Privatization and Emerging Equity Markets

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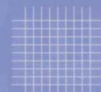

ted by Ira W. Lieberman and Christopher D. Kirkness

Privatization and Emerging Equity Markets

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Foreword

This book represents a unique collaboration between two institutions that have been deeply involved in privatization and the development of emerging stock markets. Although the World Bank and Flemings have different perspectives on privatization and emerging markets, our views are identical as to their importance for economic growth.

The World Bank's Private Sector Development Department (PSD), in conjunction with other parts of the World Bank Group, provides policy advice and technical assistance to its clients—generally government institutions charged with privatizing state enterprises—on designing and implementing privatization programs and linking them to the development of stock markets. For example, PSD has advised on mass (voucher) privatization in Russia and other members of the Commonwealth of Independent States, the Capitalization Program in Bolivia, and case-by-case privatization in Mexico, Morocco, and Turkey. PSD also has advised its clients on the regulations and institutions required to privatize natural monopolies such as utilities and infrastructure. In addition, PSD helps the World Bank's regional departments develop structural adjustment and other programs that support privatization in member countries. And PSD helps design technical assistance programs that allow governments to hire privatization advisers—including lawyers, investment banks, technical experts, regulatory economists, and communications specialists.

Flemings, on the other hand, is a leading international investment bank that advises governments on the sale of state enterprises in a variety of industries. Transactions in China, Indonesia, and Peru, for example, are discussed in this book. Flemings plays a direct role in emerging capital markets by advising on the initial public offerings of companies being privatized, managing emerging market investment funds, and marketing and underwriting offerings, both domestically and internationally, often involving global depository receipts. In addition to its experience on the "sell side" on behalf of client governments, Flemings advises private corporate clients on the "buy side" when they want to acquire a stake in a company being privatized.

The diversity and depth of experience of both institutions is reflected in this book. The introduction provides important lessons on privatization for governments and other stakeholders. The case studies elucidate experiences with privatization in an important group of emerging markets. The book makes an important contribution to the literature on privatization and capital markets, linking these two vital subjects. It is also an important primer for policymakers and private practitioners involved in privatization.

We recognize that this book is being published during a period of deep financial distress in Asia's financial markets, particularly in Hong Kong, Indonesia, the Republic of Korea, and Thailand. The crisis has also affected

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emerging markets outside Asia. Thus this work could not be more timely, as it offers important lessons on the value of well-designed structural reforms (such as privatization), on the importance of integrating and sequencing privatization with sound macroeconomic policies and other reforms (such as financial sector reform), and on the creation of a sound regulatory framework for utilities and other natural monopolies. The book deals with the links between privatization and domestic equity markets, emphasizing the importance of developing such markets—their liquidity, their infrastructure, their regulation—for privatization to succeed and support economic development. The book also discusses the need for emerging markets to develop new financial institutions—such as privately managed pension funds—to promote domestic savings and provide institutional stability for local equity markets.

It is our pleasure to present this volume and to warmly thank its editors for compiling a comprehensive and insightful analysis of privatization and emerging equity markets.

Jean-François Rischard
Vice President
Finance and Private Sector Development
World Bank

William Garrett
Group Chief Executive
Flemings

Preface

This volume is the result of a joint effort between Flemings and the World Bank's Private Sector Development Department. As such it is a unique private-public collaboration between two organizations that together can offer readers a rich diversity of experience in emerging market privatization and its links to emerging equity markets. Although there is a considerable literature on privatization and perhaps even more on emerging equity markets, there is little information linking the two.

The relationship between privatization and emerging equity markets is direct but subtle. On the one hand privatization can kick-start newly created capital markets such as those in Central and Eastern Europe and the Commonwealth of Independent States. It can also awaken moribund markets such as those in Egypt and much of Latin America. And it can deepen and diversify emerging markets such as those in Hong Kong, Malaysia, and Turkey. But sound domestic markets and financial institutions—such as pension funds and investment and mutual funds—are also needed for privatization to succeed and to have the desired effect. To attract a stable investor base, most emerging capital markets must improve the basic infrastructure and regulatory framework governing the market.

The book starts with an introduction to privatization and emerging markets—a historical overview, a statistical presentation of results to date, and a discussion of lessons learned. It then turns to country studies that analyze privatization and the creation of new equity markets in Central and Eastern Europe and the Commonwealth of Independent States, the well-publicized privatization programs in Argentina and Mexico, and the less well-known achievements of Egypt, Morocco, and Peru. After that the book focuses on privatization of telecommunications—clearly a crucial sector in terms of transaction values, economic development, and emerging stock market development. Finally, the book considers important market instruments and institutions—depository receipts, privatization bonds, emerging market investment funds, and pension funds—and their contribution to privatization and emerging stock market development.

In preparing this book we were helped by a number of people, and we want to take this opportunity to thank them. Magdi R. Iskander, director of the World Bank's Private Sector Development Department, supported this work from the start and encouraged our public-private partnership. Bill Chernenkoff of the World Bank and Lee C. Buchheit of Cleary, Gottlieb, Steen & Hamilton served as external reviewers and offered important comments and suggestions for the book. Claudia Morgenstern of the International Finance Corporation reviewed an early draft and steered us in the right direction. Raj Desai of the World Bank's Private Sector Development Department and Robert Fergusson, head of Flemings' Privatization Unit, reviewed drafts

and offered comments and criticisms. Meg Garlinghouse of the World Bank guided the project in its early stages. Our co-authors contributed their time and effort to producing the case studies that provide so much richness to the work. Paul Holtz and Bruce Ross-Larson of Communications Development Incorporated provided excellent editorial guidance, helping to ensure that the manuscript is accurate and readable. Peter Grundy, Graeme Kendrew, and Tilly Northedge of Grundy & Northedge provided an innovative design for the book and outstanding graphic presentation of the data. Garrett Cruce of Communications Development Incorporated laid out the chapters. Finally, we are grateful to our many colleagues in Flemings and the World Bank Group who reviewed specific parts and made helpful comments throughout.

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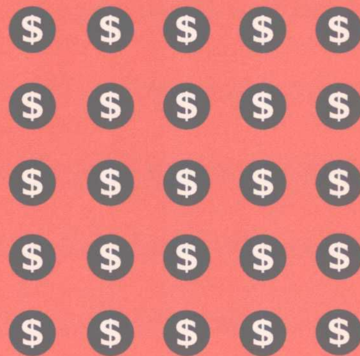
Growth of privatization revenue in emerging markets

$ = billions in annual revenue

1988

1996



Ira W. Lieberman and Robert Fergusson

1 Overview of Privatization and Emerging Equity Markets

Revenues from privatizations in emerging markets have grown dramatically over the past ten years—from just over $2 billion in 1988 to $25 billion in 1996 (World Bank 1997). This enormous jump has been made possible by increasing investor interest. Yet even these data substantially understate investor participation in privatization, as billions of dollars in assets have been privatized in the transition economies of Central and Eastern Europe and the Commonwealth of Independent States through mass (voucher) privatization (see Lieberman, Nestor, and Desai 1997).

Thus privatization has attracted millions of new investors from within emerging markets and from abroad. Moreover, investment has come from a variety of sources, including retail investors, institutional investors (international and domestic pension funds, emerging market investment funds, voucher investment funds), and corporate investors.

RECENT TRENDS IN PRIVATIZATION

International investment in privatized enterprises is part of a global increase in private capital flows to emerging markets. Whereas in 1991 official and private capital flows to emerging markets were roughly equivalent, by 1996 capital flows were overwhelmingly private. Of net long-term resource flows of $285 billion in 1996, private flows accounted for $244 billion, or 86 percent—up from $57 billion in 1991 (World Bank 1997).

Privatization's quickening pace

Why has privatization become so important to emerging markets? The debt crisis of the early 1980s is a common explanation. In many countries external debt spiraled out of control, leading to years of macroeconomic instability, painful economic adjustment, and low or negative growth. Thus, the argument goes, developing countries simply could not continue to absorb the fiscal burden of state enterprises. While the effects of the debt crisis cannot be minimized, a number of other developments in the 1980s would have made privatization inevitable in any event (Lieberman 1993).

The first was East Asia's astounding economic performance. Despite significant differences in their domestic economies and industrial structures, Hong Kong, the Republic of Korea, Singapore, and Taiwan (China) pursued a growth model based on intense competition, an outward orientation emphasizing exports and international competitiveness, and a significant role for the private sector (World Bank 1993).

Second, there was growing recognition that other models of economic development—such as the central planning model of the Commonwealth of Independent States, Central and Eastern Europe, Vietnam, and China and the import substitution model of much of Latin America—needed to be changed. One of the main weaknesses of an inward-looking approach to development is that it distorts the "infant industry" argument. That is, it implies that once developing countries have established strategic or priority industries (such

as steel, cement, fertilizer, oil refining, and petrochemicals), usually through state monopolies and almost always through subsidies, they must continue to protect them because they are too fragile to be exposed to global competition. Moreover, the antiexport bias of such regimes makes it difficult for industries to compete in world markets even if they are inclined to do so.

A third development is what some analysts call the fourth industrial revolution. Driven by information technologies, this revolution involves industries such as telecommunications, computers, microelectronics, robotics, fiber optics, and advanced and composite materials. The technology embodied in these industries helps determine competitiveness in many others—yet they have been largely absent in developing and transition economies. Moreover, important new managerial practices, such as just-in-time inventory and distribution systems, total quality control, and computer integrated manufacturing systems, have also passed by countries with an inward orientation. The pace of technological change and the research and development commitment it requires have made it counterproductive for many firms to remain under the control of the state, where decisions are politicized and response to market pressures is sluggish.

That brings us to the fourth factor, the role of state enterprises. In Latin America, as well as in Egypt, Turkey, and much of Africa, state enterprises played enormous roles in industry and services. By the end of the 1970s state enterprises in Latin America dominated extractive industries (mining, oil and gas), basic industrial subsectors (steel, petrochemicals, fertilizers, shipbuilding), and services, utilities, and infrastructure (electricity, telecommunications, railways, ports and shipping). In Central and Eastern Europe and the Commonwealth of Independent States state enterprises accounted for more than 90 percent of industrial production in almost all countries prior to privatization.

In many closed economies state enterprises were overstaffed, had poor financial and export performance, depended on subsidies and unilateral budget transfers, maintained highly centralized and politicized organizations, and relied on their protected monopoly status. And because state enterprises are often important suppliers of goods and services to the private sector, their poor performance undermined private sector performance, particularly in protected markets.

In the mid-1980s countries like Mexico tried to restructure large state enterprises. It quickly became apparent, however, that restructuring would be long and difficult, requiring extensive resources and substantial labor reductions, and offering few short-term benefits. The bureaucracies that were incapable of managing these firms were certainly not capable of turning them around. Moreover, countries could not afford to continue propping up these enterprises in the interim. After the debt crisis many state enterprises, reliant on subsidies and unilateral budget transfers, became decapitalized and increasingly obsolescent (Lieberman 1990).

Fifth, many industrial countries expressed a strong ideological commitment to private enterprise. Under Prime Minister Margaret Thatcher, Britain sought to revive its flagging economy through a large-scale privatization program. The creation of millions of small shareholders through the privatization of British Telecom, British Gas, and the electricity and water industries was a cornerstone of the administration's political and economic reforms. Although the program initially met with stiff political and union resistance, popular support grew as an enormous body of new shareholders came to enjoy handsome investment gains. Moreover, the intellectual debate that arose over privatization and restructuring piqued interest in the subject worldwide. Finance Minister Roger Douglas led a similar charge in New Zealand, initially corporatizing state enterprises—that is, forcing them to operate according to commercial principles—and subsequently privatizing them (Franks 1993).

Among developing countries Chile was perhaps the first and most successful privatizer. Privatization efforts began in 1974, following the overthrow of Salvador Allende's regime, but were largely unsuccessful. The economic crisis in 1982–83, partly induced by overleveraging of the privatization process and excessive industrial concentration, forced the government to intervene in a number of financial holding groups. From 1984 onward, however, Chile's privatization efforts blossomed. Chile used a number of privatization methods to divest nearly all state enterprises. Perhaps the program's most innovative feature was its privatization of pension funds. This move created a sizable and stable base of institutional investors for Chile's equity market, allowing a number of large privatizations to be absorbed domestically. Pension funds acquired some 23 percent of the shares in divested state enterprises (Lüders 1993). Chile's move toward private management of pensions

After the debt crisis many state enterprises became decapitalized and increasingly obsolescent

Privatization is merely the first step—albeit an important one—in restructuring former state enterprises

has been emulated by other Latin American countries, including Argentina, Bolivia, Mexico, and Peru (see chapter 12).

Finally, the political and economic revolution in Eastern Europe and the Soviet Union since 1989 has given privatization a new push. Newly emerging democracies have used privatization to form the basis for a market economy. In these countries privatization has economic, social, and political implications that go far beyond those in most developing countries. By the end of 1996 more than half the workforce in most countries in Central and Eastern Europe and the Commonwealth of Independent States was employed by the private sector. Moreover, more than half of state enterprises had been privatized, primarily through small-scale privatization of retail and service firms and through mass privatization of medium-size and large firms in the tradables sector (Lieberman, Nestor, and Desai 1997).[1]

Privatization's purpose

Privatization programs often cite a laundry list of objectives, including reducing the fiscal deficit, raising revenue through asset sales, generating additional tax revenue, encouraging the return of flight capital, promoting foreign direct investment, deepening and broadening domestic equity markets, boosting investor confidence, increasing efficiency and fostering competition, improving the quality of goods and services, and reducing the state's role in the economy.

Some of these objectives, such as reducing the fiscal deficit or raising revenue, could be direct outcomes of privatization. Others, such as increasing efficiency and productivity, are longer-term objectives that depend on what new private owners bring to a company. Privatization is merely the first step—albeit an important one—in restructuring former state enterprises. (Active restructuring, however, should generally be carried out by a company's new owners.)

This multitude of objectives boils down to three key issues:

- *Getting government out of business*—by strengthening market forces to promote competition, which will increase productivity and efficiency, lowering the cost and raising the quality of goods and services (Galal and others 1994).
- *Generating new sources of cash flow and financing for enterprises*—by eliminating government crowding out of equity markets, encouraging the return of flight capital, promoting foreign direct investment, facilitating domestic savings and investment, and broadening and deepening domestic equity markets.
- *Reducing the government's fiscal deficit*—by using privatization revenues to retire external and domestic debt, reducing fiscal transfers to state enterprises, and increasing tax revenues through the higher profits generated by privatized enterprises.

Privatization's current state

Privatization revenues reached $25 billion in 1996, up from $21 billion in 1995. During 1990–96 revenues totaled more than $155 billion (figure 1.1). As noted, however, these figures significantly understate privatization flows. In recent years countries in Central and Eastern Europe and the Commonwealth of Independent States have privatized billions of dollars in assets through mass privatization—revenues that are not included in reported privatization transactions (Lieberman, Nestor, and Desai 1997).

Institutional investors now have the international reach to go wherever good companies are being privatized. These investors prefer infrastructure: since 1990 it has accounted for $65 billion (42 percent) of the $155 billion in global privatizations (figure 1.2). Manufacturing, mainly steel, chemicals, and construction materials, has attracted $37 billion (24 percent). Natural resources companies, mainly oil and gas, accounted for $26 billion (17 percent), and financial sector privatization, primarily banking, for $22 billion (14 percent).

Direct sales targeted at strategic investors are the most common method of divestiture in developing and transition

Figure 1.1 Privatization revenues by region, 1990–96

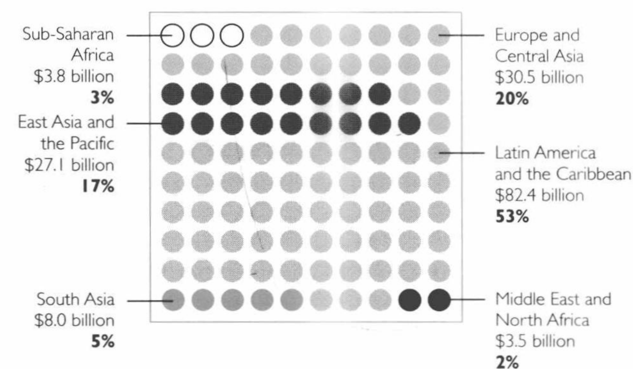


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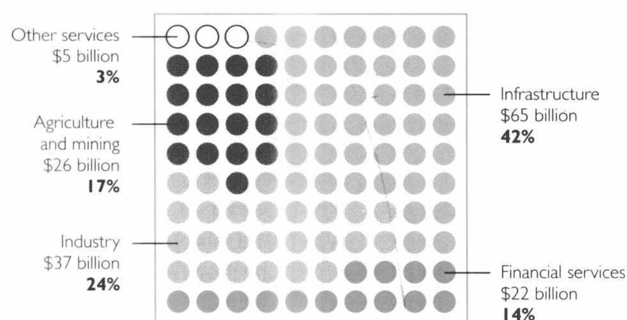
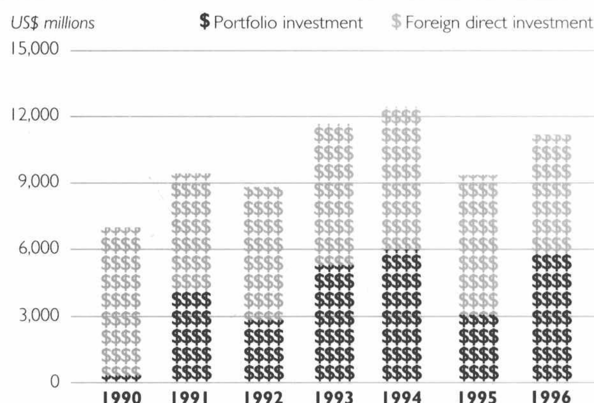
Figure 1.2 Privatization revenues by sector, 1990–96



Source: Table A1.2.

Figure 1.3 Portfolio investment and foreign direct investment in privatization, 1990–96



Source: Table A1.3.

economies. But in all regions equity markets are facilitating—and benefiting from—privatization through initial public offerings and mixed sales (a combination of a strategic sale and initial public offering). Public offerings have become increasingly common in recent years and now play a significant role in privatizations (figure 1.3).

Privatization, which was heavily concentrated in Latin America during 1991–93, became geographically diverse during 1995–96. (Still, several countries in Latin America, notably Bolivia and Peru, implemented extensive privatization programs in the mid-1990s, and Brazil has initiated what could become the region's largest program in terms of the value of assets sold; figure 1.4)

East Asia and the Pacific generated $5.4 billion from privatizations in 1995 and an estimated $2.7 billion in 1996 (figure 1.5). The 1995 sales of PT Telekom in Indonesia ($1.7 billion) and Petronas Gas in Malaysia ($1.1 billion) were the largest transactions in these countries' privatization programs.

Several countries in the Middle East and North Africa have launched aggressive privatization efforts, and in 1996 the region generated some $1.5 billion in privatization revenues. Egypt is the region's privatization leader, with $1.9 billion in revenue during 1990–96 (55 percent of the regional total; figure 1.6). Egypt's program has focused on divesting small companies in the tradables sector though public offerings on the Cairo Stock Exchange. Morocco also has made impressive progress on privatization, generating $1.1 billion during 1990–96.

In Europe and Central Asia the Czech Republic, Hungary, and Poland have started selling large strategic enterprises, generating $6.5 billion in 1995 and $2.6 billion in 1996. Many members of the Commonwealth of Independent States are still selling companies in the tradables sector through mass

Public offerings have become increasingly common in recent years and now play a significant role in privatizations

Figure 1.4 Privatization revenues in Latin America and the Caribbean, 1990–96

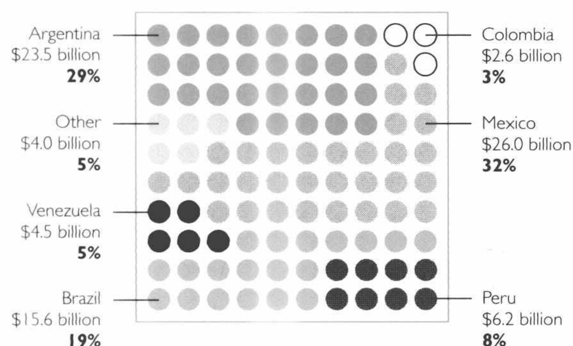


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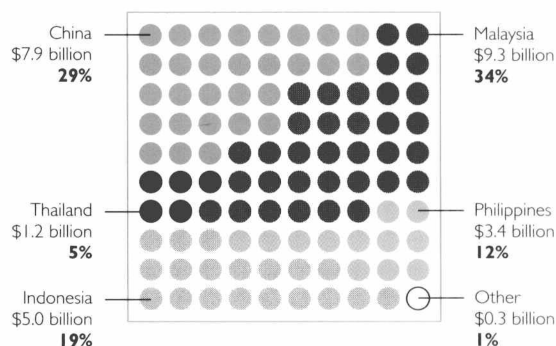
Figure 1.5 Privatization revenues in East Asia and the Pacific, 1990–96



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