



CDIE Impact Evaluation

United States Agency for International Development

DEVELOPING ROMANIA'S CAPITAL MARKET

In less than two years, USAID built from scratch an equities market and a complete set of supporting institutions. The Agency did all the right things, and the market is performing at a high technical level. But the country's economic policy reforms and privatization efforts are weak, and economic growth has stalled; thus capital markets have been depressed.

SUMMARY

- USAID supported the establishment of an equities market, Rasdaq, helping ensure a successful Mass Privatization Program and a listing for 5,600 newly privatized firms.
- Several hundred recently privatized and restructured companies have adopted new technologies, increased productivity, shed low-productivity operations, and reduced excessive employment.
- Economic competition encourages efficiency and growth, and the creation of Rasdaq encouraged the competing Bucharest Stock Exchange to improve its services.

Yet serious problems still need to be addressed:

- Securities market laws and regulation are adequate, but surveillance and enforcement are weak and could cause problems in the future.
- Managers need to improve corporate governance, which means running companies for the benefit of all shareholders and not merely for the personal gain of the managers.
- A depressed and chaotic economic policy environment along with a slow pace of privatization impedes capital market growth.

Team leader: Joseph M. Lieberman
Team members: Ross Bankson, Alain de Maynadier, Denis V. Korepanov, Michael Sipos.

COUNTRY CONTEXT

A Painful Emergence From Communism

With the end of communism in late 1989, Romania was in a state of economic turmoil. During the 1980s, food shortages were common, with urban dwellers queued up in long lines waiting to buy basics. Bread, sugar, and cooking oil were rationed. Meat was virtually unobtainable. The government placed severe limits on household energy consumption. Citizens found everyday amenities in short supply or absent altogether.

That state of affairs, which foreshadowed the downfall of dictator Nicolae Ceaușescu in 1989, was the end result of some 45 years of failed economic policy. Romania's strength traditionally lay in agriculture—Romania had been the breadbasket of the Balkans. It also had light industries in textiles, furniture, and footwear.

But from the end of World War II until the fall of communism, the country's leaders had followed an extreme Stalinist model of economic development in which power was concentrated in the hands of a small political elite. Spurred by sentiments of nationalism and protectionism, and aspiring to self-sufficiency, Romania's leaders sought to transform the country into an industrial power at any cost. No longer would Romania be dependent on imported manufactured goods; by investing in heavy industry, the country could earn foreign exchange by exporting its own manufactured goods rather than food and raw materials.

Massive industrialization came at great human cost. In 1989, the Romanian people, having suffered a decade of severe austerity, and fed up with the 45 years of repression, overthrew Ceaușescu and the communist apparatus. Ceaușescu and his wife, Elena, equally

hated, were summarily tried by a military tribunal and executed on Christmas Day 1989.

Tepid Moves Toward Privatizing

A new, parliamentary government was formed. Among its first orders of business in reforming the economy, Parliament passed law 58, the Privatization Law, in August 1991. Under the law some 6,500 (or virtually all) state-owned commercial enterprises were deemed open to privatization. A body called the State Ownership Fund was to hold 70 percent of privatized shares, and five private ownership funds were to hold 30 percent. (The private ownership funds are akin to U.S. closed-end mutual funds—investment companies with fixed capitalization whose shares are traded on the open market.) Every Romanian citizen over 18 years was given “certificates of ownership,” which represented shares in the private ownership funds.

This first attempt at privatization ended in failure. Organizational problems, conflicting incentives, and political resistance abounded. The State Ownership Fund, for example, consistently failed to meet its targets for privatization; moreover, it was reluctant to sell off profitable enterprises, using them instead to subsidize money-losing companies. The other major actors, the private ownership funds, were politicized and not run as true private sector institutions.

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Trying Again

A second attempt at reform came with the Mass Privatization Program of 1995. It reduced the share of the State Ownership Fund from 70 to 40 percent, increased the share of the private ownership funds from 30 to 60 percent, and gave vouchers to 16 million Romanians. As before, citizens could keep their shares in the private ownership funds or exchange their vouchers for shares in individual companies. Some 3 million people kept

their investment in the private ownership funds, whereas 13 million opted to directly own shares in individually privatized companies. At the same time, the State Ownership Fund was to gradually sell off its remaining 40 percent share.

In 1996 a new government took office on a pledge of rapid privatization. But reform hit a snag, as special-interest groups (such as unions and inefficient industries) sought to keep the status quo and the state lacked the

Box 1. A Violent Past in Search of a Prosperous Future

Stark drama and a legacy of subjugation are the hallmarks of Romanian history. Subjugation, first, as Romania, at a crossroads between east and west, north and south, became a prime target of conquest. And in more recent years, the subjugation came as a form of communist dictatorship as severe as any seen in the Soviet-bloc nations.

Since ancient times, the regions that now make up the Republic of Romania lay vulnerable and tempting to migrating hordes and ambitious empires from surrounding lands. First came the Romans, who colonized the province of Dacia (most of modern-day Romania) in the second and third centuries A.D. After the Romans, Romania was overrun successively by (among others) Goths, Huns, Avars, Bulgars, Tartars, Mongols, and in the 15th and 16th centuries, the Ottoman Turkish Empire.

The Turks ruled with an iron fist, keeping the peasantry in a constant state of fear. Only occasionally were local chieftains able to gain a measure of independence. One such chieftain—the 15th century's Vlad the Impaler—would become one of Romania's most notorious national figures. Vlad's epithet ably describes how he struck terror into the hearts of his enemies, Turks and countrymen alike—he methodically ran stakes through those he defeated.

Time of Dictatorship

Romania's neighbor Russia and near-neighbor Austria also controlled portions of Romania after Turkey was pushed out. Romania gained full independence in 1878, and proclaimed itself a kingdom in 1881. The country remained so (successively gaining and losing territory with the shifting winds of war and diplomacy) until December 1947, when a communist-dominated government forced the abdication of the sovereign, King Michael.

The communist era is perhaps best epitomized in the construction of the Ceaușescu palace, massive in size (it is touted as the second largest building in the world, trailing only the Pentagon), ornate in the extreme—and to any critic's eye, at once spectacular and preposterously excessive. It was built by 20,000 forced laborers working in shifts round the clock, at a cost of unknown hundreds of millions of dollars, a monument to the Ceaușescus themselves—all as the people of Romania waited hours daily in bread lines for meager rations.

Today, in the postcommunist era, Romanians struggle to find the prosperity that has so long eluded them. That search is proving more difficult than the people's violent, but brief and successful, 1989 revolution for political freedom. How long it will take is a major source of conjecture.

political will to push privatization. Thus, the state still dominates the economy, controlling 65 percent of gross domestic product (GDP). That compares with an average of 40 percent in other central and East European countries.

State Ownership Cramps Savings and Investment

In a well-functioning market economy, sav- ings can help drive investment. Savers are rewarded for putting money away by earn- ing interest at a rate invitingly above the rate of inflation. Or they have the (more chancy) prospect of increasing their returns by invest- ing in the stock market. Whatever the vehicle, the money they put away becomes investment capital that companies use to expand their product line or increase productivity.

Romania has a high national savings rate. Before an economic downturn in 1997, the rate was more than 20 percent of gross domestic product. *Private* savings have actually hovered at 22 to 24 percent of GDP, whereas public sector savings have run a negative 2 to 4 percent, generating the national average of 20 percent. This savings rate is 2 to 4 times as high as the rate in most industrial coun- tries.

The high savings rate has allowed Romania to maintain a high level of investment. The key issue, though, is the *quality* of investment. Under communism, Romania suffered from the same problem as other countries in the Soviet bloc—investment flowed to the wrong sectors, wrong technologies, or unproductive activities. Even after the 1989 revolution, and until very recently, almost all capital alloca- tions were made by administrative decision— not by price or market considerations.

The government still owns more than 500 large industrial companies. Most are energy intensive and use outdated technology to make products that are not competitive in world markets. It was not until 1995 that the

government launched comprehensive pro- grams for privatizing and for restructuring or liquidating loss-making enterprises, but those efforts have not been very successful. Although some progress has been made, the government is reluctant to close money-los- ing state enterprises or to lay off redundant workers. The economy is still largely charac- terized by state ownership and control. State enterprises lay claim to a substantial share of financial resources.

Although the private sector share of GDP is among the lowest in central and Eastern Europe, the private sector possesses the most dynamic players. They generally are small, industrious enterprises with low energy in- tensity and high labor productivity that earn relatively high returns on invested capital. But they have limited access to formal com- mercial credit.

Private enterprises have a difficult time ob- taining credit from the banking system (which is still largely state owned). A rapid 1997 stock market runup (of 500 percent) followed by a 50 percent fall in equity prices has spooked investors. Inappropriate govern- ment policies that caused high and volatile rates of inflation, along with inconsistently applied investment laws, have also deterred investors. Thus no long-term private debt market (maturities of more than one year) exists, and domestic savings are only trick- ling into equity markets. The major capital source has been foreign investors. They have provided more than 70 percent of the value of trading on Rasdaq and the Bucharest Stock Exchange. And they have funded many of the privatizations and corporate restructurings.

Capital Market Institutions

Romania's capital market institutions are new—in fact, very new. Most were not estab- lished until late in 1995 and were not fully functioning until 1996. In a little more than two years, a full range of stock market insti-

tutions and supporting services have been put in place and are trading substantial volumes of stock.

Romania has two major equity markets. The **Bucharest Stock Exchange** was established in November 1995 with assistance from the Canadian government. Like the New York Stock Exchange, it handles large blue-chip companies. By February 1998 it had 89 listed companies with a market capitalization of \$875 million, a monthly trading volume of \$20 million, and 156 broker members. To support the market, it has a stock registry and depository, clearance, and settlement institutions.

The Romanian Automated Stock Display and Quotation system (always called **Rasdaq**) patterned after the U.S. Nasdaq system, was supported by USAID. It opened for trading in October 1996, and by January 1998 had more than 5,600 listed small and medium-size companies, \$1.5 billion market capitalization, monthly turnover of \$23 million, and 199 broker members. Its peak volume came in July 1997, when trading reached 120 million shares, valued at \$88 million.

Rasdaq uses an automated, electronic screen-based trading system. It links brokers throughout the country in a quote-driven trading system. Rasdaq trading is supported by a depository, clearance, and settlement system and an independent share registry. USAID supported development of Rasdaq and those posttrade institutions.

To support mutual funds, USAID helped create a **Mutual Funds Association**, along with supporting laws and regulations and a self-regulatory organization.

The **National Securities Commission** acts much like the U.S. Securities and Exchange Commission, developing stock market legislation and regulations and providing market surveillance and enforcement.

USAID PROJECTS AND THEIR RESULTS

In March 1998, a five-person team from USAID's Center for Development Information and Evaluation traveled to Romania to assess the effectiveness of the Agency's assistance for capital markets development. The mission was part of a five-country study that also included India, Kenya, Morocco, and the Philippines. This Impact Evaluation discusses the team's findings.

Improving Market Regulation

Experience proves that if a capital market is to attract money and allocate it efficiently, the market must be transparent, have integrity, and treat all participants fairly. In addition to efficiency, capital markets must provide accurate information to the investing public. Moreover, investors must have confidence that laws and regulations are administered impartially and are not subject to constant revision. To meet these needs, USAID made development of an effective legal and regulatory system a centerpiece of its assistance. A legal framework for capital markets would support mass privatization and encourage investment.

After more than 40 years of communism, Romania lacked a legal framework for capital markets. The USAID project helped beef up the fledgling National Securities Commission. Facing the commission when USAID assistance began in the autumn of 1995 was an inadequate (indeed, often nonexistent) financial environment:

- Among citizens, key policymakers, and market practitioners, limited understanding of the concept of share ownership

- A nascent Bucharest Stock Exchange with limited trading experience and a reluctance to permit shares from newly privatized smaller companies to trade on the exchange
- No hardware, software, procedures, or plans for an effective secondary trading system (what would become Rasdaq)
- A fledgling and largely inactive brokerage community with little operational experience or understanding of transparency issues
- No depositories, registries, or clearing, settlement, or custodial institutions
- Despite overall authority to regulate and develop the market, almost no experience, on the part of the securities commission, in the legal, regulatory, and enforcement areas necessary to accomplish its objectives
- Made available USAID project staff for testimony before Parliament and supported a major legislative effort that put in place three major laws, a new ordinance, and more than 30 market regulations and instructions, providing the legislative framework for a stock market
- Successfully handled two mutual fund crises (averting default or bankruptcy) and worked with the funds to strengthen their financial viability

Over a two-year period, the project changed an institution that had good intentions but almost no experience in capital market regulation into a major player in a rapidly growing market. The USAID project accomplished a staggering amount of institution building in a very short period. It

- Reorganized the securities commission and put in place a computer system and securities market monitoring mechanism
- Provided extensive training of commissioners and staff. Conducted training of corporate issuers and prepared manuals on corporate governance
- Developed market surveillance and disclosure methodologies and assisted the commission in conducting audits, interviews, and inspections of books and records

Starting from a bleak and uncertain regulatory environment in late 1995, the project accomplished in a little more than two years what has taken many nations' capital markets decades to achieve. However, a number of areas still need attention:

Judicial reform. The commission has successfully brought nine censure cases against firms, but the court process has been agonizingly slow.

Enforcement and market surveillance. The commission's capacity needs to be improved by increasing the number of staff and their skills, improving physical facilities (see box 2), and increasing financial resources.

Corporate governance. The same managers who ran companies under communism are operating newly privatized firms. But old attitudes developed under communism are slow to change. Most managers have little interest in improving corporate governance or in keeping accurate financial records; both are needed if investors are to have the confidence to invest their funds in private companies.

Mutual Funds: A Small Slice of the Pie

As part of the capital markets program, USAID worked to create a commercially viable mu-

Box 2. Perks of Office

In Romania, no less than elsewhere, the trappings of office can convey a message of relative power. As a case in point, contrast the offices of the government-run State Ownership Fund with those of the National Securities Commission.

Arriving at the building that houses the State Ownership Fund, a visitor is imbued with a sense of turn-of-the-century opulence. Recently refurbished, the building is a neighborhood gem. The visitor enters through broad double doors that open onto a spacious, well-lit rotunda.

A guard points the way up a splendid winding marble staircase, its red carpeting new, plush, taut. The stairway opens onto a reception area similar in elegance to the one below. The walls are freshly painted a soothing off-white. Friezes at the ceiling and above the floorboard have been carefully painted gold. The marble floor glistens immaculately. A door opens onto the conference room. It is smaller, though similarly appointed. A sturdy dark wooden table, oval and polished to perfection, dominates the room. Introductions are made with two midlevel officials, and the conference begins.

In another quarter of town, a football-size rock holds open the front door of a '50s-era cement-block office building. The visitor squeezes into an elevator, too small for three, a compression chamber for four. He closes the folding wooden double doors (the left door has a cracked glass pane) and presses the "3" button.

Alighting on the third floor, the visitor follows a paper arrow marked "Secretariat" down a hall lit with a single light bulb. The hall is lined with coffee-colored filing cabinets and their overflow, stacks of fat three-ring binders. A threadbare maroon carpet absorbs footfalls—and any ambient light. Another sign, taped to the back side of a double door paned with green glass, confirms that this is the destination.

A secretary ushers the visitor into a small room off the hallway. It is a simple office; there is no conference room—instead, a hodgepodge of chairs. The visitor has arrived at the quarters of the National Securities Commission, office of the president.

tual fund industry. It encouraged improved business practices, creation of legal and regulatory structures, and an educational and training program for security analysts, the business community and the general public. It helped establish a union of investment funds as a trade association, self-regulator, and training institute.

A licensing program was established, seminars were held on disclosure and reporting systems, and extensive training was provided for security analysts. In addition, USAID helped provide training programs on portfolio management, security valuation, marketing, and shareholder relations. The Agency also assisted the National Securities Commission in drafting ordinances and regulations for the mutual fund industry.

Fifteen open-end investment companies (traditional mutual funds) are now in operation. There are also five closed-end funds. These were formerly called *private ownership funds* and are now known as *state investment funds*. They hold a mixed portfolio of stocks, with large holdings in some of the weaker sectors of the economy. They have joined the mutual fund association, and their shares will be listed on the Bucharest Stock Exchange.

A scandal involving the mutual fund known as Safi saw a sharp drop in the valuation of fund assets and an exodus of investors out of open-end mutual funds. The fund managers were found to be using questionable accounting practices and engaging in insider trading. The public is still skeptical of mutual funds, and the funds remain in a state of depression.

Mutual funds hold less than 3 percent of private sector equity securities. In a country like Romania, where average citizens do not understand the intricacies of capital markets, a successful mutual fund industry could provide expert management and diversification for small investors. Hopefully the industry will recover and develop as a useful option for small investors.

The Rasdaq Equities Market

As the Mass Privatization Program was being launched in 1995, major problems loomed. For one thing, the program would entail distribution of shares to the entire adult population, 16 million citizens (out of a total population of 21 million), but almost no infrastructure existed for registration, quotation, trading, and transfer of those shares after the initial distribution. Moreover, people at all levels—citizens, practitioners, and policymakers—had no real understanding of share ownership or the role of the capital market. And beyond that, no one was sure what shares in different companies would be worth. Even if shares had a price, if it was difficult or costly to buy or sell them, they would have little practical value.

If privatization was to succeed, it would be necessary to design a system to place a market value on shares and allow people to buy and sell them. And the market had to be honest; it had to ensure transparency and credibility.

USAID set out to create a complete equity trading system in just one year. The task was prodigious. It meant, for starters, helping draft the necessary laws and regulations. Then it involved establishing an equity trading system (Rasdaq), procuring and installing hardware and software to run the system, and establishing a broker–dealer community, licensing and regulation of brokers, a broker–dealer self-regulatory organization, a nation-

wide share-trading telecommunications system, and a clearance, settlement, registry, and depository system.

Privatization involved the transfer of ownership and control of assets in 5,600 companies. This was more than just a technical institutional development project. It related to money and power. There was a danger the process could be slowed down or damaged by Romanian special interests.

A Boost From the Ambassador

USAID was able to draw on the U.S. ambassador's keen interest in equity markets to help ensure project success. A memorandum of understanding was negotiated with the Romanian government and signed by the ambassador and the prime minister. It outlined the agreed understandings about privatization and a new equity market, what USAID would do, what the government would do, timing, resources, and responsibilities. It provided an excellent reference point and helped avoid many problems over the life of the project. The ambassador then worked closely with the government to make sure implementation proceeded apace.

The project proceeded to build, from scratch, a complete stock-trading system. USAID provided the technical experts, training, and equipment to create a nationwide trading system. All together, the project would cost nearly \$30 million.

Rasdaq started in November 1996 with seven companies listed and a trading volume of \$300,000. By January 1998 it had grown to 5,600 companies and \$23 million traded. In that month the Rasdaq market capitalization was \$1.5 billion (It peaked at \$2.5 billion in August of 1997.) Rasdaq and the Bucharest Stock Exchange (which has a capitalization of \$875 million) together represent about 7 percent of Romania's gross domestic product (see box 3).

Box 3. Dealing With Low Volume

Out of the 5,600 companies listed on Rasdaq, no more than 500 are actively traded on a daily basis, and 2,000 other companies trade only periodically. Market trading is concentrated in a small number of companies. The top 10 stocks represent only 20 percent of market capitalization but 80 percent of market volume. Shares in thousands of smaller companies are rarely traded. To deal with this problem, Rasdaq plans to set up a three-tier listing structure. The biggest and most widely traded stocks would be on the first tier. They would have the highest listing, disclosure, and capital requirements. Medium-size stocks would be on the second tier, and those that almost never trade, on the lowest tier.

Romanian Capital Markets in the Regional Context (1997)

	Market Capitalization		Monthly Trading Volume, \$ Millions	% GDP in Private Sector
	\$ Billions	% of GDP		
Romania	2.4	7.0	48	35
Czech Republic	16.2	33.7	718	70
Poland	7.2	5.4	826	60
Hungary	3.6	7.6	149	60

Low liquidity is common to all central and Eastern European equity markets. Still, Romanian stock-trading volume is substantially below that of other countries. Romania has a much smaller portion of its economy in the private sector. That means relatively less equity stock available for trading. Moreover, Romanian markets are newer than other markets; 1997 was the first full year of major operations for both Rasdaq and the Bucharest Stock Exchange. On top of that, 1997 was a time of economic turmoil: GDP declined by 6.6 percent, inflation reached 150 percent, and a tremendous demand for government financing crowded out private borrowers from capital markets.

Strengths of the System

USAID clearly demonstrated that it has the technical capability to conceive, design, and implement a very technical capital market activity. USAID and the Agency-funded contractor did an excellent job of helping create Rasdaq—an efficient, fair, and honest securities market. The market is electronically accessible with bid and ask quotes disseminated to brokers throughout Romania. Brokers are required to provide firm quotes on stocks, and trades are executed instantly through the nationwide computer system. All trades, prices, and volumes are instantly listed on-screen and published the next day in the business press. Trades are settled quickly and efficiently on “T+3” (the U.S. standard for simultaneous delivery of securities and funds transfer, three days after the

trade is made). By almost any measure of technical efficiency, Rasdaq is a success. It is well ahead of most emerging markets and close to meeting most standards of U.S. and Western European markets. The Rasdaq system clearly has much going for it. Among the strong points:

Credibility and competence. It provides excellent execution in the purchase or sale of securities throughout Romania. Owing to its transparency and issuer information functions, Rasdaq can be easily integrated into global capital markets.

Capability of information. The system has the capacity to store trading information, including transaction histories and issue information for more than 5,600 securities.

Price discovery and transparency. All issuers and traders can instantly see on their computer screen the last sale price of any security. They can also see the current bid/ask prices and number of shares offered by all brokers.

Market surveillance. The system provides for easy surveillance by allowing retrieval and analysis of all trades and quotations entered into the system by brokers and traders. It is possible to quickly identify violations of trading rules.

Maintenance and modification of software. The trading and clearance–settlement software has been upgraded several times and can be further developed as the market evolves.

Foreign investors. The transparency and integrity of the system has attracted foreign investors—and, with them, critical foreign exchange. Foreign investors are responsible for more than 70 percent of Rasdaq trades.

Areas of Concern

Perhaps because of the speed with which Rasdaq and its supporting institutions were set up and the efficiency of their performance, three areas of major concern have emerged:

1. After mass privatization, it was expected there would be a steady concentration of ownership as company managers, strategic investors, and takeover groups gained control of individual companies. So far the process is taking place slowly. In approximately 300 companies control has been consolidated with new owners and managers.

2. The institutional development of Rasdaq and supporting institutions required startup investment from the USAID project. Now that the subsidy has phased out, Rasdaq needs to generate adequate revenues to cover all costs. According to the chairman of Rasdaq, the break-even point for profitable operation should be a daily trading volume of \$3 mil-

lion. Present daily trading volume is approximately \$1 million. Rasdaq's viability may be further jeopardized by a possible exodus of larger companies to the Bucharest Stock Exchange.

3. Rasdaq's business revenues are generated from commissions on trades paid by members and from members' annual fees. Future revenue growth was expected from privatization of shares owned by the State Ownership Fund. In 1997 the entire privatization process was delayed. If this process is delayed again in 1998, Rasdaq trading volume and revenues will continue to suffer.

There are also other, lesser concerns:

- Thousands of companies listed on Rasdaq are of insignificant size. Many are merely a single store or workshop with a capitalization of less than \$5,000—mom-and-pop operations. In all likelihood shares in those companies will never be traded. They do not belong on Rasdaq. What's needed is a simplified way to allow consolidation and restructuring of small and medium-size firms scattered throughout the countryside.
- The Romanian Shareholder Registry, until recently the only independent registry in the country, ensured confidentiality and protection of shareholder rights (such as receipt of dividends and the right to vote for company directors). The possibility of up to 10 new independent registries may weaken the security features of a central registry and affect the viability of the registry business. The existing registry is already experiencing financial difficulties, and that situation will only worsen as it faces competition from other registries.
- Transactions costs on Rasdaq and the Bucharest Stock Exchange are relatively high. No evidence suggests that the ex-

istence of the two markets lowered these costs. Moreover, offering an 8 percent commission to brokers to induce them to reach remote areas of the country has not produced the expected results; trading outside the main cities is negligible.

- In the United States and Western Europe, financial markets and brokers form self-regulatory organizations to set ethical standards and provide professional discipline. Rasdaq's self-regulatory organization was set up with USAID supervision. But self-regulation is a foreign concept in Romania, and it is not easily accommodated by the Romanian legal system. It will require time and a major cultural adaptation for self-regulatory organizations to be fully accepted.

ECONOMIC EFFECTS OF USAID'S CAPITAL MARKET DEVELOPMENT PROGRAM

Large variations in income levels among countries relate much less to differences in the natural resource base (of land and minerals) than to differences in the man-made resource base of capital assets and related technology (machinery, roads, telecommunications systems). In countries where capital is abundant, workers can be highly productive and achieve high income levels.

Those who want to invest in capital assets often lack the necessary funds. Capital markets play the key role of bringing together savers and investors. When capital markets work effectively, they stimulate economic growth by encouraging savings and channeling them into the most productive investments.

Romania presents a paradox. For decades the country achieved high savings and investment rates, but living standards remained

low. Savings were channeled into investments in the wrong technologies and wrong industries with the wrong management approach. Even with the collapse of communism in 1989, living standards did not improve—they even declined. The economy was still dominated by state ownership and control, administered prices, and structural imbalances that misallocated investment resources.

The investment signals (prices, laws, and incentives) needed to be changed. Reforms since 1989 have been relatively slow. Privatizing state-owned enterprises is key to any successful reform effort. However, except for brief attempts at limited privatization in 1991 and modest restructuring in 1993, comprehensive programs for privatizing, restructuring, or liquidating loss-making enterprises were not launched until 1995.

Benefits From Creating Rasdaq

In 1995 the government was planning to privatize state-owned small and medium-size firms. But a number of potential problems loomed. When similar privatizations were launched in Russia and other former Soviet-bloc states, how to value shares and how to avoid price manipulation were always controversial issues. A fair and open market where shares can be bought and sold is an excellent way to put a price on shares.

In other countries there was also a problem with share transactions. Although people could trade shares in the capital city, in other cities it was difficult to buy or sell shares. And the possibility of fraud was a concern. There was no assurance that shareholding transfers and records were fair and aboveboard. The last was especially critical. If Romania's privatization was to succeed, it had to be open, fair, and honest. But Romania had none of the institutions needed to do the job.

The USAID project was comprehensive in coverage, creating the Rasdaq equity market along with a depository, registry, and transfer system. The original idea of setting up a complete stock market system in six months was unrealistic, but it was successfully done in a little more than a year and a half—an amazing achievement.

Impact is difficult to measure in an institutional development project, but in this case it is possible to examine indicators of performance. From 50 key-informant interviews, covering a broad range of economic interests, the overwhelming consensus emerges that the Rasdaq stock trading system is fair, honest, and efficient. The same applies to the monthly Rasdaq special auctions of State Ownership Fund companies.

All privatized firms were required to list their stock on Rasdaq and to use Rasdaq's share registry and depository. This avoided problems that arose in other former communist countries, where managers of newly privatized firms kept stock from trading on formal markets, so they could manipulate prices and fraudulently alter stock ownership records.

Fears that traders would manipulate and take advantage of the system have not come to pass. Rasdaq has 199 brokerage firms located in all of Romania's 32 counties and Bucharest. A buyer or seller anywhere in the country can go to a broker who is linked to the electronic market in real time. All quotes and all trades are displayed through the network; anyone anywhere in the country receives the same price. The Rasdaq trading system has been able to handle a monthly share volume of 50 to 60 million (and as high as 120 million) flawlessly. The brokers' self-regulatory or-

Box 4. In the Eyes of the Small Investor . . .

With the Mass Privatization Program inaugurated in 1995, the Romanian government faced the stupendous task of distributing vouchers good for shares of privatizing companies to the nation's entire adult population—some 16 million people, who had no knowledge of company shares or the stock market. How did people deal with the process and this new thing called ownership? Here are some excerpts of interviews with white-collar workers:

I had only about two months to decide what to do with my voucher. I decided to invest in one of the private ownership funds. That seemed the easiest choice because I really didn't have any information about specific companies. I still have the receipt from the fund, but since investing I have heard nothing from them.

—A., computer specialist

I learned about the voucher distribution through a big advertising campaign in the newspapers, on television, and on the streets. I have a relative who is a bank director. He advised our family to wait. We ended up putting our money in a private ownership fund. After a year we went to the fund to receive our dividend, which was only about \$3.40.

—I., civil servant

I put my coupons into a cable-manufacturing company where my father worked. I intend to become an active investor when I'm making more money and have more information. But for the average Romanian, I think these coupons meant nothing. People don't understand that trading paper can create wealth. It's not cash. Romanians only understand cash.

—R., master's candidate in international tourism

I had only about four months to decide where to invest. I could have sold my vouchers on the black market for 50 percent of nominal value. I chose not to and instead did research in a book published by USAID that listed detailed information on companies. I decided to invest in a fund, but I haven't heard anything from that company since the day I invested.

—L., office specialist

I used my voucher to buy into a brewery. I'm not sure it was the right choice, because I have received no dividends, and the stock price keeps falling. I hope that as privatization gains ground, the company will recover and the price will go up. Still, even if I wanted to sell, I really have no idea how to do it.

—F., office specialist

ganization has done a good job of setting up a code of fair practices, and the National Securities Commission has done an adequate job of framing the regulatory environment.

Probably the best stock market test is whether foreign investors will put their money in a market. There are a large number of highly savvy foreign investors. They look throughout the world for profitable investments and a trading system that will treat them fairly. Some 70 percent of Rasdaq trading volume is from foreign investors. They have confidence in the market—confidence they will get a fair price and effective transfer and custodial services from a transparent and honest market. Judged by the tough standards of international investors, Rasdaq is a success.

Supporting Mass Privatization

USAID stock market projects are usually designed to improve the efficiency of an existing market. In Romania the strategy was quite different—a stock market was created to support a new privatization effort.

In 1991, Romania had half-heartedly, and not very successfully, tried limited privatization. Now, in 1995, all Romanian citizens were to become shareholders in newly privatized companies. Overnight there would be new shareholders in new private companies (see box 4). But there were concerns—if there was no way to set a fair price on shares and everyone tried to sell his shares at once, disaster would ensue. Already a black market was trading in privatization vouchers, and people were being fleeced by unscrupulous traders.

It was essential to set a fair market value for the shares and to allow people a chance to sell their shares for cash. Just knowing their shares had a real market price and they could sell shares if they wished might be enough to give them confidence to hold on to their shares.

The economic measure of Rasdaq success was the creation of a transparent and orderly market where people had confidence in privatization. When Romanians were given the choice of leaving their privatized stock in a private ownership fund or instead receiving actual company shares, 13 million chose shares and only 3 million left their shares in a fund. The 13 million were actively involved in picking shares in companies in which they wanted to be part owners. Thanks to a nationwide education program, supported in part by the project, large numbers of people understood that they could hold shares or buy and sell them on Rasdaq. Previous privatization attempts had failed. But now, people had confidence and trust in the system and were willing to hold shares.

More recently, special Rasdaq auctions supported privatization of selected companies previously controlled by the State Ownership Fund. By March 1998, some 20 firms had been privatized in competitive and fully transparent auctions (see box 5).

How Efficient Has the Market Been At Allocating Capital?

In addition to supporting privatization, capital markets need to mobilize and channel capital to its most productive uses. Capital market price signals place a value on corporate assets. When a company's market values are out of line, the market encourages restructuring by moving capital to more successful firms and starving the low performer. It also provides signals that encourage corporate buyouts, takeovers, and divestments.

In Romania, domestic capital markets are not yet performing the capital allocation function. Except for a brief burst of enthusiasm in 1997, when the stock markets soared, economic conditions have been tight and domestic liquidity limited. Since the 1995 Mass Privatization Program, there have been only a few

Box 5. Computer Games: Auctioning Off a State-Owned Bakery

It is 12 March 1998, and the Rasdaq auction is about to begin. The brokerage trading room is filled with 25 people: traders and executives from a major brokerage firm and seven buyers representing a consortium of three companies. Today the bidding is for half the state's 40 percent stake in a large bakery, Prodaliment. Sixty percent has already been sold on Rasdaq; in six weeks the state will auction off its remaining 20 percent.

The auction is conducted by closed-circuit Rasdaq computer. Bidding takes place in three rounds: a half hour first round to shake out the less serious; a 15-minute second round to further winnow the buyers; and an open-ended third round where the real action takes place.

Three traders man three computers at desks arranged side by side. All bids will be transmitted by the trader in the middle. As bidding starts all eyes focus on the computer monitors. The consortium weighs in with a bid of 701 lei. (Prodaliment had closed earlier on Rasdaq at 1,200.) Bidding starts sluggishly but heats up near the end of round 1, when a series of bids blip the screen. Winning bid is now 740 lei, then 780. The buyers consult frantically. "Offer 800!" they shout. The bid appears instantly on trading screens throughout Romania. At the end of round 1, the consortium is still on board.

Round 2 is uneventful, but neckties are loosened, collars opened for round 3. Now the bidding gets serious. For the next two hours, all eyes stay glued to the three monitors. Another firm bids 916. The consortium counters with 1,000. More bids blip the screen. The consortium raises the ante to 1,330.

Another bidder knocks the consortium out of the box with a bid of 1,900. The seven buyers stay in the game with a counterbid of 2,002. By now the brokerage's managing director is calling the shots, and his bid goes to 2,400—double the Rasdaq closing price. The buyers have reached their limit. Higher bids would eliminate them. A tense wait ensues.

Finally, a banner, "Auction Over," floats across the computer screen. Smiles break out. Hands are pumped, backs slapped. The consortium has bought itself a piece of The Bakery—339,000 shares for about \$100,000.

It has been a victory for the Rasdaq auction system as well. The nationwide bidding has been fair, transparent, and—with leading-edge technology—instantaneous. And, at the end of the day, another sliver of state-owned property has passed into private hands.

initial public offerings and a small number of privatizations handled by the domestic capital market. There is no money market, no private debt market, and no secondary government debt market. Municipal finance, derivatives, and mortgage bonds do not exist. Until the government adopts the necessary policies to create these markets, capital markets will continue to merely limp along.

Until 1997 all state-owned banks received instructions from the government on how to allocate credit, which generally meant funding state-owned companies. Except for some key exceptions, banks now do not receive orders on how to allocate credit.

State-owned banks still dominate commercial banking, although there are plans to privatize some of the banks. They buy almost all the government debt that is issued and provide funding for state corporations. Limited private corporate financing is provided but at interest rates substantially above the rate of inflation. At such rates, few private companies use commercial bank credit. The government periodically tries to reduce inflation and balance-of-payments pressures by squeezing credit out of the domestic market. Private sector liquidity is tight. The only bright side is foreign-capital inflows, which have been strong over the period 1996–97.

The market as a mechanism to channel capital effectively has not developed beyond what was inherited from the pre-1989 central-planning regime. Rasdaq and the Bucharest Stock Exchange do reflect investor and saver demands and have market-based pricing. But stocks are less than 10 percent of Romania's total financial market. The country needs to start developing a complementary set of investment institutions.

Economic Pluralism and a Competitive Investment Market

Much like political democracy, economic democracy allows the public to have a stake and a say in their economic future. People become involved in the economy, in economic decisions, and in their own economic future. It also means that those who issue financial securities and those who invest in them can make their own economic decisions and react to price and market changes. For market pluralism to work, there needs to be free and open economic access, a number of competing economic players, and rules and regulations to prevent cartels, fraud, and other anti-competitive forces.

Good corporate governance means that management is trying to earn the highest returns on shareholder investment by managing resources and investments to generate maximum long-run profitability. A profitable firm with a strategic vision of its future will generate increased employment and sales. In Romania, privatization has done little to improve corporate governance. A number of key industrial firms were excluded from privatization, and the State Ownership Fund still holds a large stake in many of the privatized firms. The managers of previously state-owned firms continue to manage the now privatized firms. Without a change in incentives, managers manage in the same fashion as before. What's more, most private firms lack an independent board of directors. In

such a situation the danger exists that managers will mismanage company assets, discriminate against minority shareholders, or seek to personally profit at the expense of the company.

There are some hopeful signs. In March 1998 the Romanian Senate introduced legislation "For the Protection of Minority Shareholder Rights." If effectively implemented, the legislation will provide investor and shareholder protections similar to those in Western Europe and the United States. In addition, a small number of strategic investors are using their own capital to buy companies. With their own money at risk they have a strong incentive to restructure and reorganize companies and to encourage managers who maximize investment returns.

Competitive institutions encourage economic efficiency and growth. When one institution controls a market, even if its intentions are good, it runs the risk of failing to innovate, failing to keep costs reasonable, and losing sight of its clients' needs. In Romania USAID created Rasdaq, even though the Bucharest Stock Exchange had already been established. In 1995 the Bucharest Exchange was not eager to deal with the small and mid-size companies that were to be privatized. Moreover, it had a trading system not attuned to the volume and information requirements of the newly privatized stocks.

By setting up Rasdaq, a competing equity market and new settlement, depository, and registry companies, the newly privatized shares were handled efficiently. Even more important, Rasdaq's state-of-the-art trading and settlement system put pressure on the Bucharest exchange to improve its system. Competition has benefited both institutions. The Bucharest exchange recently installed a new computer to solve problems with slow trades and delays in reporting. This exchange has slightly lower transactions costs than Rasdaq and has concentrated on large-capi-

talized stocks. This has put pressure on Nasdaq, as it fears the loss of some of its large-cap listings.

But competition also created duplication and overlap in a market not yet generating the trading volume needed to cover all costs. Most stockbrokers trade on both exchanges, which means they have separate computer systems, record-keeping, and specialized staff to deal with each exchange and its unique requirements. There are now several depositories and four stock registries (with several new ones poised to open soon). The growth in institutions has reached the point where it is doubtful whether they all can provide quality services while being financially viable.

Trust and integrity are at the heart of any financial market. People are giving up money for pieces of paper or electronic statements. Absent trust, savers and investors will desert the market.

After more than 40 years of communism, Romanians had little experience with markets. Their introduction to the “miracle of markets” was not felicitous. In the early 1990s a number of financial pyramid schemes swindled unsuspecting investors. The largest of these collapsed in 1994, with deposits reportedly equal to \$700 million to \$1 billion. The collapse of the mutual fund industry in the spring of 1996 following the Safi scandal further soured people on investments. Partly as a result of a lack of trust, Romanians have an estimated \$1.2 billion of savings held as cash under the mattress.

Nasdaq’s own broker–dealer self regulatory organization has developed a set of “Rules of Fair Practice” defining appropriate business conduct, advertising standards, operating rules, and disciplinary procedures. It maintains market surveillance and discipline committees. It has done a good job of setting professional standards for the brokerage community. It could be more active in inspection and enforcement.

The critical institution is the National Securities Commission. The commission board is relatively weak, and many of its staff lack a law or securities background. Owing mainly to low pay scales, staff turnover is 50 percent a year. Thus, even after extensive USAID-sponsored training, skill levels are low.

The commission has a good record of working with the government to pass securities laws. The problems are in surveillance and enforcement. It has successfully brought nine censure cases against securities firms, but firms can file countersuits against the commission, and 70 are now pending. The commission is bogged down in the courts. It lacks lawyers and securities experts who could work on settlements that would avert litigation. It also lacks the skills and stamina to take major cases to a court that has difficulty enforcing securities rules.

The Effect Of Macroeconomic Policies

From late 1995 to early 1998, the government launched several economic reforms and privatization efforts. But they were plagued by a continuing series of economic crises. High inflation, problems in controlling the budget deficit, slow growth in gross national product, and difficulties controlling expansionary monetary and fiscal policies—all these weakened the financial system. Interest rates remained high and administratively determined. Foreign exchange rates were unstable. Moreover, privatization proceeded only sluggishly.

Periodically the government would experience problems meeting monetary and fiscal targets imposed by the International Monetary Fund. To meet IMF conditions, the government would suck cash out of the private sector. That would generate a sharp economic contraction.

Economic uncertainty and lack of domestic liquidity deterred firms from going to the market. Rasdaq handled stock generated from the initial privatization in a highly successful manner. The system was designed to handle further privatizations and new stock offerings. But new privatizations went slowly.

BENEFICIARY IMPACT

Benefits depend in part on who is investing in the market and how they manage their funds. In 1997 the economy was in trouble; gross domestic product slipped 6.6 percent, and inflation reached 150 percent. But still foreign money flowed in. An estimated \$1 billion of foreign investment funds entered the economy. Roughly half was used to buy stock on Rasdaq and the Bucharest Stock Exchange, and the other half went into direct equity investments in Romanian companies. This is a continuation of a trend that started in 1996, about the time of the Mass Privatization Program, the startup of Rasdaq, and the rapid expansion of the Bucharest exchange.

Having technically efficient markets like Rasdaq and the Bucharest exchange helps build confidence and draws foreign exchange into Romania. Foreign investors see Romania as a high risk–high payoff market. Whereas foreign investment funds are bullish on Romania, a depressed economy and a lack of liquidity have deterred domestic investors.

Romanians received their mass privatization shares as a gift from the state. Although most people are holding onto their shares, a steady stream of small amounts of shares are being sold. Brokers outside Bucharest generally have clients who want to sell. A process of concentration is taking place as small lots are sold and then packaged into one thousand, ten thousand, or larger blocks for sale to strategic domestic investors and foreign investors in Bucharest.

Romanians in government, business, and the stock market see this as a healthy trend. As active investors gain control of a company, they become involved in corporate management, take a keen interest in restructuring operations, bring in new technology, and improve profitability. This is seen as a clear benefit for the economy. Although restructuring means that many firms will cut back on employment, new technology and new production facilities should generate more productive and more highly paid employment. However, the immediate impact, which most people see, is a drop in employment. As in most countries, there is an underlying fear that foreigners will take over the economy. That may help explain why privatization has proceeded so slowly. But so far, there has been no major political problem with large foreign purchases of Romanian assets.

Against the benefits of foreign exchange inflows, better corporate management, and higher productivity, there are negatives. Many companies have dismal business prospects, and their stock is way overvalued. But there are others with good growth prospects and their stock is often undervalued. Smart-money investors see undervalued corporate assets that can be bought on the cheap. If they are right, they will be the major beneficiaries. The average citizens who are selling their shares will be the losers. The foreign hedge funds usually want to make a big profit and then take their money out within six months to a year. Many of the other investors have a longer time horizon but usually not more than five years. At some point the foreign money could start to leave Romania, and if conditions sour, it could leave quickly in a large mass. That would destabilize the economy.

DID USAID USE THE RIGHT APPROACH?

Romania is one of the few countries where USAID supported a complete turnkey approach of creating a new stock market institution. Why was this approach selected and how well did it succeed?

In 1995 USAID was working with Romanian reformers to dismantle a centrally planned economy. Key to that effort was privatization. A free and honest stock market was essential to propel the privatization effort forward, but the Bucharest Stock Exchange was viewed as flawed. USAID decided to create a new institution.

But now, several years later, with relatively low stock volume, there is some question whether there is a need for such duplication. Eliminating duplication in exchanges, registries, depositories, and brokers' equipment and staff would save money. In point of fact, there appears to be movement toward consolidation among the institutions. With present costs and low trading volume, the market probably will force brokers and exchanges to cut costs sharply, merge, or go out of business.

With 20/20 hindsight, it might have been better not to have created a second stock exchange. But it is important to remember the situation in 1995 and 1996 when Rasdaq assistance was designed. Privatizations had been often delayed and most prior efforts failed. Another failure might have ended any hope of reform. The Bucharest exchange was new, under the government's thumb, and reluctant to handle shares of newly privatized small and medium-size companies. USAID could have pressed the

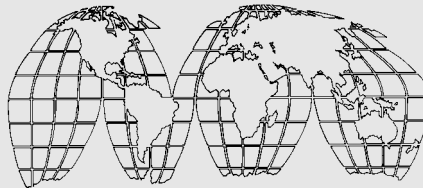
Bucharest exchange to reform, but that would have been risky. Creating a new institution was more costly, but results were more predictable.

Rasdaq successfully supported privatization of 5,600 new stocks. But that was not to be the end. It was assumed that a large number of additional privatizations would take place. Rasdaq would be waiting to provide a market for those new securities. As it turned out, the privatization pace did not accelerate and in fact slowed to a crawl. Rasdaq, the institutional mechanism, was in place but the supply of new securities was not.

In addition to delays on privatization, the government has difficulty implementing a consistent set of economic policy reforms. State-owned firms still dominate the economy. Private businesses face periods of

high inflation and low economic growth. All in all, these are not conditions that lead firms to the stock market. These conditions also deter domestic investors.

Rasdaq is a technical success. It is efficiently handling over \$1 million a day in share transactions. It has the capability to easily handle many times that volume and could handle other types of financial securities (government and private debt, municipal finance, options, futures, commodities, and the like). The problem lies elsewhere. Although communism ended in 1989, old communist ideas still hold power in government and throughout the economy. *As long as the government fails to adopt and implement needed economic policy reforms, Rasdaq and other capital markets institutions will not live up to their full potential.*



“As long as the government fails to adopt and implement needed economic policy reforms, Rasdaq and other capital markets institutions will not live up to their full potential.”

LESSONS LEARNED

1. Top-level support, healthy funding, and a firm timetable can spur the success of a capital markets program.

In many countries USAID stock market projects take five years or more to get established. In Romania, after 45 years of communist state planning, one would have expected a long development period for any new stock market project. However in just two years Rasdaq, the depository, registry, transfer agent, and self-regulatory organizations were all up and running and performing at a high technical level.

Several factors were critical to this success: 1) The U.S. ambassador took an active role in negotiations with the government, including a memorandum of understanding that set out expectations and responsibilities for all parties. 2) The project was directly linked with a major mass privatization of small and medium-size firms. 3) The project and related efforts were large—\$30 million. 4) The project was based on a complete turnkey approach covering all needed elements—technical advisers, training, equipment, software development, and the like. 5) USAID's Bureau for Europe and the New Independent States had special authority, not available to other USAID regional bureaus, to hire highly skilled capital market experts to manage the project. Finally, 6) All efforts were directed around a tight time frame—concentrated on getting all systems in place and operating within six months and fully functioning within a year.

2. Economic competition encourages efficiency and growth.

Competition means opening economic access, increasing the number of players, and preventing formation of restrictive cartels and monopolies. It also means encouraging competing institutional approaches. The Bucharest Stock Exchange was reluctant to deal with the newly privatized small and medium-size firms. Its trading and settlement system also had weaknesses. USAID created a competing market (Rasdaq) and five other institutions,

with a state-of-the-art trading and settlement system. This competitive approach encouraged the Bucharest exchange to improve its trading system.

However, economic pluralism also created duplication and overlap, in a market that has not yet generated the needed trading volume to cover all costs. It may be time to start economizing on stock clearance and settlement costs by merging some of the competing institutions, such as the depositories. At some point in the future, Rasdaq and the Bucharest Stock Exchange might also need to harmonize and combine their systems.

3. An independent regulatory commission with strong enforcement powers is critical.

Almost every nation's stock market has, at some time or another, experienced insider manipulation or fraud. When it happens the investing public is burned and often fearful of entering the market. So far, except for the mutual fund problems, Romania has been lucky—there have been no major stock market scandals. To avoid potential problems, the National Securities Commission needs to be independent and able to enforce the rules. Although the commission has made much progress, it lacks the funding, staff, and laws to fully protect investors. Market integrity is essential to success. Future efforts need to concentrate on strengthening the commission.

4. Incentives for good corporate governance need to be instituted.

The purpose of privatization is to improve economic performance by having business managers zero in on profitability, maximize returns on invested capital, and respect the rights of shareholders. The successful voucher-based privatization program launched in late 1995 distributed shares but did little to improve corporate governance. A number of key industrial firms were excluded from privatization, and the government's State Ownership Fund held a large stake in many of the privatized firms. In most firms, share ownership was spread among a large number of

people, with few having the ability to influence corporate management.

Independent boards of directors were also lacking. In such a context, privatization does not necessarily mean a change in management staff or management philosophy. In most cases, the managers of previously state-owned firms continued to manage the now “privatized” firms. Without a change in incentives, managers managed in the same fashion as before. In addition, dividends from profitable enterprises were used in the past by the State Ownership Fund to cross-subsidize the loss-making ones—eliminating any incentive to improve profitability. For the full benefits of privatization to be realized, incentives must be found to improve corporate governance.

5. A stock market alone does not a capital market make. With Rasdaq and the Bucharest Stock Exchange, Romania has an effective set of stock market institutions. In contrast, there is no private debt market (corporate bonds), no secondary market in government securities, no longer term government bonds, no municipal finance market, and no money market instruments. Moreover, commercial credit in many cases is still allocated by administrative decision rather than market and price decisions. If capital is to be allocated effectively, a country needs a variety of specialized markets and financial instru-

ments. Romania needs to develop those markets.

6. Absent a sound economic environment, even good institutions cannot yield the full benefits of privatization. When the project was designed, Romania was slowly breaking free from one of Eastern Europe’s most oppressive centrally planned economies. Capital markets did not exist, and the country needed a completely new set of laws and institutions. Everything had to be created from scratch. USAID chose a “hothouse” approach of quickly creating a new set of capital market laws, institutions, and trained personnel. But old attitudes carried over from the days of central planning, together with the slow pace of economic policy reform and privatization, proved to be major impediments to capital market development.

The project was highly successful at putting the infrastructure (institutions, hardware, software, regulations, and so forth) in place for an equity market that could effectively handle the large volume of mass privatization shares as well as future privatizations and new stock offerings. However, the macroeconomic situation has been chaotic and depressed, and additional privatizations have proceeded slowly. No matter how good the institutions, if the economic climate is bad, full benefits will not be realized.

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