent) of the company is supposed to act in favour of the shareholder’s (principal) interest.

In the context of the SOEs privatization, there are three elements necessary in order to secure the relationship of principal and agents (Takla, 1994).

The contractual and bankruptcy discipline is the first important condition in this context. In other words “trust” should be enforced in order to guarantee a secure business environment.

The next element emphasises the importance of the pressure resting on the manager to force the restructuring of the company. This situation is given as soon as the required bankruptcy and corruption laws are designed and in force. The Czech privatization process however, started with a lack of the necessary legislative and institutional framework supporting the development of the free market economy.

As Marcincin and Wijnbergen (1997) analyse within the Czech privatization process there were three types of agents. The so-called “insider”, meeting the pressure from owners; “strong outsider”, which could be “direct investors” (in the case of direct sales); or “weak outsider”, who are understood as small individual shareholders and IPFs (in the case of voucher privatization). Strong outsiders are normally capable of increasing the performance of the companies since they perceive their corporate control task. Weak outsiders on the other hand could receive some problems in gaining corporate control over the insider, making the restructuring of the enterprises dependent on the type of insider. The latter could be perceived as what went wrong during the Czech voucher privatization since the cross-ownership circumstances of the enterprises, being partly owned by the state, banks or ICs, could not create a well-developed corporate control.

As Rona-Tas (1997) points out, most bank-owned investment companies were managing IPFs that held shares in the banks itself. As a matter of fact, the representatives of the IPFs were chosen by the bank manager and were subordinate to them. Therefore, a bank manager could gain ownership rights “without actually being an owner”.

Another example is those companies which set up other affiliates. Once the affiliate was privatized they bought shares in their parent company (example: Brno Trade and Exhibitions Co.), these development are defined by Rona-Tas (1997) as “loops in the chain”.

However, if small investors who own shares would take a more active role, they could force the IPF managers to act as real owners and not as agents of the banks or the state. Nevertheless, one could assert that these so-called “loops in the chain” have strengthened the position of the manager.

Thus, it could be said that due to the lack of shareholder pressure and the non-existence of regulations, fund managers were able to make money without implementing a structural programme, simply because management fees were not tied to their performance. For instance, Harvard Investment Fund paid 300 million US Dollars for management fees and advertising expenses. As Zijlstra (1998) points out most of this money went “into the pockets of the fund’s top managers”.

Moreover, it could be determined that since the new owners did not receive the information they needed to gain an overview of the activities of the companies, the old managers could create a renewed coalition with IPF managers and act in their own interests instead of those of the enterprises (MLcoch, 2000). This dominant position of the agents might be a reason why dishonesty, fraud and illegal actions still dominate the Czech economy.

5.1.4.6.2 The Issue of Foreign Investment

In the first part of this chapter it has been shown that during the first two waves not much foreign investment flooded into the country. There were several reasons for this. Firstly, the Czech government was not sure if foreign investors were in possession of sufficient knowledge of the Czech enterprises. More importantly, the government was afraid of selling assets to foreign investors because it thought that this movement would have given foreign investors more political and economic influence which, at that time, was not supported by the Czech public. The "family jewels" should remain in Czech hands. As a matter of fact one could say that the amount of foreign investment was very small during the first years of transition. In the period 1991-1995 only 144 out of 5000 companies (basically small and medium-size enterprises) were acquired by foreign investors.

Taking the "discrimination" against foreign investors during the first waves of privatization into account, it could be shown that the Czech economy would have received more "Greenfield Investment"[18] than it did if the government would have given foreign investors more incentives to take part in the Czech privatization process (CERGE-EI, 2001).

However, Preskett (2001) suggests that foreign investment could be advantageous if it is embedded properly within the privatization process. Foreign investment can make an essential contribution to the development of a transition country's industry. They could be the only economic actors having access to sufficient capital. As the experience with the voucher privatization of state-owned assets to the public in book values has shown, the collectors of these assets (ICS, IPFs and banks) did not actually have the financial sources in order to implement the necessary steps of restructuring.

Further, in this context foreign investors could bring in knowledge and know-how which differ from local (former central planned) experiences and skills. They are also capable of linking the companies to global markets by providing contacts abroad.

The lack of foreign investment during the first years of the transition and privatization process, added to the other mistakes, further explains the failure of the former SOEs to build up efficient corporate control.

As Pehe (1998) says, the privatization process in Hungary could be seen as more effective, since direct sales to foreign investors were allowed and carried out. Therefore, western-style management and know-how could play a significant role within Hungary's privatization process.

Taking the Czech Republic itself into account, one example of a success story of foreign involvement during the privatization process, is the acquisition of the Czech Skoda plants by the German car manufacturer Volkswagen.

Due to the successful purchase by Volkswagen[19] at the very beginning of the privatization process in 1991, the plants were restructured in such a way that they can now compete not only in transition, but also in developed markets. As a survey by the OECD (2001a) shows, in the year 1999 Skoda-Volkswagen increased its revenue by 4.4% (2.82 billion US Dollars) and increased its net profits by 17.8 percent (66 million US Dollar) in comparison to 1998. It also purchased 1.7 billion US Dollars from automotive and component suppliers of which 64% were from Czech companies[20].

Thus, foreign investment could be both a force for the implementation of adequate corporate governance, as well as for the reconstruction and modernization of the companies in transition.

As a survey by the European Commission (EU, 2002b, DG Economic and Financial Affaires) shows, foreign-owned companies generally tend to develop better than domestic enterprises.

However, in the past years the Czech Republic has proved to be an attractive location for Greenfield Investment.

Foreign investors played a major role from 1997 onwards, in restructuring Czech companies. They have helped to secure access to EU markets and to make the Czech Republic an attractive location, increasing its advantages in the context of EU accession.

The reasons for this development and increasing foreign investment flows are the subject of analysis within chapter 6.

5.1.4.6.3 Conclusions

Within this chapter it has been shown that a successful privatization includes a number of different implementation strategies all of which have to be taken into account. The most important are: hard budget constraints, the existence of a competitive environment including the pressure of domestic rivals, and proper supervision by the state in order to specify the demands and targets of the enterprises as well as securing the establishment of a successful corporate governance which is (in the case of poor performance) capable of removing managers.

In the Czech government the long-lasting and extensive involvement of the state through NPF and KOB until 2000/2001 complicated the establishment of proper corporate governance since conflicts of interest were generated when state-owned banks held shares in those companies to which they were also lending. Due to this development the process of restructuring was hampered, inhibiting the allocation of resources and the ability of the former SOEs to compete. This delayed the quick transition of the Czech economy to a market-oriented economy.

The voucher privatization might have worked if the government had simultaneously introduced laws and regulations to support the whole process defining the role and activities of the funds and investment companies. However, the government had underestimated from the beginning the importance of regulations in this context. As a matter of fact, several problems have arisen from the lack of regulations and inadequate supervision. The lack of qualified personnel and an institutional framework dominated the Czech privatization throughout the 1990s. The Czech economy seemed to remain a heavily managed economy. After the Commission's warning, when it declared (in its country reports 2000/2001) that the Czech government had to bring forward the privatization of heavy industry as well as the restructuring process, the Czech government was forced to do more in this context. As Mladek (2003, p.5) says:

"The Czech reformers had forgotten that a publicly listed company is a high-tech achievement of Anglo-Saxon capitalism, the most complicated form of private ownership which requires an elaborate set of institutions and a well-functioning legal system."

It takes political will to change and develop a legal and institutional system. The Czech government did the opposite since the politicians thought that non-involvement of the state in corporate control issues would push forward the development of the free market economy and real market conditions.

As a matter of fact, management has too often accommodated itself to the given market situation so that insider dealing and corruption still dominate the Czech economy. As Anderson, Wagistyl (1998) state, due to this situation "too many Czech companies trust each other too little to do business effectively".

One should consider in this context that reforming institutions might be easier than reforming attitudes. Until now the ownership of the industrial sector has been in the wrong hands. In 2001/2002 the government started to change its policy, but this process will take years and is bound to be very costly. As Mr. Jan Mueller, the chairman of the Securities Commission had stated in an interview with Anderson and Wagstyl (1998), "… foreigners think of the Czech Republic as a den of thieves and changing this view could take three to five years".

Three years after this statement, FDI in the Czech Republic had risen dramatically (e.g. 2000). As it will be shown within the next chapter, FDI inflow into the Czech Republic was around 3718 million USD. In 2001 it amounted to 4916 million USD, and in 2002 it was expected to reach an amount of 8200 million USD (CERGE-EI-2003). These figures will be analyzed in more details in the section regarding Foreign Direct Investment.

The developments described above, reflect the investor's recognition of the long-term improvements in terms of legal and regulatory reforms. Therefore, it could be said that the Czech Republic is, at the time of writing, undergoing this process but its results remain to be seen.

The Czech privatization programme created property rights, but it also caused enormous problems. The combination of voucher privatization and other methods (e.g. foreign investment) would have been more beneficial.

However, as the report of CERGE-EI in 2003 shows, EU countries make up 80% of the FDI shares invested in the Czech Republic.

As a matter of fact, Czech product structure has become more similar to the more developed EU countries. Also, the Regular Report 2002 shows that the Czech privatization process is close to completion. The NPF has already completed 97% of those privatization projects set up in 1991, but at the same time the report warns that "… some strategic enterprises in the corporate sector still await a change of ownership".

5.2 Monetary / Fiscal Policy and the institutionalist approach

In order to support the transition process the Czechoslovak and, later on, the Czech government defined in 1990 the following economic targets (Janackova, 2001):

I) macroeconomic stabilization
II) liberalization of trade
III) enforcement of the privatization process
IV) the freeing of fixed prices
V) the convertibility of the currency

The following section will therefore deal with the developments and achievements within the monetary and fiscal sector and determine their role in terms of stabilizing the economy as well as preparing the country for accession to the European Union.

5.2.1 Monetary and inflation developments

From the very beginning of the privatization process it was clear that a tight monetary policy had to be introduced in order to increase productivity within the Czech economy. Therefore, the role of the Czech National Bank (CNB) was crucial, especially in view of its economic support throughout the whole transition process. Thus, as Tosovsky (1995) points out, in order to guarantee the stability of the currency, the CNB relished constitutional independence and therefore could not be forced to act in the government's interest. This means also the separation between the CNB financial flows and those of the government (e.g. budgetary and fiscal policy). The functions of the Czech National Bank (also called Czech Central Bank) could be determined as:

1. **Issuer of banknotes and coins**
2. **Bank for other banks (e.g. the CNB offers loans to other banks)**
3. **Supervision**
4. **Representation functions (e.g. it has to perceive its task as the representative of the Czech Republic to the IMF)**

The aim of the CNB's monetary policy was to facilitate the conditions for growth and productivity (Janackova, 2000a)

The Czechoslovak authorities therefore implemented a system of credit volumes and interest rate ceilings in order to satisfy the goals of monetary policy. However, this system was replaced by late 1992/early1993 by standard market requirements. This policy shift included, for example, the use of discount rates and Lombard rates, refinancing credits, open market operations and open foreign exchange positions (Tosovsky, 1995)[21].

Nevertheless in 1991 the country had to face some turbulence after the freeing of prices as the table below shows. The inflation rate reached the level of 57.9% but was stable at 12% in 1992. The further development of the inflation rate figures will be shown later in this section (e.g. Table 21).

Table 21***: Economic and monetary figures in Czechoslovakia 1990-1992***

Percent	*1990*	*1991*	*1992*
GDP growth rate	-1.8	-15.1	-5.8
Inflation rate	10.0	57.9	12.0
Unemployment rate (end of year)	1.0	6.6	4.8
Current account balance (GDP)	-1.8	7.0	-0.3

Source: Janackova (2001)

It could be said that through different money instruments (e.g. the development of indirect instruments of monetary control) the monetary policy was "kept on a tight leash", so that, for instance, inflation was brought down to low levels quite early during the transition process and resulted in a long-term anti-inflation policy (IMP Survey, 1994). Following these developments the annual inflation rate fell to 8% until 1997 (EU, Regular Report, 2002).

Also in 1995 the Czech Republic introduced the convertibility of the CZK according to the rules of IMF Article 8.

It was two years later (May 1997) that the Czech Republic faced its first currency crises.

Horvath (1999) highlights the fiscal circumstances showing a high current account deficit and the slow down of economic growth which led to a situation of political instability and “contagious effects”. As a result the Czech currency came under speculative attack and put the Czech economy under pressure. This speculative attack was also the beginning of the Czech economic crisis between 1997-2000.

As a first consequence, the Czech Central Bank intervened heavily in the foreign exchange market in order to stabilize the currency and keep it inside the official band. Therefore, the exchange regime, which from 1991 was based on a fixed exchange rate to the Deutschmark and US dollar, was changed to a floating exchange rate with the Deutschmark as a reference (Janackova, 2001)[22].

A second measure undertaken by the CNB in January 1998 was the shift in monetary policy to direct inflation targeting. Direct net inflation targeting had an effect on consumer price inflation (excluding regulated prices). The whole system is based on future movements of the inflation rate. Within this policy attempt, the departure from the targets influences the monetary policy of the central bank (Janackova, 2000b). For instance, the CNB introduced an inflation target of 5.5% to 6.5 % for 1998 and 3.5% for the following year including a long-term inflation targeting scenario for the year 2005 (assuming that the Czech Republic would be a member of the EU) determining the inflation rate target between 1-3 percent (Bank of Ireland, 1999).

One should also take into account the critics’ concerns of such a monetary system. For instance as Janackova underlines in her research in 2000 (b) as well in 2001, this policy is also dependent on a number of other factors such as labour productivity, the growth of wages and the price movements within neighbouring economies. In order to explain the central bank’s lack of autonomy in small transition economies, Janackova (2001) refers to the so-called “escape clauses”[23] set up by the CNB in 1999 which should minimize the currency’s dependency on unexpected external factors. Thus, it could be said that the Central bank, in its attempt to manage the exchange rate is faced with influential factors which it can not control. Managed floating does not have a strong influence on FDI inflows and could lead to a conflict between the two targets of the CNB, namely exchange rates and inflation targets.

However, as highlighted earlier, the CNB in 1999 set its medium and long-term inflation targets among other goals which also had to be achieved in order to stabilize monetary policy. These goals are determined by the Czech Ministry of Foreign Affairs (1999) as:

1. **Inflation (e.g. 3.5 – 5.5% by the end of 2000)**
2. **Some legislative tasks**
3. **Standardising monetary policy instruments (e.g. modification of the reporting derivatives operations)**
4. **Balance of payment statistics**
5. **Exchange rate tasks (e.g. pegging the foreign exchange to the Euro)**

A survey by the IMF in 2000 underlines the fact that the CNB "has made a commendable effort" in order to improve monetary policy. For instance, the attempts to internationalise banking supervision and regulations have been significant.

Another survey by OECD (2001b) points out the successful efforts of monetary policy in keeping down inflation and the decision to shift its policy to target headline inflation after negotiating an agreement with the government in terms of price deregulation. Also in 2001 the CNB could achieve its target for net inflation. Headline inflation was supposed to fall below the continuous target band from the year 2002 onwards (IMF, 2002a).

The European Commission (EU, DG Economic and Financial Affairs, 2002c, p.35) defines in its enlargement paper the following achievements of the Czech Monetary and Exchange Rate Policy:

"The Czech National Bank fulfils its tasks on the ground of a clearly defined legislation manner. This refers both to the institutional framework of monetary policy and to its implementation."

Furthermore, in its Country Report (Commission of the European Communities, EU, 2002) on the Czech Republic, the Commission highlights the fact that inflation remains at low levels in the Czech Republic (e.g. 3.9% in 2000 ad 4.5% in 2001). The CNB's policy of a managed floating exchange rate, as well as direct inflation targeting, have "served the economy well", and gives for the years 2003-2004 the following forecast:

Table 22: Inflation rate figures in the Czech Republic 2001-2004

Percent	*2001*	*2002*	*2003*	*2004*
Inflation	4.7	2.0	1.9	2.8

Source: Borja (2002)

The commission also commends the set band of inflation targets from 3-5 percent in 2002 to 2%-4% until 2005. It also emphasizes the possibility of “escape clauses” application in the event of unexpected moves in regulated prices.

All in all, the Commission welcomes the achievements of the CNB reflecting the low inflation levels and the strong exchange rate of the Czech currency, since it is expected to continue showing an appreciative trend.

Taking these developments into account, one could argue that from an institutionalist perspective the Czech Republic has established a truly strong and independent Central Bank like its western European counterparts, fulfilling the targets of monetary policy. The implementation and application of EU norms have been successfully completed, ensuring a strong currency and low inflation rates. By doing so, the Czech National Bank has not only contributed to the creation of a secure investment environment for FDI, but also started to prepare the country for successful access to the EMU. For instance, by setting up the long term net inflation targeting between 1-3 percent (until 2005), the CNB hoped to reach the levels it has to accomplish in order to join the European Monetary Union. If the CNB keeps the headline inflation between 2-4 percent, there should be no problem in qualifying for the common European currency.

5.3 Fiscal Policy and the institutional framework

Fiscal policy had to undergo huge changes not only in Czechoslovakia, but also in all transition economies of Central and Eastern Europe. Especially in Czechoslovakia, fiscal policy was distinguished through the government’s objective to reduce its role within the economy as it did during the privatization process.

In order to implement the initial steps of a successful fiscal transition process, the following measures were implemented by the government (IMF Survey, 1994):

1. **huge reductions of subsidies**
2. **reduction of corporate profit tax rates**
3. **replacement of income tax as well as the social security system**
4. **introduction of VAT (Value Added Tax) within the tax system**

As a first step a VAT system, as well as an excise duty system were implemented in 1993 in order to satisfy the acquis in taxation matters (European Commission, Regular Report, 1997). One of the European norms in the taxation context regards the existence of a non-cumulative general tax on consumption, the so-called VAT. The VAT system is applied to all stages of production and distribution of goods and services. Domestic and non domestic transactions should be equally treated.

It is important to notice that by implementing EU fiscal standards such as the VAT system the member states hope to reduce transaction costs. For instance, in its Regular Report 1997 the Commission underlines the fact that "all fiscal controls at the Community's internal frontiers" were abolished (in January 1993) in order to strengthen the European Single Market. From an institutionalist point of view the applicant countries have therefore to implement a successful VAT system in order to reduce transaction costs.

However, the Commission in its Regular Report 1997 states that the existing VAT system in the Czech Republic fulfils the main principles of the Union[24] but, at the same time, the Commission underlines the fact that the Czech Republic has still to bring VAT legislation "into line with" the obligations of the acquis, including the elimination of discrepancies between the "Czech excise regime and EU requirements".

Nevertheless, it should be noted that the tight fiscal policy, until the start of the economic crises in 1997, provided a policy through which serious unemployment problems and high inflation rates could be avoided. The beginning of the 1997 crisis put public finances under pressure. The Ministry of Finance therefore introduced medium-term projections in order to tackle the large deficit increases. As the Ministry of Foreign Affairs in 1999 highlights the measures were:

1. **the development of appropriate capacities and the introduction of the necessary institutional framework (e.g. the set up of a Government Statistics Department; the strengthening of the financial policy department)**
2. **defining fiscal risks (e.g. reinforcing analytical work)**
3. **enhancement of the legislative framework (e.g. preparing a state treasury system, further preparing an amendment regarding the Administration of Taxes and Fees as well as the Act on the State Statistical Services)**

The latest provision regarding the legislative framework also depicted the main concern of the Commission in 1999. In its country report 1999 (Commission of the European Communities, Regular Report, EU, 1999), the EU emphasizes that "tax administrative structure and control procedures" still have to be established. Furthermore, there was no progress in VAT legislative alignment as suggested by the Commission in its 1997 report as well as in 1998. Further research by GERGE-EI (2002) highlights the growing tax evasion trend by the Czech citizens. This is in part due to the taxation laws which make it easy for businesses and the self-employed to avoid taxation. Alongside this problem, the complexity of Czech income tax law aggravates the situation. For instance, the original income tax law (1993) mentioned the term "with the exception of" forty times; the figure was three times higher by 2002 after the law had undergone several revisions. Even more alarming in the fiscal context, are the developments within budgetary policy. As two surveys by OECD (2001) and the European Union (EU, DG for Economic and Financial Affaires, 2002c) in November 2002 showed, the Czech Republic had to deal with several budgetary problems less than two years before accession to the European Union. Predominantly these problems seem to be caused by the existing extra-budgetary funds accounting for a large amount of budget expenditure.

The pension system is also a subject of concern since it counted, for instance (in 2001), for 24 percent of government expenditure. In the context of the pension scheme, it is estimated by GERGE-EI (2002) that by 2030 one quarter of the Czech population will be 65 or older. As a matter of fact it is feared that the deficit within the pension scheme could rise from 1% of GDP in 2002 to about 3% before 2020. The high costs of the pension sector are reflected clearly, looking at the Czech Republic's State Budget Proposal for 2003:

Table 23***: Government spending for the year 2003(billion CZK)***

Pensions	*225.9*
Education	*88.9*
Wages of State Employees	*54.2*
Social Benefits	*44.4*
Health Care	*44.2*
Defence	*44.1*
Sickness Benefits	*34.4*
Police and Security	*31.8*
Unemployment Benefits	*10.4*
Other	*217.1*
Total	*795.4*
Deficit	**111.3**

Source: GERGE-EI (2002)

Therefore, two decisive revisions have to be implemented. The pay-as-you-go pension scheme has to undergo the necessary reforms in order to avoid its collapse. Furthermore, the whole health care system has to be redesigned since the government has to cover the deficits caused by the lack of a "self-adjusting mechanism".

Moreover, in 2001 the government faced a deficit of 5% of its budget, caused not only by the reasons explained above, but due to other new developments. The budget deficit grew because of flooding costs but, more importantly in this context, the cleaning up and the privatization of the banking sector as well as the restructuring of the corporate sector.

The budget deficit reached 66.7 billion CZK (3.1% of GDP) in 2002 and, as the figures above show it will reach the level of 111.3 billion in 2003. This means an overall public deficit of 6.3 % in 2003. These figures seem to be more alarming if one takes a look at the public deficit in 2002, which was around 9% of the GDP without counting the privatization incomes. The Czech public budget deficit shows a constant increase from 1997.

A later survey by the International Monetary Fund in November 2002b has emphasized that from 1997 onwards the government budget deficit has grown continuously without there being any efforts on government's side to reduce this dangerous tendency. Taking out the expenses of banking sector restructuring the deficit still made up 5.3 percent of GDP in 2002 and was expected to be 5.6 percent in 2003. The IMF further underlines these worrying developments and warns that without reforms public debt would continue to rise. The deficit figures could be determined as follows (figure for 2002 is estimated and for 2003 projected):

Table 24*: Consolidated Public Deficit, percent of GDP*

Year	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Without Privatization Income	-2.1	-2.4	-2.8	-4.4	-5.1	-9.0	-7.8
Without Privatization & Transformation Institutions	-1.4	-1.4	-2.4	-3.4	-2.8	-5.7	-6.3
With Privatization Revenues	-1.2	-1.5	-0.6	-3.1	-2.4	-2.9	-5.7

Source: GERGE-EI (2002)

Adding to these costs the mandatory expenditure of the government challenged the state budget, since there was no demand from the public. A survey by IMF in 2002b showed that the budgetary measurements did not correct the fiscal imbalances and therefore, Czech fiscal policy remained "very expansionary". The following table reflects the high and steadily growing amounts of mandatory expenditures by the government since 1997(2001 preliminary; 2002 budget):

Table 25*: Mandatory Expenditures (Thousand CZK):*

Per cent	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Mandatory Expenditures	266.593	299.588	310.713	335.899	355.786	386.591
Quasi Mandatory Expenditures	118.606	125.861	135.106	141.142	175.032	193.426
State Budget Expenditures	524.668	566.741	596.909	632.268	662.594	694.241
GDP in c.p. (bln.CZK)	1.680	1.837	1.887	1.960	2.131	2.296

Source: GERGE-EI (2002)

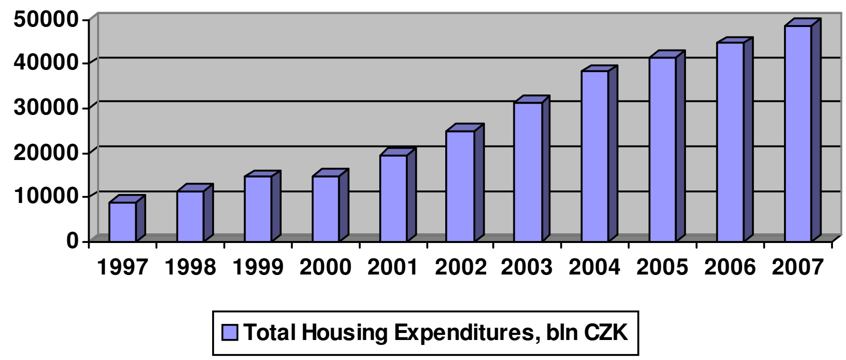
Table 26: ***Mandatory Expenditures as shares on State Budget Expenditures (in percent)***

Thousand CZK	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Mandatory Expenditures	50.8	52.9	52.1	53.1	53.7	55.7
Quasi Mandatory Expenditures	22.6	22.2	22.6	22.3	26.4	27.9
Mandatory and Quasi Mandatory	73.4	75.1	74.7	75.4	80.1	83.5

Source: GERGE- EI (2002)

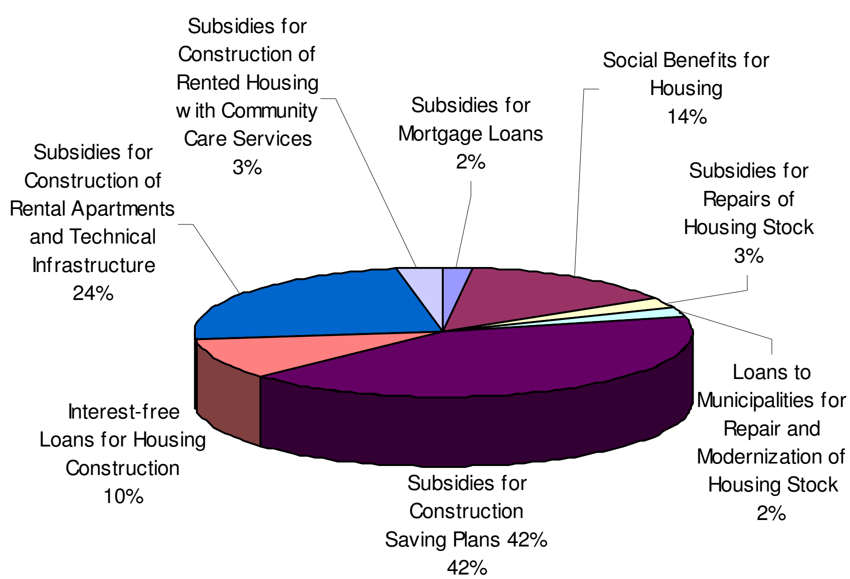
For instance, one of these extra-budgetary costs refers to the rental and housing sector. As a study by GERG-EI in 2002 highlights, Czech politicians did not take advantage of public support in order to push forward and change the regulated situation in this sector to a more market oriented one. Including all utilities, average household spending in the Czech Republic is not more than 16% of income. Another issue within this context is the “vacant” housing units. In 2001 about 12.4% of all housing units were vacant. Even in the capital city Prague, 9.4% of houses were reported to be empty. There is no apparent shift by the government to change this situation. In fact, the government is planning to double the existing funds and resources for this sector up to 1.5% of GDP. The following figure shows clearly the growing support of the housing sector by the government from 1997 onwards and gives a projection of these expenditures’ developments until the year 2007 (CERGE-EI, 2003):

Figure 4: Czech Republic's expenditure on the state housing 1997-2007



Taking the 1999 housing support into account, one could subdivide the expenses of 14.7 CZK for this sector into several subsidies as shown in figure 5, which shows clearly the high involvement of the state in the housing sector. This development might have had its positive effects if the government had ensured that the funds were invested for housing construction. Considering the construction saving plans, one could say that because of the higher returns this fund is used by the public as an "ordinary long-term savings contract" instead of investing it in housing construction.

Figure 5: Different types of housing support in the Czech Republic



Source: CERGE-EI (2003)

The EU as well as the Constitutional Court have demanded the revision of this sector. The European Commission underlines the need for changes, in order to increase the amount of investment into the housing market. The constitutional court has identified the current rent controls as violating the proprietor's rights. However, the government seems to be unable to force changes and, as a consequence, the costs within this sector remain high for the state budget in the future.

Thus, the reduction of mandatory spending in non-priority areas is an essential issue still to be addressed by the government. The reforms are of special importance if the Czech Republic desires an early adoption of the Euro too.

In conclusion, it could be said that the Czech Republic's budgetary problems are basically due to the following factors (IMF, 2002):

1. **the existence of the extra-budgetary funds (e.g. transport and housing funds)**
2. **costs related to EU accession**
3. **banking restructuring**
4. **completing the privatization process**
5. **pension scheme**

Therefore, the implementation of fiscal reforms during the years 2003-2006 is of crucial importance. The evaluation of transparent institutional mechanisms and budgetary control mechanisms by the Ministry of Finance should be strengthened in order to gain control over the increasing share of spending outside the State Budget.

In this context Brusis and Dimitrov (2001) emphasize the importance of executive - institutions centralization in order to increase fiscal performance. In the case of the Czech Republic they found out that institutional reforms were only introduced in the early 1990s. Whereas some positive institutional building could be observed in Hungary and Poland (for example the strengthening of the prime ministers' institutional position leading to substantial improvement of financial reforms), the Czech Republic shows an "under-institutionaliaztion"[25].

Despite the good performance of the Czech Republic regarding the implementation, modernization and strengthening of VAT and excise duties guidelines, the Czech Republic has still to build up a strong institutional system justifying the fiscal administrative challenges. This weakness represents one of the key issues which the European Commission refers to in its county report 2002.

In order to ensure the effectiveness of Czech fiscal policy, the Commission highlights the need for the Czech authorities to reinforce and strengthen tax administrative capacities.

Thus, the improvement of the institutional framework seems to be a crucial element if the Czech Republic desires to join the EMU successfully once it has joined the European Union.

5.4 The liberalization of the economy

It was clear from the beginning of the transition process that the old central-planned economic system had to be replaced by an economy based on private ownership, free prices as well as free trade. Therefore, one important issue within the transformation process was not only the restructuring of enterprises but also economic liberalization.

In this context the first step included the lifting of price controls in order to establish relative prices which were based on free market conditions. By doing so the former SOEs were limited in their monopoly power and, as a consequence, they faced a new situation, namely the situation of "demand-production" (Gros, Steinherr, 1995).

It was now that many weaknesses of the economy became visible. The Czech economy had to face the fact that many enterprises were operating in the wrong sector since the industrial structures had not been changed throughout the communist era.

In the former Czechoslovakia the liberalization of prices began on 1 January, 1991 (Newton, Walsh, 1999). The implementation of liberalized prices was not only a rapid process, but also led to an extreme (but isolated) rise in prices and, as it has been shown in the last section, the early introduction of VAT brought another price shock but the situation could be kept relatively stable.

Bear in mind that some price regulations still remained, especially in the energy, water, transport, rent, health and telecommunication sectors.

It could be said that both the price as well as the trade liberalization created a new supply and demand ratio in the Czech economy.

Even though successful price liberalization has been achieved, one should take into account that the convergence of Czech price levels in comparison to those of the EU is a long-term process.

As the previous enlargements have shown (for instance Portugal joined the Union with price levels as high as 55% of the EU average) equal prices can not be achieved within a few years of accession as this is rather a long process (Janackova, 2000a).

So far, the level of price liberalization in the Czech Republic has been analysed, however, in the context of the EU enlargement, a short overview should be provided in order to determine the liberalization degrees achieved within other industries such as railways, postal, electricity and the telecommunication sectors.

As a survey by Lizal (1999) shows, monopoly regulations were not introduced in any of these sectors until 1999.

The evaluation of the developments within all these sectors would go beyond the scope of this thesis, nevertheless, in order to draw a picture of the main difficulties of the liberalization process the developments within two selected branches, namely the energy and the communication sector, will be highlighted.

The Commission's Country Report in 1999 and 2000 expressed the need for the Czech energy sector to bring legislation more in line with the EU energy acquis.

In 2001 a series of changes took place. A new law was introduced in order to tackle the situation within the internal market.

In January 2002 the "gradual" liberalization of the energy market started. In its Country Report 2002 the Commission welcomes the achievements in the energy sector and emphasizes the good level of the alignment.

It is expected that the Czech Republic could fulfil the acquis regarding the energy sector by 2005 and the full opening of the market should be achieved by 2006 (CERGE-EI, 2003).

The same tendency can be seen in the case of the telecommunications sector. Also here liberalization started with some delay, and prices were regulated by the government until 1999. They "only consist of price caps set by the Ministry of Finance and Telecommunication" (Lizal, 1999).

The telecommunication Act (Act NO.151/2000) ended the monopoly position of EESKY Telecom and set new rules for a new liberalized market (Czech embassy, 2001). The Commission in its Report (2002) underlines the fact that after the implementation of the new law, competition within this sector was held back for 18 month due to gaps in the Act itself and the weak position of the "Regulator".

The telecommunication market is doing well but the regulatory framework has to be improved. Therefore, the Commission emphasizes the need for the Czech government to implement the so-called "universal services acquis" within this sector.

In conclusion, as can be seen in the two examples above, the liberalization of key network industries did not significantly take place before the year 2001.

At the time of writing, it could be said that the Czech Republic has set up the institutions necessary to regulate the market, but unfortunately at the same time there is a lack of transparency within the legal framework in order to push forward the liberalization issues bringing them in line with the acquis.

The implementation of these directives (rules and norms) is of particular importance from an institutionalist perspective. Once more the question remains and that is if the Czech Republic will be able to implement the necessary steps so shortly before accession in order to tackle the problems of the legal framework.

This seems to be rather unlikely since the first steps were undertaken in 2001. It is more likely that the liberalization of many industrial sectors will be achieved some years after the accession of the Czech Republic in 2004.

5.5 Trade liberalization

After the velvet revolution in Czechoslovakia and the beginning of the democratisation process, Czechoslovakia, and later on the Czech Republic, lost its traditional links to the CMEA (Council for Mutual Economic Assistance) countries and to the Soviet Union.

As Turnovec (2001) points out, the trade system was based on the Soviet role as a consumer of energy and raw materials on the one hand, and on the other hand it delivered mainly final products (e.g. military equipment) to the members of the CMEA. The whole system aimed to protect the former central-planned economies from competition within the world market.

Most trading among the CMEA countries was based on goods which were not "in demand" anymore or, if demanded, their large production quantities represented a problem since they could not be sold. For instance as Wineckil (1994) points out, due to the changed political and economic circumstances further industrial products, such as low-quality machinery or military equipment, were not of use anymore.

Starting from this situation Czechoslovakia had to turn around and implement reforms in order to liberalise foreign trade. As a first step the state monopoly of foreign trade was abolished, tariff and non-tariff trade barriers were reduced in order to allow the establishment of a free trade oriented economy (Stolze, 1997).

Thus, since 1989 a number of reforms were implemented in order to eliminate import quotas and export licensing requirements.

A first step towards Western Europe was the subscription to the so-called "European

Agreements". These agreements served as first measurements in order to establish a framework for international trade relations. Consequently, the EU markets were opened to Czech goods and vice versa. It was from now on that a shift in Czech trade towards EU markets started. The high degree of Czech integration into EU economic structure becomes apparent if one looks at the trade patterns. In 1990 only 38% of Czech exports had the EU as their destination whereas in 1999 it was almost 70%.
Looking at the following table the growing importance of the EU as a market for Czech goods becomes clear:

Table 27*: Czech trade figures 1990-1999 in million of US Dollars*

	1990	*1995*	*1999*
Exports			
Total	9051.6	21646.8	26878.7
EU-15	3473	13191.4	18594.9
Other developed	477.6	1096.1	1461.5
CEEC	1143.2	4479.4	4388.4
Other	3957.8	2879.8	2433.9
Imports			
Total	9815.4	25252.2	28849.3
EU-15	3971	15423.1	18461.8
Other developed	670.1	2044	2769.4
CEEC	1215.6	3914.2	3283.7
Other	3958.7	3870.8	4334.5

Source: Own draft based on Turnovec (2001)

The situation changed from 1994 as a deficit trade balance became more obvious. This tendency was due to growing domestic demand which could not be satisfied by domestic suppliers.
Thus, import rates began to rise, especially imports from the European Union. Taking the trade figures for 1993 into account, this was a surplus of 10.1 billion CZK but in 1994 the trade balance showed a deficit of 20 billion CZK up to 100.6 billion CZK in 1995 (Stouracova, 1997).
The reasons for these developments become more obvious if one examines Czech import patterns more closely. As a survey by the HypoVereinsbank (2000) has

shown, predominantly the Czech imports comprise of "intermediate products" and investment goods. Taking for instance machinery manufacturers into account, one can assert that machinery equipment imported from Western European countries are inputs for final goods which are destined not only for local demand, but also for export. Therefore, one could say that the European Union became the major trade partner for the Czech Republic. In 1996 and 1997 domestic demand increased, whereas export rates decreased due to weak demand in the European Union. Even though exports increased slightly in 1998 the trade deficit remained (Zamrazilova, 2000).

The situation did not improve. In 2001 export figures showed an amount of $ 33 billion, whereas imports amounted to 36.5 billion US dollars, leaving a gap of 3.1 billion dollars. The following table shows the major import and export goods for the Czech Republic in 2001 (Economist, 2003):

Table 28*: Czech major export and import goods*

Export Goods	*Major exports (% of total)*	*Major imports (% of total)*
Machinery and transport equipment	47.3	42.2
Intermediate manufactured goods	24.4	20.2
Chemicals	6.4	10.9
Raw materials and fuels	6.0	11.9

Source: Own table based on Economist (2003)

It was the weakness of foreign demand, which in 2002 caused a trade deficit of 3 billion US dollars, forcing Czech exporters to make price concessions in order to maintain the level of export and the market share. The trade deficit figure for the year 2003 is expected to be higher than in 2002 (Dresdner Bank, 2002).

In conclusion, it could be said that Czech exports consist mostly of machinery and transport equipment and the amount of these goods has doubled since 1993. At the same time the Czech export industry remains highly dependent on demand as well as developments within EU markets, especially Germany.

Table 29*: Czech external trade (1999-2001)*

External trade	***Million Euro***		
	1999	**2000**	**2001**
Trade balance	-1.746	-3.394	-3.425
Exports	24.638	31.492	37.267
Imports	26.384	34.886	40.692
	as % of total		
Exports with EU-15	69.2	68.6	68.9
Imports with EU-15	64.2	62.0	61.8

Source: Regular Report (2002)

The European Union is now the biggest trading partner of the Czech Republic. Looking at the trade figures above, one could say that the Czech Republic has moved from the former Soviet Union and the CMEA countries as its main trading partners to the European Union, and particularly to Germany.

The removal of the monopoly position of the state within the trade sector, the reduction of tariffs and non-tariff barriers and the establishment of EU trade rules and codes of conduct are important steps which have been undertaken so far in order to liberalize the economy.

In this context NIE emphasis the need for norms and rules in order to guarantee the transactions between the economic players, without these norms and values a smooth transaction of all market forces is not possible. Formal and informal rules and norms are necessary elements in order to guarantee transactions not only between principals and agents, but also between economic actors in general.

Nevertheless, one should still keep in mind the continuous growth of the trade deficit which must be the subject of consideration in order to guarantee a balance of payments.

Notes:

1 One should note that the German government had some agreements with its neighbours such as Poland regarding this issue. However, in the Czechoslovak case the German government was under pressure caused by the Sudeten German claims who demanded from the German government an agreement not to compensate in Czechoslovakia until their own claims are resolved.

2 Takla (1994) defines a period of minimum five years, during which these enterprises have to stay under state control.

3 One should note that the Prague Stock Exchange (PSE) started with trade on a "once-weekly" basis. It was not until September 1994 that the PSE started daily trading.

4 One should note that this development is highly questionable, since strong and healthy enterprises would probably be sold by the government for cash.

5 Important to notice at this point is that property which was held by the NPF was not part of the state budget. The privatization revenues therefore could not be used by the government in order to fill the gaps of the state budget (Schöllmann, 2001).

6 This amount was about $ 35, approximately one week's wage at the time of purchase.

7 HCC was headed by Mr. Viktor Kožený, who tried to gain public confidence through his education at Harvard University.

8 Based on Hanousek and Tůma (1998)

9 In this context one should also notice that some authors also refer to the so-called "third wave" of privatization which was not implemented by the government. For instance, Rona-Tas (1997) highlights the third wave as a "spontaneous process" which "rearranged" property already privatized during the first wave.
Here, it was in October 1995 as the Plzen Bank tried to convince disappointed investors (booklet owner) of the large IPFs through a television campaign (using the slogan: Small share-holders, weep!).
However, the Plzen Bank was the executive organ; the major player behind this massive TV campaign was Motoinvest, a small brokerage firm which was run by young people (mostly between 19-28). Motoinvest claimed that once they are in charge of the business, they won't support the passive ownership style of the large IPFs. They will force a radical restructuring policy. As a result of this aggressive policy, large banks owning the large IPFs started to respond by putting the other banks under pressure and forcing them to discontinue lending money to Plzen Bank.
However, the outcome of this wave had also its impacts on the privatization development within the Czech Republic which are examined in section 5.1.4.5. and 5.1.4.6.

10 "Tunneling" means the practice of stripping assets from enterprises.

11 The IPFs had to be established as joint-stock companies with an initial capital of 100000 Kcs. Also a founder was required in order to get the licence (Brom, 1994).

12 In this context also: Investment and Postal Bank, Czech Savings Bank and Czechoslovak Trade Bank

13 This agency was managed by two foreign companies, namely the Lazard Freres and Latona Associates.

14 In 65 enterprises the state holds through the NPF a "golden-share" and another 55 companies were under bankruptcy proceedings.

15 It should be noted that the giant and large ICs have through their IPFs holdings in many companies, and therefore in a lot of cases this development has created a situation in which they have to work together (Mc Dermott, 1993).

16 Further, the privatization process suffered also from the lack of standard procedures. For instance, in many cases the MOP failed to enforce buyers to pay for the assets they had purchased as scheduled because of the lack of adequate procedures (Bornstein, 1999).

17 This development was also a result of the insufficient laws regulating the privatization process. Here, it was determined that not more than 20% of a company could be purchased by an investor.

18 Greenfield FDI is a new investment made by setting up a new foreign affiliate.

19 One should recognize that at this time VW did not take over all the Skoda assets. The Skoda plants were at that time partly owned by the Czech government.

20 At the time of the survey the Volkswagen-Skoda venture accounted for 13.5 percent of Czech total exports.

21 One should take into account that after the "velvet separation" the new Czech currency, the Czech Koruna (crowns), was established at the same exchange rate as the Czechoslovak Koruna which was introduced in January 1991. As a matter of fact the exchange rate continued to be a fixed exchange rate to the US Dollar and the German DM for another five years (Janackova, 2001).

22 Horvath (1999) in this context emphasizes the fact that the attempt to keep the currency fixed to other strong currencies (such as the German DM and US Dollar) over a long term is not possible for small transition economics such as the Czech economy. Even other western European countries with a stronger and healthy economy were not capable of accomplishing this target.

23 *The "escape clauses" should be capable of substantiating the divergence of inflation from targets. These clauses are (Janackova, 2001, p.62):*

1 *substantial divergences of world prices of raw materials, energy resources, and commodities;*
2 *substantial divergences of the exchange rate from the prediction if they are not connected with domestic fundamentals and domestic monetary policy;*
3 *substantial changes in conditions for agricultural production, with an impact on agricultural producer prices; and*
4 *natural catastrophes and other extraordinary events with cost- and demand-induced impacts on prices.*

24 The Commission determines the Czech VAT system as a dual one where in the first stage a standard VAT rate of 22% is applied to all suppliers of goods and certain specific services. The second rate of 5% is applied to nearly all services and certain specific goods.

25 Brusis and Dimitrov (2001) justify this underdevelopment with the role of Vaclav Klaus who could define the policy guidelines unchallenged due to his "party-political and personal authority", but once this authority declined, it left the Finance Minister in a weak position.

Chapter 6 Capital markets and the financial sector

A functioning capital market is one of the key components for a free market economy. Investment and public confidence increase through a functioning capital market. Without this prerequisite any free market economy faces difficulties in attracting new capital.

Therefore, in the context of the NIE and Sociological Institutionalism it is important to analyse if the shared EU norms as for the capital markets and the financial sector in general have been implemented so far. The adoption and institutionalization of EU norms such as the Directive 92/30/EEC regarding the supervision of the banking sector or the Directive 91/308/EEC conforming to money laundering (BDE, 2003) are of special importance. It is significant to verify which actors are involved in the process of norm setting and if, so far, the implemented norms ensured the expected effects. Furthermore, have EU legislation regarding structural reforms and the transparency of the banking sector, and also norms and directives regarding the combat of insider dealing been adopted and are they effective?

Moreover, are the necessary institutions capable of monitoring and regulating the capital markets?

Newton and Walsh (1999) underline the fact that with new capital, especially enterprises in transition economies can modernize their facilities and are capable of paying dividends.

As Rusek (1999, p.178) states, certain measures have to be developed in order to guarantee the functioning of capital markets. These measures are as follows:

"I) Financial markets must be made transparent and sufficiently liquid. Detailed disclosure requirements and standards of capitalisation for companies, together with limits on cross-ownership of financial and non-financial companies, are basic steps in this area.

II) Deposit insurance must be clarified and addressed, establishing the principle of shared responsibility between the depositor, the financial institutions and the state.

III) Clear and detailed patterns of supervision and regulation of the financial sector must be established and enforced.

IV) The financial sector must be opened up to foreign ownership and competition in all areas of its activity."

Here, one should also take into account that the financial sector consists of different elements. Alongside the Central Bank as lender and supervisor of the monetary policy, other entities such as commercial banks, non-bank financial institutions and stock markets play a key role in a functioning market economy.

Thus, the aim of this chapter will be to determine whether Czech financial markets meet the conditions listed above and also to analyse how the sector will withstand the competition pressure within EU financial markets once it has joined the EU in 2004.

6.1 The banking sector

As Leff (1997) points out, the communist economy of Czechoslovakia was based on the Stalinist model and therefore these systems had always been "deficit economies facing permanent shortcomings".

Basic measures were taken in order to meet quantitative output targets and quality had never played a decisive role. In other words, due to lack of competition the customer had no choice.

State subsidies for loss-making enterprises were part of the government's economic policy. Banks mainly channelled funds instead of acting in favour of their customers (Leff, 1997).

Further, it could be said that the modern financial system of personnel, technical and supervisory complexities, which built up the crucial elements of the modern financial sector, were non-existent. There was a separation between household financial flows, which generally were held as savings in banks, and the enterprise sector. Therefore, these "monobanks" were nothing more than institutions accomplishing their task of accounting. There was no need for banking supervision and bank governance since the credit decisions for the SOEs were subject to political influences and not to free market conditions.

Furthermore, the whole sector was neither under competitive pressure nor ruled by specific regulations. As determined before, subsidies by the state were part of the system and loans were therefore given to the industrial sector even though the enterprises were not efficient. Consequently, many of the loans were non-performing. Gros and Steinherr (1995) argue that constructing a new banking infrastructure in transition countries is much more complicated than reforming the non-financial sector. An efficient credit allocation, as well as bank deposits, are crucial for these economies. The problem remains how to design and develop an effective supervision of the banking sector during the transformation phase.

Heppke (2001) highlights in this context the importance of commercial banks because of their role in how to handle “informational asymmetries”. Here, their skills and expertise enable them to reduce market risks (such as borrowers’ insolvency). In the best case banks are capable of channelling funds to those investments which are supposed to be productive. However, the situation can change if asymmetric information creates an atmosphere of “adverse selection and moral hazard” so that banks are not willing to lend. This development could create instability within the financial system. To avoid this, the Central Bank has to fulfil its task as a supervisor of financial flows as well as of the commercial banks.

From an institutional perspective, bank recapitalization has to be accompanied by effective supervision and regulations in order to ensure the effectiveness of the banking system. The institutional capacities and the legal framework are the two most crucial factors in this context.

Especially in the context of the former centrally-controlled economies of Central and Eastern Europe the implementation of a two-tier banking system is essential accompanied by a comprehensive restructuring of the banking sector (Sundararajan, 1996). An effective recapitalization should not only be implemented as quickly as possible, but it should also take care of bad loans. The banks should disclose bankruptcy procedures against those enterprises which are not able to survive under free market conditions and lend only to those which are viable. And in terms of European enlargement this would help to create a market capable of competition with those of the Union.The aim of the following section will be the determination of these significant questions:

How successful is the Central Bank in its role as a supervisor of the financial flows?

How effective are the commercial banks in terms of converting the asymmetric information given within the financial markets?

6.1.1 Implementing structural reforms

In order to create a new banking system the former socialist banking system had to be replaced by a new one, which was capable of free market operations. Thus, the former central bank, which not only accomplished its role of monetary policy, but was also responsible for the allocation of credits to the entire industrial sector, had to be replaced. This also involved the replacement of several subsidiary banks which specialized in different banking segments (Kutan, Brada, 2000). These banks could be described as (IMF, 1993):

- The development bank which was responsible for investment projects
- The foreign trade bank which specialized in dealing with foreign currency
- The savings banks responsible for the household sector (e.g. savings)

With the replacement of the "monobank" on 1 January 1990 the first steps of banking privatization were introduced. This step meant the creation of a central bank responsible for monetary policy as well as the creation of commercial banks which specialized in lending and commercial activities. A two-tier system was implemented separating commercial from monetary functions.

The Czechoslovak National Bank (and later on after the separation of the two republics the Czech National Bank) was created in order to manage monetary policy such as the formulation of monetary targets, issuing bank notes and coins and the control of currency circulation (Newton, Walsh, 1999).

In order to create a commercial sector two new banks were created, Komercni Banka Praha (Commercial Bank of Prague) and Vseobecna Uverova Banka Bratislava (General Credit Bank of Bratislava). These two banks took on the majority of the former "monobank" loan portfolio. In 1991 long-term assets were transferred to the Investici Banka (Investment Bank). The allocation of the savings function was conducted by Ceska Sporitelna and Slovenska Sporitelna, the two savings banks, operating in each case in the Czech and Slovak parts of the former CSFR. Ceskoslovenska Obchodni Banka (Czechoslovak Trade Bank) remained active in the foreign trade and foreign exchange market segment as it did during the socialist period (Borish, Ding, Noël, 1997).

In this context one should also take into account the government's attempt at the beginning of the transformation process to establish new commercial banks in the newly privatized market as quickly as possible in order to satisfy the demand for commercial banks. As a result the government did not set up as many requirements for commercial banks as might have been appropriate. Neumann, Egan (1999) criticizes the minimal licensing requirements as well as the weak governmental control and supervision over bank lending activities, especially at the beginning of the transformation process, at a time when it was crucial to regulate banking activities.

Since the centralized communist banking system had limited the development of appropriate bank governance, the supervision issue appears more decisive if one considers the lack of experience of both the personnel and the bank manager.

In the Czech Republic four commercial banks were able to establish themselves as market leaders up to the mid 1990s:

Komercni Banka (KB), Ceska Sporitela (CS), Ceskoslovenska Obchodni Banaka (CSOB) and Investicni a Postovni Banaka (IPB).

6.1.2 Banking sector problems until 2000

Throughout the 1990s the banks in the Czech Republic had to face numerous problems of varying nature. The major problems of the banking sector from which the banking crises in the mid 1990s occurred will be described below.

6.1.2.1 Cross-ownership and the conflict of principals and agents

As Brom and Orenstein in 1994 have already pointed out in their research, the role of the banking sector within the Czech industrial and enterprise sector has been crucial from the beginning of the transition process. Through their ICs the banks have played a continuous and important role within the newly privatized industrial sector. They were both not only owners but also creditors. ICs had a tendency to borrow from their parent banks and the banks were unwilling to start bankruptcy proceedings against those enterprises in which they were owners through their investment funds. Leff (1997, pp.195-196) describes this behavior:

"(Banks) as lending institutions, … are judging the creditworthiness of firms in which they also hold an ownership interest (as a matter of fact) banks… tempted to grant loans to prop up floundering firms rather than rewarding solvent ones…"

As a result of this cross-ownership, competition within the banking sector remains limited. Here, one should also notice that banks are not only owners of non-financial institutions but also of each other. For instance, as a report by OECD in 1996 determines, Investicni Banka had not only shares in Komercni Investicni but it also held 8.8 percent of Ceska Sporitelna. The following table outlines the complicated level of cross-ownership links within the Czech banking and industrial sector until 1996:

Table 30*: Ownership of the key Czech financial institutions*

Owning institutions	**Komerční banka**	**Česká Spořiteln**	**ČSOB**	**IP banka**	**Živno-Banka**	**Česká Pojišťovna**
Komerční banka (IKS KB a.s.)	1-10	*a				10
Česká spořitelna (SIS a.s.)	1-10		*a		*a	10
ČS obchodní banka	*a	*a		*a	*a	14
IP banka **(PI a.s.)** **(Rest. Fund)**[b]	 1-10 1-10	 11 3		 *a 7	 10	10 3
Živnostensá banka **Česká pojiŝt'ovna (KIS a.s.)**	1-10 1-10[c]	*a		*a	*a	*a
State institutions **FNP** **Others**	 48	 40 20[e]	 20 24[f] + 24[g] +20[h]	 34	 5	 33
Private sector **Harvard C&C**	>10	11				*a
Other named Institutions	1-10[d]				40[j]+12	
Individuals		4	1	6	12	5[l]
Unallocated		11	9	53[i]	20[i]	15

Notes: **a** Precise data not available but ownership indicated either by Brom & Orenstein or Marcinčin & Mládek, **b** This fund, set up by the Fund of National Property, is now administered by První investiční, **c** VÚB Kupón a.s., founded by Vseobecná ŭverová banka, Bratislava, **d** Wood and Co.s.r.o, **e** Municipalities, **f** Slovak National Bank, **g** Czech National Bank, **h** Czech Ministry of Finance, **i** No institution owns more than 10% of the shares, **J** BHF Bank, **k** IFC, **1** Employees
Source: Kenway, Klvačova (1996)

Another example in this context represents the case of IPB which was privatized in 1998 to the Japanese investor Nomura. However, in June 2000 IPB was forced into administration after being hit by a serious liquidity problem. After putting IPB under forced administration the government sought to find a new buyer and found in CSOB an adequate one. For many analysts this was a surprise, since a foreign consortium of Allianz and Uni Credito of Italy were also bidding.

It could be said that by selling to CSOB, although CSOB holds shares in other banks and investment banks, the government compounded the cross-ownership issue. Through this merger the cross-ownership links within the Czech banking sector became even more complicated than it was before the merger. Just taking IPB's holdings into account the disadvantage for the inter-bank and industrial links are obvious. IPB might have been the third largest bank in the Czech Republic at the time of the take over but in terms of its links with Czech industry, municipalities and utilities it was the biggest (Euromoney, 2000).

Another problem in the context of cross-ownership regards the principal-agent problem. One could easily imagine that through the inter-linked situation of banks, agents could tend to neglect their duties since they did not feel any pressure from the principals.

Further, the abuse of internal information and insider trading were dominating the financial sector in the 1990s (Neumann, Egan, 1999, Pehe, 1997). Between 1995 and 1997 twelve banks collapsed and a number of investment funds were "tunnelled out through deliberately arranged disadvantageous deals". Managers in banks have used their power to lend money for dubious business transactions.

Therefore, throughout the 1990s and in the years 2000/2001 a satisfactory principal-control over agents (managers) was absent in the Czech banking sector. The weak determination of property rights caused a serious conflict of interest. The problem was that the managers were not willing to exercise their property rights in order to gain high capital returns as it would be their task. If they did so, they claimed an inadequate part of the profits as manager dividend and since the owners were in a weak position, the executive agents had "vested interests" causing an inefficient financial market (Benacek, 1992). This development might also be the reason why many foreign investors stayed clear of Czech equity markets for almost a decade.

6.1.2.2 Bad loans

It could be said that the problems with bad loans still dominating the banking sector were driven by two different causes. Firstly, as mentioned earlier, during the communist era a lot of loans were made simply because the state plan envisaged it. A huge amount of these loans was given to the industrial sector without being really based on strict regulations and company performance. As a matter of fact, after 1990 many of the banks, especially big banks such as Komercni Banka, had to deal with non-performing loans. The main bulk of these non-performing loans was subject to government funds covering these loses from the state budget. Another part was handed over to the Consolidation Bank which was set up precisely in order to manage this issue (Kutan, Brada, 2000).

The more serious problem which is facing the banking sector is the problem with non-performing loans granted since 1990. These problems accrued due to bad lending decisions made by managers. As a report by Euromoney in 2000 highlights, on the one hand since supervision and regulation within the industrial sector were not appropriate enough, many company managers borrowed money from the banks even though they knew that they were not able to repay them. On the other hand since the bank managers could be sure that in most cases ultimately the state would pay them out if they made bad decisions, the managers were under little pressure to make decisions as they should have done.

Once more inadequate principal-agent relations become apparent. Not only managers have not shown their willingness to act in favour of the agents, but also the state as the bank's major share holder was not able to fulfil its supervision role.

The figures represented by CNB in 1996 reflected how precarious the situation was. It specified out of all banking loans an amount of 22 percent as absolutely uncollectible (Neumann, Egan, 1999). Similarly, the biggest bank in Central Europe, Komercni Banka, had to announce in September 1997 that one fifth of its loan portfolio would not receive any interest. The loan-loss provisions added up to around 10.5 billion Kcs (Economist, 1998).

It could be said that due to the unwillingness of the banks to tackle problem loans and the state to implement a proper banking supervision, the problems with bad loans dominated the Czech banking sector throughout the 1990s.

As a result in 2000, ten years after the start of the transition process, the banks' balance sheets were not transparent and the threat of illiquidity accompanied the whole banking sector. As an analysis by Schönfelder in 2001 shows, bad bank loans which were non-performing still amounted to 17% of GDP in 2000!

6.1.2.3 The role of the state as a major share holder

The role which the government has played within the Czech banking system has been a unique one. In none of the other Central and Eastern European transition economies did the government determine the fate of the banking sector to such an extent. In Poland and Hungary for instance, the banks have been privatized with the rest of the economy, but in the Czech case the state kept its majority shares in the largest banks for almost a decade. In particular the Czech government showed a continued tendency "to bail out dinosaur industries" through the banking sector (Euromoney, 2000).

As Zijlstra (1998) explains, the privatization of the banking sector is one of the most crucial processes to be undertaken in order to develop flexible market forces in transition economies. The continued majority ownership of the banking sector includes a risk of "politicising credit allocation" which can harm the reconstruction of the industrial sector. The privatization of the banking sector should also include the participation of foreign strategic investors. It should be undertaken efficiently and without the long-term involvement of the state. However, the latter seems to be exactly the development within the Czech banking sector. Until 1995 the four biggest banks[1], which accounted for 62% of the banking system assets, were still owned by the state (Borish, Ding, Noël, 1997).

As Boland (1996a) underlines, due to state ownership of the major banks investors could be assured that the state would "step in" if any of the banks faced serious problems. The best example in this context is the collapse of IPB in June 2000. As it was obvious that IPB could not keep the required capital adequacy, it was put under forced administration by the government and the CNB, guaranteeing to subsidise IPF in order to avert its collapse. IPB was simply "too big to fail" (Euromoney, 2000).

These developments created an atmosphere where the banks, as well as the investors, could be sure that in case of a banking-breakdown the state would ultimately pay. This inhibited the development of an adequate principal–agent culture[2].

Both these developments - state control and ownership of the banking sector - undermined the transition process. The privatization of the banking sector has taken too long. The table below shows the ownership of the four major banks in the Czech Republic at the end of 1999.

Table 31***: Ownership of the four biggest Czech banks in 1999***

Bank	**Assets, $bn, end 1999**	**Major shareholder**
IPB	9.5[1]	46% Nomura
CSOB	7.1	84% KBC[2]
Komercni banka	10.8	State-owned
Ceska Sporitelna	9.6	52.1% National Property Fund

Note: **1** End September 1999
2 KBC Bank and Insurance Group of Belgium

Source: Economist (2000b)

Based on this situation the Czech government started a new attempt to privatize the banking sector during the years 2000/2001. The results of this second attempt will be the subject of analysis in the next chapters.

6.1.2.4 Foreign Involvement

Another influential factor during the first years of privatization was the degree of foreign involvement.

The role of foreign banks seems to be one of the most crucial elements in shaping the banking sector of transition economies in central Europe. They could be “the agents of change” especially during the first years of transition when adequate economic development in terms of free market competition is desired (Konopielko, 1999).

Especially in Central and Eastern Europe, where the transition economies normally show many shortcomings such as a lack of capital, insufficient banking skills and inefficient banking structure, foreign banks could play a significant role in tackling these problems.

Pomerleano and Vojta (2001) explain the entry of foreign banks predominantly because of their ambition to facilitate those clients who are involved in international transactions.

Some of the foreign banks concentrate their activities in assisting these clients; others widen their activities and provide services to local customers once they have a better knowledge of the local market and after developing a network of relations to the local financial entities.

There are different ways foreign banks can enter the local market. For instance, they can open branches, subsidiaries, joint ventures, alliances, target purchases of specific activities as well as acquisitions.

As Hawkins and Mihaljek (2001) highlight, foreign banks could not only provide the necessary technology, know-how and expertise (normally lacking in domestic banks), they also have faster and cheaper access to international capital markets.

Furthermore, the presence of foreign banks encourages other foreign companies to invest in local markets because active foreign banks are generally seen as the guarantor of stability within any given market.

In this context Claessens and Klingebiel (1999) further underline the role of foreign banks in implementing a better quality of risk management and new financial products, and by doing so they can create a more competitive environment. Another positive development is their influence over the supervisory bodies. Here, the authorities could see themselves confronted with new financial products provided by foreign banks, and as a consequence the responsible supervisory entities have to increase the quality of supervision (this includes further training of employees).

In the Czech Republic foreign investors decided to enter the market by establishing branches. Konopielko (1999) describes this strategy as an "enter and wait" one, due to the unclear ownership situation and the lack of effectiveness within the Czech banking sector. This lack of effectiveness was partly due to the government because it restricted the involvement of foreign participants during the privatization process.

Hawkins and Mihaljek (2001) argue that this behaviour is caused by several fears. Governments could be worried about allowing foreign involvement in domestic capital markets not only because they could dominate the local markets and ask for "favourable treatment", but also because domestic savings could be used by foreign banks in order to finance projects in other countries. Another fear could be that the local market could become dominated by foreign banks from the same "home country". Domestic markets could get into real trouble if those banks suddenly cut off their activities.

Foreign investors did not enter the Czech market as they did in Hungary and Poland, because the Czech government did not encourage them to do so (Robinson, 1996).

The following tables show the number of banks which entered the Czech Republic during the first 6 years of transition and after 2000:

Table 32*: Foreign banks in the Czech banking sector*

	1991	**1993**	**1996**
Foreign banks	*4*	*11*	*13*
Branches of foreign banks	*0*	*7*	*9*

Source: Konopielko (1999)

Table 33*: Foreign banks in the Czech banking sector 2000 - 2003*

	2000	**2001**	**2002**	**2003**
Foreign banks	16	16	17	17

Source: CNB (2004)

Therefore, the four biggest banks, controlling 60 percent of banking sector assets, remained under government control (Anderson, 1997). It was not until 1998 that the government made its first attempts to privatize the banking sector by selling off the four biggest banks. Nevertheless, the whole process started very slowly with the sale of IPB, and was not pushed forward until the end of 2000. It could be said that the EU candidacy and the Commission's country reports have finally forced the Czech government to tackle the problems within the banking sector and to address the need to privatize the state owned banks since foreign capital and expertise are seen as one of the crucial elements in preparing the country for entering the EU markets.

6.1.3 The banking sector until 2000 and the institutionalist approach

The previous chapters have shown that inefficient banks in the Czech banking sector were the rule, not the exception. This situation was caused by different factors. Firstly, the large-scale privatization not only failed to implement a proper restructuring, it also failed to privatize the banking sector. As a consequence the biggest banks remained for an unnecessarily long time in government ownership; their privatization started only at the end of 1990s. At the same time the banks gained power over the capital markets and could dominate developments within the industrial sector through their investment funds. It could also be said that banks basically did not face any competition and therefore could run their businesses (such as savings) as they liked.

Furthermore, Czech banks became creditors and shareholders of the industrial sector to some extent similar to the German universal banking model, but the difference was that German banks had "capital and a credit culture", which was absent in the Czech banks (Euromoney, 2000).

As Neumann and Egan (1999) emphasize, the Czech banking model tried to "imitate" and "use" elements from the Anglo-Saxon[3] and the German (Rhineland) model[4] of capitalism. For instance, banks through their investment funds promised high and rapid profits which are typical characteristics of the Anglo-Saxon banking model where short-term profits and shareholder dividends are the focus of bank activities. By taking over large shares within the industrial sector, Czech banks tried to copy the German system of banking where a network of relations between banks and industry guarantees the stability of the financial market. For instance, in order to establish effective corporate control, Czech banks tried to copy typical characteristics of the German banking model such as accommodating bank representatives on the company board.

Here, one should take into account that universal banks (The German Model) are normally better informed since they are not only creditors but also shareholders at the same time. Furthermore, universal banks could increase the level of competition within the banking market if foreign banks achieve market access (Buch, 1995).

The Czech attempt to follow the German model was undertaken without considering the fact that universal banking can cause a serious conflict of interests when there is a lack of transparency. Fraud and insider dealing are the negative consequences.

This is exactly the development which seems to dominate the Czech banking sector. The progression of insider dealing and white-collar crime has dominated the banking sector ever since the transformation process was implemented. Considering the sociological institutionalism approach to the enlargement of the EU, it would be difficult (if not impossible) to justify the enlargement based on the facts (until 2000) as they have been represented above.

In this context, the prerequisite for an applicant country is determined as sharing values and adhering to the basic norms of the EU. Würz and Müller (1998) define a number of EU banking directives which represent the guideline for the CEECs.

For instance, Directive 2000/12/EC determines taking up and pursuit of the business of credit institutions. In this directive, Title II, Article 7, determines the rights of shareholders and members. Title V, Chapters I-III, Articles 26-56 underlines the principles of supervision, the technical instruments of prudential supervision and supervision on a consolidated basis. Furthermore, Council Directive 91/308/EEC determines the rules in order to prevent the financial system from being used for money laundering.

In the context of this thesis the following norms seem to be of special significance:

- Banking supervision in order to monitor the effectiveness of the banking sector
- The protection of the interests of small shareholders and third parties
- The abatement of money laundering
- The creation of minimum requirement for initial capital and own funds
- Regulations to prevent banks from giving a significantly high amount of loans to a single debtor

Practically none of the above listed norms were in place after almost a decade of transition. The analysis from the previous chapter has shown that the Czech banking sector had (until 2000) enormous problems with enterprise reporting, insider trading, non-performing loans and a fraudulent banking environment.

As a survey by Schönfelder (2001) shows, laws at the beginning of the transition process were "rather brief and laconic". Norms and codes were expected to be in force after a few years of transition therefore, the first laws which had been drafted during the early stage of transition targeted only the most urgent issues. At the same time the emergence of a sufficient legislative framework was absent.

It could be said that purchasing credits were "a matter of connections and good luck". Due to inexperienced staff, the decisions made by bank managers were not based on rational criteria. In fact, the lack of enterprise reporting was another reason why managers were not provided with any real information about the prospects of those enterprises they were dealing with.

Later on this development caused a serious problem. For instance, the European Investment Bank (EIB) (2002) suggests in order to observe the banks' bad-loan problem, one should have a closer look at the deposit interest rates offered by Czech banks. Here, the analysis has shown that many of those deposit interest rates exceeded any rates of return. To quote the report (European Investment Bank, 2002, p.63)

"Loan interest rates that had to be charged to recoup excessive deposit rates were so high that the debt service on these loans could hardly be expected. Indeed some debtors that accepted such conditions probably did not even plan to pay such interest rates."

The inefficient and in many cases fraudulent use of bank loans dominated the business environment within the Czech banking sector for many years. Thus, their capital structure was fragile and since many employees "had little to lose but a lot to gain" by lending credits to business projects which were highly risky, their equity portfolio was subject to moral hazard behavior (European Investment Bank, 2002).

As a matter of fact, banking privatization proved to be a very expensive process for the Czech government and influenced the GDP figures negatively for several years. Although the banks were sold at a profitable price, adding their total costs it could be said that their total costs exceeded their revenues. According to CNB the privatization of the major banks entailed the following revenues and costs:

Table 34*: Costs and revenues of bank privatization in the Czech Republic*

	Bank	*Revenues*	*Costs*
	Komercni Banka	40	98
	CSOB	40	57
	Ceska Sporitelna	19	47
	IPB	3	16
Total		102	218

(All figures in CZK billion)
Source: CNB

Regular enterprises' financial reports as well as liquidity reports, efficient government supervision and a banking environment which is not driven by insider trading and fraud are part of the basic norms of the EU's free functioning financial market.

For instance, Directive 2000/12/EC underlines the importance of regular enterprises financial reports in Title II, Article 16, where it is determined (p.19):

"They (credit institutions) shall also, at least once a year, inform them (competent authorities) of the names of shareholders and members possessing qualifying holdings and the size of such holdings as shown, for example, by the information received at the annual general meetings of shareholders and members or as a result of compliance with the regulations relating to companies listed on stock exchange."

Another example in the context of fraud combating is Directive 91/308/EEC. In this directive the prevention of the use of the financial system for the purpose of money laundering is underlined as one of the most important targets. Directive 91/308/EEC determines:

"…when credit and financial institutions are used to launder proceeds from criminal activities, the soundness and stability of the institution concerned and confidence in the financial system as a whole could be seriously jeopardized,…money laundering must be combated mainly by penal means…"

The unwillingness of the Czech government to implement and enforce regulations which would have changed the inefficient character of the banking sector is evidence enough that the Czech Republic has not adopted the basic EU norms concerning the banking sector.

The European Investment Bank (2002) underlines the fact that decisions or changes within the legislation were made after problems had emerged. The government never undertook an anticipatory step in order to prevent the problems.

It was simply afraid of the social consequences of such steps. Thus, not only did the politicians not act in favour of more effective legislation, they showed little will to punish the illegal behaviour of the banks. For instance, bankruptcy regulations were for a long time based on very weak regulations. The amendments to the law were not appropriately asserted and bankruptcy procedures were immensely long, giving managers enough time to strip the assets. In general, it could be said that the weakness of the regulatory framework to protect creditors' rights harmed for a long time the development of an effective banking environment.

As highlighted previously, another important role was played by the Czech state as the major owner of the banking sector. Many of the developments could have been prevented if the government had not played such a dominant role. The Czech banking sector could have presented a different view of itself if the government had been more in charge of its role as a regulator, owner and policymaker.

Not only could it not fulfil its role, for a unnecessarily long time the state postponed the privatization of the banking sector, which would have been able to help implement structural reform and proper governance. A timely privatization would also have brought decent prices in comparison to those costs the government had to face during its attempt to privatize the banking sector after 1999. As a report by the Economist in 2001 shows, the government jeopardised about 9 percent of the GDP in 2001 basically because it not only failed to prevent weak lending practises within the banking sector, but also because it had to bail out the insolvent banks with state guarantees.

Furthermore, the role of the financial institutions such as the Czech National Bank was also of special importance, for example in its role as a supervisor and regulator.

In many cases the CNB missed the opportunity to regulate the behaviour of the banks. For instance, many banks tried to avoid capital adequacy regulations by transferring assets to other affiliates or entities and if they could not do so, they simply misreported. The CNB has failed here to fulfil its role as a supervisor of the banking sector (European Investment Bank, 2002).

Consequently, the second attempt by the Czech government to privatize the banking sector had clear targets to be achieved.

Firstly, if Czech banks are supposed to withstand the competition which will face them within EU markets, they need foreign capital as well as foreign banking experience in order to be prepared for competition under real free market forces and not as the Czech banking sector presented itself in the years until 2000.

The state dominance and the cross-ownership situation of the banking sector can not be considered a truly competitive economic environment. One of the key weaknesses of the Czech banking privatization was the lack of supervision. The necessary structural reforms and institutional framework did not accompany the process of transition. For instance, Czech business culture failed to protect the right of minority shareholders for a long time. The separation of bank ownership from non-financial institutions is a crucial step in this context.

Furthermore, the establishment of institutions capable of monitoring and regulating the banking sector represent the second target. From an NIE point of view these targets represent the core of the reforms needing to be enforced in the Czech banking sector.

Thus, as the NIE emphasize, in order to integrate the Czech Republic successfully into the European Union, the creation of the necessary institutions is one of the prerequisites. An ethically-minded banking environment which is not dominated by fraud and insider dealing is crucial within the context of sociological institutionalism. Therefore, based on the facts presented above it could be said that the assumption of the European Commission, in its first and second country regular reports, where it was determined: "…the Czech Republic can be regarded as a functioning market economy", did not reflect the true situation in the banking sector. The Czech banking sector at the end of the year 2000 could not be regarded as being a functioning market, nor ready for accession to the European Union.

However, as a consequence the Czech government started a new attempt to privatize the banking sector as well as to establish the needed institutional framework from 2000 on. The steps which have been taken by the government three years before the accession and their results will be subject of analysis within the next section.

6.1.4 Current banking reforms

After the year 2000 the introduction of significant amendments had its impact on the further development of the banking sector. The most important developments could be described as:

1. **The preparation and implementation of new legislation, such as the**
2. **Commercial Code and Insolvency Act**
3. **The opening of Czech financial markets for foreign investors**
4. **The implementation of new methods such as the New Basle Capital Accord in order to monitor and control developments within the banking sector**
5. **A more effective combat of money laundering**

The following section will focus on the developments mentioned above and will try to ascertain if progress has been achieved so far.

6.1.4.1 Final privatization steps

As noted previously, the final privatization of the banking sector started in 1999. It was introduced with the disposal of CSOB to KBC Bank Belgium and continued in 2000 with the privatization of Ceska Sporitelna as the Erste Bank of Austria acquired 52% of CS (European Investment Bank, 2002).

And finally, when Komercni Banka was sold to Societe Generale in 2001 the whole Czech banking system was in private hands. Thus, due to the collapse of smaller banks during the mid 1990s and a number of mergers within the banking sector from 1999 onwards, it could be detected that out of 63 banking licences granted since 1989, only 38 banks remained active within the Czech banking sector until 31 December 2001 (CNB, 2001).

One should also keep in mind that during the banking privatization process the Czech government aimed to secure strategic partners for the banks under state control which were not only capable of sustaining the capital, but could also bring sufficient know-how and expertise in order to improve regulatory controls.

Another important step which was undertaken by the government regarded the problem of bad loans. It started to resolve the problems of bad loans after a decade of neglect.

In general the government allowed new investors to choose those loans they classified as good and transferred the non-performing credits to Konsolidacni Banka. Moreover, in many cases the government provided a guarantee for the non-performing loans as it did, for instance, in the case of Komercni Banka (ca. 20 billion CZK) before selling it!

As a banking report by the CNB in 2001 shows, the credit portfolio remained the fundamental problem of the Czech banking sector, but it showed a positive tendency to overcome the problems and has strengthened the health of the banking sector. For example, classified credits (watch, substandard, doubtful and loss credits)[7] amounted in March 2002 to around 19.6% in comparison to 32.15% at the end of 1999. The following table reflects this positive tendency:

Table 35*: Structure of classified credits*

	31 Dec. 1999	31 Dec.2000	31 Dec. 2001
	291061	257762	209866
	32.15	29.83	21.53
of which:	***in CZK millions***		
watch credits	92124	85814	75984
substandard credits	39379	54910	32295
doubtful credits	38433	27276	29725
loss credits	121125	89762	71862
of which:	***in percent***		
watch credits	31.7	33.3	36.2
substandard credits	13.5	21.3	15.4
doubtful credits	13.2	10.6	14.2
loss credits	41.6	34.8	34.2

(for banks with licences as of 31 Dec. 2001, excluding banks under conservatorship)
Source: CNB (2001)

Further, looking at the net-profit a positive development can be observed. It could be said that 1999 was the last year with losses for the banking sector. Ever since, this sector has started to gain net-profits. For instance, these profits amounted to 17.0 billion CZK in 2001 and in March 2002 they showed an average 1.46% increase compared to 0.18% loses in 1997 (EU, Regular Report, 2002). Moreover, due to new lending practices the increase of the ratio of liquid assets as a percentage share of total assets can be monitored. In 1998 the figure was around 27.4 percent in contrast to the 2001 figure which showed a 30 percent ratio (EU, 2002c).

In general it could be said that all types of banks, large as well as medium and small, started to make profits from 2000 onwards. The Czech banking sector still has a problem in terms of non-performing loans, nevertheless, due to the new privatization of the banking sector the credit portfolio of Czech banks seems to have recovered and appears healthier than it was during the 1990s.

6.1.4.2 EU norms, institutional challenges and banking supervision

One of the key factors why the effective operation of market forces in both non-financial and financial sectors was limited, was the underestimation of the legal and institutional framework. Inadequate legislation and the lack of supervision were the outcome. Thus, it was clear that the government and parliament had to implement measures in order to improve the situation in several fields such as the legal processes for bankruptcy, court procedures and creditors' rights.

Since 1999 the Czech government has implemented a number of different amendments in order to strengthen the regulatory framework within Czech financial markets. New laws, regulations as well as institutions aimed to shift away from the stagnancy of the 1990s in order to establish an adequate system of monitoring, control and supervision in this sector.

As a first consequence and in order to align banking supervision methods with EU regulations the EU Institution Building Programme was implemented and successfully completed 2001.

Another important step was the creation of the Revitalizacni Agentura (RA). The RA's task was, amongst other things, to purchase the companies' classified loans from banks and to negotiate with banks and other creditors in order to minimize the loan problems. Later on the RA merged with Konsolidacni Banka (KOB) which was also responsible for solving these loan problems. However, KOB ceased operation on 21 August 2001 and was converted to a state owned company Ceska Konsolidacni Agentura (CKA, Czech Consolidation Agency). CKA tried to prohibit a deepening of the cross-ownership situation between the banking and industrial sectors by using the new laws such as the "Bank Act", which prohibited "*banks from exercising direct or indirect control over legal entities other than banks and financial institutions." (OECD, 2001b, p.44)*

The creation of the Securities Commission and the strengthening of its rights was another positive step in order to monitor the Czech financial sector more effectively. As the Regular Report 2002 highlights, the government has strengthened the position of the Securities Commission by passing an amendment through which not only a wider information provision by financial market participants was forced through, but also it provided the Securities Commission with the right to implement secondary legislation if the Securities Commission saw it as necessary.

The Commission in its Regular Report (2002) underlines the fact that the quality of supervision has increased significantly and could ensure a more secure financial sector. The supervision policy of the CNB is regarded as "generally effective". The new amendment (Act on Banks) has helped to integrate the relevant acquis into Czech legislation. Banking supervision is supposed to be carried out on a new trilateral co-operation agreement which was signed between the CNB, the Securities Commission and the Ministry of Finance. The consolidated supervision was expected to start from 2003, but the Commission highlights that the main focus of these institutions which is "to jointly develop a system of consolidated supervision", has not been implemented so far. This should be the main focus for the coming years.

Furthermore, in order to put Czech banking regulations in line with European directives, more steps have been taken since 2000. The Regular Report (2001) emphasizes the new regulatory framework which has been implemented from 1 January 2001 as an important step in order to adjust the legislative arrangements with EU directives. Especially here three new amendments, the amendments to the Commercial Code, the Securities Act and the Bonds Act seem to improve the quality of legislation within the Czech financial sector.

The 2002 Regular Report underlines another positive development, namely the amendment to the Act on Banks regarding money laundering. In 2001 a Financial Sector Assessment Programme (FSAP) was developed with the co-operation of the IMF and the World Bank. It aimed to verify the progress which had been made by the Czech Republic to harmonize Czech law and regulations with those of the Union. It pointed out the progress which was made by the CNB in terms of banking systems and made recommendations on how to solve the remaining outstanding weaknesses[8]. The assessment also included a "review of compliance with the Core Principles for Effective Banking Supervision" which was designed by the Basle Committee on Banking Supervision (CNB, 2001).

In the same CNB report it was further determined that at the beginning of 2002 a medium-term banking supervision concept was drawn up. This programme was drafted for the years 2002-2004 and should improve the "quality and effectiveness" of supervision. The establishment of a comprehensive regulatory framework for banks, the development of an effective communication system capable of co-operation with foreign as well as domestic regulators and the development of an effective information system capable of supporting the supervisory work were part of this concept.

Nevertheless, one should take into account the multitude of provisions still to be implemented in order to secure the financial sector's stability. As a report on macroeconomic and financial sector stability by the European Commission in November 2002 highlights, the following important issues should be under further consideration (EU, 2002c, p.39):

1. **continuous qualification of human resources**
2. **a risk-based approach to supervision**
3. **implementation of supervision on a consolidated basis**
4. **clear responsibilities of CNB, Ministry of Finance and Securities Commission**
5. **the implementation of anti-money laundering reporting**

Based on the amendment to the Banking Act, the institutional building process and the improvement of supervisory standards, the regulatory framework as a whole has improved since 2000, however, some problems as mentioned above still remain to be solved. For instance, until 2004 important EU directives regarding banking supervision such as Directive 92/30/EEC or Directive 91/308/EEC as for money laundering have not been implemented or adopted into Czech laws, the adoption of these crucial directives should be the main focus of the Czech Republic once they have joined the EU.

6.1.4.3 Foreign banks

In the Czech Republic the rapid privatization of the banking sector and the participation of foreign investors did not take place from the beginning of the transition process. As a matter of fact, until the end of 1999 the Czech banking sector was mostly owned by the Czech state.

Due to the non-transparent ownership structure, asset stripping and the problems with non-performing loans, many foreign banks hesitated before entering Czech capital markets. If they did so, they focused only on serving their home country customers. In this business field they were successful and profitable from the beginning because they supplied the products which were in demand. With more experience and acknowledgment of Czech markets they started to serve the "top local clients" and with new services they began to enter the Czech capital markets on a wider basis (European Investment Bank, 2002).

As the Czech Republic implemented completely the principles of equal treatment in dealing with foreign investors, foreign banks were able to fully participate within the Czech banking sector.

However, after the final privatization of the last state owned bank, Komercni Banka in 2001, the Czech banking sector was dominated by foreign investors. In 2001 foreign banks controlled 70% of the total equity capital, which represented a 5.5% increase in comparison to the previous year (EU, 2001a).

According to Regular Report (2002) the assets controlled by foreign banks or foreign investors reached 95% at the end of March 2002. The following table clearly shows the transition from state ownership to full privatisation between 1990 and 2001:

Table 36*: Number of banks by ownership (banks carrying out activities for clients)*

		Czech-Controlled banks					***Foreign-Controlled Banks***			***Unlicensed Banks***
		Total	*SFI*	*SOB*	*CCB*	*BUC*	*Total*	*FCB*	*FBB*	
01 Jan. 1990	5	5	4	1	0	0	0	0	0	x
31 Dec. 1990	9	9	4	1	4	0	0	0	0	x
31 Dec. 1991	24	20	4	1	15	0	4	4	0	x
31 Dec. 1992	37	26	1	4	21	0	11	9	2	x
31 Dec. 1993	52	34	1	4	28	1	18	12	6	x
31 Dec. 1994	55	34	1	4	28	1	21	13	8	2
31 Dec. 1995	55	32	1	6	25	0	23	13	10	5
31 Dec. 1996	53	30	1	6	18	5	23	14	9	7
31 Dec. 1997	50	26	1	6	15	4	24	15	9	11
31 Dec. 1998	45	20	1	5	14	0	25	15	10	18
31 Dec. 1999	42	15	1	4	10	0	27	17	10	21
31 Dec. 2000	40	14	1	4	8	1	26	16	10	23
31 Dec. 2001	38	12	0	3	8	1	26	16	10	25

SFI = State Financial Institutions *SOB = State-Owned Banks*
CCB = Czech-Controlled Banks *BUC = Banks under Conservatorship*
FCB = Foreign-Controlled Banks *FBB = Foreign Bank Branches*

Source: CNB (2001)

It could be said that foreign banks could provide the necessary structural changes by focusing on those banking activities which were underdeveloped (e.g. retail strategies and risk-lending management).

According to the European Investment Bank (2002) the role of foreign banks has also been crucial in terms of financing entrepreneurial projects. This is due to the ability of foreign banks to create competitive companies capable of developing viable projects for international investors who do not have any on-ground presence or knowledge of the Czech business fields in which they seek to invest.

In general (according to European Investment Bank, 2002, p.67), foreign banks in the Czech banking sector could be subdivided into four categories based on their core activities:

I) Universal banks with regional networks
II) Large international banks
III) Investment banks
IV) Bancassurers[9]

However, as stated previously, weak corporate control and inadequate management performance during the first ten years of transition have negatively influenced the credit decisions of the Czech banks. The stability of the banking sector was undermined through the absence of a proper principal and agent relationship.
The ability of foreign banks to push forward a more aggressive and market-oriented banking investment strategy, as well as their expertise and management skills gave them an indispensable role in the Czech banking sector. It is clear that local Czech banks still have a lack of experience especially in the context of proper risk assessment and pricing. The recent role played by the foreign banks is a crucial one in order to build up an efficient and stable Czech banking sector capable of dealing with competitive pressure from other bank and non-bank institutions in the wider context of the European financial markets.

6.1.5 Critical evaluation

Taking the socialist (central-planned) economy of the Central and Eastern European countries into account, one could define four core elements which are crucial in establishing adequate capital markets:

1. **the development of institutions (such as a central bank) in order to monitor and regulate the emerging capital markets**
2. **the establishment of commercial banks and the dismantling of the former monobanks**
3. **the breakdown of the relationship between the banks and the state which was traditionally very strong**
4. **the breakdown of the relationship between banks and the former state owned enterprises in order to avoid the development of soft budget constraints on the companies’ side**

In the case of the Czech Republic the disintegration of the monobank and the establishment of a two-tier banking system was achieved within the first two years of transition. The creation of the Czech National Bank took place at an early stage of the transition process.
The banking sector is comprised of the following entities (Dedek, 2001):

I) Foreign Banks and their branches (mainly Universal Banks)

II) Banks with special products and services, such as:

(1) Ceskomoravska Zarunci a Rozvojova Banka a.s.

Business activity: supporting small and medium-sized private businesses

(2) Ceska Exportni Banka

Business activity: export support

(3) Building savings banks

Business activity: granting long-term housing loans and collecting long-term deposits

(4) Mortgage Banks

Business activity: providing state-supported housing mortgage loans

(5) Credit Unions

Business activity: even though not classified as banks, they offer services to their members (their market share is very low)

Thus, in 2002 the establishment of the commercial banks had finally been achieved!
As it has been demonstrated previously, implementing effective banking supervision turned out to be a more difficult task and, especially in the context of EU enlargement, one should keep in mind that different supervision standards could create problems if the institutional framework of the accession countries differ to a great extent from those of the current member states. For instance, if banks are operating in the same location but are treated differently from their home countries in terms of security.[10]
Therefore, the CEECs should not only adopt international banking standards but also ensure the quality of the supervision.
However, the European Commission in 2002 (EU, 2002c) and the Regular Report

(2002) highlight the fact that "stricter regulations" as well as the amendment Act on Banks (particularly the section regarding banking supervision) have improved the situation in the Czech banking sector. Here, it is stated that the "Banking Supervision Group is generally effective". The independence and efficiency of the banking supervision entities are secure, in other words, banking supervision in the Czech Republic is in line with the necessary directives set up by the European Commission. For instance, the CNB in 2002 had completed 20 of 25 Basle Core Principles[11].

Also the establishment of other institutions (such as the Securities Commission) could be viewed as another positive development. In this context, Mr. Tuma (2003), the Governor of the Czech National Bank, has determined that in order to prevent the further development of white collar crime, steps against money laundering have been taken. For instance, the creation of the Financial Analytical Unit (FAU), which is an autonomous part of the Czech Financial Ministry, is a significant development. Its task is to monitor all suspicious transactions and in the case of violations (e.g. against the Anti-Money-Laundering (AML) Act), these transactions are reported to the supervisory bodies. Mr. Tuma also points out that regulations regarding the banks' internal AML system have also been passed in August 2003.

These regulations for example, are based on BIS' "Customer Due Diligence for Banks" in order to guarantee their international standards.

Taking these developments into account, one could say that the recently approved amendments and regulations are significant steps forward in establishing an appropriate legal framework which satisfy EU directives regarding the financial sector.

Nevertheless, there are several other issues which should be considered in order to guarantee the success of the banking supervision in the long-term.

The new approved amendment is certainly a step forward in strengthening Czech financial markets with the acquis. The Commission also underlines the fact that a key feature of the new amendment is the extension of supervision to credit as well as market risks whose success is dependent on the cooperation between the supervisory bodies, namely the CNB, the Ministry of Finance and the Czech Securities Commission.

Also important in this context is the timely enforcement of laws in order to guarantee effective supervision. And since the banking environment is getting more competitive with the banks entering new and risky business fields, including the small non-bank financial sector, a closer monitoring of these developments is one of the CNB's key tasks.

The banking sector was privatized to foreign banks which performed well in restructuring the Czech banks. By doing so, not only the traditionally strong relations between the state and the banks were cut off, but also the new owners will enhance corporate governance through a healthier universal banking system capable of establishing a successful principal-agent control.

Foreign banks also started to clean up the bad credit portfolio of the banks and to implement a credit allocation system based on a more rational and market-oriented lending criteria. Even though the quality of new credits is improving, it could be said that the non-performing loan problems remain one of the key issues to be resolved, especially because they are putting the country's GDP under pressure. For instance, the Regular Report 2003 underlines the fact that the government deficit added up to 3.9 percent of GDP in 2002 but taking the bad assets of the Czech Consolidation Agency into account this figure would rise to 6.7 percent.

The IMF (2002) emphasizes that non-performing CKA assets amount to around 300 billion CZK in 2002 and suggests that direct sales to private sector investors, who are "willing to take on the workout of bad assets", should be encouraged and pushed forward. The 2003 Country Regular Report underlines the need for the CKA to accelerate this process in order to clean up the misallocated resources.

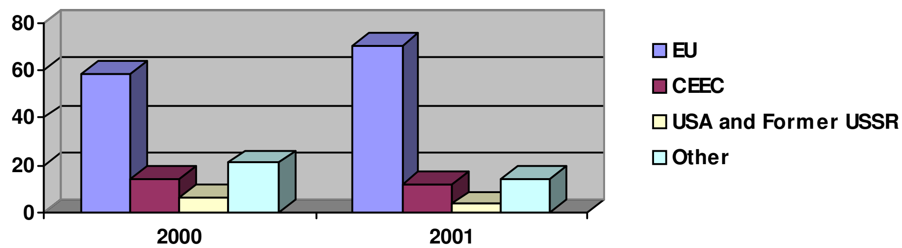
As a consequence the CKA auctioned in September 2002 and in June 2003 two asset packages which in total had an equivalent value about 4.4 percent of GDP.

With the privatization of the Czech banking sector, a greater efficiency and a higher level of stability have been achieved. It is also clear that the new role played by the foreign banks will guarantee a more efficient risk management. The continuous clean up of non-performing loans, in combination with sufficient capital and management know-how provided by the new owners, will establish the necessary conditions in order to put the Czech banking sector on a firm path on its way to joining the European Union.

Finally, one should also consider the high number of EU based investors already involved in the Czech banking sector. In terms of asset exposure EU based investors already dominate the Czech banking sector.

According to the CNB (2001), the principle partner of the Czech banking sector is the European Union. For instance, as of 31 December 2001 companies coming from the EU member states hold 70.6 percent of the international asset exposure of the Czech banking sector. This is an increase of about 12.2 percent since 2000:

Figure 6: International asset exposure of the banking sector (in percent)



Source: Own graph based on CNB (2001)

In terms of deposits and credits with banks EU investors count for 93 percent. Non-resident deposits in Czech banks are also dominated by banks from the European Union (88.5%). Also the derivatives transactions of domestic banks are dominated by the European Union (measured in the off-balance sheet):

Table 37: ***International off-balance sheet exposure of the banking sector (in percent)***

Receivables from Derivatives		
Year	**2000**	**2001**
European Union	85.6	86.4
Central and Eastern Europe	1.4	0.8
USA	7.8	5.5
Former USSR	0.0	0.0
Other	5.2	7.3

Source: CNB (2001)

Taking these figures into account, it could be said that the Czech Republic has already established tight links to the European Union.

The Czech Republic has also to implement and enforce EU norms and directives which have not been in place so far. Those norms regarding supervision and money laundering are particularly important.

6.2 Other capital markets

Equity markets could be important for the transition economies of Central and Eastern Europe, if they are fully developed. A functioning equity market could offer several advantages. For instance, the generation of information about the activities of enterprises, the diversification of companies' portfolios and in some cases political stability which could promote economic growth. Another advantage could be gained in the context of foreign investment. Fully developed equity markets could subsidize the costs of foreign capital (CERGE-EI, 2000). Since international investors are looking for a liquid market which provides low access costs, high liquidity and the necessary information to enable them to deal with the different accounting systems, listing requirements and the trading system, the existence of a developed infrastructure providing the necessary information is one of the essential requirements (European Investment Bank, 2002).

6.2.1 Czech trading markets

Several other markets exist alongside the Prague Stock Exchange. One of the most competitive markets is the RM system (RMS). The RMS is licensed by the Securities Commission to organize and supervise an off-stock exchange (SEC, 2003). Its main purpose is to give investors a low-cost facility to trade. The RMS is open to any one and its prices are on average lower than the stock exchange (Brom, Orenstein, 1994). It also has to publish the rules and prices of the securities which are traded on the stock exchange.

Another type of trading is direct block trades between investors. Even though this type of trading had to be announced on both the PSE and the RMS, a large amount was traded for a long time without being reported.

Finally, one should also note the existence of the Prague Securities Centre (SCP) which was established by the Ministry of Finance in 1993 after the privatization process was implemented in order to promote the developments of the Czech capital markets by ensuring simple and inexpensive services for securities issuer. Its activities could be described as (SCP, 2003):

1. **Keeping a unified register of owners of dematerialized and immobilized securities**
2. **Other services relating to the above securities**
3. **Information services for capital market participants**

Its services are used by issuers of securities, natural and legal persons, stock exchange securities dealers, non-stock-exchange securities public market as well as state entities.

6.2.2 Prague Stock Exchange (PSE)

"Without an efficient stock exchange to act as a financial regulator, capital surpluses may not move to high-demand areas of the economy. (…) Most importantly in an emerging market, the stock exchange gives growing firms access to available financial resources and fuels domestic economic growth through the issue of new securities." (Neumann, Egan, 1999, p.5)

The Prague Stock Exchange was founded in November 1992 by 12 Czech and Slovak banks and five brokerage companies[12] and its format was based on the Lyon Stock Exchange System[13]. The first trading session took place on 6 April 1993, and after the introduction of the first wave of privatization the PSE started trading on a daily basis.

The PSE is divided into a three level trading system. Within the first tier, those companies are traded which meet the necessary obligations in order to be listed on the exchange. The second tier accommodates those companies which meet only a limited number of requirements. And finally, the third tier of the PSE system includes the rest of the market, about which only little information exists. As a matter of fact, trading remained very limited within this section (Brom, Orenstein, 1994).

6.2.2.1 Problems facing the PSE

It could be said that from the beginning of the transition process, although the introduction of shares during the first wave of privatization was strong enough to stimulate the capital markets, trading within the Prague Stock Exchange remained limited.

Already in 1994 Brom and Orenstein found out that at the time of privatization a huge supply of company shares was issued, "despite a lack of real money demand". As a result share prices were depressed in comparison with their book value. Between 1994 and 1997 a wide range of companies, entities and individuals had access to the exchange market resulting in weak information systems and low requirements. For instance, quarterly statements or annual reports on the side of the companies listed on the PSE were not immediately available for a long time. Therefore, the PSE was not considered as a market where portfolio investors were investing money in order to lower risks nor it was a place where enterprises being restructured could gain new capital by issuing new shares (Newton, Walsh, 1999).

Many deals are made by strategic partners off the exchange. The typical exchange markets, where investors' demands are met by enterprises issuing shares, did not really exist. Thus, it is not surprising that trading during the first years of the PSE was only concentrated on the most liquid 10 companies even though more than a thousand companies were listed on the PSE.

Further, due to the failure of privatization, many of the companies issuing equities were not economically healthy enough for entry to the stock market. Robinson in 1996 underlines the fact that the Prague Stock Exchange looked bad when compared to the Warsaw Exchange. Here, strong transparency rules were implemented providing the necessary framework for domestic as well as foreign investors to feel secure to invest within the Polish capital markets.

The Prague Stock Exchange on the other hand was perceived as a market in which the protection of minority shareholders was almost non-existent, with weak regulations by the Ministry of Finance.

As previously pointed out, another problem facing the stock market was the lack of liquidity which was caused by the failed privatization programme and the cross-ownership ties between banks, newly privatized companies and investment funds. No portfolio oriented investment took place, thus the main activity of the entities remained their focus on control and consolidation issues instead of increasing capital and setting prices through a well-developed exchange market. For instance, as Brom and Orenstein (1994) highlight, from the beginning of the transition process the most important investors were the ICs. They tended to consolidate their holdings, especially those in enterprises and cash investments.

During the first privatization process in 1993, a significant degree of consolidation took place before shares were actually issued. Due to the "well-backed" funds, putting ICs in a position from which they took advantage of depressed prices (and since they also took a long-term view in their policies), it could be said that the Czech capital markets remained non liquid until the beginning of the 21st century.

Unfortunately, these negative developments were not the only ones during the set up phase of the capital markets. Due to the almost non-existent company reports and general "market information", only those market participants with inside information could trade successfully on the PSE. Insider dealing, asset stripping and non-transparent pricing were the dominant features of the Prague Stock Exchange for more than a decade. The uncertainty, the lack of transparency, fraud and inadequate corporate disclosure were the reasons why not only foreign investors, but also domestic institutional as well as public investors kept away from the PSE. The protection of minority share holders and their rights was absent from the Czech capital markets. The PSE was not able to join the membership of the Federation of European Stock Exchanges until June 2001 when it became an associated member (CERGE-EI, 2003).

6.2.2.2 Current developments

The problems outlined above forced the government to increase the quality of the exchange market. The first steps were taken in 1996 when reporting regulations were imposed on the leading 60 companies on the market (Done, 1996).

The CERGE-EI report on the Czech Republic in 2003 underlines different attempts undertaken by the government in order to improve the situation within the PSE. Firstly, a new segmentation attempt started from September 1995 when the market was split into three trading groups with specific listing requirements for each tier. In 1999 another market segment was implemented, namely the New Market. The purpose of this segment was to give those companies with promising business plans the facility to gain new capital, enabling them to invest in innovative and competitive projects.

To be registered on the four different levels of trading the following requirements are essential:

Table 38*: Listing requirements on the Prague Stock Exchange*

Trading Group	***Requirements***
Tier One	Public offer > 200 milion And at least 25% of the total capital Duration of the business activities at least 3 years
Tier Two	Public Offer > 100 million And at least 25% of the total capital Duration of the business activities at least 3 years
Tier Three	To be set by the Exchange Committee for Exchange Trades
New Market	The following and possibly additional requirements to be set by the Exchange Committee for Exchange Trades: Registered capital > 10 million Expected market capitalization > 20 million Public offer > 15% of the total capital Duration of the business activities at least 1 year

Source: CERGE-EI (2003)

After subdividing the market into these four segments, another step was undertaken, namely the delisting of non-liquid enterprises. Already in September 1997 1303 companies were de-listed. In January 1998, 35 companies were transferred from the main to the second market and less than 100 companies were traded at the PSE (CERGE, 2002). The following table shows the development of the number of traded companies, the market capitalization and the trading volume given within the Czech Stock markets (1995-2000) compared with the Hungarian and Polish stock exchanges.

Table 39***: Development of stock markets (Czech Republic, Hungary and Poland)***

	1995	***1996***	***1997***	***1998***	***1999***	***2000***
Number of domestic companies listed:						
Czech Republic	54	82	91	92	74	57
Hungary	42	44	47	53	64	58
Poland	65	83	143	198	221	225
Market capitalisation (in % of GDP):						
Czech Republic	20	27	24	19	23	19
Hungary	6	12	35	29	36	26
Poland	4	6	9	13	20	19
Trading volume (in % of market capitalization):						
Czech Republic	29	44	53	45	38	69
Hungary	14	30	48	116	84	102
Poland	61	62	61	43	36	65

Source: European Investment Bank (2002)

Further, with the shares of Komercni Banka and Unipetrol the "Share and Bond Markets Support System" (SPAD) was opened in May 1998. This market is based on: *"the exploitation of the function performed by market makers maintaining continual quotations of bid and prices for selected issues"* (CERGE, 2000, p.53).

It could be said that the following three types of trade exist within the exchange (PSE, 2003):

1. **trade with the participation of market makers (SPAD)**
2. **automatic trades (auction, continual)**
3. **block trades (member to member; member to non-member)**

Alongside these alterations, a number of laws and amendments have been set up in order to improve the transparency problem. These amendments concerned the Act on

Securities, the Act on Bonds, the Act on Stock Exchange and the Act on Investment Companies and Investment funds (EU, 2001a).

These regulations set up not only general terms, but also a number of strict regulations in order to tackle the transparency problems, especially in the case of the exchange markets and investment companies. For instance, in 2001 a major Exchange Act amendment was passed which approved the rules concerning control activities. New requirements regarding transparency activities carried out by the brokers were established (PSC, 2003).

Also in 2002 an amendment to the Securities Act took place. This amendment was set up in order to improve the illiquid situation within the market. A minimum volume of 33 CZK (Czech Crowns) is now required for a publicly traded issue, including an average of 25% of the share to be floated (CERGE-EI, 2003).

6.2.2.3 Some conclusions

It could be said that the government's attempts to increase transparency within the Prague Stock Exchange in order to arouse the interest of foreign investors were significant but failed to meet their targets. As the CERGE-EI report (2003) underlines, the main problem which is still facing this sector is the high range of shares which were traded out of the market[14]. A country study by the World Bank in 1999 showed that due to the unequal conditions within the Prague Stock Exchange, the PSE did not serve as a primary source of corporate financing. Many foreign firms hesitated before investing because of the insecure transparency situation. Thus, the World Bank suggested that recovering credibility should be the main focus of the PSE.

Further, the CNB (2001) highlights the fact that uncertainty dominates the equity markets because of the steady decline in the number of traders within the PSE as well as the decreasing number of traded issues and the growing interest of investors to invest abroad rather than in the Czech capital markets. The non-transparency of the market is also promoted by the different prices existing within the different capital markets, making manipulation of the market quite easy.

As a matter of fact, unified pricing still does not exist. In its Regular Report 2000, the Commission emphasizes that more attention should be paid to the structural problem of the "two prices" system. Furthermore, in its Regular Report 2001 the commission determines that more measures are necessary to align the securities markets with the acquis. Also in its Regular Report 2002 (p.60) the Commission states:

"However, new legislation on Capital Markets is needed to fully align with acquis principles on the functioning of capital markets. A new Act on Collective Investment is needed to replace the present Act on Investment Companies and Investment Funds, which does not transpose all the relevant acquis. Progress should also be made on a number of implementing decrees."

In conclusion, it could be said that the Czech securities markets do not behave as a standard market. It is highly questionable if foreign investors, and more importantly EU companies, will be able to operate within the Prague Stock Exchange in the near future.

The PSE has not yet established EU norms regarding a fully functioning stock market. Insider dealing and the non-transparency of the market are still key problems. Thus, it could be noted that the Czech Republic will join the EU without having established a standard capital market based on EU norms and international usage.

6.3 Foreign Direct Investment (FDI)

As demonstrated in chapter 5.1.4.6.2., Foreign Direct Investment could play a significant role within the economies of transition countries. The scale and their nature is influential in terms of shaping different economic areas. With a higher amount of FDI many Central and Eastern European countries (especially Hungary) could boost their transformation process.

Basically there are three forms of foreign involvement. Foreign Investors could enter the market by setting up a new affiliate, the so called Greenfield Investment or through merges and acquisitions, or - last but not least - through strategic joint ventures. An example of the latter is the joint venture between Tesla Telekomunikace and the Italian Marconi Communications. Here, on the one hand the Czech side could provide the necessary information about the local market and knowledge of local standards, whilst the Italian partner on the other hand could provide the technology and expertise necessary to compete within the world market (OECD, 2001).

Another example in this context is the early joint venture between the German car producer VW and the Czech Skoda Automobilova. Skoda not only maintained its position within home markets and Central and Eastern Europe, but also entered new, predominantly western European markets.

Also in the case of Greenfield Investment the major joint venture between Toyota and PSA Peugeot Citroen (CERGE-EI, 2003) presents another example of how FDI contributes to economic development and increasing competition[15].

As Misun and Tomsik (2002) highlight, there are several advantages which could occur through Foreign Direct Investment, apart from technological advantages and modern know-how. Other advantages are their ability to organize the production process and to provide the necessary marketing concepts in order to establish new products within the local as well as the global market.

Mickiewicz, Radosevic, Varblane (2000) underline the fact that in some cases FDI can maintain employment and be influential in the context of wage levels, income distribution and skill transfer. As it could be observed through the joint-venture between VW and Skoda, FDI could also improve the principal-agent situation by enforcing an appropriate organizational as well as corporate governance structure.

For instance, many departments from the old structure kept their activities, but also new departments and structural changes were applied to the organizational system. Moreover, from the very beginning Skoda implemented German governance models. The executive body consists of a board of directors which is supervised by the executive committee, and in order to treat both sides equally, the board of directors as well as the executive committee members are represented partly by VW and Skoda representatives (Bohata, 1998).

Foreign Direct investment can also increase the productivity and efficiency of former state owned enterprises. For example, as an analysis by Jarolim (2000) during the years 1993-1998 has shown, manufacturing enterprises with foreign participation have performed better in terms of productivity than domestic companies without foreign participation. Zemplinerova (1998) underlines further, in comparison to domestic companies, enterprises with foreign participation have not only twice the level of productivity and sales figures, but also they are three times more likely to export a unit of the produced goods.

Foreign Direct Investment could also play an important role within the context of research and development. Especially here technology spillovers are seen as one of the main advantages of foreign investment (Kinoshita, 2000).

Last but not least in this context, the reinvestment factor should also be kept in mind. The OECD (2001) highlights the fact that within the manufacturing sector 91% of companies with foreign participation have reinvested within this sector. In addition 50 percent of them were expected to increase the production.

In chapter 5.1.4.6.2 it has already been determined that the Czech government in its attempt to attract foreign investors had been more conservative in comparison to other transition countries such as Hungary. The Czech government did not want to sacrifice the “Family Jewels”. For instance, VW took over the Skoda plants at a very early stage of privatization, but after cut backs had to be carried out due to economic stagnation in Germany, many Czech political commentators suggested that the real reason was the manipulation of the Czech subsidiary in order to protect the main industry in Germany. Consequently, during the 1994 negotiations with Volkswagen, when VW wanted to take over the majority stake from the Czech state, the Czech government ensured its “veto power” over a number of key decisions (Leff, 1997).

Another development which hampered the participation of foreign investors was the method which was chosen by the Czech government to privatize the whole economy. The voucher privatization was without doubt a fast method to privatize enterprises but the fragmented ownership structure with weak corporate governance practices made it very difficult for foreign investors to penetrate the Czech market. In Hungary for instance, the government chose direct sale methods giving equal access to all bidders, domestic as well as foreign ones. The following table shows clearly the disadvantage of the Czech Republic vis à vis Hungary during the first seven years of transition:

Table 40: ***FDI development in the Czech Republic and Hungary 1990-2000 ($ million)***

Year	*Czech Republic*	*Hungary*
1990	132	311
1991	513	1459
1992	1004	1471
1993	654	2339
1994	868	1146
1995	2562	4453
1996	1428	1983
1997	1300	2085
1998	3718	2036
1999	6324	1944
2000	4595	2135

Source: Misun and Tomsik (2002)

Moreover, the decrease in Foreign Direct Investment inflows during the years 1996-1997 could be explained by the problems described above, e.g. the limited choices of stocks within the Czech market and a number of bureaucratic obstacles.

Mr. Zdenek Bakala, Chairman of Patria Finance (Prague brokerage), stated in an interview in 1998 that:

"The environment in the Czech Republic has to be perceived as friendly to international capital, to international portfolio and direct investors (…) the environment is not perceived as a friendly one today." (Clack, 1998)

Furthermore, the European Commission itself stated in its country Regular Report (2001), that:

"Foreign-owned companies developed better than domestic enterprises which still face considerable difficulties in access to bank and market financing."

In order to increase the level of FDI an investment incentive package was introduced by the government in 1998. Its aim was to put the Czech economy in a better position to compete in favour of FDI. This package was informed by a new law passed in 2000 and was adjusted in 2001 in order to bring it in line with the acquis, including an extension to investments in the areas of high technology and services (EU, 2001a).

This package offered incentives to investors within the manufacturing sector if they were about to invest a minimum of 10 million USD (CERGE_EI, 2000).

The commission underlines the progress which has been achieved since 1998. In its country report 2002 it states:

"The investment climate has improved substantially over the past years, not least because of a comprehensive strategy to attract foreign direct investment."

Through these incentives (since 1998) large quantities of FDI flooded into the Czech Republic. The main industries which benefited from this development were the technology intensive electrical, machinery and car industry (Mickiewicz, Radosevic, Varblane, 2000).

The 2001 Regular Report underlines once more the large quantities of Greenfield Investment which the Czech economy had received as well as the inflow of foreign investment into the financial services sector which was due to the final privatization steps undertaken within the banking sector. During the first half of 2001 an amount of 2578 million euros were invested into the Czech Republic.

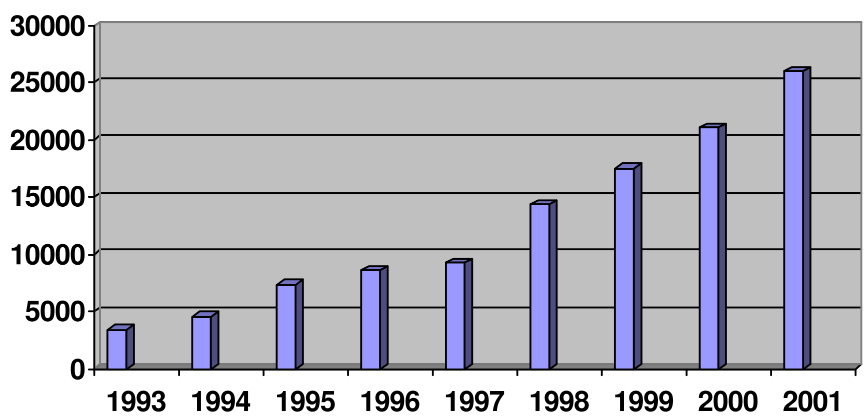
Other industrial sectors, such as food products and tobacco, have also received high quantities of foreign investment (CERGE-EI, 2003). From 1997 to 2001, average FDI inflows amounted to 7.8 percent of the GDP. In the first half of 2002 the Czech Republic attracted about 3.1 billion Euros.

In conclusion, the harmonizing of standards, the liberalization of foreign investment and the implementation of the necessary regulatory framework attracted a higher level of foreign investment. Here, one should also keep in mind that there are several other reasons why the Czech economy could attract high levels of FDI. Also important in this context are its geographical location, its stability, low inflation rates but above all, low wages and a highly skilled labor force.

For instance, the amount of labour force with a secondary school education is around 66% and another 12% have completed tertiary education (Regular Report, 2001, 2002).

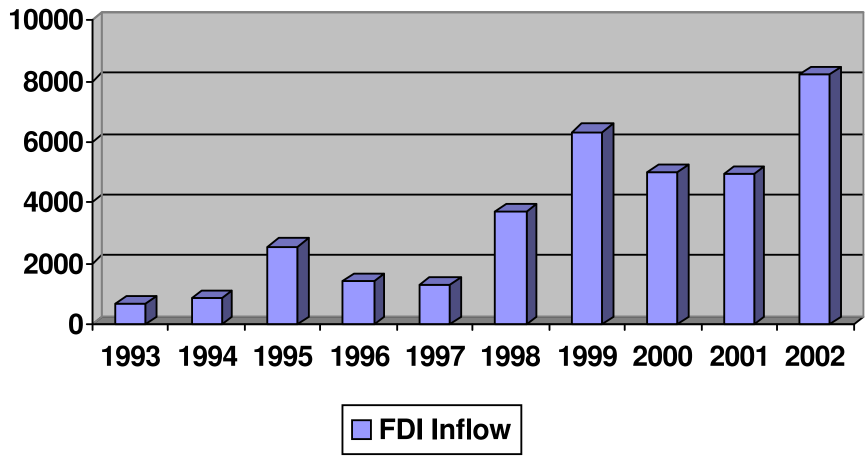
The following two figures show the increase of FDI stock between the years 1993-2001 in the Czech Republic. One can determine a significant change from 1998 onwards, when investment stocks rose significantly in comparison to the first seven years of transition.

Figure 7: FDI Stock in the Czech Republic 1993-2001 (USD billion)



Source: CERGE-EI (2001)*[16]

Figure 8: FDI Inflow in the Czech Republic 1993-2002 (USD million)



Source: CERGE-EI (2003)*[17]

Looking at the balance of payments another important role of FDI becomes apparent. FDI offsets the current account deficit; without the high level of FDI the Czech current account deficit would face major problems.

As the CERGE-EI report 2003 emphasizes, the reason why foreign investors have decided to invest within the Czech market vary, but the most significant reason is the political and economic stability. The investors would leave the country very quickly, if these favourable conditions are not met.

In the context of EU enlargement one should also pay attention to the degree of market ties which has already been achieved between the Czech Republic and the European Union. Between the years 1990-1996 the largest investors within the Czech economy were EU based companies. Germany was the biggest investor with a share of 29.6 percent followed by Switzerland and the Netherlands each with a share of 13.5 percent (Newton, Walsh, 1999). The OECD Report 2001 emphasizes the increased Dutch share amounting to 27.1 percent in 2001.

In 2003 CERGE-EI estimated an amount of 80 percent from the total FDI which the Czech economy has received as being invested by EU based companies with Germany, the Netherlands, Austria and France as the dominant countries.

The following table for instance, gives the investment amount of the three biggest investors, their names, the name of their Czech partner or subsidiary and the type of business. As can be seen, EU based enterprises play a significant role within the Czech industrial sector:

Table 41***: The largest foreign investors in the Czech Republic***

Total investment (mil. of USD)	*Foreign partner, Country*	*Type of business, Investment time span*	*Name of the Czech partner or subsidiary*
1460	*TelSource* The Netherlands, Switzerland	Telecommunications 1995	Český Telecom, a.s.
1200	*KBC Bank* Belgium	Banking 1999	ČSOB, a.s.
900	*Volkswagen* Germany	Automobiles 1991-1998	Škoda Automobilová a. s.

Source: CERGE-EI (2000)*[18]

One of the most significant advantages deriving from the above FDI inflows is the strengthening of the economy before accession to the European Union in 2004. However, more importantly EU based FDI could provide “a shift in the product structure to become more similar to the developed EU countries” (CERGE-EI, 2003, p.42).

In conclusion it could be said that during the first eight years of transition the role of FDI has been underestimated. With the voucher privatization system, a privatization method was chosen which made it very difficult for foreign investors to participate. Due to the government’s policy, the strengthening of the economy through FDI inflows was inhibited for a long time. It was not until 1998, when the Czech government implemented a national investment incentive programme in order to tackle these issues, that the situation improved.

Since then, foreign investors have played a major role in restructuring the Czech companies. They have done this not only by securing access to EU markets, but also by making the Czech Republic an attractive location, increasing its advantages in the context of EU accession. Foreign Direct Investment has facilitated the necessary restructuring and modernization steps, and increased productivity as well as the level of competitiveness which was needed to tackle the problems of principal-agent. Now the agents are faced with a more competitive environment and therefore have to realize their task as the agents of the principals’ interests.

In order to maintain these high levels of Foreign Direct Investment, the Czech Republic has to improve the situation regarding the legal system and the transparency of the economy. The implementation of important EU-Directives such as Directive 2000/12/EC and 91/308/EEC should be the main focus of the Czech government. According to the information unit of the European Union (EUR-LEX, 2003), at the beginning of 2004 these directives were not embodied in Czech national law. Moreover, not only their implementation, but also their acceptance by the economic actors and within the economic proceedings is crucial.

These targets are one of the most significant elements if the Czech Republic wants to join the European Union successfully in 2004.

6.4 The Commission's Opinion 1997-2001

The Commission in its first Country Report in 1997 stated that the Czech Republic could be regarded as a functioning market economy; some changes at the enterprise level should be implemented to further strengthen economic performance, but it highlighted the fact that: *"(the Czech Republic) should be able to cope with competitive pressure and market forces within the union in the medium term"*.

Even though the Czech Republic was considered to have a functioning market, one of the first concerns which the Commission expressed, was the problem of cross-ownership between the banks and investment funds and the conflict of interests that occurs when banks are at the same time owners and creditors of the privatized industrial sector.

Also the inter-ownership of banks was highlighted as a major problem in the banking sector. The problem of bad loans was another cause for concern. Moreover, the Commission criticized the lack of transparency in the Stock Exchange markets and its domination by illegal activities. The PSE was regarded as not being "a significant way of raising finance for enterprises". In its analysis the Commission underlines the fact that two significant and important market institutions, namely the financial and capital markets, needed to be developed further. The banking sector especially was regarded as not being competitive enough. Furthermore, the sector was weak because of the high amount of non-performing loans, the lack of transparency, the inter-ownership of banks and investment funds and its under-capitalization. Also, the state ownership of the main banks was criticized as hampering the development of the banking sector, since the state played a significant protecting role, inhibiting the development of free market conditions. Therefore, the Commission underlined the fact that:

"progress in this area is essential for the Czech Republic to achieve the competitiveness required for the European markets."

The inadequate legislation and supervision in this sector were determined as being the two significant causes of this lack of competition. Another important indicator of competitiveness was determined by the Commission as the:

"ability of enterprises to adjust to changed circumstances and for managers to restructure enterprises and adopt internationally accepted norms and practices".

Taking this analysis into account, the Commission, in its Regular report 1997, said that the weak performance of management had negative effects on the competitiveness of the Czech industry. The commission determined the need to change working practices. One of the main reasons for the failure of an adequate functioning of principal-agent relations was given as the lack of transparency regarding the ownership of the enterprises. The problem here was that managers were often not responsible or accountable for their actions.

In its first draft the Commission not only expressed its concerns regarding the situation within the industrial and banking sector, but the judiciary was also highlighted as not being effective enough. The courts were overloaded and proceedings took too long; the poor performance of the courts was alarming. Also the police force was criticized for its slowness and inefficiency in fighting organized crime.

Due to these problems the Commission suggested that the Czech Republic had to further strengthen the legal framework, especially in issues regarding corporate governance and bankruptcy procedures. It also recommended the improvement of the legal environment for business, including the improvement of the revitalization programme. Further reforms were needed in the financial sector too, including improved privatization and transparency in the banking sector.

However, in the 1998 Regular Report the Commission stated that the Czech Republic "has made little progress in the overall approximation process". The banking and capital markets sector did not improve significantly and did not satisfactorily address the issues of industrial restructuring, administrative capacity and the problems regarding JHA.

One year later in the Regular Report 1999 the Commission once more underlined that the performance of the judiciary in fighting organized crime had remained weak. The high number of corruption cases was highlighted as being a serious problem. It also criticized the uncoordinated and insufficient anti-money laundering situation, even though the legislation concerning these issues was largely compatible with those of the Union. The bankruptcy regulations and their application still did not have adequate strength and court proceedings were still criticized for being too slow. In the context of the banking and capital markets, it was determined that the key weakness of the Czech economy remained its financial sector and further alignments were necessary in order to guarantee their performance. The privatization of the banking sector was identified as the main future challenge.

The 2000 and 2001 Regular Reports basically emphasize the progress which was made by the Czech Republic in order to privatize the remaining companies within the industrial sector, but especially the steps undertaken within the banking sector were seen as significant steps forward. The situation of the financial sector in general was regarded as being better than in the previous Regular Reports presented, but the role of the financial sector as a "financial intermediary" was still perceived as "weak".

In 2001 (p. 104) the Czech economy was therefore regarded as a functioning market economy, but it had to make "further progress towards medium-term fiscal consolidation and complete the implementation of structural reforms".

6.5 The last two reports 2002 and 2003

The two final reports in 2002 and 2003 were the crucial ones in order to determine the readiness of the Czech Republic, in particular the readiness of its financial sector. In the past chapters some essential elements of these two reports have been presented. This section aims to give a final comprehensive overview of the main weakness of the Czech economy just months before its scheduled accession in May 2004.

On the one hand these two final reports in general emphasize again the progress made in restructuring and privatizing the banking sector, including the transfer of its bad loans to the Czech Consolidation Agency. On the other hand these bad assets seem to be one of the main problems that must be solved in order to tackle the government's budget deficit.

The 2003 report identifies bad assets held by the CKA amounting to around 15 percent of the GDP at face value. Therefore, a final solution for the remaining bad assets held by the CKA, is perceived as one of the most important issues still to be addressed.

Furthermore, in both reports the Commission underlines the fact that proper transparency in the Czech administration still does not exist. It underlines the widespread corruption and emphasizes that the available capacities in order to combat corruption are not sufficient. These reports further determine that parts of the police force are still involved in corrupt incidents.

In this context one should notice that the last report highlights the tendency within the official Czech data to suppress the real figures concerning corruption.

The 2003 report defines the fight against corruption as one of the main issues which has to receive high priority. Here “enhanced efforts” in fighting corruption, fraud and money laundering are seen as the key success elements not only in order to guarantee the transparency of the Czech economic sector, but also in promoting EU norms and values in Czech society.

The courts and judges also seem to be overloaded. One example involves the duration of civil proceedings from January until April 2003 in district courts. These showed a proceeding duration of 592 days compared to 560 days in 2002. Therefore, the reform of the judicial system is another important challenge for the Czech government in order to reduce the inefficiency and lack of the transparency.

Also in the financial sector many problems still have to be faced. Both reports highlight the restructuring of the banking sector as successful. Its supervision as well as legislation is regarded as being “largely” in line with the acquis but the reports also underline the fact that alignments within the investment services and the securities markets are essential, and significant measures which still have to be implemented.

The Commission expresses its hope that by the time of accession the problems within this sector will be solved and the alignments are fully in line with EU requirements and norms. The issues determined above represent the core weaknesses of the Czech economy. The Commission, however, felt confident that these issues would be addressed by the time of accession, even though since the first Regular Report in 1997 the Czech authorities could not successfully tackle the most significant issues such as the high level of corruption and fraud!

Notes

1 Komercni Banka (KB), Ceska Sporitelna (CS), Investicni a Postovni Banka (IPB) and Ceskoslovenka Obchodni Banka (CSOB)

2 As Boland (1996b) correctly observes in the case of Czech banking sector: *"…inexperienced or downright incompetent executives overextended themselves…"*

3 This model is *"characterised by an arms-length relationship between firms and banks, with a focus on short-term profit and shareholder dividends. Consequently, there are few restrictions on predatory behaviour (such as hostile takeover), and this is used as an alternative mechanism to allow banks to control management behaviour" (Neumann, Egan, 1999, p.175)*
The Stock exchange plays an important role because of its importance as a source of corporate finance.

4 This model is *"characterized by consensus, corporatism and collective achievement. Emphasis is placed on long-term results, and market governance is built on a cross-shareholding model where banks and industry are closely intertwined in a network of relations that promotes an environment of stability." (Neumann, Egan, 1999, p.175)*
Here banks are "universal" and can carry out a vast range of financial services, in other words banks are operating in the field of commercial as well as investment banking.
Therefore, it could be said that they are major participants within the capital markets providing, for instance, insurance services. In this context it should be kept in mind that universal banks could also have their representatives within those companies in which they hold the majority.
By having their representatives on the company board, banks could gain corporate governance over the activities of the manager.
However, the Rhineland model could also cause a serious problem with conflicts of interests (insider dealing, etc.) if there is a lack of transparency within the system.
Especially because universal banks tend to take deposits from "non-commercial" customers and grant it to enterprises in which they have stakes, even though the depositors may prefer another type of investment portfolio (Heppke, 2001).

5 The IPB cost estimate excludes the expected loss of CZK 40-100 billion that the Czech state guaranteed to the buyer of IPB (namely: CSOB) in mid 2000.

6 The capital market department is part of the Czech Finance Ministry

7 As a result of past experience the "watch" credits are considered as classified credits and are added to non-performing credits.
In many countries non-performing credits are normally classified credits minus watch credits, due to their minimized risk degree

8 The recommendations were made for different fields. Here, only three of those recommendations are given as examples (CNB, 2001, p.6-7):
"- to enlarge the scope of supervision, (…) (The CNB had to draft) *a decree on*

consolidated supervision and the relevant statements and internal rules of off-site and on-site supervision (…)
- to focus the regulations and supervisory work on the qualitative aspects of banks' activities, (…) (The CNB had) *to draw up basic prudential standards in the areas of credit and market risks, country and transfer risk and …*
- to strengthen the staffing levels for conducting supervision. (…) The intention to maintain and further develop experience and expertise in risk measurement and management will require targeted training and professional development of CNB supervisors;"

9 The following banks represent examples for each of these categories:

I) Erste Bank
II) Commerzbank, Credit Lyonnais, Societe Generale
III) Deutsche Bank, Dresdner Bank
IV) KBC Holding

10 When regulations against money laundering are different in each member state, some member states could, for the purpose of protecting their financial systems adopt, measures which could be inconsistent with completion of the single market.

11 The Basel Committee was founded in 1974 by a group of ten countries in order to exchange information on national supervisory arrangements, and set up minimum standards for capital adequacy as well as in other banking issues. These countries are represented by their central banks.
In 1997 the group developed the so called "Core Principles for Effective Banking Supervision" in order to set up an internationally accepted framework for effective banking supervision (BIS, 2003)

12 The developments between the founding until the year 2002 in terms of the number of shareholder and members can be seen through the following table (PSE, 2003):

Table 42*: PSE's number of shareholders and members; Founding (1992) until 2002*

Year	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Shareholder	17	38	37	43	63	61	58	58	55	53	52
Members	17	62	71	101	109	88	71	54	52	35	32

Source: PSE (2003)

13 *"The Lyon model differs from the New York stock exchange in that it includes mechanisms that are intended to maximise trading volume. This is achieved through a highly controlled process of price setting that matches buy and sell orders at an optimal price." (Brom, Orenstein, 1994, p. 918)*

14 Already in 1998 this problem was well known by the chairman of the Securities and Exchange Commission, Mr. Jan Muller, who stated in an interview (Clack, 1998):

"Ninety-five percent of all trades are conducted off market, and this will be forbidden in the future; but we want to do it in two stages. The first stage is to introduce a reporting system for all off-market deals, and in the second stage we want to disallow all off-market trades."

15 This sector is basically dominated by Skoda-VW.

16 These figures have been collected from the CNB and the figure for 2001 is estimated by CERGE-EI!

17 Data based on CNB information. Figure for 2002 is estimated by CERGE-EI!

18 Data based on CzechInvest

Chapter 7 Conclusions

This thesis has attempted to analyze the readiness of the Czech Republic for accession to the European Union from an institutionalist point of view.

The first part of this thesis tried to give a definition of the common European identity. Despite all problems regarding this topic, it could be said that the Czech Republic was considered by the European Union as part of the common European history and therefore fulfilling not only the accession criteria of being an independent state and a democracy, but perhaps more importantly being "European".

This common identity is based on norms, values and ideas which represent not only the basis of the EU.

There are two other prerequisite which the Czech Republic had to fulfill in order to be included in the "club". Firstly, it had to be a democracy and secondly, the existence of a free market economy were essential conditions for a successful accession.

Chapter four has shown that the Czech Republic could be considered as a democracy. Thus, the last condition to be fulfilled was its economic readiness. The economic conditions were the subject of analysis in the second part of this thesis.

In order to summarize the outcomes of the second part, one could take into account the core elements of both institutionalist approaches, namely "Sociological Institutionalism" and "New Institutional Economics". In particular the latter approach seems to be crucial in order to explain the Czech Republic's economic readiness.

It could be said that EU institutions, especially in the context of the European integration process, are dominated by three different characteristics. The regulative pillar includes formal rules which are laid down in treaties and laws. The normative pillar emphasizes the role of EU norms and values governing the daily policy process and finally, the cognitive pillar underlines the common identity.

NIE emphasizes the importance of formal rules (e.g. treaties; regulative pillar) as well as informal rules (e.g. norms; normative pillar). The European integration process has always been promoted through formal rules. For instance, the creation of the European Coal and Steel Community was an attempt to create formal rules in order to reduce conflicts by stabilizing the future behavior of member states. The "Acquis Communautaire" represents in this context the Community's main institutional framework regarding common rules. However, the EU is also recognized as a community of norms and values. These norms are seen as part of the (west) European culture.

Informal rules which are embedded within the institutions as well as accompanying the daily policy process are also the focus of “Sociological Institutionalism”.

In the context of NIE, institutions seek to cope with insecurity, reduce uncertainty and maximize the good of the public. For instance, to understand the importance of institutions Topan (2001) highlights the motives of each founding member. The Rome Treaty and the institutionalization of the EC aimed to reduce insecurity within the Community, but especially to reduce uncertainties about Germany, by bringing together the old rivals France and Germany. The Benelux countries not only saw the chance to expand their industrial production, but also the opportunity to more accurately predict German policy. This seemed to be easier once formal rules, complemented by informal rules, were established within a common market. Formal and informal rules of conduct create a sense of trust among the member states. Therefore, through the institutionalization of the European Community, decision making was directed to rules in order to increase the economic and political stability of post-war Western Europe.

Two different strands of NIE have played an important role in this thesis in determining the readiness of the Czech economy. The “Transaction Cost Theory” emphasizes the economic aspects of cost reduction through a proper institutional framework. Here, the transaction between parties, such as contract enforcement, causes costs which are expected to be reduced by formal rules and the necessary institutional framework which guarantee their ruling. For instance, in the case of the CEE countries it is expected that a customs union would improve productivity and provide a higher level of efficiency. With the removal of barriers affecting trade, production can exploit economies of scale. Thus, not only will competition increase and the market expand, but it would also lead to growth in high-tech industries, with beneficial effects for the consumer too.

The Czech Republic in this context had reached a high degree of economic integration. One indicator is the high levels of trade with the EU. Earlier in this thesis it was highlighted that in 2001 almost 69% of Czech Exports were headed towards EU markets and 62% of Czech imports originated in EU countries. Thus, we can view the Czech economy as highly integrated with the EU. Here, it could be said that the higher the degree of integration between the markets, the lesser the costs of transaction.

One should keep in mind that transition costs will decrease only when the accession countries can provide a free market environment.

In this context two important questions have been determined in the introductory chapter. They aimed to examine to what extent EU norms and codes of conduct have been implemented, institutionalized and promoted successfully not only within the economic sector, but also within social life.

As already seen, free competition within the Czech financial sector was not possible for a long time and taking the stock market into account one could say that free competition is still not possible due to the lack of norm-implementation. Privatization alone could not create effective and productive markets. Weak property rights and a weak institutional environment have caused an enormous efficiency problem. For instance, in order to reduce transaction costs, bankruptcy laws are crucial to effective organization. It took the Czech government more than a decade to implement adequate bankruptcy laws, but their enforcement still causes a major problem.

In chapter six the existence of a stable legal environment (capable of supporting the development within the capital markets) was the subject of analysis.

Here, as demonstrated previously, the European Commission in its latest reports still emphasizes the importance of an effective enforcement of the law regarding bankruptcy. Not only the inadequate enforcement of bankruptcy laws, but also the proceedings of criminal and civil cases cause an enormous problem. The effectiveness and transparency of Czech economic markets are influenced by lengthy court proceedings. Further, Czech securities markets represent another problem because the PSE, as well as the other securities markets, still lack transparency. EU companies which are willing to operate within the Prague Stock Exchange face huge problems. Due to widespread insider dealing, a proper functioning of the financial markets similar to other markets within the EU is not possible. As a matter of fact, an effective and free market competition remains crucial and as long as the Czech government does not tackle these issues, transaction costs might be higher than expected once the Czech Republic joins the European Union.

Also the “Principal Agent Theory” seems to be important in defining Czech economic readiness since this strand seeks to explain how corruption and fraud can emerge within an economy. Here, agents (management) act on behalf of principals (shareholders). They seek to reduce potential costs by using the asymmetric information among the parties in favour of their principals.

Therefore, the results depend on the agent's effort; however, the principal has to be in control of the agent's actions in order to guarantee the effectiveness of the agent. In the case of weak principal control the managers may use their power in order to pursue personal objectives. The term "untrustworthy agent" is often used to describe this situation. Fraud and corruption within the economy could be the result of such a failed Principal - Agent relationship.

This thesis previously highlights the fact that fraud and corruption still dominate the Czech economy. It is obvious that the state administrative services, such as the police force, are the main institutions involved.

Due to the problems caused by corruption many small banks were tunnelled; moreover, large bank loans were granted to projects which were highly doubtful and went bankrupt. Also as it has been shown, the ICs with their Investment Funds could not keep their promises of profit maximizing; instead, many managers used their position in order to strip the assets so that in the privatized sector the abuse of small shareholders was common. The absence of effective corporate governance and the non-existent principal control over the agents, favoured the development of fraud and corruption for a long time. Since 2001 this situation seems to have improved within the banking sector due to measures undertaken by the government.

Nevertheless, even though the banking sector is newly privatized and foreign investors are now in charge of the business, corruption within the economy still remains a serious problem. And as the Commission highlights, the results of anti-corruption measures remain questionable since responsibility is divided between different agencies and ministries. In other words, there is a lack of coordination in combating corruption effectively.

In conclusion, it could be said that since 2001 the Czech government has taken a number of steps in order to improve the situation. One achievement certainly worth mentioning is the privatization of the banking sector. Also, the Czech National Bank succeeds in fulfilling its function as a supervisor authority. Many amendments have been introduced in order to set up the necessary laws and institutions guaranteeing a stable free market economy.

However, even though formal rules have been implemented successfully, they could not fully overcome past norms and behavior. New Institutional Economies as well as Sociological Institutionalism emphasize the importance of informal norms, values and codes of conduct embedded within the EU institutions. These informal rules underpin the formal rules in guaranteeing the rule of law. Therefore, in chapter five and six the role of embedded EU norms and their acceptance not only within the economic proceedings, but also in the social context were stressed in order to determine their significance.

As it was ascertained previously during the communist regime in the Czech Republic, small bribes was a norm of behaviour in dealing with government institutions. To steal or misuse public goods were a form of opposition against the state clerical. As a matter of fact this behavior somehow became an acceptable norm (including corruption as a part of the system). In the Czech Republic these old norms represent a major problem. Without doubt the institutional framework and the established formal rules almost meet EU standards, but the underpinning (EU) informal rules, norms and codes of conduct are not yet in place, especially in a number of state administrative institutions.

Therefore, not only does the Czech economy still face high costs of transaction, European companies will face this as well once the Czech Republic has joined the European Union. EU companies, for instance, will face a securities market which is neither regulated nor free from insider dealing.

In the Czech case the necessary normative alterations in both economic and political institutions remain to be implemented.

People's behaviour can change - encouraged by formal rules - but the underlining attitudes are much more difficult to change. So although formal laws have been passed, peoples' informal and business norms remain relatively corrupt. It could take generations, rather than years, to really change these attitudes.

Appendices

Appendix I: Main Economic Trends Czech Republic

Czech Republic		**1998**	**1999**	**2000**	**2001**	**2002**	**2003 latest**
Real GDP growth rate	percent	*-1.0*	*0.5*	*3.3*	*3.1*	*2.0*	*2.1 Q2*
Inflation rate - annual average	percent	*9.7*	*1.8*	*3.9*	*4.5*	*1.4*	*-0.2 August*[a]
- December-on-December	percent	*5.8*	*2.5*	*4*	*3.9*	*0.1*	*-0.2 August*
Unemployment rate - LFS definition	percent	*6.4*	*8.6*	*8.7*	*8.0*	*7.3*	*7.6 Q1*
General government Budget balance	percent GDP	*-4.5*	*-3.7*	*-4.0*	*-5.5*	*-3.9**p***	
Current account balance	percent of GDP	*-2.3*	*-2.8*	*-5.3*	*-4.6*	*-6.3**p***	
	million ECU/Euro	*-1187*	*-1470*	*-2946*	*-2930*	*-4692*[b]	*-2611 Jan.-July*[b]
Gross foreign debt of the whole economy - debt export ratio	percent of exports of goods and services	*36.2*	*36.2*	*41.2*	*37.5*	*:*	
	million ECU/Euro	*10778*	*11326*	*16042*	*16960*	*:*	
Foreign direct investment inflow - balance of payments data	percent of GDP	*4.8*	*9.3*	*:*	*8.6*	*13.4*[b]	
	million ECU/Euro	*2416*	*4792*	*:*	*5489*	*9889*[b]	*2502 Jan.-July* [b]

[a] Moving 12 months average rate of change
[b] Source: Website of the Czech National Bank
P: provisional figures
LFS: Labour Force Survey

Source: Regular Report 2003 taken from Eurostat. National sources.
OECD external Debt Statistics

Appendix II: Main Indicators of Economic Structure in 2002

Population (average)	Thousand	10.201
GDP per head [a]	PPS*	
	Percent of EU average	60
Share of agriculture [b] **in:**		
- gross value added	Percent	3.7
- employment	Percent	4.9
Gross fixed capital formation/GDP	Percent	26.3
Gross foreign debt of the whole economy/GDP [c]	Percent	26.6
Exports of goods & services/GDP	Percent	65.2
Stock of foreign direct investment [d]	Million Euro	23352
	Euro per head	2289
Long term unemployment rate	Percent of labour force	3.7

[a] Figures have been calculated using the population figures from National Accounts, which may differ from those used in demographic statistics.
[b] Agriculture, hunting, forestry and fishing
[c] Data refer to 2001.
[d] Data refer to 2000.
* PPS Purchasing Power Standards

Source: Regular Report 2003 taken from Eurostat

Appendix III: Position of individual Members in the EP and in the EU Council of 27 Members

Country			
Current Members	**Population in million / percent**	**Seats in EP[1]**	**Votes in Council**
Austria	8.06 mil. / 1.68%	17	10
Belgium	10.16 mil. / 2.12%	22	12
Denmark	5.26 mil. / 1.1%	13	7
Germany	81.9 mil. / 17.08%	99	29
Greece	10.48 mil. / 2.19%	22	12
Finland	5.13 mil. / 1.07%	13	7
France	58.38 mil. / 12.18 %	72	29
Ireland	3.63 mil. / 0.76 %	12	7
Italy	57.4 mil. / 11.97 %	72	29
Luxembourg	0.42 mil. / 0.09%	6	4
Netherlands	15.53 mil. / 3.24%	25	13
Portugal	9.93 mil. / 2.07%	22	12
Spain	39.27 mil. / 8.19%	50	27
Sweden	8.84 mil. / 1.84%	18	10
United Kingdom	58.8 mil. / 12.27%	72	29
Candidate Countries			
Bulgaria	8.36 mil. / 1.74%	17	10
Cyprus	0.74 mil. / 0.15%	6	4
Czech Republic	10.32 mil. / 2.15%	20	12
Estonia	1.47 mil. / 0.31%	6	4
Hungary	10.19 mil. / 2.13%	20	12
Latvia	2.49 mil. / 0.52%	8	4
Lithuania	3.71 mil. / 0.77%	12	7
Malta	0.37 mil. / 0.08%	5	3
Poland	38.62 mil. / 8.06%	50	27
Romania	22.62 mil. / 4.72%	33	14
Slovakia	5.37 mil. / 1.12%	13	7
Slovenia	1.99 mil. / 0.42%	7	4

[1] EP: European Parliament

Source: **CERGE-EI (2002)**

Appendix IV: Ethnic Minorities in the Czech Republic

	1991		1995		2001	
	Census	*Percent*	*Estimate*	*Percent*	*Census*	*Percent*
Slovak	314.877	3.1	300.000	2.9	193.190	1.8
Polish	59.383	0.6	60.000	0.6	51.968	0.5
German	48.556	0.5	48.000	0.5	39106	0.5
Hungarian	19.932	0.2	21.000	0.2	14.672	0.1
Ukrainian	8.220	0.1	12.000	0.1	22.112	0.2
Russian	5.062	0.1	5.000	0.1	12.369	0.1
Total	488.933	4.7	746.000	7.2	807.456	7.9

Source: CERGE-EI (2002, taken from Lidove Noviny)

Appendix V: Bankruptcy and composition opened by court ruling

1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
66	294	727	808	1251	2022	2000	2491

Source: Schönfelder (2001, taken from data from Czech Ministry of Justice)

Appendix VI: The top 10 Czech exporting companies,2000

Company	*Foreign participation*
Skoda Auto	Yes
Ceska Aerolinie	No
AVX Czech Lanskroun	Yes
Metalimex	No
Barum Continental	Yes
Moravia Steel	No
Nova Hut' Ostrava	Yes
Rakona Rakovnik	Yes
Dioss Nyrany	No
Autopal Novy Jicin	Yes

Source: OECD (2001, taken from Czech Statistical Office)

Appendix VII: Appendix VII Restructuring small and medium-sized banks in the Czech Republic

Pre-1993	Consolidation programme I: bad loans from the pre-1990 period shifted to Konsolidačni Banka, capital injections to state owned banks
1993	Forced administration in Kreditni a prumyslova Banka
1994	Forced administration in Banka Bohemia (fraudulent activities; the bank ceased operation; due to insufficient deposit insurance, funds were taken over by CSOB) License revocation to AB Banka stopped (taken over by Ceska Sporitelna) The state and the CNB committed themselves to cover losses that had emerged in two problematic banks: Bohemia Banka, and AB Banka
1995	Licenses revoked to AB Banka and Ceska Banka
1996	Consolidation programme II: on the basis of external audits, potential losses from active operations of banks were provisioned; capital adequacy in the sector significantly decreased; 15 banks participated and nine banks were put under forced administration or had their banking license taken away. Stabilisation programme: designed for 13 small banks; six banks participated. Bad assets up to 110 percent of equity should be carved out temporarily (seven years) from balance sheets. The programme was conditioned on the banks following a set of very strict rules. The banking supervision body took legal actions on 16 occasions due to criminal activities in some banks. Six forced administration (Ekoagrobanka, COOP Banka, Podnikatelska Banka, Realitbanka, Velkomoravska Banka, and Agrobanka) and two licenses taken away (Prvni Slezska Banka and Kreditni Banka)
1997	Licenses of Bankovni dum Skala, Ekoagrobanka, Evrobanka and Realitbanka revoked
1998	Licenses of COOP Banka, Velkomoravska Banka, Agrobanka, and Pragobanka revoked
1999	Licenses of Univesal Banka and Moravia Banka revoked Privatization of CSOB
2000	Forced administration of IPB (business sold to CSOB) Bail-out and privatization of Ceska Sporitelna
2001	Privatization process of former state banks finished Bail-out and privatization of Komercni Banka

Source: European Investment Bank (2002, taken from CNB data)

Appendix VIII: Major characteristics of CEE stock and bond markets 2000in comparison To Portugal and Greece

	Stock Markets (Domestic Companies)			***Bond Markets***	
	Market Capitalisation		*Market Turnover*	*Capitalisation*	
	In USD billion	**In % of GDP**	**In % of capitalisation**	**In USD billion**	**In % of GDP**
Czech Republic	9.7	19	69	5.2	10
Hungary	11.9	26	102	9.2	20
Poland	29.6	19	65	17.9	11
Greece	107.5	90	88	79.5	66
Portugal	60.7	57	90	49.0	46

Notes: Market turnover shows all transactions that pass through the trading system or the trading floor for all countries. Portugal shows all transactions under the supervision of the market authority (off- and on-market). The bond market capitalisation figure for Greece is from 1999.

Source: European Investment Bank (2002, taken from IMF, National Central Bank, FIBV, National Stock Exchanges)

Bibliography

Agenda 2000 (1997a), Commission Opinion on Slovakia’s Application for Membership of the European Union, July 15

Alston, P. and Weiler, J.H.H. (1999), An „Ever Closer Union“, in Need of a Human Rights Policy, The European Union and Democracy. Harvard Jean Monnet Working Paper, No. 1/99

Amin, A., Thrift, N. (1994), Globalization, Institutions, and Regional Development in Europe, Oxford University Press, Oxford

Anderson, R., Wagstyl, S. (1998), Counting the cost of the golden years, the economy has been stabilised but reforms are needed to revive growth and investment, Financial Times, 14 May

Anderson, R. (1997a), Power, An attraction for investors, Financial Times, Survey – Czech Republic, 1 December

Anderson, R. (1997b), Banking Spotlight on sell-offs, Financial Times, Survey – Czech Republic, 1 December

Anderson, R. (2000), Czechs’ Days of Quick Profits are Over, The Financial Times, 23 August, Edition 1:27

Armstrong, S. (2002), Voucher Privatization in the Czech Republic, http://www.drake.edu/cbpa/econ/studentresearch/armstrong02.pdf

Bakala, Z. (1998), Interview, in Clack, A. (1998), Czech Republic, Attracting Investors, http://www.foreignwire.com/czech98.html

Baldwin, David A. (ed.). (1993) Neorealism and Neoliberalism: The Contemporary Debate, New York, Columbia University Press

Bank of Ireland (1999), Economic country Briefings Czech Republic, Monetary Policy, March, http://wwwbankofireland.ie/html/gws/corporate/info_res_centre/economic_country_b...

BDE (2003), Banco de España, Memoria de la Supervisión Bancaria en España, http://www.bde.es/informes/be/supervi/2003/ms2003.pdf

Beach, D. (1997), The negotiations of the Agreements with Poland, Hungary, and Czechoslovakia- A three-level game, http://www.sam.sdu.dk/~dbe/EuropeAgr.pdf

Benacek, V. (1992), Market Failure Versus Government Failure, The Ways of the emerging Market Economies (CERGE-EI, 1992), 13

BIS (Bank of International Settlements), (2003), The Basel Committee on Banking Supervision, http://www.bis.org/bcbs/aboutbcbs.htm

Boguszakova, M., Gabal, I. (1996), The Czech Republic, in Smoke, R. (ed.), Perceptions of Security, Manchester University Press, Manchester

Bohatá, M. (2000), Škoda Automobilová a.s., in Estrin, S., Richet, X., Brada, J. (2000), Investment in Central Eastern Europe, Case Studies of Firms in transition, M.E. Sharpe, Inc., London

Boland, V. (1996), Czech Finance and Investment, Embarrassing setbacks for largest shareholders, Financial Times, 26 April 1996

Boland, V., Done, K. (1996), Czech Finance and Investment, A race to bridge the wealth gap, While considerable economic progress has been made in the Czech Republic in recent years, observers point to a lack of long-term domestic investment capital, Financial Times, 26 April

Boland, V., Robinson, A. (1996), Survey - Czech Republic, “There are too many markets”, Financial Times, 6 December

Bombik, S., Samson, I. (1997), Slovakia, in Smoke, R. (ed.), Perceptions of Security, Manchester University Press, Manchester

Borish, M., Ding, W., Noël, M. (1997), The Evolution of the Sate-owned Banking Sector during Transition in Central Europe, Europe-Asia Studies, Volume 49, No. 7, 1187-1208

Borja, A. (2002), Boletin Economico DE ICE N° 2752, Principales retos de la economía checa ante su integración en la UE, Del 16 De Diciembre de 2002 Al 5 De Enero De 2003

Bornstein, M. (1999), Framework Issues in the Privatization Strategies of the Czech Republic, Hungary and Poland, Post-Communist Economies, Volume 11, No. 1, 47-77

Böse, O., Eibicht, R. (1989), Die Sudeten-deutschen, Eine Volksgruppe im Herzen Europas, Von der Frankfurter Paulskirsche zur Bundesrepublik Deutschland, Langen Müller, München

Brom, K., and Orenstein, M. (1994), The Privatised Sector in the Czech Republic, Government and Bank Control in a Transitional Economy, Europe-Asia Studies, 46:6, 893-928

Brusis, M., Dimitrov, V. (2001), Executive Configuration and fiscal performance in post-communist central and eastern Europe, Journal of European Public Policy, Volume 8, No. 6, Special Issue, 888-910

Buch, C. (1995), The Emerging Financial Systems for the Eastern European Economies, Kiel Working Paper, No. 716, December

Buch, C. (1996), Creating Efficient Banking System, Theory and Evidence from eastern Europe, Kieler Studien 227, Tubingen

Bulmer, S. J. (1998), New institutionalism and the governance of the Single European Market, Journal of European Policy, Volume 5, Number 3, 365-386

Buzan, B. (1991), People, States and Fear: An Agenda for International Security Studies in the Post- Cold War Era, Harvester Wheatsheaft, London

Buzan, B., Waever, O., De Wilde, J. (1998), Security: A New Framework for Analysis, Boulder

Carr, M. (2001), Thought Essay, "Identifying with Burke", http://hyper.vcsun.org/HyperNews/battias/get/cs327/thought/46.html?nogifs

Cave, M., Valentiny, P. (1994), Privatization and regulation of utilities in economies in transition, in Estrin, S., Privatisation in Central and Eastern Europe, Longman, Harlow

CERGE-EI (2000), Microeconomy, http://www.cerge-ei.cz/pdf/books/pdf_00/III.pdf

CERGE-EI (2001), Macroeconomy, http://www.cerge-ei.cz/pdf/books/pdf_01/IV.pdf

CERGE-EI (2003), Microeconomy, http://www.cerge-ei.cz/pdf/books/CR2002.pdf

Cesko-online (2002), Early Bohemia and Moravian History, http://www.cesko-online.com/Info/EarlyHistory.asp

Clack, A. (1998), Czech Republic, Attracting Investors, http://www.foreignwire.com/czech98.html

Claessens, S., Klingebiel D. (1999), Alternative frameworks for providing financial services, Word Bank Policy Research Working Paper, No. 2189, September

CNB (Czech National Bank) (2001), Banking Supervision, http://www.cnb.cz/

CNB (Czech National Bank), http://www.cnb.cz/

Commission of the European Communities (1997), Regular Report on the Czech Republic's Progress towards Accession, Enlargement, July 15

Commission of the European Communities (1999), Regular Report on the Czech Republic's Progress towards Accession, Enlargement, October 19

Commission of the European Communities (2001), Regular Report on the Czech Republic's Progress towards Accession, Enlargement, SEC (2001) 1746

Commission of the European Communities (2002), Regular Report on Czech Republic's Progress towards Accession, Enlargement, SEC (2002) 1402

Commons, J. (1931), Institutional Economics, American Economic Review, Volume 21, 1931, 648-657

Corbett, J., Mayer, C. (1991), Financial Reforms in Eastern Europe, Progress with the Wrong Model, Oxford Review of Economic Policy, Volume 7, Number 4, 57-75

Cornes, R., Sandler, T. (1986), The Theory of Externalities, Public Goods, and Club Goods, New York.

Council Of Ministers (1993), Conclusions of the Presidency, Copenhagen, 21-22 June, Brussels, General Secretariat of the Council

Cox, R.W. (1981), Social forces, states, and world orders, Beyond international relations theory, Millennium, A Journal of International Studies (Summer), 10(2), 126-155

Cox, R.W. (1983), Gramsci, hegemony and international relations, An essay in method, Millennium, A Journal of International Studies (Summer), 12(2), 162-175

Czech Embassy (2001), Telecommunication in the Czech Republic, Denmark, http://www.czechembassy.dk/profilefiles/tele.html

Czech Ministry of Foreign Affairs (1999), National Programme for the Preparation of the Czech Republic for Membership of the European Union, http://www.mzv.cz/EU/en/docs/np99.html

Danish Presidency (2002), One Europe, The goals and results of the Danish EU Presidency,
http://www.eu2002.dk/news/upload/PUBLIKATION20021218194049.pdf

Danish Trade Council (2002), The Challenge of EU Enlargement, Danish export opportunities following the enlargement of the European Union,
http://www.eu2002.dk/ewebeditpro2/upload/OW.StaticContent/362/1_multipart_xF8FF_2_Rapport%20final.pdf

Dedek, O, (2001), Bank consolidation in the Czech Republic, The banking industry in the emerging market economies: competition, consolidation and systemic stability – an overview, Bank for International Settlements, BIS Papers, No. 4, Monetary and Economic Department, August, 64-71

Deis, M. (1992), A study of nationalism in Czechoslovakia, RFE/RL Research Report 1 (31 January), 8-13

Delanty, G. (1995), Inventing Europe, Idea, Identity, Reality, MacMillan Press, Houndsmills

DG, IA Information Unit, EU Enlargement 1973-1999, From 6 to 15 and beyond, http://www.eu.nl/almdeell/pictures/EnlargementFINAL/sld026.htm

Dijmarescu, E. (2001), Globalization and Enlargement: What Future for Eastern Europe? (Uniting Europe: A Dream Too Far), Eastern European Economics, Volume 39, No. 6, 6-22

Dinan, D. (1999), Ever closer union, an introduction to European integration, MacMillan, London

Done, K. (1996), Concern over corporate disclosure, Financial Times, 26 April

Doner, R., Schneider B. (2000), The New Institutional Economics, Business Associations and Development, http://www.ilo.org/public/english/bureau/inst/download/dp11000.pdf

Dresdner Bank (2002), Czech Republic, EU integration calls for austerity drive, Figures and Forecasts, http://www.dresdner-bank.com/meta/kontakt/01_economic_research/05_emerging_markets_4/ldk_cz_czech_republic.pdf

Economist (1998), Provisional Problem, Volume 346, Issue 8051, 70

Economist (2000a), The Nice Summit, So that's all agreed, then, 16 December, 25

Economist (2000b), The last Crisis?, Volume 355, Issue 8176, 88

Economist (2001), The banks that don't lend, Volume 359, Issue 8219, 77

Economist (2003), Fact sheet, From the Economist Intelligence Unit, Country Views Wire, http://www.economist.com/countries/CzechRepublic/profile.cfm?folder=Profile-Fact...

Edwards, G. (1998), The Council of Ministers and Enlargement, A Search for Efficiency, Effectiveness, and Accountability, in Redmond, J., Rosenthal, G., The Expanding European Union, Past, Present, Future, Lynne Rienner Publisher, London

van Engen, S. (2000), Economic Transformation in the Czech Republic, http://www.geocities.com/czechrep495/reportthree.html

EU (2001a), Pre-Accession Economic Programme, The Czech Republic, http://europa.eu.int/comm/economy_finance/publications/external_relations/2002/pep_cz_en.pdf

EU (2001b), Enlargement of the European Union, An historic opportunity, A general overview of the enlargement process and the pre-accession strategy of the European Union, Published by the Enlargement Information Unit

EU (2002a), European Commission, Enlargement, http://europa.eu.int/comm/enlargement/arguments/index.htm

EU (2002b), European Commission, Directorate-General For Economic And Financial Affaires, Enlargement Papers, European Economy, Report on Macroeconomic and Financial Sector Stability, Developments in Candidate Countries, April

EU (2002c), European Commission, Directorate-General For Economic And Financial Affaires Enlargement Papers, Update of the Report on Macroeconomic and Financial Sector Stability, Developments in Candidate Countries, November

EU (2002d), The Enlargement Process and the three pre-accession instruments: Phare, ISPA, Sapard, European Commission, Enlargement Directorate General, February

EU (2002e), Czech Republic, Pre- Accession Report, January

EU (2002), Presidency Conclusions, Seville European council, June 2002, http://ue.eu.int/newsroom/makeFrame.asp?MAX=&BID=76&DID=71212&LANG=1&File=/pressData/en/ec/71212.pdf&Picture=0

EU (2002), Press Releases, 28 October, Council European Bruxeles Presidency Conclusions Brussels, 24 and 25 October 2002, http://europa.eu.int/rapid/start/cgi/questen.ksh?p_action.gettxt=gt&doc=Doc/02/14|0|...

EU (2001), Regular Report, Progress Towards Accession, Brussels

EU (2002), Regular Report, Progress Towards Accession, Brussels

EU (2003), Regular Report, Comprehensive monitoring report on the Czech Republic's preparations for membership, Brussels

Euractiv (2002), Issues, http://www.euractiv.com/cgi-bin/cgint.exe/2231095-20?714&1015=9&1014=cz_elect...

Eur-Lex (2003), http://europa.eu.int/celex/

Euromoney (2000), Beware! Bad banks in operation, (IMF / World Bank Issue 2000) September

European Investment Bank, (2002), The financial integration of an enlarged EU, Banking and capital markets, Cahiers Papers, Volume 7, No. 1

Fernandez Jilberto, A., Mommen, A. (1998), Regionalization and Globalization in the Modern Word Economy, Perspectives on the Third Word and transitional economies, Routledge, New York, 27-53

Fierke, K., Wiener, A. (1999), Constructing Institutional Interests: EU and NATO Enlargement, Journal of European Public Policy, Volume 6, Number 5, 721-742

Fink Hafner, D. (1999), Dilemmas in managing the expanding EU, Journal of European Public Policy, Volume 6, Number 5, 789-801

Fischer, J. (1957), Oriens-Occidens-Europe, Begriff und Gedanke "Europa" in der Späten Antike und im Frühen Mittelalter, Franz Steiner Verlag, Wiesbaden

Friis, L., Murphy, A. (1999), The European Union and Central and Eastern Europe: Governance and Boundaries, Journal of Common Market Studies, Volum 37, No. 2, 221-232

Fry, G. (2000), A "Coming Age of Regionalism", in: Fry, G., O'Hagan, J., Contending Images of Word Politics, Basingstoke, MacMillan Press, London

Frydman, R., Rapaczynski, A. (1994), Privatization in Eastern Europe: Is the state Withering away? Central European University Press, London

Gorbachev, M. (1988), Perestroika, New Thinking for Our Country and the Word, Fontana, London, quoted in: quoted in Neumann, I. B. (1996a), European Identity, EU Expansion and the Integration/Exclusion Nexus, Paper presented to the conference "Defining and Projecting Europe's Identity: Issues and Trade-Offs", Institut Universaire de Hautes Etudes Internationales, Geneva, 21-22 March, 14

Granell, F. (1995), The European union's Enlargement Negotiations with Austria, Finland, Norway and Sweden, Journal of Common Market Studies, Volume 3, No. 1, 117-141

GRECO (Council of Europe Group of States against Corruption), (2003), First Evaluation Round, Evaluation Report on the Czech Republic, Departement of Crime Problems, Strasbourg

Gros, D., Steinherr, A. (1995), Winds of Change, Economic Transition in Central and Eastern Europe, Longman, Harlow

Habel, F., Kistler, H. (1993), Deutsche und Tschechen, Die kommunistische Machtübernahme, Informationen zur politischen Bildung 132, B6897F, April, 30-34

Hanousek, J., Tůma, Z. (1998), A Test of Permanent Income Hypothesis on Czech Voucher Privatization, http://195.113.12.52/hanousek/pih.pdf

Harmanci, M. (2001), Is Turkey Europe's Other, A dissertation submitted to the School of Social Science, John Moores University, Liverpool

Havel, V. (1990), in Brown, G., New Technology and the Search for Security: Prospects for a Post-Cold-War Era, in: Disarmament Topical Paper 2., Science and Technology and their Implications for Peace and Security, New York, United Nations, 29-38

Hawkins, J., Mihaljek, D. (2001), The banking industry in the emerging market economies: competition, consolidation and systemic stability – an overview, Bank for International Settlements, BIS Papers, No. 4, Monetary and Economic Department, August, 1-44

Hay, C. (2000), Contemporary capitalism, globalization, regionalization and the persistence of national variation, Review of International Studies, Volume 26, Number 4, 509-531

Hazlett, T. (1995), The Czech Miracle, Reason, volume 26.11, 28-36* (*EBSCO Host)

Held, D., McGrew, A. (1998), The End of the Old Order? Globalization and the Prospects for World Order, Review of International Studies, Volume 24, Special Issue, 219-243

Heppke, K. (2001), Banking Sector Transformation and Monetary Policy in the Visegrád Countries, Institutions and the Significance of Monetary Transmission via Bank Laons, Nomos Verlagsgesellschaft, Baden-Baden

Herrera, G. (2002), The politics of bandwidth: international political implications of a global digital information network, Review of International Studies, Volume 28, Number 1, 93-122

Higgott, R. (1998), The international political economy of regionalism, The Asia-Pacific and Europe compared, in: Coleman, W., Underhill, G., Regionalism & Global Economic Integration, Routledge, New York

Hine, R. (1992), Regionalism and the Integration of the World Economy, Journal of Common Market Studies, Volume XXX, No. 2, 115-123

Hirst, P., Thompson, G. (1999), Globalization in Question, Blackwell Publishers, Oxford

Hoensch, J. (1997), Geschichte Böhmens, Von der slawischen Landnahme bis zur Gegenwart, C.H. Beck Verlag, München

Horváth, J. (1999), The May 1997 Currency Crises in the Czech Republic, Post-Communist Economies, Volume 11, No. 3, 276-298

Hughes, K. (1998), Enlarging the EU Eastwards, The Royal Institute of International Affaires

Hurrell, A. (1995), Explaining the resurgence of regionalism in word politics, Review of International Studies, Volume 21, 331-358

Hveen, H. (1999), Explaining the Regional Phenomenon in an Era of Globalization, in: Stubbs, R, Underhill, G., Political Economy and the Changing Global Order, Oxford University Press, Oxford, 70-81

Hyde-Price, A. (1996), The International Politics of Ease Central Europe, Manchester University Press, Manchester

HypoVereinsbank (2000), The 2000 Guide to Visegrad Countries, Euromoney, September

IMF (1993), Financial Sector Reforms and Exchange Arrangements in Eastern Europe, Occasional Paper, No. 102, Washington D. C.

IMF (2000), Report on the Observance of Standards and Codes (ROSC), Czech Republic, II Overview, http://www.imf.org/external/np/rosc/cze/over.htm

IMF (2002a), Czech Republic-Article IV consultation Discussions Preliminary Conclusions of the Mission-May 7, http://www.mfcr.cz/MonetaryFund/Concluding.htm

IMF (2002b), Czech Republic, November 2002 IMF Staff Visit, Concluding Statement (Preliminary), http://www.imf.org/external/np/ms/2002/111902.htm

IMF Survey (1994), Czech Privatization Could Speed Transition, January 24

Inalcik, H. (1998), Turkey between Europe and the Middle East, Journal of International Affairs, Volume 3, No.1, http://www.mfa.gov.tr/grupa/percept/111-1/inalc.htm

Jackson, R. H. (1995), The Political Theory of International Society, in Booth, K., Smith, S., International Relations Theory Today, Policy Press, Cambridge

Janáčková, S. (2000a), Price Convergence and the Readiness of the Czech Economy for Accession to the European Union, Eastern European Economics, Volume 38, No.4, July-August, 73-91

Janáčková, S. (2000b), European Aspects of the Disinflation Policy of the Czech National Bank, Eastern European Economics, Volume 38, No.2, March-April, 47-96

Janáčková, S. (2001), The Chimera of Autonomous Monetary Policy in a Small Open Economy, Eastern European Economics, Volume 39, No. 3, May-June, 45-74

Jarolim, M. (2000), Foreign Direct Investment and Productivity of Firms, Finance a úvěr 50, 9, 478-487

Jones, C. (1998), A Coalition challenge, The Banker, September

Kadioglu, A. (1996), The Paradox of Turkish Nationalism and the Construction of Official Identity, Middle Eastern Studies, Vol. 32, No.2, http://www.mtholyoke.edu/acad/intrel/ayse.htm

Kaiser, R. J. (1995), Czechoslovakia: the Disintegration of a Binational State, in Smith, G., Federalism, The multiethnic challenge, Longman, Essex

Kaufmann, D., Siegelbaum P. (1997), Privatization and Corruption in Transition Economies, Journal of International Affairs, 50, 2, 419-456

Kegley, C. W., Wittkopf, E. R. (1997), Word Politics, Trends and Transformation, MacMillan Press, London

Kenway, P., Klvacova, E. (1996), The web of cross-ownership among Czech financial intermediaries, an assessment, Europe-Asia studies, Volume 45, No. 5, 797-809

Kerremans, B. (1998), The Political and Institutional Consequences of Widening: Capacity and Control in an Enlarged Council, in: Laurent, P. H., Maresceau, M. (Eds.), Deepening and Widening (the State of the European Union 4), Boulder: Lynee Rienner

Keohane, Robert O. (1989), "International Relations Theory: Contribution from a Feminist Standpoint", Millennium 18 (Summer), 245-53

Kinoshita, Y. (2000), R&D and Technology Spillovers via FDI, Innovation and Absorptive Capacity, CERGE-EI Working Paper, No. 163

Klein, P. (1999), New Institutional Economics, Department of Economics, University of Georgia, http://encyclo.findlaw.com/0530book.pdf

Knox, S. (1980), The Conversion and Destruction of the Wends, http://oit.boisestate.edu/sknox/thesis/chaot5.html

Konopielko, L. (1999), Foreign Bank's Entry into Central and East European Markets: Motives and Activities, Post-Communist Economies, Volume 11, No. 4

Kundera, Milan, (1984), The Tragedy of Central Europe, The new Review of Books, 26 April, quoted in: Neumann, I. B. (1996a), European Identity, EU Expansion and the Integration/Exclusion Nexus, Paper presented to the conference "Defining and Projecting Europe's Identity: Issues and Trade-Offs", Institut Universaire de Hautes Etudes Internationales, Geneva, 21-22 March,

Kutan, A., Brada, J. (2000), The Evolution of Monetary Policy in Transition Economies, Review (Federal Reserve Bank of Saint Louis), Volume 82, Issue 2, p.31, March / April

Laffan, B. (1997), The Finances of the European Union, MacMillan Press, London

Laffan, B. (2001), The European Union polity, a union of regulative, normative and cognitive pillars, Journal of European Public Policy, Volume 8, Number 5, 709-727

Lcweb (1989), Czechoslovakia, http://lcweb2.loc.gov/cgi-bin/query/r?frd/cstdy:@field(DOCID+cs0018)

Leff, C.S. (1997), The Czech and Slovak Republics, Nation Versus State, Westview Press, Oxford

Lequesne, C. (2000), The Common Fisheries Policy, Letting the Little Ones Go?, in: Wallace, H., Wallace, W., Policy-Making in the European Union, Oxford University Press, Oxford

Lewis, B. (1993), Islam and the West, Europe and Islam, Oxford University Press, Oxford

Lewis, P., Lomax, B., Wightman,G. (1994), The emergence of multi-party systems in East Central Europe, a comparative analysis, in Pridham, G., Vanhanen T., Democratisation in Eastern Europe, Domestic and international perspectives, Routledge, London

Linek, L. (2002), Czech Republic, European Journal of Political Research, 41, 931-940

Linklater, A. (1995), Neo-realism in Theory and Practice, in Booth, K., Smith, S., International Relations Theory Today, Policy Press, Cambridge

Lipton, D., Sachs, J. (1990), Creating a market economy in Eastern Europe, he case of Poland, Brookings Papers on Economic Activity 2, 293-341

Lizal, L. (1999), Monopoly Regulation in the Czech Republic and EU, GERGE-EI, Draft prepared for the Phare ACE workshop in Podbanske, Slovakia

Lizal, L., Kocenda, E. (2000), Corruption and Anticorruption in the Czech Republic, William Davidson Institute, Working Paper, Number 345, October

Long, D. (1997), The Why and How of EU enlargement, Institute of International Relations, The University of British Columbia, Working Paper, No. 16, July, http://www.iir.ubc.ca/pdffiles/webwp16.pdf

Mannin, M. (1999), Pushing Back the Boundaries, The European Union and Central and Eastern Europe, Manchester University Press, Manchester

Marcincin, A., van Wijnbergen, S. (1997), The Impact of Czech Privatization Methods on Enterprise Performance Incorporating Initial Bias Correction, Centre for Economic Reform and Transformation, Heriot-Watt University, Riccarton, Edinburgh

Marcussen, M., Risse, T., Engelmann-Martin, D., Knopf, H.J., Roscher, K. (1999), Constructing Europe? The evolution of French, British and German nation state identities, Journal of European Public Policy, Volume 6, No. 4, 614-633

Marek, D., Baun M. (2002), The EU as a Regional Actor: The Case of the Czech Republic, Journal of Common Market Studies, Volume 40, No. 5, 895-919

Maresceau, M. (1999), Enlarging the European Union, Relations between the EU and Central and Eastern Europe, Longman, Harlow

Matthews, G. (2000), Autria-Hungary, The Habsburg lands, http://www.angelfire.com/mac/egmatthews/worldinfo/europe/habsburg.html

Mauritz, M. (2002), Tschechien, Ost- und Südosteuropa, Geschichte der Länder und Völker, Südosteuropa-Gesellschaft, München, Friedrich Pustet Verlag, Regensburg

McDermott, G. (1993), Rethinking the ties that bin, The limits of privatization in the Czech Republic, paper presented at a conference on "The Social Embeddedness of the Economic Transformation in Central and Eastern Europe", Social Science Research Centre Berlin (WZB), September 24-25

McKenzie, G., Khalidi, M. (1996), The globalization of banking and financial markets: the challenge for European regulators, Journal of European Public Policy, Volume 3, Number 4, 629-646

Merlingen, M., Mudde, C., Sedelmeier, U. (2001), The Right and the Righteous?, European Norms, Domestic Politics and the Sanctions Against Austria, Journal of Common Market Studies, Volume 39, No. 1, 59-77

Michalski, A., Wallance, H. (1992), the European Community, The Challenge of Enlargement, Royal Institute of International Affairs, London

Mickiewicz, T., Radosevic, S., Varblane, U. (2000), The Value of Diversity: Foreign Direct Investment and Employment in Central Europe During Economic Recovery, ESRC "One Europe or Several? Programme, Sussex European Institute, University of Sussex, Working Paper, 05/00

Misun, J., Vladimir, T. (2002), Does Foreign Direct Investment Crowd in or Crowd out Domestic Investment? Eastern European Economics, Volume 40, No. 2, March-April, 38-56

Mladek, J., (Svejnar, J.) (2003), Point-Counterpoint, Is Czech Voucher Privatization a Success, No, It is Too Costly a Social Engineering Project, 1-6 http://archive.tol.cz/transitions/isczechl.html

Mlčoch, L. (2000), Reflections on the Czech Economic Transformation (Úvahy o české ekonomické transformaci (Prague, Vyšehrad)

Mommen, A. (1998), External Pressures Shaping Regionalism, in: Fernandez Jilberto, A., Mommen, A., Regionalization and Globalization in the Modern Word Economy, Perspectives on the Third Word and transitional economies, Routledge, New York, 27-53

Moravcsik, A. (1998), The Choice for Europe, Social Purposes and State Power from Messina to Maastricht, UCL Press, London

Neumann, I. B. (1996a), European Identity, EU Expansion and the Integration/Exclusion Nexus, Paper presented to the conference "Defining and Projecting Europe's Identity: Issues and Trade-Offs", Institut Universaire de Hautes Etudes Internationales, Geneva, 21-22 March

Neumann, I. B. (1996b), Russia and the Idea of Europe, a Study in Identity and International Relations, Routledge, London

Neumann, I. B. (1999), Uses of the other, “The East” in European identity formation, Manchester University Press, Manchester

Neumann, S., Egan, M. (1999), Between German and Anglo-Saxon Capitalism, The Czech Financial Markets in Transition, New Political Economy, Volume 4, Issue 2, 173-195

Newton, B., Walsh, L. (1999), The Czech Republic, the economic road to transformation, in Mannin, M., Pushing Back the Boundaries, The European Union and Central and Eastern Europe, Manchester University Press, Manchester

Nice Treaty (2000), http://europa.eu.int/eur-lex/en/treaties/dat/nice_treaty_en.pdf

North, D. (1996), Institutions, Institutional change and Economic Performance, Political Economy of Institutions and Decisions, Cambridge University Press, Cambridge

North, D. (1997), The Contribution of the New Institutional Economics to an Understanding of the Transition Problem, Word Institute for Development Economics Research (WIDER) Annual Lectures 1, United Nations University

OECD (1996), The Czech Republic 1996, Economic Survey, 48

OECD (2001a), Review of Foreign Direct Investment, Czech Republic, Finance and Investment

OECD (2001b), Observer, Policy Brief, Economic Survey of Czech Republic, Summary, July

Palmer, A. (1970), The Lands Between, A History of East-Central Europe since the Congress of Vienna, Weidenfeld & Nicolson, London

Parekh, B. (1995), The concept of national identity, New Community, Vol. 21, No.2, April

Pavlínek, P. (2002), Domestic Privatization and its Effects on Industrial Enterprises in East-Central Euro, Evidence from the Czech Motor Component Industry, Europe-Asia Studies, Volume 54, No. 7, 1127-1150

Pehe, J. (1992), The referendum controversy in Czechoslovakia RFE/RL Research Report 1 (43), 35-38

Pehe, J. (1997), Czechs Fall From Their Ivory Tower, Transitions, Volume 4, No. 3, August, 22-27

Pehe, J. (1998), The disappointment of democracy, Transition, 5:5, 38-42

Perkowski, T. (1998), "With or without union-Polish NGO's attitude towards European integration", http://gate.mos.gov.pl/mos/publikac/strategia_eng.html

Perotti, E. (1994), Corporate governance in mass privatization programmes, in Estrin, S., Privatisation in Central and Eastern Europe, Longman, Harlow

Podraza, A. (2000), Central Europe in the Progress of European Integration. A Comparative Study of Strategies of the Czech Republic, Hungary, Poland and Slovakia towards Deepening and Widening of the European Union, Research Support Scheme, http://e-lib.rss.cz.

Pollack, M. A. (2001), International Relations Theory and European Integration, Journal of Common Market Studies, Volume 39, No.2, 221-44

Pomerleano, M., Vojta, G. (2001), What do foreign banks do in emerging markets? An institutional study, paper presented at the 3rd Annual Word Bank, IMF and Brookings Financial Markets and Development Conference, New York, April

Pradetto, A., Sigmund, P. (1993), Deutschland und Osteuropa, Deutschland Archive 26, 890-904

Prescott, M. (2000), Can the European Union be the Leading Institution to Address the New Security Agenda within Europe?, A dissertation submitted to the School of Social Science, John Moores University, Liverpool

Presidency Conclusions (2002), Copenhagen European Council, 12-13 December, http://www.eu2002.dk/news/upload/conclusions_uk20021216111046.pdf

Preskett, M. (2001), Privatization for whom? The Czech State, citizens or foreign investors, Emerging from "splendid isolation", http://www.ce-review.org/01/16/preskett16.html

Preston, C. (1997), Enlargement and Integration in the European Union, Routledge, London

Pridham, G., Vanhanen T. (1994), Democratisation in Eastern Europe, Domestic and international perspectives, Routledge, London

PSE, Prague Stock Exchange (2003), http://www.pse.cz

Radio Prague's History Online, http://archiv.radio.cz

Rasmussen, Anders (2002), Danish Prime Minister Anders Fogh Rasmussen's account of the Copenhagen European Council delivered to the European Parliament on 18 December 2002, http://www.eu2002.dk/news/news_read.asp?iInformationID=26138

Raunio, T., Wiberg, M. (1998), Winners and Losers in the Council: Voting Power Consequences of EU Enlargements, Journal of Common Market Studies, Volume 36, No. 4, 546-62

Redmond, J. (1994), Prospective Europeans, New Members for the European Union, Harvester Wheatsheaf, London

Redmond, J., Rosenthal, G. (1998), The Expanding European Union, Past, Present, Future, Lynne Rienner Publisher, London

Reid, T. (1785), Essays on the Intellectual Powers of Man. Essay Three: Of Memory, chapter 4: Of Identity, http://www2.canisius.edu/~gallaghr/reid.html

Reus-Smit, C. (1997), The Constitutional Structure of International Society and the Nature of Fundamental Institutions, in: International Organization 51, 555-589

Richter, R. (2001), New Economic Sociology and New Institutional Economics, Annual Conference of the International Society for New Institutional Economics (ISNIE), Berkeley, California, USA

Rifkind, M. (1996), Speech to the European Policy Forum, May 1, in, The Economist, Europe's Mid-Life Crises, A Survey of the European Union, May 31, 1997

Robinson, A. (1996), Sell-offs now give cause for concern, Financial Times, Survey – Czech Republic, 6 December

Rona-Tas, A. (1997), The Czech third wave, Problems of Post-Communism, Volume 44, Issue 6, 53-65, November / December

Rosamond, B. (1999), Theories of European Integration, Palgrave, New York

Ross, G. (1998), European Integration and Globalization, in: Axtmann, R., Globalization and Europe, Theoretical and Empirical Investigations, Library of Congress Cataloging-in-Publication Data

Rusek, A. (1999), The Czech Economic Crises, Policy Revenge?, International Advances in Economic Research, Volume 5, Issue 2, 178, May

Safioleas, P. D. (1999), Identity Shift and Europe's Changing Perception of Others, Europe, Turkey, and the Issue of Self-Identification, Online Journal of Peace and Conflict Resolution 2.1, http://www.trinstitute.org/ojpcr/2_1identity.htm

Santer, J. (1998), "Shaping Europe's Future", Speech at international Bertelsmann Forum, 3 July, Speech/98/151, Berlin

Schimmelfennig, F. (1999), The Double Puzzle of EU Enlargement: Liberal Norms, Rhetorical Action, and the Decision to Expand to the East, ARENA Working Paper, WP 1999/15, http://www.arena.uio.no/publications/wp99_15.htm

Schöllmann, W. (2001), Foreign Participation in Privatization, what does it Mean? Empirical Evidence from the Czech Republic, Hungary and Poland, Post-Communist Economies, Volume 13, No. 3, 373-388

Scholtbach, A. (1998), The European Union and its Expanding Eastern and Southern Borders,, in: Fernandez Jilberto, A., Mommen, A., Regionalization and Globalization in the Modern Word Economy, Perspectives on the Third Word and transitional economies, Routledge, New York, 146-171

Scholte, Jan Aart (1993), From Power Politics to Social Change: An Alternative Focus for International studies," Review of International Studies 19 (January), 3-21

Schönfelder, B. (2001), Debt Collection, Foreclosure and Bankruptcy in the Czech Republic, an Economic Analysis, Post-Communist Economies, Volume 13, No. 4, 409-430

Schott, J. (1991), Trading Blocs and the World Trading System, Word Economy, 14, 1, 1-19

Scott, W. R. (1995), Institutions and Organisations, Sage, London

SCP, Prague Securits Centre (2003), http://www.scp.cz

SEC, Czech Securities Commission (2003), http://www.sec.cz

Sedelmeier, U., Wallace, H. (2000), Eastern Enlargement, strategy or Second Thoughts? in: Wallace, H., Wallace, W., Policy-Making in the European Union, Oxford University Press, Oxford

Simoneti, M. (1993), A comparative review of privatization strategies in four former Socialist countries, Europe-Asia Studies, 45:1, 79-102

Sjursen, H. (2002), Why Expend? The question of Legitimacy and Justification in the EU's Enlargement Policy, Journal of Common Market Studies, Volume 40, No.3, 491-513

Smith, M. (1996), The European Union and a Changing Europe, Establishing the Boundaries of Order, Journal of Common Market Studies, Volume 43, No. 1, 5-28

Smith, M. E. (2001), Understanding Europe's "New" Common Foreign and Security Policy, A Primer for Outsiders, University of California, Institute on Global Conflict and Cooperation, Policy Paper 52

Smoke, R. (1996), Perceptions of Security, Public opinion and expert assessment in Europe's new democracies, Manchester University Press, Manchester

Sperling, J., Kirchner, E. (1997), The Security Architecture and Institutional Futures of post 1989 Europe, Journal of European Public Policy, Volume 4, No.2

Stolze, F., Changing Foreign Trade Patterns in Post-reform Czech Industry (1989-1995), Empirical Evidence, Europe-Asia Studies, Volume 49, No. 7, 1209-1235

Stouracova, J. (1997), The Czech Republic's Foreign Trade, http://www.export.cz/hj/9701/trade.htm
Strange, S. (1995), The Defective State, in: What Future for the State, Daedalus, 124 (2), 55-74

Süddeutsche Zeitung (1994), Brüssel bereite Osteuropa auf Beitritt zur EU mit ehrgeizigen Programmen vor, 7 Dezember

Sundararajan, V. (1996), The Role of Prudential Supervision and Financial Restructuring of Banks During Transition to Indirect Instruments of Monetary Control, IMF, Working Paper, No.128, November

Takla, L. (1994), The relationship between privatisation and the reform of the banking sector: the case of the Czech Republic and Slovakia, in Estrin, S., Privatisation in Central and Eastern Europe, Longman, Harlow

The Banker (1998), A coalition challenge, September

Topan, A. (2001), The European Integration Process, A Historical and Comparative Institutional Analysis, Lit Verlag, Münster

Torreblanca, J. I. (2001), The Reuniting of Europe, promises, negotiations and compromises, Ashgate, Aldershot

Tosovsky, J. (1995), Monetary, Credit and Exchange rate Policies in the Czech Republic, Institutional Framework, http://www.ecu-activities.be/1995_3/tosovsky.htm

Tuma, Z. (2003), Challenges of free capital movement and the role of international standards, forcing on money laundering prevention, BIS Review, 40

Tunander, O., Baev, P., Einagel, V. I. (1997), Geopolitics in Post-Wall Europe, Security, Territory and Identity, SAGE Publications, London

Turnovec, F. (2001), The Czech Republic on its Way to the European Union, Working Paper No.6, Karlova University, Faculty of Social Sciences, Institute of Economic Studies, http://ies.fsv.cuni.cz

UNICE (1999), European Business Supports, Enlargement of the European Union, UNICE statement in view f the Helsinki European Council, http://www.unice.org/unice/docum.nsf/all+by+description/5DAC5895AEDCD218C1256850005723A8/$File/Enlarg1e.pdf

Universität Würzburg (1996), Czech Republic Index, http://www.oefre.unibe.ch/law/icl/ez_index.html

Van den Broek, H. (1998), "The EU – Looking Ahead to the 21st Century", Speech to the 'Forum 2000' Conference, 13 October, Prague

Vasquez, John. (1993), The War Puzzle. Cambridge, Cambridge University Press.

Verheugen, G. (2001), in: EU (2001b), Enlargement of the European Union, An historic opportunity, A general overview of the enlargement process and the pre-accession strategy of the European Union, Published by the Enlargement Information Unit

Vit, J. (1999), Central Banking in Czech Republic, Speech of Mr. Jan Vit, Vice-governor of the Czech National Bank at the international conference, "The Art of Central Banking in Eastern Europe in the 1990", On the Occasion of 120th Anniversary of Bulgarian National Bank, 26 January, Sofia

Wallace, H. (2000), The Institutional setting, Five Variations on a Theme, in: Wallace, H., Wallace, W., Policy-Making in the European Union, Oxford University Press, Oxford

Wallach, R. (1972), Das Abendländische Gemeinschaftsbewusstsein im Mittelalter, Gerstenberg Verlag, Hildesheim

White, S., Batt, J., Lewis, P. (1998), Developments in Eastern European Politics 2, MacMillan Press, London

Wilming, C. (1995), Institutionelle Konsequenzen einer Erweiterung der Europäischen Union. Eine ökonomische Analyse der Entscheidungsverfahren in Ministerrat, Baden Baden, Nomos

Winiecki, J. (1994), East-Central Europe, A Regional Survey – The Czech Republic, Hungary, Poland and Slovakia in 1993, Europe-Asia Studies, Volume 46, No. 5, 709-734

Wittenberg, B. R. (2000), From Red to Green? Environmental issues as barriers to CEEC accession to the European Union, A dissertation submitted to the School of Social Science, John Moores University, Liverpool

World Bank (1995), http://www.worldbank.org

World Bank (1999), Country Study, Czech Republic, Summary Report, http://www.worldbank.org

Würz, M., Müller, W. (1998), Prudential Supervision in Central and Eastern Europe, A Status Report on the Czech Republic, Hungary, Poland, and Slovenia, in Österreichische Nationalbank (ed.), Focus on Transition, Vienna, 80-93

Yenicag, The Copenhagen European council and the "Copenhagen criteria", http://www.yenicag-net.com/kitap/belgeler/copenhagen_criteria.htm

Zamrazilova, E. (2000), External Imbalance, The Czech Case, Eastern European Economics, Volume 38, No. 3, 82-94

Zaroff, R. (1995), Germanisation of the land between the Elbe-Saale and the Oder rivers Colonisation or assimilation? http://www-user.tu-cottbus.de/Sorben/inhalt11/d0101.htm

Zemplinerová, A., Laštovička, R. (1997), enterprises Restructing During and after Privatization, in Mejstřík, A., Zemplinerová A., The Privatization Process in East-Central Europe, Evolutionary Process of Czech Privatization, International Studies in Economics and Econometrics, Volume 36, 203-214

Zemplinerova, A. (1998), Impact of FDI on the Restructuring and Growth in Manufacturing, Prague Economic Papers 7(4), December, 329-345

Zijlstra, K. (1998), Privatization in Hungary, Poland and the Czech Republic, http://www.comrad.cz/item102.htm

Zloch-Christy, I (1994), Eastern Europe in a Time of Change: Economic and Political Dimensions, Praeger Publisher, London