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**The William Davidson Institute (WDI) Research Update**  
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**In This Edition**  
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1. Secretary Albright to deliver speech: *UN, WTO, IMF: Time for a Change?*
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4. UM Law School/WDI to host Globalization, Law and Development Conference
5. International Conference on Transition Economics
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**1. Secretary Albright to speak on *UN, WTO, IMF: Time for a Change?***  
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The Davidson Institute's Distinguished Scholar Madeleine Albright will deliver a public speech *UN, WTO, IMF: Time for a Change?* on Wednesday, March 10, 4:30-5:45 pm in Hale Auditorium. The talk will highlight today's international environment, provide an assessment of current international institutions' performance and capabilities in this environment, and present suggestions for restructuring existing international institutions or creating new ones. We hope you will be able to join us!

Secretary Albright will also participate in several other events in her role as WDI Distinguished Scholar during her visit to Ann Arbor, MI, March 9-11. Please contact Sharon Robinson for further details at [sharrob@umich.edu](mailto:sharrob@umich.edu).

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**2. Globalization of Services: Growth Catalyst or the Final Straw for U.S. Workers**  
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Secretary Madeleine Albright, in her role as WDI Distinguished Scholar, will convene a forum: *Globalization of Services: Growth Catalyst or the Final Straw for U.S. Workers?* on Friday, April 23, 2004, 8:30 – 2:00 in Room 902 of the Hart Building, on Capitol Hill, Washington D.C. The-half day forum will explore offshoring from three perspectives: 1) How will the globalization of service activities affect growth prospects for developing countries and what does this mean for development and for the global economy? 2) How will offshoring affect developed country businesses and how will the effects vary across sectors? and 3) How should developed country governments respond to this development? Do efforts to protect “U.S. Jobs” make sense and if not, what alternatives are preferable? More information regarding this event is available at

[http://www.wdi.bus.umich.edu/events/glob\\_services.htm](http://www.wdi.bus.umich.edu/events/glob_services.htm). Please contact Laurie Gendron at [llegendron@umich.edu](mailto:llegendron@umich.edu) or 734-615-5020 if you are interested to attend.

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### **3. Business and Politics as Usual? The US and EU after EU Enlargement**

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The Davidson Institute, together with the European Union Center at the University of Michigan, is organizing the conference *Politics and Business as Usual? Europe and the US after EU Enlargement*. Secretary Albright, WDI Distinguished Scholar, will convene the event to be held on Monday, March 24, from 8:30 am – 2:30 pm in the US House of Representatives, 2168 Rayburn House Office Building (The Gold Room), Washington DC. Other panelists include: **Joseph R. Biden**, Senior Senator, Delaware; **Jeffrey M. Fettig**, President and COO, Whirlpool Corporation; **Daniel S. Hamilton**, Director, The Center for Transatlantic Relations at Johns Hopkins University/SAIS; **Danuta Hübner**, Minister for European Affairs, Poland; **Henry Hyde**, Congressman, Illinois; **Michal Kleiber**, Polish Minister for Science and Technology for Europe; **Tom Lantos**, Representative, California; **Gary Litman**, VP, Europe & Eurasia, US Chamber of Commerce; **Christopher Makins**, President, Atlantic Council of the US; **Catherine Novelli**, Assistant, US Trade Representative for Europe; **Aleksander Smolar**, President, Stefan Batory Foundation; **Thomas Usher**, President and CEO, US Steel; **John Vinocur**, International Herald Tribune; and **Robert Wexler**, Representative, Florida. Further information regarding the event is available at <http://www.umich.edu/~iinet/euc/MiscHTML/euEnlargementConf.html> Please contact Kelly Janiga at [janigak@umich.edu](mailto:janigak@umich.edu) for further details.

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### **4. Globalization, Law and Development Conference**

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The Davidson Institute and the University of Michigan Law School, are organizing the conference *Globalization, Law and Development* on April 16-18, 2004 in Ann Arbor, MI. This conference is designed to contribute to a renewed debate in the last several years on how best to promote development in an era of globalization. The UN began the process in 2000, by setting out a series of far-reaching and concrete “Millennium Development Goals,” which are designed to significantly reduce global poverty by 2020. More information is available on the conference website at [www.law.umich.edu/globalization](http://www.law.umich.edu/globalization) Please contact Kelly Janiga at [janigak@umich.edu](mailto:janigak@umich.edu) if you are interested to attend or would like further details.

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### **5. WDI/CEPR International Conference on Transition Economics**

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The International Conference on Transition Economics will be held on May 27-30, 2004 in Hanoi, Vietnam. The conference is organized by WDI, the Centre for Economic Policy Research (CEPR), and hosted this year by the [National Center for Social Sciences and Humanities of Vietnam \(NCSSH\)](#) and the [United Nations Development Program \(UNDP\)](#). It will provide a forum for leading economists and other social scientists working on transition and on broader issues of development and institutional change to meet, present new research, develop collaborative relationships, and complete ongoing research. The call for papers deadline has passed. More information about the conference is available at [http://www.wdi.bus.umich.edu/events/ann\\_int\\_conf\\_04.htm](http://www.wdi.bus.umich.edu/events/ann_int_conf_04.htm)

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## 6. New Additions to WDI Working Paper Series

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The following are fourteen recent additions to the WDI **Working Paper Series** dealing with a variety of transition issues. The abstracts can be found below the titles, or click on the http address to go directly to the paper on our web site.

**No. 652: Ownership, Control and Corporate Performance After Large-Scale Privatization**

*Jan Hanousek, Evžen Kočenda and Jan Svejnar*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp652.pdf>

**No. 651: Czech Social Reform/Non-reform: Routes, Actors and Problems**

*Jiri Vecernik*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp651.pdf>

**No. 650: Financial Integration, Exchange Rate Regimes in CEECs, And Joining the EMU: Just Do It...**

*Mathilde MAUREL*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp650.pdf>

**No. 649: Corporate Investments, Liquidity and Bank Financing: Empirical Evidence from an Emerging Market**

*Arun Khanna*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp649.pdf>

**No. 648: Financial Constraints in Investment - Foreign Versus Domestic Firms. Panel Data Results From Estonia, 1995-1999.**

*Tomasz Mickiewicz, Kate Bishop and Urmaz Varblane*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp648.pdf>

**No. 647: Legal Minimum Wages and the Wages of Formal and Informal Sector Workers in Costa Rica**

*T.H. Gindling and Katherine Terrell*

<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp647.pdf>

**No. 646: Employment Expectations and Gross Flows by Type of Work Contract**  
*Catalina Amuedo-Dorantes and Miguel Á. Malo*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp646.pdf>

**No. 645: Transition on the Shop Floor - The Restructuring of a Weaving Mill, Hungary 1988-97**  
*János Köllő*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp645.pdf>

**No. 644: Fighting “Low Equilibria” by Doubling the Minimum Wage ? Hungary’s Experiment**  
*Gábor Kertei and János Köllő*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp644.pdf>

**No. 643: Mind the Break! Accounting for Changing Patterns of Growth during Transition**  
*Jan Fidrmuc and Ariane Tichit*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp643.pdf>

**No. 642: The Monetary Approach to Exchange Rates in the CEECs**  
*Jesús Crespo-Cuaresma, Jarko Fidrmuc and Ronald MacDonald*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp642.pdf>

**No. 641: Community Norms and Organizational Practices: The Legitimization of Wage Arrears in Russia, 1992-1999**  
*John S. Earle, Andrew Spicer and Klara Sabirianova Peter*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp641.pdf>

**No. 640: Trust in Transition: Cross Country and Firm Evidence**  
*Martin Raiser, Alan Rousso, and Franklin Steves*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp640.pdf>

**No. 639: What Makes Small Firms Grow? Finance, Human Capital, Technical Assistance, and the Business Environment in Romania**  
*J. David Brown, John S. Earle and Dana Lup*  
<http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp639.pdf>

## **Abstracts of Recent Working Papers**

**No. 652: Ownership, Control and Corporate Performance After Large-Scale Privatization**  
*Jan Hanousek, Evžen Kočenda and Jan Svejnar*  
We analyze the effects of ownership type and concentration on performance of a population of firms in a model large-scale privatization economy (Czech Republic).

Using specifications based on first-differences and unique instrumental variables, we find that few types of private ownership improve dynamic post-privatization performance. Concentrated foreign (but not domestic) ownership improves some measures of performance relative to state ownership. Foreign investors engage in strategic restructuring by increasing the rate of change of sales, while domestic private owners reduce the rate of change of sales and labor cost without increasing profitability. The effects of concentrated foreign ownership support the agency theory and go against theories stressing the positive effects of managerial autonomy and initiative. Our results are also consistent with the thesis that large domestic stockholders are not improving performance because they loot the firms. We find some support for the hypothesis that firms restructure by first lowering and later increasing the rate of change of employment. The state as a holder of the golden share has a positive effect on employment, while stimulating profitable restructuring. The state hence appears as a more economically and socially helping agent than in some recent studies.

No. 651: Czech Social Reform/Non-reform: Routes, Actors and Problems

*Jiri Vecernik*

In this contribution, the author first considers the characteristics of the Czechoslovak communist welfare state and its theoretical alternatives. Throughout the reform process, dependency on both corporatist and socialist regimes won out, while residualist efforts were promoted in the beginning, but were later held back. The author then considers the possible actors involved in social reforms. In this respect, when proceeding from a general to a more concrete level, thought should first be devoted to the social classes and their ideologies, and second to political parties and their leaders. The author goes on to summarise the particular problems and traps in individual sections of the Czech social system. While no objection to decent standards of social protection and health care could be raised, the poor efficiency of their achievement should evoke concern. The author concludes by reflecting on the possible specificities of Czech social reform in comparison with the other countries undergoing reform and the EU. The current lethargy of the Czech welfare system corresponds to a “frozen edifice”, just as in most Western countries. However, such stagnation is apparently acceptable to both the politicians (who mask it in reformist rhetoric) and the population (which learned to master taking advantage of the generous welfare state) and thus is basically sustainable in the long run.

No. 650: Financial Integration, Exchange Rate Regimes in CEECs, And Joining the EMU: Just Do It...

*Mathilde Maurel*

Candidate countries of central and eastern Europe (CEECs) are suppose to join the EU in 2004, June, which imply that they will face important challenges in the conduct of macroeconomic policy, in order to be able to enter the ERM-II system and eventually enter the EMU (European Monetary Union). Abandoning an independent monetary policy might entail significant costs for countries, which have succeeded in recovering and are in a process of catching-up. However those costs have probably been exaggerated, and their estimation biased by the traditional optimal currency area criteria. The main criticism against a too strong emphasis on the latter rests on two arguments. The first one is that assessing the trade-off for joining the EMU does not deliver the same

conclusion *ex ante* and *ex post*. Meanwhile, the degree of financial integration will likely increase dramatically, which in turns will decrease the opportunity cost of loosing the monetary policy for absorbing country specific shocks. In a world of capital mobility, the room left for an independent monetary policy is very narrow, maybe close to zero in small, emerging countries, more vulnerable to speculative attacks than countries in the core. The second argument is more empirical. While the link between the exchange rate regime and the fundamentals is rather weak, the political agenda of joining the EU and subsequently the EMU seems to explain the choice of the exchange rate regime.

No. 649: Corporate Investments, Liquidity and Bank Financing: Empirical Evidence from an Emerging Market

*Arun Khanna*

A number of studies in the prior literature have found a link between cash flow and firm investment [Hubbard (1998) and cites therein]. Findings of most of these studies have the caveat that cash flow could simply be capturing expectations of future profitability because the empirical proxy (typically a version of average Q or market to book ratio) for marginal Q is imperfect. This study removes this caveat while retaining the Fazzari, Hubbard and Petersen's (1988) a-priori sorting of firms into liquidity constrained and non-liquidity constrained regression framework. This study focuses on inventory investments of two sets of Indian manufacturing firms: issuers and non-issuers of short-term arm's length debt during 1996-97, a time period of robust economic growth and simultaneously an inward shift in the supply of bank loans instituted by the Reserve Bank of India (RBI). Non-issuer firms have significantly higher investment-liquidity sensitivities vis-à-vis issuer firms for inventory investments in 1996-97. Issuer and non-issuer firms investing less than their internal funds have no differences in liquidity coefficients while firms investing more than their internal funds do. Issuer and non-issuer firms that do not face an increase in the cost of external debt (ergo not an increase in inferred external and internal cost of funds wedge) have no differences in liquidity coefficients while the two set of firms that face an increase do. Differences in investment-liquidity sensitivities between the two set of firms arise from their differences in bank dependence and hypotheses including pure bank dependence, priority lending and loans above banks' rule for estimating a firm's debt capacity find empirical support. Bank characteristics based hypotheses including single banking relationship and weak banks with below Basle capital standards cannot explain differences in liquidity constraints. Alternative explanations including agency problems, the flypaper effect, over-investment, legal regimes of parent companies and crony capitalism do not find empirical support. Debt overhang hypothesis is supported by the data. The findings are consistent with Almeida, Campello and Weisbach (2002) and represent differences in liquidity demand by firms explaining differences in liquidity constraints between issuers and non-issuers. Relatively pristine sub-sample of new short-term public debt issuers in 1996-97 (who were non-issuers till 1996), sub-sample of potentially 'misclassified' liquidity constrained non-issuers firms and a holdout sample of government owned firms that have access to state budgetary support provide results consistent with differences in liquidity constraints between issuers and non-issuers. Propensity score regressions match issuer and non-issuer firms on three dimensions: Q, net profit and age of the firm. In 4 out of 5 blocks the liquidity coefficient of non-issuer firms is higher than that of issuer firms. The results

confirm that non-issuer firms face higher liquidity constraints and that the differences in liquidity coefficients are not subject to the caveat that firm characteristics, differences in mismeasurement of Q or differences in expectations of future firm profitability between issuers and non-issuers. In sum, relative differences in inventories investment-liquidity sensitivities represent differences in liquidity constraints. Empirical evidence is consistent with a causal link between differences in liquidity constraints and RBI's regulatory fiat in 1996-97. The allocation of bank debt during 1996-97 is not consistent with maximizing economic efficiency measured by either ratio of value added to capital or ratio of operating profits to capital. Results from examining components of inventories: raw materials, work-in-process and finished goods are not supportive of differences in investment liquidity sensitivities between issuers and non-issuers. Differences in investment liquidity sensitivities between issuer and non-issuer firms in capital investments and total firm investments regressions provide support for the findings that the investment liquidity sensitivities documented earlier represent liquidity constraints driven by bank dependence. However, using propensity scores to match issuers and non-issuers on profitability, Q and age of the firm the results on capital investments and total firm investments are consistent with the differences in liquidity coefficients being potentially driven by differences in the mismeasurement of Q or that non-issuer firms are less liquidity constrained than issuer firms.

No. 648: Financial Constraints in Investment - Foreign Versus Domestic Firms. Panel Data Results From Estonia, 1995-1999.

*Tomasz Mickiewicz, Kate Bishop and Urmaz Varblane*

Using data from Estonian manufacturing firms during the period 1995-1999 we apply panel data techniques, in particular the Arellano-Bond (1991) method to investigate the investment behaviour. We employ the model of optimal capital accumulation in the presence of convex adjustment costs. We find that the domestic companies seem to be more financial constrained than those with the presence of foreign investors. Furthermore we find that smaller firms are more constrained than their larger counterparts.

No. 647: Legal Minimum Wages and the Wages of Formal and Informal Sector Workers in Costa Rica

*T.H. Gindling and Katherine Terrell*

The classic dual economy models of developing countries hold minimum wages (among other institutions) accountable for persistent dualism. They note that applying or enforcing minimum wage laws in only one sector of the economy will create wage differentials which will not be eroded with labor mobility to the high wage sector. In this paper we use 12 years of micro data on thousands workers living in Costa Rica to test whether legal minimum wages have a differential impact on the wages of workers in the formal sector vs. informal sector, defined in various ways in accordance with the dual development models. The evidence from Costa Rica is contrary to the assumptions of these models. We find that increases in minimum wages not only raise the wages of workers in the urban formal sector (large urban enterprises) who are covered by minimum wage law, but they also increase the wages of all other workers covered by minimum wage legislation in what are traditionally regarded as informal sectors and where the legislation is often considered not to be enforced. Specifically, we provide

evidence that minimum wages increase the wages of workers in small urban enterprises, large rural enterprises and small rural enterprises. Further, our results suggest that higher legal minimum wages raise the average wage of workers in these “informal” sectors more than in the urban formal sector. We concluded that in Costa Rica minimum wages are being enforced in the rural and small scale sectors and may actually work to reduce average wage differentials between these sectors and the urban formal sector. On the other hand, minimum wages have no significant impact on the wages of workers in another sector that is regarded as informal but which is not covered by minimum wage legislation: the self-employed workers (both urban and rural). Thus, one could argue that minimum wages may contribute to dualism between the formal and informal, defined as self-employed vs. salaried workers. However, we find no evidence of the bleaker scenario, that self-employed earnings are being lowered by minimum wages.

No. 646: Employment Expectations and Gross Flows by Type of Work Contract  
*Catalina Amuedo-Dorantes and Miguel Á. Malo*

There is growing interest in understanding firms’ temporary and permanent employment practices and how institutional changes shape them. Using data on Spanish establishments, we examine: (a) how employers adjust temporary and permanent job and worker flows to prior employment expectations, and (b) how the 1994 and 1997 labour reforms promoting permanent employment affected establishments’ employment practices. Generally, establishments’ prior employment expectations are realized through changes in all job and worker flows. However, establishments uniquely rely on temporary hires as a buffer to confront diminishing long-run employment expectations. None of the reforms significantly affected establishments’ net temporary or permanent employment flows.

No. 645: Transition on the Shop Floor - The Restructuring of a Weaving Mill, Hungary 1988-1997

*János Köllő*

While a variety of studies analysed the benign effects of privatisation on firm performance under post-socialist transition using financial data very little is known about how the apparent productivity gains were achieved. This paper follows a weaving mill from 1998 to 1997 on its way of becoming a capitalist enterprise and gives a detailed account of the sources and limits of productivity growth. The data suggests that the factory was not far from the competitive optimum given the size of ‘plant and equipment’ - efficiency gains were mostly achieved by plant size reduction and asset stripping. The gains from this sort of initial restructuring helped many former state enterprises stay on the market but they did not necessarily indicate high levels of adaptability, capacity to innovate and ability to attract outside investors. In economies with many ‘seemingly restructured’ privatised enterprises the elimination of the former state sector jobs is likely to continue within the private sector. The process may last for years after privatisation as a legal act had been fully accomplished.

No. 644: Fighting “Low Equilibria” by Doubling the Minimum Wage ?  
Hungary’s Experiment

*Gábor Kertei and János Köllő*

In January 2001 the Hungarian government increased the minimum wage from Ft 25,500 to Ft 40,000. One year later the wage floor rose further to Ft 50,000. The paper looks at the short-run impact of the first hike on small-firm employment and flows between employment and unemployment. It finds that the hike significantly increased labor costs and reduced employment in the small firm sector; and adversely affected the job retention and job finding probabilities of low-wage workers. While the conditions for a positive employment effect were mostly met in depressed regions spatial inequalities were amplified rather than reduced.

No. 643: Mind the Break! Accounting for Changing Patterns of Growth during Transition  
*Jan Fidrmuc and Ariane Tichit*

We argue that econometric analyses based on transition countries' data can be vulnerable to structural breaks across time and/or countries. We demonstrate this argument by identifying structural breaks in growth regressions estimated with data for 25 countries and 12 years. Our method allows identification of structural breaks at a-priori unknown points in space or time. The only prior assumption is that breaks occur in relation to progress in implementing market-oriented reforms. We find robust evidence that the pattern of growth in transition has changed at least two times, yielding thus three different models of growth associated with different stages of reform. The speed with which individual countries progress through these stages differs dramatically, however.

No. 642: The Monetary Approach to Exchange Rates in the CEECs  
*Jesús Crespo-Cuaresma, Jarko Fidrmuc and Ronald MacDonald*

A panel data set for six Central and Eastern European countries (the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia) is used to estimate the monetary exchange rate model with panel cointegration methods, including the Pooled Mean Group estimator, the Fully Modified Least Square estimator and the Dynamic Least Square estimator. The monetary model is able to convincingly explain the long-run dynamics of exchange rates in CEECs, particularly when this is supplemented by a Balassa-Samuelson effect. We then use our long-run monetary estimates to compute equilibrium exchange rates. Finally, we discuss the implications for the accession of selected countries to the European Economic and Monetary Union.

No. 641: Community Norms and Organizational Practices: The Legitimization of Wage Arrears in Russia, 1992-1999

*John S. Earle, Andrew Spicer and Klara Sabirianova Peter*

What role do community norms play in the diffusion and persistence of new organizational practices? We explore this question through an examination of the widespread practice of wage arrears, the late and nonpayment of wages, in Russia during the 1990s. Existing research on wage arrears most often examines this practice as a means of flexible wage adjustment under difficult economic conditions. We develop an alternative theory that explains wage arrears through their acceptance as a legitimate form of organizational behavior within local communities. Our empirical analysis finds some support for the neoclassical position that wage arrears reflect adjustment to negative shocks, but this perspective fails to account for a number of important facts, including a

high level of arrears among apparently successful firms. In contrast, our results find strong support for the institutional perspective. The statistical analysis demonstrates powerful and robust community effects both in firm adoption of this practice, controlling for firm performance, liquidity, and fixed firm effects, and in workers' reaction to arrears, through their quit (exit) and strike (voice) behavior.

No. 640: Trust in Transition: Cross Country and Firm Evidence

*Martin Raiser, Alan Rousso, and Franklin Steves*

This paper uses data from a large survey of firms across 26 transition countries to examine the determinants of trust in the transition process. We first introduce a new measure of trust between firms: the level of prepayment demanded by suppliers from their customers in advance of delivery. Using this new measure, we confirm earlier findings that trust is higher where firms have confidence in third party enforcement through the legal system. However, the fairness and honesty of the courts are a more important determinant of interfirm trust than are the courts' efficiency or ability to enforce decisions. We then examine the role of business networks in building trust and find that networks based around personal ties – family and friends – and business associations actively promote the development of trust, while business networks based on enterprise insiders and government agencies do not. Finally, we find that country-level effects are significantly more important determinants of interfirm trust than are firm-level effects.

No. 639: What Makes Small Firms Grow? Finance, Human Capital, Technical Assistance, and the Business Environment in Romania

*J. David Brown, John S. Earle and Dana Lup*

Although the development of a new private sector is generally considered crucial to economic transition and development, there has been little empirical research on the determinants of startup firm growth. This paper uses panel data techniques to analyze a survey of 297 new small enterprises in Romania containing detailed information from the startup date through 2001. We find strong evidence that access to external finance (loans) increases the growth of both employment and sales. Taxes appear to constrain growth. There is some evidence that entrepreneurial skills increase growth, but only weak evidence for the effectiveness of technical assistance, and only when it is provided by foreign partners or international agencies. A wide variety of alternative measures of the business environment (contract enforcement, property rights, and corruption) are tested, but are found to have little or no association with firm growth.

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