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Corporate Governance

Alan Greenspan*

Corporate governance[1] has evolved over the past century to more effectively promote the allocation of the nation's savings to its most productive uses. And, generally speaking, the resulting structure of business incentives, reporting, and accountability has served us well. We could not have achieved our current level of national productivity if corporate governance had been deeply flawed.

And yet, our most recent experiences with the bankruptcy of Enron and, preceding that, several lesser such incidents suggest that the governance of our corporations has strayed from our perceptions of how it is supposed to work. By law, shareholders own our corporations and, ideally, corporate managers should be working on behalf of shareholders to allocate business resources to their optimum use.

But as our economy has grown, and our business units have become ever larger, de facto shareholder control has diminished: Ownership has become more dispersed and few shareholders have sufficient stakes to individually influence the choice of boards of directors or chief executive officers. The vast majority of corporate share ownership is for investment, not to achieve operating control of a company.

More dispersed ownership has shifted control to the CEO

Thus, it has increasingly fallen to corporate officers, especially the chief executive officer, to guide the business, hopefully in what he or she perceives to be in the best interests of shareholders. Indeed, the boards of directors appointed by shareholders are in the overwhelming majority of cases chosen from the slate proposed by the CEO. The CEO sets the business strategy of the organization and strongly influences the choice of the accounting practices that measure the ongoing degree of success or failure of that strategy. Outside auditors are generally chosen by the CEO or by an audit committee of CEO-chosen directors. Shareholders usually perfunctorily affirm such choices.

To be sure, a CEO can maintain control over corporate governance only so long as companies are not demonstrably in difficulty. When companies do run into trouble, the *carte blanche* granted CEOs by shareholders is withdrawn. Existing shareholders, or successful hostile bidders for the corporation, usually then displace the board of directors and the CEO. Such changes in corporate leadership have been relatively rare but, more often than not, have contributed to a more effective allocation of corporate capital.

For the most part, despite providing limited incentives for board members to safeguard shareholder interests, this paradigm has worked well. We are fortunate, for financial markets have had no realistic alternative other than to depend on the chief executive officer to ensure an objective evaluation of the prospects of the corporation. Apart from a relatively few large institutional investors, not many existing or potential shareholders have the research capability to analyze corporate reports and thus to judge the investment value of a corporation. This vitally important service has become dominated by firms in the business of underwriting or selling securities.

But, as we can see from recent history, long-term earnings forecasts of brokerage-based securities analysts, on average, have been persistently overly optimistic. Three to five-year earnings forecasts for each of the S&P 500 corporations, compiled from projections of securities analysts by I/B/E/S, averaged almost 12 percent per year between 1985 and 2001. Actual earnings growth over that period averaged about 7 percent.

Perhaps the last sixteen years, for which systematic data have been available, are an historical aber-

* Remarks at the Stern School of Business, New York University, New York, New York March 26, 2002.

[1] On topics such as nonfinancial corporate governance, which is not in the Federal Reserve Board's jurisdiction, I am obviously speaking for myself. In addition, my comments do not represent the official views on this subject of the President's Working Group on Financial Markets, of which I am a member.

ration. But the persistence of the bias year after year suggests that it more likely results, at least in part, from the proclivity of firms that sell securities to retain and promote analysts with an optimistic inclination. Moreover, the bias apparently has been especially large when the brokerage firm issuing the forecast also serves as an underwriter for the company's securities.

The performance of securities analysts may improve as a result of the recent joint initiative by the National Association of Securities Dealers and the New York Stock Exchange to require brokerage firms to include in research reports the distribution of the firms' ratings, among "buy", "sell", and "hold", for example. Brokerage firms must also include in research reports a record that indicates when an analyst assigned or changed a rating for a company.

Investors' interest has shifted from dividends to earnings

I suspect that with the underlying database publicly available, it is just a matter of time before the ex-post results of analysts' recommendations are compiled and published on a regular basis. I venture to say that with such transparency, the current upward bias of analysts' earnings projections would diminish rather rapidly, because investment firms are well aware that security analysis without credibility has no market value.

Prior to the past several decades, earnings forecasts were not nearly so important a factor in assessing the value of corporations. In fact, I do not recall price-to-earnings ratios as a prominent statistic in the 1950s. Instead, investors tended to value stocks on the basis of their dividend yields. Since the early 1980s, however, corporations increasingly have been paying out cash to shareholders in the form of share repurchases rather than dividends. The marginal individual tax rate on dividends, with rare exceptions, has always been higher than the marginal tax rate on capital gains that repurchases create by raising per share earnings through share reduction. But, until the early 1980s, share repurchases were frowned upon by the Securities and Exchange Commission, and companies that repurchased shares took the risk of being investigated for price manipulation.

In 1982, the SEC gave companies a safe harbor to conduct share repurchases without risk of investigation. This action prompted a marked shift toward repurchases in lieu of dividends to avail shareholders of a lower tax rate on their cash receipts. More recently, a desire to manage shareholder dilution from the rising incidence of employee stock options has also spurred repurchases.

As a consequence, dividend payout ratios, which in decades past averaged about 55 percent, have in recent years fallen on average to about 35 percent. But because share prices have risen so much more than earnings in recent years, dividend yields – the ratio of dividends per share to a company's share price – have fallen appreciably more than the payout ratio. A half-century ago, for example, dividend yields on stocks typically averaged 6 percent. Today such yields are barely above 1 percent.

The sharp fall in dividend payout ratios and yields has dramatically shifted the focus of stock price evaluation toward earnings. Unlike cash dividends, whose value is unambiguous, there is no unambiguously "correct" value of earnings.

Although most pretax profits reflect cash receipts less out-of-pocket cash costs, a significant part results from changes in balance-sheet valuations. The values of almost all assets are based on the assets' ability to produce future income. But an appropriate judgment of that asset value depends critically on a forecast of forthcoming events, which by their nature are uncertain.

A bank, for example, books interest paid on a loan as current revenue. However, if the borrower subsequently defaults, that presumed interest payment would, in retrospect, be seen as a partial return of principal. We seek to cope with this uncertainty by constructing loan reserves, but the adequacy of those reserves is also subject to a forecast. Depreciation charges against income, based on book values, are very crude approximations of deterioration in the economic value of physical plant. The actual deterioration will not be known until the asset is retired or sold. And projections of future investment returns on defined-benefit pension plans markedly affect corporate pension contributions and, hence, pre-tax profits. Thus, how one chooses to evaluate the future income potential of the balance sheet has a significant impact on current reported earnings.

Earnings uncertainty has been particularly elevated in recent years. Improvements in information technology have created new opportunities for innovative companies, but an environment of rapid technological change is also one in which the resulting profit opportunities are difficult to assess and project. In particular, such rapid change has heightened the potential for competitors to encroach on established market positions. This process of capital reallocation has not only increased the long-term earnings growth potential of the economy as a whole, but has widened as well the degree of uncertainty for individual firms.

Not surprisingly then, with the longer-term outlook increasingly amorphous, the level and recent growth of short-term earnings have taken on special significance in stock price evaluation, with quarterly earnings reports subject to anticipation, rumor, and "spin." Such tactics, presumably, attempt to induce investors to extrapolate short-term trends into a favorable long-term view that would raise the current stock price.

CEOs, under increasing pressure from the investment community to meet short-term elevated expectations, in too many instances have been drawn to accounting devices whose sole purpose is arguably to obscure potential adverse results. Outside auditors, on several well-publicized occasions, have sanctioned such devices, allegedly for fear of losing valued corporate clients. Thus, it is not surprising that since 1998 earnings restatements have proliferated. This situation is a far cry from earlier decades when, if my recollection serves me correctly, firms competed on the basis of which one had the most conservative set of books. Short-term stock price values then seemed less of a focus than maintaining unquestioned credit worthiness.

A change in behavior, however, may already be in train. The sharp decline in stock and bond prices following Enron's collapse has chastened many of the uncritical practitioners of questionable accounting. Corporate reputation is fortunately reemerging out of the ashes of the Enron debacle as a significant economic value. Markets are evidently beginning to put a price-earnings premium on reported earnings that appear free of spin. Likewise, perceptions of the reliability of firms' financial statements are increasingly reflected in yield spreads on corporate bonds. Corporate governance has doubtless already measurably improved as a result of this greater market discipline in the wake of recent events.

But the Congress is clearly signaling that more needs to be done. I hope that any legislative and regulatory initiatives will move to further realign current practice with the de jure governance model that served us well in generations past. Most success in that direction would seem to come primarily from changes in incentives for corporate officers.

In particular, as President Bush has suggested, defining more clearly the duties of CEOs with respect to accounting and disclosure appears appropriate. There are, doubtless, other measures that could reinforce the aforementioned Enron-induced market incentives for disclosures and thereby strengthen investors' trust, which is so essential to the effective functioning of free-market capitalism.

We have to be careful, however, not to look to a significant expansion of regulation as the solution to current problems, especially as price-earnings ratios increasingly reflect the market's perception of the quality of accounting. Regulation has, over the years, proven only partially successful in dissuading individuals from playing with the rules of accounting.

Earnings uncertainty and elevated expectations have led to questionable accounting practices

Some changes, however, appear overdue. In principle, stock-option grants, properly constructed, can be highly effective in aligning corporate officers' incentives with those of shareholders. Regrettably, the current accounting for options has created some perverse effects on the quality of corporate disclosures that, arguably, is further complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance. The failure to include the value of most stock-option grants as employee compensation and, hence, to subtract them from pretax profits, has increased reported earnings and presumably stock prices. This would be the case even if offsets for expired, unexercised options were made. The Financial Accounting Standards Board proposed to require expensing in the early to middle 1990s but abandoned the proposal in the face of significant political pressure.

The Federal Reserve staff estimates that the substitution of unexpensed option grants for cash compensation added about 2½ percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. Many argue that this distortion to reported earnings growth contributed to a misallocation of capital investment, especially in high-tech firms.

If market participants indeed have been misled, that, in itself, should be surprising, for there is little mystery about the effect of stock-option grants on earnings reported to shareholders. Accounting rules require that enough data on option grants be reported in footnotes to corporate financial statements to enable analysts to calculate reasonable estimates of their effect on earnings.

Some have argued that Black-Scholes option pricing, the prevailing means of estimating option expense, is approximate. But so is a good deal of all other earnings estimation, as I indicated earlier. Moreover, every corporation does report an implicit estimate of option expense on its income statement. That number for most, of course, is zero. Are option grants truly without any value?

Needed are changes in behavior and in accounting rules and other codes

Critics of option expensing have also argued that expensing will make raising capital more difficult. But expensing is only a bookkeeping transaction. Nothing real is changed in the actual operations or cash flow of the corporation. If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been. Capital employed on the basis of misinformation is likely to be capital misused.

Critics of expensing also argue that the availability of options enables corporations to attract more-productive employees. That may well be true. But option expensing in no way precludes the issuance of options. To be sure, lower reported earnings as a result of expensing could temper stock price increases and thereby exacerbate the effects of share dilution. That, presumably, could inhibit option issuance. But again, that inhibition would be appropriate, because it would reflect the correction of misinformation.

In a further endeavor to align boards of directors with shareholders, rather than management, considerable attention has been placed on filling board seats with so-called independent directors. However, in my experience, few directors in modern times have seen their interests as separate from those of the CEO, who effectively appointed them and, presumably, could remove them from future slates of directors submitted to shareholders.

I do not deny that laws could be passed to force selection of slates of directors who are patently independent of CEO influence and thereby significantly diminish the role of the CEO. I suspect, however, that such an initiative, while ensuring independent directors, would create competing power centers within a corporation, and thus dilute coherent control and impair effective governance.

After considerable soul-searching and many congressional hearings, the current CEO-dominant paradigm, with all its faults, will likely continue to be viewed as the most viable form of corporate governance for today's world. The only credible alternative is for large – primarily institutional – shareholders to exert far more control over corporate affairs than they appear to be willing to exercise.

Fortunately, it seems clear that, if the CEO chooses to govern in the interests of shareholders, he or she can, by example and through oversight, induce corporate colleagues and outside auditors to behave in ways that produce de facto governance that matches the de jure shareholder-led model. Such CEO leadership is critical for achieving the optimum allocation of the nation's corporate capital.

Before concluding, I should like to emphasize that a market economy requires a structure of formal rules – a law of contracts, bankruptcy statutes, a code of shareholder rights – to name but a few. But rules cannot substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could not be exchanged efficiently.

Companies run by people with high ethical standards arguably do not need detailed rules to act in the long-run interests of shareholders and, presumably, themselves. But, regrettably, human beings come as we are – some with enviable standards, but others who continually seek to cut corners. Yet there can be only one set of rules for corporate governance, and it must apply to all. Crafting the rules to provide the proper mix of regulatory and market-based incentives and penalties has never been easy. And I suspect that even after we get beyond the Enron debacle, crafting and updating such rules will continue to be a challenge.

Corporate Governance and Shareholder Value: How did we get here and where are we going?

Fred R. Kaen*

The Roots: Modern Financial Theory

Modern financial theory emerged in the late 1950s and early 1960s to provide a scientific basis for explaining corporate investment, financing and dividend decisions. I emphasize the word scientific because many academics believed the financial decision-making rules of practitioners were riddled with inconsistencies and made no logical sense.

For example, a typical story about why firms should use debt financing was that the stock price of the firm would be unaffected because investors wouldn't notice or care as long as not too much debt was used and, as a result, the overall cost of financing the company would fall. No "scientific" theory existed as to why this would happen, or for that matter, why and how any financing decision, including the decision to pay cash dividends, would affect the company's market value and stock price.

Lurking in the background of pre-modern finance was also the idea that the earnings a corporation retained and reinvested in the company were costless. And as this source of equity capital was costless, managers did not have to worry about how they invested these earnings or whether they earned an adequate return on this capital. This attitude about retained earnings is duly noted in Adolph Berle's preface to the 1967 re-issue of his classic work (Berle and Means 1967), where Berle writes:

> "The purchaser of stock does not contribute savings to an enterprise, thus enabling it to increase its plant operations. He does not take the "risk" on a new or increased economic operation; he merely estimates the chance of the corporation's shares increasing in value. The contribution his purchase makes to anyone other than himself is the maintenance of liquidity for other shareholders who may wish to convert their holdings into cash. Clearly, he cannot and does not intend to contribute managerial or entrepreneurial effort or service."

And then came the revolution of modern finance theory. It began with Harry Markowitz giving us portfolio theory and formalizing what the English merchants already knew in the 17th century – don't send all your cargo in one ship (Markowitz 1959). Benoit Mandelbrot (1966) and Eugene Fama (1970) gave us market efficiency – don't look for twenty-dollar bills on the floor; but if you find one, pick it up quickly before it's gone. Modigliani and Miller (1959) told us that in perfect capital markets financing and dividend decisions didn't matter – at least for the shareholders – so don't waste time with worrying about whether and how much debt to use. And, William Sharpe (1964) and others introduced us to beta and the capital asset pricing model.

Modern finance theory: "What determines the market value of a firm?"

Fundamentally, these founders of modern financial theory were concerned with a very important public policy as well as scientific question: What determines the market value of a company and, in particular, the per share stock price in efficient markets? The answer was: the greater the cash flows and the lower the risk, the more the company is worth. In other words, these "scientists" produced "scientific" models that showed a manager how to maximize the company's market value and share price. As to whether managers should and would make decisions to maximize share price was another matter. And, here is where corporate governance reemerged from historical debates about the modern corporation and how it should be controlled and managed.

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The German/ Japanese model vs. the U.S. model of corporate governance

The Corporate Governance Debate

Especially in the United States, the debate was about how to ensure that managers of publicly owned corporations would manage the firm in the best interests of society rather than in their own personal interests or the interests of political oligarchy. A number of proposals were advanced; but the one that concerns us here is that which says the best way to make sure managers use resources efficiently is to have them maximize shareholder value and return any cash that cannot be profitably invested to the shareholders. This is the "should" part.

A good way to get a handle on the "should" part and how it has influenced the corporate governance debate in the post-"modern finance" era is to go back to the early 1980s and recall the often emotional debates about the demise of American corporations and the superiority of the German and especially Japanese corporate governance systems.

In a classic article, Hayes and Abernathy (1980) were confident that America was in decline and they knew why. It was the short-term myopic behavior of managers who focused on quarterly earnings, ROI (return on investment) and other accounting performance measures that supposedly led to a reduction in R&D expenditures and the development of new technologies. And who was responsible for this? Well, supposedly it was short-term myopic stockholders who demanded high ROIs and quarterly increases in earnings per share at the expense of long-term growth – in other words, financial markets.

According to these and other critics, the problem with the American economy was a capital-market-based corporate governance system with public shareholders and institutional investors forcing management to make decisions not in the best interests of the economy as a whole. And, what was the solution? Imitate the Germans and the Japanese (Porter 1992).

What was the "scientific" evidence behind these condemnations of markets and institutional investors? Not much! In fact, the evidence that began emerging from academic studies done by financial economists suggested just the opposite. Woolridge's study of market reactions to corporate investment decisions is typical of the accumulated evidence (Woolridge 1988). He found that company stock prices actually went up (not down) when companies announced increases in research and development expenditures, new product introductions and capital expenditures for capacity expansion and plant modernization.

What was going on here? Maybe the problem was not the investors but rather the managers and other organizational stakeholders who, like everyone else, acted in their own self-interest. Now we are back to the question: How do we get managers to make economically efficient investments and distribute any remaining cash to the shareholders rather than keep it for themselves? How do the suppliers of capital make sure they get back their investment as well as a return on their money?

Here is where corporate governance comes into its own.[1] What we want are ways to align the interests of managers with those of the shareholders, to ensure that managers and boards of directors represent the interests of the public shareholder or their representatives – the pension funds and mutual funds – and *make it possible for shareholders to monitor and replace management and directors who attempt to extract wealth from the public shareholders.*

Monitoring and Controlling Managers

One of the most popular answers in the 1990s for controlling managers and aligning their interests with the shareholders was pay for performance. But, how do you measure performance?

If we go back to the critique of Abernathy and Hayes about manager myopia, we find that they focused almost exclusively on ROI as the measure that was causing short-termism. This outcome occurred because ROI, like other financial statement measures such as net income and earnings per share, are backward looking accounting measures easily subject to the manipulation of managers. Instead, why not measure managerial performance and compensate managers using stock prices – the very thing shareholders wanted man-

[1] The "should" part remains controversial and lies at the heart of the growing protests and concerns over globalization, the power of multinational corporations and proposals for a new international architecture.

agement to maximize. Or, alternatively, award stock based on stock price performance. As long as you believe financial markets are efficient and investors are not myopic, stock options and stock ownership are reasonable means for aligning managerial interests with public shareholders. But for investors to properly price out the stock, they need dependable, trustworthy and transparent financial statements. No "cooked books", thank you!

Other useful ways for controlling managers from a disciplinary perspective have to do with the company's financing and dividend policies. In doing so, however, we transform the financing and dividend decision from one focused solely on identifying that capital structure which minimizes the company's cost of capital to a governance question of how investors control managers and prevent them from making unprofitable investments.

The best way to grasp this shift is to look at the data in the exhibit below. When we arrange a variety of investment and financing events according to whether they generate cash flows from the firm to investors or from investors to the firm, we find the former all have positive returns and the latter all negative returns. Why?

Michael Jensen's answer is the free cash flow theory of corporate finance (Jensen 1986). Investors like to get cash from companies and do not like to leave cash lying around for managers to spend on other things unless, and this is the big unless, they can invest these funds in growth opportunities. But how do you keep managers from squandering shareholder funds? You finance the company with debt instead of equity, because debt requires periodic outflows of cash from the company in the form of interest and principal payments. You also pay cash dividends or buy back your stock – the same thing as a cash dividend payment.

Of course, not all companies pay cash dividends and not all companies have debt in their capital structure. Does this mean something is wrong with the free cash flow story? Not really. For companies with substantial growth opportunities you want managers to have wide discretion over the cash flows so as to be able to take advantage of these opportunities. You also don't want to burden them with debt financing and the restrictions normally associated with bank loans. Thus, these are the firms who should not pay cash dividends and avoid debt.

How to align the interest of managers with those of the shareholders?

Now we have a story about why managers should maximize shareholder value and a governance story about how managerial compensation schemes and financing and dividend decisions can be used to align the interests of managers with those of shareholders and control managerial behavior. What we are missing is a story about why managers would do any of this or why boards and directors would be responsive to shareholder instead of management concerns. The question is: Suppose public investors don't like what the boards and management are doing with their money. What can they do about it? The answer is a market for corporate control, a legal system that protects the rights of public investors to vote their shares and fend off attempts by corporate boards and insiders to disenfranchise them and an accounting and financial reporting system that investors can trust.

Also important in the U.S. was the growth of institutional investors in the 1990s. As these became more active, corporate boards and management came under increased scrutiny and, by the 1990s, were confronted with a set of cor-

Exhibit

Stock Returns Adjusted for Overall Market Performance with Respect to Cash Flows Between the Firm and its Shareholders

	Two-Day Stock Return
CASH FLOWING FROM THE COMPANY TO THE SHAREHOLDERS	
Common stock repurchases	
Tender offer	16.2%
Open-market purchases	3.6
Dividend Increases	
Dividend initiation	3.7
Dividend increase	0.9
Special dividend	2.1
Investment increases	1.0
CASH FLOWING FROM SHAREHOLDERS TO THE COMPANY	
Security sales	
Common stock	– 1.6
Preferred stock	0.1
Convertible preferred	– 1.4
Convertible debt	– 2.1
Straight debt	– 0.2
Dividend decreases	– 3.6
Investment decreases	– 1.1

Source: Clifford W. Smith, Jr., 1986, "Raising Capital: Theory and Evidence," *Midland Corporate Finance Journal,* 4, pp. 6–22.

porate governance guidelines such as those developed by the largest US institutional investor (TIAA-CREF 2000).

TIAA-CREF (Teachers Insurance and Annuity Association – College Retirement Equity Fund) is really quite blunt about its corporate governance concerns. It says that "corporate governance initiatives – in which TIAA-CREF monitors the companies it invests in and presses for improved management when appropriate – is an important aspect of ensuring that the investments we make on behalf of participants produce the highest possible returns."

A market for corporate control and active institutional investors

And then came Enron, Tyco, WorldCom and a host of other governance fiascos. What failed and why?

What Went Wrong?

Popular attention in these high profile debacles has focused on the pay of senior management, especially pay-for-performance schemes connected to stock options. Essentially, management sought ways to inflate and aggressively manage and manipulate revenues and earnings so as "to fool" or mislead investors into driving up the company's stock price and make their stock options ever more valuable. Additionally, balance sheets were managed so as to keep debt off the books, again misleading investors. For example, Citigroup and J.P. Morgan lent Enron billions of dollars disguised as energy trades on Enron's balance sheet. But, how could this happen in a world where companies were audited and financial statements certified by public accounting firms such as Arthur Andersen so as to prevent just such an outcome from happening?

Cooking the books and conflicts of interest

Well, the public accounting firms may have been more interested in earning consulting fees from the managers of the firms they were auditing and retaining the company's auditing business than in representing the clients who, in theory, had hired them – the shareholders. In 2001, for example, non-audit fees comprised over fifty percent of the fees paid to accounting firms by 28 of the 30 companies making up the Dow Jones Industrial Average.[2]

And the directors? Where were the directors?

[2] "Accounting Industry Fights Calls for 'Audit Only' Rules," *Wall Street Journal*, March 7, 2002, p. C1.

It turns out that directors are effectively appointed by corporate management, not by the shareholders – even if they are the so-called independent directors with no direct ties to the company. Consequently, the directors often face their own conflicts of interest with respect to keeping their directorships and the benefits that go with them and guarding the interests of the public shareholders.

Tyco Corporation offers an example of a board member receiving consulting fees as well as having the company donate money to a selected charity. Tyco International paid a total of $20 million to an outside director and to a charity he controlled, in return for his help in brokering a major acquisition in 2001.[3] Similar donations appear to have occurred at Enron.[4]

What can be done to eliminate these abuses?

The Board Of Directors

Clearly, independent directors must be independent and they should be a majority of the board. Past executives, consultants and individuals beholden to current management for charitable contributions and so forth are not independent.

As for the election of directors, reforms are needed to make it much easier for shareholders to elect directors other than those proposed and beholden to management. One such reform would be to have institutional investors nominate directors in addition to the management nominees. Also, much easier access to shareholders of record by competing control groups would help by permitting the contesting groups to "campaign" for votes.

Other board reforms could include requiring independent board members to meet separately from inside members for evaluating corporate and managerial performance, requiring the Board chairman to be selected from the independent members or at least prohibiting the CEO from also serving as the Board chairperson and restricting the number of boards on which a person can serve.

[3] "Tyco Paid Director For Advisement on CIT Merger," Monitor Daily, January 29, 2002, http://www.monitordily.com/story_page.cfm?News_id.
[4] Janet Elliott, "UT dean's Enron ties questioned," *Houston Chronicle*, January 17, 2002, http://www.HoustonChronicle.com.

Accounting And Financial Reporting

Many people would address the aggressive accounting and manipulation of earnings problem by simply prohibiting the accounting firm that audits the company's financial statements from also providing consulting services to the company. Some institutional investors have already moved in this direction with regard to how they vote their shares. The California Public Employees' Retirement System (Calpers) has announced it will vote against reappointing auditors at companies where the auditors also provide consulting services. And, recent legislation enacted in the U.S. prohibits auditors from also selling certain consulting services to their clients.

But, the most important task here is to restore the integrity of the accounting profession and the confidence investors have in the way financial statements are prepared. The U.S. has moved in this direction by establishing an independent government board to oversee corporate audits. Still, more than independent oversight is necessary.

Restoring the integrity of the accounting profession

A good place to start (in addition to getting rid of special entity vehicles used to hide debt) is with reporting stock options as expenses. These options are compensation and compensation is an expense; therefore it should be recognized as such on the income statement. The argument against expensing options is that it would drive down the company's stock price making it more difficult to attract employees. In other words, the argument against expensing options is that companies need to fool investors into paying more for the company than it is worth!

Maybe what is really needed is to jettison the current U.S. accounting system, which relies extensively on rules. Under this system, accountants and managers are more likely to ask whether they are "breaking the rules" rather than whether they are reporting the true financial position of the company and complying with the spirit of the accounting standards. The European system under the U.K based International Accounting Standards Board (IASB) has far fewer rules. Instead, the objective is to provide a true and honest representation of the transaction.

Managerial Pay

One of the biggest scandals arising out of the Enron fiasco is CEO pay. In theory, agency costs can be reduced by tying managerial pay to performance through stock options and bonuses dependent on achieving certain financial goals such as return on equity. But, it now appears that managers were manipulating financial statements so as to drive up stock prices and cash in on the bonuses and options. Furthermore, CEOs of now bankrupt companies walked away with millions of dollars while the companies were going under and employees were losing their jobs.[5] How did these and other managers manage to get these pay packages?

Once again we are back to the cozy relationship that exists between senior managers and their boards, because the boards must approve these packages. And, we are also back to the lack of transparency regarding managerial pay. Without considerable effort, it is nearly impossible to figure out the "true" compensation of an executive from forms filed with the SEC.

What is the answer? Tying compensation more closely to the performance of the company relative to other firms in its industry and the overall stock market would help. Another solution would be to have the shareholders vote on the pay for senior managers.

Making transparent the true compensation of managers

New legislation in the U.S. has addressed the "pay" issue by banning personal loans to the top executives of public companies and by requiring shareholder approval of option plans. But more needs to be done, especially with regard to the transparency question and letting shareholders vote on overall compensation plans.

Where Are We Going?

In 1776, Adam Smith had the following to say about public corporations, then called joint-stock companies (Smith 1776):

"The directors of such [joint stock] companies, however, being the managers of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. ...

[5] Ian Cheng, "Survivors Who Laughed All the Way to the Bank," *Financial Times*, July 30, 2002.

Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Today, it looks like Smith was prescient. The Board of Directors of many U.S corporations have failed to carry out the spirit of their "duty of care" to the public shareholders. Instead, they let management, and some would say assisted it in the act, extract wealth from the public by manipulating earnings, awarding themselves excessive compensation and engaging in dubious schemes to hide the deteriorating financial performance of their companies.

The board of directors must be held accountable

In other words, we are still muddling our way through the morass of how to ensure that managers of publicly held corporations (where management is separated from owners) don't misuse scarce resources or line their own pockets at the expense of the other stakeholders of the firm. The lesson of the current "crisis" is that public shareholders need to be better empowered to control managers and to hold accountable the directors of public corporations. For such empowerment to occur, major accounting reforms are needed along with governance changes designed to protect the individual (small) investor. Without such changes, we are likely to see an exit of the small investor and an increased concentration of ownership of corporations as the solution to holding management accountable, a governance arrangement commonly found in countries with weak investor protection laws. We are also likely to see an increase in the cost of equity capital leading to a reduction in investment and the overall performance of the economy.

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Corporate governance in the UK – contrasted with the US system[1]

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1. Introduction

Who governs UK companies and how well do they do it? The immediate response that most people would give is the board of directors and they operate largely in their own self-interest. Few people would see shareholders as being at the helm. The one exception is takeovers when shareholders get the upper hand.

The difficulties of shareholder activism are illustrated by the activities of Phillips and Drew in 1998. Despite perceived poor performance, the management of some of the companies, in which they had large shareholdings, stubbornly remained in place.[2] As a result, Phillips and Drew actively used their holdings to encourage hostile takeovers. In the case of Marley, the buildings and materials group, Phillips and Drew approached John Mansfield, a much smaller company than Marley, and pledged their holding of 24.9% in a forthcoming hostile bid. They also agreed to invest 1.5 million pounds in Mansfield if their bid failed. The hostile bid for Marley produced a series of competing bids, and large profits for the fund managers. What is striking about this case is the inability of financial institutions to effect changes in control in manifestly poorly performing companies and that in the end Phillips and Drew had to stimulate a takeover market to achieve this.

What underlies this perception of passive governance is the highly dispersed nature of share ownership in the UK. As has been by now well documented, in comparison with virtually every Continental European country, Far Eastern and South American country, the UK has exceptionally dispersed ownership (see La Porta et al. (1999)). In most countries a high proportion of companies have single majority shareholders in even the largest quoted companies. However, dispersal of ownership in the US is comparable to that in the UK. The US is therefore a particularly important country against which to compare UK governance because, unlike Continental Europe and most of the rest of the world, the underlying structure of its capital markets and companies is similar.

In a paper with Luc Renneboog (2001) we document the structure of ownership of UK companies, we examine how well governance functions in rectifying management of poorly performing firms, and we draw contrasts with the US. The main observations on which we expand in the subsequent sections are:

- While ownership is dispersed in the UK in comparison with most other countries, coalitions of 5 shareholders can on average control more than 30% of outstanding equity.
- There is little evidence that shareholders in practice exercise this potential to exert control.
- The single most important holders of large blocks are insiders (directors) who use their holdings to resist outside intervention.
- Boards play a weak role in corporate governance. Non-executive directors do not in general perform a disciplinary function. An important exception is when the role of CEO and chairman are separated.
- In addition to an active takeover market, there is a market in blocks of shares.
- Neither hostile takeovers nor markets in share blocks are associated with the disciplining of the

Corporate governance in the UK does not rely on active shareholders ...

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[1] A previous version of this paper was prepared for the UK Government's Company Law Review, Committee E on Corporate Governance.

[2] See the article in The Financial Times, The ABC of management performance, according to P&D, December, 1998.

management of poorly performing firms, with the exception of holdings held by industrial companies.

These observations stand in some contrast to those reported in the US:

- Boards of directors are important in disciplining management. Non-executive directors play an important role in this process.
- Disciplinary takeovers and the market in share blocks in the US are both associated with poorly performing companies.

In the absence of active shareholder involvement, governance in the UK relies on financial constraints. We find that:

... but on financial constraints

- Management is more likely to be replaced in poorly performing companies that have poor financial ratios.
- There is a high level of (distressed) new equity issues by poorly performing UK companies. These are associated with a high level of managerial changes.

What can explain these differences, notwithstanding the similar structures of the two countries' capital markets? We believe that legal rules and regulation play a key role. There are two areas where we believe that regulatory differences between the UK and US are particularly significant: fiduciary responsibilities of directors and protection of minorities, in particular in relation to takeovers and new equity issues. The former are significantly weaker and the latter significantly stronger in the UK than in the US, leading to a reliance of governance in the UK on financial constraints relative to boards.

In section 2 of this paper, we describe the performance of the takeover market and the extent to which managerial changes are related to poor performance. In section 3 we describe the results of the research into UK governance mechanisms. In section 4 we explore how governance outcomes in the US and UK might be explained in terms of differences in legal and regulatory rules and we discuss how recent events in the US have altered our perception of corporate governance.

2. Market for corporate control

In this section on the takeover market we discuss three questions:

– Do takeovers increase shareholder value?
– What role do hostile takeovers play in disciplining poorly performing management?
– Do targets underperform prior to being acquired?

Do takeovers increase shareholder value?

In Table 1 below, we show the results of a recent paper by Loughran and Vijh (1997) for a large sample of takeovers in the US that took place over the period 1970–1989. They measure the returns from a buy and hold strategy for shareholders of the target over the announcement period of the takeover and up to 5 years subsequent to the consummation of the merger. For the purposes of calculating returns, it is assumed that the shareholders of the target purchase shares in the bidder when the offer is accepted, at a price that reflects any bid premium. The excess returns around the announcement date, i.e. the bid premium, are about the same in mergers as in tender offers, 25.8% versus 24.5%. However, after 5 years the cumulative returns to shareholders in the merged firm has hardly changed from 25.8% to 29.6% i.e. there are virtually no abnormal returns to the acquiring firm over this period. In contrast, the returns in tender offers have improved dramatically from 24.5% to 126.9%, suggesting large post merger gains, in excess of those anticipated on announcement. All

Table 1
Cumulative excess returns of 516 US merging firms from the bid announcement to 5 years post merger in the period 1970 to 1989

	No.	Announcement Period	Year 1	Year 2	Year 3	Year 4	Year 5
		%					
Mergers	419	25.8	28.5	24.0	20.9	30.4	29.6
Tender offers	97	24.5	42.2	48.4	69.6	81.6	126.9

Announcement period begins 2 days prior to the announcement date and ends with the effective date of the acquisition.
Loughran & Vijh (1997).

these returns are after the deduction of returns on a suitable benchmark, thereby measuring 'excess' or 'abnormal' returns.

The authors' explanation for the difference in tender offers and mergers is 'that tender offers, which are often hostile to incumbent managers, may create additional value as new managers are appointed. In the case of mergers, that are friendlier and enjoy the co-operation of incumbent management, the additional value creation is less likely to occur.' (Page 1787).

Table 2 provides a measure of performance for a large sample of UK takeovers by Higson and Elliot (1996) that took place over the period 1975 to 1990. The abnormal returns are calculated after deducting the returns of a benchmark consisting of a sample of non-merging companies of equivalent size to the merging companies. The bid premium to target shareholders averages 37.5%, although it is larger in hostile bids, at 42.7%, compared with 36.6% for friendly bids. Bidders do far less well earning abnormal returns of about 0.43% or 1.3% on a value weighted basis. Thus, there are substantial gains to shareholders from takeovers but virtually all the gains accrue to the target. The long run returns of these takeovers are roughly breakeven on an equal weighted basis, although value weighted returns of 12% suggest that larger acquisitions, relative to the bidder, perform better than smaller ones.[3]

Role of hostile takeovers in disciplining poorly performing management

Although only 15% of all acquisitions in the sample, hostile takeovers comprise 40% of the largest 100 takeovers. Not only are the announcement returns i.e. the bid premium, to target shareholders higher in hostile takeovers, but the long-term performance of the combined company, subsequent to the merger, is better: 12.8% over 24 months compared with 1.33% for the top 100.

[3] Note that these long run returns do not include the bid premium.

Table 2
Long-term performance for a sample of 722 UK takeovers in the period 1975 to 1990

	Announcement month		Abnormal returns in 3 years post merger
	Bidder %	Target %	%
Abnormal returns: equal weighted	0.43	37.5	0.83
Value weighted	1.3	33.2	12.0

Higson and Elliot (1996).

Franks and Mayer (1996) made a detailed study of 80 hostile takeover bids in the UK in 1985–1986. Like Higson and Elliot, they found much larger bid premiums for successful tender offers where management opposed the bid, compared with friendly bids: 29.8% compared with 18.4%. In opposed bids there was also a very high degree of management replacement after the bid. On average, 90% of the target board was replaced compared with only 50% in friendly bids. They attributed the higher bid premiums in hostile takeovers to larger merger benefits rather than to lower returns to bidders.[4]

Are takeovers about the acquisition of underperforming companies?

If the market for corporate control is about replacing weak management, we might expect evidence that the targets of hostile takeovers are on average underperforming companies; however, UK evidence suggests little underperformance prior to the bid. For example, over the five-years prior to the bid, targets of hostile takeovers appreciated by only – 0.14% per year; these returns included both dividends and capital gains. The returns are virtually zero. The equivalent performance of the non-merging sample is + 0.14%, again close to zero. Shorter periods show somewhat worse performance for targets of hostile bids, but still not very poor performance.[5]

In the UK hostile takeovers are more profitable for shareholders, although the target may not have been underperforming

The main research findings for the UK are that takeovers in general are good for shareholders, although most of the gains accrue to the target.[6] Hostile takeovers look even more profitable and this may be attributable to a greater willingness to change management and make other more radical

[4] Hostile takeovers may also be effective as a threat to managers. Thus, performance may be affected even in the absence of a bid.
[5] Using another benchmark consisting of dividend changes, the authors found confirmation that the majority of targets of hostile takeovers were not poor performers.
[6] Accounting studies show somewhat different results to share price studies. Meeks (1977) compares the accounting return on assets of the merging firm both before and after the event. They find much lower returns post-merger, and attribute the lower return to losses on the acquisition. A study by Ravenscraft and Scherer (1987) in the US shows similar results. A study by Healy, Palepu and Ruback (1992) show that when you convert the accounting rates of return to economic rates of return there are gains to merging.

changes. However, the targets of hostile takeovers do not show evidence of past poor performance. Targets look to be average, or slightly below average, performers in comparison with other quoted companies.

Experience with US takeovers appears different in one important respect. A study on hostile takeovers by Martin and McConnell (1991) found higher bid premiums in hostile than in friendly takeovers, and that takeovers, which led to the replacement of the top manager in the target, tended to underperform their non-merging industry counterparts prior to a bid. Shareholders of such targets suffered abnormal returns of – 15.4% compared with + 4.4% for targets, which were non-disciplinary. They concluded that 'the takeover market plays an important role in controlling the non-value maximising behaviour of top corporate managers.' (page 671). Thus, the US market operates more like a market for corporate control than the UK market.

US studies show that hostile takeovers improve value through managerial change

Another study of US hostile takeovers by Bhide (1989) uses a different methodology to examine the issue of whether hostile takeovers improve value through managerial change. He examined case studies of the restructuring activities that followed 47 US hostile takeovers attempted between 1985–1986 and compared them with a randomly selected group of friendly takeover transactions. He found that hostile transactions were characterised by added value in the acquisition process whereas friendly acquisitions showed little evidence of synergies. The latter were largely well managed companies and its management was largely left in place.

Even if takeover markets function well as a market for corporate control they appear to be especially expensive when the sole or prime objective is managerial replacement or the correction of managerial failure. The costs of changing control are high and are significantly affected by takeover regulation protecting minorities and the transaction costs of acquisition.[7] Also, shareholders may benefit on average from mergers, but there is evidence that the risk of failure is high. For example, in assessing the returns to shareholders on the announcement of bids about 46% of bidders lose value, notwithstanding that on average bidders gain.

3. How are poorly performing companies restructured in the UK?

If hostile takeovers do not provide the mechanism for restructuring poorly performing companies, how are those companies restructured? In this section we summarise a study by Franks, Mayer and Renneboog (2001) of under performing UK companies and investigate the incidence of managerial changes and their influences.

We collected data on ownership, performance, capital structure and board structure for the period 1988–1993. We chose 250 companies randomly from all LSE quoted companies and an additional 50 poorly performing companies, defined as those performing in the lowest decile of share price performance during the period 1988–1991.

We address two questions:

> How much managerial change is there in poorly performing companies?
>
> What are the influences on managerial change? (i) large outside shareholdings, (ii) non executive directors, (iii) high leverage giving rise to new financing and encouraging intervention by shareholders and creditors, and (iv) sales of large share stakes performing like a market for corporate control.

Another important question that is not addressed is the extent to which particular forms of intervention lead to better subsequent performance.

Board turnover and performance

We used 5 different measures of (poor) performance including abnormal share price returns, dividend cuts/omissions, after-tax cash flow margins, after-tax rates of return on book equity, and earnings losses. Table 3 shows various measures of board turnover related to abnormal share price returns. Only for very poor performance, as measured by the worst decile, i.e. decile 1, is there a strong relation between board turnover and per-

[7] Changes in large share block ownership in Germany are associated with much smaller bid premiums to sellers of about 10% than in the UK. Also, non-selling shareholders received virtually no gains from the transaction (see Franks and Mayer (2001)). They explain these differences in terms of the lower level of legal protection for minority shareholders, the lack of effective takeover rules, and the lower level of merger benefits. Their results suggest significant private benefits to large shareholders in Germany.

Table 3
Average board turnover annualised over 3 years for firms in different deciles of share price performance

Boad turnover	Worst decile: 1 %	Decile 5 %	Best decile: 10 %
Executive directors	21.1	8.1	6.9
Non-executive	7.4	4.2	4.8
CEO	28.8	11.6	10.4
Chariman	15.8	7.2	5.9

formance. For example, for the three-year period following the year of poor performance there is an annual rate of turnover of executive directors of 21.1% or 63% over three years for decile 1. The turnover of the CEO is even higher, with a cumulative rate of 86.4% over three years or an average annual rate of 28.8%. Only for one other decile, decile 2, is there significant management turnover; for other below average performing deciles, 3 and 4, the level of managerial change is little different from that of average performing companies.[8]

Types of ownership and concentration of ownership

In this section we briefly describe ownership in the UK quoted share markets. This shows the level of concentration of ownership and that with coalitions of shareholders, the often-cited monitoring problems arising from dispersed ownership might be substantially mitigated. We also compare the level of concentration with that in US markets.

UK capital markets are relatively dispersed by international comparison. For example, more than 85% of large German quoted companies have a single blockholder with more than 25% of the voting equity.

In our UK sample, the largest single shareholding averages about 15%, and for the five largest shareholdings it averages 30–35% depending upon the year. These numbers are similar to the US, where Demsetz and Lehn (1985) find an average ownership of the five largest shareholders of 24.8% for the average firm in the Fortune 500 compared with 33% for our UK sample. However, the level of concentration does vary with the size of company.

[8] The average size of board is 9.3, and the average proportion of non executive directors is 40%, and the CEO is combined with Chairman in 32.9% of cases.

This may be important since smaller companies tend to have greater representation in the worst performing deciles. This is illustrated in Table 4 where the worst and best performing companies are shown to have much smaller equity capitalisations than average performing companies, i.e. decile 5. Average performing companies are more than twice as large as best performers, and are about six times larger than companies in the worst performing decile.

Using the largest shareholding as one metric of concentration, it is 11.0% for average performers, i.e. decile 5, compared with 16.9% for the sample of worst performers, i.e. decile 1. This difference mainly reflects lower insider ownership by directors, which is 6.8% among average performers compared with 15.3% among poor performers. Thus, the pattern of insider ownership explains a large part of differences in the concentration of ownership among firms of different size and performance. Our results suggest that the size of insider ownership plays an important role in protecting or entrenching management from change when performance is poor.[9]

Insider ownership by directors tends to protect management from change when performance is poor

The two largest types of shareholders are institutional shareholders and insider shareholders, i.e. directors. Industrial shareholders are also significant.

The pattern of share blocks is not static in our sample. There is a significant market in share stakes. For example, there are 82 sales of stakes greater than 10% for the period 1991–1993, and this constitutes an annual turnover rate of 9%. We explore the extent to which sales of blocks are

[9] Results are similar for the US. Insider holdings can be used to entrench management.

Table 4
Concentration of ownership by performance of firms in different deciles

	Worst decile: 1 %	Decile 5 %	Best decile: 10 %
Largest shareholding	16.9	11.0	17.1
Sum of all large shareholdings	42.4	30.5	45.9
Institutions	17.9	17.2	17.4
Industrial companies	5.8	4.8	6.2
Families	3.5	0.9	4.7
All directors	15.3	6.8	17.6
Market cap. (mill. £)	132	993	408

influenced by performance and lead to managerial changes.

High leverage and managerial change

An important question explored in this study is the extent to which high leverage and the need for new financing may explain managerial changes among poorly performing companies. Table 5 explores this question. We show that where poorly performing companies are not highly levered there is a comparatively low level of managerial turnover, whereas where similarly performing companies have high leverage there is a high level of managerial change.

We calculate cumulative executive board turnover and CEO turnover for a sample of poorly performing companies in the lowest decile of share price performance for at least 1 year in the period 1988-1993. Board turnover is ranked by quartile of interest cover, with quartile 1 containing companies with the lowest interest cover, and quartile 4 those with the highest cover. Board turnover is accumulated over 3 years.

High gearing in addition to poor performance leads to high board turnover

We find that cumulative executive board turnover is highest at 67.2% for companies with the lowest interest cover. For companies with the highest interest cover the cumulative board turnover is about one half, at 34.3%. It should be stressed that the performance of companies in different quartiles are the same. Statistics for cumulative CEO turnover show the same relation – low interest cover is correlated with high turnover. A similar relation holds when we use other definitions of gearing. Thus, for the same poor performance, companies with high leverage have much higher board turnover than companies with low gearing. This suggests that the relation between performance and board turnover shown in Table 3 may be driven by a combination of high gearing and poor performance and not poor performance on its own.

Table 5
Executive board turnover and CEO turnover for a sample of poorly performing companies ranked by quartile of interest cover

Interest cover:	Cum. executive turnover %	Cum. CEO turnover %
Quartile 1 (Lowest)	67.2	69.6
Quartile 2	44.6	59.3
Quartile 3	45.4	55.9
Quartile 4 (Highest)	34.3	24.2

Board turnover is accumulated over 3 years.

The importance of high leverage fits with the view attributed to Jensen (1989) that high gearing is good for corporate governance because poor performance causes management to default on its loan obligations and to seek renewal of facilities from lenders who are better at monitoring management than shareholders.

To investigate the role of shareholders and creditors in firms with high gearing, we analysed 34 case studies of poorly performing companies. In 28 cases the CEO or Chairman resigned, or both resigned. In 18 cases or about 54% of the sample new equity finance was raised. The question that we investigated was the extent to which managerial change was related to the provision of new equity financing and was triggered by shareholders and (or) creditors.

Interviews with senior management at some of the largest fund managers suggested that although they might intervene where there was very poor performance, in the face of management opposition, they were likely to avoid confrontation because of the dislike of any consequent publicity and the problems of co-ordinating other shareholders. However, it was a very different story when the poor performer required new finance: "it comes to a crunch when companies raise additional finance" or "it all unpicks when a company needs new money".[10]

More formal regression results confirm that although there is a strong relation between performance and board turnover, concentration of ownership and the category of owner play a limited role in the disciplining of management. The exceptions are inside ownership, which is used to entrench existing management, and industrial companies, which acquire stakes in poorly performing companies and precipitate high executive board turnover. Capital structure is important in explaining high levels of board turnover and the significance of new equity issues points to an important role for shareholders in disciplining boards of poorly performing companies when they are forced to seek additional equity. Board structure has little influence on overall executive board

[10] These interviews were carried out in 1997–8.

turnover but is important in the CEO regression with separation of the position of CEO and chairman leading to higher CEO turnover. Boards are therefore instrumental in dismissing CEOs in response to earnings losses or dividend cuts. To achieve wider board restructuring, investors require the leverage of external finance provided by high debt levels.

4. What might explain differences between outcomes in the US and UK?

There are three respects in which the exercise of corporate control is quite different in the UK and US. First, in the US, Weisbach (1988) reports a closer relation of CEO turnover to performance in firms where non-executive directors dominate the board. Also, Gilson (1990) and Kaplan and Reishus (1990) find that non-executive directors of poorly performing companies lose reputation and are frequently unable to find replacement positions. In the UK, we found no evidence of disciplining by non-executive directors; indeed, the relation is negative between the proportion of non-executives and board turnover. However, there is a strong association between CEO turnover and separation of the positions of chairman and CEO; separation seems to play an important role in CEO turnover.

Second, we find that takeover markets, and hostile takeovers in particular, in the UK are not significantly related to poor performance. In addition, we find no significant relation between managerial disciplining and large outside share blocks held by financial institutions, individuals, families and non-executive directors. The one exception involves purchases of share blocks by industrial investors where we report higher board turnover with poor performance. In some contrast in the US there is strong evidence in the US that hostile takeovers are related to poorly performing targets. A study by Bethel et al. (1998) reports that purchases of share blocks by 'active investors' are targeted on poorly performing companies. Also, Holderness and Sheehan (1988) find that when their majority blocks trade, there is substantial management turnover and stock prices increase. Thus, in both countries, changes in share blocks by active investors perform a disciplinary function, although the definition and size of active investors in the US is considerably broader than that in the UK.

Third, we find that financial structure and new financing are particularly significant influences on board turnover in the UK. We are not aware of any US study reporting this relation.

What could explain these differences? We argue that legal rules or regulation could play an important role.

Fiduciary responsibilities of directors

Powers to enforce fiduciary responsibilities of directors in the UK are weak. Stapledon (1996) records that although directors in the UK owe their companies 'fiduciary duties of honesty and loyalty, and a duty of care and skill', in practice 'actions to enforce the duties of directors of quoted companies have been almost non-existent' (pp. 13–14). Parkinson (1993) states "Historically, the standard of diligence set by the courts has been comically low, as can be seen from the cases concerning failure to supervise fellow directors and managers who turn out to have been defrauding the company" (page 98). All this might explain why directors of UK companies perform more of an advisory than a monitoring role.

In the UK, powers to enforce fiduciary responsibilities of directors are weak

In the US, directors (both executive and non-executive) have a duty of care to shareholders and they can be sued for failing to fulfil fiduciary responsibilities. However, in reviewing lawsuits in the 1960s to 1987, Romano (1991) concludes that shareholder litigation is a weak, if not ineffective instrument of corporate governance. One important exception is block ownership, where she finds that "for blockholders who are not insiders, litigation can be a valuable mechanism to redirect corporate policy" (page 80).

Minority protection

The 1989 Companies Act requires that share blocks in excess of 3% must be disclosed. Where there is a controlling firm, the Stock Exchange lays down specific rules concerning the controlling shareholding and transactions with related parties. For example, a majority of the directors of the board of the subsidiary must be independent of the parent firm. Shareholders have to be notified about transactions with the parent firm and their approval has to be sought in advance with the related party abstaining from voting on the transaction.

Minority shareholders are also protected in the UK by the City Code on Takeovers and Mergers. The Code requires that any person accumulating 15% or more of the voting rights of a firm must declare his intentions about making a takeover, and those acquiring 30% must offer to purchase all remaining shares at the highest price paid by the acquirer for the target over the previous twelve months. Also, a 25% minority of shareholders can block particular forms of new equity issues and mergers, and new issues have to be made in the form of rights issues where they exceed 5% of share capital.

The US is different from the UK by allowing transactions to be imposed on an unwilling minority but ensuring that the minority is adequately protected in objective market value terms. Protection of investors, especially minorities, is primarily the concern of the courts. For example, Delaware courts in the US approved a discriminatory share buyback by Unocal against Boone Pickens, who was a large shareholder attempting a coercive takeover (Herzel and Shepro, 1990). There is no US equivalent of the UK Takeover Code requiring full bids for companies to be made. However, there is extensive State legislation discouraging takeovers, and companies implement more defence mechanisms than are permitted in the UK (Miller (1998)).

Minority protection is greater in the UK; in the US it is primarily the concern of courts

Rights Issue Requirements

Differences in minority protection are particularly pronounced in relation to new equity issues. In the UK, the association of corporate governance with new equity finance revolves crucially around the investment banks and underwriters that organise the issue. The Companies Act of 1985 states that seasoned new equity issues by companies must be in the form of rights issues and that if shareholders fail to take up their rights, the rights may be sold for the shareholder's benefit.[11] The Act also describes the circumstances under which pre-emption rights may be disapplied. It requires a super majority vote by shareholders of at least 75% on each and every occasion an equity issue is to be made.

In the US, companies frequently obtain shareholders' agreement to drop pre-emption rights. Such agreement does not have to be renewed on each occasion the firm makes a rights issue as in the UK. Brealey and Myers (1996) suggest that 'the arguments [by management] for dropping pre-emption rights do not make sense' (p. 405). Our results imply that managers have incentives to drop pre-emption rights so as to allow issues of equity to be made to new shareholders at a discount to the equilibrium price, thereby diluting existing shareholder wealth. The discount would be in exchange for implicit or explicit agreements to new shareholders to leave existing management in place.

Thus while superficially the capital markets of the UK and US are similar and both have common law legal systems, there are subtle but important differences in regulation. These place greater burdens on directors in the US than in the UK but more protection of minorities in takeovers, share block purchases and new equity issues in the UK. They make control by large shareholders more difficult and expensive in the UK than in the US but facilitate control when new financing is sought in new equity issues. Consistent with this, we have reported that corporate governance in the UK relies more heavily on financial factors and new financing, and less on boards, non-executive directors and large shareholders.

What is the significance of this difference? Is it the case that the UK has evolved arrangements that are different from those in the US but perform similar functions? We would argue caution in concluding that the governance arrangements in the UK and US are close substitutes. Reliance on financial constraints and distress implies that governance in the UK is primarily restricted to the very worst performing companies. This is consistent with the observation that it is only the very worst performing companies in the UK that appear to display unusually high board turnover. It suggests a slow response of UK corporate governance to the emergence of poor performance.

The implication is that the greater protection of minority investors in the UK may have come at a price. It facilitates the operation of securities markets and encourages wider participation by investors but it may discourage active corporate governance by large shareholders and markets in corporate control.

[11] These pre-emption rights are recognised in European Community law.

An alternative view is that governance procedures in the UK and US are not static and evolve in response to past performance. Capital markets are constantly responding to past inefficiencies and governance may be no exception to this rule. Under this interpretation changes in legal rules are unnecessary, and we might expect to see improved governance procedures reflected in more recent data. One study by Dahya, McConnell and Travlos (2002) finds a stronger negative relation post Cadbury between top management turnover and corporate performance, and that increased sensitivity of turnover to performance was concentrated among firms that adopted the Cadbury Committee's recommendations.

5. More recent events

How should recent events in the US affect our views of governance in the two countries? There are two important questions: Where was the failure of governance? And, what is the best way of rectifying the failure? In the case of Enron the failure appears to be more the result of serious conflicts of interest between the auditor and the company. It is less easy to judge the extent to which non-executive directors did not exercise sufficient care. In this regard, it will be important to see how the US courts are prepared to evaluate the business decisions of the non-executive directors. In the past they have largely avoided such an approach, citing 'the business judgement rule', in which the courts decline to judge management's business management.

However, there does seem one area where non-executives may have influenced the current crisis of governance. They designed remuneration policies for management that were supposed to align the interests of management and shareholders. Often those packages were very asymmetric; that is, large rewards were given for success and there was little financial penalty for failure. Thus, they did not mimic entrepreneurs who lose large amounts of capital when they experience failure. Dow and Raposo (2002) have shown that when executive remuneration is very asymmetric and large, i.e. has large upside with little downside, chief executives will choose much riskier strategies and less profitable ones from the point of view of shareholders. In this respect, the excesses of the past few years may be less a question of whether the board should have spotted the error, and more a question of the incentives given to management to choose grand strategies which were not in shareholders' interests.

Given these excesses, what should be done? One view might be to let the markets respond. Shareholders do not like losing large parts of their capital, and in the face of such losses they will evolve changes in governance that will provide remedies for the failure. A very different view is that there is a serious market failure and institutional shareholders have little incentive to devise the right kind of innovations in governance. This interpretation of the problem suggests more regulation.

Asymmetric remuneration packages for managers give the wrong incentives

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POWER, RENT EXTRACTION, AND EXECUTIVE COMPENSATION

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JESSE FRIED**

Executive compensation in companies with substantial separation of ownership and control has long attracted a great deal of attention – from both the public at large and financial economists. During the extended bull market of the 1990s, stock option programs adopted by publicly traded U.S. companies yielded unprecedented compensation for senior executives. These gains were accompanied by a parallel rise in academic work on the subject; in fact, it appears that the growth rate of such work has outpaced even that of executive compensation (Murphy, 1999, at 2487).

In studying executive compensation, financial economists traditionally have followed what might be referred to as "the optimal contracting approach." Under this approach, executive compensation practices in large, publicly traded companies are viewed as being designed to minimize agency costs arising in the relationship between senior executives (the agents) and shareholders (the principals). The board is seen as seeking to maximize shareholder value, with the compensation scheme designed to serve this objective. Although recognition of potentially large deviations from optimal contracting lies at the heart of public criticism of compensation schemes, such deviations have received insufficient attention from financial economists.

Another approach to the study of executive compensation – the "managerial power approach" – focuses on the role of managerial power in shaping executive compensation practices. In a recent article written jointly with David Walker (Bebchuk, Fried and Walker (2002)), we have put forward an account of this alternative approach. As will be discussed in this brief note, which draws on the article, the substantial role of managerial power on executive compensation is suggested by both theory and the evidence.

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Jesse Fried

At the level of theory, we argue that an analysis of the compensation-setting process indicates that its outcomes are likely to be greatly influenced by managerial power and by managers' interest in extracting rents. In addition, we argue that the extensive empirical evidence on executive compensation is consistent with the predictions of the managerial power approach. Indeed, this approach can better explain some significant features of the executive compensation landscape, including ones long regarded as puzzling.

Optimal contracting and its limitations

Financial economists have made great effort to understand, within the optimal contracting model, the executive compensation arrangements that have arisen over the last two decades. Many papers have attempted to show that the various features of executive compensation arrangements, as well as the cross-sectional variation in compensation practices among firms, can be explained from this perspective. But there are good reasons to doubt the ability of this model to explain managerial pay practices adequately. Optimal compensation contracts could result from effective arm's-length bargaining between the board and the executives, or from market constraints that induce players to adopt such contracts even in the absence of such bargaining. Our analysis, however, indicates that neither of these forces can be expected to constrain executive compensation effectively.

The optimal contracting model cannot adequately explain managerial pay practices

Bargaining with the board is far from arm's length. In the optimal contracting model, the directors seek to maximize shareholder value in bargaining

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with the managers. However, given that managers do not automatically serve shareholders' interests – which is why incentivizing them adequately is important – there is no reason to expect *a priori* that directors would maximize shareholder value. Even nominally independent directors often have incentives to favor the CEO, who might have played a role in their nomination or will play a role in their re-nomination to the board, and with whom they work closely. Even if directors have no reason to favor the CEO, they commonly have little incentive to exert effort to get shareholders the best executive compensation agreements possible, and often lack independent information and professional advice. Similarly, market forces are not sufficiently strong and fine-tuned to assure optimal contracting outcomes. In our work, we have analyzed constraints posed by the market for control, the market for capital, and the labor market for executives. These markets all impose *some* constraints on what directors will agree to, and what managers will ask them to approve. But these constraints are far from tight and permit substantial deviations from optimal contracting.

Constraints on pay are insufficient to produce efficient outcomes

Consider, for example, whether the market for corporate control – the takeover threat – could ensure optimal contracting outcomes. Suppose that an executive of a 10 billion dollar company contemplates increasing compensation by 100 million dollars. Clearly, the direct benefit to the executive would be quite substantial. In contrast, the cost to the executive – the increase in the likelihood of a hostile takeover or ouster as a result of the accompanying 1% reduction in company value – would be limited. Undoubtedly, the corporate control market would place some constraint on an increase in pay. At a certain point, shareholders could become outraged enough to support outside challengers or bidders in a control contest. Still, management pay could substantially exceed the amount consistent with optimal contracting, without creating much additional risk of a takeover.

The managerial power approach

The very reasons for questioning the ability of optimal contracting to explain adequately compensation practices also suggest that executives will have substantial influence over their own pay. The managerial power approach focuses on the role of this influence in shaping pay arrangements. Under this approach, executive compensation is viewed not only as an instrument for addressing agency problems, but also as a *part* of the agency problem itself.

One important building block of the managerial power approach is that of "outrage" costs and constraints. Executives can exert influence on their own pay, but that does not imply an unlimited ability to do so. Although the need for board approval and the presence of market forces cannot be expected to produce compensation arrangements consistent with optimal contracting, they can and commonly do provide some constraints. For example, although the takeover threat is not sufficiently fine-tuned to discourage managers from seeking to extract substantial rent, the concern about losing shareholder support in the event of a control contest places some limits on what managers and directors can do. The tightness of the constraints managers and directors confront depends, in part, on the outrage, if any, expected to be generated by a particular compensation arrangement.

Outrage can be costly to directors and managers in several ways. For instance, outrage may cause embarrassment or reputational harm, and it may reduce the willingness of shareholders to support incumbents in control contests. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve the arrangement, and the more hesitant managers will be to propose it in the first instance. Thus, whether a compensation arrangement that is favorable to executives but sub-optimal for shareholders is adopted will depend on how the arrangement is perceived by outsiders and, in particular, on how much outrage (if any) it can be expected to produce.

The potential significance of outrage costs explains the importance of "camouflage"– a second building block of the managerial power approach. Because outrage arising from outsiders' recognition of significant rent extraction provides a possible check on managers' power to extract rent, managers have an incentive to obscure and legitimize – or, more generally, to camouflage – their extraction of rents. Indeed, even the extensive use of compensation consultants, which could be viewed under the optimal contracting approach as part of an effort to design the most efficient incentive scheme, can be seen as a means of justifying and legitimizing pay under the managerial power approach. This concept of camouflage turns out to be quite useful in explaining many of the patterns and puzzles provided by the executive compensation landscape.

The desire to camouflage might lead to the adoption of inefficient compensation structures that fail to provide desirable incentives, or even supply perverse incentives. In our view, the reduction in shareholder value caused by these inefficiencies, rather than the rent captured by managers, might well be the biggest cost arising from the influence of managerial power on compensation practices. Thus, better compensation arrangements may provide shareholders with considerable benefits by improving managerial incentives and performance.

Although the managerial power approach is conceptually different from the optimal contracting approach, the former is not proposed as a complete replacement for the latter. Compensation arrangements are likely shaped by both managerial power and what would be considered optimal for shareholders. The managerial power approach merely implies that compensation practices cannot adequately be explained by optimal contracting alone. Rather, practices may deviate significantly from those suggested by optimal contracting, and such deviations can be well understood only with careful attention to the role of managerial power.

A brief look at the evidence

We now discuss three compensation practices to illustrate how the managerial power approach can help explain the executive compensation landscape. (A more detailed analysis of these and other practices can be found in Bebchuk, Fried, and Walker (2002).)

Near-universal use of at-the-money options
Almost all of the stock options used to compensate executives are issued "at-the-money" – their exercise price is set to the grant-date market price. However, it is highly unlikely that this is always the optimal strike price. An optimally designed option scheme would seek to provide risk-averse managers with the strongest cost-effective incentives to exert effort and make value-maximizing decisions. The optimal exercise price under such a scheme should depend on a multitude of factors that are likely to vary from executive to executive, from company to company, from industry to industry, and from time to time. Such factors might include the degree of managerial risk aversion (which in turn might be affected by the manager's age and wealth), the project choices available to the company, the volatility of the company's stock, the expected rate of inflation, and the length of the executive's contract, among other things. There is no reason to expect that "one size fits all" – that is, that the same exercise price would be optimal for all executives at all firms in all industries at all times.

It is highly unlikely that out-of-the-money options (options whose exercise price is above the grant-date market price) are *never* optimal. As Hall (1999) has argued, out-of-the-money options offer much higher pay-for-performance sensitivity per dollar of expected value than conventional options. And there is empirical evidence suggesting that giving managers out-of-the-money options rather than at-the-money-options would, on average, boost firm value (Habib and Ljungqvist, 2000). The fact that options are almost uniformly issued at-the-money is thus difficult to explain by optimal contracting. Indeed, economists working within this model have called this practice "puzzling" (Hall, 1999, at 43).

The managerial power approach can explain deviations from optimal contracting

The near-uniform use of at-the-money options is not puzzling, however, when examined under the managerial power approach. Given that executives benefit from lower exercise prices, executives will wish to push exercise prices as far down as possible without generating outrage. Therefore, there is little reason for designers of plans to award out-of-the-money options given that some justification is available for at-the-money options. On the other hand, in-the-money options (options whose exercise price is below the grant-date market price) might be regarded as a windfall and thereby generate outrage costs. Furthermore, a grant of in-the-money options would trigger a charge to accounting earnings, and this might undermine one of the excuses for not using indexed options – that the use of such options would give rise to an accounting charge. Because in-the-money options might thus be difficult or costly for managers to obtain, and at-the-money options are the ones most favorable to managers within the remaining range of possibilities, a uniform use of at-the-money options is consistent with the managerial power approach.

Freedom to unload options and shares

Another problem for the optimal contracting approach – and one that has received insufficient attention by researchers despite its importance – concerns managers' widespread freedom to undo the financial incentives provided to them by their compensation arrangements. When value is spent on providing managers with incentives, it might well be desirable to place substantial limits on managers' freedom to unwind them. But firms take surprisingly few steps to prevent or regulate the unwinding of the incentives created by grants of options and restricted stock.

Practices managerial influence can explain include the use of at-the-money options, freedom to unload equity, and "golden goodbyes"

Stock options generally vest after a specified period, which ensures that the executive cannot walk away with the underlying shares without first serving the company for the specified period. Although an executive becomes entitled to the awarded options once their vesting period is over, the compensation contract could preclude the executive from "cashing out" the vested options – that is, from exercising the options and then selling the acquired shares. Such a limitation would maintain incentives for an additional period and thus prevent the need to grant new options to replace the ones that have been cashed out. There is no reason to expect that optimal contracts would generally make the vesting date and the cash-out date the same. Yet, the two dates are almost always the same. Not surprisingly, managers exercise many of their options well before expiration, and sell most of the shares acquired through the exercise of these options (Ofek and Yermack, 2000).

An optimal contract also might prohibit managers receiving options from weakening (if not eliminating) the incentive effects of the option grant by selling an equivalent number of shares already owned by them. Standard practice fails to prohibit this, however, and executives receiving new options often respond by heavily selling already-owned shares. Contracts also do not generally prohibit executives from hedging vested or even unvested options, and executives often hedge their equity exposure to the firm when disposal is either not possible or too costly from a tax perspective.

It should be emphasized that permitting executives to unload their positions in the short run can lead to substantial distortions (modeled in Bebchuk and Bar-Gill (2002a, 2002b)) in the way companies are managed. Compared with executives who must maintain their equity positions for the long haul, executives who may sell in the short run would tend to make investment decisions distorted in favor of short-term projects, to misreport corporate performance, and to exert less effort both before and after they unload their stock. The reductions in shareholder value produced by these distortions might far exceed the extra rent executives get from their freedom to unload options and shares.

Furthermore, even if it were optimal in some cases to grant an executive broad freedom to cash out because of the executive's liquidity or diversification needs, there would be little reason to give the executive unrestricted control over the timing of stock sales. When managers can control the exact timing of stock sales, they can profit by selling when they know that the stock is overpriced. Although it is illegal in the U.S. for managers to trade on "material" inside information, the "materiality" standard is sufficiently high that managers can – and do – make significant profits trading on information that is valuable but not considered legally "material" (Fried, 1998). These profits are unlikely to be an efficient mechanism for compensating executives. Indeed, executives' control of the timing of their sales aggravates the perverse incentives created by executives' broad freedom to unload shares and options.

To be sure, executives have liquidity and diversification needs that might require them to sell some of their shares. However, liquidity and diversification needs hardly call for permitting the executive to cash out positions whenever the executive so chooses. Most of these needs can be anticipated and planned for. One could require sales to be carried out gradually over a specified period pursuant to a pre-arranged plan. Or the executive could be required to sell shares directly to the firm for the average share price over a specified and sufficiently long period of time (say, the preceding 6 months). Yet, although some firms have put in place "trading windows" in response to the adoption of tough insider-trading penalties on employers who fail to take steps to prevent illegal insider trading by their employees, many firms place no limits on the freedom of executives to time the cashing out or hedging of their equity positions.

Whether or not the board restricts the timing of sales, it could require enhanced disclosure of those trades. Until recently, the securities laws required that executives disclose their trades to the SEC by the tenth day of the month following the trade. In the wake of the Enron and other corporate scandals, Congress has required executives to disclose their trades shortly after they are made. Congress might not have gone far enough. It might be desirable to require executives to publicly disclose shortly in advance of their planned trades, as one of us has proposed (Fried, 1998). In any event, when the law did not compel disclosure of trades until the month after the trade, one might have expected firms adopting optimal contracts to require executives to make earlier disclosures. Yet firms, including those that use trading windows, made no attempt to provide timely disclosure of managers' sales until forced by the government to do so. In fact, many firms have moved in the opposite direction and taken steps to reduce the transparency of insider sales.

The lack of restrictions on the amount and timing of stock selling, while difficult to explicate from an optimal contracting perspective, can easily be explained under the managerial power approach. Under this approach, the design of compensation plans is partly influenced by managerial power. Avoiding such restrictions benefits managers and does so in a way that in the past has been largely under the radar screen.

"Golden Goodbyes"

Another significant practice worth noting is that of the board giving the CEO "gratuitous" goodbye-payments. The payments are "gratuitous" in that they are not required under the terms of the CEO's compensation contract. These payments can arise in a number of contexts – an important one being the acquisition of the CEO's firm. CEOs of acquired firms, in many cases, receive payments from their firm or the acquiring firm. These payments take a number of different forms, including increases in the contractual golden parachute payout and separate cash payments. Another context is that in which CEOs are "pushed" out by the board of directors. Even when these CEOs have performed poorly, they commonly receive gratuitous payments and benefits not called for by their contract.

Some believe that such "golden goodbyes" can benefit shareholders. Given that executives' influence over their boards enables them to resist beneficial acquisitions or their own firing, such payments might be needed to make a beneficial acquisition or CEO departure possible. Even on this account, which views the payments as overall (second-best) beneficial for shareholders *given* managers' power, the payments indicate the existence of substantial managerial power.

Conclusion

In sum, there are reasons to suspect that managerial power has had a substantial impact on the design of executive compensation in companies in which ownership and control are separated. Executive compensation can be analyzed fruitfully not only as an instrument for addressing the agency problem, but as a part of the agency problem itself. The main cost to shareholders might well arise from inefficient pay arrangements that are designed to camouflage the extraction of rent and which provide sub-optimal or even adverse incentives.

To limit rent extraction, compensation disclosure should be transparent

The conclusion that managerial power and rent extraction play a significant role in executive compensation has important implications. To the extent that the way in which compensation arrangements are perceived is important, it is desirable to ensure not only that information about executive compensation be in the public domain but also that the compensation be disclosed in a highly visible and transparent manner. Because boards cannot be relied on to negotiate optimal contracts with executives, institutional investors would do well to pressure firms to stop using some of the conventional practices that appear to be sub-optimal. We are planning to explore these and other implications in future work on the subject of managerial power and executive compensation. We hope that the significance of managerial power will receive, from financial economists studying executive compensation, some of the attention that the optimal contracting model has long enjoyed.

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NATIONAL ACCOUNTING RULES IN A GLOBALISED WORLD

PRO: AN ALTERNATIVE TO A SINGLE SET OF ACCOUNTING STANDARDS FOR THE WORLD

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The corporate accounting scandals in the United States during 2002 have strengthened calls from around the world for having a single set of accounting standards. Current Generally Accepted Accounting Principles (GAAP) in the United States, it is claimed, have been a major part of the problem. The reason: because the principles are so detailed, they virtually invite clever accountants and attorneys to skirt the intent of the rules by carefully circumventing their precise contours. One widely discussed solution is for the United States to follow the many other countries that have embraced or, like the European Union are about to adopt, International Accounting Standards, which are written in broad principles instead.

There is a case for having a single set of accounting standards – as shortly argued – but it does not and should not rest on the recent accounting failures in the United States. In virtually all of the highly publicized cases – Enron, Worldcom, Xerox, and AOL/Time Warner, to name a few – the problems (alleged or documented) grow out of the failure to enforce U.S. GAAP, specifically rules on revenue and expense recognition, and not out of some flaw in GAAP itself. The one apparent exception, Enron's failure to consolidate many of its off-balance sheet "special purpose entities", in fact does not support an indictment of U.S. GAAP. Even in Enron the main problems were failures by the company and its auditor to disclose contingent liabilities of the SPEs, not consolidation per se.

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Moreover, there are drawbacks to the broad principles-based approach embodied in IAS, which leave ample discretion to management and auditors on how to report a variety of transactions. Can one be easily assured that the same managements that were so willing to skirt the detailed rules of U.S. GAAP suddenly would follow conservative accounting if they were given the freedom or license to do so? Skepticism about the answer is a major reason why the U.S. standards have been driven by regulators and litigation toward detailed rules.

A far better argument for a single set of reporting standards worldwide is to ensure that investors, wherever they may reside, can easily understand and compare the financial accounts of companies headquartered in different countries. This has become an increasingly important objective as investors expand their portfolios to contain ever larger fractions of foreign securities, while exchanges from different countries are merging or forming cross-border alliances. A global capital market seems to cry out for a global set of reporting standards.

The world's two main accounting standards-setters, the Financial Accounting Standards Board (responsible for U.S. GAAP) and the International Accounting Standards Board (which sets international standards), formally recognized this imperative in September 2002 by announcing their intention to eliminate major differences between the two sets of standards by 2005. In essence, the two bodies intend to set a single world standard although the two standards-setters presumably would continue to co-exist.

Therein lies at least one of the reasons to be cautious about the joint effort. For one thing, bridging the large philosophical difference between the details of U.S. GAAP and the broad principles of IAS will not be easy. More fundamentally, even if the two bodies initially agree to a single set of stan-

If you want to comment on this topic or react to the opinion expressed here, please visit the CESifo Internet Forum on our web site: www.cesifo.de dards, it is far from clear whether that outcome will be stable over time. Pressures are certainly likely to arise in the United States and elsewhere for "interpretations" of the single standard. Are the two bodies going to coordinate their responses to every one of these inquiries or pressures, or more likely, are they going to go their separate ways? If the latter, then multiple interpretations over time will lead right back to different standards, thus defeating the objective of a single global standard. If the two bodies instead seek to coordinate their responses, the outcomes are likely to be very slow in coming. The repeated attempts by the Basel Committee, over many years now, to refine bank capital standards, a much less complicated task than setting and maintaining a comprehensive list of accounting standards, provides a clear example of how even one body can find it very difficult to adapt to changing market conditions.

In short, achieving and maintaining a single set of accounting standards is likely to prove very difficult, if not impossible. It is not too late to consider an alternative paradigm, one based on true *competition* between the two standards – that is, one where exchanges are permitted to recognize reports under both standards, or the exchanges themselves are permitted to compete in different countries.

Under competition, standard-setters have much stronger market-based incentives to respond to investor pressures for sound standards, and to do so more quickly, than is the case when standard-setters seek to compromise for the sake of achieving uniformity, or if the two standards-setting bodies collapse to a single organization (most likely the IAS). To be sure, there would be less uniformity with two standards, but market pressures over time should also encourage companies to provide sufficient information for analysts to compare financial results of companies under either standard.

Sometimes the perfect can be the enemy of the good. Such is the case with the quest for a single set of global accounting standards for all time.

Contra: The best of both Worlds – a German view

Hanno Merkt*

In recent years, a steadily growing number of German companies have been reporting consolidated financial statements under US GAAP or IAS, driven by the need for fresh equity capital which cannot be raised to a sufficient extent on the domestic market. This development benefits all those involved. It provides German companies with access to a deep and liquid source of capital – including a "currency" in the form of listed stock available for acquisitions in the U.S. It provides U.S. investors with increased opportunities for the allocation of their investments. At the same time market observers, researchers and regulators point to the fact that financial statements prepared under the shareholder (or investor) model, such as US GAAP or IAS, provide better information than financial statements prepared under the stakeholder model (German GAAP). What is the economic and legal rationale behind these differences?

In common-law economies (US and IAS models), accounting rules are determined largely by the disclosure needs of actual and prospective shareholders. Capital is generally raised in public stock and bond markets. The problem of asymmetric information between managers and shareholders is addressed through financial reporting and other means of timely public disclosure. Thus, the primary focus of US GAAP and IAS is the need of current and prospective shareholders for relevant and reliable information. In a common-law environment, accounting standards evolve by becoming commonly accepted in practice and are generally separate from tax laws. In other words, accounting standards arise in an accounting market and are not determined by government.

In clear contrast to this rather monistic concept of accounting, German accounting standards were developed in a highly politicised environment serving a number of stakeholders as well as taxation requirements. Under the German code-law model of accounting, governments, debt holders, shareholders, employees, suppliers, and managers are viewed as stakeholders of a firm. Net income is distributed amongst stakeholders, as pay increase to employees, bonuses to managers, tax to government, and dividends to shareholders. In Germany, banks traditionally play a key role in providing finance and representing investors. Agents of stakeholders tend to be informed by private and inside access to information. This reduces the need for timely public disclosure of income. Also, the incentives (e.g., minimising taxes) and opportunities (e.g. reserve accounting) to reduce earnings volatility are comparably high. Specifically, with financial reporting the same as tax reporting and with progressive income tax rates, smoothing earnings results in a reduction of distribution of income. The German approach has been labelled quite aptly as paternalistic, in that accounting under traditional German standards operates as a guardian in favour of all of the firm's stakeholders. This makes the firm more reliable for debtors but at the same time less attractive for investors. Moreover, the accounting concept is deeply rooted in the corporate legal system serving as shield against looting the firm's legal capital and as a pretty effective substitute for what in common law jurisdictions is known as financial covenants, i.e. contractual safeguards against the risk of default. Hence, the German accounting system as such is definitely not up for consideration.

Therefore, it appears to be quite a challenge to reconcile the stakeholder oriented German accounting model with the investor oriented common law

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If you want to comment on this topic or react to the opinion expressed here, please visit the CESifo Internet Forum on our web site: www.cesifo.de accounting philosophy in order to facilitate the raising of equity capital on international markets. Various concepts are discussed among experts, one alternative being a careful and gradual modification and adaptation of German accounting principles to IAS, another and quite promising one the implementation of a system of two separated sets of rules for information purposes and for the determination of distributable earnings. This latter approach would permit preserving the traditional German system without keeping German corporations locked out of international capital markets. Market participants would have to learn that a corporation and its performance can be looked at easily through different sets of glasses. However, only the future will tell whether it is possible to combine the best of both worlds.

The euro in Central and Eastern Europe – survey evidence from five countries

Helmut Stix*

Introduction

Last year, there was a lively debate about whether the euro will be able to take over the role of the Deutsche mark in Central and Eastern Europe. This debate was mainly driven by indications of a decreasing foreign demand for Deutsche marks which was attributed to uncertainties in relation to the changeover and fears of owners of black market money to disclose the origin of their holdings. (Sinn and Westermann, 2001a and b). Now, in light of this debate and a few months after the cash changeover, this article presents new survey results that allow an assessment of the role of the euro in Central and Eastern Europe. In particular, the survey shows the actual exchange behaviour of residents of Central and Eastern European countries and whether any major shifts in the composition of foreign cash have occurred. Furthermore, the results shed light on the motives behind the decision to hold euros, people's opinions about the euro or what people in Central and Eastern European countries think about the stability of the euro.

The representative survey was commissioned by the Oesterreichische Nationalbank and conducted by Gallup in Croatia, Hungary, the Republic of Slovenia, the Czech Republic and the Slovak Republic in April/May 2002. It is in line with previous surveys that have been conducted since 1997 on a biannual basis each April/May and October/November (Stix, 2001). For each survey and in each country about 1,000 persons over the age of 14 are interviewed.[1] The fact that the surveys have been repeated allows to analyse changes in the behaviour of Central and Eastern Europeans over time.

For which currencies were Deutsche marks exchanged?

All respondents who held Deutsche marks around 1 January 2002 were asked about their exchange behaviour. The answers, expressed in percent of respondents, are summarised in the table below. In sum, 69 percent exchanged their Deutsche marks for euros, 5 percent for US dollars, 1 percent for Swiss francs and 23 percent for local currencies. As the figures for the individual countries show, the vast majority of Croatians and Slovenians exchanged their foreign currency holdings for euros. In the other countries, a large share of respondents opted for local currencies and in the Czech Republic and in Slovakia to a sizeable extent for US dollars.[2] By and large, similar results were obtained for the Austrian schilling (not shown).

The spread of foreign currency holdings

The focus of the previous question on currency holdings around 1 January 2002 might bias the results in favour of the euro, which had not been available before 1 January 2002. For example, this could be the case if Deutsche mark holdings, and here supposedly illegal holdings, had already been exchanged for US dollars during the year 2001.[3] At

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The views expressed in this paper are those of the author and do not necessarily reflect the views of the Oesterreichische Nationalbank.

[1] The main focus of the surveys was to estimate foreign currency cash holdings of euros (EUR), US dollars (USD) and Swiss francs (CHF). For further details about the surveys, the reader is referred to Stix (2001).

[2] As the number of respondents is quite low for Hungary, these numbers should be treated with some caution.

[3] Probably because of fears of declaring black market Deutsche mark holdings.

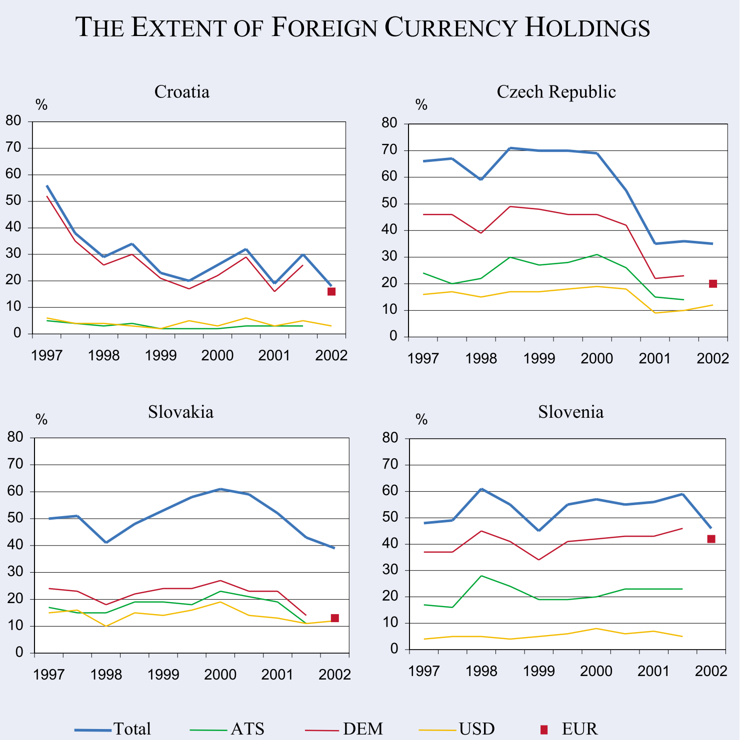
For which currencies were Deutsche marks exchanged?

	Euro	U.S. dollar	Swiss franc	Local currency	Others
Total	**69**	**5**	**1**	**23**	**2**
Croatia	82	2	1	15	0
Czech Rep.	46	11	1	40	3
Hungary*	43	3	3	52	0
Slovakia	50	14	1	31	4
Slovenia	77	2	0	17	4

Note: Numbers in percent of respondents who held Deutsche marks in the months around January 1, 2002.
* Low number of observations (40) for Hungary.

Source: OeNB, own calculations.

Figure 1



Note: Values on vertical axis correspond to the percentage of respondents that held foreign cash. "Total" corresponds to the percentage of respondents that hold any foreign cash.

Source: OeNB, own calculations.

any rate, the result that a relatively high share of respondents exchanged Deutsche marks for local currencies is in line with the findings from previous surveys which indicated a decline in the diffusion of foreign currency holdings in all countries except Slovenia. Figure 1 shows the evolution of both the percentage of private persons holding some kind of foreign cash (blue line) and a breakdown by currency (DEM, ATS, USD and EUR) from May 1997 to May 2002. The new survey results show clearly that this decline continued to be strongest in Croatia and the Czech Republic and to be a little weaker in Slovakia.[4] In May 2002, euros were held by 42 percent of Slovenians, 20 percent of Czechs, 16 percent of Croatians, 13 percent of Slovaks and 11 percent of Hungarians over the age of 14.

To compare these euro shares with previous values, we need data on the percentage of persons who held either schillings or Deutsche marks prior to 2002 (thus preventing double counting by eliminating all respondents that held both currencies). However, these data are not available. Therefore, we compare the share of holders of euros, including the share of those that still held Deutsche marks in 2002, with the shares of Deutsche mark holders found in earlier surveys. This exercise shows that in all countries the euro share in 2002 is lower than the Deutsche mark share in November 2001. It should be noted that the euro share is even lower than the Deutsche mark share alone (i.e. not counting any previous schilling shares). This suggests that a "correct" comparison, that is a comparison that also includes the share of respondents who held schillings, would show an even sharper drop.

Interestingly, in all countries alike, the US dollar share was highest around the year 2000 and declined slightly thereafter. During the last few surveys it remained roughly constant. Although both the share of US dollar and Deutsche mark holdings declined in a longer-term perspective, the percentage decline from the peak in 2000 to November 2001 is stronger for the Deutsche mark than for the US dollar (except in Slovenia).

Foreign currency amounts

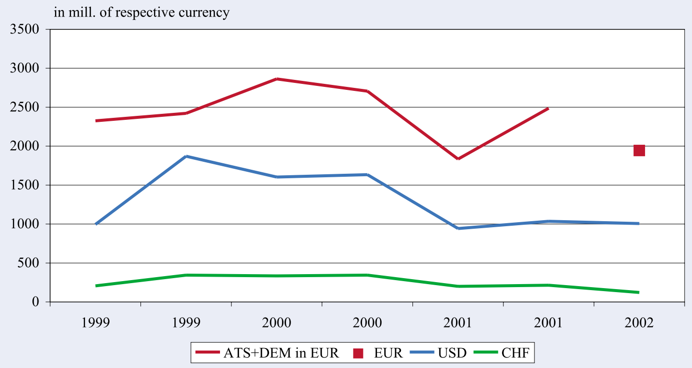
The table and Figure 1 contain information about the behaviour of respondents but are otherwise uninformative about the size of foreign cash balances. As the respondents are also asked about their individual foreign cash holdings, it is possible to derive an estimate of the actual amounts that were circulating. In particular, this figure is calculated by weighting the class means of the categorised amounts with the percentage share of respondents who answered that the amount of their foreign currency holdings lies in the respective range.[5] Then, by multiplying the resulting per

[4] Again, the graph for Hungary is not shown due to the low number of respondents.

[5] The survey does not ask about the precise amount but rather about categorized amounts (< 100, < 500, etc.).

Figure 2

ESTIMATED FOREIGN CURRENCY HOLDINGS



Note: The graph shows the estimated amounts of foreign currencies held in Croatia, the Czech Republic, Slovakia and Slovenia in millions of the respective currency. The estimates for the Swiss franc only include Slovenia, the Czech Republic and Slovakia.

Source: OeNB, own calculations.

capita average holdings by total population (older than 14 years), we obtain an estimate of the amount of foreign currency held in the respective country. It should be emphasised that the resulting numbers represent just crude estimates which incorporate neither illegal nor other undisclosed cash holdings (Stix, 2001). Therefore, these estimates are likely to understate the true amount by a sizeable factor. However, even in spite of these limitations, we still consider these estimates to be useful, as changes over time might be indicative of changes in the overall demand for foreign cash.

The results are summarised in Figure 2, which shows the euro amount of May 2002 and, for ease of comparison, the aggregated schilling and Deutsche mark amounts expressed in millions of euros from May 1999 to November 2001. Also the estimated US dollar and Swiss franc amounts are depicted.[6]

As presented in Figure 2, the estimated nominal amount of euros that circulated in the analysed countries clearly declined from May 2000 to May 2002.[7] However, due to some short-run fluctuations, the size of the percentage change depends heavily on the choice of the base year, ranging from – 32 (May 2000 to May 2002) to – 16 percent (May 1999 to May 2002). Since we do not rely too much on such individual observations, we think that a more robust measure of the percentage decline in the demand for euros might be obtained by calculating the mean holdings in 1999 and 2000 and by comparing this figure with the euro amount of May 2002. This exercise shows that, relative to the average holdings in 1999 and 2000, the amount of euro holdings declined by about 25 percent. The surveys also allow to get (albeit quite imprecise) estimates of the size of Deutsche mark and schilling stocks that had not been exchanged yet. If we assume that these stocks are exchanged for euros, then the average decline would be somewhat lower (– 18 percent), but still substantial.

Concerning the US dollar, the surveys show that the amount of US dollars has remained roughly constant over the last three surveys. If seen in a longer-term perspective, however, there is also a decline in US dollars. A longer-term reduction is also found for the Swiss franc.

What are the motives behind euro and US dollar holdings?

Prior to the introduction of euro cash, there were arguments that the euro would not be able to attain as high a reputation as the Deutsche mark had enjoyed in Central and Eastern Europe. An analysis of the reasons behind the decision to hold foreign currencies may shed some light on this issue. Therefore, the respondents were asked about their motives. The corresponding results for the euro and the US dollar, expressed in percentage of respondents, are depicted in Figure 3. To compare the role of the euro with the role of the Deutsche mark, the corresponding values for the latter from the survey in May 2001 are also given.[8] The results show that currency holdings are hardly motivated by domestic transactions except in one case: in Croatia 15 percent (euro) and 7 percent (dollar) of all respondents answered that this is their main motive for holding euros or US dollars. Euro hold-

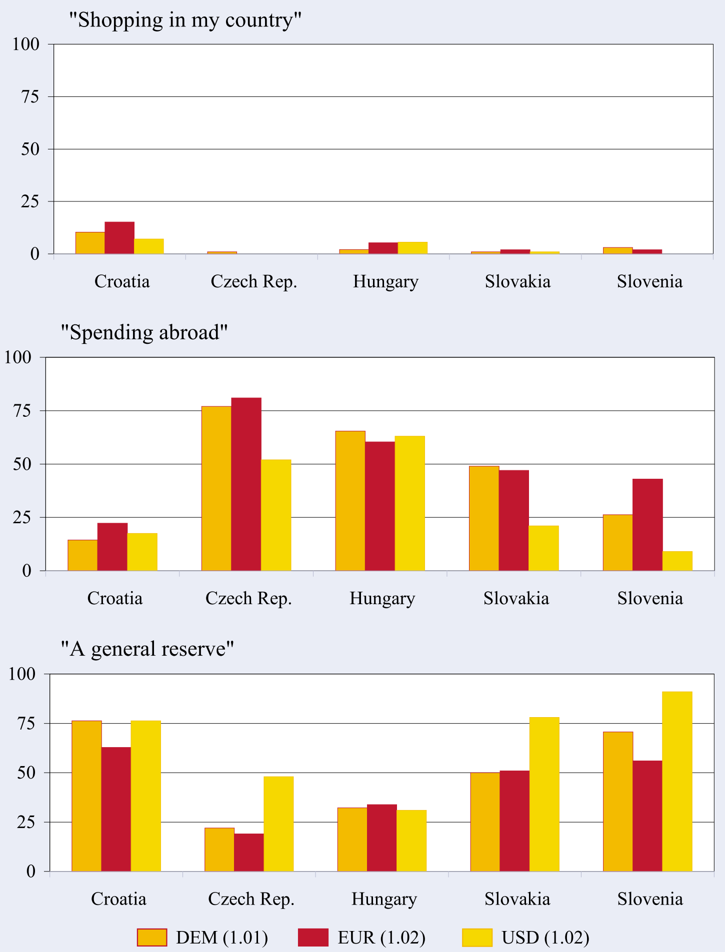
[6] If the number of respondents is very small, the estimated amounts show sizeable variations. Therefore, we do not put too much faith in analyses based on single observations. Because the number of respondents is small in Hungary, the euro and US dollar estimates are based on the remaining four countries only. In the case of the franc, which in general is only held by a low percentage of respondents, Croatia was also excluded.

[7] In comparison to the survey in May 2001, the euro amounts did not decline. However, as mentioned above (compare with footnote 4), we do not rely on one individual observation.

[8] Due to the possible presence of seasonality effects, the May 2002 values are compared with the May 2001 and not with the November 2001 values.

Figure 3

MOTIVES BEHIND FOREIGN CURRENCY HOLDINGS



Note: The figures show the motives behind the decision to hold foreign currencies. The question is: "For which reasons do you kepp your foreign cash mainly? Do you keep (it) in cash mainly for .....?" The numbers represent percentages of respondents.

Source: OeNB, own calculations.

ings are predominantly used for transaction purposes (e.g. shopping or holidays in Austria or in Germany) by Czechs and Hungarians. This was also found to be a major motive in Slovakia. By contrast, euro holdings are predominantly considered to be a general reserve by Croatians and Slovenians and, to a high degree, by Slovaks. In these three countries, US dollars are also held primarily because of their store of value function. In the Czech Republic and in Hungary, US dollars are mainly used for expenditures abroad.

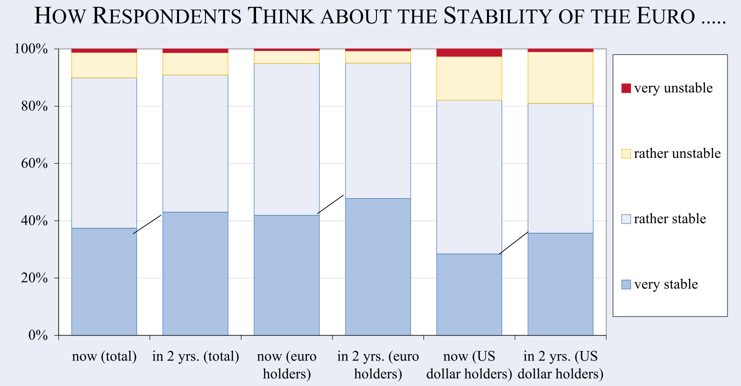
A comparison of the motives for holding Deutsche marks and euros shows sizeable changes only for Croatia and Slovenia, where the "spending abroad" motive gained in importance. Most likely, this can be explained by the fact that a high share of former schilling amounts in both countries was held for shopping purposes. These schilling holdings were partly transformed into euro holdings, implying that a larger share of euro holdings – in comparison to Deutsche mark holdings – in these two countries can now be linked to shopping purposes. However, apart from these two cases, the motives for holding euros are remarkably similar to those for holding Deutsche marks.

What do respondents think about the stability of the euro?

One aspect of the most recent survey was to get an indication of the overall standing of the euro in the countries under consideration. To this end, the respondents were asked whether their attitude towards the euro had turned more or less favourable compared to their previous opinion. The answers show that in May 2002, 51 percent of respondents had a more favourable opinion of the euro. Only 13 percent answered that their opinion had turned less favourable. Among those who held euros, 70 percent had a better opinion and 10 percent a worse opinion than before. The respondents were also asked for their opinion of the US dollar: Here, the share of people with a more positive opinion about the dollar is smaller (42 percent) and the share of those with a more negative opinion larger (16 percent). Among those who actually held US dollars, 64 percent had a better and 12 percent a worse opinion (compared to their previous opinion).

Further, the respondents were asked for their assessment of the current and future stability of the euro and the US dollar. In particular, respondents were asked how stable or unstable they con-

Figure 4



Note: Numbers in percent of respondents that have made up their minds. The figure shows the answers to the following question: "From your point of view - how stable is the euro at the moment?" and What do you think, how stable will the euro be within the next 2 years?" "Total" refers to all respondents, "euro holders" to those that held euro but no US dollars and "US dollar holders" to those that held US dollar but no euros.

Source: OeNB, own calculations.

sider both currencies at the moment and over the next two years.[9] The results for the euro are summarised in Figure 4, which shows the percentage of respondents that answered either "very stable," "rather stable," "rather unstable," and "very unstable." Figure 4 also shows a pairwise comparison of the answers concerning the current and the future situation for all respondents ("total"), then for those respondents who held euros but no US dollars (labelled "euro holders" in Figure 4) and finally for all respondents that held US dollars but no euro ("US dollar holders"). Four months after the introduction of euro cash, about 90 percent of the total population considers the euro to be rather stable or very stable. Among euro holders, this value is 95 percent. Among US dollar holders, expectedly, this value is lower, or, put differently, the percentage of those who consider the euro rather or very unstable is quite high (18 percent). Two things are remarkable about the respondents' assessment of the future stability of the euro: First, the percentage of those with a skeptical view about the future stability of the euro is low and about the same as the percentage of those with a skeptical view about the current stability of the euro. Second, the percentage share of those who answered that the euro would be very stable over the next two years is considerably higher than the share of those who answered that the euro is currently very stable. Surprisingly, this is even the case for those who held US dollars only.[10]

Finally, all respondents who held euros (or US dollars) were asked whether they planned to exchange these holdings for US dollars (or euros). Overall, 7 percent of all respondents answered that they think about exchanging their holdings (or plan to do so) and 88 percent answered that they do not.[11] In Croatia and Slovakia, where the percentage of those who exchanged Deutsche marks for US dollars was highest (see Table), 14 and 10 percent, respectively, answered "yes, sure" or "yes, maybe". As to the planned exchange of existing US dollar holdings for euro holdings, three percent answered "yes, sure" or "yes, maybe" and 88 percent "probably not" or "no." Therefore, there seems to be a slight indication that more respondents plan to replace their dollar holdings by euro holdings than the other way around. However, due to the predominance of those who do not plan to switch currencies, the results provide more support to the view that sizeable portfolio shifts between euro and US dollar cash balances will not take place in the near future.

Expectations about the introduction of the euro

In light of the debates about European Union enlargement and, later, the introduction of the euro in some or all of the prospective EU member countries, the respondents were also asked whether they believed that their country would introduce the euro within the foreseeable future.[12] The answers of those who actually expressed an opinion can be summarised as follows: Only in Slovakia do the sceptics hold a majority: a total of 63 percent answered that they were "very or rather unsure." In all other countries, the clear majority was either "very sure" or "rather sure" that their

[9] Notice that "stability" in this sense is used as a metaphor, a very general notion that can refer to the exchange rate or the inflation rate. We do not ask for the respondents' view about the stability of the exchange rate or of the inflation rate separately because the number of those without an opinion would be very high.

[10] Similar to the euro, the results for the US dollar reveal a high degree of confidence in the current and future stability of the US dollar (90 percent and 92 percent, respectively). Among euro holders, the respective values are ("very stable" plus "rather stable"): 89.2 percent (now) and 90 percent (within the next two years). US dollar holders: 94.3 percent now and 95 percent within the next two years.

[11] The remaining share of respondents answered "do not know".

[12] The question was: "Do you believe that your country will introduce the euro within the foreseeable future – that is will it join the euro area?"

country would join the euro area; the largest majority was found in Slovenia, where 67 percent answered that they were "very sure" and 19 percent that they were "sure."

Summary and implications

A recent representative survey commissioned by the Oesterreichische Nationalbank and conducted in May 2002 allows an assessment of the extent of foreign currency holdings in euros and US dollars among adult citizens in Croatia, the Czech Republic, Hungary, Slovakia and Slovenia. The main results and implications can be summarised as follows:

First, people who held Deutsche marks around 1 January 2002 were asked about their exchange behaviour. The results show that the majority exchanged their Deutsche marks for euros. Furthermore, a substantial share of respondents opted for local currencies, while the share of those who exchanged their holdings for US dollars is sizeable only in Croatia and Slovakia.

Second, the share of respondents who held euros in May 2002 is significantly lower than the share who held either schillings or Deutsche marks in November 2001 while the US dollar share remained roughly constant. In general, the proportion of inhabitants that held any foreign currency declined not only in a short-term perspective from autumn 2001 to spring 2002, but also in a longer-term perspective from 1997 to 2002 (in the long run except Slovenia).

Third, the estimated nominal amounts of euros held in Croatia, the Czech Republic, Slovakia and Slovenia declined substantially from 1999/2000 to May 2002. A decline relative to 1999/2000 can also be found for the US dollar and the Swiss franc while in the last three surveys from May 2001 to May 2002, the nominal amount of US dollars remained roughly constant.

Taken together, the results about the exchange behaviour (Table) and about the extent of foreign currency holdings (Figure 1) as well as the results from the analysis of the estimated amounts (Figure 2) do not point to a substantial substitution of Deutsche mark or Austrian schilling holdings for legal US dollar holdings. The surveys show that people exchanged Deutsche marks mainly for euros or, to a lesser extent, for local currencies. The long-run reduction in the extent of foreign currency holdings as well as the fact that the euro amounts declined without an associated increase in either US dollar or Swiss franc amounts might reflect, as conjectured in Stix (2001), an increased confidence of Central and Eastern Europeans in either their local currencies (if foreign currencies were exchanged for domestic cash) or into their banking systems (if foreign currencies were exchanged for bank deposits). Of course, these results must be qualified to the extent that the survey cannot measure unreported illegal holdings.

Fourth, the results as to the perceived stability and the opinion of the euro show that only a few months after its introduction, the euro already has excellent "approval ratings" in Central and Eastern Europe. About 90 percent of all respondents think that the euro is currently rather or very stable and will remain stable or rather stable over the next two years. Among the group of individuals that actually held euros in May 2002, these numbers are even higher (about 95 percent). Furthermore, the motives behind the decision to hold euros are quite similar to the motives behind the decision to hold Deutsche marks.

Finally, a majority in Croatia, the Czech Republic, Hungary and Slovenia believes that the euro will be introduced in their country within the foreseeable future. Only in Slovakia, the majority doubts that the euro will be introduced.

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Poland's road to the euro: A review of options[1]

Stanislaw Gomulka*

Long-term economic benefits of adopting the euro

Euroization is an important part of what appears to be a new general tendency in the world economy, one towards fewer but better monies (Dornbusch, 2001).

The main arguments in favour of the European Union (EU) countries' adopting a common currency may be divided into three categories: (a) those related to international trade and static efficiency gains, (b) those related to stability, and (c) those related to growth. Although these arguments are well known, I should like to recall them briefly, in order to make the point that while (a) applies to all countries, (b) and (c) apply mainly to the least developed members and candidates of the EU.

Trade and efficiency: The elimination of an exchange rate risk within a common currency area (CCA) reduces the transaction cost in international trade and therefore stimulates the integration of national markets for traded goods. This in turn creates opportunities to reduce costs through economies of scale and increased competition. The efficiency gains of this kind should be enjoyed by all CCA countries, but especially those which trade a great deal with other EU countries.

Stability: The arguments in this category note that the countries whose record of stability was poor in the past stand to improve significantly the credibility of their macroeconomic policies. Credibility gains in those countries would result in lowering inflation expectations, which in turn would lower both current interest rates and the cost of keeping the inflation rate at a low level. Further implications would be a lower cost of servicing the public debt and smaller speculative and destabilising capital inflows. Benefits of this kind have been already enjoyed by some EMU countries, notably Italy, Spain, Portugal and Greece. However, credibility gains would be particularly strong for new EMU members belonging to the group of emerging market economies (EMEs), such as Poland or Turkey. The credibility of macroeconomic policies in all EMEs is relatively low, the group having suffered from the macroeconomic instabilities which in the past were concentrated in those economies.

Growth: Some EMEs, including Poland, also suffer from low domestic savings. In China and the Southeast Asian countries, prospects of rapid growth have in the past tended to stimulate domestic savings. During the period 1960–2000, the savings rates in those countries increased from about 15–20% of GDP to levels in the range of 30–50% of GDP. But in those countries public expenditures, and hence tax burdens, have been very low by European standards. The private sector was then in a position to respond to investment opportunities by increasing its own savings. In Poland, parallel tendencies were likewise observed during the 1990s: a lowering of the tax burden and an increase of the domestic savings rate, produced changes in savings and investment of around 5% of GDP. However, the domestic savings rate is still only 20–22% of GDP. This is much lower than what is needed to support growth at a rate of 6–7%, which may be the potential rate of growth in the current decade. Judging by the experience of successful EMEs, the investment rate required to support 6–7% GDP growth over a long period of time is about 30 to 35% (Gomulka, 2000).

The Strategy for Poland (Government of Poland, 1999) was designed specifically to close the gap between this required total investment and the supplied domestic savings by increasing the latter by some 8% of GDP and by adopting policies that would maintain the inflow of foreign savings at the present level of around 5% of GDP. However, the central components of this strategy related to public expenditures (other than public investments) and domestic savings seem to have failed. As a result, public expenditures are unlikely, in the medium term, to decrease (significantly) in relation to GDP, so that domestic savings are unlikely to show a (significant) increase. This would be no problem whatsoever if Poland were already a member of EMU. In that case Polish enterprises would have direct access to the savings pool of the entire Euro area at low interest rates with no exchange rate risk. An increase of the savings

[1] An earlier version of this paper was presented at a conference organised by the National Bank of Poland, Warsaw, 22–23 October 2001.

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inflow to Poland by 8% of Poland's GDP would represent only about 0.2% of the Euro area's GDP. Such an increase, while large for Poland, would require practically no adjustments in EU interest rates and the euro/dollar exchange rate.

While the potentially large impact of euroization on the supply of savings is well understood by economists, a point little stressed so far, though of general political interest, should be made with respect to the parallel impact on investment. Namely, foreign savings could and probably would be used above all by Polish-owned enterprises to supplement their profits in financing their own investments. Under the present floating exchange rate mechanism this is not the case, for the exchange rate risk associated with borrowing euros is particularly high for enterprises which supply predominantly domestic markets, and these enterprises tend to be Polish owned. Euroization would thus remove this form of credit discrimination. This, in turn, would mean that the utilisation of foreign savings would no longer be tied to the size of foreign direct investment.

Medium-term concerns in selecting a euro strategy

While the long-term gains from euroization are large enough to favour the choice of a fast-lane approach, in the medium term the potential risks and net costs vary substantially among the different possible strategies. Of particular concern is the impact of any chosen strategy on developments in three areas: (1) the rate of inflation – and hence the risk of not meeting the Maastricht criteria on inflation and interest rates, (2) the current account deficit and (3) the size of the foreign debt, the risk being that both the current account and the debt may become excessive. Other causes of concern are supply-side and demand-side negative shocks – that they may be excessive if changes in the zloty exchange rate are too fast and too large. I shall discuss these concerns in general terms in this section and in a somewhat greater detail in the following two sections.

Inflation and interest rates

While Poland's failure, to date, to reform public finances has increased the attractiveness of an early euroization strategy, it has also increased the risk that Poland will not be able to meet, in the near future, the Maastricht criteria regarding budget deficit and interest rates. There are essentially three possible policy responses to these conflicting implications:

(A) One response is to adopt unilateral euroization as early as feasible on purely internal practical grounds, e.g. soon after joining the EU (probably January 2004).

(B) The second response is to adopt policies explicitly aimed at meeting the Maastricht criteria by about 2005, with a view to join EMU in 2006 or 2007, which is probably the earliest feasible accession date .

(C) The third response is to delay the entry to EMU on the grounds that the costs of meeting the entry requirements are so large that they must be spread over a longer period, e.g. 8 to 10 years.

Strategy (A) offers the benefits of an early entry, in particular much lower interest rates, while finessing the cost obstacle by shifting to a later date the question of meeting the Maastricht criteria, especially on the budget deficit and interest rates. The risks associated with this option are discussed in the next section.

Strategies (B) and (C) are variants of what may be called the standard approach, one which presupposes full co-operation with the European Central Bank (ECB) and the EU authorities.

Current account and foreign debt

A high-growth strategy in the circumstances of low domestic savings presupposes the acceptance of a high current account deficit. In order to lift the investment rate to a level of about 30% of GDP, the deficit would have to increase from the present level of about 3 to 5% of GDP, to a level possibly in the range of 8 to 10% of GDP.

Foreign direct investment and transfers from the EU may amount to 4 to 6% of GDP. Therefore foreign borrowing by banks and enterprises would have to amount to some 4 to 6% of GDP as well. Given the currently low level of the country's foreign debt, increasing it by about 5% of GDP annually would be acceptable for the several years of the transition period. If the prospect of Poland's joining EMU in about four years were credible, Poland's total foreign borrowing could yet increase substantially without any significant risk to macroeconomic stability. If the official international reserves of the National Bank of Poland are kept comfortably above the short-term debt, augmented by portfolio capital and annual debt amortisation, the maximum safe level of total foreign debt could be some 70% of GDP, which is double the present level of about 35% of GDP. An additional debt of 20% of GDP above the present level would still keep the total comfortably below that maximum and yet be sufficient to finance an additional current account deficit of some 5% of GDP for four years. The debt constraint may therefore be binding for strategy (C), but need not be binding for strategy (B).

Supply-side and demand-side shocks

The euroization of the Polish economy would deprive it of the ability to respond flexibly to external shocks through a suitable change of the zloty exchange rate. The associated cost is known, however, or at any rate believed to be relatively small. A much greater potential problem for the real economy is that, during transition to the euro, the zloty exchange rate may become highly volatile, causing significant supply-side shocks for importers, demand-side shocks for exporters, and cash-flow shocks for holders of foreign debt. This exchange rate volatility would be particularly high when the current account deficit is significantly larger than at present. Moreover, an increasing current account deficit under strategies B and C presupposes some persistent real appreciation of the zloty . Such appreciation should also be expected to inflict costs on the supply side. In theory, the cost of the shocks due to high volatility of the exchange rate could be curbed by the ERM-2 arrangement. In practice, the (15% band would have to be shifted under strong market pressure.

The unilateral euroization strategy

The idea of adopting unilaterally a major world currency, such as the US dollar, the euro or the yen, as a national currency has been proposed or revisited for several countries. This idea has been typically presented as an improvement over a currency board arrangement, and as an even bigger improvement over the standard fixed peg exchange rate policy.

Bratkowski and Rostowski have modified this idea for Poland and some other EU applicant countries (Rostowski, 2001a,b). The modification stipulates that unilateral euroization is just a transitory policy to be followed by full membership of EMU.

Key advantages

The unilateral euroization strategy offers two closely related advantages: immediate access to large foreign savings and substantially lower interest rates. These advantages are therefore tailormade for a country, such as Poland, where domestic savings are, and are likely to remain, low for reasons of culture and politics, while the pool of highly profitable investment projects is large due to earlier reforms and the availability of entrepreneurial capital.

Key risks

Unfortunately, the risks associated with this strategy are also formidable. The primary risk is that, due to the impact of the Harrod-Balassa-Samuelson effect, Poland will be unable to meet the Maastricht criterion on inflation for a very long time. Sinn and Reutter (2001) calculated that this effect would be much greater in Poland than in Germany with the result that, under the fixed zloty-euro exchange rate, inflation in Poland would be 4.2% higher. This calculation is based on the empirically supported assumption that labour productivity growth in Poland is 10.3% in the traded goods sector and 3.9% in the non-traded goods sector. It is also assumed that nominal wages grow at the same rate in both sectors. Even if the HBS effect is significantly lower than the Sinn-Reutter estimate, it would still pose a risk for an early entry to the official Euro zone.

It is conceivable that the EU countries may be persuaded to modify the Maastricht criterion on inflation for those countries which adopt the euro unilaterally. But the probability that they will keep the criterion in place is too close to 100% for the risk to be ignored. This risk would be priced in by money markets, and this pricing would be reflected in higher interest rates on Poland's foreign debt. If that risk is high, the potential advantages of a unilateral euroization would be much diminished, or even wiped out altogether.

Another risk is that adoption of this strategy would lower pressure on fiscal and other structural reforms. That risk would also be priced in by the financial markets, reducing further any potential advantages of the unilateral euroization strategy.

Finally, until Poland joins the EMU, there would be the standard risk associated with a fixed exchange rate, namely that foreign borrowing by corporations could explode, as it did in the Czech Republic in 1995 (Dedek, 2001).

The standard strategy: a fast lane variant

A broad outline and timetable

This option is, I believe, still the current official strategy. Its central theme states that: "*[i]n view of the large benefits which an early entry to the EMU would bring about, Poland will offer to submit its exchange rate policy to the rigours of the ERM-2 soon after joining the EU*" (Government of Poland, 1999, p. 26). If Poland were to join the EU on 1 January 2004, this statement proposes to join ERM-2 sometime during 2004, and to join EMU two years later or soon afterwards.

Initial conditions and macroeconomic policies

The initial conditions of transition to EMU must be carefully noted, since they will have a large impact on economic policies, the macro-financial risks and the growth performance during the transition period. The standard euroization strategy will be helped by the currently low stock of foreign debt and the high rate of unemployment. As noted earlier, the low level of debt provides room for a sizeable increase of the current account deficit from the present 3–5% of GDP. Such an increase would serve two purposes. It would provide room for some real appreciation of the zloty and it would permit a high rate of economic growth. The high unemployment rate will keep the growth of nominal wages low, and this should help to stabilise inflation at a rate close to the currently very low level. Low inflation would permit the central bank to keep interest rates on a declining trend. This latter is needed to meet the Maastricht criterion on interest rates. Lower rates would also stimulate bank borrowing by companies. This borrowing remains low by international standards, which is another favourable initial condition of the Polish economy. Bank credits would be funded to a greater extent than at present by foreign borrowing. This borrowing would be encouraged by the expectation that, during the transition, the zloty will rather appreciate than depreciate. But any appreciation should be moderate. Kawalec and Krzak (2001) warn that the current policy of pure floating may cause excessive appreciation which could stifle economic growth. They advocate a policy of 'controlled appreciation'. Although agreeing that a rapid appreciation should be avoided, this aim can and must be achieved while keeping the economy on the targeted low inflation path. Hence the balanced policies proposed here: little growth of public expenditures, much lower budget deficits of the general government as a result of faster growth, lower real interest rates, higher current account deficit, fuller labour market liberalisation, official reserves kept above short-term debt, the long-term debt of corporations allowed to increase more sharply.

It is interesting, though perhaps not surprising, that the current theoretical debate on exchange rate policies has revealed sharp disagreements between supporters of fixed and floating exchange rates (Reinhart 2000, Obstfeld and Rogoff, 2000), prompting Williamson (2000) to argue against any 'corner solutions'. In fact, monetary authorities and governments in most countries have tended to practice the Williamson doctrine (Calvo and Reinhart, 2000). The intended adoption of ERM-2 by Poland would mean embracing this doctrine for a while with respect to the euro. Following the entry to EMU, Poland will have a fixed peg for transactions within the Euro area and fully floating rates for transactions outside the area. This arrangement, though a combination of two corner solutions, will be a kind of intermediate solution.

An important feature of the initial conditions in Poland is a severe 'reform deficit' in the areas of public finance. Large and increasing unemployment have already induced a substantial liberalisation of the labour code, and this, in turn, will keep both the growth of nominal wages and the natural rate of unemployment low. A reform of the public finances is, however, still needed to release resources for investment and growth. This redistribution of resources requires a restructuring of public expenditures away from social transfers. If such a restructuring does not take place, which is a possible development during the transition period, the unemployment rate will continue to be very high. Although this outcome could increase social tension, it should also help to keep the economy on the targeted low inflation path.

The only necessary fiscal requirement is the Maastricht criterion of keeping the deficit below 3% of GDP. But this EMU entry requirement can probably be met without substantial fiscal reforms. The Maastricht stability and growth pact would require Poland, after joining EMU, to have a balanced budget on average and a budget surplus in years of rapid growth. However, meeting this post-entry requirement would be eased by lower debt servicing costs, the EU net transfers to the budget and some 4–5 years of GDP growth between now and the entry date.

Macroeconomic risks

There will be considerable risks associated with this fast lane variant of the standard euroization strategy. These risks have five ultimate causes: excessive and poorly structured public expenditures, low domestic savings, an economy capable of fast productivity growth and high returns to investment, hence high investment demand, high growth of the labour supply, and a large pool of poorly educated labour. The first two causes are interrelated. Attempts to remove these two causes have so far been largely unsuccessful. But if domestic savings continue to be low, then in view of the high growth potential, we have a range of possibilities between the following two extreme scenarios.

One such scenario is that which we have already begun to observe in the years 2000–2001: a moderate current account deficit, a low increase in foreign debt, extremely high real interest rates and, as a result, a costly recession in industry and construction, and very high and still increasing unemployment. Under this scenario, the risk of a macroeconomic instability is indeed close to nil. However, the rate of unemployment could reach a socially unsustainable level, affecting very seriously some parts of the country and some segments of the population. This experience of rapid and prolonged poverty growth rather than economic growth is bound to put into question the underlying policies. The other extreme scenario is the one outlined above: a high current account deficit, a moderately rapid increase in the foreign debt of corporations, much lower real and nominal interest rates, rapid growth of GDP, and stable or declining unemployment. Under such a policy, the zloty may appreciate moderately in real terms, and this appreciation, along with high unemployment and labour market reforms, would help to meet the Maastricht criteria on inflation and interest rates. The risk of a macroeconomic instability would be clearly higher than at present, might well become significant, rising together with the size of the foreign debt in relation to GDP. However, as was argued earlier in this paper, this risk need not be excessive if the projected entry date to EMU, the years 2006–2007 were credible. The conditions required to keep this risk acceptable are that the debt increase is smooth and takes place at a moderate rate, the debt's maturity composition is heavily skewed in favour of post-entry dates, and official reserves are kept comfortably above short-term payment obligations. The main intellectual and policy innovation of the fast growth variant of this standard euroization strategy lie in the acceptance of high current account deficits already during the transition to EMU.

Intermediate cases are those which lie between the two extreme strategies.

The standard strategy: a slow lane variant

The losses associated with a delayed entry to EMU are self-evident. But are there any substantial gains? Can the costs and the risks associated with a fast lane variant of the standard strategy be reduced significantly by postponing the entry for several years?

Let us recall that the costs and the risks of that strategy are interrelated. The former are associated first and foremost with the expected real appreciation of the zloty, while the latter are associated with a projected high current account deficit and an increasing level of foreign debt. Given the large size of the HBS effect, some real appreciation may be needed to support a low-inflation policy, while in view of the low level of domestic savings, the current account deficit will be required to support a high growth policy.

These costs and risks can be reduced if strong reforms are undertaken to increase both domestic savings and the flexibility and competitiveness of domestic markets, especially the labour market. It may be argued that although the Buzek-Balcerowicz attempted reforms of this kind have failed, in the new circumstances of very high unemployment, the need for such reforms could become more evident to political leaders and the general public. The recent implementation of a more flexible labour code is a clear expression of that need.

However, one cannot rule out the scenario that the much needed fiscal reforms will not be undertaken during this current decade. In the medium term there might, indeed, be some regress in this area of the public finances, beginning with the adverse fiscal developments in 2001. Does this mixed reform scenario provide a case for adopting a slow lane variant of the standard euroization strategy?

The answer depends on the magnitude of risk which it would be sensible to accept. If regress in the public finances were to be considerable, then the risk of macro-economic instability associated with an attempt to implement the fast-lane variant would increase sharply, making it at some point a sub-optimal strategy.

Concluding remarks

The unilateral euroization strategy, if adopted, would bring about the substantial benefits which Poland stands to reap by adopting the euro as its national currency. However, the strategy involves the risk that the date of official entry to EMU will be highly uncertain, possibly much delayed. Therefore this strategy could and should become a serious candidate for consideration only if the Maastricht criteria on inflation and interest rates can be renegotiated. As things stand now, the choice is, effectively, between different variants of the standard strategy. The costs and risks associated with a fast lane variant of this strategy are considerable. However, the initial conditions and potential net gains are such that Poland should and is likely to attempt to implement that variant.

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ELECTRIC ENERGY EXCHANGES GAIN IN IMPORTANCE

Liberalisation of the energy markets in Europe and new competition have given rise to new trade structures. Since the early 1990s around one dozen power exchanges have been created in Europe and more are in the making.

The change in the power industry, that can be observed world-wide and that has been characterised by privatisation and the opening of markets, was triggered in Europe by the EU Electricity Directive of 1996. Its translation into national laws, guidelines and rules was left to the Member States. Correspondingly diverse and varied is the state of the development, not only regarding the degree of market opening but also with respect to the rules for access to the markets and networks. Any uniform rules for cross-border power transport are likewise still missing.

Prerequisite for market openings is the break-up of formerly monopolistic producer/consumer relationships and the accessibility of the market for consumers in particular. Today the consumers or clients may actively take part in the power markets. In combination with longer-term contracts for price hedging, new market chances have opened up on the demand side.

Power exchanges provide a neutral, fair and transparent market place that produces – under government oversight – a reliable and generally accepted price signal. They also provide instruments for risk management.

Selected Power Exchanges in Europe

Exchange	Participants	Spot Market	Forward Market
Nordpool (Norway, Sweden, Finland, Denmark)	304	yes	yes
EEX (Germany)	111	yes	yes
Omel (Spain)	104	yes	no
PolPX (Poland)	44	yes	yes
UKPX (United Kingdom)	44	yes	yes
APX (Netherlands)	38	yes	no
PowerEX (United Kingdom)	35	yes	yes
IPE (United Kingdom)	34	no	yes
Powernext (France)	26	yes	no
EXXAA (Austria)	16	yes	no

Source: VDEW (German Association of the Power Industry).

The biggest and oldest European energy exchange is the Scandinavian NordPool, founded in Oslo in 1993, initially only offering a spot and forward market for Norway. In 1996 it expanded its dealings to Sweden with an effective network-bottleneck management. Finland and Denmark followed in 1998 and 2000. Today Nordpool handles a volume of more than 20 percent of Scandinavian electricity consumption.

At the end of 1998 a spot market started in Spain. Half a year later followed the day-ahead market of APX for the Netherlands, which in turn expanded its activities to Germany, across the border characterised by severely limited transport capacity. In the summer of 2000 spot dealing started on the two German power exchanges LPX and EEX which have since merged. In the same year the Polish energy exchange went live with a spot market modelled on the Dutch exchange and the UK Power Exchange placed its first power future in London. Increasing acceptance and dynamism has led to the creation of a number of new exchanges (see Table).

H.C.S.

Another oil price spike?

In August 2002, crude oil prices surged, with West Texas Intermediate closing at over $30 per barrel for the first time since February 2001. According to the International Energy Agency's September *Oil Market Report*, lower Iraqi exports, North Sea maintenance and a reduction in Former Soviet Union crude exports constrained supply in August to 76.1 million barrels per day, down 580 thousand barrels per day from July. As the *Economist* reported, the reasons for the recent decline in Iraqi oil exports was not due to intentionally introduced volatility, but rather to a UN crack-down on a scheme under which Mr. Hussein was directly paid a surcharge by middlemen. Now buyers must commit to a shipment before knowing which price the UN has imposed. This stamps out the surcharge, but also discourages many buyers.

Not only lower supply, but primarily talk about war with Iraq has pushed up oil prices. According to Cambridge Energy Research Associates, the "fear premium" on each barrel of oil is now $3–5. As war becomes an ever greater risk, prices are bound to go still higher. During the Gulf war oil prices peaked at over $40/b in nominal terms. Rumours of war will also have been in the minds of the OPEC ministers' meeting in Osaka, Japan.

Yet, they decided to leave official supply limits unchanged at 21.7 mb/d, pointing to the existing OPEC formula under which prices staying above $28 for the basket, equivalent to about $30.50 for US crude, for 20 consecutive trading days would trigger more oil production.

They will decide on future OPEC output. Non-OPEC supply is projected to rise by 1.2 mb/d in 2002 and 700 kb/d in 2003. Global oil demand, which at 75.9 mb/d fell short of total oil supply of 76.9 mb/d in 2001, was forecast to rise to 76.1 mb/d in 2002 and 77.3 mb/d in 2003. These IEA forecasts have not factored in a war with Iraq and its economic consequences on oil consumers and producers. The short-term oil price may well go above $50/b.

The long-term outlook for oil prices is more modest, around $22-24 in today's prices, according to Boston Consulting. Proven oil reserves are believed to be sufficient to satisfy projected demand for the next two decades. By 2020, oil production, as projected in the IEA's *World Energy Outlook 2000*, will reach 115 mb/d or 40% of the world's total energy supply. Over the next two decades, most of the expected demand growth will come from the transport sector, where the potential for replacing oil with another fuel is still limited. Global oil production need not peak in the next two decades if necessary investments are made. Middle East oil producers have a challenge to exploit their low-cost oil resources, but their ability to mobilise capital is uncertain. Their production and investment will closely depend on their pricing policies. As the *World Energy Model* has shown, neither very high nor very low oil prices would improve cumulative revenues for the major producers over what they can earn under moderate-price conditions.

H.C.S.

London Brent Crude Oil Price - US$/Barrel

Source: Datastream and daily newspaper.

TEMPORARY AGENCY EMPLOYMENT IN THE EUROPEAN UNION

In temporary agency work, which frequently is also called loan work, an independent operator (loan employer) lets his employee (loan employee) to a third party (borrower) for work to be performed.

Temp work offers a number of advantages to the employing firms: flexible temporary use of loan workers, short-term deployment possibilities depending on demand (and thus the circumvention of dismissal protection provisions), outsourcing of the personnel sifting function to the loan agency and the opportunity of getting to know loaned workers before final employment. Workers, on the other hand, can use temp work to gather job experience, to work flexible times (e.g. only in winter) and to increase their chances of getting a regular permanent job.

In the European Union, temporary agency work has greatly expanded. In 1999 the number of temporary workers amounted to 2.1 million, corresponding to 1.4% of total employment. It is most important in the Netherlands, Luxembourg, France and the United Kingdom. It is least important in Finland, Ireland, Italy and Greece (see Fig. 1).

The importance of temporary work depends on the strictness of employment protection laws. If employment protection is strict, overcoming personnel bottlenecks by employing regular staff implies high firing costs that may be avoided by employing temporary staff. In France, strict employment protection (cf. OECD 1999, p. 66) is likely to be the cause of a high share of temporary agency workers, in Ireland liberal job protection laws may have led to a low share of temporary workers in total employment.

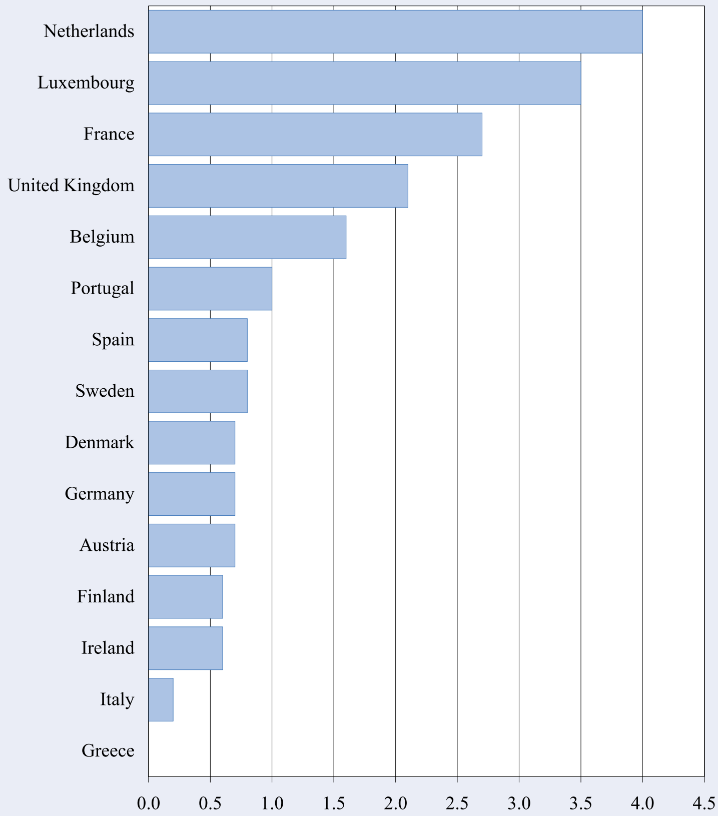
Besides employment protection, the form and intensity of regulation of temporary agency work also affect its expansion. According to a McKinsey study for the International Confederation of Private Employment Agencies (CIETT), temporary agency work is little regulated in the Netherlands and the United Kingdom, whereas it is highly regulated in Italy with corresponding consequences for the spread of temporary work (see Fig. 2).[1]

Temporary agency workers in the European Union share a number of typical characteristics: They have attended primary or secondary school, are primarily male, and 74% of them are below 35 years of age. They are employed above all in trade and industry and in various social services.

[1] There are no data on the two indicators for Luxembourg. In Greece temporary agency work was prohibited. In Finland, average strictness of dismissal protection coincided with relatively liberal legal provisions for temporary agency work.

Figure 1

INTERNATIONAL COMPARISON OF SHARES OF TEMPORARY AGENCY WORK, 1999[a)]

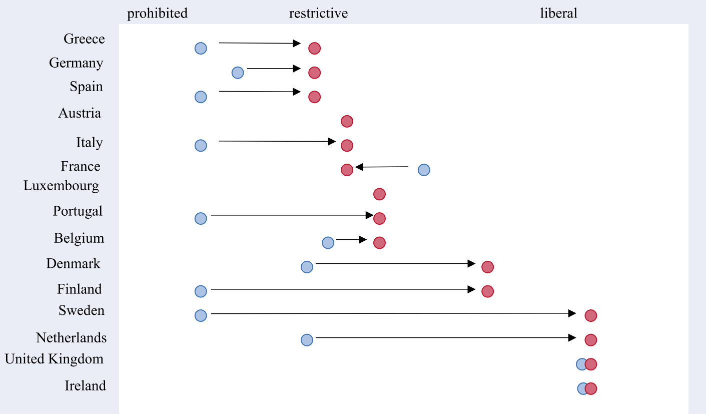


a) Temporary agency employment in percent of total employment.

Source: D. Storrie, Temporary Agency Work in the European Union, European Foundation for the Improvement of Living and Working Conditions, Dublin 2002, p. 28.

Figure 2

DEREGULATION OF TEMPORARY AGENCY WORK IN THE EUROPEAN UNION, 1989-1999



Source: CIETT (2000), p. 39.

65% of their work is manual. The duration of employment per temporary work user is short (CIETT 2000, Appendix).

As a rule, temporary agency workers have worse working conditions than other kinds of workers. Work accidents are more frequent. Their safety and health risks are relatively high. Temporary workers have fewer opportunities than other workers to help determine work content and work processes. Their pay is frequently lower than that of regular employees. In particular, they do not receive any additions to pay and special remuneration. Finally, temporary workers participate to a much smaller extent in training measures. The relatively poor working conditions are likely to be one reason for the short employment duration in loan work firms (Paoli and Merllié 2001; Storrie 2002).

W.O.

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DICE REPORTS*

RESULTS OF PISA 2000: THE CASE OF GERMANY

PISA stands for "Programme for International Student Assessment", an international study of educational performance. It is part of the indicator programme INES, "Indicators of Educational Systems", of the OECD. The following details the findings by category tested.

Reading proficiency

The PISA 2000 study emphasised reading proficiency which comprised approximately two thirds of the required tasks.

- In reading proficiency Finland finished in first place whereas Germany only placed 21st out of 31 countries. Only three other western European countries scored below the OECD average: Liechtenstein, Switzerland and Luxembourg (see Table).
- German adolescents did particularly poorly in comprehension and appraisal.
- The gap between top performers and weak performers is the widest in Germany, and the mean variation is the greatest. The average performance at the upper secondary schools (Gymnasium) stood at 582, much higher than the OECD mean of 500 points; at intermediate secondary schools it was slightly below at 494 points. At lower secondary schools it was only 394 points and at integrated comprehensive schools it was 459.

* DICE = Database of Institutional Comparison in Europe (www.cesifo.de).

International comparison of educational performance

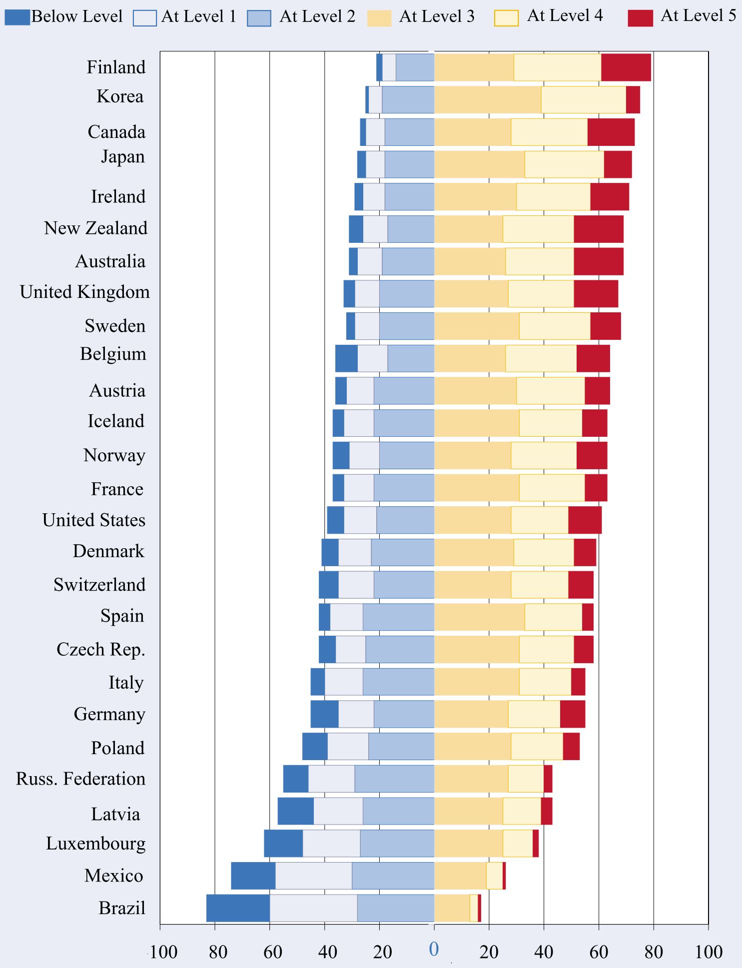
Reading		Mathematics		Natural Sciences	
Country	A	Country	A	Country	A
Finland	546	Japan	557	Korea	552
Canada	534	Korea	547	Japan	550
New Zealand	529	New Zealand	537	Finland	538
Australia	528	Finland	536	United Kingdom	532
Ireland	527	Australia	533	Canada	529
Korea	525	Canada	533	New Zealand	528
United Kingdom	523	Switzerland	529	Australia	528
Japan	522	United Kingdom	529	Austria	519
Sweden	516	Belgium	520	Ireland	513
Austria	507	France	517	Sweden	512
Belgium	507	Austria	515	Czech Republic	511
Iceland	507	Denmark	514	France	500
Norway	505	Iceland	514	Norway	500
France	505	Liechtenstein	514	OECD Average	500
United States	504	Sweden	510	United States	499
OECD Average	500	Ireland	503	Hungary	496
Denmark	497	OECD Average	500	Iceland	496
Switzerland	494	Norway	499	Belgium	496
Spain	493	Czech Republic	498	Switzerland	496
Czech Republic	492	United States	493	Spain	491
Italy	487	Germany	490	Germany	487
Germany	484	Hungary	488	Poland	483
Liechtenstein	483	Russian Federation	478	Denmark	481
Hungary	480	Spain	476	Mexico	478
Poland	479	Poland	470	Italy	476
Greece	474	Latvia	463	Liechtenstein	461
Portugal	470	Italy	457	Greece	460
Russian Federation	462	Portugal	454	Russian Federation	460
Latvia	458	Greece	447	Latvia	459
Luxembourg	441	Luxembourg	446	Portugal	443
Mexico	422	Mexico	387	Luxembourg	422
Brazil	396	Brazil	334	Brazil	375

A = Average.
Source: OECD, PISA 2000.

- The percentage of adolescents that were at proficiency stage 1 (i.e., grasping simple information and recognising the main topic of simple texts) was 13% in Germany. Almost 10% of the German pupils did not even reach this stage. This means that 23% can only read at an elementary level (see Figure 1).
- Of the adolescents that did not reach proficiency stage 1, nearly half (47%) were born in Germany, as were their parents, and speak German at home.
- There were no clear reasons for good or poor reading performance. It was striking, however, that 42% of the 15 year-olds indicated that they did not read for pleasure.
- The teachers were asked before the test to identify particularly weak readers. The adolescents they mentioned were only a small portion of the risk group. This means that most of the pupils with reading problems were not identified. A targeted and early identification and promotion of weak readers might lead – as the study indicates – to a considerable reduction of the risk group.
- Intermediate and lower secondary schools that have class libraries show higher medium performance levels.

Figure 1

PERCENTAGE OF STUDENTS PERFORMING AT THE FIVE LEVELS OF READING PROFICIENCY



Source: OECD, PISA 2000.

Basic mathematical skills

In the PISA test of 2000, mathematics and natural sciences were secondary fields.

- In mathematical skills the top position went to Japan. Germany ranked 20th out of 31 countries, behind the Czech Republic and the United States but before Hungary and the Russian Federation (see Table).
- Very few German adolescents placed in the top group, and a quarter of the 15 year-olds only reached proficiency stage 1 (primary school level) or below. This was an unusually high share by international comparison.
- Causes: On the one hand, mathematical proficiency is closely associated with reading proficiency. On the other hand, there is a connection between mathematical capabilities and self-esteem; special support should therefore be given to girls and to adolescents with weaker abilities.

Basic scientific skills

- Here Korea occupies first place. Germany placed 20th among 31 countries and again was below the OECD average. Its immediate neighbours were Spain and Poland (see Table).

- About a quarter of German adolescents did not get beyond proficiency level 1 (expressing simple factual knowledge, drawing conclusions from everyday knowledge). The portion that reached the highest proficiency level 5 was relatively small (3.4%).
- Again, the range is comparably wide in Germany and performance is concentrated at the lower level. The example of other countries shows that pupils can be helped so that they perform at a uniform, high level (Korea) or in spite of a wider range their performance is concentrated at higher levels than in Germany (England, U.S., Austria).
- Causes and conclusions: The performance of the adolescents reflects the value placed on the natural sciences. The difficulties of the pupils indicate that instruction is not sufficiently problem and application oriented. Scientific thinking and procedures are not practiced enough.

Children from immigrant families

- Adolescents from nationally mixed families do not differ in their reading proficiency from adolescents whose parents were both born in Germany. However, if both parents are immigrants, almost 50% of the pupils did not get beyond proficiency level 1, although most of them (about 70%) have only attended German schools.
- Migrant families live in all countries. With regard to immigration rates, Germany is most comparable to Sweden. If there is a language barrier, i.e. the language spoken in the family is not the language of the country, the social situation of the immigrants is, as a rule, more unfavourable than that of the local families. It is striking that this difference is relatively small in Denmark, Norway and Sweden. The adolescents from these families performed at a clearly higher proficiency level.

Social origin and education

- The connection between social origin and education has loosened, but is still fairly close. Upper secondary schools are full of upper class children. Children of unskilled and semi-skilled workers primarily attend lower secondary schools. In intermediate secondary schools, the social classes are fairly evenly distributed. On the whole, the chances of a working-class child attending an upper secondary school are four times smaller than those of a child from the upper classes. The social separation of the schools is greater in Germany than in the United States.
- The study demonstrated a close relationship on the whole between social origin and acquired competencies. Adolescents with low reading proficiency (level 1 or below) come primarily from the lower social strata, a phenomenon that seems to be supported by the educational system. This is presumably also related to the early differentiation of school types: since the decision of what secondary school to attend is made in the 5th grade, the period for distribution-relevant intervention is relatively short.
- Germany and Switzerland belong to the countries with the greatest differences in the reading proficiency of adolescents from higher and lower social strata. Even the United States has significantly lower socially determined performance differences. Countries such as Finland, Iceland, Korea and Japan have managed to limit the effects of social origin and to achieve a high level of proficiency at the same time (see Figure 2).

Family structure

- The great majority of pupils in Germany live with their biological parents – a little more so at upper and lower secondary schools than in other school types. They have one or more siblings. Adolescents from single-parent households (16%) usually also have siblings. If we control for school type and social strata, children of single-parent households perform just as well at school as children from “complete” families.

Boys and girls

In all PISA countries girls have higher reading proficiency than boys, amounting on average to half a proficiency level. In mathematics boys do better, but by a much smaller margin. The gender differences vary greatly among countries; some countries have managed to achieve good total performance and to balance the differences in the performance between boys and girls.

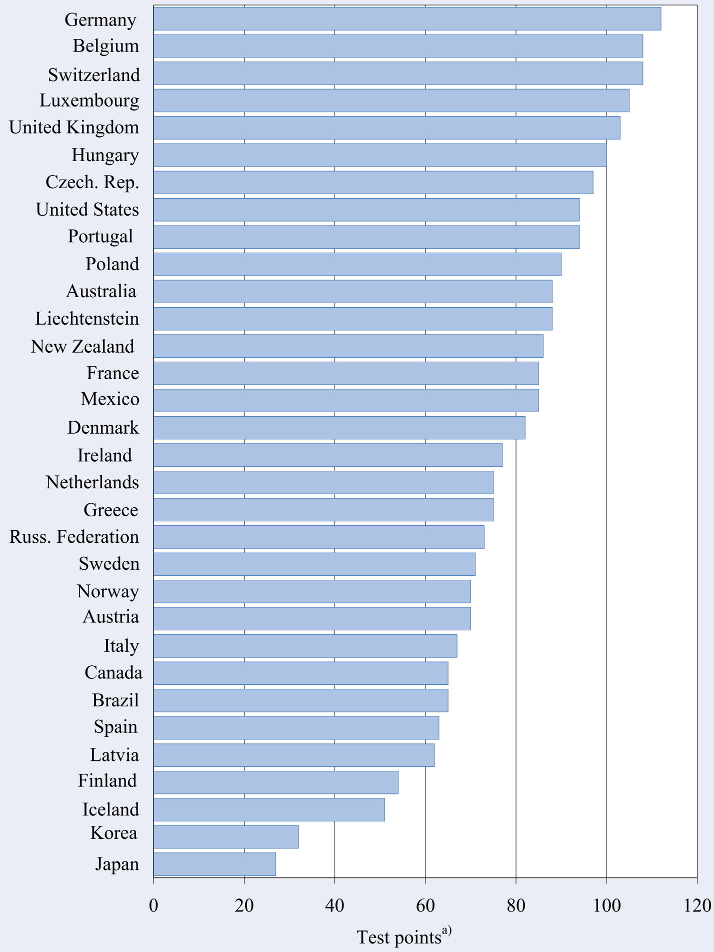
General educational conditions

- The individual countries have very different models. In some countries nearly all 3 or 4 year-olds attend kindergartens or pre-schools; sometimes compulsory schooling begins at 4 or 5 years of age, in part as late as 7. In some countries the 15 year-olds are distributed among six grades (Germany, France), in other countries advancement is automatic so that 15 year-olds are only found in two grades (England). If schools offering compulsory education have different levels of requirements, the division is usually not made until the 7th, 8th or 9th grades. Countries without these different school types usually have different curricula or flexible course systems adapted to individual learning speeds.
- Approximately 60% of the 15 year-olds in Germany attend the 9th grade. At least a third of the pupils tested had a school career that was marked by failure (not including pupils that were demoted to a lower grade). The study reveals that demotion or repeating a grade does not necessarily lead to greater educational success. The pedagogical effect is most often negative: repeaters usually do not achieve the medium level of the classes they join. Those demoted to the next lowest school type, however, are usually among the better performers in their new schools.
- Pupil assessment of instruction: regardless of type of school, German pupils assessed instruction and school atmosphere positively on the whole. A striking difference: pupils at upper secondary schools feel they receive less support from their teachers in German and mathematics than students in other school types.

Figure 2

MEDIUM READING PROFICIENCY

Differences between 15 year olds from families of the upper and lower quartile of the social strata



a) Difference in reading proficiency in points on the PISA test scale

Source: OECD, PISA 2000.

Compilation by Wolfgang Ochel.
Source: Max Planck Institute for Educational Research, Berlin.

World Economic Survey

World Economic Climate Deteriorates

In July the world economic climate indicator slipped after having risen in the previous two surveys. At 101.1 (1995 = 100), the world economic climate is still somewhat higher than its long-term average.

The deterioration of the overall climate indicator is exclusively due to less optimistic expectations for the next six months which, however, still signal a continuation of the economic recovery. The second component of the world economic climate, the evaluation of the current economic situation, continued to improve. This data constellation points to further economic recovery in coming months, though at a slower pace than expected last spring.

World economy: Slight dip, no severe setback of climate indicator

The strong turbulences in world capital markets were thought likely to have a negative impact on the world economic climate. The indicator declined only marginally, however, signalling that the recovery of the world economy is still on track, although the upswing will have less momentum in coming months than could have been expected on the basis of the April survey (see Figure 1).

The decline of the indicator resulted exclusively from more cautious expectations for the coming six months, whereas the assessments of the current economic situation became a bit more positive. In most countries the recovery in the hard-hit capital expenditure sector is still expected to be somewhat more pronounced than in private consumption.

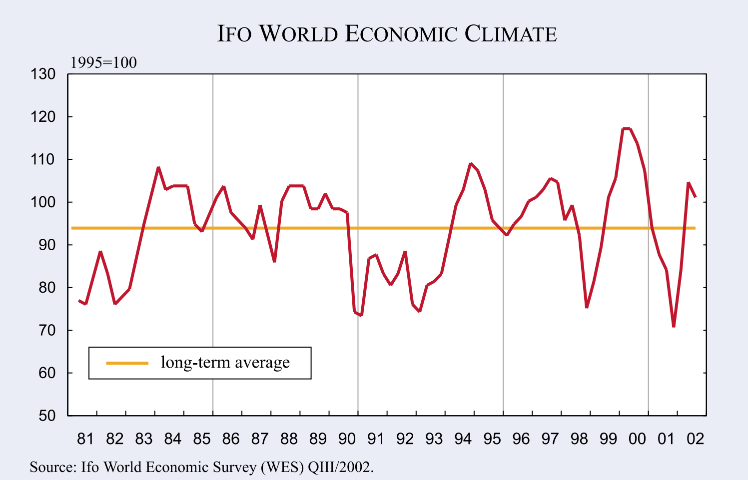
United States: Economic recovery lost momentum

The economic climate, which had constantly risen since the end of last year, has now experienced a setback. The reason is more negative expectations for the future whereas the current economic situation has slightly improved, reaching a satisfactory level. This is mainly due to the still buoyant consumer sector whereas capital expenditure is seen to remain quite subdued in the third quarter. The results of the survey show clearly that the recovery in the United States has lost momentum. The WES correspondents expect a remarkable improvement in the trade balance, however, mainly caused by falling imports.

Western Europe: Economic recovery temporarily stalled

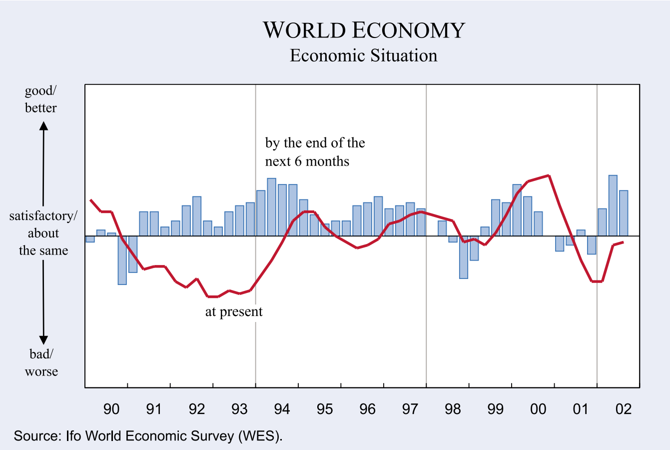
In about half of the Western European countries the current economic situation remained unchanged or improved modestly (Belgium, Finland, France, Germany, Greece, Ireland, Sweden), whereas in the other half a deterioration was observed (particularly in the Netherlands, Portugal and Italy). Expectations for the next half year worsened almost everywhere, Switzerland, where the outlook brightened somewhat, being the only exception. The economic climate (the combination of the

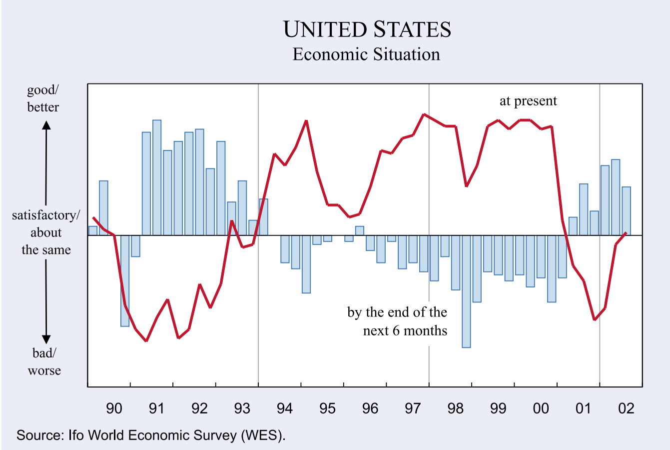
Figure 1

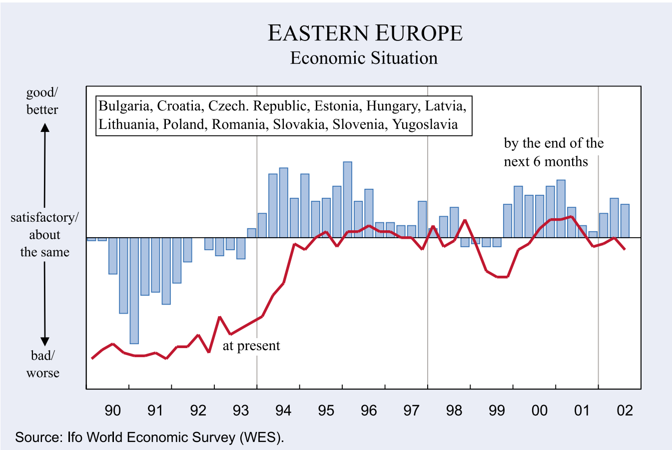


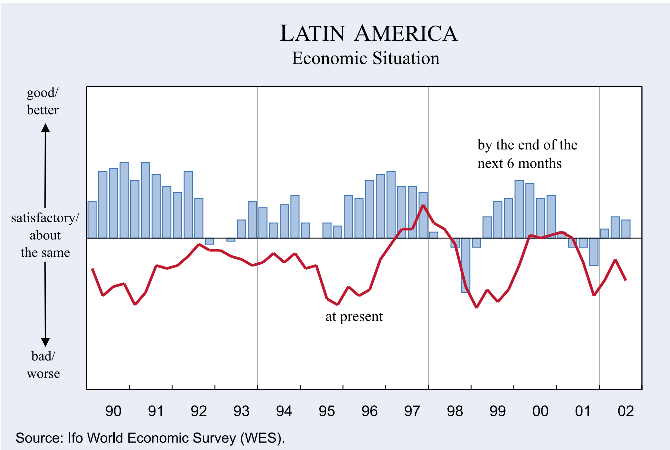
Source: Ifo World Economic Survey (WES) QIII/2002.

Figure 2


WORLD ECONOMY
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
by the end of the next 6 months
at present
90 91 92 93 94 95 96 97 98 99 00 01 02
Source: Ifo World Economic Survey (WES).


UNITED STATES
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
at present
by the end of the next 6 months
90 91 92 93 94 95 96 97 98 99 00 01 02
Source: Ifo World Economic Survey (WES).


EASTERN EUROPE
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
Bulgaria, Croatia, Czech. Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Yugoslavia
by the end of the next 6 months
at present
90 91 92 93 94 95 96 97 98 99 00 01 02
Source: Ifo World Economic Survey (WES).


LATIN AMERICA
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
by the end of the next 6 months
at present
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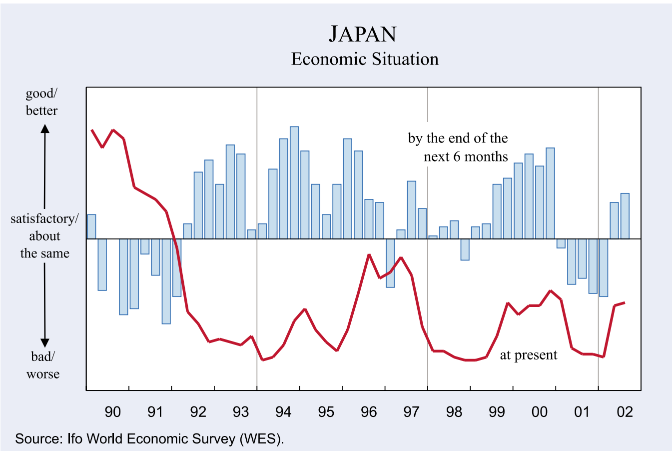
Source: Ifo World Economic Survey (WES).


JAPAN
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
by the end of the next 6 months
at present
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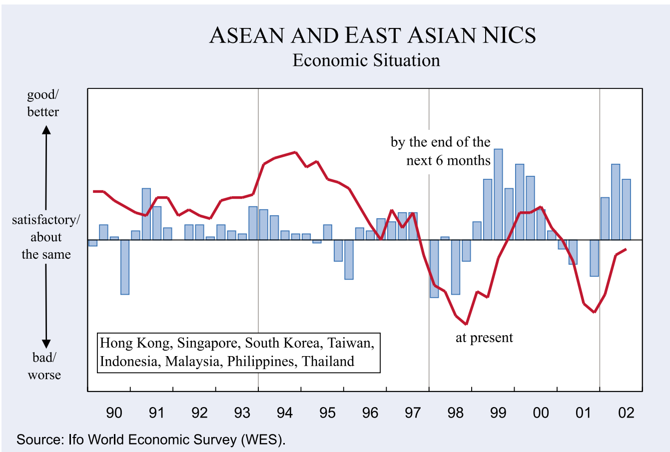
Source: Ifo World Economic Survey (WES).


ASEAN AND EAST ASIAN NICS
Economic Situation
good/ better
satisfactory/ about the same
bad/ worse
by the end of the next 6 months
at present
Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Thailand
90 91 92 93 94 95 96 97 98 99 00 01 02
Source: Ifo World Economic Survey (WES).

assessment of the current economic situation and the expectations for the next six months) in Norway, Finland and Denmark remained better than the European average. The climate indicator in Western Europe is moving downward towards its long-term average, which is almost entirely due to more negative expectations for the coming months. Germany shows by far the lowest level of capital expenditure and private consumption. Nevertheless, its overall economic situation – still less than satisfactory – is quite surprisingly ranked above that of the Netherlands, Austria or Italy, for example. WES correspondents expect a continuing recovery of the German economy, though at a slower pace than before.

Comparing the Euro area with countries outside the monetary union (i.e. Denmark, Norway, Sweden, Switzerland and the United Kingdom), the current economic situation is judged significantly better in the non-Euro area than in the countries with the single currency. In contrast, economic expectations for the next six months are much more positive on average in the Euro area than outside. According to the WES survey, among the countries with the single currency it is especially Finland and Ireland that have the best economic performance, while Norway and Denmark take first places in the group of European countries outside the Euro area.

Eastern Europe: Economic climate levels off

The assessments of the current economic situation deteriorated, slipping slightly below the satisfactory level which had just been reached last April. On average, the optimism expressed in the last survey regarding the outlook for Eastern Europe waned a bit. The current economic situation continues to be above average, particularly in Latvia, Estonia and Slovenia. Worth mentioning is the ongoing recovery in Croatia, which in the coming six months is expected to continue and to reach or even surpass the satisfactory level for the first time since 1996. On the other hand, in Hungary and the Czech Republic the economic situation worsened and is now just little above the satisfactory level and no longer considered good. In Poland and Bulgaria the present state of the economies remained clearly below satisfactory and is expected to brighten only a little in the course of the next six months.

Latin America: Current economic situation remains unsatisfactory

Brazil and Chile show the comparatively best economic performance at present, although they – like almost all countries in Latin America – are following a negative trend. Uruguay's assessment of its current economic situation is unchanged, and Argentina is showing first signs of a slow recovery from the recent severe currency and banking crises. With regard to the outlook for the next six months, the economic performance on the average of Latin America is expected to improve slightly, with Chile, Mexico and Uruguay having the best prospects. The outlook for Argentina and Brazil seems quite negative and Venezuela's economy is not expected to change much for the better in the coming half year.

Japan: Not out of the woods yet

Japan is still lagging behind the general upward trend in Asia; its current economic situation is rated well below satisfactory, though expectations for the next six months point to some improvement in economic activity.

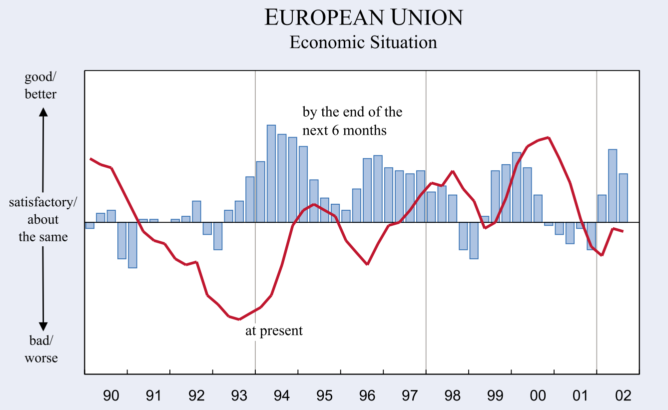
Asean and East Asian NICs: Economic climate continues to improve

According to the new survey, the assessments of the current economic situation improved further while the outlook for the next six months remained practically unchanged. The assessment of the present economic condition is highest for the Republic of Korea, followed by Malaysia, Taiwan and Thailand. Malaysia and Taiwan also have the best prospects for the next six months. The economic recovery in Singapore and the Philippines slowed in recent months, but expectations for the next half year remained clearly positive, especially in Singapore. Indonesia and, even more so, Hong Kong show considerable weakness in present economic performance; the outlook for the next six months is also still clouded. Both countries have a position below the Asian average.

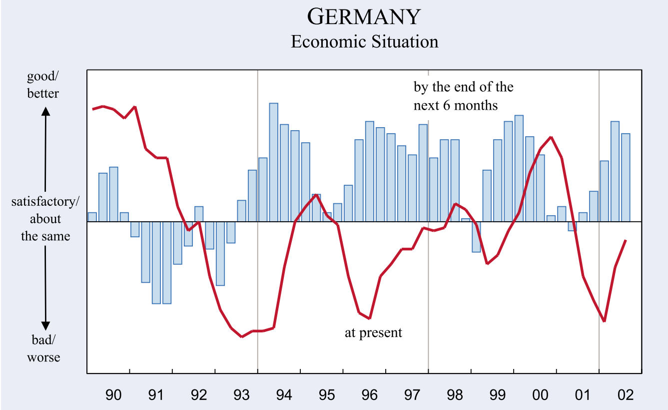
Interest rates: Fewer participants expect increase

In line with the weakening of the economic upswing and the slowdown of inflation, worries about

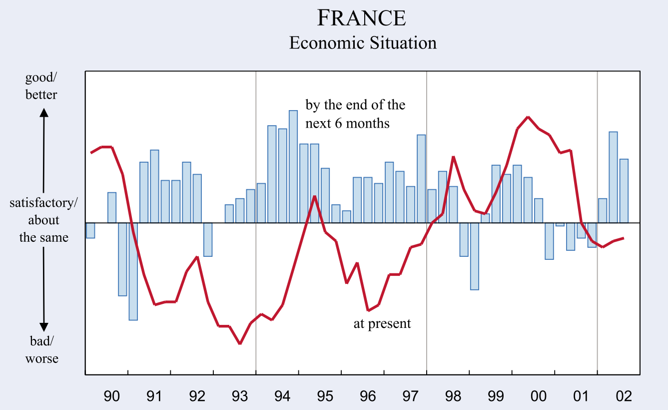
Figure 3



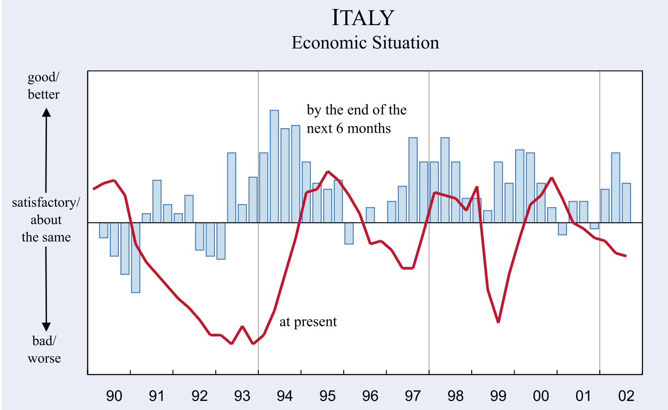
Source: Ifo World Economic Survey (WES).



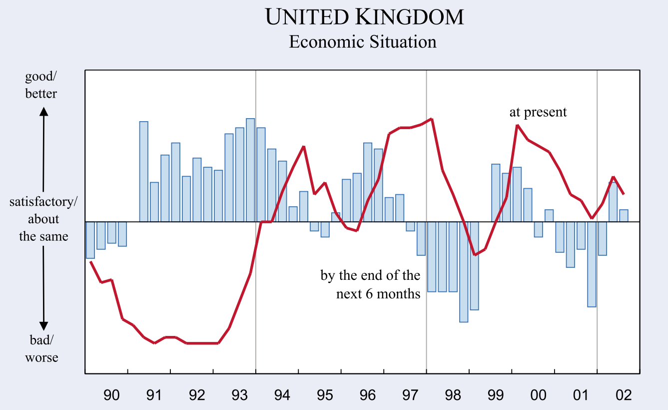
Source: Ifo World Economic Survey (WES).



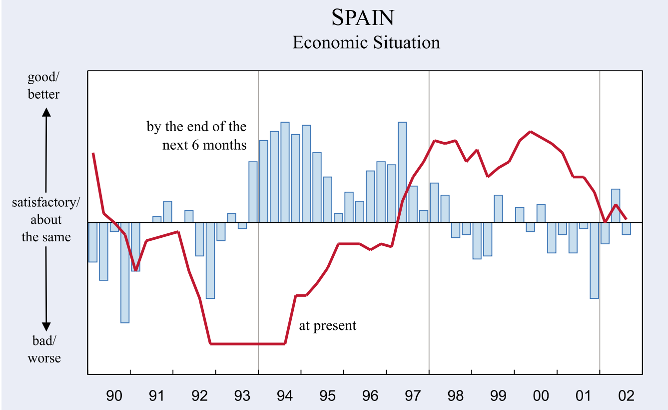
Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

a tightening of monetary policy were less widespread than in the previous survey. This tendency was particularly pronounced in the United States, whereas in Western Europe, Latin America and Asia expectations of an increase of interest rates in the course of the next six months edged up further. In Eastern Europe the prevailing view is still that short-term interest rates will decline in coming months, though to a somewhat lesser degree than previously.

A similar message is given by the new WES results for the likely trend of long-term interest rates in the next six months. Expectations of rising rates are slightly less widespread than in the previous survey. This tendency is particularly pronounced in the United States, where the expected moderate rise in long-term interest rates is now about the same as in Western Europe. In Latin America and Asia an even weaker rise in interest rates is expected. In Eastern Europe long-term interest rates are seen to decline further in coming months.

Inflation: Expected to slow world-wide

World-wide, consumer price inflation in 2002 is now expected to be 3.3%, slightly less than in the April survey and much less than in 2001. Regarding the Euro zone, the July survey confirms the April results with an expected rate of 2.3% for 2002. About half of the countries in the Euro area (namely Austria, Belgium, Finland, France and Germany) are expected to meet or even fall below the 2% mark, the ECB's target. The rest, except for Italy, will come in at more than 1% above this mark. At 2.1%, the inflation figure for the United States is now expected to be lower than for Europe. Asia continues to have by far the highest degree of price stability. At 1.1%, the Asian data are again suggesting that some countries may face a contracted deflationary process, which already is the case in Japan (expected price change in 2002: – 0.7%) and Hong Kong (– 1.6%). The inflation outlook for Central and Eastern Europe has declined since April, from 6.7% to 5.9%. The sole exception is Yugoslavia with an expected inflation rate of around 20%. In Latin America as a whole, inflation is also expected to fall slightly, although in half of the countries the inflation outlook has increased (Uruguay: 11.5%, Venezuela: 7.8%). In Argentina inflation is also still on the rise, reaching an expected rate of 87.5% (compared to 82.5% in the April survey).

World currencies: Moving towards equilibrium

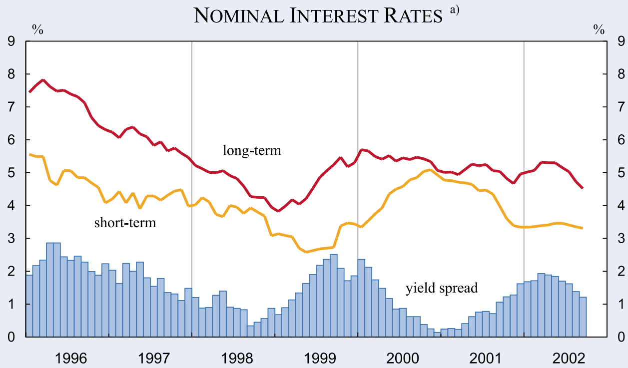
On average of the 90 countries polled, the US dollar and British pound sterling are still judged to be overvalued, but significantly less than in the previous surveys. On the other hand, the euro, which for a long time has been assessed to be undervalued, is gradually approaching an "appropriate" level. Such a level has already been reached by the Japanese yen, according to the WES experts.

WES experts in Eastern Europe consider the major world currencies close to "fair value" against their local currencies. In Latin America, the US dollar as well as the euro and the yen are judged undervalued against some local currencies such as the Mexican peso. However, after strong devaluations, the currencies of Brazil and Columbia appear now to be generally undervalued.

Independent of these different assessments of the current situation, the US dollar is predicted to remain unchanged or even to rise within the next six months. This applies again to all regions of the world except for Western Europe and some Asian countries like Taiwan, Thailand, the Philippines and the Republic of Korea. In Japan, where in the previous survey experts had expected the US dollar to strengthen against the yen, the outlook for the next six months has now changed in favour of a likely stabilisation of the yen/US dollar cross-rates at the current level.

FINANCIAL CONDITIONS IN THE EURO-AREA

NOMINAL INTEREST RATES a)

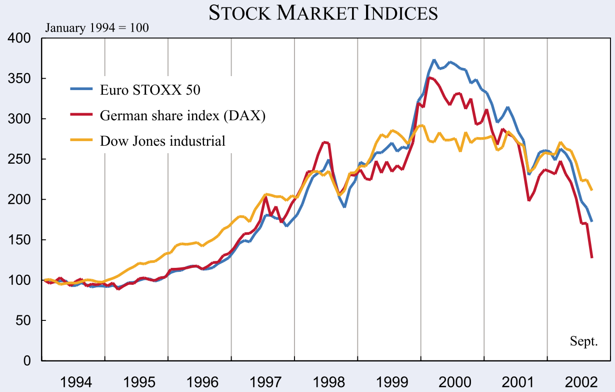


a) Weighted averages (GDP weights).

Sources: European Central Bank.

The ECB has left its key interest rate (the minimum bid rate on the main refinancing operations of the Eurosystem) unchanged at 3.25%, the rate in effect since November 2001. Since then, the 3-month money market rate has fluctuated around 3.3%. Long-term interest rates (yields on 10-year government bonds), which had peaked in May 2002 at 5.3%, have since declined to 4.5% in early September. The yield spread has diminished accordingly.

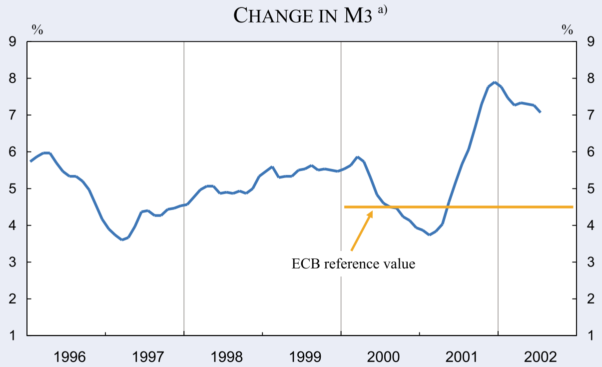
STOCK MARKET INDICES



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

Following a temporary recovery in US and European stock prices in early August, the waning optimism regarding the world-wide economic recovery as well as the concern regarding future company profits exerted downward pressure on all major stock markets. In 2002, the Dow Jones has so far outperformed the Euro STOXX and, in particular, the German DAX.

CHANGE IN M3 a)

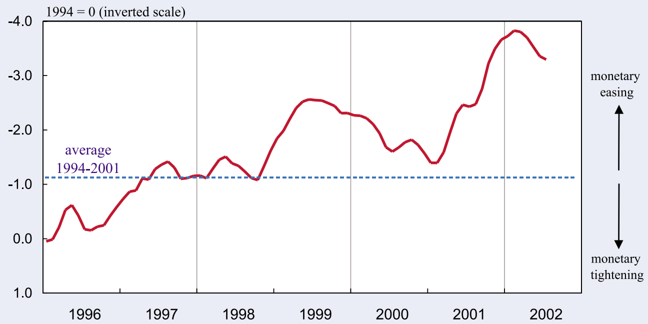


a) Annual percentage change (3-month moving average).

Sources: European Central Bank.

The 3-month average of the annual growth rates of M3 decreased further to 7.1% in the period from June to August from 7.3% in the period from May to July 2002. It still remains significantly above the reference value of 4.5%. According to the ECB, the continued strength of monetary growth may partly be due to precautionary motives, partly also to the low opportunity cost of holding money as reflected in the sharp rise in the annual growth rate of M1 (from 7.6% in July to 7.8% in August).

MONETARY CONDITIONS INDEX



Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

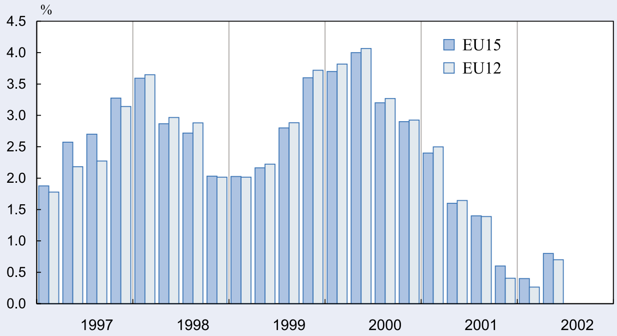
Sources: European Central Bank, calculations by the Ifo Institute.

The monetary conditions index declined marginally, but is still high in the monetary easing range. This is one reason why the ECB has so far refused to cut its key interest rates.

EU Survey Results

Gross Domestic Product in Constant 1995 Prices

Percentage change over previous year

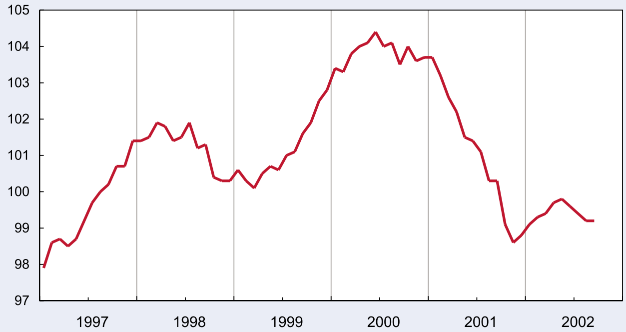


Source: Eurostat.

In the second quarter of 2001 GDP increased by 0.7% year-on-year in the euro area and by 0.8% in EU15, following growth rates of 0.3% and 0.4%, respectively, in the pre-ceding quarter. Greece (4%), Finland (2.5%) and Spain (2.0%) grew the fastest, Ger-many (0.1) and the Netherlands (-0.1%) were among the slowest. Whereas con-sumer spending and exports recovered, investment declined for the sixth consecutive quarter.

EU Economic Sentiment Indicator

Index 1995 = 100, seasonally adjusted

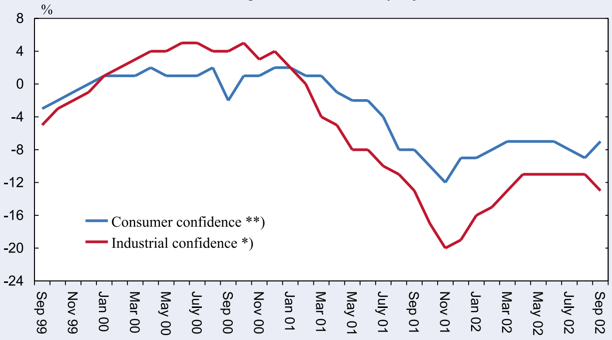


Source: European Commission.

The economic sentiment indicator in the EU remained unchanged, at 99.2, in September. It rose in Italy (0.6 percentage points), Ireland (0.4), Spain, Austria and Finland (0.2) and Belgium (0.1), while it remained unchanged in Portugal and Sweden. It fell in Greece and the United Kingdom (0.4), Germany and the Nether-lands (0.3), Denmark (0.2) and France (0.1).
Such developments are due to the falls recorded in the industrial and retail trade compo-nents. The consumer and construction confidence indicators rose, while industry confi-dence remained unchanged.

EU Industrial and Consumer Confidence Indicators

Percentage balances, seasonally adjusted

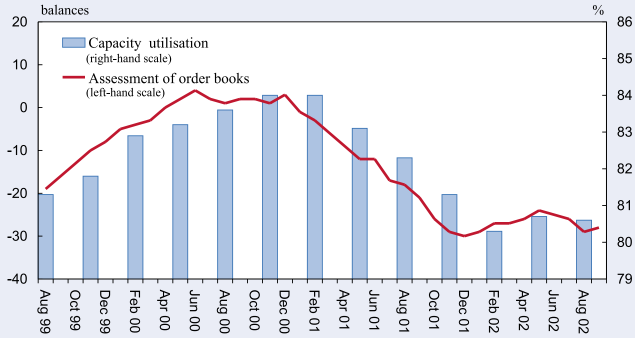


Source: European Commission.

* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

The **industrial confidence indicator** declined by 2 percentage points. It decreased most in the UK, Luxembourg and Spain and, to a lesser extent, in Germany, France, Greece, the Netherlands, Denmark and Portugal. It increased in Ireland, Finland, Italy and Sweden and, to a much lesser extent, in Belgium.
The **consumer confidence indicator** increased by 2 percentage points, mostly due to increases in Austria and Germany, and to a lesser extent, in Spain, Ireland, Finland, Sweden, Denmark and the UK. It declined significantly in Greece and the Netherlands.

EU Capacity Utilisation and Order Books in the Manufacturing Industry

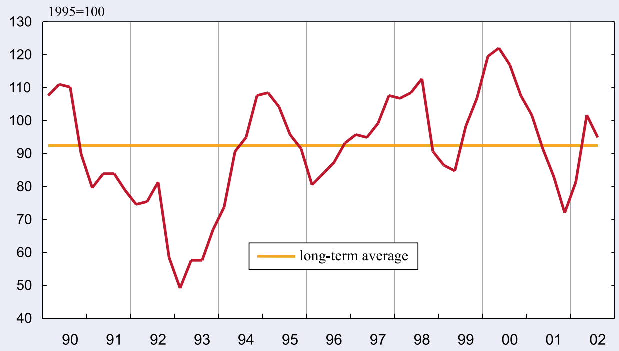


Source: European Commission.

Capacity utilisation declined marginally from 80.7 in May to 80.6 in September. The assessment of order books improved slightly from – 29 in August to – 28 in September. The lowest assessments were registered in Austria, Germany and Luxembourg.

EURO AREA INDICATORS

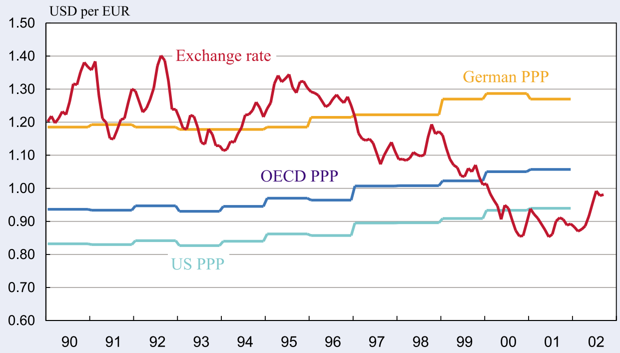
IFO ECONOMIC CLIMATE FOR THE EURO AREA



Source: Ifo World Economic Survey (WES) QIII/ 2002.

This Ifo indicator declined in July 2002 compared with the survey results of the preceding quarter, but remained above its long-term mean. The decline results exclusively from less favourable expectations of the economic situation in the coming six months, whereas assessments of the current economic situation remained unchanged. Expectations still point to a continuation of the slow economic recovery in the euro area.

EXCHANGE RATES OF THE EURO AND PPPS

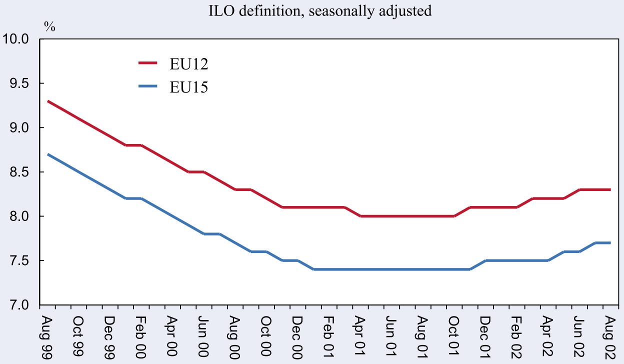


Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

After the introduction of the euro as a unit of account in January 1999 (the currency proper did not replace national currencies in the hands of the public until January 2002), the exchange rate followed a declining trend until October/November 2000. It recovered in the course of 2002, almost achieving parity with the US dollar in July. The purchasing power parities indicate the range within which the $/€ exchange rate might stabilise.

UNEMPLOYMENT RATE

ILO definition, seasonally adjusted



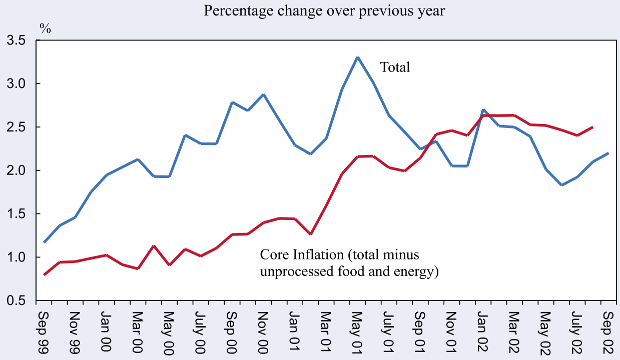
Source: Eurostat.

The seasonally adjusted unemployment rate has edged upward from 8% through most of 2001 to 8.2% in the winter months of 2002 and 8.3% since April. The unemployment rate in the EU15 group of countries also remained unchanged, at 7.7%, in July. A year earlier it had stood at 7.3%. In July, the highest unemployment rates were registered by Belgium (6.9%), Germany (8.3%), France (8.9%), Finland (9.3%), and Spain (11.3%).

Luxembourg, the Netherlands, Austria, Denmark, Ireland and Portugal had the lowest unemployment rates.

INFLATION RATE (HICP)

Percentage change over previous year



Source: Eurostat, Ifo Institute.

The annual inflation rate of the Euro area rose from 2.1% in August to a preliminary 2.2% in September 2002. In August 2001 it had amounted to 2.4%. The highest year-on-year rates of price increase were registered in August by Ireland (4.5%), Portugal (3.9%), Greece and the Netherlands (3.8% each). Germany and the United Kingdom (1.0% each) and Belgium (1.3%) had the lowest inflation rates. Core inflation remained rather stable in the euro area, although it also rose back to 2.5% in August after a dip to 2.4% in July.

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Please return (by fax or mail) to:

Department PRK
Ifo Institute for Economic Research
Poschingerstr. 5
D-81679 Munich, Germany
Tel.: xx49-89-9224 1604
Fax: xx49-89-9224 1267

The Ifo Institute takes pleasure in announcing

The 2003 CESifo International Spring Conference
"Prospects for the European Economy"

Thursday and Friday
20-21 March 2003
at the Kardinal Wendel Haus in Munich

This annual event offers macroeconomic forecasts as well as industry analyses. The conference, which will take place over two half days, is aimed at business and banking representatives, as well as the public at large.

The first section of the Thursday afternoon session will be devoted to examining the outlook for the world economy, with special emphasis on the United States, followed by an analysis of the state of the European economy and a forecast on its prospects. The second section will start with a close look at the economies of China and the Asian NIEs, leading then to a presentation on the state of the financial markets, the reasons for their retrenchment and the likelihood of their prompt recovery. Discussion of these issues will be furhter pursued over dinner at the end of this first day.

On Friday morning the focus will be on the major branches of European industry. In the first section, representatives of well-known companies will discuss developments in the chemical and steel industries. In the second section, the electronics, engineering and automobile industries will be analysed. This second day concludes with a hot buffet lunch.

Check out our website, **www.cesifo.de**, for a registration form, map, and a selection of hotels in the vicinity of the conference venue.

Mark your calendar and register now!

A detailed programme will be published on our website and mailed to you.
Once at the conference, you will receive a folder containing the conference papers and a wealth of practical info.

Please enter my registration for the **2003 CESifo Spring Conference** as follows

Last name, first name

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