PRIVATISATION EAST & WEST

Office Copy.

PRIVATIZATION EAST AND WEST

First published in the UK in 1992
by ASI (Research) Ltd

The views expressed in this publication are those of the authors and do not necessarily reflect those of the publisher or copyright owner. They are presented as a contribution to public debate.

ISBN 1 873712 14 6

Printed in Great Britain by Imediacopy Limited, London SW1.

CONTENTS

TECHNIQUES OF PRIVATIZATION

DOES PRIVATIZATION WORK?

1. COMMERCIALIZATION, PRIVATIZATION, AND DEVELOPMENT

Henrietta Holsman Fore
US Agency for International Development

Driven by the realization that markets succeed only when private initiative and private ownership are allowed to bloom, privatization is sweeping the world. Of the 174 countries in the world, 100 are currently implementing privatization to one degree or another. Last year some $25 billion of assets were transferred from government to private hands, bringing the total for the decade to more than $200 billion.

Although this sounds like a lot, it represents only a portion of the universe. Germany has nearly $250 billion in state-owned holdings. Poland, Hungary, and Czechoslovakia have over 13,000 enterprises. The Soviet Union alone owns nearly 50,000 industrial firms and 800,000 trade and service enterprises. The enormity of the task ahead seems daunting; especially when you are working in countries with few institutions. Mongolia is literally starting from scratch, and there are few consultants that are beating their way there. We estimate that Mongolia will face one of the ten highest inflation rates this century. We know that all of this change will not occur overnight.

But we are making progress everywhere. Latin America was a pioneer in privatization, and still has one of the world's most active programmes. But East Europe is racing past them, and Asia and Africa are in the chase. By some accounts, Poland already has almost half of its smaller service sector in private hands. Poland has done this partly through privatization but, just as importantly, through an open system that allows new competition into the market. Malaysia leads South East Asia in new, creative approaches. And Nigeria tops the African continent with its efforts. We can all learn from these examples, if each country shares its particular experiences.

Industries such as telecommunications, finance, and energy are being restructured to respond to the needs of an integrated world economy. The global structure of these industries demands their participation in the privatization process. In Eastern Europe, $350 billion is needed for investment in telecommunications alone. Official donor assistance will provide only $50 billion per year. Clearly, private international investment is the only answer until domestic private savings grow.

Countries are trying new approaches to privatization, and are emphasizing pragmatism and speed. Some of these approaches, like the proposed voucher systems, are controversial. In Hungary, the government approved more than 80% of the so-called 'spontaneous' privatizations last year. In Venezuela, leasing, with purchase options, of telecommunications is working. We see other new approaches, too: management buy-outs, investor-led privatizations, joint-ventures, private offerings, issuance of convertible bonds, and share offerings on foreign stock exchanges.

The importance of public support

In the face of unpredictable political change and deteriorating economic conditions, the citizens on the street are confused. Workers in factories and offices are bewildered. The people need to know what is happening. Workers with pension rights under old systems are afraid of what the future will bring. Employee unions of state-owned enterprises are prominent stake-holders in the outcome of this change. They must be dealt with thoughtfully and equitably. They must be part of the process and feel a vested interest.

To succeed, privatization movements need public and political support. We must explain to the public how these changes will result in a better future for themselves and for their children. We must explain the process of change and how long it will take. In many instances, this requires new approaches.

Let me give you an example from Jamaica. Publicity campaigns for the National Commercial Bank offering focused on the man and woman in the street. Offerings were available in supermarkets; share applications were easy to obtain as well as to fill out. In Tunisia, privatization took off after a heavy public relations campaign that used the press, television, radio, and conferences. I have recently returned from Nicaragua where the privatization issue there is struggling with an issue that many countries have encountered over the past year: that of prior ownership. Former owners, whose homes and businesses were seized 40 or more years ago, are returning to claim what was once theirs. What are their rights? How should they be compensated? The issue is difficult, to say the least, considering the economic, social and political consequences.

The Ministry of Ownership Transformation in Poland has received over 50,000 claims for properties taken over by the state since World War II. Potential claims may soar to 200,000 or more with a possible cost of up to 200 trillion zlotys. Czechoslovakia and other East European countries are facing similar situations.

The passage of 45 years and three generations have made equitable resolution of these claims a near impossibility. Many properties no longer exist. Others have been so developed, rebuilt, modernized, or just plain changed that they are no longer the item claimed. It is clear that only limited restitution in kind can be contemplated. Even cash payments probably will be limited given the murky trail of most property claims. In Nicaragua, the problem is not that government has held on to the property that was confiscated, but that the Sandinistas gave properties away to their supporters before leaving office last year.

One thing is clear. We must not allow the issue of prior ownership and restitution to distract attention from the task of rebuilding democratic capitalism, freedom of choice, and the market. No matter how few of your transactions have clear title, sell those now.

New forms of private participation

New ways to insure broad-based participation are crucial to the long-term success in creating a New World Order. Economic participation creates political participation. As economies are restructured, they must *not* concentrate ownership in the hands of a few. Here in the UK, the number of individuals owning shares in businesses increased threefold because of privatization. The people have a big stake in the country's present and future.

How much more important this will be for Eastern Europe and others! As we accelerate the speed of privatization, we must project over the horizon of time our vision of a dynamic, integrated political and economic world. We must take steps now to realize that vision.

One of the significant trends of this century has been people migrating to the cities in search of jobs. Some 60% of the gross domestic product worldwide now comes from urban areas. According to the United Nations, the urban population, currently 1.5 billion, will double again by the year 2000.

The enormity of the financial resources necessary to build and maintain the industrial and social infrastructure for this exploding population is staggering. We need new forms of public/private co-operation to provide transportation, communications, water, sanitation and education services -- services traditionally financed by the public sector.

Commercialization -- the private provision of these services -- is spreading rapidly. Contracting out is probably the oldest form of commercializing public services, and is widespread. But now it is being replaced by newer forms of partnership, driven primarily by the need to draw on private investment. Public-private joint ventures, and build-operate-transfer schemes for power plants, roads and other infrastructure are successfully attracting capital, lowering the cost and improving efficiency in scores of locations.

In the United States, we are taking a hard look at public assets that would be better off in private hands. Plans are underway to privatize the functions of sports facilities, including the football stadium at the West Point Military Academy. The new home for our Supreme Court will be a building constructed by a private developer and leased back to the federal government. Chicago is turning over management of its parking facilities and drug treatment programmes to private firms.

In the face of fiscal deficits, state and local governments from coast to coast are privatizing public services -- from garbage collection to construction and to the operation of prisons. One recent survey showed over 100 local jurisdictions in 34 states contract out some form of service. Mass transit was entirely privately owned in the nineteenth century in the United States, then moved into being publicly owned in the middle of the century, and is now inexorably moving back toward private hands.

From private enforcement of parking rules on the street of Buenos Aires, to electric generation in Bangkok, to schools in the United States, commercialization of public services is seen as a way for financially troubled governments to provide public services through private means. Guarantees, particularly effective in housing, or tax incentives to attract capital or to promote private-voluntary service providers, are old tools being used in new ways to forge public/private co-operation. But we must do more.

New capital

Our housing office in USAID offers guarantees to private banks for low income housing in many areas of the developing world. Thousands of houses have been built, not only providing shelter, but also developing the private construction sector. This expertise is now being applied in Poland to privatize housing stocks there.

The global requirements for capital far outstrip the capability of the world market. We estimate that the gap is hundreds of billions of dollars.

We must invest existing capital wisely and we must create new capital. Long-term political and economic stability, and transparency in legal, regulatory, and accounting systems are critical to an environment for creating capital. The problems of low domestic savings rates, high external debt, underdeveloped capital markets, and poor legal systems only serve to scare away potential investors. Worse, they promote capital flight, which, of course, is the market's response to these adverse conditions. The global integration of trade and investment is creating a global financial market.

There, too, privatization is forcing a change. Over the past several years, capital flight has denied the use of billions of dollars to the developing world. But recently, in Argentina, the first private bond offering in forty years was aimed at repatriating private capital. Country after country is reforming the climate for investment, making it attractive for money to stay home and attractive to foreign capital as well. Discriminatory taxes on foreign investment are falling everywhere.

In a gradual way, capital is being invited back home. This is a very important point. I believe all of us are beginning to realize the importance of creating and keeping domestic capital at home. Domestic capital fuelled the rapid growth of East Asia and should be the major area of focus for developing countries for the next decade.

Change is at our doorstep. The most startling examples of fundamental changes are in Eastern Europe, where the rapid shift from command pricing control to free market pricing has shocked consumers and suppliers alike. Two years ago in Czechoslovakia, for example, it was a crime to be a private entrepreneur -- now the state is busy auctioning off thousands of small shops and setting the stage for selling the larger ones. All over the world the environment for investment is getting better and friendlier for the entrepreneur and for capital.

This year, we have seen new, creative financing techniques. Foreign debt as a currency of payment is now common. In Latin America in 1987, almost half the foreign direct investment was generated by debt-to-equity conversions. The ENTEL transaction in Argentina was the largest debt swap privatization in history. Others will follow.

Some 150 country funds are seeking sound country-specific investments. The International Finance Corporation recently created the Brazil fund, capitalized with $2 billion of government debt. We must set up more vehicles like this to mobilize capital. The need to accelerate the creation of capital is critical. Fiscal and monetary policies must make currencies convertible to enable investment flows to happen. Domestic savings must be promoted and permitted to flow freely to productive investments.

Equity markets must grow. Guarantees by donors (like the Multilateral Investment Guarantee Authority at the World Bank or USAID's own Loan Portfolio Guarantee) spur investment and should be expanded. My own staff is currently preparing a guarantee specifically aimed at privatization transactions.

The Polish-American Enterprise Fund, small by international standards, is proving that donors can successfully leverage their resources. With only $34 million from the government, the Fund has invested in 220 businesses. Through joint venture companies, the Fund will create housing for a thousand families in four Polish cities over the next two years.

The Polish American Enterprise Fund and others like it face two vexing problems: the uncertainty of the legal system and the cumbersome government approval process, problems common to most developing countries and emerging democracies. But they must be solved.

USAID's contribution

We at the USAID are committed to the concept of privatization as a key to unlocking the door of economic opportunity. USAID is the principal American organization charged with international development. The Agency traces its lineage back to the Marshall Plan and the heroic age of reconstruction in Europe after the devastation of World War II.

Today, we have a budget of $7.5 billion. We are a network of approximately 12,000 people working throughout seventy developing countries. We strive to create free market economies. We support democracies. Our programmes aim to increase individual well-being; attack transitional problems such as environmental degradation, AIDS and narcotics; and provide humanitarian relief around the globe.

We at USAID are aware of the vital relation between democracy and self-sustaining economic systems. That is why we have directed increasing amounts of foreign assistance funds to those nations that are moving toward economic and political liberalization -- to those who welcome the inflow of ideas and investments from the rest of the world. Building self-reliant market economies that produce sustained growth and economic opportunity is our major challenge for the 1990s.

We are USAID also recognize what President Bush has described as three pillars for a sound economy: encouraging economic growth, investing in the future, and giving power and opportunity to the individual. Privatization of state-owned enterprises is a key ingredient in the quest for growth and giving power to the individual, and a major opportunity for our respective business communities.

Some of you may recall that in the spring of 1985, USAID invited 400 government leaders from around the world to a conference on privatization. That conference marked the beginning of a new era in the donor community and in the developing countries.

Since then, USAID has invested hundreds of millions of dollars in assistance to many developing countries. We have promoted the concept of privatization and have designed and implemented privatization programmes. We are helping governments get the policy environment right and change legal, fiscal, regulatory and institutional systems. Many of our activities stress efforts for widespread participation, including training and business development, so that all enterprises, domestic and foreign, can enter the marketplace and compete on equal footing. In this way, we can bring democratic capitalism to the world.

For example, our programmes in Indonesia have led to increasingly open markets, foreign investment, and a bustling stock market, as well as new opportunities for all citizens. Worldwide, there is a pressure to create policies that encourage business.

We have accomplished much in this past year. The wave of privatization has swept the shores of many more countries. It is changing the economic and political landscape. There are six new country programmes to privatize telecommunications. A half-dozen new competition laws. A 100% foreign ownership is now permitted in many countries. Trends, like spontaneous privatization, are beginning everywhere. Even in the Soviet Union, at least fifteen enterprises with 3,000 workers have partially or wholly privatized themselves. They have done this, despite a lack of an official legal framework. East Germany alone has already sold over 22,000 businesses. Stock markets have raised billions of dollars of equity and debt swaps have raised billions of dollars for transactions.

New challenges

But more challenges confront us now and await our next move. Let me close by challenging you to:

- keep pace with the rapidly changing new trends of privatization and increase that pace;

- be certain your constituents and the local populous, feel a vested interest in the outcome, as they are vital to your success, look for ways to mobilize domestic capital;

- increase the speed and lower the cost of your transactions, because we all have little money and less time;

- apply creative solutions to difficult problems, like prior ownership, and share those solutions with other countries that are facing similar problems;

- create a business climate conducive to newly privatized enterprises and a climate conducive to competition to those same privatized enterprises;

- find ways to factor in the cost of the environmental clean-up caused by state-owned enterprises: perhaps a fee from the buyer and the seller at the time of transaction;

- actively look for ways to break down a large enterprise into smaller, more viable enterprises before sale, so that local buyers can bid;

- tackle the arena of the private provision of public services, from sewer systems to post offices; and

- look to the future -- project your vision of the new world order and dedicating yourselves to making that vision a reality.

In this effort I hope we can all help each other find solutions to our problems. I hope you will discover new ways to look at the challenges facing us, as we work together to achieve what Adam Smith described as a thriving 'society of perfect liberty'.

2. PRIVATIZATION AND ECONOMIC PROGRESS

Edward Nassim
Director, IFC Corporate Finances Services

Privatization is on everybody's mind. Governments in all the continents of the world are privatizing, or are thinking of privatizing. From the Philippines to Mexico, from Poland to Pakistan, to Hungary, Turkey, Brazil and Argentina, and so on. That is by no means a complete list; we may soon be adding to it the largest privatization operation in history -- in the Soviet Union.

Is this all a fashion which will pass? I think not. The fundamental reasons why so many countries are privatizing are very practical and pressing ones. We are not looking at a swing of the ideological pendulum, but at changes which have been forced upon governments by the failures of state-managed companies and state-managed economies.

Does privatization work?

Why is privatization a good idea? There is now substantial evidence to show that in the production of goods for competitive markets, private ownership and management are superior and produce high levels of efficiency and productivity.

To succeed in competitive markets, enterprises need to be innovative and flexible, and able to adapt quickly to new circumstances and new challenges. It is a characteristic of state-owned institutions that they can not do these things. It follows, of course, that the benefits of privatization grow with the benefits of competition, and it goes without saying (and here any follower of Adam Smith would agree) that governments should arrange things so that there is competition wherever this can possibly be done.

That is to say, the benefits of privatization are the benefits we expect from a market economy where competition is free as possible. But that is not to say that privatization is an easy matter. IFC has quite a bit of experience of privatization efforts in countries of different kinds: here in the UK, in a number of developing countries, and a little bit of experience in the former communist countries of Europe; so we know some of the problems.

What are these problems and obstacles? There are I think four basic ones.

First there are always **vested interests** standing in the way of privatization: people who have benefited from the existing system can stand to lose if it is changed. To overcome these interests, which are often very powerful, needs a determination and perseverance.

Second, privatization still runs into **ideological opposition** in some countries, although it is good to see that this is diminishing considerably.

Third, in many countries the problem of **finding investors** to buy the enterprises can be quite a difficult one.

Fourth, in many cases the main reason why the government wants to privatize is partly that **the enterprises are loss-making,** and this raises a dilemma. Do you put the loss making enterprise back on its feet and make it profitable before privatization, in which case the government has less incentive to get rid of it; or do you auction it off immediately for whatever you can get?

I would say that all these difficulties seem to be generally greater in the developing world and in former communist countries than they were in the UK. Despite this, privatization is proceeding on a remarkable scale in some of those countries.

Scale of the problems

At the moment the two areas of the world who where privatization is proceeding most vigorously are Eastern and Central Europe and Latin America. There are some interesting contrasts between these two regions where the problems involved in privatization are rather different.

When the Eastern European countries embarked on the road to democracy and the market economy I do not believe anyone had much idea about the scale and difficulty of the risk they faced. Privatization is one part, although a very central and crucial part, of a more general process of transition from a command to a market economy. That transition cannot be achieved unless very large numbers of enterprises are transferred to private ownership, and adapt themselves to operating in a market economy.

For privatization to succeed in these countries some basic nationwide things need to be done.

First, a proper **legal structure** for privatization has to be established. In the first stages it was not clear who legally owned the enterprises and who had the right and the responsibility to sell them.

Second, for privatization to work, the **macroeconomic reforms** needed to establish a market environment have to be undertaken. Again, Poland, Czechoslovakia and Hungary have made great progress in this respect; and others are following.

Third, another basic need before privatization can succeed is to **create national systems**: a proper system of **company law**, systems of **accounting**, and above all, a market-based **financial and banking system** to support the privatized enterprises. Progress is being made in these fields but it does take time.

I would particularly emphasize the point about the financial system. In a market economy competition for capital is one important means by which efficiency is achieved. The Eastern European countries suffer from a lack of banks and institutional investors who are experienced in channelling funds to enterprises on the basis of performance. For privatization to work efficiently, this kind of system needs to be developed, and this too will take time.

These are some of the basic problems inherent in the system as a whole. But let us look at the problems which have to be faced when it comes to transferring individual enterprises from state ownership to the private sector.

There are two fundamental ones: how to **find the capital** to buy the enterprises, and how to **correct the weaknesses of managements** which have been used to working in a wholly controlled and planned economy.

Finding the capital

On the question of capital, Hungary, and recently Poland, have re-opened their stockmarkets. Czechoslovakia will do so soon. In Hungary and in Poland companies have been privatized through public offerings. This method will continue to be used but these are new and small markets which will need time to grow and mature. As a practical matter there are not enough savings at the hands of the populations of Poland, Czechoslovakia and Hungary to buy all the industrial assets of the country from the government at full face value, quickly.

Foreign investment, of course, can play (and is playing) an important role, particularly with the larger and more viable enterprises; and we are seeing a considerable number of western companies looking around for opportunities to acquire these assets. Interesting deals are being struck: Volkswagen has taken over Skoda in Czechoslovakia; Trust House Forte has taken over the Bristol Hotel in Warsaw; General Electric acquired Tungsram in Hungary, and so on. But the potential scale of foreign investment still leaves by far the largest part of the privatization problem to be dealt with.

This is what is leading some governments to consider that the process of **giving away** the assets of the state should probably play at least some part in the privatization programme. There is some logic to this. Industrial assets of these countries are now accumulated in the hands of the state, but except in cases where the original owners can stake a clear claim, in which case they should be compensated, they are in reality the property of the nation. It would, therefore, be difficult to require the citizens to pay the state large sums of money for the transfer of these assets to private ownership. Apart from the lack of resources, the key argument for considering giveaways is one of speed. Privatization in Eastern and Central European countries threatens to take a long time and there is a risk that it will get stuck along the way. If governments were to insist on full value payments by the citizens they will probably extend the process of privatization well into the next century.

So we come to the interesting ideas and proposals which are being developed for **issuing vouchers** to the population, to enable them to buy some of the shares of state-owned enterprises. There are arguments against this, of course. The value and viability of the enterprises to be privatized will often be very much in doubt, so the citizens will not know what they are buying and may be disillusioned and upset if their investments turn out to be worth nothing. But allowing time for careful valuation of all enterprises to be privatized may prolong the process endlessly.

Another argument is that if you spread ownership of an enterprise among one million people, then in effect nobody owns it and the management is simply given a free hand. And since the efficiency of management is the other half of the problem in ex-communist countries, this is a scary prospect.

Intermediary institutions

One conclusion is that there is an urgent need to try to create intermediary institutions; institutional investors who would stand between the small private investor and the larger enterprises, and exercise some supervision over the managements of the enterprises. Voucher holders would then have the option of buying participation in a fund which would own shares in the enterprises.

Creating such institutions quickly out of nothing and defining their role is not going to be easy. For example: how would funds acquire shares in enterprises -- by bidding or allocation, and on what basis? What percentage of companies' capital should they acquire? Should the funds have a limited life? How pro-active should they be in managing their investments? All this needs sorting out, and it will also be necessary to agree on their number, and, most importantly, agree on how they would be managed.

Finding suitable management for these funds, which could be a combination of mutual funds in venture capital companies, will not be easy. All this is quite a formidable task; and what makes matters even more difficult is how to arrange efficiently for millions of citizens to take vouchers for shares in the funds.

Probably the answer to privatization in Eastern and Central Europe is a mixture of different methods: trade sales to domestic and foreign investors, public offerings, and possibly a voucher system, if it includes well-designed intermediaries.

I like the way the Czechoslovakian republics are going about it. Each enterprise is required to produce its own plan for its own privatization, for government's approval. These plans may include mixtures of sales of shares to foreign investors, to the public at large for cash, and to the public through the voucher sales. The thing is to get the process moving. It will take some years, but once a few large enterprises have been successfully privatized the wagon will begin to roll.

The IFC hopes to play some part in this process, mainly in a trend-setting way. We have already privatized, through a public offering, a large manufacturing company in Poland; we privatized the Bristol Hotel in Warsaw through a joint venture, and are assisting with the privatization of a number of companies in Czechoslovakia.

Improving the management

The second main problem I mentioned was modernizing the management (and here I know no general or easy answer). To some extent governments will have to rely on the operation of the market economy and competition to improve their awareness of the performance of managements. Open borders and international competition will add to these pressures. Trading programmes, as part of general technical assistance from western governments, can certainly help. When individual enterprises are privatized with the advice of western merchant banks, or investment banks, or organizations like IFC, the rehabitation of management has got to be one of the key questions to be dealt with.

The question of the quality of management is linked to the other question I left hanging. Should you try to privatize a loss- making enterprise? The UK government's answer was 'No'; and probably that was right for the United Kingdom. The danger, if you take that position in Eastern and Central Europe, is that the whole privatization process may be delayed too long while governments struggle to restructure the enormous number of enterprises to be sold. Eastern and Central European governments simply do not have the time, or the capacity, for too much of that. And I think they must be willing to cut some corners by inviting investors -- domestic or foreign -- to take over enterprises as they are, if the potential buyers believe that they can be made viable and profitable.

Other countries

Let me turn to the other countries, and particularly Latin America, where privatization is also taking place. The context in which privatization is happening there is very different from that in Eastern and Central Europe. For one thing, in Latin American countries a strong private sector already exists: legal, accounting and financial systems (although certainly not always perfect) also exist. In a number of cases there are stockmarkets of some size and importance. All the same, privatization is never an easy business. Vested interests and ideological opposition are able to create problems.

Yet in countries like Brazil, Argentina, Venezuela and Mexico there are options available which the governments of Poland, Czechoslovakia and Hungary simply do not have. Three in particular stand out.

First, in a good many cases privatization can be achieved by selling state companies, or large portions of the capital, to existing private companies in the country. This can be an easy and convenient way of getting the job done. Of course there are risks. Such a negotiated deal may mean that the government does not get full value and in Latin America there is no reason why the government should accept anything less than full value. There is the danger of the cosy deal which produces something other than a market price; or at least of allegations of that.

Second, there are debt-equity conversion possibilities. There has been much argument about the merits and the merits of debt- equity conversion in the heavily indebted countries, but most of the disadvantages are absent if the assets acquired are those of the state. Debt-equity conversion combined with privatization is an excellent idea.

A third option which is open to Latin American countries, but is more difficult for Eastern and Central European countries, is flotation on the stock markets. This is happening already in Mexico, Argentina and Brazil. In Latin America, just as in Eastern Europe, part of the challenge of privatization is to improve the quality of management. If companies are bought by successful existing private companies, that deals with the problem; otherwise privatization plans should include whatever is needed to get the management right: and in countries like Brazil and Mexico there are resources available to solve these problems.

I have focused mainly on two areas of the world, but of course there are privatization programmes elsewhere. Some African countries are now doing it, and in that continent the difficulties of finding buyers and finding good management are considerable. In the Middle East and Asia, Turkey, Pakistan, Sri Lanka and Malaysia, all have privatization programmes. Egypt, Morocco and Tunisia are now thinking about embarking on something of the same kind. I hope that India will begin to move in this direction also -- the potential there is enormous.

Conclusion

As the world moves towards market economies -- and we are seeing a remarkable worldwide trend in that direction -- there is a need to rethink our methods of helping developing countries. We need a change in emphasis. More emphasis is needed on facilitating the working of the private markets to provide for investment needs from inside the country and from abroad. Agencies like the world bank and the IFC cannot meet government's policies for them, but because we believe that the market economy is the most efficient way to fast economic growth, we will encourage and help any governments which decide to embark on programmes of privatization.

3. FINANCING THE RECONSTRUCTION OF STATE FIRMS

Stephen Hall
Partner, Ernst & Young

I am going to split this talk into four particular sections: firstly I am going to deal with assessing the scale and type of capital which may be needed in an emergency economy; then I shall go on to deal with sources of capital; followed by a few words on the various sources of advice which are available to the intending business which is being privatized; and I shall review some of the concerns over foreign investment which are occasionally raised. I shall then conclude with three short pieces of advice for which on this occasion there is no charge.

Scale and type of capital needed

The first step in assessing the scale of capital needed is to carry out a fundamental review of the current financial situation of the business. This review cannot be limited solely to the financial position of the business and must consider the general, political and economic environment in which the business is operating.

Privatizations are often taking place against the background of dramatically changing economic environments which will have a major impact on the business itself. The review of the current situation of the business will form the basis for looking at the future prospects of the company in order to assess the capital requirements of the business operating in the new environment without the automatic life-support of government funds.

In the case of emerging economies, the projection may have to be prepared on the basis of very little market research. And there may well be inflation in the local economy, which may or may not be reflected in an erratic movement in exchange rates.

A strategic business plan for the company must be prepared, taking into account the new factors which would exist as a result of privatization. It will often be found that the managers of a state company will not have applied their minds to how the company would be run once they are operating in the private sector environment where they have total managerial responsibility. It is only through a clear and detailed plan, based on realistic assumptions, that an assessment of the future funding needs of the company can be made. This will include the preparation of a balance sheet, based on a realistic assessment of the assets of the business, together with future projections of cash requirements.

Once management is clear about the current and future capital requirements of the company, the appropriate type of financing can then be put together. At Ernst & Young we think this so fundamental to the process that we have produced a short video entitled 'A Change of Focus' on the subject.

One of the major considerations to deal with will be the apparent conflict between the state -- wishing to realize as much cash as possible from the sale price of the shares, or extract surplus cash from the company by repayment of debts, or indeed a combination of both of these ideas -- and the future capital requirements of the company. The ability of the state to recover debt which is not written off is dependent upon future profits and the cash flows which these will generate. Any new capital required to finance growth has to be serviced from the same source. There is thus a limit to how much old debt can be left with the company if the raising of new capital is not to be prejudiced. Governments may well have to consider writing off some of these old debts.

The direction which the state chooses to go will be very much a part of the negotiations as the wider considerations of the best way to finance the company are considered. Questions such as the ratio of debt to equity, and whether fixed assets should be financed with long term debt, will need to be addressed.

Sources of capital

It is certainly important to be attractive as a home for private sector investment, particularly bearing in mind the possibility of the capital shortages which may appear in the late 1990s. In emerging economies -- of which Eastern Europe is a clear example -- sources of finance are often restricted both by economic difficulties and a lack of the more sophisticated financial instruments which are familiar in Western economies. Political stability and concern over exchange rates will also affect the views of potential investors.

Banks. The first, and traditional source, to which most companies turn are the banks, who are the usual suppliers of working capital. High interest rates may be a deterrent, or the funds may not be available because of a lack of a suitable security, or concern about the risks involved in the business: this is particularly the case with bank finance being supplied from banking sources outside the country itself. In Eastern Europe, traditionally, bank borrowings have taken the form of a revolving three-month credit. It is only now that a variety of long and medium-term borrowings are becoming available; and in our view the privatization of banks should be left to the very end because we do not want to see unsympathetic criteria applied to loans until the enterprises have a decent breathing space in which they can establish themselves. The thought of sharp American credit experts working on some of the delicate Eastern European balance sheets frightens a number of us.

Equity sales. Sources of capital depend very much on the individual circumstances of the company. A large profitable company, with little or no need for working capital, for example, will be most likely to raise new capital by selling its shares through an offer for sale to the general or investing public, hopefully with a percentage being made available to employees on preferential terms.

For a company which requires large sums of working capital, or funds for capital investment projects, a trade investor may be the best source of capital for the provision of funds to a joint venture. This is particularly appropriate when the company is also looking for technology, know-how, or new markets where the new investor will bring his own skills as well as cash.

Where state-owned businesses in an emerging economy are being privatized, this kind of investment will often come from outside the country.

Funds. A third source of capital may well be the specialized funds which are being set up both in the United States and in Europe, to invest in specific countries or geographical areas. These funds may well be prepared to take a medium-term view of the timing for investment returns. Such funds are being established in a number of countries, usually under the title of 'emerging market funds' or some other such phrase.

International community. Finally, the international community in the form of the World Bank, and in particular its International Finance Company subsidiary, the European Investment Bank, and USAID.

Sources of advice

Turning now to sources of advice, the benefits of expert advice at all stages of the privatization process cannot be underestimated. Advice is available in abundance; the skill is to select the source which is most appropriate to solve the given problem, and that which is free or cheap is not necessarily the best.

The available sources are numerous. The major international funding organizations, together with investment banks (and even nowadays accountants) can all provide this advice: not only on the sources of funds which may be available but also on the financial information which needs to be put together to present to an investor. The know-how fund of the United Kingdom government has been particularly active in funding the cost of advice and expertise in order to assist Eastern European countries move towards democracy and a free market economy.

Investment bankers of many nationalities and types are becoming involved as middle-men, linking companies with the funding which they seek, but the terms upon which they are employed must always be clearly understood at the outset.

One of the advantages of the strong competition in this area is that state-owned enterprises and governments are in a position to choose those advisors whom they feel are able to offer the best experience for the appropriate fee: but the benefit of expert advice at all stages of the privatization process cannot be over-emphasized.

Foreign investment

The capital needs may have been assessed, the sources of funding identified, and the structure of the deal outlined; but there may still be concerns to address before a structure can be finalized. In all sales of state-owned assets popular interest is high, due to the concept that state assets belong to everybody. There is always a concern that these assets will be sold too cheaply to the private sector, to the detriment of the citizen and the taxpayer. When this is coupled with a sale of part or all of these assets to a foreign investor, there is often intense popular concern and suspicion; usually combined with a limited understanding of the nature of the transaction and the benefits it will bring. All governments, therefore, tend to view foreign investment as something of a threat, if only as a political response to the concern of the general public. Even the most hospitable countries sometimes do not want to lose control of their industries and business assets to foreigners. And yet it is rarely possible to retain full ownership where equity share capital from foreign investors is a necessity.

What has to be addressed is the range of safeguards available to protect the interests of the local citizens. There are a number of ways which this can be done.

Majority transfer. In some cases the state may initially choose to retain some control over companies whose shares have been sold to the private sector. It is usual to suggest that the state should not maintain control by keeping more than 50% of the shares in the company as this can inhibit the purpose of privatization; after all, the state would still control the company. Furthermore, it can also make the other shares somewhat more difficult to sell, since many investors are unwilling to be a minority shareholder in a company controlled by government.

The golden share. Some of the worries can be overcome in a better way, by the concept of the golden share. This is a single share retained by government, which has attached to it special rights designed principally to protect the company from takeover in its earlier years, and to safeguard the national interest. It is important to note that the golden share is not there to be used to shield companies from the discipline of the threat of takeover for ever, since this would remove the element of competition which is the corner-stone of the privatization philosophy. It is there to give management a clear breathing space so that they are able to establish themselves in running a private sector company. It is not there to provide a means of exercising political influence.

Regulation. Many of the state-owned industries being privatized around the world operate monopolies. One of the reasons for privatizing them is to introduce competition, but without regulation it would be difficult to control the potential abuse of the customers for the operation of an unregulated monopoly. In the UK, control has been achieved by limiting price increases to a level below the inflation rate, thus ensuring that profits can only be achieved by controlling costs (though this method is now being questioned, with a number of people advocating the use of the rate of return approach).

Scrutiny. I would also emphasize a third method of reassuring the public about foreign investment. Where inward investment is taking the form, not only of purchasing shares from the state but also of the investment of a sum of money into the enterprise, it is important to ensure that those investors actually deliver the cash and the investment in the manner which has been agreed.

Conclusion

In conclusion I would encapsulate some of the advice which we give to governments or managers of state-owned enterprises who are approaching the introduction of foreign capital;

* be realistic in assessing the needs and potentials of the company, and do recognize that old factories with out-of-date machinery have little value in a cold, competitive environment;

* be reasonable in your attitude towards new investors by recognizing that risk capital must have its reward. The needs of government have to be balanced with those of the new investors;

* restructure as fast as you can to start generating the operating efficiencies on which your ability to service the new capital will depend.

4. BANKING SERVICES AND RECONSTRUCTION

Oliver Letwin
N M Rothschild & Sons

While commercialization means something if it is on the way to privatization, the experience has been that commercialization by itself is a manifest dead-end. Nationalized industries in Britain and in many other western countries have been 'commercialized' for years. Our nationalized industries operated more or less as companies, some of them literally so, but they still behave like nationalized industries in many respects -- in fact in most respects. So will they in Central and Eastern Europe if they are left in that condition.

Commercialization changes the structure of a company but does nothing to change the source of its capital. It is therefore a change of status masquerading as a change of substance. If commercialization means not simply transforming the status of a company, but trying to install some new management, and perhaps doing a bit of restructuring en route to privatization while the momentum is still there, that is altogether another matter. Most of these activities, in fact, are essential to privatization. In all the countries of Central and Eastern Europe it has been conceived as necessary for many, if not all, privatizations that commercialization -- in the sense of formation into a company and transformation from a state industry into something which is owned by shareholding of the state -- is a crucial element of privatization.

But if anyone tells you that there is no real need to privatize anything in Central and Eastern Europe, that you can just commercialize it and leave it in the hands of the state; and if anyone also tells you that there will be radical transformation as a result; I think they are talking through their hat. All we have seen in the course of our work in those countries indicates that it is the privatization itself, the bringing in of private capital, and the transformation of attitudes which occurs in a company as it becomes subject to the disciplines of the private capital markets, that are the crucial ingredients.

Achieving the transfer

The big question in Central and Eastern Europe has been, from a banker's point of view: how do you actually achieve that transfer to the private sector?

Remember just what a remarkable thing it is to take a company in Central and Eastern Europe into the private sector. The remarkableness comes about from the fact that there is not a private sector, or has not been a private sector, into which to take those companies. It is a mistake many of us made in the West to suppose the privatization in Central and Eastern Europe was somehow very similar to things which went on in the West -- a transfer from one sector to another. In the West there was already flourishing a private sector, and it was a question of transfer. It is much better put in the case of Central and Eastern Europe as the creation of a private sector. What is happening is something new, a birth, and not merely a rebirth in a different form.

Where is the material for that new creation? In Central and Eastern Europe there are few private sector institutions to act as the providers of capital and to buy up the shares. There are few private sector trade investors -- there are no large industrial companies working in the private sector in those countries to act as purchasers. There is little in the way of retail demand because there are not very many people who have large accumulated savings or high disposable incomes.

Perhaps you can give the companies away in more or less elegant and elaborate forms, through the voucher system and the public participation funds; but as to raising capital domestically, it is a difficult business.

Where can one seek capital? Clearly, one can seek it from foreign sources, above all trade investors, other industries, other companies in the same industry willing to invest. Indeed, there is a massive pool of available capital: in one of the companies which we have been responsible for privatizing in Central Europe, the purchase price for 100% of the company concerned was approximately one-hundredth of the market capitalization of the company doing the purchasing.

Secondly, new technology of one kind or another is necessary. This is true even in the service sector where financial skills, retailing skills, traditional service sector skills in the hotel and catering industries, all of these items are lacking. How are those companies which have been privatized but are not being protected by barriers, to compete against world competition? The answer must be by having technology in its wider sense, which brings their services and products up to levels which actually provide them with a quality that can compete against the outside. So it is not just a question of investment but a question of technology transfer. That too can be brought on a large scale by trade investors from the West.

Finally, the implementation of that technology and the organization of that investment through management skills is obviously critical. Good Western companies can bring those things on a scale which Central and Eastern European countries' managements have not traditionally provided.

Dealing with outside investors

But there is a terrible problem, a problem which even the unsubtle merchant banking advisor is bound to be aware of throughout. Do you really want your country run by foreigners? Some of the techniques available to ameliorate that problem are well known. But you will not find a large number of prospective trade investors from overseas if you limit too extensively the scope of those investors to engage in running and developing the businesses concerned. If you sell them only 45%, if you refuse to give them real control, you will find the potential trade investors very limited.

There are two possible strategies which one could imagine being used. Giving the overseas investor monopoly rights of one kind or another, while it may sound attractive, may actually deter people because overseas trade investors are now well-used to the phenomenem of acquiring monopoly rights and then finding a little later that they are stripped away again because they are so offensive to the domestic voters.

Likewise with legal privileges. If what is offered to the trade investor is some special treatment of a legal or a non-legal kind, it is all too likely that he will fear that before long his special status will be taken away, so he is likely to value it at little or nothing.

Similarly, subsidies, while they may appear as bonuses, are likely to be heavily discounted across time because the Western trade investor knows that subsidies are coming from governments which may not be able to sustain them in the long term.

Positive initiatives

What might actually have an affect? We find to our surprise that what trade investors really care about, and what leads them to be willing to come in is a clear movement on the part of the government towards liberalization so that they can see a gradual and sustainable development towards a market economy within which they know how to operate. Remember that these are companies which are used to operating in the West, under fairly liberal regimes. If they find that that is the general direction then life is becoming more and more familiar and every investor would like more rather than less certainty.

That is reflected also in attitudes to the legal framework. One of the most frequent questions we have been asked when dealing with trade sales in Central and Eastern Europe is: will the legal framework get clearer? Are we going to know what our legal rights will be, and what will they be?

A crucial component is the ability to make a return on one's capital which can actually be brought home. No-one can expect that Western trade investors will revitalize Central and Eastern European countries' economies as an act of charity; repatriation of dividends (and ultimately of capital) is a crucial component.

Some other items are much weaker obstacles. Excess labour, for example, which is much talked about, can quite frequently be a minor component because, by comparison with Western levels of pay, wage levels are extremely low. Even if the industry is over-manned, that is likely to be a fairly small component of cost.

Of much more serious consideration is what proportion of expected profit will be removed by taxation? We have been asked a lot of questions by potential tenderers about our views on likely later taxation.

A crucial component is professionalism; bidders will be willing to accept constraints if they believe that they are buying into something serious which has been properly documented, where the information is actually available and where the rules of the game are clear.

Those are the techniques which make it feasible to bring in overseas investors. So there is every reason why Central and Eastern Europe should be moving towards serious privatization rather than mere commercialization.

The money, the expertise, and the technology will not come largely from domestic capital sources; there are no domestic capital sources sufficient, nor domestic institutions. It will come through trade sales by overseas trade investors who have the money and the knowledge, provided that those trade sales are done against a background which is conceived by the trade investor as liberal, open, and professional.

And, finally, if there is a political problem then the right solution seems to us to be to keep that separate from the process of the injection of capital. That is where the voucher schemes, the public participation funds in Poland and their equivalent in Czechoslovakia, come to bear. We see them as a very useful second string from a financial point of view, a way of making acceptable a process which, economically speaking, centres on the sale in part or whole of companies to Western trade investors. We see those two marching hand-in-hand with the public receiving free give aways in the form of vouchers or other forms of investment in trusts, and with the real capital and the technology and management coming from Western trade partners.

All the evidence we have is that the process in, at least, Hungary, Czechoslovakia, Poland, and East Germany, is just at the beginning. We see all the signs of a continuing trend and an effective one; and we are not alone in this, as merchant bankers. Unfortunately the competition is tough and there are a number of other parties who are out there bidding to act as advisors, and

succeeding in doing so. But those things, while they are bad for us, are good news for the populations of Central and Eastern Europe.

5. WHAT CAN GO WRONG IN COMMERCIALIZATION AND PRIVATIZATION

Vicky Pryce
KPMG, Peat Marwick McLintock

Privatization is a favoured option in Eastern Europe because it is seen as likely to produce a swift move to a market economy, facilitate the development of the capital markets, and attract foreign investment. The methods used so far have been sales, either public sales or trade sales, and in some countries (mainly Poland and Czechoslovakia) the voucher system.

Obstacles for vendors

The progress has been slower than expected and governments have been attacked for stalling the whole process. However, I think this is hardly surprising if you look at the economic and financial environment in the East European countries.

Conventional and public offers take time -- especially due to the lack of developed capital markets.

Real problems exist in reconciling the political and economic objectives of privatization. Countries start by intending to restrict foreign investment in privatized companies, but reality unfortunately often forces them to concede this principle. One of the reasons is not only the lack of domestic savings and the under-developed capital markets but also the very weak position of some of the companies which they would like to privatize. How can you privatize with ease a loss-making company in a loss-making industry in a loss-making economy?

Reform is especially difficult when the funds are not available domestically to write off the debts of weaker companies, or turn them round before privatization.

There is difficulty also in reconciling the public accountability with the need for speed.

If the position of the industries which they intend to privatize is actually very weak, then privatizing those companies could well be against the interest of the economy because it reduces the viability of industry as a whole.

And how do you sell those companies when, under the circumstances just outlined, valuing them is a very difficult and tendentious issue?

Buyers' doubt

In addition to that there are the problems from the side of the foreign investor.

First comes uncertainty, not only economic uncertainty but also uncertainty as far as privatization policy is concerned. In some of the countries it is still not quite clear how privatization should proceed for some industries.

Even if the companies are privatized and the foreign investor is successful in actually buying some of the companies, he is still left with the economy having a number of monopoly suppliers and monopoly customers. So you are dealing with an economy which is going to take some time before it becomes a proper market economy.

Inflation is, of course, a worry, in terms of what it might do to a business you acquire; and it is one of the more significant problems we have had to face when preparing business plans for the companies we are trying to privatize.

Convertibility is now much less of a problem. The issues of ownership and valuation are well known.

Progress so far

Poland is moving closer to a mass privatization programme. We have had the first wave of public offers; second wave advisors have been appointed; there are a number of industry restructuring and privatization studies to try and shape the policy for their industry before individual companies get privatized . The voucher scheme is about to become effective. Many small and medium-sized enterprises have been privatized or are abut to be.

In Czechoslovakia we have seen some very well publicized joint ventures -- the Skoda Volkswagen issue is actually a joint venture between the two companies. We are now seeing a move towards small privatizations, the sales of large companies are commencing and the voucher scheme is being introduced.

Hungary is by all accounts the most advanced. It has had a pre- privatization programme with mixed success; not all the companies have been sold off, mostly small shops. The first privatization programme advisors have been working for some of the first 21 companies to be privatized. The second privatization programme has been launched; and there are a number of investor- and management-initiated programmes -- so-called spontaneous and negotiated privatizations. Interestingly, in Hungary there are no vouchers.

Despite superficial similarities, the approaches of these three countries do vary in some crucial aspects. In addition to there being different levels of progress it is very interesting to see Hungary, for example, having adopted a very centralized approach, with the state property agency at least attempting to control sale prices; whereas (in theory at least) Czechoslovakia is leaning the other way, trying to leave the onus on the individual enterprises which are to be privatized.

Poland has gone for public flotations first, while Hungary has chosen a series of companies from different sectors, of different sizes, and requiring different methods of sale.

What can go wrong

Nevertheless, despite the different approaches, the pitfalls have been very similar, and I would like to take you through some of the ones we have encountered.

One of the problems is the diversity of operations of many companies. Under the old Eastern European system, companies were all encouraged to develop non-core activities in order to be self-sufficient in all aspects of production. What that means now is that a considerable amount of restructuring is required -- selling off the non-core activities, or perhaps giving them away or closing them down. One has to prepare, in quite a hurry, restructuring programmes and separate business plans for the hundreds of individual enterprises that exist within one firm. So this is actually quite a big task which quite often extends the job much beyond what an advising firm had in mind when it first accepted the assignment.

The second problem is deteriorating trading conditions, which in Eastern Europe means mainly the loss of the USSR market, which has affected a number of state enterprises very substantially. In Hungary, for example, the SBA went through the process of choosing very carefully the companies in the first round of privatization to make sure that they were the types of companies which could be easily privatized and would be a success. But by the time they were ready to privatize such companies it had sometimes become more of a corporate recovery job, not a privatization job, because markets were and still are deteriorating all the time.

The third question which makes the whole process more difficult is the debt situation. Quite a lot of those companies have accumulated debt, quite often encouraged by the government, and now you have the unwillingness or inability of the government (and the financial institutions), to do anything about it -- they have no wish to take it on or write it off. So you are trying to privatize companies that are severely weakened by debt.

You also often have an over-reaction of governments keen, in the early stages of privatization, to promote competition. We started doing work with some firms which were big conglomerates with a number of different plants, identifying all sorts of quite exciting new strategies. But before we had finished, the government has already moved in and split each company up into several different components. It is very difficult to do much if such a company has actually been weakened financially, in the process; and one finds it difficult then to acquire buyers for the individual plants. It varies, of course, from company to company, but there have been cases where it has been a difficult task to implement what you were actually engaged to do in the face of this political trend.

You also have the management issue. Quite often the people you are dealing with and who are managing the enterprise, are the very same people who were there before the revolutions, and are not really very willing to accept the recommendations you make.

Another issue is the control of the enterprise. Who actually controls it? Who has any power to make the enterprise change before privatization?

The results

All these issues make it rather difficult to find a buyer and adhere to the policy aims you started with.

What are the consequences? Not surprisingly there hasn't been as much investment in the various countries as you would have expected. It has taken longer. It has led to considerable weakening of some of the enterprises, especially when speed was of the essence as far as the authorities were concerned, yet at the same time there was an unwillingness to continue with government assistance. For the advisor caught in the middle, there is a need for both political as well as technical skills in order to achieve the task.

As a result, for the whole of 1990, joint ventures continued to be the favoured way of entering the various countries. Even then, however, although we hear about thousands of joint ventures taking place in those countries, in reality the number of operating joint ventures (in other words joint ventures which are doing something) are, in our estimates, still very small. What is more, just looking at the Hungarian example, most of them are in trade rather than in industry, suggesting that the amount of investment going into these countries has remained small.

What does that all mean for Eastern Europe? The UK experience has been one of privatizing utilities, the big public sector monopolies; they have tended to require quite a big process of commercialization, the writing off of debts, and a considerable amount of money spent by the government in turning those companies round before they get privatized. In the UK, regulation has been important in ensuring that those big monopolies operate in a semi-competitive way.

It hasn't been so in Eastern Europe; we have had some very small enterprises just being given away or auctioned off; the large companies' privatization has really only just begun; public utilities are a long way down the road in terms of privatization; and so, little importance has been attached to commercialization and regulation. In our view commercialization and regulation should both become greater priorities in the future, to at least ensure the viability of some of the industries which may well not survive the opening up of competition.

There is also, in some sectors that we have looked at, a need for the authorities to set an intervention policy and pricing policy in order to ensure viability of the sectors. And therefore we welcome the practice in some countries of looking at whole sectors before doing anything to the individual companies within them.

It is also important to allow some key companies time to commercialize. One interesting example has been that of Eastern Germany where the initial emphasis of the Treuhand was to just sell everything at any cost. That, of course, has been a failure and it has had detrimental effects on the East German economy. The emphasis has now shifted very firmly to us doing industry studies and then trying to commercialize key enterprises within those industries.

Conclusion

I will leave you with these final thoughts. The policies that should be developed in each individual country have to suit the demands of these countries, and suit the interests of these countries. Many mistakes will be made. Do be demanding, but do not exploit the advisors -- who often find themselves in a very difficult position. And remember that the hardest work in terms of privatization is yet to come.

6. CASE STUDY: REFORMS IN POLAND

Krzysztof Lis
Deputy Minister for Privatization, Poland

I define my role today as a kind of live exhibit, having been the former minister of privatization for two years and still surviving.

From the very beginning we knew that we were not talking about the privatization of a few companies. This is not the task in our case. We are talking about the privatization of an economy. We came through the terrible disaster of communism and now we have to find a way out. I don't want to say that, being retired, I know everything better now, and simply blame the government (which is a very popular activity in Poland); but I do want to define what we are talking about. In Poland we are talking about 9,000 enterprises. About 1,500 companies have gone from state ownership into municipal ownership, and this was one of the best steps we did. It allowed us to privatize small shops and services through the local government, and thus more rapidly. In many places in Poland people were fighting to buy and sell shops and service companies. This was decentralized privatization.

For the remaining 9,000 enterprises, commercialization is now the most important issue.

What does commercialization mean? First of all it is to give a corporate form to the company, because until now the companies have had a strange corporate government which includes managers, workers' councils, and trade unions; we call it the Bermuda triangle. Efficiency is being lost. We cannot continue working on such a system.

I would say that the free distribution of vouchers might be a solution for 300-400 enterprises, but what about the other 8000? Only commercialization is practicable at the moment. How do you do that? This is the problem of logistics; how to prepare masses of new managers, how to train them, how to gain time. Something which is obvious to people with experience in Central Europe is that privatization will not be so quick as the optimists say. That is not possible.

Some people say that we should simply introduce the voucher system and by that we will gain time for a real privatization later. I am totally for that and support the free distribution. But if anyone says that we would be revitalizing the companies and will increase efficiency through the free distribution scheme, I remain very skeptical.

How can we proceed in the case of those companies? The problem is how to install an efficient owner to a company, and to supply the company with capital, marketing, managerial skills, access to the market, and so on.

The first barrier is conceptual; should we concentrate on commercialization before we go on to privatization? Or do we go a different way?

The second is a technical barrier. We should know how to privatize. On this score we have done quite well in Poland: we know what to do, and the technology was transferred. We did some public offers, we developed the law on privatization, the law on securities, we built up a security commission and a stock exchange. We executed two cases of management employee buyouts, many trade sales, and some others.

But there are other problems, managerial and organizational, inside the government. It should be decided very clearly who is the authority in the field of privatization, because too many people are playing games about who is responsible for what, and how to do it. The other thing is our resources. People expect that privatization will supply the budget with money. That is not true. At the very beginning we have to invest in privatization.

7. MASS PRIVATIZATION IN POLAND

Matthew Olex

Before I say something about the Polish approach to wholesale privatization, a word or two about the context. Poland's economy is about 70% larger than Czechoslovakia's, and three times the size of Hungary's. Our population is almost 40 million, compared to Czechoslovakia's 15 million and Hungary's 10 million. Our reform programme is widely regarded as the most radical in post-communist Central Europe, and we are aware that the political and economic uncertainties are considerable.

Accordingly, even if it were desirable, it is not feasible for us to embark on the strategy which some of our smaller comrades seem at times to have adopted: namely the divestment of whole sectors of the economy to foreign corporate investors. We do, of course, need foreign investment, large volumes of it, and we welcome foreign investors of all kinds. However, we are aware that we have to privatize Poland mainly within Poland.

What then are the Polish government's intentions? With its overriding objective of creating an efficient market economy, in 1989 the new government embarked upon a vast programme to transfer state assets to private owners. Within five years we intend to transform Poland's ownership structure into one resembling that in Western Europe. Approximately half of our state owned assets are to be transferred into private hands within the first three years.

Size of the challenge

By far the largest element of the state-owned economy are the 9,000 so-called productive enterprises, 65% of which are in industry. These industrial enterprises alone produce about 45% of GNP and employ a little over 20% of the workforce. Their total assets are about US $40 billion and sales in 1990 were some US $63 billion: the largest 500 account for approximately 50% of sales. These firms are often highly vertically integrated and capital intensive and, to say the least, they are not famous for their productivity and efficiency.

Before we look in detail at this industrial hard-core it is useful to note what is happening on the periphery, and the picture here is extremely encouraging. For example, much local wholesale and retail trade was in the hands of the municipalities, and here there has been a veritable wave of buy-outs and leasing to incumbent workforces or newcomers. Some 70,000 retail outlets have been privatized so far, representing 70% of the country's retail trade. And a similar picture can be seen in other services, such as road transport, which is now almost wholly private.

Another category beyond the industrial hard-core are the 13,000 cooperatives which make up about 20% of GNP, and privatization here has been proceeding in a spontaneous fashion, which is perhaps not adequately regulated but is nevertheless very welcome.

Most encouraging of all is what one might call the indigenous private sector. Over 70% of arable land is privately owned through 2.6 million farms, and this represents a block of about 20% of GNP which has always been private.

Private industry goes back to the early 1980s and now includes some very sizeable firms for Polish circumstances, turning over US $20-50 million, and some much more. Most private industry, however, is still very small scale, but nevertheless this sector now employs over 10% of the industrial workforce, and provides well over 6% of industrial output.

At the end of 1990 there were 23,000 Polish private companies, 1,400 active joint venture companies with foreign capital, and well over 1 million registered unincorporated private businesses. And in the fifteen months from the beginning of 1990 there were 515,000 registered start-ups of various kinds. Add to that the black and the grey economies and you get a picture of a country where not only is the economic environment largely free, but the market determines prices, currency is convertible, tariffs are low, and something like 35%-40% of GNP and perhaps 30% of the population are already private in the fullest sense.

While this periphery is doing very well, there is no doubt that the industrial hard-core will have to be privatized quickly in order to shift the balance decisively. Here our privatization strategy envisages the simultaneous use of different techniques, matching them to corporate size and performance.

Privatization strategies

Our economic restructuring law provides two main alternative routes: firstly there is commercialization, the incorporation of state-owned enterprises, followed by the transfer of their capital to private owners. Unsurprisingly this is used for state-owned enterprises which are deemed to be in viable financial and structural condition. Larger enterprises usually require a diversified ownership structure whereas in most cases small and medium-size enterprises can be sold in whole or substantial part to a single buyer, with, of course, its management and workforce.

The second main route is liquidation, which is applied to enterprises which are deemed not to be viable either financially or in terms of size. They are broken up and their assets leased or auctioned off.

So far, privatization of the larger viable companies has been on traditional lines, using public offerings or trade sales to domestic and foreign investors. The process began with the spontaneous privatization of a foreign trade enterprise and of a commercial bank, and has continued with numerous joint ventures. A further 14 medium-to-large enterprises have been sold en bloc: seven by public offering, a further six by trade sale to foreign investors such as Philips, Thompson of France, and Unilever, and one through an employee-led leveraged buyout.

Overall, 283 programmes of classic privatization are underway, involving 170 firms which are still state-owned, and 113 enterprises which have already been commercialized -- all voluntarily. Some will be sold by public offering; the next 7 are now being prepared, including 2 breweries, a confectioner, and a glass works. Numerous negotiations with foreign investors are in train. General Motors and Fiat are reportedly vying for major car projects, and the latter seems willing to invest $2.6 billion; and among other names known to be negotiating are Heinz, Pilkington, and Otis Elevator. In all we aim to have 15 major public offerings, 15-20 domestic trade sales, and a similar number of trade sales to foreigners this year.

The process of liquidation is also gathering momentum. By the end of May, 347 state-owned enterprises had been liquidated, of this 156 had had their assets leased to existing employees. A further 148 were privatized, mainly by the method of public auction. In coming months the significance of these auctions will increase as they become the basic formula for the quick sale of small and medium-sized enterprises.

Mass privatization

These are massive achievements, especially given the fact that the Ministry of Ownership Changes has only about 150 professional staff. Nevertheless, our progress so far is clearly insufficient and the figures are an explanation of why we have also been considering a so-called mass privatization programme.

But apart from the slow pace so far we have another reason to move forward rapidly towards mass privatization. This is the wholly inadequate link between the owner and the firm that is found across much of the country's state sector.

In their present form state firms are nominally owned by the state, representing the people. But in fact they are owned and run jointly by a shifting and imprecise constellation of managers, workers and the state. In effect, the majority of state firms are self-managed, either by a well-organized workers' council, or, when these councils are not effectively organized, by the managers who act with considerable independence of the workers and of the state bureaucracy as well. These workers or managers have considerable incentives to try to appropriate income, to under-invest, and even to strip the assets. Under these circumstances it is not surprising that enterprises have had difficulty in facing up to some of the hard decisions which will be necessary for survival in a market environment.

Commercialization is, therefore, a crucial step which removes some of the problems arising from muddled ownership. Through the conversion of enterprises into corporate form, property rights are enforced by a board of directors appointed by the owners -- initially the state, but eventually the new private shareholders. Some more enlightened managements and workforces have voluntarily joined in the process but this is not enough, and we now plan, forcibly, to convert up to 400 firms to corporate form; and politically this can best be achieved against the backdrop of a mass privatization project.

What will this mass privatization programme consist of? In essence a range of investment groups will be constituted with Polish majority supervisory boards but managed by international fund managers and other intermediaries. A share ownership of these investment groups will be distributed to all adult citizens free. The majority ownership of 200-400 medium to large-sized state-owned enterprises will be transferred to the investment groups. These firms in the main come from a group of 500, which accounts for half of industrial sales. The project has been under development for well over one year. S G Warburg has been brought in to crystallize the scheme, building on earlier conceptual work, and on logistical studies which have been undertaken by Touche Ross.

Let me elaborate briefly on the two key elements of this programme: the involvement of the population at large and the nature and expected behaviour of the funds.

As currently envisaged, every adult Polish citizen will be allocated a share in each investment group. Those who wish will be able to obtain physical confirmation of receipt of the shares by visiting their local governmental offices, but nothing more need by done. Those who do visit their local government office will have a personal identification number inserted on their ID card. This will provide proof of ownership when tradeable interim certificates of aggregate ownership are issued in the Spring of 1993. From then on it will be possible to sell these certificates and to purchase shares in individual investment groups. As the initial value of the shares will be low, special arrangements will be designed to facilitate trading outside the stock exchange, using the country's wide network of retail commodity and currency dealers. These dealers will be expected to combine, and to trade large volumes of interim certificates and fund shares, using the Warsaw stock exchange. Larger investors, including foreigners, will, of course, also be able to buy in.

Why have we gone for this particular solution? The original idea was to give physical vouchers to the citizenry, with perhaps the right to choose among the funds, but this was rejected for a range of logistical, security, cost and political reasons. Touche Ross and we concluded that we could use the country's computerized population register to control share distribution; this register needs to be updated and this will of course take some time. So the two-phased distribution system now adopted initially uses the 100% accurate, locally held physical card register of the population. It also meets the political requirement for people to be able to receive something tangible if they wish.

The selling facility, as conceived, offers a compromise between the need to provide a market and the desire to reduce the propensity for people to hold, and ultimately to vote, real shares, with logistical and registration implications.

As regards the funds themselves, the intention is that they will be allocated shares in 200 of those 400 medium and large-sized industrial enterprises I mentioned. Up to 10% of the shares of each industrial company in the scheme will be given to employees, subject to an annual earnings ceiling. Of the remainder a 33% lead shareholding will go to one fund, and 27% will be distributed pro rata among many investment companies, giving a total of 60% to be held by the investment companies as a group. Including the 10% given free to employees, 70% will thus be privatized and the remaining 30% will be retained by the state directly or through the social insurance system in order to benefit from eventual capital appreciation and to facilitate trade sales and takeovers.

The fund groups will be closed-end companies in public company form and they will in due course be listed on the Warsaw stock exchange. Polish citizens not linked to the fund managers will comprise the majority of each supervisory board. The management boards will be small, and also comprise a majority of Polish citizens. The fund manager firm will assume day-to-day management: these management firms will be expected to include Poles and their teams, either by direct recruitment or by working with Polish banks, consulting firms or other institutions. Thus, while legally they will be similar to investment trusts in the UK, in their behaviour the Polish privatization groups are going to be hybrid financial institutions which might draw on the skills of a variety of professions, including those typically found among merchant banks, investment capital fund managers, mutual fund managers, and management consultants.

They will not be mutual funds in the fullest sense, since traditional mutual funds are passive investors, nor will they be venture capital funds to the extent that traditional venture capital funds often invest in small or developing enterprises. The Polish funds will, however, be unit trusts or mutual funds to the extent that these manage portfolios to maximize shareholder returns, and since their primary compensation will be based on an annual management fee. They will also be venture or development capital funds in the sense that such funds are active investors, and given the fact that an interest in capital gains might be an important part of their compensation.

The funds will have very great freedom of action to restructure the management and the operations of their firms in order to maximize profitability and returns to shareholders. They will be able to attract joint venture partners and foreign direct investors of all types, and to raise additional funds through borrowing, debt issues, and equity offerings in Poland or (eventually) abroad, in their own name or directly by their investee companies. In due course they could arrange for the sale of the enterprises in their portfolios through public offerings or trade sale methods, and to liquidate themselves and distribute the proceeds.

Conclusion

The Polish privatization fund is a new concept and it will provide much needed management oversight and accountability for the newly-privatized enterprises, and add value so the Polish population, the Polish government as minority owner, and the fund managers themselves, will all benefit. Its political appeal lies in its potential to permit ownership of a significant portion of industry to remain in the hands of the country's citizens, while enlisting Western management and financial expertise to the greatest possible extent to help in restructuring.

The task of managing such a fund will be a major challenge but the potential profits for a Western institution will be very exciting. This profit will derive from a relatively stable annual management fees based on assets under management, and from an incentive in the shape of a carried interest in a proportion of the realized capital gains. Much will depend, of course, on the quality of the companies in the portfolio, the detailed allocation method per fund, and the initial valuation against which the capital gains will be measured. But together with Warburgs we will derive a set of formulas which will be workable.

Our medium-term goal in Poland is to recapture the relative position in Europe which we have had historically. Remember that in 1936 Poland was more developed by every criterion than Spain. With its entrepreneurial and educated population, large market, central geographical location, reasonable infrastructure, and fast privatizing economy, there is little reason why Poland cannot soon start growing in terms of GNP at 5%-10% per year. For those in financial services the mass privatization programme will be an excellent way to participate, and for others I invite you to watch and to share in our experiences.

8. CZECHOSLOVAKIA: VOUCHERS AND OTHER DEBATES

Dr Dusan Triska
Director of Privatization,
Federal Ministry of Finance, Czechoslovakia

In Czechoslovakia we have 4,000 state-owned enterprises: and to privatize 4,000 enterprises is a tremendous task. We are aware that the world record is held by Chile which privatized only 500 enterprises within ten years. We know that in the UK the speed was much slower than that by far. If you are faced with the problem to privatize 4,000 enterprises, you are in an entirely different situation from the privatizers operating in UK, France, America or Germany.

How did we approach this problem?

These 4,000 enterprises can be differentiated into three basic groups. First came 1,000 enterprises which will not be privatized in the short term. These are enterprises which will be kept aside and will be kept in the government's hands for 3-5 years.

Another 1,000 enterprises are scheduled for standard-type, UK- style case-by-case privatization, which involves restructuring, changes in management, proper evaluation of the enterprise, and so on.

Then there remain 2,000 enterprises which are to be privatized with the help of investment vouchers. I would like to stress that when we introduced the voucher scheme into the privatization programme in Czechoslovakia, it was by no means in any conflict with foreign investment and any standard-type privatization processes. We have reserved 2,000 enterprises for voucher privatization and there remain another 2,000 enterprises. So these 2,000, and at least the 1,000 best enterprises, can be kept for the standard privatization and the government will be happy to invite foreign investment to Czechoslovakia. But the government is aware of the fact that to sell 1,000 is a tremendous task and it will take decades to sell those enterprises.

I would like to stress that the voucher scheme is also in no conflict with standard privatization which is already underway in Czechoslovakia and which has strong

political support by the government; and foreign investment, foreign investors, and foreign capital are most welcome. In Czechoslovakia, unlike any other post-communist countries, there is absolutely no phobia against foreign capital.

How is the process to be organized?

The voucher privatization process has two sides: the supply side and the demand side. I spoke about 2,000 enterprises and they can, we believe, be privatized in two ways. We select 1,000 enterprises for the first privatization wave, they are then converted into companies, you take the book value of these enterprises (because the valuation doesn't matter), and you represent their net worth in the form of shares. So this is the supply side and represented by millions of sharers of 1,000 enterprises.

On the demand side we create voucher holders by selling voucher books all over the country. The number of eligible people over 18, with citizenship and a permanent address in Czechoslovakia, is 11.5 million, so if 30-40% of people join the process then we shall create some 4 million voucher holders.

Then comes the logistical problem of how to convert vouchers and how to exchange vouchers for shares of privatized companies. There is not time for me to explain the technical problems of the process. We will announce the prices of the shares of each of the privatized companies, and people who are interested will fill out the number of the company on their voucher and place their order. You can imagine that to serve these millions of participants of voucher holders is quite a tremendous task.

How far have we progressed?

The data handling for this task will be done by our nationwide computer company in Czechoslovakia, which covers the whole country and took care of our elections and has the mailing list information from the election data. The second contract we signed was with the Czechoslovakian Post Office and Telephones because the applications will be made through the network of post offices. Our largest nationwide advertising company will take care of the information campaign concerning vouchers and the privatization process. Our opinion poll company has already started to monitor the attitudes of people; and through this company we shall have better information about the development on the demand side of the whole process.

The management group is rather small, but the suppliers are there, and the contracts are signed. The overall budget is 1.5 billion crowns, and to give you a rough idea of the scale of this, the total state budget of Czechoslovakia is 400 billion crowns. We hope to finance the scheme largely from the registration fees, and we also hope that we may have some contributions from international organizations to support this process of transformation.

There are many reasons why we should implement the voucher scheme. One is that not only will we be explaining to people what the security market is all about and how the market operates, but also telling them directly and exactly how to participate and how to join the process, where to go and how to place the order, where to get shares, how to trade with shares.

Yes, we organize auctions all around Czechoslovakia to sell and auction small business services units -- restaurants and so on. But it is not always easy for ordinary people to come to the auction, and often they do not know how to go to a bank and get loans to enable them to participate. With vouchers we can tell everybody in the country how to participate, if they so wish.

9. HUNGARY: DIFFERENT STRATEGIES

Ernoe Racz
State Property Agency, Hungary

I would like to talk about the major elements of the Hungarian reform: the political reforms, the economic environment, the legal environment that encourages foreign investment, the goals and the principles of the privatization, and of course about the organization of the privatization process.

In 1990 a peaceful revolution took place in Hungary, leading to free elections and a coalition government of three parties: the Hungarian Democratic Forum, the Independent Smallholder's Party, and the Christian Democratic People's Party. This coalition became the first accountable government of the new Hungarian Republic.

The principles underlying the new constitution were of freedom for the people and for economic transformation, a social market economy and private property.

In order to create a real market economy a very large volume of state property rights have to be transferred to the private sector. The government's objective is that as a result of the privatization the share of private property should be increased so that the share of the state-owned enterprises in industry, trade, banking, and other economic activities should be reduced to about 30-40% in a few years.

Attracting investment

In order to reach that target, Hungary has to create a proper environment to attract direct foreign investment. We believe Hungary *is* attractive because its central position offers access to the huge Eastern market; it has very well trained labour with relatively low labour costs, and it has considerable political stability.

The reform of the banking system also makes Hungary attractive. Only about 16% of products and services have fixed prices in Hungary. This figures is similar to the Western countries. In 1989 the rigid state wage regulation was ended. The government has also expanded the liberalization of imports to the point where about 90% do not require any licence. The Hungarian currency is already convertible in the business sector; for the general population, full convertiblity will necessarily take longer.

Hungary has created stable legal rules and institutional systems. The privatization process is based on fundamental laws: the company laws which were adopted two years ago, the transformation law which was adopted in 1989, and three laws which were adopted last year -- the law on state property agencies, a law on the protection of state assets, and a law on the privatization of state enterprises dealing with the retail trade, the catering trade and consumer services.

The Hungarian government also encourages purchases by foreigners, giving them advantages in the course of privatization. Owing to limited domestic demand, purchases by foreigners will dominate in the initial stage of privatization. Foreign capital may promote the modernization of factories and plants, the means of production and business instruments, and it will encourage technical development and the reform of management techniques.

To grant more security and provide other economic advantages for foreign investors the Hungarian parliament adopted an Act on foreign investments in Hungary, giving them several privileges and advantages. Foreigners may establish joint ventures in Hungary on the basis of company law and on the basis of this Act.

Any company can now pursue any activity which is not a state monopoly (foreign trade is not a state monopoly any longer in Hungary); and a joint venture needs permission for an activity only in cases where Hungarian state-owned enterprises, cooperatives, or commercial companies need it as well.

Acts have been adopted providing the necessary legal guarantees for the sale of shares on the Hungarian stock exchange. The Hungarian stock exchange was established last summer and its activities are continually developing.

Foreigners can freely establish a joint venture in Hungary. The Act on Foreign Investments in Hungary gives further advantages to these companies. For example, non-cash contributions to the company's capital, productive capital goods, can cross the Hungarian border duty free. Cash contributions to the capital can be kept in foreign convertible currency by the company. The company can buy spare parts and equipment freely from abroad in convertible currency. Joint ventures may acquire real estate for their economic activities.

Foreign partners are entitled to freely transfer their dividend abroad in convertible currency: they can repatriate their profits.

Privatization strategies

The main principles of the privatization strategy I mentioned earlier are the following. The transfer of property rights has to be carried out by a market oriented privatization process and not through redistribution of state property. The privatization process should conform to the characteristics of a market, such as real domestic and foreign demand, but in certain cases state intervention is needed -- for example, protecting the national interest in strategic situations. The application of different privatization methods should promote a wide circle of investors, including employees.

Some privatization of state-owned enterprises is initiated by the enterprises themselves, the so-called 'spontaneous privatization'.

The second general method is the centrally initiated selling and privatization of state properties, called 'active programmes'.

The organization of monitoring and processing of privatization, and the selling of state-owned enterprises and companies, are tasks of the State Property Agency. Set up in the last year, this is controlled by a board of directors appointed by the prime minister; the general manager is appointed by the government, and the total number of staff is about 120 people. In Hungary the SPA plays the role of the owner, so it is the partner of foreign investors in Hungary.

Unfortunately the SPA does not take part in the restructuring of companies because the number of staff is too low and we have no money for this restructuring and not enough experience.

The number of state enterprises which belong to the SPA is about 2,200 and the book value of their assets is beyond £20 billion. Some 63% of these enterprises were funded by ministries and 37% were funded by municipalities. Since March 1990 about 10% of these enterprises have been privatized fully or partly, under the co-ordinating and controlling rules of the SPA.

The selling of state property by deals initiated by the potential investors now plays a very important role in future privatizations.

The last method of privatization is the privatization of state enterprises, dealing with retail trade and consumer services -- the so-called 'small privatizations' where we have auctions and sell them to Hungarian buyers.

The form of the privatization will be similar to any Western country. In the process of privatization the SPA will regard as a primary goal the most efficient possible future operation of state properties. The SPA will take care of the fulfilment of the requirements of publicity, transparency, tendering, and property evaluations. Within the legal framework the SPA will try to ensure the smoothest and quickest possible realization of the privatization plans initiated by enterprises, in order to accelerate the privatization process.

10. GERMANY: PROSPECTS FOR NON-GERMAN INVESTORS

Wolfgang von Eckartsberg
Head of Corporate Finance, Deutchebank

Over the last few years, the GDR in fact has lost its most important markets due to the deterioration of the economies in the Eastern part of Europe. So the demand for the products which we have produced in the former GDR has slipped away. Companies in the GDR faced the introduction of the deutschmark which made their products even less attractive to the East, while their quality was insufficient for Western Europe and other countries.

The major problems are not so much within the complex of technology and on the production side, but on the management side. Within a centralized planned economy there was no management or marketing for effective production, which mostly went into the Eastern European countries. The production was not effectively regulated by the demand. Research and development was also limited just to what was produced for a certain existing market but not within a dynamic competitive market. And the financial requirement of the companies or of the whole industry simply was not defined in this centralized planned economy; capital was distributed by a big agency in Berlin according to political and bureaucratic rules.

So we had the former GDR as an institution working for a certain market. But this market has changed now and the institutional structure has to be introduced into a new one; we have to analyze how we can just change the situation. That brings us to an analysis of the general economic environment as well as to a capability analysis.

With regard to the general environment, we had the problems of the availability of energy and raw materials, environmental protection and air pollution, and there were major issues in water and legislation from Western Germany on the unification contract of October 1990. So the challenge now is to improve the ecological environment which needs investments. To reform and restructure the water industry will cost 150 billion deutschmarks.

With regard to the technology, we have technologies which, compared to other countries in the Eastern bloc, are quite good. But now we have to face a market which wants other standards -- quality of *products* -- and that requires new investment in technology as well.

And it means we have to introduce new methods. Within the unification of Germany, we now have implemented new methods of marketing which we are learning from Western Europe and other parts of the Western world.

Then we come to one of the more important and key issues of unification, that is demographic, social and psychological trends. The key issue for quick success within Germany is the capability to integrate the people there within our economic system. That means that all of us are in a deep educational process where both parties have to learn what has happened in this past 40 years.

I think that after the euphoria we had in October 1989 now we have come back to reality and have to accept that it will take some time because the issue is how to integrate the people. We want to give trust to the people living there and give them confidence to integrate them and assist them. That means that the banker is not only a banker now, he is a psychologist and a teacher as well.

We also have to recognize that the economic development of the country is very much dependent on the effectiveness of the public sector. That may surprise people here, but we must remember that the effectiveness of the region of the Eastern part of Germany in many cases is dependent upon the infrastructure of that sector -- meaning telephones, communications of all kinds, transport systems, highways, the water industry and so on -- creating a new environment. The planning of all this infrastructure is in the hands of the public sector, but the public sector has been changed completely in the last two years. Therefore in our corporate finance activities, for at least 70% of our time we are arranging seminars, for example, teaching major members of the public sector, representatives of cities and communities, how to manager their own cities, how to set up factories, how to define financing possibilities with regard to investment within the infrastructure. I think that we have to accept that if the public sector does not work, the attractiveness of certain sectors in private industry will evaporate.

All foreign investment is very much welcome. We have to realize that due to the management shortcomings which we were talking about, the investors coming into the country have to have their own managers who can communicate with the investor company (say, in the US or UK), meaning that they have to bring management who are in a position to cover the reporting needs of the investing company. We do face a communications problem. The investors' languages (English or French, mostly) are not that well known as those of other parts of Europe. We know Russian but that is no use to a company boss in New York.

We have only very small and unimportant regulation to overcome for a foreign company to invest effectively in Eastern Germany. This is also shown by the report of the Treuhand dated 31 May. The Treuhand has sold about 2,000 companies so far and of those, 81 were sold to 68 foreign investors of whom the majority came from Switzerland and France. This shows that the problems are in the structure of the industry and in the management, and that language is a major obstacle to the investor coming from outside.

We need far more investment in the construction area, the transport area, the communication industry and the environmental area. These four sectors give enormous chances to any investor interested in investing in the former GDR.

11. THE CHALLENGE OF ECONOMIC REFORM

Guy de Selliers
Group Manager, Merchant Banking
European Bank for Reconstruction & Development

I would like to say a few words about our general approach to business at the European Bank. Our overall philosophy is to operate at two different levels at the same time: the government level to help create the infrastructure for the market economy; but also at the enterprise level, to help the market players actually play the market and take market risks. This philosophy is reflected in the bank's organizational structure where we have two operational departments: the development banking department which will deal mostly with the government and finance infrastructure projects; and the merchant banking department which which is concentrating its efforts at the level of the enterprise.

Unleashing enterprise

The balance between the two activities (the top-down and the bottom-up) is mandated by our charter, which requires that no less than 60% of our resources be devoted to the enterprise sector.

The bank's involvement is exclusively project based. We are not allowed to provide any balance of payments support nor are we allowed to undertake structural adjustment lending of the type the World Bank engages in. But we do have at project level a very flexible arrangement in the sense that we can provide financing with or without guarantee, and we can also provide equity up to 3 billion ECUs for the next few years. This flexibility will allow us to develop projects which combine public sector and private sector aspects in one project -- and I think there is going to be a lot of scope for those types of activities in Eastern Europe. For quite a few years the governments of that area will still be playing a very active role, but the needs are so vast that it is extremely important to mobilize private sector financing, even for infrastructure investment.

Another important aspect of our approach is to be a catalyst for private sector involvement. We have 10 billion ECUs of authorized capital -- really not much money when you look at the magnitude of the need in Eastern and Central

Europe -- so we have to act as a catalyst for a large transfer of financing from the private sector, and for the transfer of technology and skills. Being a catalyst for the private sector at this stage is tough because private sector banks are not really willing to commit large resources to Eastern and Central Europe for the time being, and industrial investors (with a few exceptions) are still quite shy.

Our job is to facilitate industrialists' and bankers' involvement in this region of the world through risk sharing, project financing, and by tailoring our own financial packages to the needs and the specific concerns of the private sector.

Another point I want to stress about our approach is that we want to work at a decentralized level. A number of countries already have bottleneck problems at government level. The best way to resolve that is to try and work at a different level and that is why on the merchant banking side we have been working very much at the enterprise level. On the development banking side, we will try to work not just with the central government but also with the municipalities, the regions, and all the various other layers of government infrastructure.

General priorities

Let me now refer to our general priorities, recognizing of course that true priorities can only be defined on a country-by-country basis. Generally the kind of activities we are going to engage in are: the strengthening of infrastructure for the market economy (both physical and regulatory infrastructure); privatization, which is at the very core of our business; reform of the financial sector; restructuring of enterprises; stimulation of direct investment; environment; and training. You might say that that covers just about everything. Not quite: there is still a number of areas where we are not planning to focus such as agriculture and the health care sector; these are areas we might get engaged in but probably not just yet.

A few more words about some of these. Firstly, as regards the financial sector the critical task in our mind is to strengthen the commercial banking sector, which includes restructuring and cleaning up the portfolios of the existing banks, as well as improving the existing commercial banks' capacity to handle transactions efficiently, reliably, and fast.

Additional to strengthening the existing institutions, we must help create new ones, particularly new ones to support small businesses. Here a whole variety of different types of institutions can and should be created, and that is something which we would like to participate in actively, because small business is the very fabric of a market economy. From London we are not going to be able to assist small businesses effectively, however, so it is very important for us to be able to operate through local financial intermediaries, the creation of which we will have to assist.

Finally within the financial sector, there is the whole question of capital markets development, though some caution needs to be exercised. I am sometimes concerned about the emphasis which is put on the development of capital markets, and stock markets in particular. I think that if stock markets develop too fast, if they develop prematurely, we will end up with extremely volatile markets. The assets which are going to be listed are inherently unstable, the information is going to remain scarce and the markets are still going to be illiquid. And this should be of great concern because if people are encouraged to participate and then end up losing their savings in the stock market, I think the whole transition to a market economy can be hurt. The stock market is the ultimate symbol of a market economy. When people lose faith in the symbol the danger is that they also lose faith in what the symbol represents.

In the context of privatization, we are still in the process of defining our role, because the privatization programmes in the various countries are still being defined. But we are exploring a number of different activities which we might engage in; ranging from advising governments to (more importantly) using our capital to participate directly in the privatization process as an investor, as a core shareholder to help stabilize ownership, or as an underwriter to help bring in foreign financial investors. We could also act as a merchant banker to help attract foreign industrial partners, but in doing so I have to say that we are not planning to compete with the merchant bankers, the investment bankers and the other financial intermediaries who can perform this service; we are planning to get involved only in those situations where we have a comparative advantage and where we could really bring in some special value added that other parties could not.

Restructuring

Restructuring is obviously the most essential element of the transition, and its scope is gigantic. Virtually every company, whether it is privatized or not, or whether it is going to be privatized or whether it is going to remain in state hands, is a candidate for some form of industrial restructuring. It is a pretty radical form in most cases because there is a need to produce a radical shift in how business is conducted. But when you think about a restructuring of Eastern and Central European industry you realize that timing is absolutely critical. The macro-reforms such as price deregulation are occurring very fast -- and it is very much to the credit of some countries that it *is* happening so fast. But turning around companies takes a lot longer.

Already now the former trade patterns and trade arrangements have been dismantled, and companies are forced to find new markets and are forced to adapt extremely rapidly to a completely different environment. This is leading to great strains on the companies and I think we can see a working capital crisis developing in a number of countries. Companies which could become very good companies, which have good quality assets, are in danger of bankruptcy just because the restructuring has not had time to occur yet and there is a shortage of capital. It is not just a liquidity problem within the banking sector; it is that the banks, even if they have the liquidity, will be very reluctant to lend in this kind of environment because things are so uncertain. There is nothing more difficult and dangerous for a banker than to lend to companies which are going through such a deep restructuring.

Essential steps. The restructuring measures which should take place are in themselves easy to identify.

Many companies in the region are engaged in too many activities with one activity often subsidizing another. The first thing to do is to sort out those activities which make money from those which do not; that is not hard to do if your have the right information, and the right information can be developed.

That information can be used to reduce the vertical integration which is so extensive in Eastern Europe, and which leads to losses of productivity; and to spin off the social assets. (In a number of companies we have been looking at, the social assets can represent as much as 30-40% of the total assets of the company; but an enterprise which is supposed to make money has no business managing hospitals, sport complexes and various other social assets. So the first thing to do is to refocus the activities of the enterprise.

The second measure must be to reorganize the management structure, create accountability, and provide people with incentives. In those companies where that has already occurred, the improvements in productivity are tremendous, and the labour force is proving to be a really high quality and hard working labour force.

The third thing is to rationalize production and improve the technology; and that, of course, will require capital. In some industries the old plants are basically so obsolete there is not much we can do with them, but in the majority of cases the assets are of reasonable quality and with some investment they can be improved and gradually brought up to the standards of the western world.

The last aspect of the restructuring is the most painful one, namely to reduce labour. We all know the horror stories of plants which have ten times too many people: things are not usually quite so bad but there is no doubt that the restructuring is on average going to mean making large numbers of workers being made redundant.

But none of this is impossible to do and the major constraint is quite often time. Timing is of the essence and there really is some urgency. To develop a plan for restructuring takes perhaps a few months, but to actually implement the restructuring takes several years. As the years go by the working capital is dwindling and the companies are facing bankruptcy. Money will be needed to help bridge the working capital needs of the company during the restructuring; money will be needed to finance the new investments; and money will be needed to help alleviate the social consequences of the restructuring.

An example. A good example of a successful restructuring was British Steel which took about seven years. Between 1977 and 1983 they managed to bring down employment from 225,000 to about 65,000 people. But to do that a lot of money was spent, both by British Steel and by the government, on helping the workers who had been made redundant by giving them generous redundancy packages and launching a number of job creation schemes. About 55,000 jobs were created around the British Steel plants which had been closed or scaled down, primarily in small businesses.

British Steel is a success story but it shows that you need a lot of money and time. The other thing you need is a broader perspective. You cannot just restructure an enterprise in isolation of the industry and environment in which it operates. That might be one of the greatest challenges we are facing in Eastern and Central Europe -- because you are restructuring all enterprises at the same time. There is absolutely no predictability about the outcome, making it extremely hard to plan.

Main players in restructuring

Who should do what in this process of restructuring? The main thrust will have to come from **the enterprise**, and in that context the two main ingredients are going to be commitment and new skills. Commitment to change is not going to present in all cases because restructuring is painful for both management and employees. So new shareholders will have to brought in with the incentive and the will to force the painful adjustments. That is why privatization is such an important and urgent task, because it will force some of these changes in ownership and mentality which will enable the restructuring to take place.

Foreign companies are going to have a crucial role to play because they are going to be a major source of skill, expertise, and assistance for the companies being restructured. Of course the easiest way to achieve this is to have a foreign partner come in, but foreign partners are still very cautious. One way to attract them would be to sell them the assets at bargain prices, but governments are understandably reluctant to sell assets at bargain prices and indeed they should *not* sell assets at bargain prices. But then it still remains very difficult to motivate industrial partners to come in and devote the human and financial resources necessary to assist and to effect a restructuring.

A further source of skill for the restructuring will be the **professional firms:** consultants, engineering firms, merchant bankers, and so on. Here the key is to make sure that once the advisors have done their work it is properly followed through. So often, restructuring studies have been done and then they sit on the bookshelf because there is nobody there to actually push the restructuring through, and the advisors are often not in a position to do so. The key is to have a mechanism by which the recommendations (at least, to the extent that people agree with them) can be implemented.

Governments will have a major role to play in the restructuring of industry. It is an illusion to think that the market can do it all on its own. This has never happened: the market has not done everything on its own in the UK, it hasn't done it on its own in France; there will be a role for governments to play. In particular there will be a role in some of the more difficult industries such as heavy industry, where there is not just a question of dealing with one enterprise but of dealing with a whole industry and developing industry plans.

So the government's responsibility is going to take various forms, the first of which is to help deal with the lay-offs and social problems. Another role of the government in some cases will be to help protect (on a temporary basis) some of the industries as they go through the restructuring process. This can be done in a variety of ways -- such as subsidies or tariffs. These are very dangerous concepts and we do not want to perpetuate the bad habits of the past, but sometimes there is no other choice than to have some kind of temporary protection.

The **international community** has a responsibility here and it is becoming more and more clear that the best way the developed world can help Eastern and Central Europe is by opening their markets. I think there will be some serious sources of tension between some of the countries in Eastern and Central Europe and the European Community on trade matters: but if the European Community wants to help the best way is obviously to remove some of the barriers which currently exist against imports from those countries.

What is the **European Bank** doing in the context of restructuring? Our main role would be to provide finance, and finance new assets or the improvement of the existing ones, but I think we might also look to provide working capital assistance to some of those companies, and maybe also bridge financing. This is an extremely difficult and dangerous thing to do; but I think it is our duty to look at and explore ways of providing immediate assistance to those companies which are going through a restructuring effort, which have sound restructuring plans and a true commitment to restructuring, but which just need some breathing space in order to implement these plans.

We are planning also to assist governments in dealing with some of the costs of restructuring and to help some of the municipalities in dealing with some of the costs of restructuring and the social costs. I think there is some interesting scope here for combined packages of assistance to the enterprise as well as financial assistance to the surrounding environment, to the local municipalities and governments which are going to have to share the burden of the restructuring.

Finally, for a number of industries there will be a need to develop regional plans (particularly heavy industry), and that is where the EBRD will have a special role to play in terms of assisting not just one government but various governments in the region to develop plans which are compatible with the plans of the EC. I think there will be some interesting negotiations going on on that score. (The steel industry is an obvious example of where that is going to be needed.)

In conclusion I shall restate my belief that the potential for successful transition is certainly there. When you look at the quality of the labour force, the quality of the people, the geographical proximity and the common heritage; all of these give grounds for a lot of optimism.

To my mind the biggest problem is one of timing and that we are faced with an extremely urgent problem. Bold initiatives are needed. The countries of Central and Eastern Europe have already demonstrated quite a lot of boldness: it is up to our institution and others who are involved in the region to demonstrate the same creativity and courage.